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# Current Tax Issues with Captive Insurance Companies

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Large U.S. companies have been forming captive insurance companies (wholly owned insurance subsidiaries) since the 1950s. In general, such large captives are formed for one of three main reasons. First, some companies are unable to obtain necessary insurance coverage. For example, certain nuclear power companies formed a captive named Nuclear Electric Insurance Limited, because they could find no other insurance coverage. Second, some companies seek to obtain cheaper insurance. For example, the trucking market is currently "hardening" (premiums are increasing), leading to trucking companies forming captives. Third, some companies seek to gain more control over their current insurance program.

The insurance code offers a small insurance company a strategic advantage: Internal Revenue Code (IRC) § 831(b) allows insurance companies with less than $1.2 million in premiums to be taxed on their investment earnings rather than on their gross income. As a simple example, suppose a small insurance company had $500,000 in income but earned 5 percent on its total portfolio earning $25,000 for the year. The company would use the $25,000 figure as their gross income figure for the year.

A captive can also be formed offshore and still be deemed a U.S.

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captive, provided it makes an IRC § 953(d) election agreeing to be taxed as a domestic company. For many large captives, forming offshore may provide a great deal of flexibility not found onshore. However, it should be noted that the Internal Revenue Service (IRS) is currently spending a great deal of time focused on offshore tax enforcement. Recently, the IRS refused to issue a positive private letter ruling to a number of foreign captives seeking 831(b) status, which may be an indication of tougher IRS scrutiny in this area. Thus, while a compliant captive should ultimately have nothing to fear from operating internationally, there is at least some chance that doing so may result in some additional compliance costs if it gets caught up in the IRS dragnet.

This article will: (1) provide a brief history of captive insurance companies; (2) outline key requirements for captive insurance including insurance risks, risk shifting, risk distribution, and reinsurance; and (3) discuss certain IRS enforcement areas in captives, including excessive premiums and IRC § 831(b) tax shelter issues.

**A Short History of Captive Insurance Companies**

The IRS defines a captive insurance company as a "wholly owned insurance subsidiary." According to the case law of that time, companies started forming captives in the 1950s because they couldn't find insurance, could only find very expensive insurance, or simply decided that forming their own insurance company made more sense. The taxpayers in both *United States v. Weber Paper Co.*, 320 F.2d 199 (8th Cir. Mo. 1963) and *Consumer's Oil Corp. of Trenton, NJ v. United States*, 188 F. Supp. 796 (NJ 1960) owned property for which they could not procure flood insurance, leading both to form an insurance company. While the taxpayer in *Beech Aircraft Corp. v. United States*, 797 F.2d 920 (10th Cir. Kan. 1986) did have an insurance policy, its carrier had complete control of its attorneys during litigation. When Beech was sued under a products liability claim in the early 1970s, it filed a motion to remove its insurer-appointed counsel several weeks before trial. The court denied this motion and Beech lost the case. Subsequently, Beech formed a captive to write its own insurance policy. Other cases provide similar examples.

The IRS was concerned by the rise of captive insurance for two inter-related reasons. Their first concern was that the "captive insurer" was in fact a reserve account, defined as "an estimate of

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a definite liability of indefinite or uncertain amount." While there is a certain amount of conceptual overlap between a reserve account and insurance (in both, a party is attempting to financially prepare for an anticipated contingency), contributions to a reserve account are non-deductible while premium payments are deductible. This leads to the IRS' second concern – the rather uncertain nature of the legal definition of insurance. While the Supreme Court in *Helvering v. Le Gierse,* 312 U.S. 531 (U.S. 1941) defined insurance in 1943 as being comprised of both risk shifting and risk distribution, it provided no further guidance for either term. Hence, the IRS could legitimately argue that the captive insurance company was not in fact a bona fide insurance company but instead a reserve account, allowing the IRS to deny the deduction claimed by the parent company for the premium paid to the captive.

Captive litigation can be broken down into pre- and post-*Humana v. Commissioner*, 88 T.C. 197 (1987). From the late 1970s to the late 1980s (pre-*Humana*) the IRS won a majority of their cases due to better preparation, weak taxpayer defenses, and a judiciary unaccustomed to dealing with the technical requirements of insurance. The *Humana* decision changed this, as the structure was well set-up and expertly defended and explained by counsel, leading to a partial taxpayer victory. Between *Humana* in the late 1980s and *United Parcel Service of America v. Commissioner*, 254 F.3d 1014 (11th Circuit 2001) in the early 2000s, the IRS lost most of its cases as taxpayers established better structures, these structures were better defended, and several states passed captive insurance-enabling legislation. The death knell for this initial wave of IRS captive litigation was the *UPS* decision, which the IRS won at trial based on an assignment of income argument, but which the appeals court disagreed with in a tersely worded decision, in which it reversed the tax court's ruling and remanded for further action. Following the *UPS* case, the IRS largely ended its initial quest of litigating to prove the invalidity of captive insurance.

**Insurance Risks, Risk Shifting, and Risk Distribution**

Counsel interested in recommending a captive to a client needs to be aware of several basic concepts, the first of which is derived from *The Harper Group v. Commiss'r*, 96 T.C. 45, 47 (1991), which states that all captives must comply with the following three factors: (1) the arrangement involves the existence of an "insurance risk"; (2) there is both risk shifting and risk

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distribution; and (3) the arrangement is for "insurance" in its commonly accepted sense. Points one and three can be reworded to simply say all captives must function as insurance companies; the insured must demonstrate it will be materially harmed (usually through financial loss derived from an ownership interest), and that the harm is "fortuitous" – one which is random and cannot be prevented.

Risk shifting and risk distribution are a bit more complicated. Risk shifting is seen from the insured's perspective and requires the risk of loss to "shift" from the insured to a third party. This is accomplished via an insurance policy (whose formation and terms are interpreted under basic contract law principles). Risk distribution is seen from the insurer's perspective, and requires the insurer to pool risk from a sufficient number of resources such that losses smooth out over time. Non-compliance with either of these factors comprised the "economic family argument," the IRS' primary anti-captive weapon.

**Reinsurance or Safe Harbor IRS Revenue Rulings**

One of the largest benefits of a captive is the ability to access the reinsurance market. Reinsurance is often called "insurance for insurance companies" as it allows insurers to spread out the risk of their own portfolios. For example, suppose an insurer was exposed to $5 million of potential claims for the year. The insurer could purchase reinsurance, thereby lowering its risk exposure. In our example, the insurer could purchase reinsurance that covered risks of about $2,000,000. Therefore, if the parent company had losses over $2,000,000, the reinsurer would be liable.

The IRS has provided two safe harbors for captive insurance companies that decide not to use traditional reinsurance. All captives that wish to take advantage of a safe harbor must comply with one of two fact patterns outlined in specific IRS Revenue Rulings. In Rev. Rul. 2002-89, the captive insurer must derive at least 50 percent of its revenue and risk from a non-parent. For smaller captives, this is usually accomplished through the use of "risk pools" wherein a group of captives shares a portion of their risk with other captives, usually managed by the same captive management company. Participation is usually accomplished through a quota treaty retrocessional reinsurance arrangement. In Rev. Rul. 2002-90, a captive must underwrite risk for at least 12 different subsidiaries, with none comprising less that 5 percent nor more than 15 percent of the total risk

underwritten by the captives.

**Excessive Premiums**

One area that is currently being litigated by the IRS is excessive premium payments beyond what is reasonable for the claimed insurance risks. The IRS has a few cases in the U.S. Tax Court pipeline that address this issue, so it would not be unexpected that more such cases will follow. The IRS is concerned with transactions in which the tax deduction claimed is actually the reason for the existence of the policy. Treasury Regulation § 1.801-3(a) provides that an insurance company is "a company whose primary and predominant business activity . . . is the issuing of insurance or annuity contracts, or the reinsuring of risks underwritten by insurance companies." When the captive charges commercially unreasonable or non-arm's length premiums, it may not be treated as bona fide insurance company. Thus, if the true purpose of an insurance company is to provide tax deductions, then the company may not qualify as an "insurance company" under the IRC.

In the area of small captives, the existence of a $1.2 million maximum premium payment makes this type of analysis particularly relevant. The IRS requires that a captive operate as an actual insurance company in order for it to receive the economic benefit allowed under IRC § 831(b). It is important to remember that the $1.2 million can purchase a large amount of commercial insurance, so any small captive claiming policy premiums of that size may come under IRS scrutiny unless it has a very significant amount of provable potential claims.

**IRC § 831(b) Tax Shelter Issues**

The IRS is aware of certain questionable tax shelter practices in the captive world, especially in connection with small IRC § 831(b) captive insurance companies. While these arrangements are certainly a minority of the larger pool of compliant captives, it is worth noting some of the more prevalent IRS tax shelter issues here.

Some IRC § 831(b) captive policies insure risks that are unrealistic with respect to the insured business. Specifically, certain insurance risk pools centered on terrorism are currently attracting increased IRS attention. The concern arises here because so few businesses may actually have the need for insuring against a terrorist act, making this coverage appear to be too remote to be justified for most insureds. While there are

certainly business operations that involve terrorism risk, there are also many businesses that do not have this risk.

The IRS has also become aware of the use of life insurance in IRC § 831(b) captives as a pre-ordained investment. Since life insurance is not generally a deductible business expense, the concern here is that the IRS may see a pre-planned use of an IRC § 831(b) captive as a conduit for life insurance as both undermining the business purpose of the captive, as well as a device for taking a deduction that the business could not otherwise take directly. The judicial doctrines and codified economic substance doctrine could be applicable here.

Since an IRC § 831(b) captive may result in the deferral of realization of ordinary income, over a long period of time, this type of captive may accumulate a very large amount of retained resources. Because a captive is taxed as a C corporation, this type of large reserve could be subject to the Accumulated Earnings Tax (AET). The AET is a 15 percent penalty tax designed to prevent corporations from unreasonably retaining after-tax earnings and profits in lieu of paying current dividends to shareholders. Accumulated taxable income is reduced by a credit for an accumulation amount sufficient to satisfy reasonable current and future anticipated business needs.

**Conclusion**

Captive insurance companies have been around since the 1950s and are currently a popular alternative vehicle for insuring risks associated with businesses. There are several key requirements that must be met for captive insurance to be deemed proper by the IRS. These include insuring real risks, shifting the risk from the insured business to the insuring captive, and the captive distributing the shifted risk among several other captive insurance companies. The IRS has raised specific tax issues that are currently the subject of IRS enforcement actions. These include the payment of excessive insurance premiums, as well as several IRC § 831(b) tax shelter issues. Overall, captive insurance may be an excellent insurance option for midsize and large businesses, provided that the professionals structuring the arrangements comply with IRS requirements in connection with the formation and maintenance of the captive insurance company.

**Additional Resources**

*For other materials on this topic, please refer to the following.*

Beckett G. Cantley, *Repeat as Necessary: Historical IRS Policy Weapons to Combat Conduit Captive Insurance Company Deductible Purchases of Life Insurance*, 13 UC Davis Bus. L.J. 29 (2012). Available at SSRN: http://ssrn.com/abstract=2315868.

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