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In this article, the authors describe their view on the content of the IRS "Dirty Dozen" listing and discuss several administrative guideposts.

Ever since the IRS included some captive insurance transactions on the 2015 "Dirty Dozen" list of tax scams,[1] practitioners in the micro-captive area of law have been trying to answer one question: What is the difference between a compliant and a noncompliant structure? They have found no recent precedential-level authority to guide them. Although some in the industry have argued that the recent *Securitas*[2] and *Rent-A-Center*[3] decisions are controlling, these cases only apply to bigger companies with a large geographic footprint.[4] Guidance, however, does exist for smaller captives, with several recent chief counsel memoranda shedding light on fact patterns that have concerned the IRS. While not controlling, they provide meaningful insight into the Service's thinking. This article first describes our view on the content of the Dirty Dozen listing, and second, discusses several of the above-referenced administrative guideposts.

The Dirty Dozen Listing

Section 831(b) captive insurance companies earned the unenviable distinction of being placed on the 2015 Dirty Dozen list of questionable tax transactions. Advisers and clients should be given pause by the use of words like "prosecute" and "scams" in the Dirty Dozen notices. This language is a clear signal from the IRS that the inclusion of section 831(b) captives on its list should not be taken lightly. Notably, other 2015 Dirty Dozen transactions include identity theft and false promises of "free money" from inflated refunds. This is the kind of company even a risk-tolerant client or adviser should be wary to keep.

Of course, a garden-variety section 831(b) captive insurance company, done correctly, is an entirely permissible transaction. The Dirty Dozen list makes this clear. The section 831(b) arrangements apparently targeted by the IRS take the allowable captive framework and add one (or more) of the four negative attributes described below.

The first section 831(b) transactions described by the Dirty Dozen list are those involving poorly drafted policies covering ordinary business risks, or overpriced policies covering esoteric or implausible risks, while the insured maintains its economical commercial coverage through traditional insurers. Clearly, the IRS is concerned by the use of section 831(b) captives to provide coverage either for risks commonly (and inexpensively) covered by mainstream carriers, or for risks that are very unlikely to occur, at what it deems highly inflated premiums. As tempting as it may be to view this solely as a pricing issue, the IRS appears to be laying the groundwork for an argument that the intent of the insurance coverage was to generate large deductions without any claim incidence, rather than to insure actual risks.

Second, the IRS targets transactions in which annual premiums often approximate the amount of deductions businesses require to offset income for the year, or (in the case of a wealthy entity) total annual premiums amount to $1.2 million, to reap the full benefit of the section 831(b) election. This is a manifestation of IRS concern that premiums are being structured by promoters to maximize client tax deductions, rather than representing the actual business expense paid for needed insurance coverage.

The third negative factor described in the Dirty Dozen list that may call into question the validity of a section 831(b) captive is insufficient (or absent) underwriting and actuarial substantiation for the insurance premiums paid. This factor may, at first blush, seem to be a symptom of the larger afflictions listed above. However, it is reasonable that the IRS

[1]IR-2015-19.

[2]*Securitas Holdings Inc. v. Commissioner*, T.C. Memo. 2014-225.

[3]*Rent-A-Center Inc. v. Commissioner*, 142 T.C. No. 1 (2014).

[4]F. Hale Stewart and Beckett G. Cantley, "IRS Loses Captive Insurance Case on Good Taxpayer Facts," *Tax Notes*, Nov. 17, 2014, p. 827 ("However, when it gets to the small business sector, the *Rent-A-Center* and *Securitas* precedent will not be of much assistance.").

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could find that a failure to properly substantiate the insurance premiums paid undermines the taxpayer's good faith in taking the premium deduction. In other words, absent a thorough professional assessment of the relationship between premium and risk, the entire premium deduction is questionable. If a taxpayer is not sophisticated enough to ascertain the adequacy of the actuary's work, knowledge of its insufficiency could easily be imputed to the taxpayer's advisers.

Finally, the Dirty Dozen list also alleges that promoters assist unsophisticated taxpayers in continuing the "charade" by charging "hefty" annual fees to manage the captive insurance companies. This statement places promoters squarely in the Service's sights. The IRS is cautioning unsophisticated taxpayers against working with promoters on section 831(b) captives containing any of the dubious aspects described above. At the same time, the IRS is signaling to promoters that it considers them to be administering a fraud in exchange for excessive fees. When the IRS provides such a warning, promoters should not dismiss it as bluster.

Risks Within Taxpayer Control

The taxpayer in a recent legal memorandum[5] formed a captive insurance company to underwrite several risks, including exposure to currency fluctuations. The captive underwrote two policies for this risk. The first covered losses caused by a decrease in the currency's value. Premiums for this policy were calculated by multiplying the "premium," which was derived from the forward currency markets, by a "policy limit," which was based on previous annual sales. The purpose of this coverage was clearly to cover the loss in revenue directly attributable to currency losses. The second policy covered losses caused by an increase in the underlying currency. Premiums were determined by multiplying a "premium amount" against a policy limit. Like the other policy, this premium amount was derived from the forward currency market. However, the policy limit was derived from the company's total debt outstanding.

The legal memorandum focused exclusively on developing the rationale for denying the deductions for both currency policies. The IRS first noted that insurance mitigated solely against a "fortuitous" risk, which, according to *Black's Law Dictionary,* is "a happening that, because it occurs only by chance or accident, the parties could not reasonably have foreseen."[6] The IRS next stated that defining a fortuitous event required answering the following questions:

1. What are the ordinary activities of a business enterprise?

2. What are the typical activities and obligations of running a business?

3. Is the action that might be covered by a policy in the control of the insured within a business context?

4. Is the economic risk involved a market risk that is part of the business environment?

5. Is the insured required by a law or regulation to pay for the covered claim?

6. Is the action in question willful or inevitable?

While the legal memorandum offered no analysis based on the preceding questions, the context of the questions strongly suggests that insurance is unavailable for events that the insured could reasonably control or that normally occur in day-to-day business operations. In the memorandum, the losses caused by currency fluctuations are within the normal operations of a U.S. business that sells goods or services overseas. This means the risk cannot be covered by an ordinary insurance policy, which was the memorandum's conclusion.

Attributes of a Bona Fide Captive Arrangement

In another legal memorandum,[7] a parent and its single-member limited liability company subsidiaries provided clients with several professional services including workers' compensation. The parent obtained this coverage from a mainline insurer but purchased a high-deductible policy to lower the cost. It then formed a captive insurance company to issue a "deductible reimbursement policy" that indemnifies the parent for expenses resulting from the higher deductible.

The legal memorandum offers six factors[8] the IRS will consider in its analysis of the transaction, beginning with whether the captive is regulated by the

[5]ILM 201511021.

[6]*Black's Law Dictionary* 725 (2009); *see also* 7 Couch on Ins. section 102:7 ("Implicit in the concept of insurance is that the loss occur as a result of an event that is fortuitous rather than planned, intended, or anticipated. This principle is involved in the liability insurance requirements of an accident, occurrence, or the like, as well as in the rules prohibiting property insurance recovery for an insured who sets fire to the insured property and life insurance recovery on the part of a beneficiary who intentionally kills the insured.").

[7]ILM 201503011.

[8]*Harper Group v. Commissioner*, 96 T.C. 45, 58 (T.C. 1991). (These factors are similar to the three-prong *Harper* test: (1)

(Footnote continued on next page.)

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state as an insurance company. Each state with captive-enabling legislation has specific regulations that include a well-articulated formation process, capital and annual reporting requirements, and general investment guidelines. Only after being 100 percent compliant does the insurance commissioner grant the captive the legal privilege of underwriting parental risks. This factor assumes that strict observance of existing law is a somewhat validating process.

The second factor to be considered is whether the particular arrangement qualifies as insurance under state law. Insurance has five legal elements: a definable risk, fortuity, an insurable interest, risk-shifting, and risk distribution. All five must be present for insurance to exist.

The third factor is whether the captive is adequately capitalized. All U.S. jurisdictions have minimum capital requirements. Depending on the state, single-parent captives must have a minimum of $200,000 to $250,000 in capital. Naturally, group captive limits are higher. Problems can emerge, however, in locating offshore, where some locations have minimum capital levels as low as $10,000.

The fourth factor is whether the premium is set under customary insurance industry rating formulas. Some premium pricing is already available from services such as Insurance Services Office. Most captives, however, use an independent actuary. State regulators verify the validity of these conclusions with their own actuary.

The fifth factor is whether the parent cannot expressly guarantee the captive's obligations. This requirement references *Carnation*, in which a parental guarantee was fatal to the captive arrangement. While two recent cases that included a parental guarantee were ruled as valid insurance companies, the parent companies in both had national reach. This distinguishes them from smaller section 831(b) micro-captives.

The sixth factor is whether the documentation underlying the arrangement supports characterization of the arrangement as providing income and deductions for the taxpayer. A typical captive transaction has numerous documents: a feasibility study, insurance policies, an actuarial report, corporate documents, and annual reports. At a minimum, all documents must be present in the record.

The legal memorandum does not say this list is exhaustive, but it is illustrative of the questions the IRS will ask to determine the transaction's validity. Curiously absent is any discussion of risk distribution, which requires all insurance companies to contain a sufficient amount of third-party risk.

Additional Risk Distribution Considerations

A third set of obviously related memoranda,[9] however, develops the risk distribution requirement. Although the insurance companies were different in every memorandum, each transaction involved the same reinsurance program. To adequately distribute risk,[10] all captives sent a "large percentage" of their risk to a reinsurance pool, which sent an equal amount of premiums and risk back to each captive.[11] For example, the reinsurance policies contained language providing for experience refunds and experience loss carryforwards, which were to be paid back with interest. The IRS could not determine whether the captive in each memorandum was a valid insurance company for tax purposes. Regarding the reinsurance contracts, the IRS uniformly stated: "In particular, we were concerned that the reinsurance agreements between Company and the Pool contained provisions whose net effect might be to negate risk shifting and risk distribution."

The return of the reinsurance premium obviously created an insurmountable problem for this structure, although the feature is noncontroversial when done properly. For example, suppose a policyholder pays a $10,000 premium and files no claims. After the policy expires, the insurance company returns $1,000 to the policyholder, rewarding him for being a "good risk." This is appropriate and can be seen as a justifiable economic incentive. However, assuming the same set of facts, suppose the pool returns the entire $10,000 with interest. In that case, the IRS has a strong argument that the reinsurance premium was in fact a loan to the reinsurance pool.

Conclusion

While the listing of some section 831(b) captive insurance arrangements on the Dirty Dozen list is a serious enforcement action, there are several fundamental attributes of a captive that, if followed, could vastly reduce the chance that a particular captive runs afoul of the IRS restrictions. Many of these attributes are in a series of administrative

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whether the arrangement involves the existence of an "insurance risk"; (2) whether there was both risk shifting and risk distribution; and (3) whether the arrangement was for "insurance" in its commonly accepted sense.)

[9]ILM 201350008, ILM 201350009, and ILM 201350010; and ILM 201350026, ILM 201350027, ILM 201350028, ILM 201350029, ILM 201350030, and ILM 201350031.

[10]Under federal law, all insurance companies must pool premiums from a sufficiently diverse pool of risk to be considered an insurance company for tax purposes. Smaller captives meet this requirement by participating in "risk pools" in which they send a percentage of their risk to a pool that sends risk back to the captive. When the same pool receives risk from a sufficient number of captives, it creates "distribution."

[11]LTR 200950017 (highlighting this particular method of achieving risk distribution).

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announcements that provide specific guidance on the matter. Although these administrative rulings lack the force of precedent, they do telegraph the Service's thinking on where the lines are drawn.

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