2016 Report - Section 831(b) Captive Insurance Companies
IRS Audit Forecast©[1]

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This article is written for the business owner who has been sold a Section 831(b) captive. It is written in three parts. The first part describes the legal issues relating Section 831(b) Captives and the abuses perceived by the IRS. The second part is an online survey "Are You Ready for an IRS Captive Audit?" You may take that online survey at this link - http://freeonlinesurveys.com/s/AefUb7oA. The third part relates to the Survey and is provided to those who complete the survey to provide explanations for the areas of IRS concern and advice for business owners with captives and for those who are currently considering a captive.

> ***Williams Coulson as an Advisor.*** *Williams Coulson is actively handling IRS audits of captive insurance companies, the parent companies and business owners. We have cases currently being considered by IRS Exam and IRS Appeals. Williams Coulson also advises many businesses on the advantages and disadvantages of Captives and provides pre and post establishment audits. Because Williams Coulson is not connected with any particular captive promoter or promotion, our advice is independent and unbiased.*

Introduction. At the beginning of each tax season, the IRS publishes a list of "Dirty Dozen Tax Scams."[2] Normally, this list includes abhorrent behavior that all can agree is wrong and probably criminal such as phone scams, identity theft, return preparer fraud, fake charities and frivolous tax arguments.

In 2015, however, the IRS sent a chilling message to all small business owners who have created Section 831(b) captives. In the 2015 Dirty Dozen List, the IRS added a new category called "Abusive Tax Shelters" and under that category had the following to say about captive insurance transactions[3]:

> *"Another abuse involving a legitimate tax structure involves **certain small or 'micro' captive insurance companies**.[4] Tax law allows businesses to create 'captive' insurance companies to enable those businesses to protect against certain risks. The insured claims deductions under the tax code for premiums paid for the insurance policies while the premiums end up with the captive insurance company owned by same owners of the insured or family members.*

[2] See IR-2016-29 (2/19/16), and IR-2015-26 (2/9/15).
[3] See IR-2016-29 (2/19/16), and IR-2015-26 (2/9/15).
[4] To be clear, the IRS recognizes that captive insurance companies can be legitimate. Their focus is on certain "small or micro captives."

The captive insurance company, in turn, can elect under a separate section of the tax code to be taxed only on the investment income from the pool of premiums, excluding taxable income of up to $1.2 million per year in net written premiums.[5]

In the abusive structure, unscrupulous promoters persuade closely held entities to participate in this scheme by assisting entities to create captive insurance companies onshore or offshore, drafting organizational documents and preparing initial filings to state insurance authorities and the IRS. The promoters assist with creating and 'selling' to the entities often times poorly drafted 'insurance binders and policies to cover ordinary business risks or esoteric, implausible risks for exorbitant 'premiums,' while maintaining their economical commercial coverage with traditional insurers.[6]

Total amounts of annual premiums often equal the amount of deductions business entities need to reduce income for the year, or, for a wealthy entity, total premiums amount to $1.2, million annually to take full advantage of the Code provision. Underwriting and actuarial substantiation for the insurance premiums paid are either missing or insufficient. The promoters manage the entities' captive insurance companies year after year for hefty fees, assisting taxpayers unsophisticated in insurance to continue the charade." *(emphasis, and footnotes added).*

Legal Standards of "Insurance". The term "insurance" is not defined in the Internal Revenue Code or in Treasury Regulations. Instead, its meaning has been developed through case law.[7] The United States Supreme Court observed that historically and commonly, insurance involves risk-shifting and risk-distribution.[8] Also courts have considered whether the transaction constitutes insurance "in its commonly accepted sense" and whether the risk transferred is an "insurance risk".[9]

- Risk Shifting. Risk shifting is considered from the perspective of the insured. To meet this standard, there must be some identifiable risk and it must be transferred from the insured to the insurer.

- Risk Distribution. Risk distribution is considered from the perspective of the insurer and is a mechanism by which the insurer pools multiple risks of multiple insureds in order to take advantage of "the law of large numbers." The IRS published safe harbors for meeting risk distribution in Revenue Ruling 2002-89. The safe harbor that most applies to 831(b) captives is that at least 50% of a captive's revenue must be from a non-parent.

- Insurance in its Commonly Accepted Sense. To determine whether an arrangement constitutes insurance in its commonly accepted sense, Courts have considered such factors as:

[5] This discussion describes what the Code allows as benefits for captives.
[6] See discussion below about types of insurance and underwriting.
[7] *R.V.I. Guaranty Co., Ltd. & Subsidiaries v. Commissioner,* 145 TC – No. 9 (2015).
[8] *Helvering v. LeGierse,* 312 US 531, 539 (1941).
[9] *Black Hills Corp. v. Commissioner*, 101 TC 173, 182 (1993), aff'd 73 F.3d 799 (8th Cir. 1996).

- Whether the insurer is organized, operated, and regulated as an insurance company by the States in which it does business;
- Whether the insurer is adequately capitalized;
- Whether the insurance policies are valid and binding;
- Whether the premiums are reasonable in relation to the risk of loss; and
- Whether premiums are duly paid and loss claims are duly satisfied.[10]

- Insurance Risk. In the case, *R.V.I. Guaranty Co., v. Commissioner*[11], the Court summarized the issues relating to whether a risk is an "insurance risk". Initially, insurance risk is involved when an insured faces some "loss-producing hazard" and not an investment risk. Another distinction is whether the risk is an insurance risk as opposed to "a financial risk of the sort assumed by a bank."[12]

Legal Standards as Applied to Section 831(b) Captives. The legal theories discussed above apply to any consideration of whether a transaction constitutes "insurance". These theories and others have been applied by the IRS to Section 831(b) Captives with the following general areas of concentration.

- Insurance Policies not Valid. The most common IRS position is that the insurance policies themselves are not valid for any or all of the following reasons:
    - The insurance policies are not insuring an "insurance risk", because the policies relate to investment or "traditional business risks".[13]
    - The risk set forth in the policies does not really exist (e.g., tsunami insurance in Nebraska).
    - The Captive was never intended to take on the risks or pay claims.

- Insurance Premiums are not Reasonable. The IRS believes that in many cases the insurance premiums are not reasonable for any or all of the following reasons:
    - The premiums are not determined by an actuary or insurance underwriter.
    - The premiums are excessive compared to the cost of similar coverage in the traditional insurance market.
    - The premiums are not determined by taking into account the insured's business, loss history, or other insurance.

- No Risk Distribution. The IRS has focused on the reinsurance pools that are most often used by Section 831(b) Captives and consider many to not meet the risk distribution requirement for any or all of the following reasons:
    - The reinsurance pool is set up so that each captive is insulated from actually sharing any of the risks of the captive pool members.

[10] See *Harper Group v. Commissioner*, 96 TC 45 at 60 (1991); and *Securitas Holdings, Inc. v. Commissioner*, TC Memo 2014-225.
[11] 145 TC --- No. 9 (2015).
[12] Id at 133 and 134. See also *"When is a Business Risk an Insurance Risk?"* Business Law Today, may, 2016, by Fred Turner.
[13] See *R.V.I.* discussion.

- The risk that is shared is not substantial because the portion that is shared is not likely to occur.
- Even if the pool is set up to share the risk of the pool, the risk is effectively not shared because pool members do not file claims.
- Even if the pool is set up to share the risk of the pool, the risk is effectively not shared because the insurance itself is not real for the reasons discussed above.

- Sham Transaction / No Economic Purpose. The IRS has a number of theories that all relate to the same conclusion that the Section 831(b) Captives are not insuring legitimate risks and are motivated solely by the lure of big deductions, a deferral or elimination of income tax and the opportunity to transfer wealth among generations with no transfer tax.

Congressional Correction. In late 2015, Congress amended Section 831(b). The changes were surprising in contrast to the IRS attacks of small captives. The changes which become effective in 2017 include the following:

- The limit on premiums not taxable under Section 831(b) will be increased from $1,200,000 to $2,200,000.
- The perceived abuse of avoiding the transfer tax system by having different ownership of the parent and captive has been addressed by adding a two-part test that is difficult to explain and more difficult to implement. In its most general description, the part of the test most likely to apply to most Section 831(b) Captives will require a commonality of ownership interests between the parent and Captive of 98%. As a result, a common design of ownership of the business at the parent generation and ownership of the captive in trust for the children will not meet this test.

Tax Court Test Case. The Captive community is holding its breath as we wait for the holding and decision in the case *Avrahami v. Commissioner* which was heard by the Tax Court in the fall of 2015. This is the first of many cases that have been waiting to be heard by the Tax Court. Although taxpayers have had unusual success in the Tax Court litigating insurance and captive issues in general, this case may be viewed differently by the Court as it is portrayed by the IRS as the next generation of abusive tax shelters. If the taxpayer is victorious in *Avrahami*, it is not expected that the IRS will back-off on their attacks of Section 831(b) captives, but it might make IRS Appeals Settlements better. If the taxpayer loses in Avrahami, look for the IRS to take as many of these cases to trial as possible to build up consecutive wins as they previously did in the 419 welfare plan cases.

IRS Promoter and Captive Audits. From a strategic perspective, it makes a lot of sense for the IRS to audit abusive Section 831(b) Captives. The IRS can focus its attention on the Promoter and if they find their transactions to be abusive, they can obtain the Promoter's customer list, declare the reinsurance pool to be invalid and audit every captive that participates in the pool. Each taxpayer will then be in the difficult position of trying to defend the underwriting and insurance pool of the Promoter without the resources or knowledge to launch such a defense. The IRS already has audited many Captive Promoters, obtained customer lists and is actively auditing businesses, captives and their owners.

We have observed that once the IRS has the list of captive customers, there is some process of selecting the order of audits and one or more IRS offices begin a process of auditing the customers of the Promoter. The IRS Agents use information requests that are written in a template format by IRS Counsel and require incredible amounts of information, request taxpayer interviews and lead to a disallowance of deductions, inclusions in income and possible revocations of the captive's insurance status. The idea that an individual taxpayer can educate an IRS Agent on the merits of a captive that has been the target of a promoter audit such that the Agent will agree to a no-change audit is most unlikely.

In Appeals, there is also a coordination of efforts with an Appeals Technical Coordinator who offers advice to individual Appeals Officers on specific promotions to make sure that the Appeals Officers are uniform within certain ranges.

Advice to Captive Owners. For the Captive owner who is not under an IRS audit, it is not too late to do a self-audit to identify and address weaknesses that may exist in the Captive formation and operation. For Captive owners already under audit, it is recommended that tax counsel familiar with the legal issues discussed above be engaged as soon as possible.

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