DEVELOPING ISSUES CHALLENGING THE CAPTIVE INDUSTRY

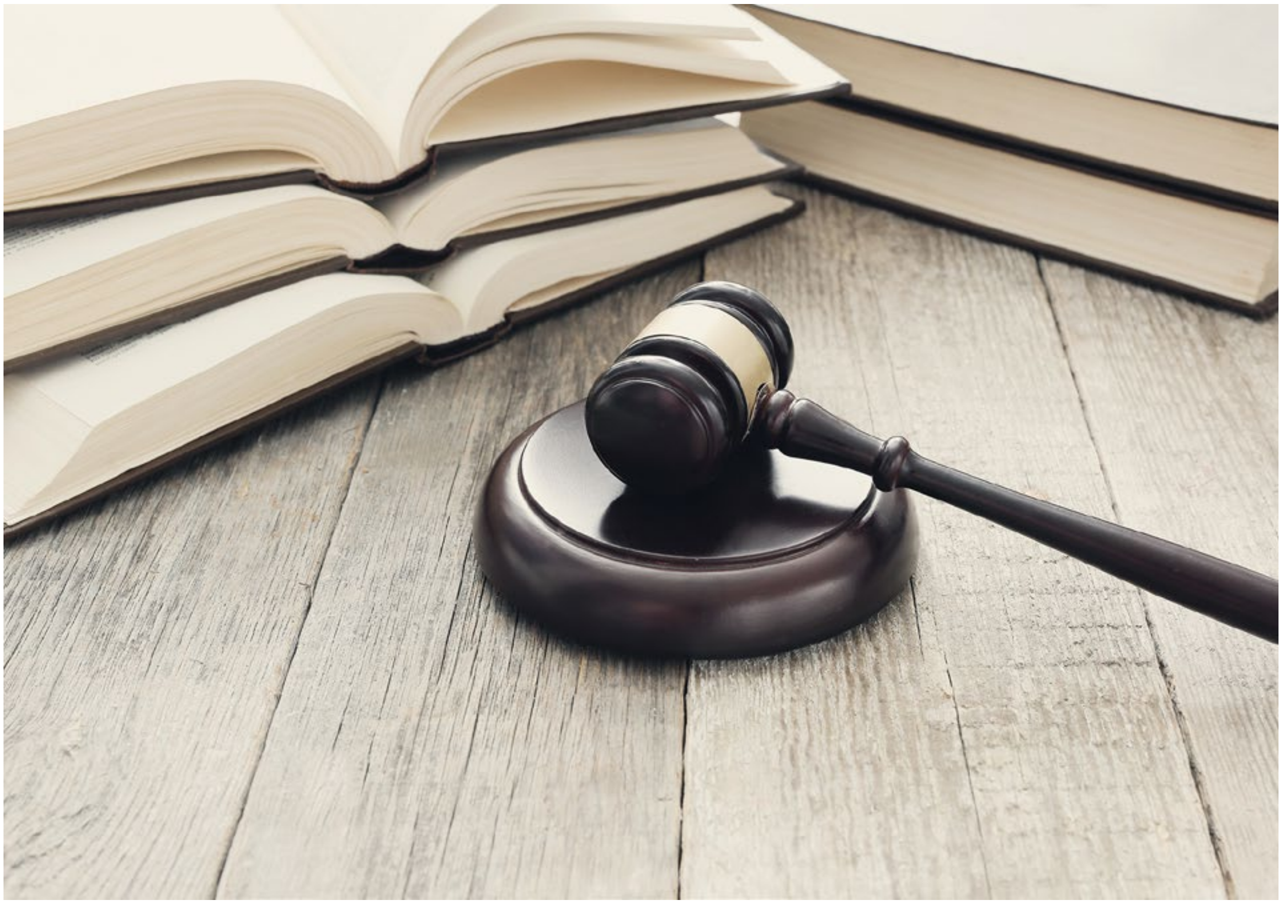
Written By Karrie Hyatt

Captives have been hit with a number of challenges so far this year. Even while captive numbers are growing as a result of the hard market and the pandemic, obstacles—from state legislation to continued IRS actions—have continually been thrown in their way. There is a silver lining to the clouds that have been shading the industry that comes from the U.S. Supreme Court decision in favor of CIC Services Inc. in its suit against the IRS, which was announced in mid-May.

WASHINGTON STATE LEGISLATION

Since 2018, the Washington state Office of the Insurance Commissioner has been investigating captive insurance companies operating in the state. The culmination of this investigation has resulted in the passing of legislation by the state that requires captives to pay premium tax on the risk insured for their parent company.

Insurance Commissioner Mike Kreidler first made waves in May 2018 when he issued a cease-and-desist order to Cypress Insurance Company, a pure captive owned by Microsoft Corporation, requiring that the captive stop selling insurance to its parent company and pay more than two million in back taxes and penalties.



Cypress Insurance is domiciled in Arizona and had been insuring its parent company since 2008 without using a fronting carrier. By August 2018, the case had been settled out of court with reduced fines for the insurer. After the settlement, Commissioner Kreidler announced via a press release that the state would pursue other captive insurance companies insuring risk within the state.

The commissioner kept his promise and has investigated and fined other captives, including Costco's captive, NW Re Limited. Washington is one of just a dozen states that does not have captive law and was one of the few states in the U.S. that did not have direct procurement or self-procurement tax requirements. Direct procurement taxes are levied by states when a company purchases insurance from an insurer not licensed or registered in the state.

Last August, Commissioner Kreidler surveyed around 5,000 businesses in the state to determine how many businesses insure through captive insurance. This was done in an effort to determine how much risk in the state captives were covering. In a report of the survey, compiled by actuarial firm Milliman, it was estimated that in 2019 captives collected $300 million in direct written premiums.

In February of this year, Bill 5315 was introduced in the state senate. The bill requires captive insurers to pay a 2% procurement tax on premiums. Captives would also have to register with the state and pay an initial $2,500 fee, as well as an annual renewal fee of up to $2,500.

Captives insuring public institutions of higher education are exempt from the law. Captives that have been insuring risk in the state since January 1, 2011 will owe back taxes on any premiums for which they have not previously paid taxes, but will not be subject to penalties and fees for non-payment.

The legislation was approved by the state senate in March and by the house of representatives in April, then landed on Governor Jay Inslee's desk. He signed the bill into law on May 12th.

Criticized as "poorly drafted" by Vermont Captive Insurance Company president Rich Smith, the legislation will add a layer of regulation to captives insuring their parent companies. The concern among captive professionals is that other states without direct procurement tax for captives will see Washington's efforts as a revenue generator and will follow the state's lead in profiting off captive insurance companies, making operating a captive more expensive.

CAYLOR DECISION

The captive industry took another blow in March when the U.S. Tax Court decision was handed down in Caylor Land & Development v. Commissioner. This was the fourth case in which the Tax Court decided in favor of the IRS involving ERCs that elect to take the 831(b) tax option.

Judge Holmes, who also decided the Avrahami case, cited all three previously decided cases (Avrahami, Reserve Mechanical, and Syzygy) in his decision, finding that Caylor's use of their captive, Consolidated Inc., did not constitute insurance. Unlike the three previous cases, Caylor did not involve a question of risk distribution, but brother-sister insurance arrangement.

The decision in this case has been long in coming with the original hearing in 2017 and was not a huge surprise for the captive industry given the previous three decisions. The biggest surprise was that Judge Holmes ordered penalties to be paid. In the previous cases, the companies involved were charged with paying back taxes but were shielded against penalty fees by section 6664(c) that allows for a good faith defense.

One point about all four of these cases is that the period of operation in question for each is prior to 2014, and for Avrahami as far back as 2009. The IRS seems to be focusing on ERCs from when small and medium-sized captives first really began forming and opting for the 831(b) tax exemption in the late part of the 2000s.

Caylor was the last of the Tax Court decisions that the captive industry had been waiting for. Although, in the case of *Reserve Mechanical Corp. v. Commissioner*, while the Tax Court found in favor of the IRS, the decision has been appealed, so the final outcome in still undecided.

AND THE IRS

Last year, amid the pandemic, the IRS continued to pursue micro-captives—their term for ERCs that take the 831(b) tax election. With actions in March, July, and October, and twelve investigative teams launched to focus solely on micro-captives, the Service continued its charge against captives they see as abusive.

This year is no different. In early April, the IRS released a letter urging "abusive micro-captive insurance arrangements to exit these transactions as soon as possible." The statement came a month after the Caylor decision was handed down and capitalized on the Service's fourth court win.

As has been the case for going on eight years, the IRS admonishes abusive micro-captives while offering zero guidance on what a properly structured micro-captive looks like. At this point, it seems that by not describing a "good" captive the IRS is assuming all micro-captives are abusive.

This is the stance that SIIA took in an April 16 statement responding to the IRS's letter, "While the IRS continues activities related to captive insurance, it must also move towards recognizing what an appropriate structure is, and issue appropriate guidance to that purpose." SIIA supports curbing abuses within the industry and supports legitimate efforts to weed out abusive transactions. However, the vast majority of captive owners and professionals are using micro-captives responsibly.

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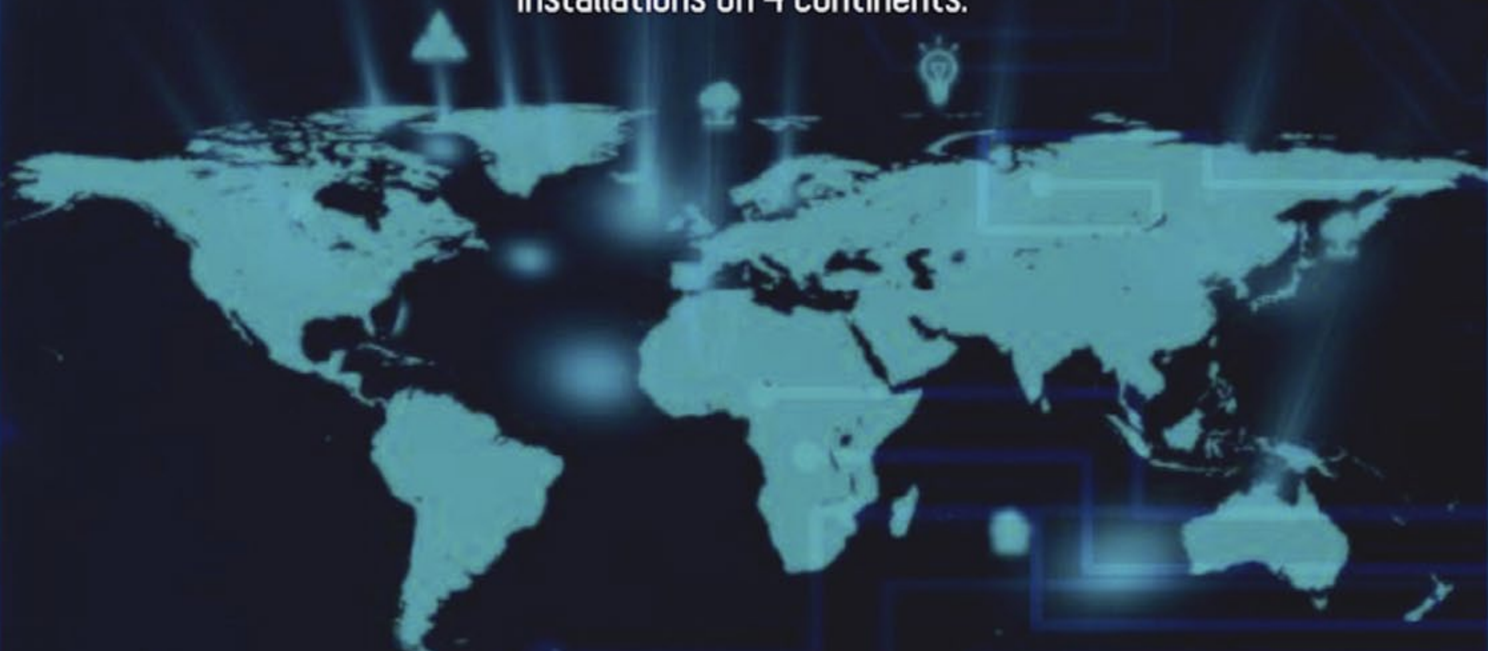

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According to the IRS's narrative, there are no ERCs that are using the 831(b) tax option for legitimate business purposes. Yet, as last year proved, captives are incredibly important to help small and medium-sized businesses on a day-to-day basis, and especially in times of upheaval.

SIIA's statement ends with "While the IRS may remain focused on certain captive structures, SIIA strongly believes that it must do so in a responsible and fair manner. As American business continues to nav[i]gate through COVID disruptions, captive insurance companies remain committed to providing a needed and legitimate risk management tool for these businesses to grow and thrive."

In contrast, as if to emphasize their commitment to pursue ERCs, on April 19, the IRS announced the establishment of the Office of Promoter Investigations (OPI). According to the statement released by the Service, the office will expand the efforts of the Promoter Investigations Coordinator, a position established last summer.

The OPI will focus of promoters of abusive tax avoidance transactions which covers a variety of tax-dodging schemes. However, Commissioner Chuck Rettig made no pretense that micro-captives were not one of the main focuses of the new office. "This office will coordinate efforts across multiple business divisions to address abusive syndicated conservation easements and abusive micro-captive insurance arrangements, as well as other transactions," he was quoted as saying in the IRS's announcement.

While this office may fill a need in the IRS's administrative structure, the captive industry is still waiting for guidance relating to abusive captive practices as authorized by Congress in the *PATH Act of 2015*. There is no indication that the OPI has any directive regarding establishing guidance for captive owners and professionals. The IRS continues its laser focus on ERCs hindering the operation of well-structured captives instead of helping by offering direction. ■

Karrie Hyatt is a freelance writer who has been involved in the captive industry for more than ten years.
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