Spring 5-7-2022

What is Insurance? An Analysis of the Tax Deductibility of Captive Insurance Premiums

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WHAT IS INSURANCE?

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NORTHERN ILLINOIS UNIVERSITY

What is Insurance?
An Analysis of the Deductibility of Captive Insurance Premiums

A Capstone Submitted to the

University Honors Program

In Partial Fulfillment of the

Requirements of the Baccalaureate Degree

With Honors

Department Of Accountancy

By

John D. Patten

DeKalb, Illinois

May 2022

University Honors Program
Capstone Faculty Approval Page

Capstone Title (print or type)

What is Insurance? An Analysis of the Deductibility of Captive Insurance Premiums

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Date of Approval (print or type) May 2, 2022

Date and Venue of Presentation _CLB 110, May 3, 2022, 11:30am

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About the Author

John D. Patten graduated *summa cum laude* from Northern Illinois University in 2022 with Full University Honors and a B.S. in Accountancy and Political Science. Prior to enrolling at NIU, John attended Normal Community High School, where he graduated Salutatorian and *summa cum laude,* earning NIU's Presidential Scholarship. At NCHS, John played football and competed on the Bass Fishing and Scholastic Bowl teams. During his time at NIU, John was involved as a Research Rookie and Research Rookie Peer Mentor, inspiring a four-year journey in undergraduate research. John's first project, "Déjà Vu: An Analysis of Tax Incentives and Auto Manufacturers in Bloomington-Normal, Illinois," was published with Dr. Kate Mantzke in the Fall 2020 issue of the *Journal of Government Financial Management.* John also served as President of the New Hall Community Council, where he lived for four years, and later served as President of NIU's Residence Hall Association. In accordance with his longtime goal of becoming an attorney, John joined NIU's nationally ranked Mock Trial program in 2020 and was elected President in 2021. In his time in college, John worked three seasons as a garden center Associate at Lowe's in Bloomington, where he was an essential worker during pandemic lockdowns. In the summer of 2021, John was a legal intern at Captive Resources, LLC, a captive insurance consultant headquartered in Itasca, Illinois. That experience inspired the topic for this paper, which received the Honors Program's Outstanding Capstone Award in the Social Science category in 2022. John also received the Patrick R. Delaney Endowed Accountancy Scholarship and the Accountancy Scholarship in 2021, and he is a member of Beta Gamma Sigma. During his NIU tenure, John was involved with numerous campus committees including an executive search committee, the 2020 Democracy Challenge Committee and its events subcommittee, a university finance committee, and the College of Business Dean's Student Advisory Board. After NIU, John will attend law school. He received the full-tuition Dean's Scholarship from the University of Illinois College of Law and has sought additional options for his legal education. John enjoys reading, fishing, and football. When not at school, he lives in Dwight, Illinois, near his family's farm.

Abstract

What is insurance for the purposes of a tax deduction? The Internal Revenue Code does not define insurance. Without this definition, taxpayers using alternative insurance products to manage their risks must look to case law to determine whether their arrangements count as tax-deductible insurance or non-deductible self-insurance. This paper dives into the four prongs of insurance: insurance risk, risk shifting, risk distributing, and commonly accepted notions of insurance. This paper looks to cases that have dealt with the deduction of captive insurance premiums to provide better insight into the practical application of this test.

After discussing the evolution of case law on this issue, this paper goes on to discuss the current issue in the captive insurance world: the IRS crackdown on microcaptive arrangements. Microcaptives are small captive insurance companies which have special tax advantages. As the IRS attempts to crack down on abuse of these entities, this paper considers the case law defining insurance and offers suggestions to Congress on how to best protect the law it has passed.

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Introduction & Background

What is insurance for purposes of a tax deduction? This may seem a strange question to ask because insurance has existed for thousands of years, and it can be found everywhere in the business world and in personal finance. In general, insurance is protection against potential future losses. Insureds pay premiums to insurers to obtain this protection. When insureds experience losses, they collect benefits from their insurers as stipulated in their insurance contracts. Despite this common understanding of what insurance is, the term ‘insurance’ is not explicitly defined in the Internal Revenue Code (IRC) or the Treasury Regulations. Instead, its definition has been left to the courts to decide on a case-by-case basis. This paper examines how the judicial definition of insurance has evolved over time, with a focus on how this definition relates to captive insurance companies (hereinafter captives). Given increased IRS scrutiny of microcaptive insurance arrangements in recent years, the paper concludes with policy recommendations to augment the judicial definition of insurance for a clearer understanding of when insurance exists for tax purposes.

What is Captive Insurance?

Captive insurance is not a new phenomenon. Some industry professionals trace its roots back to Lloyd's Teahouse (now Lloyd's of London) when 17th century merchants would work together to share the risks of their voyages to acquire and transport product to stock their stores. The word "captive" is credited to Frederic Reiss, who set up a captive insurance company for Youngstown Sheet & Tube in the 1950s. He borrowed the name from the mines which Youngstown owned and called captive mines. The first modern captive insurance company was incorporated in Bermuda in 1962. Reiss eventually set up shop in Bermuda, which to this day is the world's leading domicile for captive insurers.[1]

A captive is an insurer which is wholly owned and controlled by its insureds. The insureds participate in the captive insurance program to insure their risks more efficiently and be rewarded with the captive's underwriting profits, which are returned to owner-insureds via dividends. Captives generally write property and casualty insurance for their insureds.

As a general rule, captives do not write insurance directly for the insureds. Instead, captives write reinsurance for fronting carriers, typically commercial insurers. Fronting carriers (also known as ceding insurers) sell insurance to the insureds who own all or part of the captive. The fronting carrier then cedes the premium and risk to the captive and retains a percentage of the premium, called a ceding commission, as remuneration for writing insurance for the insureds. A

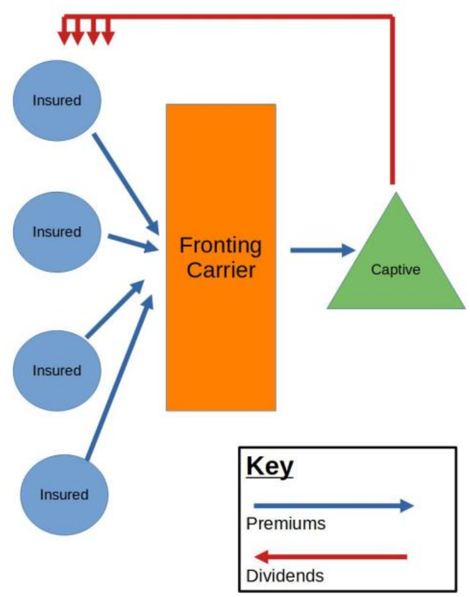

Figure 1: Captive Insurance Model using a Fronting Carrier

[1] https://www.insurancehalloffame.org/frederic-reiss-simple

captive arrangement using a fronting carrier is shown in Figure 1. The captive then may obtain reinsurance for certain risks it does not wish to retain.

A captive is different from a mutual insurance company. A mutual insurer's policyholders own the company by virtue of holding a policy. Once that policy has expired, their ownership ceases. Captive owners contribute capital to the captive and receive stock. Ownership ceases when stock in the captive is sold or when the captive is liquidated.

Captive insurance should also not be confused with self-insurance. Captives are separate legal entities owned by the insured(s). When the captive operates within the parameters of the tax law, premiums paid to the captive are tax deductible. Self-insurance is the creation of actuarially determined reserves to protect against future losses. Deposits to these reserves are not tax deductible when they are made. Instead, taxpayers deduct losses when they are incurred, and they use the reserve funds to cover their losses.

Captive insurance also has important differences from traditional commercial insurance. In most traditional insurance arrangements, the insured and the insurer are not related. The insured pays premiums to the insurer, and the insurer pays claims on covered losses pursuant to the policy agreement between the two parties. Disputes about claims are resolved through arbitration or in court. In a captive insurance arrangement, the insurer and the insured are related parties. Arrangements can vary significantly, but generally the insured benefits from minimizing losses and offsetting these losses with the underwriting and investment profits of the captive. Disputes are rare because the captive is related to the insured.

A significant motivation behind the use of captive insurance is the reduction of the moral hazard costs associated with traditional insurance. Moral hazard refers to an insured's inclination to take on more risk than it otherwise would have because the insurance it carries ensures it does not bear the total cost of the consequences of that behavior. Bad actors may decline to take necessary steps to prevent losses if they are insured against the consequences of those losses. Commercial insurers must charge premiums high enough to cover the potential costs of the risks they insure as well as the additional risk created by moral hazard. Companies who do not make many claims on their insurance policies are more likely to be drawn to captive insurance, as they see their traditional premiums being pushed up by other, less responsible, insureds. By affiliating with other companies who are not bad actors, members in captive programs can reduce moral hazard and shrink premium costs. In addition to reducing the costs of moral hazard, insureds can tailor captive insurance arrangements to better manage their unique risks with the help of captive insurance consultants who specialize in risk control. If managed properly, captive insurance programs can ultimately lower net costs of insurance by charging competitive premiums and returning underwriting profits to shareholder insureds.

The popularity of captive insurance has increased significantly since the first modern captive was formed in 1962. Almost all the *Fortune* 500 companies use captive insurance.[2] There are now over 7,000 captives worldwide, with the leading domiciles being Bermuda, Cayman Islands, and Vermont. While premium data for the entire industry is difficult to access, the total premiums paid to captives in 2020 is estimated to be over $140 billion.[3] Insurance rating service A.M. Best notes that captives have significantly outperformed commercial insurers over the last

[2] https://www.cpajournal.com/2018/12/19/captive-insurance-companies/

[3] This estimate is based on a review of data collected from domicile regulators for foreign captives and captive.com for U.S. captives.

twenty years. A.M. Best's report further notes that the "hardening"[4] insurance market in the post-pandemic environment is pushing more businesses towards captive insurance.[5]

Insurance and Statutory Tax Law

Tax Rules for Insureds

Insured businesses are permitted to deduct insurance premiums as ordinary and necessary costs of doing business under §162(a) and Reg.§1.162-1(a). None of the judicial opinions reviewed dispute that insurance costs are deductible by insureds in computing federal taxable income. When an asset that is covered by property insurance is destroyed, the insured will compute a gain/loss on the disposition under §1001. Losses on such dispositions are deductible as permitted by §165. Gains on such dispositions are generally includible in income under §1001(c). However, if the gain is generated by an involuntary conversion, the insured can elect under §1033 to defer the gain if the insurance proceeds are used to acquire appropriate replacement property within a specified time frame.

Tax Rules for Insurers

Insurers (other than life insurance companies) are generally required by §831(a) to pay tax on their taxable income. Insurance company taxable income is defined in §832(a) as the net underwriting income from the insurance business plus investment income earned on insurance reserves. However, small non-life insurers defined in §501(c)(15) are exempt from paying income tax per §501(a). Other qualified non-life insurers can elect under §831(b)[6] to pay tax only on their investment income, thereby exempting their underwriting income from taxation.

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[4] In insurance, the term "hard market" refers to a time when premiums rise as the demand for insurance increases relative to supply.

[5](2021, Aug. 4) 'Captives' Flexibility and Control Enable Them to Outperform Commercial Peers.' Best's Market Segment Report. A.M. Best.

[6] Some in the industry refer to §831(b) captives as "minicaptives" and §501(c)(15) captives as "microcaptives." The term microcaptive is used throughout this analysis to refer to §831(b) captives, consistent with IRS parlance.

A variation of §501(c)(15) can be traced back to §101(11) of the IRC of 1939, predating the first modern day captive by decades. Currently, non-life insurers can elect the §501(c)(15) exemption if their annual gross receipts do not exceed $600,000 and more than 50% of those receipts are insurance premiums. Congress added §831(b) to the IRC in 1986 to expand the reach of the §501(c)(15) income tax exemption. The Joint Committee on Taxation (JCT) Bluebook for the Tax Reform Act of 1986 explains the motivation for the change as follows:

> "Congress determined that the prior-law rules applicable to small and certain ordinary mutual companies were inordinately complex and should be simplified. Congress concluded that one provision should afford benefits comparable to prior law to small mutual companies. Further, Congress concluded that it was appropriate to eliminate the distinction between small mutual companies and other small companies, and extended the benefit of the small company provision to all eligible small companies, whether stock or mutual."[7]

This Bluebook excerpt demonstrates that Congress deliberately intended to make the tax "benefits" historically available only under §501(c)(15) more widely available to other small insurance companies.

In 1986, the §501(c)(15) election was available for certain non-life insurers whose premiums did not exceed $350,000. The newly enacted §831(b) election extended the tax exemption to other non-life insurers whose premiums exceeded $350,000 but did not exceed $1.2 million. Congress removed the lower premium threshold from §831(b) in 2004, erasing any implicit connection between §831(b) and §501(c)(15).

[7] JCS-10-87 p. 620

In 2015, Congress raised the §831(b) premium cap to $2.2 million and provided for it to increase with inflation over time. These changes brought §831(b) into the modern era by raising the premium threshold to account for the three decades that passed since its codification. One could argue these changes reaffirmed Congress' commitment to simplify reporting and extend tax benefits to more small non-life insurance companies.

At the same time Congress nearly doubled the premium cap for §831(b) from $1.2 million to $2.2 million, it also created two new diversification requirements. Small insurers need to meet one of these two tests to make this election. To pass the risk diversification test in §831(b)(2)(B)(i)(I), the captive must derive no more than 20% of its premiums from a single policy holder. The relatedness test in §831(b)(2)(B)(i)(II) is based on relationships between the insurer's owners, requiring ownership of the microcaptive to mirror ownership of the insured business when a younger generation owns part of the captive. A difference of no more than 2% is allowed. The effect of this test is to discourage taxpayers from passing ownership of the insurance companies to their heirs for additional tax advantages related to estate planning. Under this test, if a taxpayer owns 70% of the insured and her child owns the remaining 30%, then the child can own no more than 32% of the microcaptive insurance company.[8]

Current Issues in the Captive Insurance Industry

The IRS publishes no statistics regarding how many §831(b) insurers are captive insurance companies, but one can infer from IRS enforcement efforts that there are many §831(b) captives. The IRS has taken many actions in recent years against microcaptive arrangements including:

[8] For further explanation of how the PATH Act affected §831(b), see: DeVellis, C. (Oct. 2016) Planning with Micro- Captive Insurance Companies After the PATH Act. *Journal of Taxation.*

- Labelling microcaptives 'abusive tax shelters,' the IRS placed them on its annual "Dirty Dozen" list of "the worst of the worst tax scams" in 2015. Except for 2020, microcaptives have been on the "Dirty Dozen" list each year since.[9]

- In Notice 2016-66, the IRS mandated taxpayer disclosure of participation in microcaptive insurance arrangements along with significant related reporting requirements. While this Notice was vacated by the U.S. District Court for the Eastern District of Tennessee in 2022, the battle over reporting requirements is expected to continue.[10]

- Microcaptive insurance arrangements were among the 13 issue-based examination and compliance campaigns announced by the IRS Large Business and International Enforcement Division in 2017.[11]

- From 2017 through 2021, the Tax Court ruled in favor of the IRS four times in cases against so-called "abusive" microcaptive arrangements. Those cases are discussed below.

- Based on these Tax Court rulings, the IRS extended settlement offers via warning letters in 2019 to roughly 200 taxpayers whose audits included issues related to microcaptive arrangements.[12]

- In 2020, the IRS reported that nearly 80% of the taxpayers who received 2019 settlement offers accepted them, paying penalties in addition to back taxes. In addition,

[9] IR-2021-144, July 1, 2021
[10] *CIC Services LLC v. IRS,* 3:17-cv-110 (E.D. Tenn. Mar. 21, 2022).
[11] IRS News Release, January 31, 2017 https://www.irs.gov/businesses/irs-lbi-compliance-campaigns-jan-31-2017
[12] IR-2019-157, September 16, 2019

the IRS announced the creation of 12 specialized examination teams to focus on "abusive" microcaptive arrangements.[13]

The Potential Tax Abuse with Microcaptives

The IRS is generally wary of captive insurance transactions because premiums paid to microcaptives escape taxation entirely. Insureds deduct the premiums paid to the microcaptives, yet the microcaptives are never taxed on their underwriting income. The only way that income taxes are paid on these underwriting profits is if the microcaptive pays a dividend back to its owner, but this can be delayed indefinitely. Just as the profits of domestic microcaptives are tax-advantaged, so too are those of off-shore captives who conduct no business in the United States; they are not subject to US income taxation.

Regardless of the type of captive, the insured's ability to deduct premiums paid to a captive depends on the existence of true insurance. The IRS disputes true insurance exists in captive insurance arrangements given the connection between insureds and their captive insurers. Yet, caselaw shows that the determination of what constitutes insurance is more complicated than this relationship.

The General Test

Case law is crucial to defining insurance for tax purposes. The first case dealing with the definition of insurance is *Helvering v. Le Gierse* (1941)[14]. In a 7-2 decision, the United States Supreme Court ruled against Ms. Le Gierse, who was the beneficiary of a life insurance policy purchased by her deceased mother. While the policy had the presence of customary provisions, the Court found that the arrangement was not insurance because the insurance policy was

[13] IR-2020-26, January 31, 2020
[14] *Helvering v. Le Gierse*, 312 US 531 (S.Ct., 1941)

purchased alongside an annuity. When the annuity and life insurance policy were considered together, no true insurance risk existed because the two policies offset each other. In the majority opinion, the Court indicated that insurance involves risk shifting and risk distributing. The opinion further stated that the Court believed that "Congress used the word 'insurance' in its commonly accepted sense."[15] The effects of the *Le Gierse* opinion were long lasting. Although the case did not deal with the deductibility of insurance premiums, it set a precedent that true "insurance" requires both risk shifting and risk distributing.

The Tax Court first included commonly accepted notions of insurance in its analysis in *Sears, Roebuck & Co. v. Commissioner*[16] in 1991, bringing a four-prong test to life. Before the *Sears* case, the considerations of commonly accepted notions of insurance were still made implicitly. Subsequent Tax Court cases have followed this logic. This test requires that an arrangement must have all of the following elements to qualify as "insurance":

1. Insurance risk
2. Risk shifting (transfer)
3. Risk distributing (pooling)
4. Commonly accepted notions of insurance

While some legal tests involve independent elements, these four prongs are not independent.[17] First, risk shifting and risk distributing cannot occur without an insurance risk to shift and distribute. Second, the discussion below explains how risk shifting and risk distributing

[15] *Helvering* at 540
[16] *Sears, Roebuck & Co. v. Commissioner*, 96 T.C. 61, 96 T.C. 5 (U.S.T.C. 1991)
[17] Sometimes, this is referred to as a three-prong test with risk shifting and risk distributing listed as one prong.

are intertwined in practice. Third, no court has ruled that an arrangement lacked the commonly accepted notions of insurance unless it had already ruled that the arrangement lacked risk shifting or risk distributing.

Insurance Risk

Insurance risk is the least discussed of all the prongs in the test. Insurance risk is almost always present in the analyzed cases, and rarely does the IRS claim that no insurance risk is present. Usually, the IRS claims that the risk is not properly distributed or shifted, or the insurance program is not managed legitimately. However, in one case, *RVI Guaranty v. Commissioner*,[18] the IRS claimed that the policies issued by RVI, a Bermuda company, held no inherent insurance risk and that the risk in question was actually an investment risk. RVI sold contracts for residual value insurance related to leases, with insureds being lessors (or their financers). The policies insured against the risk that the actual value of the leased asset would be much less than expected at the termination of the lease. It was the position of the IRS that the inherent risk was an investment risk, not an insurance risk. The Tax Court ruled against the IRS. The risk was an insurance risk because the business model relied on the talent of underwriters, and the business complied with applicable insurance regulations. The Court pointed out that while the residual value insurance may be similar to a put option, the same could be said for many property or casualty insurance policies. A put option is a financial derivative which protects the holder from a decline in price in an underlying asset. Likewise, an insurance policy on an asset, whether residual value insurance, fire insurance, or another type of insurance, protects the holder against a decline in value in that asset.

[18] *R.V.I. Guaranty. Co., Ltd. v. Commissioner*, 145 T.C. No. 9 (U.S.T.C. Sep. 21, 2015)

Risk Shifting and Risk Distributing

While insurance risk is rarely disputed by the IRS, the same is not the case for risk shifting and risk distributing. These two prongs, which are often considered together, are central to what makes an arrangement "insurance." This paper considers the evolution of jurisprudence on the issue to demonstrate what does and does not meet these standards in the eyes of the courts, and to demonstrate how the taxpayers and the IRS have shifted strategies over the last few decades. The cases discussed below begin with a string of IRS victories invalidating the parent-child model. In response, taxpayers developed new models, such as the brother-sister model and the outside risk model. In addition, taxpayers were also successful in defending other captive insurance arrangements, even demonstrating that parental guarantees can be allowed in certain circumstances.

On a basic level, risk shifting is when a risk or group of risks moves away from one entity and is taken on by another. In a traditional insurance arrangement, the risks outlined in the policy are shifted away from the insured and shifted to the insured. Risk distributing is when an insurer has enough statistically independent risk exposures to create a pool of risk which allows it to operate on the basis of actuarial calculations. When such a pool of risk is created, the specific premiums cannot be traced back to a specific insured or risk exposure, rather, the premiums simply belong to the pool of risk.

Economic Family Theory

In 1977, the IRS unveiled what would become known as the Economic Family Theory in Revenue Ruling 77-316.[19] This theory posited that many transactions between entities in the same economic family should be disregarded for the sake of tax benefits. The adoption of this

[19] Revenue Ruling 77-316, 1977-2 C.B. 53

theory by the IRS led to the deduction disallowances at issue in the original captive insurance cases. In court, the IRS would use this theory to argue that no captive insurance premiums could ever be deductible since the captive is in the same economic family as the insured. This theory would be relied upon by the IRS in many of the cases below. The IRS used this argument in various cases in the 1980's and 1990's. By the early 2000s, the IRS had abandoned the economic family theory.[20]

Original Captive Litigation

Just sixteen years after Reiss established the first modern captive in Bermuda and one year after the IRS ruling on the Economic Family Theory, litigation began as a result of another Bermuda captive, Three Flowers Assurance Co. Ltd. This captive was a wholly owned subsidiary of Carnation Co.[21] Carnation purchased insurance with a fronting carrier who reinsured 90% of that risk with Three Flowers. The fronting carrier required that Carnation hold a capitalization agreement, meaning that Carnation was responsible for keeping Three Flowers adequately capitalized. The IRS determined that the payments Carnation made to Three Flowers were not "insurance." In the opinion, the Tax Court ruled that risk shifting did not occur, so the arrangement could not be insurance. Because Three Flowers was wholly owned by Carnation, only received premiums from Carnation, and had a

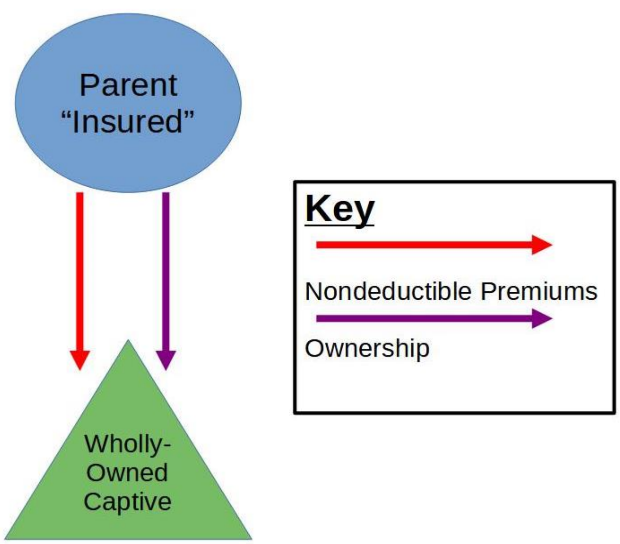

Figure 2: Basic Parent-Child Captive Model. Risk never truly leaves the parent. For simplicity, no fronting carrier is shown.

[20] Revenue Ruling 2001-31, 2001-1 C.B. 1348
[21] *Carnation Co. v. Commissioner*, 640 F.2d 1010 (9th Cir. 1981)

capitalization agreement with Carnation, the Tax Court determined that the risk remained with Carnation. The opinion stated that the premiums were to be treated as nondeductible contributions of capital. It is worth noting that Three Flowers was undercapitalized, calling into question its ability to be the recipient of true risk shifting. The Ninth Circuit later affirmed the Tax Court's decision. The *Carnation* case is the first of several cases where the arrangement at issue was a parent-child captive. A basic parent-child model is demonstrated in Figure 2.

In 1978, a Texas petroleum transporter tried unsuccessfully to defend its insurance arrangement in court. In *Steere Tank Lines v. United States,*[22] the District Court for the Northern District of Texas ruled, and the Fifth Circuit affirmed, that the arrangement between Steere Tank Lines and Tri-State Insurance Co. was not deductible insurance. The arrangement was not technically a captive, but it helps to illustrate the concept of risk shifting, or lack thereof. The agreement between Steere Tank Lines and Tri-State Insurance was such that Tri-State had a contractual right to compel Steere to make payments to keep an account balance at least equal to the amount of the claims made by Steere. As a result, the only risk to Tri-State was if Steere became insolvent. Consequently, the courts found that risk did not transfer from Steere to Tri-State, and Tri-State was not insuring Steere. Though not a captive, this arrangement is analogous to the pure parent-child model seen in *Carnation* because the insured retains all the risk of loss.

Seven years later, in 1985, the Tax Court decided, and the Ninth Circuit affirmed, *Clougherty Packaging Co. v. Commissioner,*[23] which had a similar fact pattern to *Carnation.* Once again, the taxpayer had a captive which was a wholly owned subsidiary. The captive, called Lombardy and domiciled in Colorado, reinsured risk from a fronting carrier. Heavily citing *Carnation,* the Court

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[22] *Steere Tank Lines, Inc. v. U.S.*, 577 F.2d 279 (5th Cir. 1978)
[23] *Clougherty Packing Company v. Commissioner*, 811 F.2d 1297 (9th Cir. 1987)

found that risk was not shifted since the economic consequences of losses stayed with Clougherty. The Court further noted that two District Court decisions had used the *Carnation* rationale and come to the same conclusion in the interim. (*Stearns-Roger Corp. Inc. v. United States*[24] and *Beech Aircraft Corp. v. United States.*[25]) Importantly, in *Stearns-Roger,* the captive was adequately capitalized, while in *Beech Aircraft* the captive was undercapitalized, but both cases yielded the same result, indicating the extent of the problem with the parent-child model. A few years later, another parent-child captive deduction was disallowed by the Third Circuit in *Gulf Oil Corp. v. Commissioner.*[26] Clearly, simply the presence of a separate legal entity was insufficient for the transfer of risk.

[24] *Stearns-Roger Corp. v. United States*, 774 F.2d 414 (10th Cir. 1985)
[25] *Beech Aircraft Corp. v. United States*, 797 F.2d 920 (10th Cir. 1986)
[26] *Gulf Oil Corp. v. Commissioner*, 914 F.2d 396 (3rd Cir. 1990)

New Captive Models

With the so-called parent-child model lacking the approval of the courts, other captive models became the subject of litigation in the late 1980s and early 1990s. Between 1989 and 1992, taxpayers successfully defended four cases where the IRS challenged the deductibility of premiums. These cases provide guidance on how captive arrangements can result in deductible premium payments. Further, although the IRS had been successful arguing the economic family theory in prior years (even when the courts did not explicitly endorse the validity of that theory), the courts made it clear that the economic family theory is no longer valid.

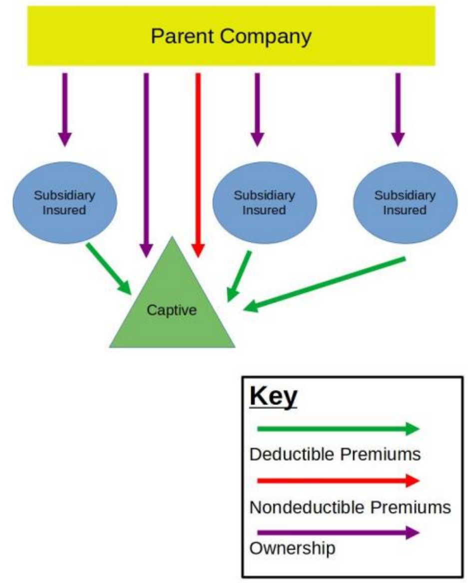

Figure 3: Basic Brother-Sister Captive Model. Generally, a brother-sister model has a dozen or more subsidiary insureds. For simplicity fewer insureds and no fronting carrier are shown.

Brother-Sister Model

In 1989, *Humana Inc. v. Commissioner*[27] set the precedent for the brother-sister model (see Figure 3). In this case, Humana operated through many subsidiaries, and some of those subsidiaries purchased insurance from Health Care Indemnity, Inc. (HCI). HCI was a wholly owned subsidiary of Humana domiciled in Colorado, and it was capitalized with the help of a Humana subsidiary domiciled in the Netherland Antilles. The subsidiaries purchasing insurance from the captive did not own stock in the captive (nor did the captive own stock in those subsidiaries). As a result, the captive and insured entities were siblings (brother-sister). The Tax Court ruled against Humana on the basis of the *Carnation* and *Clougherty* rationale, but the Sixth

[27] *Humana Inc. v. Commissioner* 881 F.2d 247 (6th Cir. 1989)

Circuit reversed with respect to the brother-sister premiums, noting the difference between the parent-child model and the brother-sister model. Some premiums received by the captive were paid by its parent, and those premiums were not deductible by the parent. The Sixth Circuit ruled that risk shifting did occur in the brother-sister model. The opinion took note of the Supreme Court decision in *Moline Properties v. Commissioner* (1943)[28], which was also noted in a dissenting opinion in the Tax Court case. The *Moline Properties* case compelled the Sixth Circuit to treat Humana, its subsidiaries, and HCI as distinct entities.

Since sibling entities were distinct, risk truly did move from one company to another. Under *Moline Properties*, entities are treated as distinct as long as the entity (or transaction) is not found to be a sham. The Sixth Circuit concluded that there was no indication of sham in this case because the arrangement clearly had a legitimate business purpose. Risk distribution was also satisfied because so many different distinct entities were covered by the captive. Finally, the Sixth Circuit stated that "under no circumstances do we adopt the economic family argument."[29] The brother-sister model continues to be a viable model today.

In the early 2000s, the brother-sister model was given further support by the Treasury Department. Revenue Ruling 2002-90[30] and Revenue Ruling 2005-40[31] provided examples of hypothetical scenarios where a holding company had twelve domestic subsidiaries, one being an insurer. Ultimately, a safe harbor is created for qualifying arrangements, meaning that eleven insured subsidiaries is a sufficient amount under the right circumstances. For example, each of those subsidiaries must account for between 5% and 15% of the premiums that the insurer receives,

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[28] *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (S.Ct., 1943)
[29] *Humana* at 257
[30] Revenue Ruling 2002-90, 2002-52 I.R.B. 985
[31] Revenue Ruling 2005-40, 2005-27 I.R.B. 4

and the subsidiaries cannot be single-member LLCs because single-member LLCs are disregarded for tax purposes.

Outside Risk Model

Another captive model developed by taxpayers is the Outside Risk Model. As Figure 4 shows, the captive in this model take on risks from both its owner(s) and parties who are not related to the captive. This way, inside and outside risk is pooled together.

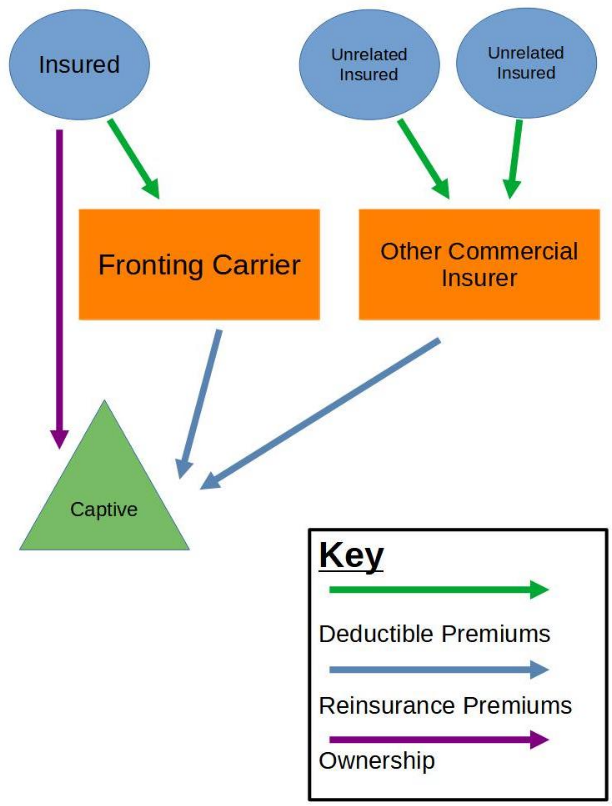

Figure 4: Basic Outside Risk Captive Model. Simply the presence of outside risk is not sufficient; it must be substantial.

This model was used by Harper Group and challenged by the IRS, leading to the case *Harper Group v. Commissioner.*[32] In that case, the Tax Court ruled, and the Ninth Circuit affirmed, that premium payments made to Rampart Insurance Co., Ltd. were deductible. Although some of these premiums were of the brother-sister variety and others were of the parent-child variety, the courts ruled that both types of premiums were deductible. The difference between this case and *Humana*, where only the brother-sister premiums were found to be deductible was the risk from unrelated parties. Roughly 30% of Rampart's business was from insureds who were unrelated to Harper Group. The Tax Court found

[32] *Harper Group v. Commissioner*, 979 F.2d 1341 (9th Cir. 1992)

that risk shifting and risk distributing are two sides of the same coin and that once the premiums are pooled, the insured's identity is lost. Hence, the distribution of Harper Group's risk with the risk of unrelated entities made the captive an economically separate entity to which risk could be shifted. Thus, risk shifting and risk distributing were achieved by the arrangement.

In 1992, a similar case yielded a similar result. AMERCO, which owned U-Haul, bought insurance from its wholly owned subsidiary, Republic Western Insurance Co. (RWI). Like Rampart, Republic Western took on risks from both related and unrelated businesses. The arrangement achieved risk shifting and risk distribution because outside risk was between 26% and 48% of RWI's business from 1979 to 1985, the years at issue. The Tax Court ruled, and the Ninth Circuit affirmed, that a parent-child model captive arrangement resulted in tax deductible insurance payments.[33] The Court concluded that "substantial unrelated risk"[34] had been achieved (and the IRS's "economic family argument" was rejected).

The Outside Risk model was further endorsed in Revenue Ruling 2002-89. That ruling reiterated that parent-child premiums where not deductible in a captive arrangement that receives all of its premiums from the parent. However, a captive arrangement that received over 50% of its premiums from outside parties could result in deductible premiums. The outside risk levels in both *Harper Group* and *AMERCO* were both lower than 50%.

Commercial Insurance Subsidiary

Allstate Insurance was a subsidiary of Sears, Roebuck & Co. and began as a captive insurance company. Later, Sears turned Allstate into a commercial insurer (and spun it off in 1995). In *Sears, Roebuck & Co. v. Commissioner* (1992) the IRS claimed that Sears' premium payments to

[33] *AMERCO, Inc. v. Commissioner* 979 F.2d 172 (9th Cir. 1992)
[34] *AMERCO* at 168

Allstate were not deductible (using the "economic family argument"). Allstate received 99.75% of its premiums from other parties. Ultimately, Sears was successful at the Seventh Circuit and the IRS's "economic family argument" was set aside in a different appellate circuit.

Other Captive Models

The courts have not ruled on the deductibility of insurance premiums for every type of captive. Group captives, agency captives, and rent-a-captive (also known as cell captives) have never been the subject of case law. Additionally, new captive types might be created in the future. However, the same framework would be used by the courts if the IRS were to challenge premiums paid in these arrangements or any other arrangement.

Group captives are captives owned by a group of unrelated insureds that insure a wide variety of risks. These captives can have a handful or hundreds of insureds. While group captives have not been the subject of caselaw, the outside risk model is applicable to them. Since risk unrelated to the insured generally accounts for the vast majority of the premiums paid to the captive (often over 99% for members of larger group captives), it is highly unlikely that the IRS would challenge a responsibly run group captive. Revenue Ruling 2002-91 endorsed the group captive model for the purposes of §831(b) where no company owned or controlled more than 15% of the captive.

Parental Guarantees

The next era to discuss in the evolution of jurisprudence on risk shifting and risk distributing is 2014, when the IRS lost two cases where brother-sister premiums were at issue. While some guarantees had been problematic in earlier cases, these two cases demonstrated that parental guarantees are not strictly forbidden. The reasoning behind the permissibility of brother-sister premiums has already been discussed, so only additional features of these cases will be discussed here. In *Rent-A-Center v. Commissioner,*[35] the Tax Court ruled that risk was shifted and distributed even though the parent had to guarantee the deferred tax assets that were used to capitalize the Bermuda-domiciled captive. In *Securitas v. Commissioner,*[36] the Tax Court again found that the presence of a parental guarantee does not negate risk shifting nor risk distributing if the captive is adequately capitalized. In that case, Securitas had a parental guaranty on its pass-through Vermont captive, which had a net premium to surplus ratio of zero. Risk distributing was also achieved through many statistically independent risks. Beyond the parental guarantee issue, the *Rent-A-Center* opinion also made note that, "We respect separate taxable treatment of a captive unless there is a finding of sham or lack of business purpose."[37] In addition, the Tax Court indicated that significant and legitimate nontax reasons for the captive existed, including the recommendation of insurance consultant Aon, the desire to reduce premiums, the ability to obtain otherwise unobtainable coverage, and the ability to control its insurance program.

Parental guarantees are not always permissible for tax-deductible insurance arrangements. For example, in *Gulf Oil Corp.*, Gulf Oil had a parental guarantee in favor of American International Group (AIG) who was the fronting carrier which would require Gulf Oil to reimburse AIG if its captive, Insco, Ltd. could not fulfill its obligations to AIG as the reinsurer. There were other problems with Gulf Oil's arrangement, including a lack of meaningful outside risk and a parent-child model, but it is important to differentiate this guarantee with the guarantees in the 2014 cases. Likewise, in *Malone & Hyde, Inc. v. Commissioner* (1995)[38], the parent company, Malone & Hyde, executed a hold harmless agreement for the fronting carrier. The effect of this agreement was that Malone & Hyde would be responsible if the captive (Eastland Insurance, Ltd.) could not meet its

[35] *Rent-A-Center, Inc. v. Commissioner*, 142 T.C. No. 1 (U.S.T.C. Jan. 14, 2014)
[36] *Securitas Holdings, Inc. v. Commissioner*, T.C. Memo. 2014-225 (U.S.T.C. Oct. 29, 2014)
[37] *Rent-A-Center* at 17
[38] *Malone & Hyde, Inc. v. Commissioner,* 62 F.3d 835 (6th Cir. 1995)

obligations under the reinsurance agreement between the captive and the fronting carrier. The Sixth Circuit held that the parent company still may be responsible for those risks (especially considering that the captive was thinly capitalized), risk had not been shifted. Specifically, if the captive was not able to reimburse the fronting carrier for claims pursuant to the reinsurance agreement, the parent company would have to reimburse the fronting carrier for the losses that it had paid to insure. Similarly, in *Kidde Industries, Inc. v. Commissioner* (1997)[39], the parent company had entered into an indemnification agreement with the fronting carrier, AIG. This indemnification agreement was in effect for part of the years at issue, and the court found that the premiums were not deductible while the indemnification agreement was in effect. However, it allowed the deduction of brother-sister premiums after the termination of the indemnification agreement. The indemnification agreement, like Malone & Hyde's hold harmless agreement, prevented risk shifting. The parent had responsibility for the losses if the undercapitalized captive could not pay the claims. The effect of these guarantees was quite similar to Steere Tank Lines' guarantee to Tri State Insurance: The parent company maintains the risk and consequence of the future losses.

The capitalization of the captive is an important consideration when determining whether or not a parental guarantee prevents risk shifting from occurring. The more capitalized a captive is, the less of an issue the guarantee will likely be. However, the most important fact about a guarantee is what the parent is guaranteeing. While the guarantees made by Gulf Oil, Malone & Hyde, and Kidde ultimately had the effect of keeping all of the risk with the parent company, the guarantees in *Securitas* and *Rent-A-Center* only guaranteed specific assets (a pass-through captive and deferred tax assets, respectively), not the insurance risk itself. In summary, parents may

[39] *Kidde Industries, Inc, v. U.S.,* 40 Fed.Cl. 42 (Ct.Cl. 1997)

guarantee specific assets owned by sufficiently capitalized captives, but under no circumstances may they guarantee risks that they claim to be insuring.

Commonly Accepted Notions of Insurance

The final prong of the test is that the arrangement has the commonly accepted notions of insurance. While the concept was first introduced in *Le Gierse,* it did not become part of a formal test until it was used by the Tax Court in *Sears.* In none of the cases described in this paper does a court rule that an arrangement is not insurance solely on the basis of this prong. In each loss by the taxpayer, the court found that risk shifting and/or risk distributing were not present. In some taxpayer losses, the court has ruled that the arrangement did not meet the commonly accepted notions of insurance, while in others, the courts have been silent on the topic, since all four prongs must be met. The most extensive discussion of this prong takes place in the microcaptive cases.

An important consideration that courts make, often implicitly, is along the lines of the economic substance principle. While most of the cases discussed in this paper predate the 2010 codification of this principle,[40] the need for a nontax purpose underlies whether or not the commonly accepted notions of insurance are met. Generally speaking, if the court does not find the arrangement to have a meaningful nontax purpose, then the premiums will not be deductible because insurance by its commonly accepted notions is a meaningful nontax purpose. Eliminating or reducing risk of a potential future loss is a meaningful nontax purpose.

In each case where this argument was contested, the courts have historically considered five questions to determine whether the arrangement meets this prong of the test. The questions are:[41]

[40] IRC §7701(o)
[41] These questions were first laid out in this manner in *Securitas* as a compilation of things courts had looked to in prior cases.

1. whether the company was organized, operated, and regulated as an insurance company;
2. whether the insurer was adequately capitalized;
3. whether the policies were valid and binding;
4. whether the premiums were reasonable and the result of an arm's length transaction; and
5. whether claims were paid.

Responses to these questions are used by the courts to determine whether or not an arrangement looks like the "commonly accepted notions of insurance." In general, a captive would need to meet all of these requirements in order to qualify any arrangement as insurance. A brief discussion of each of these five questions follows.

Regulation & Operation

Captive insurers are subject to the insurance regulators in whatever domicile that they choose. These regulators set the rules for licensing, capitalization, and operation. When a captive is licensed with its domicile's regulator and remains in good standing with that regulator, its chances of meeting this criterion are improved. The United States courts will consider the regulations of foreign countries when making this determination. For example, the courts pointed out that Rent-A-Center's captive (Legacy) complied with regulations from the Bermuda Monetary Authority and that Harper Group's captive (Rampart) complied with Hong Kong insurance law.

Capitalization

The level of capitalization that is deemed to be adequate can come from the regulator's requirements and insurance industry best practices. If a captive is being used as a tax shelter or if it appears to be, then the captive is more likely overcapitalized than undercapitalized. This is because if an insured is deliberately overpaying premiums with the intent of receiving a larger tax deduction, then the captive will progressively become more and more overcapitalized as the parent pays in excessive premiums and makes relatively small claims.

However, the courts do use a captive's undercapitalization as evidence of an arrangement not being insurance (see, for example, the captives in *Carnation, Gulf Oil, Malone & Hyde*, and *Beech Aircraft*). Although these cases predate the introduction of the idea of commonly accepted notions of insurance, it is obvious that capitalization has always mattered. Further, simply meeting minimum regulatory requirements for capitalization is not sufficient if the capitalization does not allow the captive to operate responsibly.[42]

Valid and Binding Policies

Valid and binding policies are another consideration of "commonly accepted notions of insurance." For policies to be valid and binding, they should not be issued after the fact. For example, in *Syzygy v. Commissioner* (2019),[43] the policies were not issued until after the policy year was over. Thus, the Tax Court determined that no binding policy had existed.

Reasonable Premiums

The reasonableness of premiums may be the most important indicator of whether or not an insurance arrangement is legitimate. In *Reserve Mechanical Corp. v. Commissioner* (2018),[44] the Tax Court noted, citing *Rent-A-Center,* that for premiums to be reasonable, the arrangement must be "undertaken principally to achieve a business purpose,"[45] not a tax purpose. If premiums are equal to or lower than the market rate for comparable insurance, then the arrangement is likely legitimate. If the premiums are substantially higher than what a commercial insurer would charge

[42] For example, at one time, in both Carnation and Gulf Oil, the captives were capitalized with $120,000. At the time, that was a minimum required by the Bermuda Monetary Authority.
[43] *Syzygy Insurance Co. v. Commissioner*, T.C. Memo. 2019-34 (U.S.T.C. Apr. 10, 2019)
[44] *Reserve Mechanical Corp. v. Commissioner,* T.C. Memo. 2018-86 (Jun. 18, 2018)
[45] *Reserve Mechanical* at p. 59

for similar policies, then courts are likely to find that the premiums are not reasonable (and that the arrangement is a tax shelter via the inflated premiums and related deduction). It is not rational to pay more in insurance than the market demands. Premiums must be reasonable in the context of the correlating risks.

For example, *Caylor Land & Development, Inc. v. Commissioner* (2021),[46] Caylor entities were paying $1.2 million in annual premiums to a captive (then the limit for a §831(b) microcaptive) despite the fact that relevant losses were roughly $50,000 annually. In *Avrahami v. Commissioner* (2017),[47] the premiums were also close to the limit, despite a lack of correlating risk. The total of the premiums is not all that must be reasonable; the allocation of those premiums, if applicable, must be reasonable as well. For example, in *Syzygy*, the captive, called Syzygy, had two loss layers with premiums uniformly allocated 49% to layer 1 and 51% to layer 2. The cutoff between the layers was $250,000. Figure 5 demonstrates how claims would fall into layer 1 or layer 2. This was considered unreasonable because the actuary had determined that the premiums should be allocated 70% to layer 1 and 30% to layer 2. More premiums are allocated to the layer with smaller losses because smaller losses are more frequent. Because the premiums were not actuarially sound, the premiums could not be

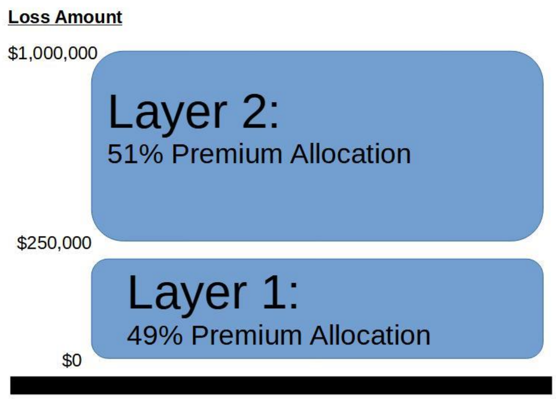

Figure 5: Syzygy's 2-Layer Structure. Premiums were allocated 49% to layer 1 and 51% to layer 2 uniformly with no actuarial backing. Hence, the premiums were unreasonable.

[46] *Caylor Land & Dev., Inc. v. Commissioner*, T.C. Memo. 2021-30 (U.S.T.C. Mar. 10, 2021)
[47] *Avrahami v. Commissioner*, 149 TC No. 7 (Aug. 21, 2017)

considered reasonable. Actuaries were not involved in the determination of premium amount, which further indicated that the premiums were not reasonable.

Nonfinancial evidence can also be considered by the Tax Court when determining reasonableness. For example, in *Syzygy*, the Court took notice of the taxpayer's decision to leave the consultant's program because of displeasure with a *decline* in premiums. In that same case, the Court also noted that the underwriter who had determined the premium amount had admitted in an email that he was just guessing.

Payment of Claims

The final consideration for commonly accepted notions of insurance is whether claims were paid. Insurance companies with plentiful risk exposures generally pays claims, so an insurance arrangement which pays little to no claims may draw suspicion. In *Avrahami*, there was a lack of claims paid before IRS intervened, in *Caylor*, only four claims were ever paid, and in *Reserve Mechanical* only one major claim was ever paid.

Recent IRS Action

It is through the lens of this four prong test and the accompanying case law that the Tax Court has been evaluating microcaptive arrangements since the *Avrahami* case in 2017. The IRS takes particular issue with microcaptives because of their tax advantages and an accompanying concern that they can be used as abusive tax shelters. As explained above, premium received by microcaptives are tax exempt and they only pay tax on investment income. On the other side of the transaction, the insured is deducting the premiums, so those premiums escape taxation entirely due to the benefits Congress has given taxpayers via I.R.C. §831(b). In recent years, the IRS has made it known that it plans to do everything it can to halt microcaptive abuse. In this quest, the IRS has issued new reporting requirements through Notice 2016-66 and continued to audit taxpayers, litigating cases at the Tax Court to deny deductions to taxpayers using microcaptives where it believes abuse is present.

Reporting Requirements

In Notice 2016-66, the IRS lays out the type of microcaptive arrangement it deems transactions of interest, and it outlines items the that those microcaptives must report on Form 8886 (Reportable Transaction Disclosure Statement). These items include:

1. Why the captive is required to report (identifying the transaction(s)),
2. The captive's charter authority,
3. The types of coverage the captive provides to insureds,
4. How the premiums were determined for the aforementioned coverage and the name and contact information of any actuary or underwriter involved in making that determination,
5. A description of claims paid by the captive and the amount of the captive's reserve, including the reason for those reserves, and
6. A description of the assets held by the captive, including an identification of any related parties involved in any transactions that involved any of those assets.

Failure to comply with the Notice 2016-66 requirements could result in penalties. Many in the industry resent this requirement and believe it to be overly burdensome. Even the IRS, in its instructions for Form 8886, acknowledge the significant amount of time required to complete the form:

- Recordkeeping 10 hr., 16 min.
- Learning about the law or the form 4 hr., 50 min.
- Preparing, copying, assembling, and sending the form to the IRS 6 hr., 25 min.

Microcaptives generally are set up and operated with the help of industry professionals, including lawyers, accountants, and actuaries. Hence, the responsibility to keep these records and perform this reporting is done by these professionals, whom taxpayers must compensate at their own expense. Notice 2016-66 was issued on November 1, 2016 and was effective immediately, with reporting due on January 30, 2017. Notice 2017-08 pushed that deadline back by 90 days. The notice-and-comment period prescribed by the Notice began after it took effect.

Notice 2016-66[48] was successfully challenged by captive adviser CIC Services in the Eastern District of Tennessee in *CIC Services LLC v. IRS*.[49] CIC claimed that the reporting requirements violate the Administrative Procedure Act (APA). The case was initially dismissed on the grounds that the suit violated the Anti-Injunction Act, but that ruling was reversed and remanded to the Eastern District of Tennessee by a unanimous Supreme Court in the summer of 2021.[50]

Once remanded the District Court granted summary judgment to the plaintiff and vacated Notice 2016-66 on two grounds under the APA. First, the Court ruled that the IRS failed to perform the necessary notice-and-comment procedures required by the APA. Second, and more importantly, the Court ruled that the "the Notice must also be set aside as agency action that is arbitrary and capricious."[51] The Court determined that, "The administrative record in this case simply does not include underlying facts and data showing that micro-captive insurance arrangements have a potential for tax avoidance or evasion."[52] As a result, the Court vacated the

[48] Some industry professionals found it fitting that this particular notice included three sixes in a row.
[49] *CIC Services LLC v. IRS*, 3:17-cv-110 (E.D. Tenn. Mar. 21, 2022).
[50] *CIC Services LLC v. IRS* 141 S.Ct. 1582 (2021)
[51] *CIC Services* at p. 13
[52] *CIC Services* at p. 13

Notice 2016-66 and ordered the IRS to return the documents and information produced as a result of the notice to the taxpayers.

In response, CIC Services is encouraging its clients to send a letter to Congress which argues that the IRS is conducting an "illegal and improper terror campaign" against microcaptives with the intent to render §831(b) unusable. For years, CIC has maintained that the IRS intends to "publicly taint the entire captive industry as one filled with crooked operatives and tax scammers."[53] Regarding the weight of the compliance burden that Notice 2016-66 and Form 8886 imposed on taxpayers, CIC also stated:

> "[t]he terrible fact is that every one of the thousands of taxpayers who complied with the Notice will never again see a dime of the tens to hundreds of thousands of dollars that each had to spend complying with it over the last five years, all while living under the threat of draconian penalties and even criminal sanctions for even inadvertent noncompliance."[54]

Clearly, the IRS has struck a nerve with its actions. The fight over reporting requirements for microcaptives will likely continue for some time. The IRS can appeal the Court's decision to the U.S. Court of Appeals for the Sixth Circuit. Further, the IRS could issue a new Notice based on the opinion.

Settlement Offers

In September 2019, the IRS offered a settlement to some taxpayers who had engaged in microcaptive arrangements who were under exam. The *Avrahami*, *Reserve Mechanical*, and *Syzygy* decisions gave the IRS the standing it believed it needed to make this offer. The settlement

[53] *CIC Services*, Initial complaint, at #56
[54] Letter available on CIC Services website, captivatingthinking.com

"requires substantial concession of the income tax benefits claimed by the taxpayer together with appropriate penalties."[55]

In the following autumn, the IRS offered a new settlement to taxpayers under exam with microcaptives. It described this settlement as stricter than the 2019 offer. Just before the announcement of this settlement offer, the IRS deployed 12 microcaptive examination teams to "substantially increase the examinations of abusive micro-captive insurance transactions."[56] Some in the industry believe these offers, combined with the examination teams, reporting requirements, and litigation, are meant to scare taxpayers away from using the §831(b) election.

Tax Court Litigation Against Microcaptives

Since issuing Notice 2016-66, the IRS has denied deductions to taxpayers who it believes are abusing the microcaptive structure, and these denials have led to Tax Court litigation. Since 2017, the IRS has won four cases and lost one on the issue. The four victories were: *Avrahami v. Commissioner* (2017), *Reserve Mechanical v. Commissioner* (2018), *Syzygy v. Commissioner* (2019), and *Caylor Land & Development v. Commissioner* (2021). Notably, each of these cases, with the exception of *Reserve Mechanical*, revolved around a captive taking the §831(b) election. The *Reserve Mechanical* case was about a §501(c)(15) captive but was focused on the legal issue of defining "insurance." Some elements of these cases are discussed in the "Commonly Accepted Notions of Insurance" section.

In each of these four cases, the fact pattern demonstrated that the arrangement did not meet the criteria laid out above for tax-deductible insurance. The captive in each case charged premiums that were unreasonably high, claims were rarely paid, and the agreements were not made

[55] IR-2019-157, September 16, 2019
[56] IR-2020-241, October 22, 2020

at arms-length. Each opinion concluded that the captive in question failed to achieve the commonly accepted notions of insurance as well as either risk shifting or risk distributing.

In 2021, the IRS was unsuccessful in *Puglisi v. Commissioner* (2021),[57] where the IRS disallowed a deduction on insurance premiums paid by Puglisi Egg Farms of Delaware, LLC. In a brief Tax Court Order, a decision was entered for the petitioner after the IRS had indicated that it wished to concede the deficiencies. This case was completely different from the other four cases in the microcaptive era. The captive, called Series KF, only held 20% of the risk that Puglisi had insured with the fronting carrier. Further, the evidence available in the case showed that Puglisi had sought the captive arrangement solely for the purpose of obtaining insurance that otherwise would not be obtainable.

Other such cases scheduled for Tax Court litigation have settled before trial. One of those cases, *Pilot Series of Fortress Insurance LLC v. Commissioner*,[58] further demonstrates the IRS's approach to enforcement. In that case, the IRS sent an undercover agent posing as a potential client to meet with executives of Tribeca Strategic Advisors LLC, a captive services firm which, among other services, helped clients set up microcaptive arrangements.[59] One of those clients was Caylor Land & Development. The IRS undercover agent recorded conversations with Tribeca executives over multiple years as part of a probe into Tribeca.[60] This was not the only case where the IRS considered criminal measures related to microcaptives. At a 2019 AICPA conference, the

[57] *Puglisi v. Commissioner of Internal Revenue*, No. 4796-20 (U.S.T.C. Oct. 29, 2021)
[58] *Pilot Series of Fortress Insurance LLC v. Commissioner*, Dkt. Nos. 29948-15, 9627-16, and 22148-16 (2019)
[59] Tribeca was acquired by Artex Risk Solutions Inc. in 2010. Artex is a subsidiary of Arthur J. Gallagher & Co., an insurance brokerage and risk management services firm headquartered in Rolling Meadows, Illinois.
[60] Parillo, K. (2019, June 3) Economic Substance Test Case Settles Before Trial. *Tax Notes.*

Commissioner of the IRS Small Business/Self-Employed Division said the IRS is looking into making referrals of some microcaptive cases to its criminal investigations office.[61]

It is likely that the IRS actions against microcaptive abuse will continue. The only IRS victories thus far have been fairly egregious examples of what insurance is not, and the IRS may begin to deny deductions to taxpayers with microcaptives which are operating more legitimately than those in *Avrahami*, *Reserve Mechanical*, *Syzygy*, and *Caylor*, as it did when it denied deductions to Puglisi Egg Farms. The *Reserve Mechanical* case is currently being appealed, with an unlikely chance of success for the taxpayer. In 2019, the IRS released a statement saying that more than 500 microcaptive cases were docketed at the Tax Court.[62] As of this writing, one trial including a microcaptive is ongoing and another is set to start on May 31, 2022. Further case law should be closely monitored on this issue.

Going Forward

Insurance, given all of the forementioned caselaw, is still not defined. Gray area abounds today and has abounded for decades. While certain models, such as the brother-sister model and the outside risk model, have been given approval by the courts, there are limitless possibilities for arrangements whose validity has not been tested. This uncertainty is overwhelming when it comes to microcaptives, since the IRS has taken so many adverse actions against them, including denying deductions to a legitimate microcaptive arrangement and imposing expensive, "arbitrary and capricious" reporting requirements.

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[61] See https://www.njcpa.org/article/2021/11/03/how-the-irs-distinguishes-legitimate-micro-captive-transactions-and-works-to-wipe-out-abuse

[62] IR-2019-47, March 19, 2019

Tax law that lacks clarity is problematic in multiple ways. The AICPA's guiding principles of good tax policy should be considered here.[63] One of those is certainty, which is also one of the four maxims of taxation Adam Smith described in *The Wealth of Nations*.[64] Currently, there is a distinct lack of certainty regarding the tax status of microcaptives as the IRS continues to take action against some of those entities. With insurance far from defined, honest consultants attempting to set up legitimate microcaptive programs while advocating for their clients lack the certainty needed. Further, another of the AICPA's principles is simplicity. As the AICPA puts it, "Simple tax laws are necessary so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner."[65] While the IRC is certainly not "simple" by an everyday definition of the word, there are steps Congress could take, outlined below, that would simplify the law in the microcaptive area by codifying more guidance and allowing taxpayers to rely more on statutory law than on a variety of caselaw.

This lack of clarity has allowed the IRS enough leeway that it has been able to take actions which possibly encroach on Congress's legislative authority derived from Article 1 and the 16th Amendment of the U.S. Constitution. Some professionals in the microcaptive industry believe that the IRS has used its enforcement power in an excessive attempt to render §831(b) useless. As shown above, Congress deliberately added §831(b) to the IRC in order to provide benefits to taxpayers. It would be wrong, then for the IRS to attempt to take those benefits away; the IRS has no right to second-guess the legislative wisdom of Congress. Whether or not the IRS is deliberately working to invalidate §831(b) *de facto*, taxpayers do not have the certainty to which

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63 Nellen, Annette. The AICPA's 10 Guiding Principles. *The Tax Adviser*, Feb. 2002; 33,2; Proquest pg. 100
64 Smith, Adam. *The Wealth of Nations*, edited by Edwin Cannan, New York, The Modern Library, 1994, pages 887 to 890
65 Guiding principles of good tax policy: A framework for evaluating tax proposals. AICPA, 2017.

they are entitled. To reclaim its legislative authority and protect a provision that it deliberately included in the IRC, Congress should act.

While it is certainly a complicated issue with many important considerations, there are steps Congress could take to eliminate confusion and clarify the definition of insurance. By codifying a clearer definition, Congress could achieve a few key successes. If more clarity was provided, the IRS would be freer to focus more of its limited resources on the many other pressing issues facing it. Lawyers, consultants, and accountants in the captive industry could not only give better advice to their clients, but also enjoy more certainty for their own practices. Specifically, §831(b) microcaptives have been in the Internal Revenue Code for over thirty-five years, and Congress increased their ability to collect premiums in 2015, reaffirming its commitment to providing this tax benefit to taxpayers. While §831(b) is undoubtedly the law of the land, the combination between the IRS's stance on the matter and the lack of clarity in the I.R.C. makes it difficult for taxpayers to understand how to operate within the bounds of the law. There is no question that all laws, tax and otherwise, should be clear and understood by the public. For this reason, Congress should act.

What Congress Can Do

It is unlikely that Congress would define insurance entirely, given the many other issues that Congress faces. Rather, Congress should take steps to create legislative guidance and safe harbors for microcaptives. Congress could legislatively build upon the caselaw that already exists to provide this guidance. However, Congress should not follow the guidance from non-microcaptive cases entirely. Microcaptives are, as the name suggests, smaller. As demonstrated above, Congress deliberately intended to provide unique benefits to insurance companies which were smaller than other insurance companies. Since their premiums are legally limited to relatively small amounts, they cannot possibly be expected to have as many risk exposures as other captives, and they also should not be required to retain as much outside risk.

Outside Risk

Two cases discussed earlier in this paper set the standard for outside risk, which Congress should consider. In *AMERCO*, 26%-48% outside risk was deemed sufficient as "substantial unrelated risk,"[66] and in *Harper Group*, 30% of Rampart's business was outside economic family, which was sufficient. Because microcaptives must be far smaller in terms of premiums than the captives in these cases, Congress should draw the line at 20% outside risk. At 20% outside risk, the entity becomes truly separate from the parent, as its fortunes rely greatly on the outside risk.

For example, consider a captive that receives 80% of its premiums from related entities and 20% of its premiums from unrelated entities. Just one severe loss in a year from the unrelated insureds could cause the captive to have an underwriting loss even if the insureds related to the microcaptive.[67] Therefore, the risk has been pooled between the related parties and the unrelated parties because the microcaptive's fortunes do not directly correlate with the presence or absence of claims by related parties. Because a substantial amount of risk is mixed in from outside parties, risk becomes distributed between those parties and thus shifted away from the insureds.

Risk Exposures

It would be impossible for Congress to codify a specific number of risk exposures that would allow a captive to achieve risk shifting and risk distributing. This is because it is not only the sheer number of risk exposures, but the type of risk exposures and their degree of statistical independence from each other which create a true pool of risk. However, despite the fact that a

[66] *AMERCO* at 168

[67] If a microcaptive has an underwriting loss, its principal tax benefit is irrelevant because the benefit is to be exempt from income tax on underwriting income.

specific quantification cannot be reached, common sense should prevail for both the IRS and the courts who rule on these issues. As with outside risk, but to an even greater extent, the number of risk exposures that a captive can reasonably be expected to take on is severely lower when its premiums are capped at such a low level. For this reason, the number of risk exposures present in the taxpayer victories in the 1989 – 1993[68] and 2014[69] periods cannot serve as guides to what is acceptable. Furthermore, in none of the microcaptive cases does the Tax Court opine on what an appropriate number of risk exposures would be. The idea is that there would be enough risk exposures that the law of large numbers would be in effect, but how large must those numbers be? It depends on the type of risk, and the degree to which they are related or independent, further complicating the matter.

Number of Insureds

As noted above, Revenue Rulings have created a safe harbor for qualifying captives insuring at least eleven insureds. Microcaptives, by their nature, are limited in the amount of premiums they can legally take on, and they should therefore not be expected to insure as many insureds as those captives which are unlimited in the amount of premium volume that they can retain. To further provide clarity and give the industry more certainty, Congress could codify a safe harbor for five distinct insureds (not single-member LLCs, which are disregarded for tax purposes). Each of the five insureds would have to account for between 10% and 30% of the premium volume taken in by the microcaptive.

Application

If Congress were to heed these recommendations and codify more clarity for the sake of §831(b), the taxpayers would have an easier job determining what is insurance. Safe harbors

[68] *Humana, Harper Group, AMERCO,* and *Sears*
[69] *Securitas* and *Rent-A-Center*

would be created, allowing microcaptives to operate with more certainty and allowing the IRS to focus its limited resources on other critical issues it faces. If greater clarity was provided, then the courts could do what Judge Easterbrook suggested in the *Sears* case when he wrote, "Suppose we ask not 'What is insurance?' but 'Is there adequate reason to recharacterize this transaction?'"[70] Litigation would then only be necessary if there is an allegation of sham or lack of business purpose.

Conclusion

The microcaptive controversy between the captive insurance industry and the IRS is far from over. The actions taken by the IRS, including Notice 2016-66, settlement offers, Dirty Dozen assignment, and audits all demonstrate the IRS's substantial concern regarding microcaptive arrangements generally. The most recent microcaptive Tax Court case, *Puglisi,* demonstrates how far the IRS is willing to go, as it denied deductions to a clearly legitimate arrangement. If, as some in the captive industry believe, the IRS is deliberately attempting to render §831(b) useless, this raises considerable constitutional issues regarding the separation of powers between the legislative and executive branches.

If the IRS is attempting to effectively nullify §831(b), it would be directly contradicting the will of Congress. As an executive agency under the U.S. Department of the Treasury, it is responsible for enforcing the laws as Congress has passed them under its Article 1 and 16th Amendment powers. The IRS, nor any executive agency, has the right to actively subvert any law passed by Congress and signed by the President. To allow the IRS to nullify a duly passed law would be to give it legislative and judicial power as well, which is completely at odds with the Constitution and is dangerous: "The accumulation of all powers, legislative, executive, and

[70] *Sears* at 864

judiciary, in the same hands, whether of one, a few, or many, and whether hereditary, self-appointive, or elective, may justly be pronounced the very definition of tyranny."[71]

Even if it is not the IRS's intention to eliminate §831(b) *de facto*, the actions it has taken since 2015 are clearly adversarial to microcaptives and may, if left unchecked, significantly and negatively affect taxpayers' willingness and ability to take advantage of an IRC provision that Congress clearly intended for taxpayers to have. As shown, it is a lack of clarity in this area of the law that has given the IRS the ability to make these determinations at its discretion.

Congress should not allow any executive agency to nullify duly passed law. To make its voice heard and protect its legislation, Congress should act in a timely fashion to address a major lack of clarity in the Internal Revenue Code. As the law is written, it is unclear in such a way that it adversely affects the taxpayer. While caselaw has created a framework for what insurance is and is not, gray area abounds. Even the most well-reasoned opinions are more subjective than objective. When denying a deduction, the courts' reasoning often echoes Justice Potter Stewart's concurring opinion in the obscenity case *Jacobellis v. Ohio* (1964) when he stated, "I know it when I see it, and [this] is not that."[72] Taxpayers deserve more clarity, and Congress should stand up for itself.

[71] Publius, Federalist No. 47
[72] *Jacobellis v. Ohio,* 378 U.S. 184 (S.Ct., 1964) at 197