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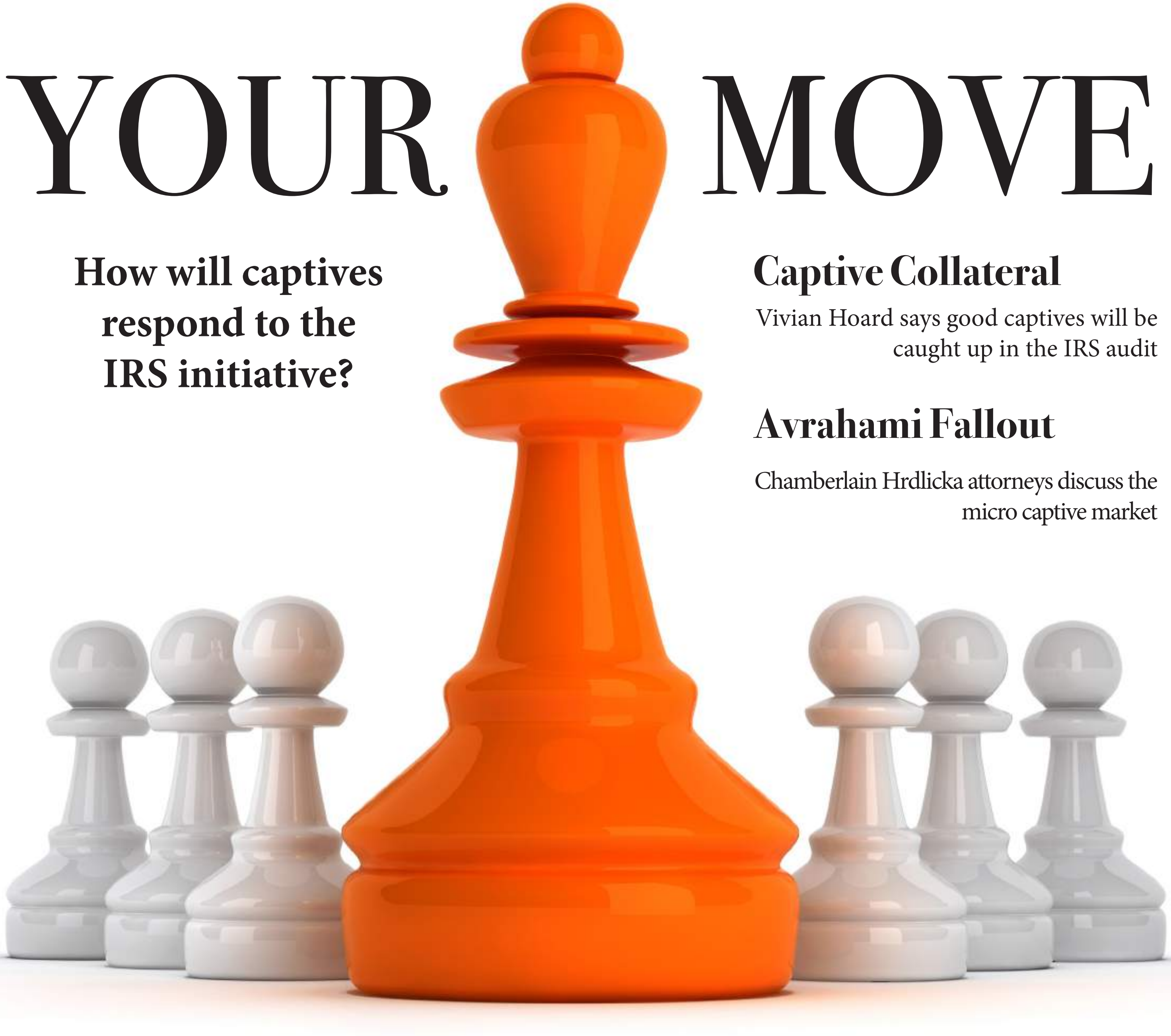
YOUR MOVE



How will captives respond to the IRS initiative?

Captive Collateral

Vivian Hoard says good captives will be caught up in the IRS audit

Avrahami Fallout

Chamberlain Hrdlicka attorneys discuss the micro captive market

TO SELF-INSURE OR NOT TO SELF-INSURE?

That is the question

Philip Karter, Scot Kirkpatrick and Christopher Steele, attorneys at Chamberlain Hrdlicka, discuss the landscape of the micro captive market and whether the IRS doth protest too much

In the wake of the Protecting Americans from Tax Hikes (PATH) Act changes to section 831(b), Notice 2016-66 and the Avrahami decision, we must ask whether 'tis nobler to suffer the slings and arrows of a possible IRS attack or to take arms against a sea of troubles with micro captives and by opposing, end them? While some may be tempted to avoid the "natural shocks that [micro captives are] heir to", business owners who are committed to forming and operating them correctly should not be dissuaded.

Risk management is essential to the health of any business and Congress has encouraged it by incentivising businesses to form captive insurance companies. For micro businesses, Congress has created an additional incentive under section 831(b) of the tax code, which allows their associated captive insurers to exclude premium income from tax altogether, up to a specified annual dollar limit of $2.3 million in 2018.

But the picture is not entirely rosy. Although most captives are formed for valid businesses reasons and operated as true insurance companies, the significant tax exemption available to micro captives has prompted the IRS for a number of years to attack a broad range of micro captives as abusive tax-motivated transactions. Many tax practitioners consider the IRS's attack overbroad and coercive with insufficient attention paid by auditors to distinguishing legitimate arrangements from others that are poorly conceived, formed and operated.

Despite its heavy-handed approach to casting a wide audit net for micro captives and their insureds, the IRS did have legitimate concerns that section 831(b) provided insufficient protections from taxpayer abuse by generating tax deductions for unnecessary insurance while transferring wealth between business owners' family members.

On August 21, 2017, after more than a two-year wait, the US Tax Court, in Avrahami v Commissioner, finally issued the first decision in a case involving a section 831(b) micro captive. Unsurprisingly, the decision went badly for the taxpayers and the deductions claimed for insurance premiums paid to the captive were disallowed; however, no penalties were imposed.

Although the deck may appear stacked against micro captives in light of the continued attack by the IRS and the recent ruling in Avrahami, captives remain a legitimate business arrangement under the code. As long as a micro captive is set up and operated as a true insurance company covering bona-fide insurable business risks, they continue to provide significant risk-mitigation benefits to business owners as well the favorable tax treatment Congress intended by enacting section 831(b). The key to avoiding (or winning) an attack on a micro captive by the IRS is in the details.

Lessons from Avrahami

Despite the adverse outcome, Avrahami can reasonably be described as a bad facts case that represents a cautionary tale for captive planners to do their homework. This includes ensuring that the captive arrangement has, among other things, a solid non-tax business purpose behind the issuance of each policy, commercially reasonable policy terms, defensible risk premiums, appropriate claims review and payment procedures and sufficient liquidity in the captive to actually pay claims should they arise. Further, there must be adequate risk distribution for the arrangement to be respected as insurance.

Before the Avrahami decision, the IRS was already taking a very hard line in micro captive audits, routinely disallowing captive premium deductions and forcing taxpayers to fight it out with appeals or file petitions in tax court. The unfortunate consequence of this hostile environment has been that little effort has been made by auditors to distinguish one section 831(b) case from another. Unsurprisingly, the Avrahami decision has only increased the IRS's hubris in taking hardline positions in audits and even administrative appeals. Unfortunately, this means many taxpayers with legitimate captive insurance arrangements have been caught up in the assault.

Although IRS 'chest-thumping' may increase the trepidation some taxpayers have about utilising micro captives, a company that faces significant insurable business risks should not be deterred from taking the section 831(b) tax election. As other decisions come down from the courts, it will be increasingly apparent that, like every other congressionally authorised tax-advantaged transaction that has been challenged by the IRS over the years, the facts do actually matter.

Avoiding IRS attacks and developing a winning strategy

Taxpayers must approach the use of micro captive insurance companies with a focus on inoculating the captive from a potential attack. Moreover, it is as critical that taxpayers avoid certain 'hot-button' transactions that invite scrutiny.

Proper captive formation and operation:

To qualify as a captive insurance company, the captive must actually provide insurance and have appropriate risk shifting and risk distribution. The concept of what constitutes insurance has long been debated by the courts, but more specific guidelines have now been developed.

As is true with any business planning, a captive must possess a legitimate business reason to avoid being treated by the IRS as a tax-motivated sham transaction. Every business reason for forming a captive should be fully analysed, documented at the outset and reevaluated over time. Insureds that periodically adjust their coverage to align with changing business considerations present better arguments that risk minimisation, not tax, is the primary motivator.

A good rule of thumb is that if the taxpayer cannot think of a good reason why its business needs insurance coverage for a particular risk, it should not simply rely on a third-party advisor recommending coverage for that risk. The goal is not to hit a target number for the total premiums paid to the captive, but rather to insure the risks that need to be mitigated by paying for fairly-priced insurance coverage, whatever its cost may be.

Proper management and operation of a captive is essential to its success. Caution should be exercised to avoid captive managers who set up a captive but do not provide it with any true risk management services, both to insure success of the venture and to avoid problems with the IRS.

Factors to consider:

- Business purpose: Every captive transaction should begin with an assessment of the insurance risks borne by a business not by a tax savings analysis. Similarly, it is best if the recommendation to consider a captive risk management strategy originates with a recommendation from an insurance professional not a tax advisor.

- Avoiding excessive premiums: Under section 162(a), insurance premiums paid by a taxpayer are deductible if they are connected directly with the taxpayer's trade or business and represent an ordinary and necessary business expense.

  Even though insureds may be incentivised to pay higher captive premiums for coverage than they would want to pay a third-party insurer, paying premiums consistently higher than the actual loss claims are an indicator that the taxpayer is primarily tax motivated. Another red flag for the IRS is when a captive is charging premiums in an amount close or equal to the premiums threshold exemption under section 831(b).

- Reliable actuarial method: One of the reasons taxpayers undertake captive insurance is because there is no commercial counterpart to cover such risks. In that case, there is no available pricing data to compare captive premiums to third-party insurance coverage. Consequently, it will be necessary to rely on actuarial forecasts to analyse the taxpayer's loss history and to project the timing and size of future claim payments.

- Loan-backs: A captive that lends money back to an operating business which is insured by the captive is often referred to as a loan-back. A loan-back is used to invest the assets of the captive back into the operating business. The IRS carefully scrutinises loan-backs and has contemplated issuing regulations relating to them. Such an arrangement was present in Avrahami, and the court did not look upon it favorably.

- Retroactive premiums: Policies that cover time periods already expired (for example, retroactive coverage) are highly frowned upon as an indicator that the captive arrangement is not legitimate. Taxpayers are well advised to avoid retroactive coverage, particularly in the absence of a strong and consistent claims history.

- Exotic coverages: Much has been written in Avrahami and elsewhere about the issuance of captive coverage in the event of terrorism, although the IRS's criticisms of exotic coverages are not limited to that. It simply bears repeating that the coverage should match the business.

- Standard coverages: The micro captive exemption is specifically devised from a tax inducement perspective to insure 'low frequency, high severity' types of risk. These risks (for example, earthquake, flood, crop, hurricane, even loss of key customers, supplies or an employee) do not occur often, but when a loss occurs, it is usually devastating. To address this concern, Congress wanted to encourage the accumulation of capital unreduced by taxation for these infrequent, but potentially disastrous occurrences, which can be fatal to a business. The IRS has argued the infrequency of claims is evidence of a sham. Given the IRS's position, a taxpayer would be prudent to mix lower severity and higher frequency risks into the captive coverage such as a high deductible workers compensation plan, a portion of the self-insured retention in a commercial liability insurance policy, or even medical stop loss coverage. These coverages are very likely to generate some claims every year which may dissuade the IRS from attacking.

- To elect or not to elect section 831(b) status: The election of section 831(b) should not be automatic. Rather consideration should first be given to the type of coverages needed and then an analysis should be prepared to determine whether it is advisable. It may be that treating the captive as a large captive under the normal rules of section 831(a) is most appropriate, particularly if the coverage needs are substantial. Moreover, starting out as a section 831(a) micro captive does not preclude a section 831(b) election in future years if appropriate.

Preparing a captive for a fight

Beyond the proper formation and operation of a captive, there are a number of key factors the IRS will invariably focus on when auditing small captive arrangements with a predisposition toward disregarding them.

By taking these factors into consideration during the planning, formation and operational stages of the captive's lifespan, and consistently reevaluating them to take into account changing business and risk circumstances, taxpayers will be far better prepared to successfully withstand an IRS challenge.

- Is there a documented business purpose for the formation and operation of the captive?
- Does the captive have a defensible feasibility study and business plan?
- Is the captive adequately capitalised?
- Are the insurance coverages written by the captive legitimate and consistent with the needs of the business?
- Is the policy language commercially reasonable and does it actually provide coverage for the risks insured?
- Are the coverages standard or would they be considered exotic in nature?
- Is there valid and documented support for the pricing of premiums each year?
- Are actual (and meaningful) claims being made against the captive policies? If so, are those claims being paid by the captive?
- Are the captive reserves being invested to ensure liquidity in the event of significant claims?
- Are distributions being made from the captive? If so, do they appear to reflect a circular flow of cash?
- Are there any loan backs by the captive?
- Are premiums written prospectively or retroactively?

Conclusion

Although the past three years have caused many taxpayers to second guess the wisdom of using micro captives, section 831(b) remains a congressionally endorsed and highly valuable option for small businesses to effectuate cost-effective risk minimisation. Indeed through the PATH Act, Congress has doubled down on its commitment to micro captives by almost doubling the premium income excluded from income tax.

Ay, there's the rub! Instead of being deterred from taking advantage of the benefits micro captives can provide, taxpayers should approach them with the same caution and diligence as any other congressionally authorised planning arrangement, including acquiring guidance from professionals who know where the pitfalls of such arrangements are and how to avoid them. **CIT**

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