

Quarles & Brady LLP



831(b) Captives and Tax Issues

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Captives & Estate Planning

- A captive is not a tax tool, it is an insurance company formed for the primary purpose of risk management, but like any other business, if run successfully it can appreciate in value, and thus estate planning becomes a concern for closely-held company owners.

Estate Planning – Dynasty Trust

Settlor



1. Gifted property avoids inclusion in gross estate
2. Funding with **after-tax** earnings
3. Allocation of gift and GST exemption
4. Property can appreciate outside of settlor's estate and pass free of estate tax

Estate Planning – Dynasty Trust

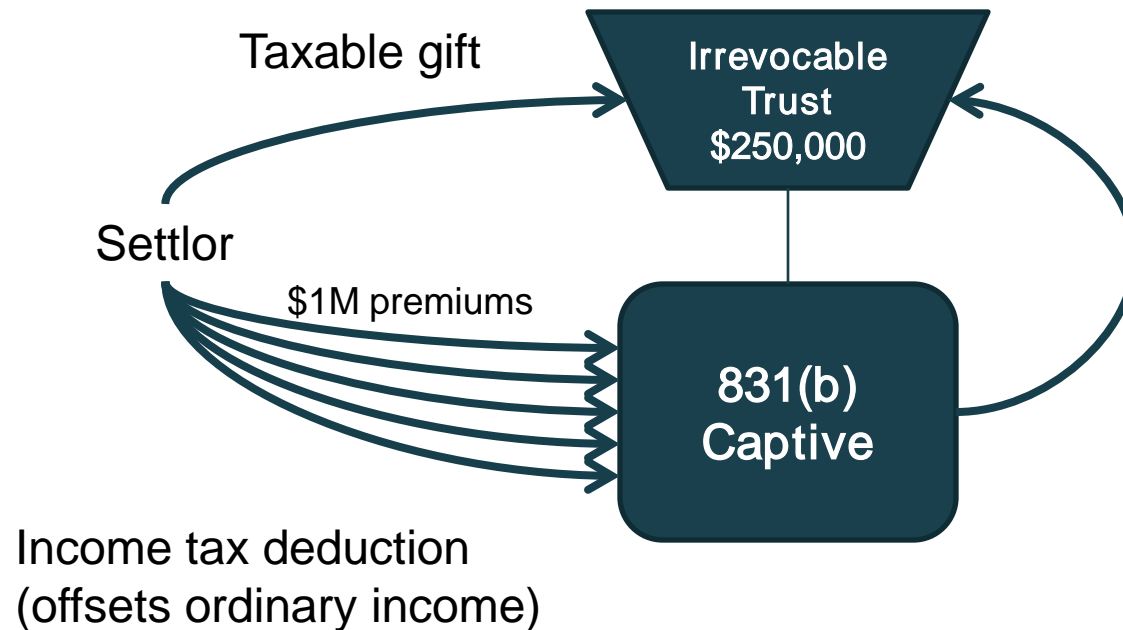
Settlor



Irrevocable
Life
Insurance
Trust

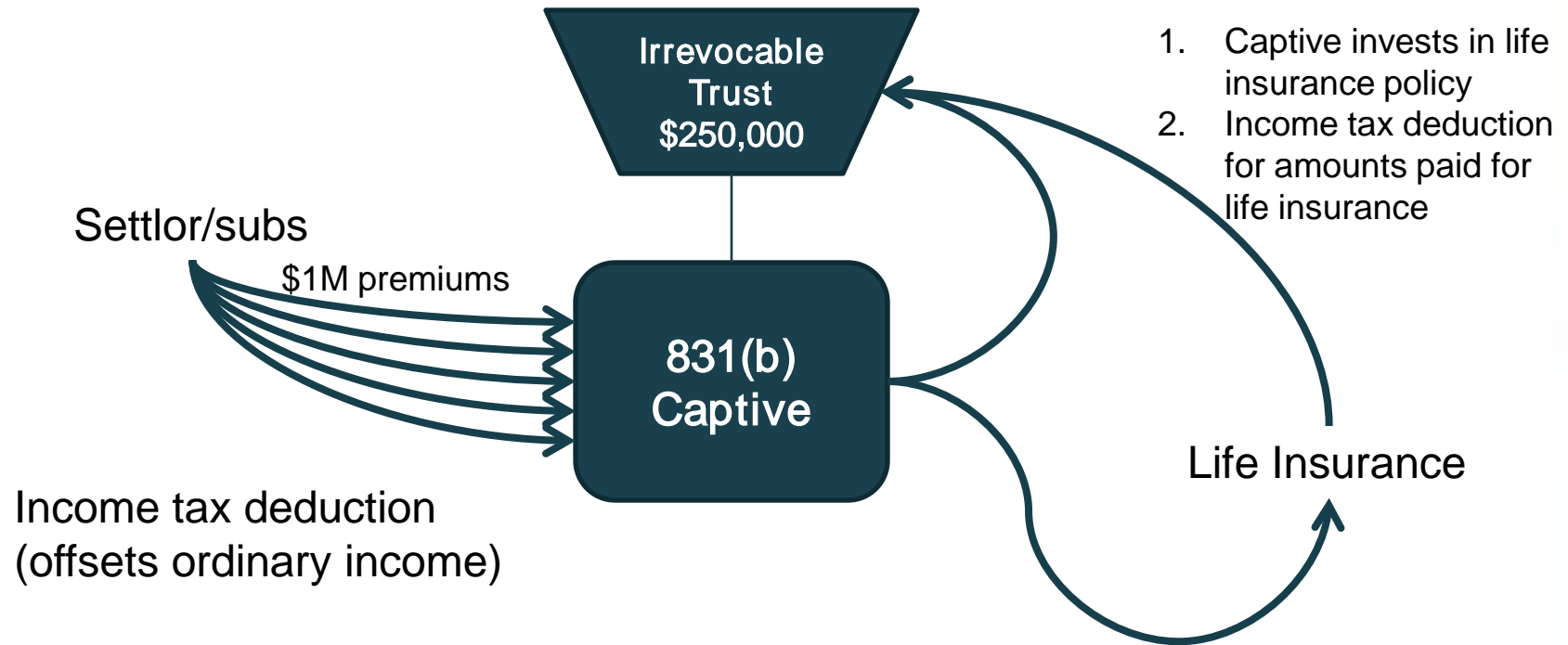
1. ILIT acquires/receives insurance policy
2. **After-tax** dollars pay premiums for ILIT to keep policy in force
3. Proceeds excluded from settlor's estate
4. Life insurance receives favorable income tax treatment

Captive Insurance + Dynasty Trust



1. If little to no claims are paid, surplus distributed to Dynasty Trust either as dividend or via liquidation and taxed as preferred dividend/capital gain rate
2. Captive pays no tax on premium income, just net investment income
3. **Red flags**

Captive Insurance + Dynasty Trust

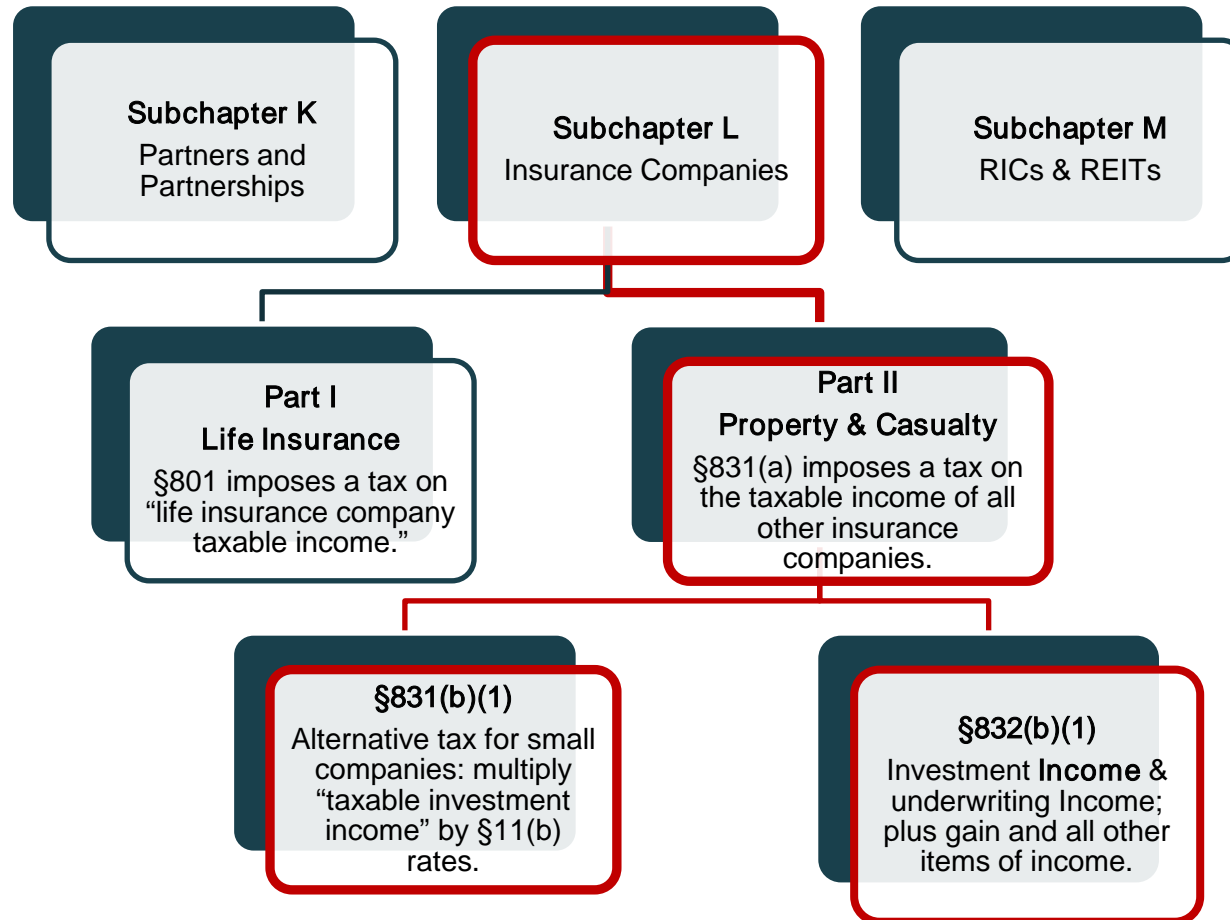


Income tax deduction
(offsets ordinary income)

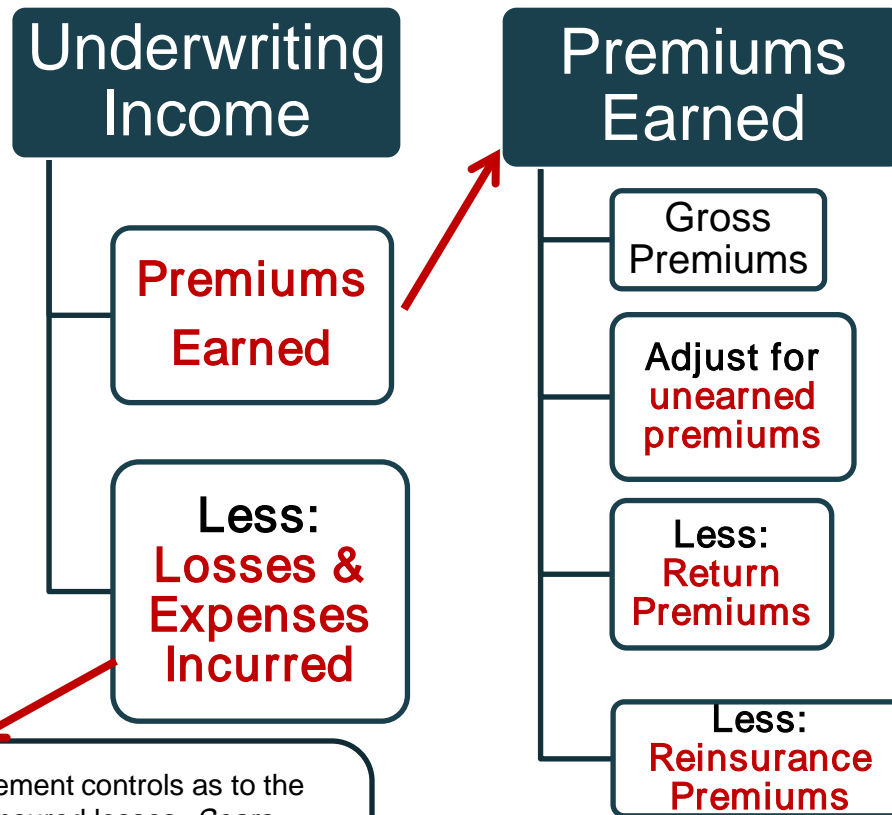
- Avoid depleting gift/GST exemption
- Preserve estate tax exemption
- Income tax deduction for life insurance policy
- Policy enjoys favorable income tax treatment

- Favorable treatment upon distribution to trust (capital gain rate versus ordinary income)
- **Red flags**

Insurance Company Taxation



§ 832 Underwriting Income



The insurance annual statement controls as to the timing of the deduction of insured losses. *Sears, Roebuck & Co. v. Commissioner*, 972 F.2d 858 (7th Cir. 1992). *But see State Farm Mutual Automobile Ins. Co. v. Commissioner*, 135 T.C. 543 (2010).

Insurance Company Taxation

§831

Tax on insurance companies other than life insurance companies

(a) **General rule** - Taxes computed as provided in section 11 shall be imposed for each taxable year on the taxable income of every insurance company other than a life insurance company.

(b) **Alternative tax for certain small companies**

(1) **In general**

In lieu of the tax otherwise applicable under subsection (a), there is hereby imposed for each taxable year on the income of every insurance company to which this subsection applies a tax computed by multiplying the taxable investment income of such company for such taxable year by the rates provided in section 11 (b).

Insurance Company Taxation

§832

Insurance company taxable income

(a) Definition of taxable income.--In the case of an insurance company subject to the tax imposed by section 831, the term “taxable income” means the gross income as defined in subsection (b)(1) less the deductions allowed by subsection (c).

(b) Definitions.--In the case of an insurance company subject to the tax imposed by section 831--

(1) Gross income.--The term “gross income” means the sum of--

(3) Underwriting income.--The term “underwriting income” means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred.

Insurance Company Taxation

§831

Tax on insurance companies other than life insurance companies

(2) Companies to which this subsection applies

(A) In general

This subsection shall apply to every insurance company other than life (including interinsurers and reciprocal underwriters) if—

- (i) the net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed \$1,200,000, and
- (ii) such company elects the application of this subsection for such taxable year.

The election under clause (ii) shall apply to the taxable year for which made and for all subsequent taxable years for which the requirements of clause (i) are met. Such an election, once made, may be revoked only with the consent of the Secretary.

Insurance Company Taxation

- Neither the Code nor the regulations define the terms “insurance” or “insurance contract.”

Insurance for Federal Tax Purposes

- *Helvering v. LeGierse*, 312 U.S. 531 (1941)
 - Estate tax issue – whether the “insurance” proceeds may be included in decedent's gross estate.
 - “Historically and commonly insurance involves risk-shifting and risk-distributing.”
 - “Analysis of the apparent purpose of the partial exemption granted in s 302(g) strengthens the assumption that Congress used the word ‘insurance’ in its commonly accepted sense. Implicit in this provision is acknowledgement of the fact that usually insurance payable to specific beneficiaries is designed to shift to a group of individuals the risk of premature death of the one upon whom the beneficiaries are dependent for support.”

Insurance for Federal Tax Purposes

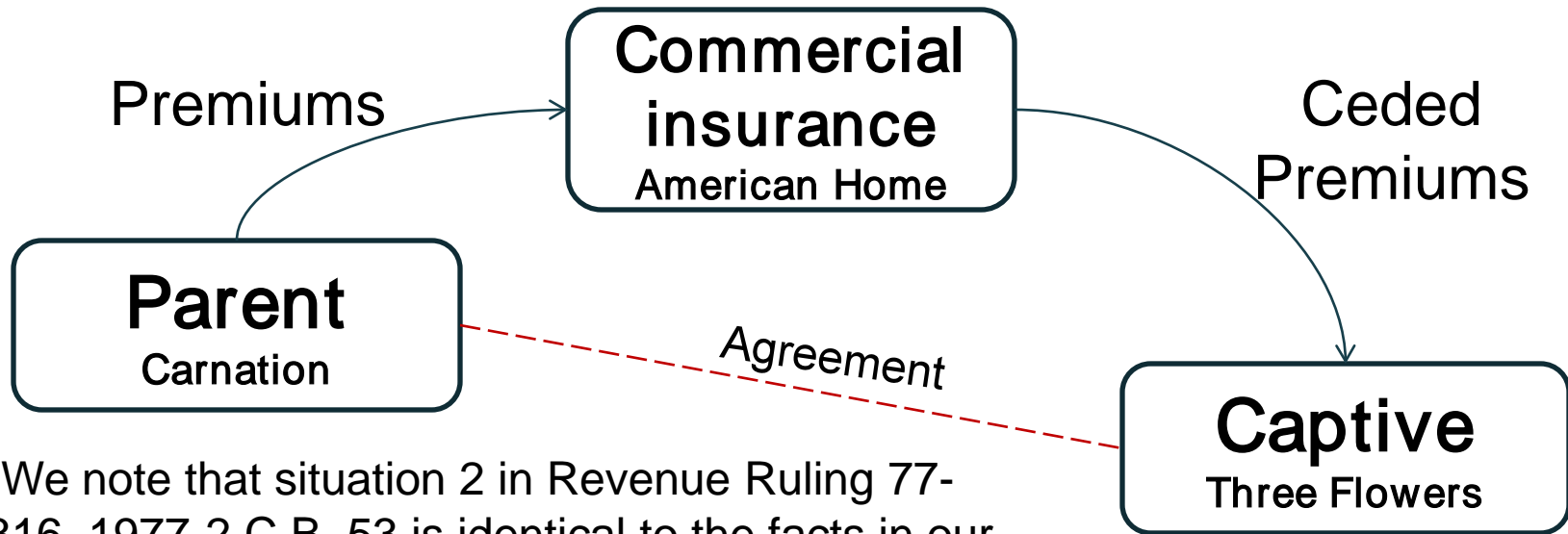
- *Moline Properties v. Comm'r of Internal Revenue*, 319 U.S. 436, 440, 63 S. Ct. 1132, 1134, 87 L. Ed. 1499 (1943)
- Separate entities should be respected by IRS
- IRS will go on to argue (in the captive insurance context) that separation is not ignored, but instead, focus must be on the nature and consequences of the payments by the parent.

Insurance for Federal Tax Purposes

- Rev. Rul. 77-316, 1977-2 C.B. 53 (1977)
- “Economic Family” concept
 - In each situation described, the insuring parent corporation and its domestic subsidiaries, and the wholly owned ‘insurance’ subsidiary, though separate corporate entities, represent one economic family with the result that those who bear the ultimate economic burden of loss are the same persons who suffer the loss.

Insurance for Federal Tax Purposes

- *Carnation Co. v. C. I. R.*, 640 F.2d 1010 (9th Cir. 1981)



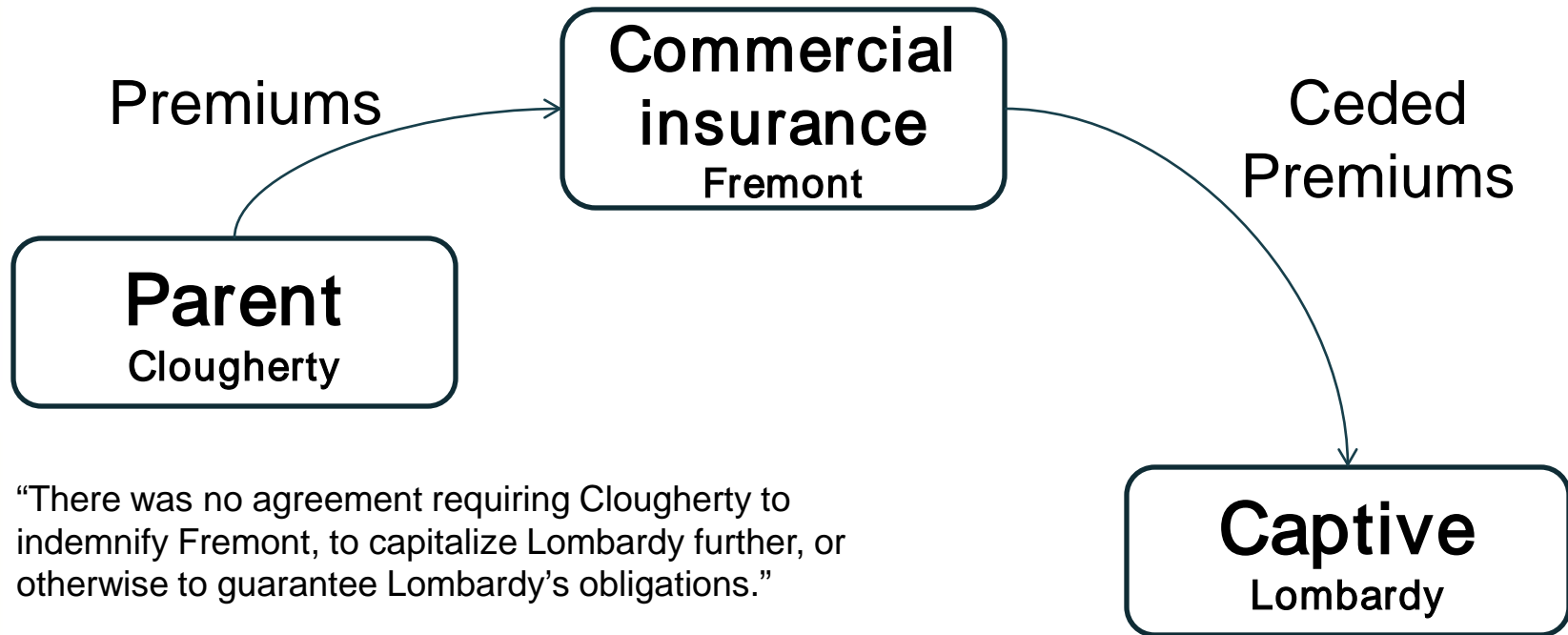
“We note that situation 2 in Revenue Ruling 77-316, 1977-2 C.B. 53 is identical to the facts in our case.”

“Carnation...agreed to capitalize Three Flowers up to \$3,000,000 at the election of Carnation or the request of Three Flowers.”

Arrangement simplified for illustration purposes.

Insurance for Federal Tax Purposes

- *Clougherty Packing Co. v. C.I.R.*, 811 F.2d 1297, 1300 (9th Cir. 1987)



“There was no agreement requiring Clougherty to indemnify Fremont, to capitalize Lombardy further, or otherwise to guarantee Lombardy’s obligations.”

Arrangement simplified for illustration purposes.

Insurance for Federal Tax Purposes

- *Clougherty Packing Co. v. C.I.R.*, 811 F.2d 1297, 1300 (9th Cir. 1987)
 - “We are presented with another version of a not so novel question: Are amounts paid as “insurance premiums” by a parent corporation to its “captive insurance company” subsidiary deductible for purposes of federal income taxation?
 - This latest twist, like the previous case we considered, *Carnation Co. v. Commissioner*, 640 F.2d 1010 (9th Cir.), *cert. denied*, 454 U.S. 965, 102 S.Ct. 506, 70 L.Ed.2d 381 (1981), *aff'g* 71 T.C. 400 (1978), involves the purchase by a parent of insurance from an unrelated insurance company and the reinsurance by the unrelated company of the principal portion of that liability with the parent's captive subsidiary; **however, in the case now before us there is no agreement between the parties providing for additional capitalization of the captive by the parent or otherwise ensuring that the captive will be able to perform its obligations under the reinsurance agreement.**”

Insurance for Federal Tax Purposes

- “Because a covered claim still affects Clougherty's assets, its captive insurance arrangement does not succeed in shifting its risk of loss. Therefore, under *Le Gierse* the arrangement is not insurance.”

Insurance for Federal Tax Purposes

- *Clougherty Packing Co. v. C.I.R.*
 - Shifting risk entails the transfer of the impact of a potential loss from the insured to the insurer. If the insured has shifted its risk to the insurer, then a loss by or a claim against the insured does not affect it because the loss is offset by the proceeds of an insurance payment.

Insurance for Federal Tax Purposes

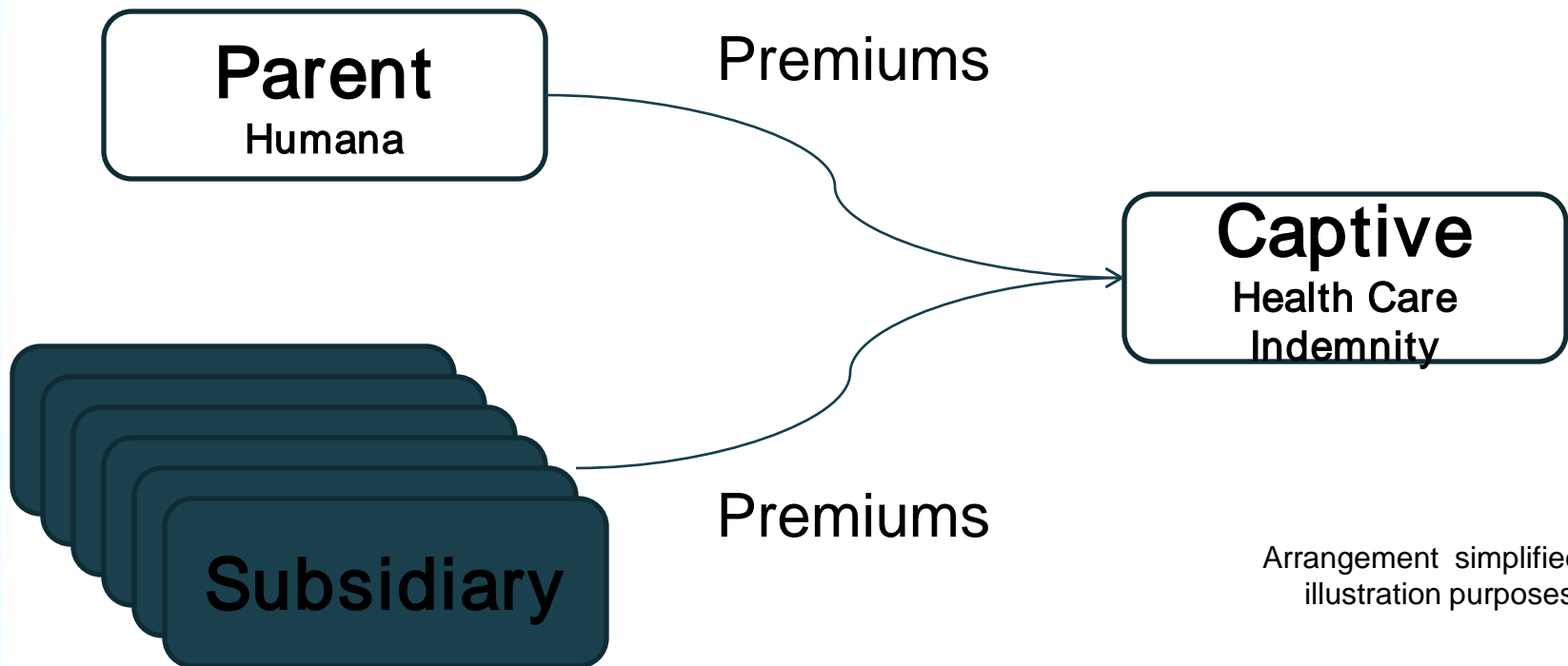
- *Clougherty Packing Co. v. C.I.R.*
- Risk distribution:
 - Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as a premium and set aside for the payment of such a claim.
 - Insuring many independent risks in return for numerous premiums serves to distribute risk.
 - Risk distribution incorporates the statistical phenomenon known as the law of large numbers.

Insurance for Federal Tax Purposes

- 1990 LGM TL-85
 - The Service has mounted a broad attack on the reported tax consequences of captive insurance arrangements, which has produced mostly favorable court results but poor compliance. As a result, approximately ten cases are docketed for trial in either the Tax Court or the Claims Court, and many more cases are being considered by the Appeals Division. In addition, Exam has identified over sixty corporations that are insuring with a captive insurance company as of the date of issuance of this LGM.
 - This poor compliance may be due in large part to the Tax Court's refusal to embrace the rationale of Rev. Rul. 77-316, even while holding for the Service in all of the captive insurance cases tried thus far. In setting forth its criticism of the Service's arguments, the Tax Court has given hope to taxpayers.

Insurance for Federal Tax Purposes

- *Humana Inc. v. C.I.R.*, 881 F.2d 247, 251 (6th Cir. 1989)



Arrangement simplified for illustration purposes.

Insurance for Federal Tax Purposes

- *Humana Inc. v. C.I.R.*, 881 F.2d 247, 251 (6th Cir. 1989)
 - We believe that the tax court correctly held on the **first issue**, the **parent-sub subsidiary issue**, that under the principles of *Clougherty* and *Carnation* the premiums paid by Humana Inc., the parent to Health Care Indemnity, its wholly owned subsidiary, did not constitute insurance premiums and, therefore, were not deductible. Humana Inc. did not shift the risk to Health Care Indemnity.

Insurance for Federal Tax Purposes

- *Humana Inc. v. C.I.R.*, 881 F.2d 247, 251 (6th Cir. 1989)
 - “With regard to the **second issue**, the **brother-sister issue**, we believe that the tax court incorrectly extended the rationale of *Carnation* and *Clougherty* in holding that the premiums paid by the subsidiaries of Humana Inc. to Health Care Indemnity, as charged to them by Humana Inc., did not constitute valid insurance agreements with the premiums deductible under Internal Revenue Code § 162(a) (1954).
 - We must treat Humana Inc., its subsidiaries and Health Care Indemnity as separate corporate entities under *Moline Properties*. When considered as separate entities, the first prong of *Le Gierse* is clearly met. Risk shifting exists between the subsidiaries and the insurance company.
 - There is simply no direct connection in this case between a loss sustained by the insurance company and the affiliates of Humana Inc. as existed between the parent company and the captive insurance company in both *Carnation* and *Clougherty*.”

Insurance for Federal Tax Purposes

- *Harper Grp. & Includible Subsidiaries v. C. I. R.*, 96 T.C. 45, 56 (1991)
aff'd sub nom. Harper Grp. v. C.I.R., 979 F.2d 1341 (9th Cir. 1992)
 - “In *Clougherty Packing Co. v. Commissioner*, *supra*, the Ninth Circuit's analysis was premised on the fact that the captive insurer insured only the risks of its grandparent corporation (i.e., the parent of the parent of the captive insurance company).*** Here, Rampart insured unrelated parties as well as affiliated corporations. *Clougherty Packing Co. v. Commissioner*, *supra*, is not squarely on point; accordingly, we are not bound to apply the result reached therein.”

Insurance for Federal Tax Purposes

- In our opinion, the tax treatment of an alleged insurance payment by a parent or affiliated company to a captive insurance company is to be governed by:
 - 1) the facts and circumstances of the particular case, and
 - 2) principles of Federal taxation, rather than economic and risk management theories.

Insurance for Federal Tax Purposes

- In determining the propriety of claimed insurance deductions by a parent or affiliated company to a captive insurance company, the following 3-prong test must be applied, and each part must be satisfied:
 - 1) 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.

Insurance for Federal Tax Purposes

- *Sears, Roebuck & Co. v. C.I.R.*, 972 F.2d 858, 860-61 (7th Cir. 1992)
 - No judge of the Tax Court has ever embraced the IRS's “economic family” approach, which is hard to reconcile with the doctrine that tax law respects corporate forms.
 - Even the ninth circuit,^{***} has drawn back by implying that subsidiaries doing substantial outside business cannot be lumped with true captives into a single pot. *Carnation Co. v. CIR*, 640 F.2d 1010 (9th Cir.1981); *Clougherty Packing Co. v. CIR*, 811 F.2d 1297, 1298 n. 1 (9th Cir.1987).

Revenue Rulings

- 2001-31
- 2002-89
- 2002-90
- 2005-40

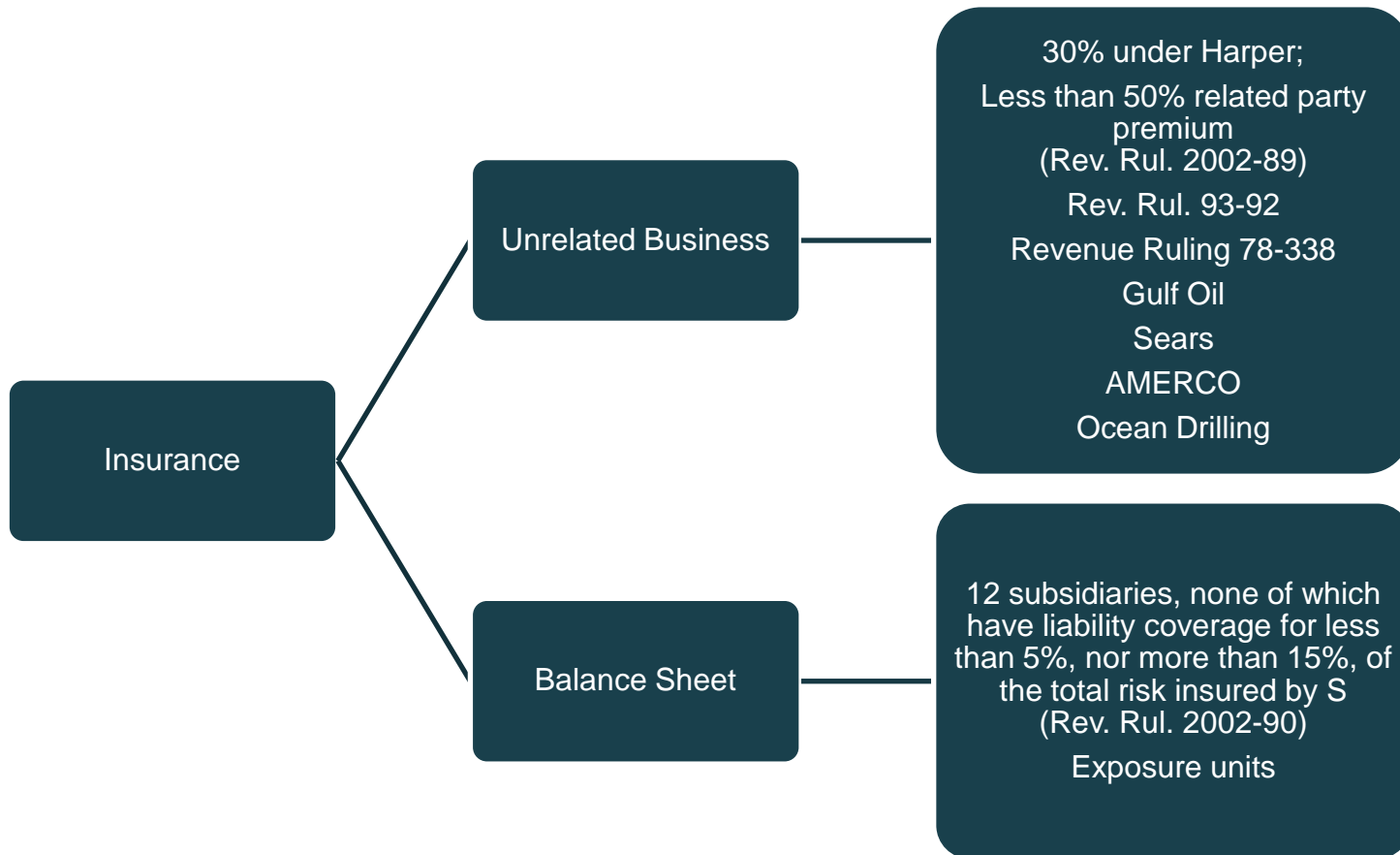
Insurance for Federal Tax Purposes

- I.R.S. P.L.R. 200724036 (June 15, 2007)
 - Although courts have not yet established a bright line percentage test, **Harper Group represents the edge of the spectrum** as the Tax Court found an insurance agreement with the least amount of unrelated risk (***)%.
 - Likewise, other cases recognize that risk distribution involves not only the portion of *** unrelated risks assumed but also a **large number of insureds**. See, e.g., Humana, 881 F.2d 24.

Rent-A-Center

- *Rent-A-Ctr., Inc. v. C.I.R.*, 8320-09, 2014 WL 128000 (T.C. Jan. 14, 2014)
 - The Code does not define insurance. The Supreme Court, however, has established two necessary criteria: **risk shifting and risk distribution**. See *Helvering v. Le Gierse*, 312 U.S. 531, 539, 61 S.Ct. 646, 85 L.Ed. 996 (1941).
 - In addition, the arrangement must involve **insurance risk** and meet **commonly accepted notions of insurance**. See *Harper Grp. v. Commissioner*, 96 T.C. at 58; *AMERCO v. Commissioner*, 96 T.C. at 38. These four criteria are not independent or exclusive, but establish a framework for determining “the existence of insurance for Federal tax purposes.” See *AMERCO v. Commissioner*, 96 T.C. at 38.
 - Insurance premiums may be deductible. A taxpayer may not, however, deduct amounts set aside in its own possession to compensate itself for perils which are generally the subject of insurance. See *Clougherty Packing Co. v. Commissioner*, 84 T.C. 948, 958, 1985 WL 15353 (1985), *aff'd*, 811 F.2d 1297 (9th Cir.1987).
 - We consider all of the **facts and circumstances** to determine whether an arrangement qualifies as insurance. See *Harper Grp. v. Commissioner*, 96 T.C. at 57.

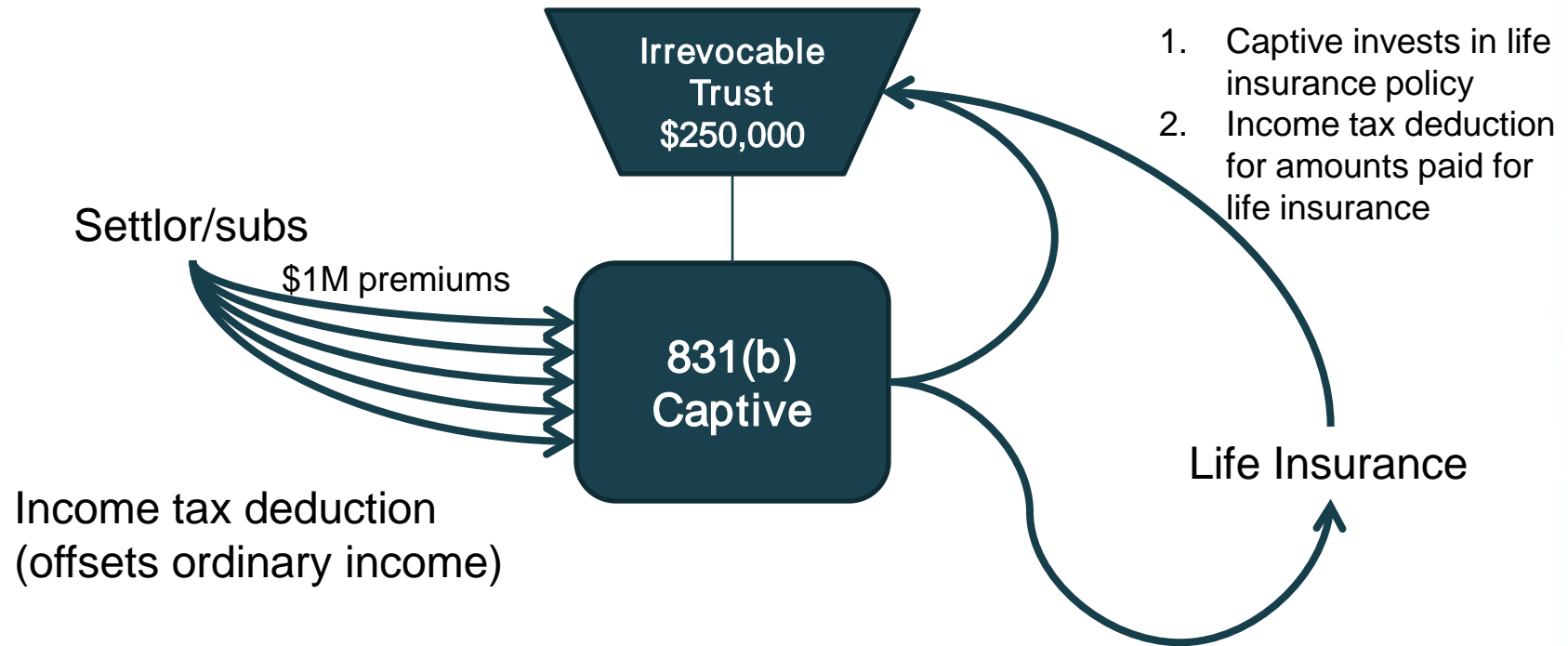
Insurance for Federal Tax Purposes



Facts & Circumstances

Commercial insurance uneconomical or impossible to obtain/volatile market	Business operations kept separate from parent
Premiums actuarially sound	Large number of homogeneous, independent risks among insureds
No parental guarantees/indemnification	Insurance contract(s)
Adequate capital	Unrelated risk safe harbor (Rev. Rul. 2002-89)
Invests in typical insurance company investments (no life insurance)	Brother-sister safe harbor (Rev. Ru. 2002-90); and large number of exposure units
Not loosely regulated in an offshore domicile	Captive has employees
Strong financial ratios	Insurance risk versus business risk
No loans to parent	Feasibility study
Low degree of negative correlation	Retrospective rated premiums*
Claims filed and paid	Conduct consistent with standards applicable to insurance arrangement between unrelated parties

Captive Insurance + Dynasty Trust



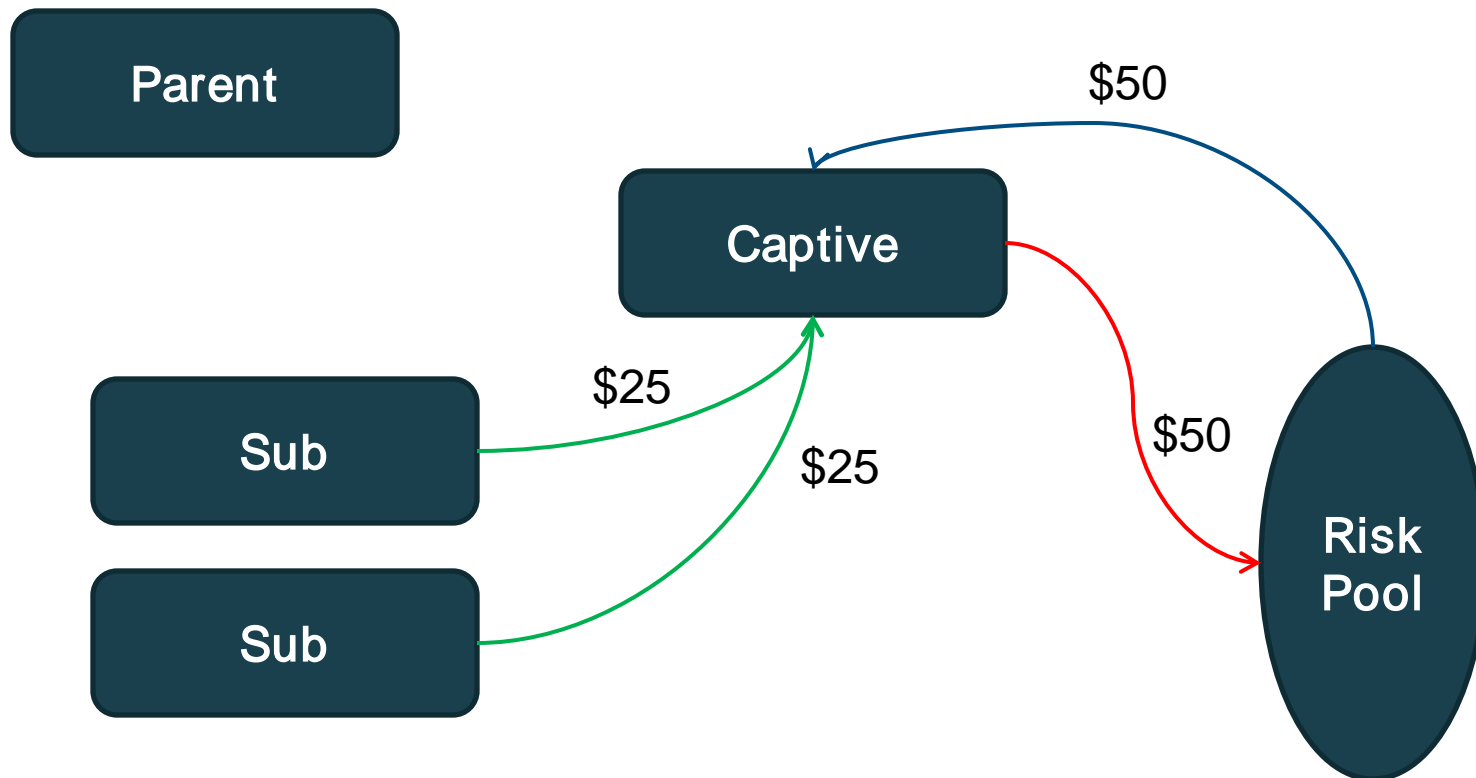
Income tax deduction
(offsets ordinary income)

- Avoid depleting gift/GST exemption
- Preserve estate tax exemption
- Income tax deduction for life insurance policy
- Policy enjoys favorable income tax treatment

- Favorable treatment upon distribution to trust (capital gain rate versus ordinary income)
- **Red flags**

Risks

- Trust ownership not necessarily a red flag but IRS will want to know why the captive is structured in such a fashion
- Captive will not pass muster if it was set up to accomplish tax savings and does not reflect an insurance arrangement
- Information document requests



1. (Green) Captive insures related party risks and receives \$25 from each sub for total of \$50 direct written premium
2. (Red) Captive cedes risk to risk pool and pays \$50.
3. (Blue) Risk pool cedes \$50 worth of risk to captive and pays \$50 to captive.
4. Captive now has 50% unrelated party risk.
5. This is similar to Rev. Rul. 2002-89, although Rev. Rul. 2002-89 shows the captive having less than 50% related party risk.

Denial of Insurance Status

- Loss of deduction
- Possible captive taxation
- Possible accumulated earnings tax
- 953(d) election issues (see AM 2014-002)

- For excellent discussion of these issues, *see* Beckett G. Cantley, *Can an IRC § 831(B) Captive Insurance Company Become an Impermissible Virtual IRA?* Captive Visions (www.captiveglobal.com)

Helpful Resources

- Kathryn A. Westover, *Captives and the Management of Risk*
- Jay D. Adkisson, *Adkisson's Captive Insurance Companies*
- Emanuel S. Burstein, *Federal Income Taxation of Insurance Companies*
- Captive Insurance Company Reports, see www.irmi.com
- Beckett G. Cantley, F. Hale Stewart, *Current Tax Issues with Captive Insurance Companies*, 2014-FEB Bus. L. Today 1
- Ocasal, 931 T.M., *U.S. Income Taxation of International Insurance Activities*

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