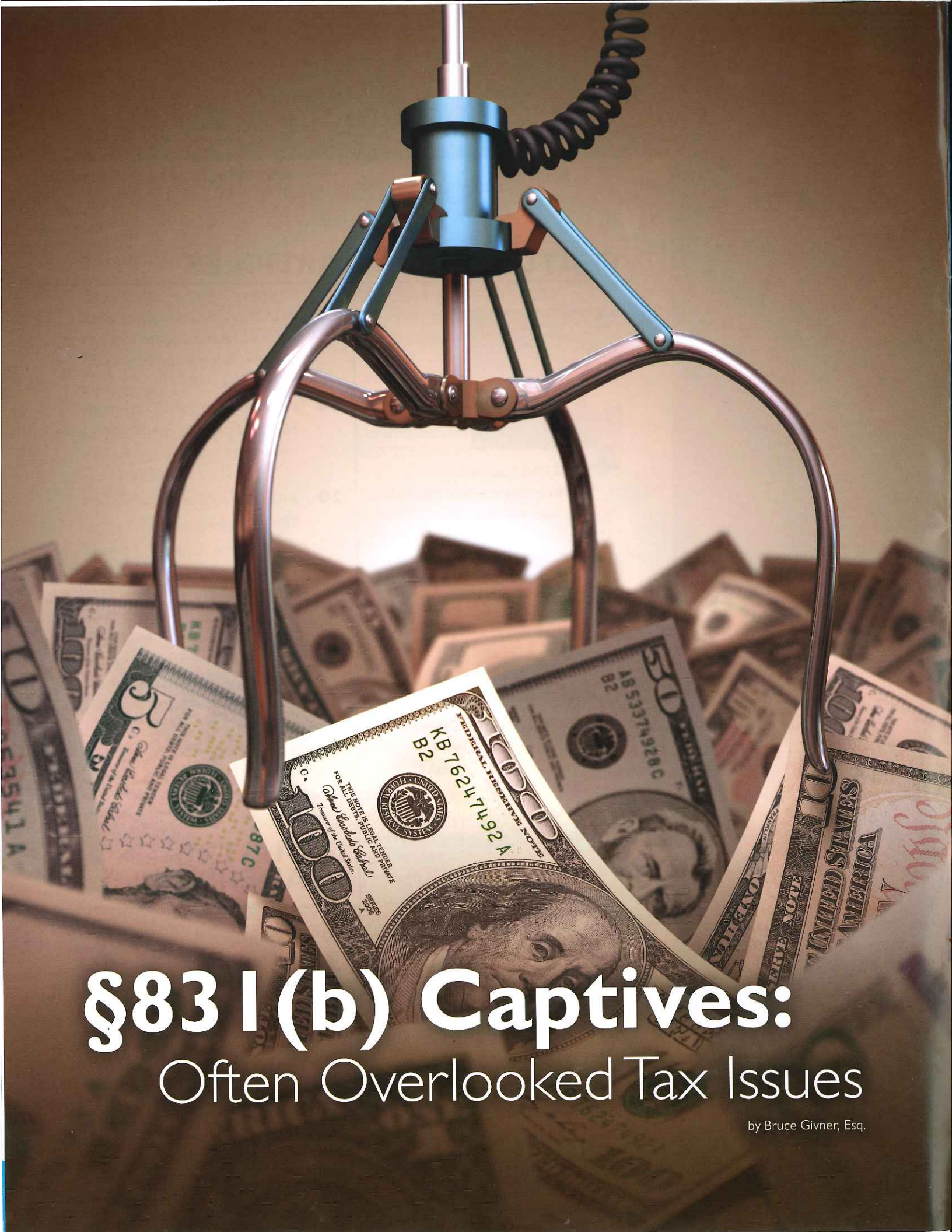

§831(b) Captives:
Often Overlooked Tax Issues

by Bruce Givner, Esq.

History of Captives. The Internal Revenue Code does not define insurance. As a result, taxpayers and the Internal Revenue Service have been litigating about what is, and what is not, deductible as insurance since at least the 1920s. *Spring Canyon Coal Co. v. Commissioner of Internal Revenue, 13 BTA 189 (1928), aff'd,* 43 F. 2d 78 (10th Cir. 1930). The idea of a "captive" insurance company began in 1955. The term "captive" came from the steel industry in which a mine that only produced coke and iron ore for its owner was a "captive" mine. Again, the Internal Revenue Service and taxpayers litigated for decades this time over what is, and what is not, deductible as premiums paid to captive insurance companies. The most famous case is probably *Humana, Inc., v. Commissioner,* 881 F. 2d 247 (6th Cir. 1989), which held that amounts paid to a wholly owned subsidiary were not deductible because the risk has not shifted and the arrangement is, in effect self-insurance. However, amounts paid for insurance by the taxpayer to the wholly-owned subsidiary of its parent are deductible if the risk shifts to the insurance subsidiary and the taxpayer is a separate and distinct corporate entity.

History Of §831(b) Captives

In 1986 Congress added §831(b) to the Internal Revenue Code to replace the prior complex, and modestly favorable, treatment for small insurance companies. See page 619 of the General Explanation of the Tax Reform Act of 1986. To understand the current special treatment we must first understand the general rule of taxation of property and casualty insurance companies:

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

In other words, insurance companies (other than life insurance companies are taxed at the normal rates applicable to corporations, e.g., 15% on the first $25,000 of taxable income; 25% on the next $50,000; 34% up to $10,000,000; and 35% over $10,000,000. Section 832 defined "insurance company taxable income" to include investment income and underwriting income. Most importantly, underwriting income includes premiums earned on insurance contracts.

- By contrast, §831(b) provides, in part, as follows:
  (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 §11(b).
    (2) Companies to which this subsection applies.
      (A) In general. This subsection shall apply to every insurance company...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.

Note the important omission for a §831(b) insurance company: the normal corporate tax rate only applies to "taxable investment income," not to underwriting income, as long as the premiums do not exceed $1,200,000.

Current Guidance on §831(b) Captives

In 2002 the IRS issued three revenue ruling to provide "safe-harbors" for captive insurance arrangements. Revenue Ruling 2002-89 advises that where over 50% of the subsidiaries' risk is with unrelated third parties, there is sufficient risk shifting and risk distribution. In Revenue Ruling 2002-90 the IRS concluded that the premiums paid by 12 operating subsidiaries to a captive insurance subsidiary owned by a common parent were deductible. One key fact is that none of the subsidiaries was insured for less than 5% or more than 15% of the total insured risk. In Revenue Ruling 2002-91 the IRS concluded that a group captive arrangement, with each insured having no more than 15% of the total risk, was a good insurance arrangement. Of course, there have been important later rulings also.

Standard Operating Procedure For §831(b) Captives

Taxpayers and their advisors spend time interviewing captive managers; providing financial statements; commissioning "feasibility studies"; reviewing proposed lines of coverage; determining the optimal tax deduction; reviewing contracts with the captive managers; and determining the best party to own the proposed captive. As the calendar year ticks to a close, there is precious little time available to spend on these important considerations. Sometimes there is little or no time left for two tax issues, the failure of either of which can be fatal to the taxpayer's desired deduction. Unfortunately, both have tests which lack – to use a phrase made infamous by a recent international political situation – a red line.

Often Overlooked Tax Issue #1

Internal Revenue Code §162, entitled "Trade or Business Expense," is the primary section for business

deductions. It provides, in relevant part, as follows:

- (a) In general. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business... [emphasis added]

The regulations issued by the Internal Revenue Service are not terribly helpful:

- (a) In general. Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business... Among the items included in business expenses are management expenses, commissions..., labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business..., advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property... The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is deductible, even though such expenses exceed the gross income derived during the taxable year from such business... [emphasis added].

How is this test to be applied by the taxpayer? In virtually every fact situation the taxpayer will be presented with a "feasibility study" showing lines of coverage that just happen to have premiums totaling slightly under $1,200,000. That is true for a taxpayer with $50,000,000 of revenue and $8,000,000 of profit; for a taxpayer with $20,000,000 of gross revenue and $4,000,000 of profit; and even for a taxpayer with $5,000,000 of revenue and $2,000,000 of profit. With that type of feedback from the captive manager and the actuarial firm, what is the taxpayer to do? Answer: rely on the taxpayer's CPA and tax lawyer.

First, let us understand the "ordinary and necessary" test. The Supreme Court has indicated that an expense must be both ordinary and necessary to be deductible. Welch v. Helvering, 290 U.S. 111 (1933). Whether an expense is ordinary is determined by the time, place and circumstances. In a later case the Supreme Court observed that "One of the extremely relevant circumstances is the nature and scope of the particular business out of which the expense in question accrued.... It is the kind of transaction out of which the obligation arose and its normalcy in the particular business which are crucial and controlling." Deputy v. Dupont, 308 U.S. 488 (1940). "Necessary" means that the expense is appropriate and helpful, rather than essential. Although to be necessary an expense need not be essential nor be the only means to the result, the means chosen must still be reasonable. Maule, 505-3rd T.M., Trade or Business Expenses and For-Profit Deductions, II.C.

How do the taxpayer's CPA and tax lawyer apply the "ordinary and necessary" test in practice? In most cases this can be done in about one minute. The tax lawyer has X years of experience; the CPA has X years of experience. Each has counseled dozens, hundreds or thousands of taxpayers in a broad range of industries, including (at least) dozens in the same industry as this taxpayer. Each is a "tax return preparer" for purposes of the Internal Revenue Code §6694 penalty. (The lawyer is a "nonsigning tax return preparer" as defined in Reg. §301.7701-15(b)(2).) That penalty is as follows:

- (a) Understatement due to unreasonable positions
  - (1) In general If a tax return preparer –
    - (A) prepares any return or claim of refund with respect to which any part of an understatement of liability is due to a position described in ¶(2), and
    - (B) knew (or reasonably should have known) of the position, such tax return preparer shall pay a penalty with respect to each such return or claim in an amount equal to the greater of $1,000 or 50% of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.

So, the question to the two "tax return preparers" is whether they will be comfortable being responsible for the return with the proposed insurance premium constituting part of the business expenses. "Is the figure provided by the captive manager ordinary and necessary for this taxpayer given all you know about the taxpayer? Or is the figure which is ordinary and necessary some lesser figure" Within one minute the tax lawyer and the CPA will both articulate figures with which they are comfortable and, in virtually every situation, the figures will be remarkably similar. As a result, the taxpayer has the benefit of X years or decades of experience. Unfortunately, they is little in the way of statistical information available to confirm the correct figure for each taxpayer.

Is there precedent for this type of analysis? Yes. How is this for an analogy? In his concurring opinion in Jacobellis v. Ohio, 378 U.S. 184 (1964), regarding the possibility of obscenity in the firm The Lovers, Justice Potter Stewart wrote: "I shall not today attempt further to define the kinds of material I understand to be embraced within that shorthand description ["hard-core pornography"], and perhaps I could never succeed in intelligibly doing so. But I know it when I see it, and the motion picture involved in this case is not that." [emphasis added]

Assume that the figure with which the tax professionals are comfortable is less than the figure provided by the feasibility study. How does the taxpayer get to the lesser figure? Does the taxpayer drops some of the proposed lines of coverage? Does the taxpayer buy less of some of the proposed lines of coverage? This is the perfect transition to the second topic because one problem may be that the pricing of the lines of coverage.

Often Overlooked Tax Issue #2

Internal Revenue Code §482 is often thought of as a tool used by the Internal Revenue Service to combat overpayment by a U.S. parent to a foreign subsidiary. It provides, in relevant part, as follows:

- §482. Allocation Of Income and Deductions Among Taxpayers. In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order

to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses...

This section can trace its lineage back to 1921, a mere 8 years after the enactment of the first income tax. Congress was concerned that related business taxpayers might set prices between themselves to inflate the income of entities subject to lower rates. The application to the operating business's payment of a premium to a captive, to which the premium is non-taxable, is obvious. Lip service is given to this, of course. That is the entire reason behind the feasibility study which is given to the taxpayer at the beginning of the engagement to establish a captive. However, will the feasibility study protect the taxpayer from an attack by the Internal Revenue Service?

The answer is a resounding "it depends". Feasibility studies are typically prepared by actuaries. The actuaries engaged in the captive insurance business are almost uniformly outstanding, both as individuals and as professionals. Actuaries compile and analyze statistics and use them to calculate insurance risks and premiums. However, inside an insurance company, the actual pricing of premiums is not determined by actuaries, but by underwriters. Insurance underwriters use actuarial data to help determine premiums. But actuarial data is only one component in the pricing decision. Underwriters must also consider the competition; the need for new business; the earnings of the carrier's reserves; management's risk tolerance; and other factors that must be managed using computer programs and judgment gained over years of experience in the field.

The question becomes, for each taxpayer wishing to institute a captive for its operating a business, to what extent it can rely on the "feasibility" study to set the rates and feel comfortable that the rates would not be vulnerable to a charge by the Internal Revenue Service under §482 that they are higher than what would be charged by an independent third party in the marketplace? At a minimum the taxpayer and the taxpayer's advisors must read the description of how the coverage was priced. Mathematical mistakes may occur. Conceptual mistakes may occur. In some cases the coverage may violate "the eyeball" test as being incredible. In the case of some lines of coverage the taxpayer can get quotes from commercial carriers. Many types of coverage proposed for captives are unusual or non-existent in regular commercial markets so the taxpayer may be lucky to get a quote from any third party, except perhaps Lloyds.

Each actuarial firm has its own method for determining the cost of insurance for a captive to charge to the operating entity (premium payor). One source of statistics is the information taxpayers provide to captive managers about their existing insurance. Another source of date are rate sheets submitted by large insurance companies to the departments of insurance of the various states. Smart actuaries also hire any freelance underwriters they can locate to provide input to their proprietary database. However, freelance underwriters with good quality experience from property and casualty insurance companies are not easy to find, and getting help from underwriters currently inside carriers is difficult. The taxpayer may have to find the taxpayer's own freelance underwriter to review the feasibility study. The taxpayer may feel most comfortable hiring a captive manager that has people on staff who spent decades in-house with large property and casualty insurance brokers or carriers.

Audits

There is no evidence that the Internal Revenue Service is currently targeting captives in general, or any particular manager's captives in particular, for audits using the Code sections discussed above. (There is a targeted audit campaign against one captive manager, but for problems unrelated to those discussed in this article.) However, the lack of current audit activity should not give comfort to any taxpayer. Everything works until it is audited. Taxpayers are obliged to take deductions with care and thought. Also, if we learned anything from the Internal Revenue Service's assault on the late 1990's tax shelter industry, it is that once something is marketed widely, especially on the internet, it is on the Internal Revenue Service's radar and an appropriate subject for an enforcement program.

Conclusion

Internal Revenue Code Section 831(b) has now been law for 26 years. Captives for closely held businesses have proliferated over the past decade driven in part by the growth in the number of captive managers, which has created downward price pressures, and in part by the number of states adopting favorable legislation, which has now reached thirty. The benefits, both in terms of risk amelioration and tax benefits are large. However, there are tax risks, and not just the obvious one, that can cause complete failure. ■

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