

# Captive Tax Developments

*Kentucky Captive Association  
2016 Educational Conference*

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# Agenda

- Section 831(b) Amendments
- Captive Tax Tests
- Insurance Risks
- Rent-A-Center and Securitas
- Acuity
- Validus
- IRS Business Plan
- IRS Scrutiny: Captives Electing Section 831(b)

# Protecting America From Tax Hikes (PATH) Act of 2015

- **Protecting America from Tax Hikes of 2015 (HR 2029) - passed December 18, 2015 and included changes to section 831(b):**
  - The maximum premium is increased to \$2,200,000, and indexed for inflation.
  - The captive must meet one of two diversification tests
  - Effective for years beginning after December 31, 2016

# What Hasn't Changed

On their face, the amendments do not have anything to do with the definition of insurance.

- If the arrangement qualified as insurance before the amendments, it remains a good insurance arrangement after the amendments
- If the captive fails to meet the new tests in 2017 or beyond, it is still an insurance company for tax purposes. The consequence will be that it is taxed under section 831(a), just like any insurance company with more than \$2.2 million of premiums (more than \$1.2 million in premiums in 2016 or before)

# PATH Act of 2015, *cont*

## Must meet one of two:

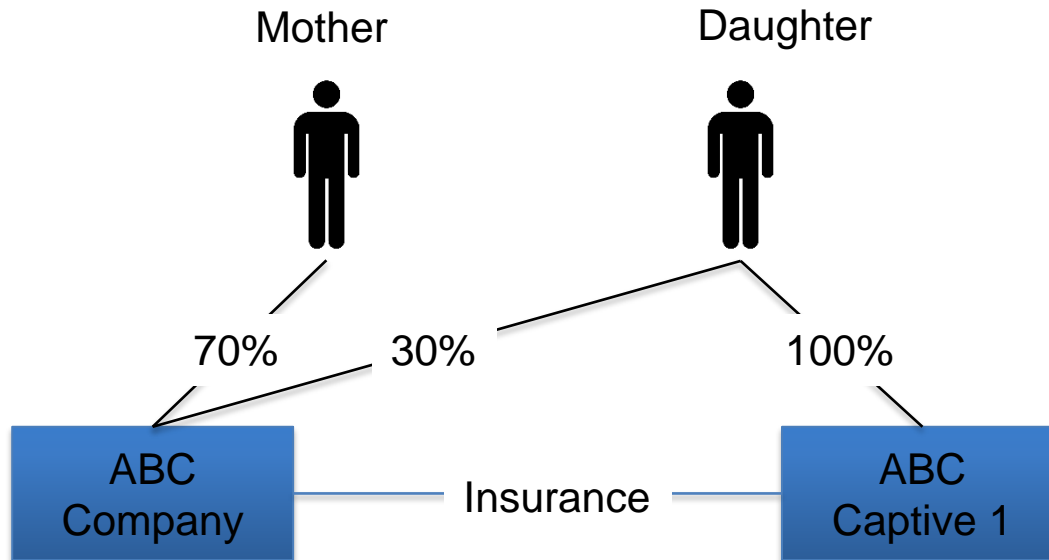
**Test 1:** No more than 20% from any one policy holder

- Premiums are the greater of net written or direct premiums
- Related insureds are treated as one policy holder

**Test 2:** The spouse and lineal descendants cannot own more in the insurance company than the operating entity

- Examples are provided below
- There is a 2% de minimus tolerance for different ownership, which the IRS is authorized to change

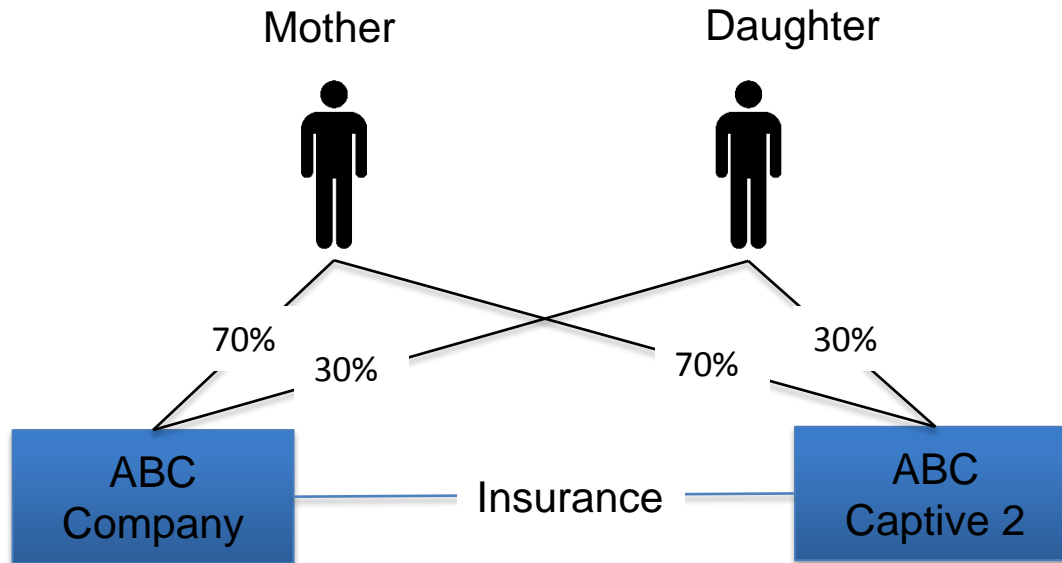
# Captive 1



Because Daughter owns more in Captive\* [100%] than she owns in Business [30%], Captive 1 is not eligible to make an election under section 831(b)

\* subject to the 2% de minimus rule

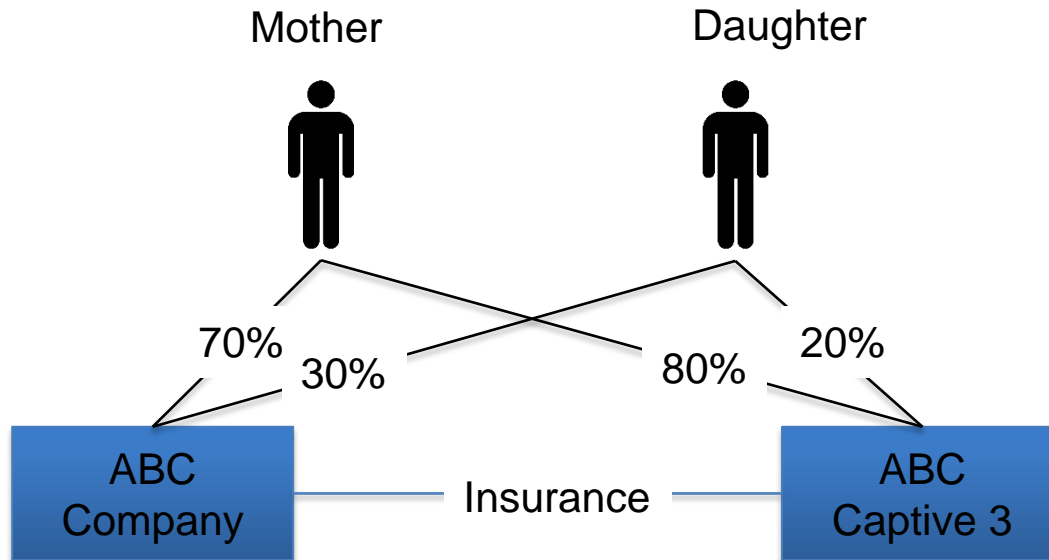
# Captive 2



Because Daughter owns no more in Captive\* [30%] than she owns in Business [30%], Captive 2 is eligible to make an election under section 831(b)

\* would also be subject to the 2% de minimus rule, if needed

# Captive 3



Because Daughter owns no more in Captive\* [20%] than she owns in Business [30%], Captive 3 is eligible to make an election under section 831(b)

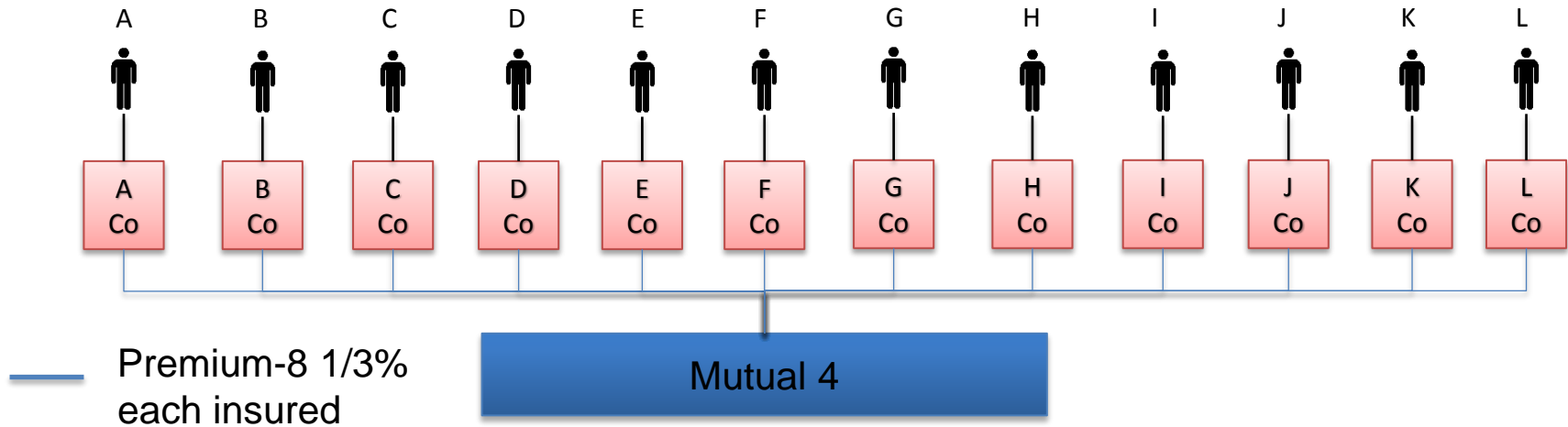
\* would also be subject to the 2% de minimus rule, if needed



# Summary of Examples

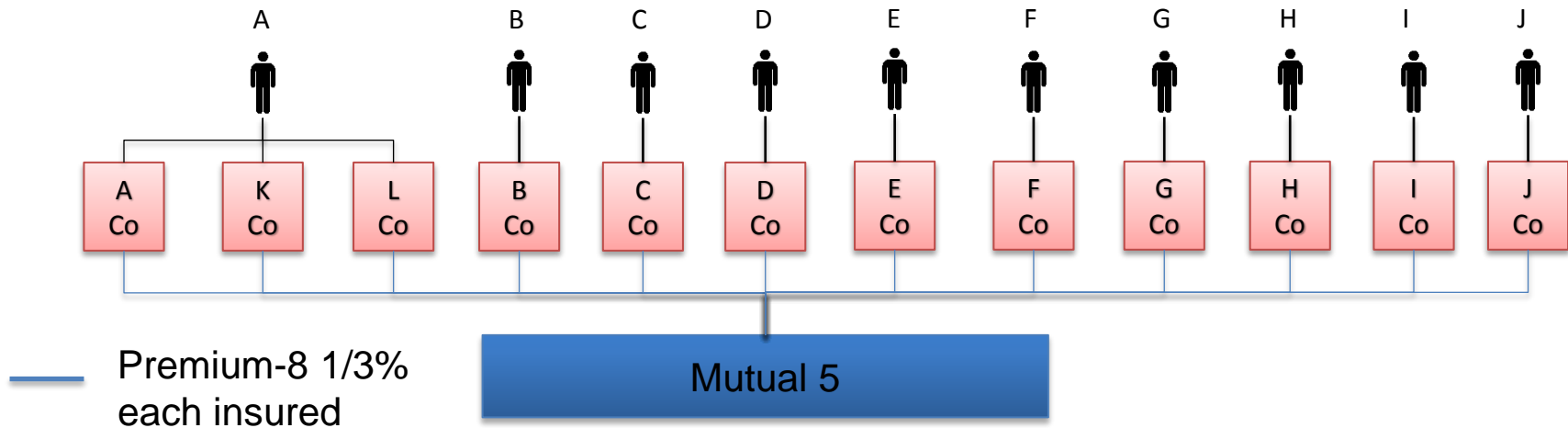
Owner	Business %age Owned	Captive %age Owned	Eligible for 831(b) Election
	Captive 1		No
Mother	70%		
Daughter	30%	100%	
	Captive 2		Yes
Mother	70%	70%	
Daughter	30%	30%	
	Captive 3		Yes
Mother	70%	80%	
Daughter	30%	20%	

# Mutual 4



12 corporations (A Co., B Co., C Co., etc.) insure with a mutual insurance company. A owns A Co., B owns B Co., etc. A through L are unrelated. Each of the insureds pays 8-1/3% of the premiums. The mutual would meet the 20% diversity test because no policy holder pays more than 20% of the premiums.

# Mutual 5



12 corporations insure with a mutual. A owns A Co., B owns B Co., etc. though J owns J Co. In addition to A Co., A also owns K Co. and L Co. Each of the insureds pays 8-1/3% of the premiums. The mutual would not meet the 20% diversity test because A Co., K Co. and L Co. are treated as one policy holder that pays more than 20% of the total premiums.

# PATH Act Open Questions

- The three goals of the amendments are narrow; they do not go into effect until 2017
- Over the next year there may be interpretations by the IRS and people will read the statute in light of specific fact situations
- For instance, if 20 equal insureds insure with a commercial front, which reinsures with a group captive, is that one policy holder or twenty 5% policy holders
- How does the “relatedness” apply where the next generation owns differing amounts in the operating entities ?

# Tax Tests

- Non-Tax Business Purpose
- Insurance Risk
- Common Notions of Insurance
- Risk Shifting
- Risk Distribution

# Insurance Risks - RVI Guaranty Ltd

- The Tax Court decided RVI Guaranty Ltd in favor of the taxpayer
- RVI is a commercial insurance company that insures the difference between the actual value of assets at the end of leases compared to their projected value;
- For instance, a car dealer may lease 10,000 vehicles with projected return value of \$7,000, and insure the difference between actual value and \$5,000
- The Tax Court found that the risks involved were insurance risks
- The Tax Court was influenced by the fact that these were regulated insurance policies offered by multiple companies
- The IRS did not appeal the decision

# Other Insurance Risks

- The IRS informally ruled that insurance of foreign exchange losses is not an insurance risk
- The Tax Exempt Group ruled that numerous non-traditional coverages are not insurance risks

# Rent-A-Center

- Rent-A-Center established a captive insurance company to insure its operation in subsidiaries
- One of the subsidiaries had 2/3 of all the risks
- The brokers could not get comparable coverage in the commercial market



# Rent-A-Center

- There were several potentially sub-optimal facts:
  - A guaranty
  - Coverage was written before the entity was licensed
  - The captive bought treasury stock of the parent
  - Offset of premiums and losses
  - Premium allocation could not be replicated
- The taxpayer won in a divided Tax Court (10-6)
- The Court found risk distribution where there were 15,000 employees, 7,000 vehicles and 3,000 stores
- It did not focus on the concentration of risk in one subsidiary/insured

# Securitas

- Another Tax Court case in which there was a large concentration of risks in one or a few subsidiaries
- Again, the Court seemed more influenced by the number of exposure units (100,000 employees and 2,240 vehicles) than the concentration of risk or the number of subsidiaries
- Like Rent-A-Center, there was a guaranty and the offset of premiums and losses
- Tax Court found this to be a valid insurance arrangement

# Securitas

- The Court found that the arrangement was insurance in its commonly accepted sense because:
- The captives were organized, operated and regulated like insurance companies
- They were adequately capitalized
- The policies were valid and binding
- The premiums were reasonable
- The premiums and losses were paid (some by offset)

# Post Rent-A-Center and Securitas

- The IRS did not appeal either Rent-A-Center or Securitas
- It has not issued an “Action on Decision” or otherwise explained its views of these cases
- The Revenue Rulings focusing on concentration of risk in one insured remain outstanding
- It is unknown if the IRS will ultimately focus more on number of exposure units, and what collateral effects that will have on those relying on number of entities

# Post Rent-A-Center and Securitas

- If number of exposure units becomes the test, then how many exposure units are needed
- There will be questions as to what constitutes an exposure unit
- Regardless of whether exposure units, number of entities, or other becomes the ultimate test, it would still be good to avoid the potentially sub-optimal facts such as guarantees, treasury stock purchases, other illiquid investments, etc.

# Acuity v IRS

- Case another in a long line indicating that reserves determined by an actuary and recorded by the insurance company will be determined to be fair and reasonable

# Validus v United States

- There is an excise tax imposed on the insurance (generally 4%) or reinsurance (1%) of U.S. risks by a foreign insurance company
  - The IRS believed that if a foreign insurer reinsured U. S. risks to another foreign insurer, that a 1% “cascading” excise tax is due on the reinsurance of U. S. risks
  - District Court: no tax on retrocession
  - Court of Appeals: no tax on reinsurance between two foreign insurance companies
  - Revenue Ruling 2016-03

# IRS Business Plan (Priority Guidance)

- The IRS publishes its Priority Guidance Plan annually; this is the IRS' Business Plan listing projects it hopes to work on during the year
  - Finalization of the cell/series regulations
    - Apply to domestic cells and series LLCs; it only applies to foreign cells engaged in insurance
    - Each cell or series is its own separate entity with its own EIN, tax returns and elections
  - “Guidance with respect to captive insurance”
    - No topics or other details provided



# IRS Scrutiny

- The IRS is auditing a substantial number of captives electing to be taxed under section 831(b)
- Tax Shelter Promoter Investigations:
  - One or more captive managers are being investigated to determine if they are tax shelter promoters
- Just because the IRS is investigating an issue or conducting an audit does not mean that there is wrongdoing
- No results announced yet from the investigations

# Audits of Captives Electing Section 831(b)

- Comprehensive information document requests:
  - Information from the inception of the captive, even if it preceded the years under audit
  - All emails, marketing materials, etc.
  - Questions on how one got involved in the captive and who the taxpayer consulted
  - What commercial insurance was in place, what are the gaps and exclusions, how the captive program fit

# Audits of Captives Electing Section 831(b), *cont.*

- Comprehensive Information Document Requests (cont):
  - What is the operating company's risk management program
  - How were the premiums priced
  - For the ten years prior to its inception, were there any losses that would have been covered by the captive program had it been in place
  - What is the loss experience of the related party and pool insurance
  - What are the investments of the captive

# IRS Scrutiny: The Dirty Dozen

In 2015 and 2016, the IRS identified Tax Shelters as one of its “Dirty Dozen.” For the first time, captives electing section 831(b) were linked to tax shelters.

- *“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.”*
- *“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.”*

# Avrahami v Commissioner

- **Avrahami v Commissioner is the first case involving a captive electing to be taxed under section 831(b)**
  - The briefs have been filed; an opinion is expected in 2016 or 2017
- **The IRS is arguing that the contracts did not have “insurance risk” but rather investment or business risk.**
  - The IRS does not believe that economic substance is present in the captive insurance arrangement and thinks that the arrangement appears to be tax motivated.
  - The captive also participated in a pool that insured against terrorism, primarily against terrorism risks not available in the commercial market.
- Caylor case was tried in May 2016

# Questions?

