TAX UPDATE ON THE CAPTIVE INSURANCE INDUSTRY

Federal income tax issues involving small captive insurance companies have been in the news lately

Captive Review (CR): What is the nature of this continued business press reporting of tax issues involving captives?

Stewart A. Feldman and Logan R. Gremillion (SF & LG): There are a couple of things happening. First, a mid-west-based national insurance brokerage firm is in litigation with the IRS. This surfaced just last year. This national brokerage firm acquired an Arizona-based captive services firm four or five years ago that provides 'captive management services', essentially administrative services. No legal, tax, CPA or professional services are provided to the client by the mid-west-based broker, with the client left to secure these on its own.

As we've explained for years, captive management services inherently require the delivery of complex legal services (for example, tax, corporate, regulatory, and so on). Despite such, we have seen where the mid-west broker 'disclaimed' in its usual contract providing any professional legal, tax or CPA services. To the best of our knowledge, there has not been an investigation of this organisation for providing unlicensed professional services. However, the IRS has sued the mid-west-based broker in US District Court to enforce a subpoena which essentially mandates the turnover of all its client files and has obtained an order of the US District Court ordering the wholesale turnover to the IRS of these files. These matters were previously reported by *Business Insurance* on 14 September 2014.

It appears that the IRS' arguments are that the planning spearheaded by the mid-west-based insurance broker failed to meet the complex, lengthy and involved requirements of an insurance company for US income tax purposes. The service is now targeting the brokers' clients. The long and short is that the IRS now has or is about to receive the voluminous files and likely deficiencies will surface. A similar problem has developed with another administrative services provider based in Orange County, CA. The IRS rightly or wrongly has accused these groups as being 'tax shelter promoters'.

In both situations many clients apparently thought they were receiving all the advice needed to put the planning into place and to carry it out. Yet the contracts with the administrative providers said that only a limited range of administrative services was being provided.

Earlier this year the IRS named captives to its 'Dirty Dozen' list, although the IRS announcement doesn't say much. Essentially the notice says that captives are a legitimate planning tool under the Internal Revenue Code, but if not done correctly, can be abusive. This is hardly newsworthy. To be sure, if anything allowed or provided for under the Internal Revenue Code isn't done correctly, such can be abusive.

However, when implemented properly, captives can be a viable risk management strategy as they have for 100 years in the US and longer outside of our country.

CR: Has the position of the IRS changed?

SF & LG: We don't think it has. The IRS has challenged captive insurance arrangements from time to time for the last 40 years on various grounds. If the planning isn't done correctly, there is a problem. This is no different than if a defined benefit plan is put in place incorrectly, then the taxpayer has a problem. And if a foreign sales corporation is put in place incorrectly, there is a similar problem.

In the case of a P&C captive, there are many moving parts. There are a lot of things that are needed to do the planning correctly. There also needs to be recognition that these entities spring out of US tax provisions which control the structure and operations of the planning. State insurance licensing is important but the IRS is not bound by the findings of a state insurance department. There are hundreds if not thousands of captives which are regulated

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"Forming and operating a captive takes comprehensive planning, involving insurance and accounting professionals and senior tax, corporate and regulatory lawyers"

insurance companies that do not purport to be insurance companies for federal income tax purposes. In a similar vein, the underwriting is also important. Many clients of the Orange County, CA and mid-west-based administrative providers may find themselves in these unfortunate positions. But these tasks (that is, the state insurance issues, the underwriting, and so on) are just part of the equation because of large gaps in the planning. Yet this is where the administrative providers seem to focus.

Over the past 40 years, we have seen IRS interest in the captive area. For the last 15 or so years, there has not been much IRS activity. This period of relative dormancy was broken last year when the US Tax Court ruled on two high-profile captive insurance arrangements (*Rent-A-Center, Inc. & Affiliated Subsidiaries v. Commissioner*, 142 T.C. 1 (2014) and *Securitas Holdings, Inc. & Subsidiaries v. Commissioner*, TC Memo 2014-225). The IRS lost both cases in US Tax Court.

CR: What are the recent trends you are seeing with regard to captives?

SF & LG: Captives are moving onshore and away from traditional UK territories, principally Caribbean domiciles. This is notwithstanding the greater expertise in many of these locations than exists in most domestic domiciles. Bermuda is still the home of many major industrial and financial services captives. The Cayman s is the home of many healthcare captives. The BVI is essentially out of the captive business. Anguilla remains a viable alternative for small captives. Dodd Frank has changed the playing field and may ultimately erode most captives domiciled, for example, in Vermont and other 'non-home state' domiciles. Washington, DC would disappear as a domicile.

We see this primarily as a response to licensed traditional insurance brokers' attempt to minimise the administrative burden on their filing independently procured premium (IPP) tax returns in multiple states. The loose language of Dodd Frank has caused an unfortunate cascading effect.

In response, most states have passed legislation that enables the formation of captives, with a carrot and stick approach. The new state legislation encourages re-domestication of captives to the so-called 'home state'. Captives are in turn leaving the traditional domiciles in favour of these newly created domiciles in order to avoid the overhanging risk of double taxation.

CR: What advice do you have for captive owners and advisors?

SF & LG: Captives are a complex creature involving the application of complicated federal, state and sometimes cross border tax laws to the P&C industry, with an additional overlay of finance, state law regulatory oversight, insurance and insurance economics. Captives require the participation of numerous professionals to get it right. There are many wrong things that can be done, any of which are the death knell for the planning. Few get it right. Most so-called 'captive managers' – which have virtually no licensing or minimum skills requirements in any domicile – provide only clerical services and administrative work, disclaiming any legal, tax or accounting advice. The clients are left exposed.

We've seen where unqualified people (including unlicensed lawyers, promoters and even former Starbucks managers) providing only clerical and administrative services are now 'captive managers'. And the states are licensing them! The states should be taking a leadership role in acting as the gatekeeper but they have not. Forming and operating a captive takes comprehensive planning, involving insurance and accounting professionals and senior tax, corporate and regulatory lawyers. Going into a captive planning arrangement without this level of comprehensive planning is playing the tax audit lottery, which is very bad judgment.