Covid-19, the IRS and captives

By Nate Reznicek

We find ourselves in an interesting time. The threat of an exponentially contagious disease has people across the globe facing a new reality. Measures such as restricted travel, curfews, government-mandated closures of businesses, and stay at home orders are the new normal for millions. Actions necessary to help control the spread and mitigate the loss of life have also resulted in a situation where businesses around the world are experiencing sometimes massive business interruption losses, the ultimate cost of which will likely not be able to be determined for several years, if ever.

As is often the case in times of tragedy and catastrophe, businesses are looking to their insurance for assistance in rebuilding. With Covid-19, businesses may well find themselves in a situation where no reimbursement will be forthcoming. Bills attempting to retroactively force carrier coverages have been introduced and immediately challenged. New lawsuits are filed for coverage determination between insureds and the traditional carrier market almost daily. As with all things, the situation will ultimately be resolved and decided with the passage of time. Unfortunately, many small and midmarket enterprises do not have the luxury of a large surplus of time and their closed doors may never reopen.

The good news is a number of successful small and middle-market enterprises had the foresight and financial wherewithal to have previously formed a captive insurance company. Some of these captives may even provide some sort of coverage for Covid-19 related losses. Generally speaking, companies that formed their own captives have access to accumulated reserves and can rely on them not only for reimbursement of covered losses but may also lean on them for financial assistance via regulatory approved distributions.

If there has been a potential preventative solution to this situation, why have more businesses not taken advantage? I would argue that a good portion of the blame lies with the Internal Revenue Service (IRS) and its recent targeted campaign and often fear-based publicising efforts. Which

begs another question: What does the IRS have to do with any of this? Short answer: Taxes.

What is likely a surprise to those who are not involved in the insurance space is there is no standardised definition of insurance in the US Code. There is no bright-line guidance that captive owners and US taxpayers can look to in order to ensure that the risks they place with their insurance company can be treated as "insurance" for federal income tax purposes. This is an issue because tax treatment of funds set used for insurance premiums is very different than what a "normal" US taxpaying corporation can achieve if they fund for losses with deposit accounting.

At a high-level US taxed insurance companies are allowed to accelerate the deductibility of the full value of future losses in the current tax year, regardless of whether the full value has actually been paid yet. This accelerated deduction gives insurance companies the opportunity to align the receipt of premium income and investment earnings with future claim payments. Thus, additional funds may be available to pay for potential losses while still allowing the insured business to deduct the premium as an ordinary business expense just like they do when paying premiums to traditional commercial insurance. For small insurance companies (commonly called microcaptives) this accelerated depreciation is provided via the 831(b) tax election. Underwriting profit is taxed at 0% for those insurance companies that fall within specific premium and eligibility requirements. These smaller captive arrangements are the most utilised by small and mid-market businesses, but their structures have also been the focus of some incredible scrutiny and reputational attacks by the IRS.

Regardless of the tax election of the captive, the following criteria is evaluated to determine if premium payments are insurance for tax purposes:

- Do the actions of the captive reflect what should be expected under the common notions of insurance and do the actions align with transaction documentation? Was the arrangement entered into for insurance in the commonly accepted sense? i.e. a non-tax, good faith purpose.
- Is there legitimate risk shifting? i.e. are policies transferring liabilities of the insured to the captive actually being issued.

- Is there appropriate risk sharing/risk distribution?
- Do the coverages being purchased from the captive cover real insurance risk?

For the purposes of this article we'll focus our conversation on item number 4 above. The questioning of legitimate "insurance" risk is not only routinely challenged by the Service, but I would argue that coverages provided by small captives has even been looked upon with disdain from larger captives and the commercial market. On the surface this is an interesting argument for the Service to make as it is important to note that the IRS does not regulate insurance. So who does then?

According to the McCarran–Ferguson Act (15 U.S.C. §§ 1011-1015) "Acts of Congress" which are not specifically intended to regulate the "business of insurance" will not override the laws of individual states or the state regulations that govern the "business of insurance." Essentially the state/domicile insurance regulator has purview for determining if policies cover insurance risk (i.e. they are fortuitous, unexpected, and quantifiable) not the IRS.

It could be reasonably argued that the Service didn't really care if the determination was within their purview, as over the years it has attempted to use its authority over tax collection issues to regulate the business of insurance. For a period of time the allegation that a line of coverage was "business risk" as opposed to "insurance risk" was a primary lead argument of the Service – after all if the risk wasn't ever "insurance" it certainly shouldn't be taxed as such.

Often the Service argues that if the insured business never bought the policy before then it had no need of the coverage, so therefore it's "business risk" and not insurance. It seems they believe if the coverages purchased from the captive aren't available in the traditional commercial insurance market then they aren't really insurance. Additionally, if the insured purchased coverage from a captive but the captive didn't have any losses, then the policy purchased wasn't insurance. These arguments simply don't make sense.

The focus on this argument largely continued until *R.V.I. Guaranty Co., Ltd. and Subsidiaries v. Commissioner*, 145 T.C. No. 9 (2015) at the conclusion of which the Tax Court issued their opinion holding in favor of the taxpayer.

This decision ultimately placed great weight on the interpretation of an "insurable risk" by the state insurance regulators, who recognised the policies as insurance. Although recent court cases have largely been determined by appropriate risk distribution and operations of the insurance company, the issue of "business risk" vs "insurance risk" still remains and is still a near-blanket argument by the IRS.

This default challenge is also a foundational reason for the Service's position on small captives, which I think can be boiled down to the following: If you own a small captive there's a really good chance the IRS thinks you're committing tax fraud and they're going to look into it. Which again is a strange default position to make as the 831(b) election was codified in 1986 with US Congress reaffirming the importance of the 831(b) in the Protecting Americans From Tax Hikes (PATH) Act of 2015 by increasing the premium threshold (by almost double) and clarifying eligibility requirements.

You would be hard-pressed to find a captive professional that would not agree that the recent campaign being waged by the IRS against the industry has dissuaded a great number of business from exploring the concept. Threats of audit and the burden of additional and redundant reporting has caused the closing of even some legitimate captive structures. From the "Dirty Dozen" list, to Notice 2016-66 (which the Service admitted they implemented without following their own rules and is being challenged at the US Supreme Court), to the recent release Letter 6336 in the middle of the Covid-19 pandemic, the message of intimidation is hard to miss. Few entities can acknowledge the potential legitimacy of a transaction while simultaneously maintaining a default position alleging impropriety. Requesting "voluntary" reporting under penalties of perjury with only an implication of the POTENTIAL ability to avoid audit sounds more like a shakedown from a criminal enterprise in a Hollywood film as opposed to the actions of an official regulatory body.

How many qualifying businesses were ultimately dissuaded by their tactic? How many of these same businesses are now nonoperational and employees sent home? How many will never reopen? How many years will it take for the impacted employees to return to the workforce? The final number will likely remain unknown, but it's not hard to imagine the

staggering impact and ripple effect that will play out in the US and global economies as a result.

However, out of the turmoil and uncertainty, we are now seeing a small change in tone regarding small insurance companies. I have long argued that captives (particularly small captives) are ideally positioned to address these emerging risks. Due to the nexus between captive shareholder and insureds, there's a natural synergy to provide coverage that mirrors the exposures of the business. Perfectly positioned to respond quickly to emerging risks that the commercial market is slow to respond to, small captives are also often the epicenter of innovation in the industry. Coverages that were once considered unique and issued by small captives are now commonly included in commercial policy forms, available via endorsement or able to be purchased as a standalone product (like reputational damage, cyber liability, etc.).

Interest in captives, particularly small captives, is now exploding. It has become an obvious fact to millions that simply because something hasn't happened before doesn't mean that there is no risk of it ever happening. There are also a number of arguments to be made over if coverage afforded by in-force commercial policies can be extended to pandemic related loss or not. There is, however, no reasonable argument to be made that the risk is not insurance risk. The losses that are currently being incurred as a result of the pandemic completely torpedo the default "business risk" position and represent the exact type of black swan event that sophisticated risk managers have been worried about for years.

All this being said, this is not a suggestion that captives have been given carte blanche to write whatever they can imagine. Common notions of insurance must still be adhered to. Actual risk needs to be shifted, acceptable levels of risk distribution/sharing must occur, professional actuarially determined premiums are still critical, captive investments are reasonably expected to look like those of traditional insurance carriers, etc. Captive owners and promoters that encourage and allow things like typhoon insurance in South Dakota, or avalanche coverage in coastal Texas, should be shut down, fined, and run out of the industry. There is no place for that here.

By and large captive owners enter into arrangements for valid risk protection purposes and to pre-fund for future losses as efficiently as possible. Captive promoters and business owners motivated to explore a captive for estate planning, tax avoidance, or pre-tax sale of financial products, etc. have no standing for forming, owning, or managing a captive.

The IRS has a very important job to do and it can be easy to view the Service as and its agents as part of some villainous overzealous hive-mind with the sole purpose of making taxpayers lives miserable. I truly believe that is not the case here. Tax fraud is still tax fraud. In these instances, I believe the IRS is entirely within their rights and duties to pursue, expose, and punish these individuals. In these scenarios I am their biggest fan and they have my complete support and encouragement.

I also do not believe that it was ever the intention of the Service's campaign to indirectly contribute to the likely permanent closure of thousands of well-run generational businesses, to burden an unknown number of individuals with unemployment, and to exacerbate a global humanitarian and economic pandemic. Unfortunately, intentions don't matter at this point and we are left with terrible results of their actions.

Enforcement actions that should be targeted and surgical have instead been carpet-bombed across an entire industry, one that the IRS must continuously acknowledge as legitimate. What is and what is not regarded as insurance must be assessed on the unique facts and circumstances of each case. Ultimate determination of if a risk constitutes "insurance" risk should be left with the highly qualified and competent domicile regulatory bodies as intended by Congress. By painting an entire legitimate industry with the same fear-based brush they have made a terrible situation worse and millions may will pay the price for years to come.

Originally published by Captive Review