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THE TAX COURT TAKETH AWAY WHILE CONGRESS GIVETH BACK

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Philip Karter, J. Scot Kirkpatrick, and Christopher A. Steele

The past few years have been very active for captive insurance. On the one hand, the Internal Revenue Service ("IRS") finally achieved a victory in its war on small captive insurance companies. On the other, Congress has once again passed legislation improving Section 831(b) to benefit taxpayers as we explain below.

Small Captives and the *Avrahami* Case

The 2017 Tax Court decision in *Avrahami v. Commissioner*[1] provided the IRS a much sought-after victory against the congressionally induced authorized use of small captive insurance companies under Section 831(b) of the Internal Revenue Code. In *Avrahami*, the Tax Court upheld the IRS' disallowance of premium deductions after determining that the captive policies at issue did not cover real insurable risks in a manner that qualified them as insurance in the commonly accepted sense, and that the captive did not operate as a true insurance company.

Although the IRS had reason to cheer the outcome in *Avrahami*, the case also provided taxpayers much-needed judicial guidance on the proper use of Section 831(b) that should help navigate around the potential pitfalls of small captive transactions more successfully. Specifically, taxpayers need to ensure that the captive arrangement has, among other things, a solid non-tax business purpose behind the issuance of each policy, commercially reasonable policy terms, defensible risk premiums, appropriate claims review and payment procedures, and sufficient liquidity in the captive to pay claims should they arise. Further, the transaction must avoid the appearance of self-dealing through circular cash flow arrangements such as loan backs. Finally, as with all insurance arrangements – not just those involving small captives – there must be adequate risk distribution for the arrangement to be respected.

The IRS' victory in *Avrahami* may cause some business owners to have second thoughts about incorporating a captive – and especially small captives – into their risk management program. However, any company that faces significant insurable business risks should not be deterred from availing itself of the benefits Congress has repeatedly encouraged through the enactment and recent amendments to Section 831(b). From taxpayers' viewpoint, *Avrahami* was a poor choice to be the first small captive case tried in court and many practitioners familiar with the facts of that case correctly predicted the outcome. Yet, with many small captive cases now working their way through the judicial process (primarily through the Tax Court), *Avrahami* is far from the last word on the subject. As other decisions come down from the courts, it will be increasingly apparent that, like every other congressionally authorized tax-advantaged transaction challenged by the IRS over the years, the facts do matter.

The 2018 Consolidated Appropriations Act

Despite the IRS' continued attacks on Section 831(b) captives and the failure to issue much in the way of administrative guidance, Congress continues to provide incentives for small businesses to use small captive insurance companies. In 2015, at the request of the IRS, Congress added some restrictions to curtail the estate planning use of small captive insurance companies; however, at the same time, Congress increased the dollar amount of the tax incentive by raising the amount of premiums a small captive insurer can receive free from income tax under Section 831(b) from $1.2 million to $2.2 million for 2017 and adjusted this exemption for inflation – $2.3 million is the 2018 exemption. Just three short years later, Congress helped small captive insurance companies by clarifying the 2015 PATH Act ownership requirements and giving taxpayers guidance on how to satisfy the requirements under Section 831(b).

Signed on March 23, 2018, HB 1625, also known as the Consolidated Appropriations Act, 2018 ("CAA"), clarifies several key areas of the Section 831(b)(2)(B) diversification requirements which were originally implemented by the PATH Act. First, the CAA clarified the 20 percent test – no more than 20 percent of the annual net written premiums of the captive may be attributed to any one policyholder – by defining the term "policyholder" as "each policyholder of the underlying direct

written insurance with respect to such reinsurance or arrangement." In other words, a small captive insurance company should be able to satisfy the 20 percent test, and the diversification requirements by utilizing an 80 percent pool arrangement. This approach is consistent with prior IRS guidance in Rev. Ruling 2009-26 (2009), which is not specific to small captives. Meanwhile, with its attack on small captives unabated, the IRS has still not issued regulations or any additional guidance specific to Section 831(b), making it difficult for taxpayers to know how to comply with the law. A cynic might say this is a government tactic to de-incentivize legislation passed by multiple congresses and signed into law by multiple presidents.

The CAA further helps taxpayers in their use of small captive insurance companies by removing spouses who are U.S. citizens from the definition of the term "specified holder." The PATH Act defined a specified holder as anyone who was a spouse or lineal descendant of an individual who held an interest in the specified assets (i.e., the insured entity) with respect to such insurance company. Under the CAA, the term "specified holder" no longer includes spouses, creating some additional flexibility for planning under the diversification requirements. In its place, the CAA includes a new rule aggregating the interests of spouses with respect to the insurance company. In other words, if a spouse owns a portion of the insurance company, such ownership will be attributed to their spouse for purposes of determining the 20 percent net written premium test or the mirror ownership less two percent de minimis rule.

For taxpayers, this so-called clarification can be beneficial as it eliminates a minor hurdle to satisfying the ownership test. The diversification requirements under Section 831(b) are satisfied if the structure passes either the 20 percent net written premiums test or the ownership test. Drafted in the negative, the ownership test is satisfied if no one is a specified holder who holds more of the insurance company than such specified holder owns in the insured entity with respect to such insurance company. If there is no specified holder, the ownership test is not an issue, meaning that the small insurance company will satisfy the diversification requirements. Thanks to the changes under the CAA, avoiding violation of the ownership test becomes easier with the removal of spouses.

For example, under the CAA, a husband should be permitted to own 100 percent of a small captive insurance company while his wife owns 100 percent of the insurance company. The aggregation under the CAA would only apply to the ownership of the insurance company. In this example, 100 percent of the wife's ownership in the insurance company would be attributed to the spouse; however, the absence of a specified holder would still allow the captive ownership to satisfy the diversification requirements.

Finally, the CAA changed the ownership test by substituting the term "specified assets" with the term "relevant specified assets." The term "specified assets" were defined as trades, businesses, rights or assets with respect to which the net written premiums of an insurance company are paid. Section 831(b) still uses this term. However, for purposes of the ownership test, the term "relevant specified assets" is used and is defined as the aggregate amount of an interest in the trade, business, rights or assets insured by the captive, held by a specified holder, or the spouse of a specified holder. Further, the definition of "relevant specified assets" excludes assets that have been transferred to a spouse or other relation passed "by bequest, devise, or inheritance from a decedent during the taxable year of the insurance company or the preceding taxable year."

Conclusion

With the passage of the CAA, Congress has again swung the small captive insurance company pendulum back in favor of the taxpayer, albeit slightly. By providing clarity with respect to the proper organization of a Section 831(b) small captive insurance company, Congress has provided taxpayers a path forward while the IRS continues to bask in it's so-called victory under *Avrahami*. Perhaps even more importantly, Congress, unlike the IRS, has made clear its intention to continue to encourage small businesses to take advantage of Section 831(b). Taxpayers' take-away from Congress' continued support for small captives should be that while *Avrahami* may represent a "what not to do" roadmap for setting up and running a small captive, it should not deter taxpayers from taking advantage of the benefits small captive insurance companies can provide in effective risk minimization. Instead, taxpayers should approach them with the same caution and diligence as any other congressionally authorized planning arrangement, including acquiring guidance from professionals who know where the pitfalls of such arrangements are and how to avoid them.

Note

[1] 149 T.C. No. 7.

About the Authors

Philp Karter is an attorney at and shareholder in the firm of **Chamberlain Hrdlicka** representing clients in various complex tax planning transactions, federal tax controversies, and high-profile tax litigation matters. Resident in the firm's Philadelphia office, he may be reached at pkarter@chamberlainlaw.com.

J. Scot Kirkpatrick is an attorney at and shareholder in the firm of **Chamberlain Hrdlicka**. As the head of the firm's Trust and Estates Practice Group in Atlanta, he counsels clients on a variety of tax and estate matters including planning for business owners. Mr. Kirkpatrick may be reached at scot.kirkpatrick@chamberlainlaw.com.

Christopher A. Steele is an associate in **Chamberlain Hrdlicka**'s Trusts and Estates Practice focusing on estate and asset protection planning as well as the administration of complex trusts and estates. Resident in the firm's Atlanta office, he may be reached at christopher.steele@chamberlainlaw.com.

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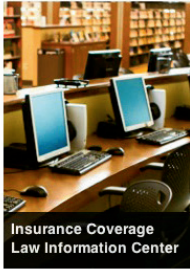

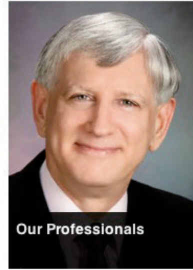

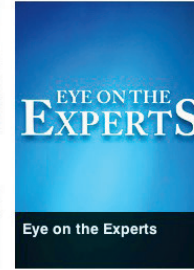

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