

CONGRESS' STATUTORY "FIX" TO MICRO CAPTIVE INSURANCE COMPANY ABUSE

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In February 2015, the IRS released its annual "Dirty Dozen" list, which, for the first time, included the use of "micro" captive insurance companies as a prevalent and abusive tax evasion vehicle. "Captive" insurance companies are ones formed as subsidiaries to insure risks of or affiliated with their corporate parents. "Micro" captives are, for the time being at least, those with no more than \$1.2 million in annual net written premium, and which make an election under Section 831(b) to be taxed on their investment rather than premium income. It is a micro captive's ability to deduct the receipt of those premiums, coupled with the potential for the insured to deduct the payment of the same that has led to so much perceived abuse.

While the IRS has gone on the offensive with a significant number of audits of captive insurers and their suspected promoters, it has also appealed to Congress for a statutory solution. At a Committee hearing in February 2015, Senator Charles Grassley echoed the IRS's concern that many captive insurers are "taking advantage of the special treatment for small mutuals for estate planning rather than legitimate business needs."¹ However, while Senator Grassley

acknowledged at least one of the abuses perceived by the IRS, he also expressed support not only for the continued availability of the Section 831(b) deduction, but also for an increase of the \$1.2 million cap on net written premium.

On 12/18/15, President Obama signed into law the Consolidated Appropriations Act of 2016 (the Act). The press has reported widely on Congress' use of legislative procedures to attach various riders to that bill. Given the flurry of activity leading to the Act's passage, it appears that Congress lacked a thorough understanding of many things that made their way into the law.

Congress included in the Act revisions to the Section 831(b) rules governing captives' qualification for the stated tax benefits. The amendments, which are comprised of dense—if not impenetrable—prose, are far from a panacea. They leave open certain questions and do not address a host of widely-known abuses of micro captives. Though the IRS may issue interpretative regulations to address some of the questions raised by the amendments, it is nevertheless evident that a statutory solution to abuses outside of the estate planning realm is not forthcoming. The following discussion en-

Although Congress provided a statutory solution to micro captive insurance company abuse, it failed to address several of the IRS's concerns.

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deavors to make sense of and contextualize the amendments, highlight a central ambiguity, and briefly describe some of the other abuses of micro captives that Congress did not address.

Amendments

The Section 831(b) amendments, which become effective 1/1/17, raise the net written premium cap to \$2.2 million and add an inflation adjuster to allow for the continued increase. In this regard, the amendments threaten to make the abuse of micro captives all the more tempting by increasing the potential to shelter income. Congress did, however, add a “diversification” requirement to qualify for the 831(b) election. There are two ways a captive can meet the diversification requirement. The first is relatively straightforward: “An insurance company meets the [diversification] requirement[] . . . if no more than 20 percent of the net written premiums . . . of such company for the taxable year is attributable to any one policy holder.” This diversification test borrows from the facts in Rev. Rul. 2002-89,² which created one of the first “safe harbors” for meeting the widely-accepted definition of “insurance” for tax purposes.³

More specifically, in Rev. Rul. 2002-89, the IRS held that when a captive’s premiums from its parent reflected no more than 50% of the company’s total assumed risks, there was adequate risk shifting to qualify as “insurance,” but when that number increased to 90%, no real risk shifting took place.⁴ Thus, the first diversification test under the revisions to Section 831(b) essentially moves the goal post of this 50% safe harbor under Rev. Rul. 2002-89. Beginning 1/1/17, therefore, any micro captive that previously met all published IRS standards by insuring no more than 50% of its parent’s risks will have to reduce that exposure to 20% if it wants to qualify for the Section 831(b) election. Note, however, that this 20% standard merely borrows from, but does not supplant, the insurance test. Thus, if a micro captive continues to insure between 20% and

50% of its parent’s risk, while it may not qualify for the deduction under Section 831(b), the IRS still should treat it as “insurance.” This distinction can be vital for the deductibility of the parent’s payment of premiums.

The second diversification test is more complicated and ambiguous. The following is the statutory language, in relevant part and with emphasis supplied:

An insurance company meets the [diversification] requirement[] if . . . no person who holds . . . an interest in such insurance company is a *specified holder* who holds . . . aggregate interests in such insurance company which constitute a percentage of the entire interests in such insurance company which is more than a *de minimis* percentage higher than the percentage of interests in the *specified assets* with respect to such insurance company held . . . by such *specified holder*.

The statute defines the emphasized terms. “Specified assets” are “the trades or businesses, rights, or assets with respect to which the net written premiums . . . of such insurance company are paid.” In the prototypical example of a parent-subsidiary captive arrangement, the “specified assets” presumably are those belonging to the parent and transferred to the captive as premium. A “specified holder,” by contrast, is “any individual who holds . . . an interest in such insurance company and who is a spouse or lineal descendant . . . of an individual who holds an interest in the specified assets.” Finally, “de minimis,” for these purposes, means “2 percentage points or less.”

This diversification test is designed to combat the estate planning abuse highlighted by Senator Grassley, when, for example, a husband places equitable ownership of the captive in his wife’s name. This maneuver would allow the husband to gift from his share of a business without taxation up to the net written premium cap each year. In this example, the “specified assets” are the assets in the business that are used to pay insurance premiums, and which are transferred without taxation. The wife is the “specified holder.” To meet the second diversification test, therefore, the wife’s interest in the captive cannot exceed her interest in the business by more than 2%. Thus, if the wife has a 50% interest in the business from which the “premiums” are paid, the captive will fail diversification if she owns any more than a 52% interest in the captive. With that example, it is easy to see how Congress believes that this rule will stymie further use of captives as a means to transfer ownership of assets without taxation.

¹ Grassley, Open Executive Session to Consider Various Original Tax Bills, U. S. Senate Committee on Finance (2/11/15), www.finance.senate.gov/hearings/hearing/?id=5499ed9f-5056-a032-5212-6b9d23e05a31.

² 2002-2 CB 984.

³ See *Helvering v. Le Gierse*, 312 U.S. 531, 25 AFTR 1181 (1941) for the Supreme Court’s definition of insurance, which requires both risk-shifting and distribution.

⁴ For more background on the standards governing whether a particular arrangement qualifies as insurance, see Euliss and Fore, “The IRS Has Declared War on the Abusive Use of Micro Captive Insurers,” 95 PTS 360 (August 2015).

⁵ *Id.*

⁶ *Id.*

However, the statute does not address what happens when there is more than one specified holder and more than one pool of specified assets. For example, assume that a captive's premiums come from two separate bank accounts, the first held jointly by a husband and wife, and the second held jointly by the same husband and his daughter. Both mother and daughter, who each have a 50% interest in their respective accounts used to pay some of the premium, are "specified holders." To what pool of assets would the IRS compare each specified holder's interest in the captive for purposes of diversification? If the comparison is only to the account in which each specified holder has a 50% interest, either can safely hold up to 52% of the captive without threatening diversification. Instead, if the amendment aggregates the assets in both accounts, each specified holder owns decidedly less than 50% of the total "specified assets," which would significantly affect the maximum interest each could have in the captive. The statute is silent on this issue, though the

IRS may choose to clarify the confusion with a regulation.

Conclusion

Going forward, the IRS likely will play a key role in interpreting and enforcing the amendments. While the new amendments may have adequately addressed one perceived abuse of micro captives, there are several additional known tax strategies that use these entities.⁵ For uses outside of the estate planning context, the same standards that pre-date the amendments will continue to apply in testing the bona fides of a particular arrangement.⁶ Thus, because of Congress' narrow focus, promoters will continue to market micro captives as an effective means of tax savings, meaning that taxpayers must remain vigilant in distinguishing between sound, legitimate uses of captives and those that the IRS has made a policy decision to combat. Undoubtedly audit and litigation activity in these areas will continue over the coming years. ■