FEATURE

Tax Court Deals Blow to **Enterprise Risk Captives**

Written by Karrie Hyatt

On April 10, the U.S. Tax Court released its decision in *Syzygy Insurance Co. v. Commissioner*, finding in favor of the Internal Revenue Service (IRS). This was the first of three similar cases that are due to be decided this year that involve Enterprise Risk Captives (ERC) electing the 831(b) tax deduction.

Referring to these small to medium-sized companies as "micro captives," the IRS has been investigating ERC insurers that opt for the 831(b) tax filing for more than seven years. The department has long suspected that some companies claiming to be captive insurers are really using the 831(b) designation as a tax dodge, especially in regards to estate planning and wealth transfer.

For the last five years the IRS has named these types of captives to their "Dirty Dozen" list—a list the Service releases each year warning tax payers of potential tax scams. In late 2016, the IRS issued Notice 2016-66 which named "micro captives" as "transactions of interest" and required additional financial disclosures from captives opting for the 831(b) election for the purpose of gathering further data on how these captives operate.

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Syzygy is the third case regarding ERCs taking the 831(b) option to be decided by the Federal Tax Court since 2017. The two other cases were *Avrahami v. Commissioner* in 2017 and *Reserve Mechanical Corp. v. Commissioner* in 2018. In all three of these cases, the Court's decision was in favor of the IRS.

"I think it's important to remember a few things when it comes to the recent IRS tax court wins," said Ryan Work, vice president of government relations with SIIA. "First, many of the captives in these cases were formed at a time during ERC's formative years, meaning that the industry has matured and put in place more robust practices. Second, captive taxpayers have also had wins in cases such as Securitas and Rent-A-Center, that should not be forgotten simply because of recent wins by the Service"

THE SYZYGY DECISION

In 2008, Pennsylvania-based Highland Tank & Manufacturing Co.—a steel tank manufacturer—and its affiliates formed Syzygy Insurance Co., domiciled in Delaware. California-based captive manager, Alta Holdings, LLC, provided management services for Syzygy and the captive participated in Alta's captive pooling program. During the years in question, 2008 to 2011, Highland Tank purchased policies through Alta-related fronting carriers—first U.S. Risk Associates Insurance Co. (SPC), Ltd. and then Newport Re, Inc. During this time, the captive owners relied on advice from Emanuel DiNatale, a C.P.A. with Alpern Rosenthal.

Judge Ruwe, who wrote the opinion, narrowed down the case into four parts: (1) were the payments made by Highland Tank to Syzygy and its fronting insurers deductible as insurance premiums; (2) if Syzygy was eligible for the 831(b) tax election during the years 2008 to 2011; (3) if the premium payments to Syzygy should have been considered income, if the court decided the arrangement wasn't insurance; and (4) if the captive owners would be liable for income tax-related penalties.

On the first point, the Court relied heavily on the *Avrahami vs. Commissioner* decision and used the same criteria it used to judge that case—how risk was distributed and if the captive provided "insurance in commonly accepted sense."

The Court found that in terms of risk distribution the premiums paid to Syzygy and its fronting insurers, while not a complete loop, "looks suspiciously like a circular flow of funds." The court found no evidence of arm's length contracts and that premiums were not actuarially determined. Citing both the Avrahami and Reserve Mechanical decisions, the Court stated, "We have held that premiums were not actuarially determined when there has been no evidence to support the calculation of premiums and when the purpose of premium pricing has been to fit squarely within the limits of section 831(b)."

The Court went on to state, "This means Syzygy's reinsurance of those policies did not distribute risk; therefore, Syzygy did not accomplish sufficient risk distribution for Federal income tax purposes through the fronting carriers." In terms of "insurance in the commonly accepted sense," the Court had concerns regarding the captive's zero insurance claims over the period of time in question and also in its investment choices.

Based on the information detailed in the Decision about whether or not the payments made by Highland Tanks to Syzygy counted as premium, the Court found that "Syzygy was not operated like an insurance company" and was not considered eligible during the years in question for the 831(b) tax deduction. It also found that the premiums paid to Syzygy should have been considered taxable income for the captive. As to the fourth point in the Decision, the Court decided that the individual petitioners, or individuals who paid premiums to Syzygy and its fronting carriers, would not be liable for "accuracy-related penalties" as requested by the IRS.

THE SYZYGY IMPACT

According to Ryan Work, the lessons to be learned from all three cases is that the IRS is focusing on several key points when it comes to ERCs—appropriate risk and premium, loss history, binding policies, and arm's length transactions. "The larger question in all three cases also surrounds the viability of risk pooling and how the court is considering that in part of the larger context," said Work.

The IRS seems to be handpicking cases that they believe will be easy wins that will help establish case law for future legal action. The cases they chose illustrates the key points they are focusing on and allows them to get the court decisions they are looking for. Yet, in the overall scheme of things, the cases that are making it to court are a tiny percentage of the number of captives being audited.

Even with all the negative press from the IRS's aggressive attitude towards small captives taking the 831(b) tax election, ERCs continue to grow. According to Work, "First and foremost, small and medium size business owners still see ERC captives as an important and viable risk mitigation tool. Rest assured that with all the recent criticism and court decisions, these owners are taking a harder look at ERCs and still seeing them as not only legitimate, but a necessary part of their overall business operation."

Yet, with the continuing interest that the IRS has in "micro captives," there has never been a better time for captive owners to look into their captive arrangements to make sure that they are being used properly as insurance vehicles.

"The captive industry needs to continue to take a deep dive look at itself and ensure that managers are creating captives appropriately, both with risk and premium, and that owners fully understand the captive insurance they are forming. This is real insurance with real risk," said Work.

Based on Avrahami, Reserved Mechanical, and now Syzygy, it looks like the IRS is creating a template with which to approach small captives electing the 831(b) designation. "There is little doubt that the IRS is creating additional guidelines to review captives, both through recent court cases as well as the information collected through Notice 2016-66. While some of this is detrimental to the growth of the captive industry, I believe the industry will come out stronger for it at the end of the day, learning lessons, creating better practices and management guidelines, and helping create a clear future."

SIIA has been committed to that end by advocating on behalf of ERCs through exploring policy issues, working with and educating regulators, working closely with its member organizations, and being proactive in creating guiding principles such as the Captive Manager Code of Conduct, which was released earlier this year.

That leaves the question, what does the future hold for ERCs? Like many other captive arrangements, they've proven their worth to their owners and despite the negative press from the IRS are continuing to grow. Yet these highly publicized tax court decisions could have a negative impact on future growth.

Not so, according to Work. "I've repeated this many times over the past several years, but the future remains bright for ERCs. While there will continue to be short term pain, that pain will weed out the bad actors and, at the end of the day, the industry is going to be better and stronger because of this. The IRS and courts are helping with that, but more importantly, the industry needs to look deeply into practices and internal guidelines and continue to showcase what's going right and why businesses continue to utilize captives appropriately and for the right reasons. It's not just about the captives in tax court, it's about the 99% that aren't." ■

Karrie Hyatt is a freelance writer who has been involved in the captive industry for more than ten years. More information about her work can be found at: www.karriehyatt.com.