MICRO-CAPTIVES:
THE INSURANCE COMPANY YOU KEEP

Presented and Co-Authored by:

MICHAEL H. RIPP, JR.
Giordani, Swanger, Ripp & Phillips, LLP
100 Congress Avenue, Suite 1440
Austin, Texas 78701

Co-Authored by:

CINDY L. GROSSMAN
Giordani, Swanger, Ripp & Phillips, LLP
100 Congress Avenue, Suite 1440
Austin, Texas 78701

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CHAPTER 18

MICHAEL H. RIPP, JR.

Giordani, Swanger, Ripp & Phillips, LLP
100 Congress Avenue, Suite 1440
Austin, Texas 78701
(512) 767-7100
www.gsrp.com

Michael H. Ripp, Jr. is a partner in the Austin, Texas law firm of Giordani, Swanger, Ripp & Phillips, LLP ("GSRP"). Mr. Ripp represents high net worth individuals and family offices in the design, implementation, and administration of domestic and international trust, investment, and life insurance structures, including the tax planning and compliance aspects of such structures. He advises non-U.S. individuals regarding the tax and legal issues involved in pre-immigration planning, temporary residency, and planning for gifts to their U.S.-resident families, both during lifetime and at death. A significant portion of his practice involves advice regarding mechanisms for deploying leverage in the acquisition or monetization of assets, including real estate. Mr. Ripp's practice also includes counseling fiduciaries with respect to the administration of trusts and estates, and he is Board Certified in Estate Planning and Probate by the Texas Board of Legal Specialization.

EDUCATION

Washington University School of Law (J.D., 1997)
Texas A&M University (B.B.A., Business Analysis, 1994)

PROFESSIONAL AFFILIATIONS & HONORS

Board Certified, Estate Planning and Probate Law (Texas Board of Legal Specialization)
American Bar Association
- Real Property, Probate and Trust Law Section
- Taxation Section

State Bar of Texas
- Real Estate, Probate and Trust Law Section
- Business Law Section
- Taxation Section

Austin Bar Association
- Estate Planning and Probate Law Section
  - Director (2001 through 2005)
  - Treasurer (2004 through 2005)
- Business, Corporation and Taxation Section

Texas Bar Foundation, Fellow
Society of Trust and Estate Practitioners (STEP), Member
Listed in The Best Lawyers in America© for Trusts and Estates, as selected by Woodward White, Inc.
(2008 through Present)

CINDY L. GROSSMAN

Giordani, Swanger, Ripp & Phillips, LLP
100 Congress Avenue, Suite 1440
Austin, Texas 78701
(512) 767-7100
www.gsrp.com

Cindy L. Grossman is a partner in the Austin, Texas law firm of Giordani, Swanger, Ripp & Phillips, LLP ("GSRP"). Ms. Grossman's practice encompasses a wide variety of corporate and partnership transactions with international, federal, and state tax implications, including stock and asset acquisitions, partnership freeze transactions, planning, structuring, and implementation of mergers, real estate transactions, and other recurring and non-recurring business transactions. Ms. Grossman has a breadth of experience in corporate and partnership formation and operation, entity conversion and reorganization, business planning, business succession planning, and asset protection planning. She represents business clients at all stages of their ventures, from establishing start-ups and negotiating and structuring angel and later round debt and equity financing, to growth planning and implementation, to devising and implementing appropriate exit strategies, including equity and asset sale transactions. Ms. Grossman also assists clients with proper planning and structuring of cross-border transactions, as well as with strategic offshore placement of business assets for asset protection and tax planning purposes. Ms. Grossman utilizes her expertise in tax-efficient entity planning to assist individual clients in the establishment or maintenance of complex estate planning structures involving partnerships, limited liability companies, and other entity types. In addition to her experience with entities, Ms. Grossman has represented clients in federal and state tax controversies.

EDUCATION

University of Texas School of Law (J.D., 2004)
University of Tennessee at Knoxville (M.A., Philosophy, Concentration in Medical Ethics, 2002)
Emory University at Atlanta (B.S., Biology, B.A., Religious Studies, 2000)

PROFESSIONAL AFFILIATIONS & HONORS

United States Tax Court
American Bar Association
- Taxation Section
- Business Law Section

State Bar of Texas
- Tax Section
- Business Law Section

Austin Bar Association
- Corporate and Tax Section
- Estate Planning Section
  - Board of Directors (2009 through 2011)
- International Section

Austin Young Lawyers Association
- Board of Directors (2007 through 2009)
- Director-at-Large (2009 through 2010)

Austin Tax Study Group
- Treasurer (2012 through Present)

Texas Bar Foundation Fellow
Texas Rising Star (2009 through Present) (selected by Thomson Reuters)

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MICRO-CAPTIVES: THE INSURANCE COMPANY YOU KEEP

I. INTRODUCTION

A captive insurance company is a corporation formed by an operating business or its affiliates (including its owners) for the purpose of providing property and casualty insurance to the operating business. Captives have become increasingly popular as a complementary addition to the overall risk management plan of a business. However, the income and estate tax benefits of captives—particularly of captives that have made an election under Section 831(b) of the Internal Revenue Code (the "Code") to be taxed only on their investment income (so-called "micro-captives")—have been aggressively promoted over their risk management function, causing the Internal Revenue Service to identify micro-captives as potential vehicles for abuse.

The IRS has closely scrutinized captive structures for decades and, in 2015, added micro-captives to the so-called "Dirty Dozen" list of abusive tax structures.[1] In the announcement, the IRS categorized micro-captives as "abusive tax shelters," stating that certain aggressive promoters are selling captive structures to clients, emphasizing the tax benefits of the structure while failing to properly form the insurance company and implement the insurance program that was intended, all while collecting large annual captive management fees from the client.[2] These promoted captive arrangements often involve artificially high premiums, policies written on risks that are not appropriate to the insured business, undercapitalization of the captive by the use of loan-back schemes between the captive and the insured, and inadequate documentation of the captive's insurance program and corporate structure. Captive insurance arrangements are clearly permitted under the Code, but due to the heightened scrutiny they now face from the IRS, it is paramount that those who are considering forming a captive have a valid business purpose for implementing the structure and that the company is organized and operated as a bona fide insurance company. Captives that are "sold" primarily for their tax benefits are unlikely to pass the business purpose requirement and may fail for other reasons discussed below.

This paper will examine the features of the Section 831(b) "micro-captive," including its use as a risk management tool, as well as significant income tax and estate planning benefits if the captive is otherwise validly established and managed. It will also discuss areas in which the IRS has historically challenged captives, and how a captive should be structured to avoid or mitigate the consequences of such a challenge.

II. ADVANTAGES OF ESTABLISHING A CAPTIVE

A. Risk Management Benefits

Captive insurance companies should supplement a company's risk management program by aligning the risk-reduction incentives of the insured enterprise with those of the captive. By reducing overall losses at the insured business, the common owner of the captive and the business can enjoy capital accumulation inside the captive, and eventually lower insurance costs for the business.

Captives can also improve a company's cash flow by lowering the cost of insurance by providing a mechanism for obtaining coverage that is difficult to find or prohibitively expensive and providing flexibility for the timing of premium payments. Policies written by a captive may be more economically priced than commercial policies because the premiums do not contain mark-ups for typical commercial insurer expenses such as marketing and agent commission. Additionally, a captive provides a mechanism for accessing reinsurance markets, which may provide cheaper coverage than direct insurers.

The business can also gain more control over its insurance policy features through the use of a captive. The insured can tailor policies that fit its specific needs. It is also more closely involved in the claims process, which may result in improved claims processing times and service.

B. Tax Benefits

Establishing a captive insurance company under Section 831(b) of the Code can yield significant tax benefits for the owner of the captive and for the insured business in addition to supplementing the insured's risk management activities. Captives are property and casualty insurance companies that operate under Section 831 of the Code. The Internal Revenue Code provides for two types of captive insurance companies: captives that do not make an election under Section 831(b) of the Code (referred to herein as an "831(b) election"), and those that do (i.e., "micro-captives"). Unless it has made an 831(b) election, a captive is taxed on underwriting and investment income, although it does receive a deduction equal to the actuarially determined reserve requirement that it must meet.[3] As long as the

[1] IR-2015-19, February 3, 2015.
[2] *Id.*
[3] IRC §831(a).

arrangement qualifies as insurance, premiums paid to a captive are deductible by the insured.[4]

An insurance company may make an 831(b) election if its annual premium income does not exceed $1.2 million.[5] A captive that has made the 831(b) election pays tax only on its investment income. Thus, premium income is excluded from its taxable income.[6] When an insured makes a premium payment to a micro-captive, the insured may deduct the premium payment under Section 162 of the Code (provided the arrangement qualifies as insurance), but the captive does not have a corresponding income recognition event when it receives the premium payment.[7] As an offset to this benefit, micro-captives may not use net operating losses to offset taxable income.[8]

A micro-captive pays tax at regular C corporation rates on its investment income.[9] Dividends issued by the captive are taxed at qualified dividend rates, provided that the captive is a domestic corporation, or, if it is a foreign corporation, provided that the captive has either filed an election under Section 953(d) of the Code to be taxed under Subchapter L of the Code as a domestic insurance company or is a "qualified foreign corporation."[10] Similarly, if the shares of the captive are redeemed by the captive, the shareholder will be taxed at capital gain rates unless the captive is a foreign corporation that does not have a Section 953(d) election in place at the time of the redemption or is not a qualified foreign corporation, in which case Section 1248 of the Code will cause an amount equal to the retained earnings and profits of the corporation to be taxed at ordinary income rates.[11]

To illustrate, if an insured makes a premium payment of $1 million to the captive, the insured may deduct the full amount of the premium payment if it is otherwise an ordinary and necessary trade or business expense.[12] The $1 million in premium paid to the captive is not taxable income to the captive pursuant to Section 831(b) of the Code. When these dollars are later distributed to the shareholder in the form of a dividend or a payment in redemption of shares, the shareholder pays tax on this income at capital gains rates (assuming the captive is taxed as a domestic corporation or is a qualified foreign corporation). The use of the captive insurance structure has achieved tax deferral as well as conversion of ordinary income into capital gain income. However, because investment income is taxed at ordinary corporate rates within the captive, this income will be taxed again at dividend rates or capital gain rates, as applicable, and is therefore double-taxed when it is distributed to the shareholders via a dividend payment or payment in redemption of the shares of the captive.

C. Estate Planning Benefits

To the extent that the captive does not have significant loss experience resulting from its share of claims by its direct insureds (the affiliated businesses) or from the captive's proportionate share of claims made against its risk pool, there is a significant opportunity and likelihood for the captive's assets to grow substantially over time, particularly since only the captive's investment income is subject to income taxes. Given that the initial capitalization is relatively small, it is not uncommon for the owners of the affiliated business to further leverage the benefits of the captive by causing the captive to be owned by a trust for the benefit of the business owner's family.

More specifically, the business owner will settle a trust for his descendants and give cash at least equal to the captive's required capitalization. The trustee then forms the captive insurance company and engages a captive manager to implement the negotiation and issuance of the insurance policies to the business owner's business(es). As the assets of the captive grow to exceed its reserves necessary for satisfying claims, the company can pay dividends to the trustee to facilitate distributions to beneficiaries or the trust's other cash flow requirements.

One variant on that structure involves the establishment of a limited liability company that is co-owned by the gifting trust and the business owner, where the limited liability company then forms and operates the captive. This structure provides a mechanism for the captive's dividends to inure and be payable proportionately to the limited liability company's members.

Notwithstanding the frequency with which captive planners propose this estate planning ownership structure for the captive, it is not without risk—a risk that some would argue is significant.[13] The concern is

[4] IRC §162.

[5] IRC §831(b).

[6] IRC §831(b).

[7] IRC §162; IRC §832(b).

[8] IRC §831(b)(3).

[9] IRC §831(b).

[10] IRC §1(h)(3)(B). A qualified foreign corporation is a foreign corporation that (1) is formed in a U.S. possession, or (2) is eligible for the benefits of a comprehensive income tax treaty with the United States that the Treasury Department determines is satisfactory for this purpose and that includes an exchange of information program. For a current list of those treaties, see IRS Publication 17 (2014).

[11] IRC §1248.

[12] IRC §162.

[13] Beckett Cantley, *Steering into the Storm: Amplification of Captive Insurance Company Compliance Issues in the Offshore Tax Crackdown*, Houston Business and Tax Law Journal, Vol. XII, 2012.

that the gifting trust's ownership of the captive implies that the owner of the insured business was actually using the captive insurance arrangements as a mechanism for shifting wealth (and the business's profits) to the next generation free of income and transfer taxes (other than the use of lifetime gift tax exclusion required to fund the required capital). The IRS then uses that estate planning purpose to lend suspicion to the scope of the insurance coverages and the pricing of the premiums and call into question the captive's motivation to pay the insured's claims or, alternatively, the business owner's motivation to file those claims and thereby deplete the assets of the trust.[14]

III. TECHNICAL REQUIREMENTS OF THE CAPTIVE INSURANCE COMPANY ARRANGEMENT

To be a valid captive insurance arrangement under Section 831(b), an insurance company must meet the following three criteria: (1) the captive must be an insurance company; (2) the arrangement between the insured and the captive must be considered "insurance"; and (3) the captive must be eligible to make an 831(b) election.

A. Insurance Company Requirement

To be an insurance company, the captive must first obtain all necessary insurance licenses and certifications that are required by the jurisdiction in which it is formed. However, qualification as an insurance company for federal income tax purposes is not met through compliance with state insurance regulatory laws alone. Although the organization and charter of the company and its operations (such as issuing policies with reasonable premiums negotiated at arms-length) are important factors, ultimately it is the nature of the business actually engaged in by the company in the taxable year that determines whether the company is an insurance company.[15] An insurance company is one whose primary and predominant business activity is issuing insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.[16] Some captive marketers heavily promote the ability to use the captive as a great investment vehicle for the deductible premium payments made to the captive, and most captives will invest their reserves in various securities and other investments in order to make those reserves productive. However, if a captive's investment activities and income exceed its insurance activity and income, the captive may not qualify as an insurance company for federal tax purposes. Under Section 831(c) of the Code, an insurance company ceases to be an insurance company when less than half of its business derives from the issuing of insurance or annuity contracts or reinsuring risks underwritten by insurance companies.[17] This threshold is important throughout the life of the captive, including during its start-up and winding down phases. Although there is some indirect indication that the IRS will continue to confer insurance company status during a captive's startup or wind down phase, the general rule is that once an insurance company has disposed of or discontinued its insurance operations, it may no longer qualify as an insurance company.[18]

If the captive fails to qualify as an insurance company, the insured would not be entitled to a deduction for premium payments made and the captive may be required to report the payments received as income. If the captive is organized in a foreign jurisdiction, it may lose any Section 953(d) election it had in place and may be subject to the Subpart F or PFIC tax regimes, discussed in further detail below.

B. Insurance Business Requirement

To be engaged in the business of insurance, the captive must enter into insurance arrangements between the captive and the insured that are "insurance" for purposes of federal tax law. The Code does not define the term "insurance," but it has been defined through a series of cases examining what qualifies as insurance for federal tax purposes. This body of case law defies

[14] *Id.*
[15] Treas. Reg. §1.801-3(a).
[16] *Id.*
[17] IRC §831(c), referencing IRC §816(a).
[18] TAM 200520035, TAM 200807018, and Technical Advice PTMA 2008-01343 all state that, in some cases, an insurance company in the startup phase will qualify as such, even though premiums may represent less than half the receipts of the company, *provided that the company's capital and efforts are devoted to the insurance business*. Rev. Rul. 56-106 concluded that a life insurance company that had ceased its insurance operations by disposing of its life insurance business is taxable as a regular corporation, even if the company remains in existence for purposes of winding up and liquidating. Similarly, in Rev. Rul. 69-405, the Service held that a life insurance company ceased to qualify as a life insurance company after disposing of its life insurance business, even though it retained other assets and remained in existence for the remainder of the year.

insurance as an arrangement that meets the following criteria:

- the arrangement involves "insurance risk";
- the arrangement is "insurance" in the commonly accepted sense; and
- the arrangement involves both risk-shifting and risk-distribution.[19]

Insurance risk exists when the insured party faces possible loss, and the insurer, in exchange for a premium, agrees to perform some act for the benefit of the insured when the loss materializes.[20] Arrangements involving "after-loss" insurance or residual value insurance are not considered insurance risks because they protect against an investment or timing risk and not against a hazard.[21] Protection against regular business risks, such as residual losses or lost profits, is not insurance, nor are contracts that pre-fund anticipated future obligations.[22]

An arrangement is insurance in the commonly accepted sense if (1) the insurer is organized and operated as an insurance company, (2) the insurance company is regulated as an insurance company by the jurisdictional insurance regulatory body, (3) the premiums paid were negotiated at arms-length, and (4) the arrangement is valid and binding.[23] Additionally, the arrangement should contemplate a specified insurable hazard or risk between one party willing to agree to sustain economic loss resulting from the occurrence of the risk specified in exchange for the payment of premiums and another party that has an insurable interest in the insurable risk.[24]

Finally, an arrangement will not be a valid insurance arrangement unless both risk shifting and risk distribution are present. Risk shifting occurs when risk is transferred from the policy holder to the insurer, and risk distribution occurs when risk is dispersed by the insurer among a larger pool of policy holders. In creating risk distribution, the insurer reduces the risk that a single claim will exceed the amount of total premiums actually received by the policy holders. Pooling of risks reduces the possibility that the insured may suffer as a result of its own losses covered by the related captive. Thus, the larger the pool of premium received by the captive relative to the premium received from the related insured, and the larger the group of risks insured by the insurer, the greater the amount of risk distribution achieved by the insurer.

Until 2001, the IRS took the position that risk shifting and distribution could not exist in an arrangement in which the insured and insurer are related parties.[25] This position is referred to as the "economic family doctrine." This doctrine slowly eroded as courts began adopting a competing test for risk shifting and risk distribution known as the "balance sheet test," which states that insurance premiums paid to a captive by its related insured are deductible by the insured only if there will be a net change in the balance sheet of the insured upon the payment of a claim.[26] *Humana v. Commissioner*, decided by the Sixth Circuit in 1989, formally rejected the economic family doctrine in favor of the balance sheet test, thus clarifying the circumstances that generate risk shifting and risk distribution.[27] Citing *Moline Properties*, the *Humana* court stated that the separate corporate existence of brother-sister corporations must be respected, meaning that their status as separate taxpayers should also be respected.[28] However, *Humana* did not go so far as to permit deduction of premiums paid by a parent to its subsidiary captive, citing the lack of change to the parent company's balance sheet upon payment of a claim.[29]

In 1991, the IRS lost another attempt to revive the economic family doctrine in *Harper Group v. Commissioner*. In *Harper*, the court found that risk

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[19] *Harper Group and Subsidiaries v. Comm'r*, 96 T.C. 45 (1991), 58.
[20] *Id*.
[21] Rev. Rul. 89-96; TAM 200149021.
[22] FSA 200209017; *SEC v. United Benefit Life Ins. Co.*, 387. U.S. 202, 211 (1967); Rev. Rul. 2007-47.
[23] *Harper*, at 57. In 2011, the IRS issued Technical Advice Memorandum 201149021, which muddled the concept of "insurance in the commonly accepted sense" with the requirement that the arrangement involve insurance risk. Despite significant evidence that the insurance company at issue met all of the requirements set forth in *Harper* for the arrangement to constitute insurance, the IRS concluded that it was not insurance in the commonly accepted sense because there was no casualty event and damage or impairment in some form. The contracts in this case insured residual value risks and the IRS stated that "while there are insurance policies that may be influenced by a decline in asset value, the insurance company's obligation under these policies still rests on a casualty event and the casualty must cause the decline in value." This confusion may make it difficult for insurers with a new or unique insurance product to know whether they meet the "insurance in the commonly accepted sense" prong of the *Harper* test.
[24] *Allied Fidelity Corp v. Comm'r*, 572 F.2d 1190, 1193 (7th Cir. 1978).
[25] Rev. Rul. 77-316.
[26] *Carnation Company v. Commissioner*, 640 F. 2d 1010 (9th Cir. 1981); *Clougherty Packing Co. v. Commissioner*, 84 T.C. 948 (1985).
[27] *Humana v. Commissioner*, 640 F.2d 247 (6th Cir. 1989).
[28] *Id*.
[29] *Id*.

shifting occurred as between the insured parent and its captive subsidiary. The captive insurance company owned by Harper Group was a functioning insurance company.[30] The Harper court found risk distribution in the arrangement, citing the fact that in addition to insuring its parent company, approximately 30 percent of the captive's business came from unrelated policy holders.[31] Thus, Harper Group's captive distributed the risk it assumed in insuring Harper Group by also insuring a group of unrelated entities whose insured risks were not related to Harper's. The IRS finally conceded the economic family doctrine in Rev. Rul. 2001-31, stating therein that it would no longer advance the economic family doctrine as a device to disallow deductions of premiums paid to a captive insurance company by a parent or brother-sister insured.[32]

Beginning in 2002, the IRS issued a series Revenue Rulings that provided certain safe harbors for establishing risk shifting and risk distribution in related party insurance arrangements. Since their issuance, these Revenue Rulings have served as guideposts to establish captives that meet the IRS's thresholds for risk shifting and risk distribution. The first of these rulings, Revenue Ruling 2002-89, provides that a captive that is wholly-owned by the insured operating parent can establish risk distribution by receiving at least 50 percent of its premiums from unrelated policy holders. One can infer that this safe harbor would also apply to situations in which the captive and the insured are related by common ownership. This safe harbor is helpful in an arrangement in which the captive may have just one or a small number of related policy holders.

For captives with multiple related policy holders, Revenue Ruling 2002-90 establishes a safe harbor for risk shifting and risk distribution where at least twelve operating entities purchase insurance from the captive, provided that each related policy holder has no less than 5 percent and no more than 15 percent of the total risk insured by the captive. Revenue Ruling 2002-90 framed this safe harbor in the context of twelve subsidiaries of one parent company, but it establishes the safe harbor for any arrangement of related or unrelated policy holders. Revenue Ruling 2005-40 clarified that the 12-subsidiary test will be met provided that none of the twelve policy holders is a disregarded entity.[33]

A captive that is established for the purpose of insuring its parent or a brother-sister entity cannot achieve adequate risk distribution through the single-party insurance arrangement for which it was created. Its collection of premium from a single insured will leave it overly exposed to the claims of that insured. Thus, a captive may need to seek other arrangements that create adequate risk distribution, such as reinsuring its risks with a third party reinsurer.

Risk distribution can also be achieved through use of a reinsurance pool, or "risk pool." Risk pools exchange insurance business among a group of captives, spreading risk and creating a pool of unrelated business that the captive may insure in order to meet the Revenue Ruling 2002-89 and 2002-90 safe harbors. In addition to reinsuring a portion of its own risks through the reinsurance pool, the captive also agrees to insure a proportionate amount of risks of other participants in the pool. This is accomplished by the captive and the risk pool entering into a retrocession agreement that provides for payment to the captive of retrocession premiums that exceed 50 percent of the captive's direct premiums from its insureds. The existence of the third party risk reduces the parent's risk because it is distributed with the third party risk. The more third party risk a captive takes on, the more diluted, or distributed, the parent's risk becomes.

Risk shifting and risk distribution may also be created as a result of diverse ownership of the captive itself.[34] Revenue Ruling 2002-91 establishes that a captive with multiple unrelated owners meets the requirements of risk shifting and risk distribution provided that no owner owns more than 15 percent of the captive and no owner's individual risk insured by the captive exceeds 15 percent of the total risk insured by the captive.[35]

In creating risk distribution arrangements, the captive must be aware of circumstances that may fail to create risk distribution despite the pooling of risks. Such a situation may arise if the pooled risks are subject to interrelated risks. In a 2011 Technical Advice Memorandum, the IRS found that risk distribution did not exist where the assets reinsured through a risk pool were subject to the same market forces.[36] In TAM 200149021, the captive was obligated under its policy with the insured to pay to the insured the excess of the

[30] *Harper Group & Subsidiaries v. Commissioner*, 96 T.C. 45 (1991).
[31] *Id*. at 59.
[32] Rev. Rul. 2001-31.
[33] Two recent cases, *Securitas Holdings Inc. v. Commissioner*, T.C. Memo 2014-255, and *Rent-A-Center Inc. v. Commissioner*, 142 T.C. No. 1 (2014), have directly contradicted the holding in Rev. Rul. 2005-40 that risk distribution is measured based on the number of insureds rather than the number of statistically independent risks. Both cases held that risk distribution is established by the existence of a sufficient number of statistically independent risks, regardless of who is the owner of such risks.
[34] Rev. Rul. 2002-91; see also Rev. Rul. 78-338 (group captive owned by more than 30 members).
[35] *Id*.
[36] TAM 201149021.

predicted residual value of an insured asset over the fair market value of the asset at the end of the lease term.[37] The IRS found that risks under the contracts were interdependent because under certain circumstances every asset within the portfolio could suffer losses due to exposure to the same risks. Specifically, the insurance policies were designed to protect the insured against market forces that depressed the value of the protected assets. An actuarial review of the arrangement found that the same market forces could impact all assets, and based on that finding the IRS concluded that risk distribution could not exist in such an arrangement.[38] Similarly, in Revenue Ruling 60-275, the IRS found that risk distribution was not present because the assets insured were subject to the same flood risk because all properties were located in the same flood basin.[39] Thus, there can be interdependence in the covered risks that affect the protected assets that will cause a pooling arrangement to fail to create risk distribution.

C. Section 831(b) Eligibility

A captive that has made a valid 831(b) election is taxed only on its investment income.[40] A captive may make an 831(b) election if the captive's annual premiums received do not exceed $1.2 million.[41] The 831(b) election is made by attaching a statement to the captive's income tax return, and the election remains in effect until premium income exceeds $1.2 million or the election is revoked with the consent of the IRS.[42]

Premiums received by the members of a group of related captives may be aggregated in some circumstances, causing the 831(b) election of each member of the group to become invalid. The controlled group rules of Section 831(b)(2) state that captives that are related by more than 50 percent common ownership[43] will be combined for purposes of determining whether a captive has exceeded the $1.2 million premium ceiling.[44] For purposes of Section 831(b) of the Code, a controlled group includes the following:

- parent-subsidiary groups in which one or more of a group of corporations is connected through stock ownership with a common parent corporation, which occurs when at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock of each of the corporations (except the common parent corporation), is owned by one or more of the other corporations, and the common parent corporation owns stock possessing at least 80 percent of the total combined voting power or all classes of stock or 80 percent of the total value of all shares of classes of stock of at least one of the other corporations, excluding stock owned directly by such other corporations;

- brother-sister controlled groups in which 5 or fewer individuals, estates, or trusts own stock possessing more than 50 percent of the combined voting power of all classes of stock of each corporation or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation; and

- a combined group in which three or more corporations are members of a parent-subsidiary or brother-sister group, and one of such corporations is a common parent corporation included in a parent-subsidiary group, and is included in a brother-sister group.

Captive marketers will sometimes promote captive structures that involve the creation of multiple captives. If the ownership of the captives is not carefully structured to avoid application of the controlled group rules, then the captives will not meet the Section 831(b) eligibility requirements if their combined premium

[37] *Id.*
[38] *Id.*
[39] Rev. Rul. 60-275.
[40] IRC §831(b).
[41] *Id.*
[42] *Id.*
[43] "Ownership" of stock for purposes of identifying members of a controlled group is determined using the constructive ownership rules found in Section 1563(e) of the Code. Those rules treat the following persons as direct owners of stock: (1) a person holding an option to acquire the stock; (2) any partner having a 5 percent or greater interest in the capital or profits of a partnership that owns, directly or indirectly, the stock; (3) a beneficiary of a trust or estate who has an actuarial interest of 5 percent or more in the stock; (4) the grantor of a trust (or other individuals treated as substantial owners of the trust) that directly or indirectly owns the stock; (5) a 5 percent or greater owner of a corporation that directly or indirectly owns the stock; (6) the spouse of a person who directly or indirectly owns the stock, subject to certain exceptions set forth in IRC §1563(e)(5); (7) the parent of a minor child (under age 21) who directly or indirectly owns the stock; (8) an individual who owns more than 50 percent of the total combined voting power or value of shares of all classes of stock if stock is owned, directly or indirectly, by or for such individual's parents, grandparents, grandchildren, or children over the age of 21.
[44] *Id.*

income exceeds $1.2 million. Even in cases where the combined group rules have been skillfully avoided, the IRS may attempt to collapse a multi-captive arrangement by arguing that there is no business purpose for establishing more than one captive to insure the same operating company. A group of captives that insure the same risks for the same policy holders in identical or similar proportions is particularly vulnerable to such an attack.

IV. DOMICILE AND FOREIGN CAPTIVES

Prior to the 1970's, no U.S. jurisdiction had adopted captive legislation, forcing companies that wished to establish a captive to do so in an international jurisdiction. Vermont was among the first U.S. states to adopt comprehensive captive laws. In recent years, many other U.S. states have passed their own captive legislation, including Texas in 2013.[45] The lack of choice in domestic captive jurisdictions and the lack of experience of their regulators may have been an initial driver of captives to the international market, but now that over half of U.S. states have captive legislation and many states boast experienced insurance regulators, some domestic jurisdictions are comparable to many of the more established international jurisdictions in this regard.

A. Distinguishing Characteristics

While fundamentally similar, domestic and international captives differ in several significant areas such as capitalization requirements and investment regulations. Some international captive jurisdictions offer capitalization requirements that are lower than those in the U.S. When establishing a U.S. captive, one can expect minimum capitalization requirements to be between $150,000 and $250,000. Some of the more well-known international jurisdictions have capitalization requirements approaching or even exceeding these amounts, but others set minimum capitalization requirements as low as $10,000. Although a lower capitalization requirement may appear attractive to the captive owner, it is important that a captive be properly capitalized so that its ability to pay claims is not jeopardized, which can lead to a finding by the IRS that risk shifting is not present.[46] Capitalization should be determined actuarially and should not be based solely on the jurisdiction's capitalization requirements. Thus, low capitalization requirements of an international jurisdiction should not be a deciding factor in selecting the captive's domicile.

Different jurisdictions may also vary in terms of what investment programs are permitted with respect to investment of the captive's reserves. The Code and Treasury Regulations do not place restrictions on the types of investments a captive may make, regardless of domicile. Local jurisdictional rules regarding investments may restrict investment options available to the captive, and liquidity ratios may also vary between jurisdictions. Many international jurisdictions have more relaxed investment guidelines, and some do not place any restrictions on investments at all. Regardless, a captive should still meet actuarially-determined solvency requirements, so any relaxed foreign investment standards will still have practical limitations.

Other factors that should be considered when selecting a captive domicile include: (1) whether the captive's ownership structure would make a foreign or domestic captive more advantageous; (2) whether loans from the captive are contemplated and if so, whether the jurisdiction permits such loans; (3) whether the jurisdiction permits the lines of business intended to be written by the captive; and (4) operational requirements of the jurisdiction (i.e., whether the jurisdiction requires annual meetings in the jurisdiction, availability of local captive managers and other advisors).

B. Taxation of Foreign Captives

If an international structure is used, the captive should strongly consider making an election under Section 953(d) of the Code to be taxed under Subchapter L of the Code as a domestic insurance company for income tax purposes. The Section 953(d) election allows the captive to take advantage of the non-tax benefits offered by the foreign jurisdiction without having to navigate the complexity of being taxed as a foreign entity under the Code. Additionally, a foreign captive that makes a Section 953(d) election will not be subject to the federal excise tax that is otherwise imposed on premium payments made to foreign insurers.[47] To qualify for the Section 953(d) election, at least 25 percent of the captive's outstanding stock must be owned by U.S. persons, the captive must be taxable as an insurance company under the Code, and it must meet certain prescribed IRS requirements for payment of its taxes.[48]

A special Subpart F regime applies to U.S. shareholders of a foreign captive without a Section 953(d) election in place. This special regime is relevant to group captives in which multiple unrelated parties own the captive and was established to bring those

[45] TX Ins. Code. §964.001 *et seq.*

[46] *Malone & Hyde v. Comm'r*, 62 F.3d 835; *see also* Rev. Rul. 2002-90.

[47] IRC §4371 provides for a 4 percent excise tax on premiums paid by U.S. payers to a foreign insurance company.

[48] IRC §953(d).

attempting to avoid classification as a controlled foreign corporation back into the Subpart F regime. Typically, U.S. shareholders of a foreign corporation can avoid current taxation on the Subpart F income of that foreign corporation if ownership of the corporation is spread among a sufficient number of U.S. persons. However, reduced thresholds are applied for foreign captive insurance companies that do not have a Section 953(d) election in place that requires any U.S. shareholder of a captive to include as Subpart F income the "related party insurance income" of the captive.[49] A foreign captive is a "controlled foreign corporation" for purposes of determining "related party insurance income" if U.S. shareholders own 25 percent or more of the captive's stock.[50] The U.S. owners of the captive are required to include their pro rata share of "related party insurance income" as Subpart F income. The U.S. shareholder's pro rata share is determined as if related party insurance income is the captive's only income, and the U.S. shareholders are treated as owning all of the captive's outstanding stock (i.e., shares held by foreign shareholders are ignored).[51] A group captive that is a controlled foreign corporation only with respect to related party insurance income will not be subject to Subpart F reporting on its other income.

A foreign captive that is a controlled foreign corporation for all purposes of Subpart F and that does not have a Section 953(d) election in place will be taxed under Subpart F on all of its income that otherwise constitutes "Subpart F" income under the Code, including its investment income.[52] The Subpart F tax regime requires a U.S. shareholder to report and pay tax on its distributable share of the captive's income, even if such income was not distributed to the shareholder.[53] If the foreign captive does not meet the definition of "insurance company" under the Code due to excessive non-insurance income, it would be required to report all of its Subpart F income, and its shareholders will be subject to tax on such income regardless of whether it is distributed.

A foreign corporation that has U.S. persons as shareholders but which does not qualify as a controlled foreign corporation may be a passive foreign investment company ("PFIC"), which is subject to a separate tax regime apart from the Subpart F regime.[54] A PFIC is a corporation in which (1) 75 percent or more of the corporation's gross income is passive income, or (2) at least 50 percent of the corporation's assets, on average, produce passive income or are held for the production of passive income.[55] A U.S. shareholder of a PFIC is subject to an interest charge on excess distributions of the PFIC, absent certain elections that may cause current inclusion of income of the PFIC or the marked-to-market value of its stock held by the U.S. shareholder.[56] A foreign corporation that is primarily engaged in the business of insurance and that would be taxable as an insurance company under the Code if it was a domestic corporation is exempt from PFIC classification.[57] However, if such a company was not predominantly engaged in the business of insurance, the PFIC exemption may not be applicable, and the U.S. shareholders of such company would be subject to PFIC taxation. In Notice 2003-34, the IRS declared that a foreign insurance company that is not primarily engaged in the business of insurance will not be taxed under the favorable insurance company tax regime, but instead will be taxed as a PFIC.[58] The IRS will analyze the foreign captive's total activities and income when making this determination.[59]

V. CAPTIVE MECHANICS

Most captive insurance arrangements are structured to meet one of the several safe harbor rulings issued by the IRS in 2002. If a captive structure is relying on a risk pool to create risk distribution, the operating business may pay premiums directly to the captive or the risk pool, or may split premiums between the captive and the risk pool. These arrangements are discussed in greater detail below. The mechanics of how a captive shares risk with the risk pool vary as well, but generally operate in one of three ways.

1. Layered Risk Pooling. In a layered risk pooling arrangement, the captive will retain a certain percentage of the policy limit, while the pool assumes the remainder of the policy limit. For example, the captive might be obligated to pay the first 20% of the policy limit on a claim submitted to the risk pool, and the risk pool will pay amounts above that up to the policy limit.

[49] IRC§953(c).

[50] *Id*. For purposes of §953(c), a "U.S. shareholder" is any U.S. person (as defined in §957(c) of the Code) who owns any shares in the foreign corporation. For purposes other than determining related party insurance income, a U.S. shareholder is any U.S. person who owns 10 percent or more of the foreign corporation's outstanding shares.

[51] IRC §953(c)(5).

[52] IRC §952.

[53] IRC §951(a).

[54] Under IRC §951(c), if a PFIC is also a controlled foreign corporation, the Subpart F regime will trump the PFIC regime.

[55] IRC §1297(a).

[56] IRC §1293-1296.

[57] IRC §1297(b)(2)(B).

[58] IRS Notice 2003-34.

[59] IRS Notice 2004-34.

Policy Limits
80% above retained layer borne by pool (% pooled varies)
1st 20% of policy limit retained by captive
Deductible (insured)

2. First Dollar Quota Share. In a first dollar quota share arrangement, the captive and the risk pool agree to split the obligation to pay the claim proportionately. For example, if the arrangement provided that the captive would retain 49% of the claim and the risk pool 51%, then for every dollar of loss payable to the insured, the captive would retain 49% and the risk pool would pay 51% to the captive.

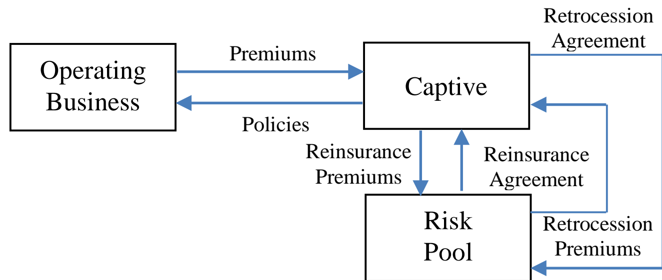
Policy Limits	
49% of first dollar quota share retained by captive (% varies)	51% of first dollar quota share borne by pool (% varies)
Deductible (insured)	

3. Hybrid. A hybrid arrangement combines layered risk pooling with first dollar quota sharing. For example, the first 80 percent of the policy limit is paid under a quota share arrangement between the captive and the risk pool, whereby the captive retains 15 percent of each dollar of policy limit within the 80 percent bracket, and the risk pool pays the remaining 85 percent. The captive then retains the remaining 20 percent of the policy limit.

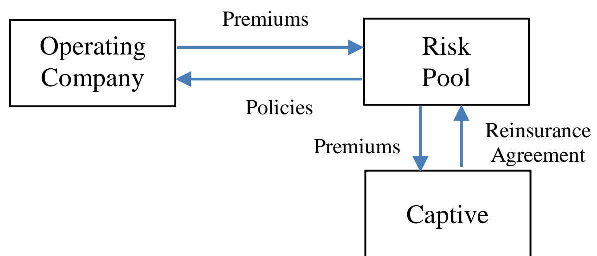
Policy Limits	
top 20% of policy limit retained by captive	
15 % quota share retained by captive	85% of quota share borne by pool
Deductible (insured)	

If the operating business pays premium directly to the captive, then the captive must receive more than 50 percent of its premium from unrelated third parties in order to meet the risk distribution safe harbor of Revenue Ruling 2002-89. To accomplish this, the captive enters into a retrocession agreement with the risk pool by which it reinsures an amount of the pool's risk proportionate to reinsurance premiums that are paid by the captive to the pool. The reinsurance purchased from the pool by the captive helps to offset the risk the captive is assuming by entering into the retrocession agreement. This arrangement is depicted in Example 1 below.

Example 1: Premium paid directly to captive



Example 2: Premium paid directly to Risk Pool



VI. APPROPRIATE CANDIDATES FOR CAPTIVE INSURANCE

Captive insurance presents an attractive risk management solution for many businesses, but the structure is not suitable for every business. The factors that determine whether a captive makes sense for an operating business track closely with establishing a business purpose for the creation of the captive. Perhaps the most important factor is the presence of risks that are difficult or expensive to insure in the commercial insurance market. These may include insurance covering administrative actions, cyber risk, business interruption, construction defect, credit default, deductible insurance, difference in conditions, earthquake, hurricane, employment practices, exclusions, legal defense reimbursements, loss of key customer, pollution, product recall, and certain types of warranty claims. The captive must have risks for which coverage through a captive provides a benefit to the business over obtaining commercial coverage.

The amount of risk should be sufficient to support at least $300,000 to $500,000 of annual premium. Initial organization of the captive may cost from $60,000 to $100,000, and annual costs, including captive management, actuarial, audit, legal, and tax fees, can range from $50,000 to $60,000 annually. If the business does not have insurable risks resulting in at least the minimum range of premiums suggested above, then it is not cost-effective for the business to establish the captive.

If the business does have sufficient risk to justify at least the minimum threshold in premium, it still must have sufficient net profits to support payment of such premium. For example, a business that had $800,000 in profits prior to payment of its captive premium would not support a premium of $500,000. The premium costs must make sense from a business perspective. It is unlikely that a business owner would pay over 50 percent of his profits to a third party insurer.

VII. MITIGATING OR AVOIDING IRS CHALLENGES

In a notice dated February 3, 2015, the IRS officially placed micro-captive insurance companies on its "Dirty Dozen" list of abusive tax schemes. The IRS stated that, "[i]n 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 oftentimes 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."[60] The IRS has an arsenal of tools at its disposal with which to attack abusive or improperly structured captives. The arguments it has frequently relied on—and found success with—are discussed below.

A. Lack of Business Purpose

Unpacking the statement in the February 2015 IRS notice, it is clear that the IRS is primarily focused on captive arrangements that lack a fundamental business purpose. The fact that a captive structure affords tax benefits to its owner does not negate the legitimacy of the planning.[61] However, a captive that is structured for the sole purpose of avoiding taxes and that otherwise lacks true economic substance is at risk for challenge by the IRS. Anecdotally, the IRS has been very focused on the pre-organization "paper trail" and has made production requests of captive owners that make clear it is searching for evidence of tax-motivated purposes for establishment of captives. In search of support for its position that the captive was established primarily for the purpose of tax avoidance, the IRS will request that the taxpayer provide documentation indicating why the captive was created. Captives that are marketed to the taxpayer by the captive manager as tax avoidance schemes rather than legitimate business arrangements may not fare well under audit, as tax planning alone is not considered a legitimate business purpose.

To counter the IRS's presumption of a tax-motivated purpose, the legitimate business purposes for organizing a captive should be thoroughly documented throughout the planning and organizational process. For example, a captive may determine that there is significant benefit to accessing reinsurance markets, since reinsurers can usually provide cheaper coverage than direct insurers. A captive may also provide a way for the operating business to obtain coverage that is difficult to find or prohibitively expensive to obtain on the commercial markets. Additionally, policies written by a captive may be more economically priced than commercial policies because the premiums do not contain mark-ups for typical commercial insurer expenses such as marketing and agent commission. A captive can also provide an effective mechanism for cash flow management, permitting the insured to spread premium payments over the course of the coverage year rather than requiring a single upfront premium. Finally, a captive is one prong of an overall risk management program that includes commercial insurance and risk mitigation practices by the insured. By linking the insured's risk management successes to the increased profitability of the captive (by avoiding excessive claims), use of a captive aligns the interests of the insured and the captive. All of the above are compelling business purposes for establishing a captive. If a captive will not provide at least some of these benefits to the insured, then the insured should give serious consideration as to whether it makes business sense to establish the captive, and perhaps should not proceed.

B. Capitalization and Excess Accumulated Earnings

A captive should be properly capitalized to enable it to support claims made by the insured and should not rely solely on premium reserves to pay claims (i.e., its initial capital should be substantial—at least $150,000 or higher if required by the jurisdiction in which the captive was formed). While some jurisdictional minimum capitalization requirements may be sufficient, the captive should determine its capitalization requirements through an actuarial study and should document that it has followed the recommendations of the study. In some cases, even formally documented transactions may be attacked if the transaction results in under-capitalization of the captive. This may be the case in a shareholder loan-back arrangement in which a policy owner pays premium to the captive, and the captive then issues a loan to the policy owner for some amount of the premium just paid. Although this has not

[60] IRS Notice, February 3, 2015.

[61] See, *Estate of Stranahan v. C.I.R.*, 472 F.2d 867 (6th Cir. 1973).

been specifically challenged in the captive arena, factually-similar cases have been determined to be fraudulent on the basis that the lending entity is a sham or alter ego of the shareholder. With respect to captives, the IRS has noted that such arrangements may indicate self-dealing, and could undermine the taxpayer's argument that the insurer was an independent entity and that premiums were negotiated at arm's-length.[62] Therefore, dividends and loans should only be issued if the captive has sufficient reserves to support payment of future claims.

At the other end of the spectrum from undercapitalization is the possibility that the captive may have improperly retained excess earnings in order to avoid issuing dividends that would result in additional tax to the shareholders of the captive. To deter corporations from retaining after-tax earnings and profits, Section 531 of the Code establishes a 20 percent tax on a corporation's accumulated taxable income for each year in which such income remains undistributed.[63] The accumulated earnings tax will apply to excess retained earnings regardless of their form. Thus, liquid accumulated earnings that are converted into illiquid assets will remain subject to the tax if the assets into which they are converted are not considered to be reasonably necessary for the furtherance of the captive's operations or future plans.[64]

The accumulated earnings tax applies to a corporation only to the extent that it retains earnings in excess of the corporation's reasonable business needs.[65] The burden is on the taxpayer to demonstrate that the accumulation of earnings was not in an amount in excess of the corporation's reasonable business needs.[66] Reasonable business needs include both current and future business needs. Current needs include working capital and other liquid assets required for the current business cycle of the business.[67] Future needs of the business must be demonstrated by a specific, definite, and feasible plan for use of the accumulated amounts.[68] Consideration as to these needs is determined at the close of the taxable year each year.[69] The accumulated amount does not need to be used immediately or in the same taxable year, provided that it will be used within a reasonable time.[70] Where the future needs of the business are uncertain or vague, where the plans for the future use of an accumulation are not specific, definite, and feasible, or where the execution of such a plan is postponed indefinitely, an accumulation cannot be justified on the grounds of reasonably anticipated needs of the business.[71]

In the context of a captive insurance company, the captive has a definite need to maintain adequate reserves for the payment of claims, and these reserves may be held in investments as well as cash, provided the investment portfolio of the captive meets the requirements of the jurisdiction in which the captive was formed. The captive should obtain an actuarial calculation of the amount necessary in order to demonstrate that these amounts should not be subject to the accumulated earnings tax.[72] Additionally, the annual costs of the captive to maintain its operations may be excluded from excess retained earnings. These costs may be in the form of expenses paid for employees, facilities, business insurance, and other costs reasonably expected to be incurred in the operation of the captive, or if the captive outsources most of its management, the costs may consist of captive management fees, audit, actuary, legal, and tax advisor fees.

Future capital needs that are otherwise common for other corporations, such as for facilities, workforce, or business expansion, may not be applicable to a captive that outsources most of its operations. Similarly, shareholder redemption and debt repayment planning will not contribute to acceptable future capital needs where there is only one shareholder or debt is issued to the shareholder or a related party, but reserve requirements may apply if the captive intends to redeem a minority shareholder or retire third party debt of the captive.[73]

Finally, capital for diversification by stock and asset purchases is another generally acceptable category of future capital needs of a captive.[74] However, as mentioned previously, in order to qualify as an insurance company, a captive must be predominantly engaged in the business of insurance.[75] Therefore, while it may engage in an investment program in order to increase reserves through investment gains, it must be careful that its investment and asset acquisition activities do not outweigh its insurance activities or it will not qualify as an insurance company and the premium deduction will be unavailable to the taxpayer and premium payments could be taxable income to the captive.

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[62] FSA 199945009 (Nov. 12, 1999).
[63] IRC §531.
[64] Treas. Reg. §1.537-2(c)(4).
[65] IRC §533(a).
[66] *Id*.
[67] Treas. Reg. §1.537-2(b).
[68] Treas. Reg. s1.537-1(b).
[69] *Id*.
[70] *Id*.
[71] *Id*.
[72] Beckett Cantley, *The Forgotten Taxation Landmine: Application of the Accumulated Earnings Tax to IRC §831(b) Captive Insurance Companies*, Richmond Journal of Global Law & Business, Vol. 11:2, April 2012.
[73] *Id*. at 181.
[74] *Id*. at 180.
[75] Treas. Reg. §1.803-1.

In conclusion, the accumulated earnings tax is intended to prevent a corporation from deferring shareholder-level tax indefinitely. Therefore, a captive insurance company should take reasonable steps to document its capital needs in order to rebut the presumption that earnings were retained in excess of the captive's present and future capital needs.

C. Management and Operational Formalities

Implementation and ongoing management of the captive are also areas in which the IRS may challenge a captive structure. A captive that does not adhere to corporate formalities and is not treated by its shareholders as a separate legal entity may be considered a sham and collapsed by the IRS. The captive should be managed as a stand-alone corporation, respecting all corporate formalities. Some captive owners find that this is best achieved by using a captive management company to professionally administer the captive on an ongoing basis in addition to assisting with the initial formation and setup. The captive manager should oversee compliance with all regulatory and administrative requirements, such as obtaining the captive's insurance license, maintenance of accounting and record keeping, regulatory filing and reporting, production of financial statements at reasonable intervals, annual review of premium pricing and claims activity. The captive manager should coordinate with tax, legal, and accounting advisors and regulatory bodies on behalf of the captive.

The captive should also have claims procedures in place, and policies should be relevant to the claims priced in the actuarial report produced for the insured. A captive that writes policies for risks that were not covered in the actuarial report may not be able to justify the premiums charged for such policies upon examination by the IRS, which could result in a denial of the deduction of the premiums for such risks.

D. Excessive Premiums and Inappropriate Risks

The IRS may also challenge the premium amount established for the risks written by the captive, as well as the types of risks themselves. The operating business should obtain a feasibility study to determine whether it has potential risks that could be insured by a captive. If the feasibility study indicates that the business should continue pursuing the captive, then a detailed actuarial study should be obtained to accurately identify and price the business's risks and provide thorough documentation of the pricing that is established. The actuarial study should be performed by a reliable and experienced actuary. An actuarial study pricing premium at exactly or just below $1.2 million year after year will be suspect. Additionally, premiums that fluctuate proportionately with the insured's taxable income each year may be seen as fabricated to meet a tax avoidance goal rather than to accurately price risk. Insurance premiums charged by a captive and the insurance provided thereby must be determined using a reliable actuarial method estimating the risk of loss.[76]

From the insured's perspective, inappropriately priced risk could lead to a loss of the premium deduction available under Section 162 of the Code.[77] A premium payment will be deductible by the insured if it is an ordinary and necessary business expense of the insured, meaning that it must have a business purpose, provide a necessary benefit, and be a reasonable expense of the insured's business.[78] If a taxpayer pays too much premium for the amount of insurance it receives, the IRS may disallow the deduction because the expense is not reasonable.[79] The IRS may also find that the insured is retaining too much of the risk relative to the coverage (via excessive premiums), and could determine on that basis that risk shifting did not occur.

In addition to the loss of the deduction by the insured, excessive premium payments may be taxable income to the captive since they may not be excluded as underwriting profits under Section 831(b) of the Code. The IRS could argue that the payment of excess premium was a disguised gift if the captive is owned by the business owner's heirs or trusts for their benefit.

The IRS has also been critical of the types of risks insured and their appropriateness to the insured's business. Some aggressive promoters have encouraged manufacturing risks in order to reach a higher premium amount. Unless these risks are legitimately established by a reliable actuarial report, the deduction taken for the premiums relating to such risks may be disallowed. Such risks may include those that are too remote to the taxpayer's business type or geographic location.

Challenges to premium levels and insured risks can be avoided or reduced by the use of a feasibility study to analyze the insured's overall risk profile and existing coverage and pricing of that coverage. In addition, the captive should retain a qualified and reliable actuary to perform an annual actuarial study, and who should review changes in the insured's risk profile and claims history, and use that information to adjust annual premiums and coverage appropriately. Relatedly, the use of multiple captives with common ownership whose collective premium income exceeds $1.2 million should be very carefully scrutinized, as this may indicate that

[76] *Gulf Oil Corp. v. Comm'r*, 89 T.C. 1010 (1987).
[77] Treas. Reg. §1.162-1(a).
[78] *Id*.
[79] Non Docketed Service Advice Review, 2002 I.R.S. N.S.A.R. 20160 (April 17, 2002).

premium should be established in excess of $1.2 million.[80]

E. Claims History

A captive that has not submitted claims may be subject to IRS scrutiny. If the insured business does not suffer any insured losses, then the IRS may argue that premiums are excessively priced, or worse, that there is no risk to insure. The same issue may arise with risk pools if the pool has a low claims history. Without claims to justify the premiums paid to the risk pool, the IRS may successfully argue that the premiums are excessive relative to the risk insured and could disallow all or a portion of the premium deduction. If the premium paid to the pool is reduced, the captive may not meet the requirement that premiums from third parties more than 50 percent of the total premium income received by the captive, which would undermine the risk distribution that the pool was created to produce. Low loss ratios (those below 5 percent) increase the probability of a successful claim by the IRS that premiums are too high for the risk insured. For this reason, extreme caution should be exercised with new risk pools and established risk pools with low loss ratios.

F. Investments

Captives are generally not restricted as to how premium reserves are invested, provided that their investment programs meet the requirements of the jurisdiction in which the captive is licensed. As mentioned above, it is important that the captive remains primarily involved in the business of insurance.[81] If investment income begins to exceed underwriting income, the captive will not be considered to be an insurance company, resulting in negative tax consequences for the insured and the captive.[82]

Life insurance is frequently promoted by as a tax-advantaged investment for captives, but captives should proceed with extreme caution when considering such an investment. Although captive investment in life insurance is not specifically prohibited in most jurisdictions, the arrangement could be collapsed by the IRS by the argument that the premium paid by the captive to the life insurer was really a direct payment of premium by the captive's insured to the life insurer, particularly if the individual insured under the life policy is the owner of the business that is insured by the captive or a relative of the owner.[83] Captives are advised to avoid such arrangements, but if they are pursued, the captive should be very cautious about how the transaction is documented. For example, the investment strategy of the captive should not be discussed until the business purpose for establishing the captive has been well documented. Some have recommended that life insurance make up no more than 49 percent of the captive's investment portfolio.[84] Generally, a conservative captive would avoid investing in life insurance.

G. Consequences of a Successful IRS Challenge

As mentioned above, the consequences of a taxpayer loss to the IRS's challenge of the captive arrangement can include denial of the premium deduction claimed by the insured businesses, income recognition by the purported captive of amounts that do not constitute underwriting profits, and possible gift tax consequences if the purported captive is owned outside of the estate of the insured business's owner. The resulting restatements of taxable income will likely come with a 20 percent accuracy-related penalty, which could increase to 40 percent if the IRS imposes economic substance penalties.[85]

Additionally, a successful IRS challenge of one or more noncompliant members of a risk pool—or the risk pool itself—could jeopardize the risk distribution generated by the pool arrangement. If a member of the risk pool is no longer participating in the overall reinsurance or retrocession arrangement, then the third-party premiums received by the taxpayer's captive may dip below fifty percent of overall premiums it receives, thus falling outside of the safe harbor created under Revenue Ruling 2002-89. This pool-related risk is of particular concern because the IRS has recently initiated "inquiries" of captive pool managers thought to be promoters of aggressive structures.

VIII. CONCLUSION

Micro-captives provide an excellent opportunity for businesses to manage their risk profiles in a cost-effective manner while also providing meaningful income tax and estate planning benefits to the captive owners and their heirs. When established correctly, a captive can reduce risk management costs and provide cash-flow improvement and other benefits to the operation of the enterprise. The increased IRS scrutiny that has been visited on captives recently is the result of aggressive promoters using the 2002 safe harbor rulings to sell captive structures to those who may not be

[80] It is possible that multiple captives could be justified if the owner used such an arrangement to segregate the types of risks insured across the related captives. A multi-captive arrangement with identical coverage written across all members of the group would not be recommended, as there is no separate business reason for such an arrangement.

[81] IRC §831(c); IRC §816(a).

[82] *Id.*

[83] IRC §264 states that life insurance premiums are not deductible, directly or indirectly.

[84] *Illustrating, Integrating, Implementing, and Funding Captive Insurance Companies*, presentation by Jay Adkisson to Association for Advanced Life Underwriting.

[85] IRC §6662(i).

appropriate candidates, primarily focusing on the tax benefits of captives to the exclusion of a possible business purpose. The IRS and the courts have provided a fairly straightforward roadmap for taxpayers to follow in order to establish a tax-compliant captive insurance company. When taxpayers are seduced by the captive's tax benefits and do not give full attention to the operational aspects of, and business purpose for, the captive, the IRS may mount a successful challenge of the structure.

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