

Global insurance pricing has been on the increase for the last seven quarters, while capacity is tightening in certain lines of business and in some regions. According to the Willis Towers Watson survey report, *Insurance Marketplace Realities 2020*, “The most challenged lines of insurance (i.e., those experiencing the most widespread price increases and capacity withdrawals) are property, umbrella and public company [directors and officers].” The report predicts continued rate hikes and capacity constriction through 2020 and into the following year, although property should sort itself out by the middle of 2020.

According to *The Property/Casualty Underwriting Cycle*, a report released by Fitch Ratings in November, while the P&C market has been in a phase of increased pricing, the ratings agency has found that due to “competitive forces and less favorable claims trends in some lines” that the trend of rising premiums will not lead to a long-lasting hard market.

For captives, a hardening market means more companies will look to alternative sources for insurance. During periods of a hard insurance market, the numbers of captives and other alternative risk transfer vehicles see large growth. Given that the captive insurance market has been growing exponentially over the

last twelve years, despite a continuing soft market, the captive market will likely not expand significantly during this period of hard market conditions. However, existing captives might feel the pinch in rising reinsurance pricing.

INSURTECH

Hard markets may become a thing of the past as insurtech takes over the insurance space. As companies become technology based, they will have the ability to have a flexible underwriting approach driven by very specific data. Being able to underwrite policies based on individual factors, rather than actuarial estimates, could create a more stable insurance market.

Insurtech is coming to the sector in a big way. In 2018, more than \$2.5 billion dollars was invested in insurtech companies. The numbers for 2019 are expected to double that amount. Gone are the days when startup insurtech companies wanted to disrupt the industry. Now, large insurers to small captives are taking advantage of the accuracy and efficiencies that insurtech has to offer. With so much investment, the insurtech space is becoming more competitive, with more vendors offering services to insurance companies of all sizes—and some focusing on providing services only to captives.

2020 is going to be the year for captives to get on board with the innovations that insurtech developers are bringing to the table.



ERCS AND THE IRS

The IRS has not decreased its interest in captives electing the 831(b) tax option. For medium and small-sized captives, known as Enterprise Risk Captives (ERCS), this means continued scrutiny. The IRS will likely name captives taking the 831(b) option, what they refer to as “micro-captives,” to its annual “Dirty Dozen” list for the sixth time in a row.

The captive sector is still waiting to see what the impact will be from the IRS’s settlement offer to some ERCS currently under audit. At this time, there is no information on how many captives may have accepted the offer, though it is estimated that the offer went out

to approximately 200 captives. In making the settlement offer, the IRS was using its leverage from three successful court decisions against “micro-captives” to help reduce the estimated 500 or more audits it is currently reviewing.

When “micro-captives” were named to the “Dirty Dozen” list in 2019 (release IR-2019-47), delivered on March 19, 2019, the IRS used much stronger language than in previous releases regarding the entities on the “Dirty Dozen” list. The release stated, “Taxpayers are reminded that those who participate in illegal schemes may face prosecution, civil litigation and ultimately having to pay all taxes owed along with stiff penalties and interest. Participants who utilize such schemes for tax evasion also risk imprisonment.” In previous years’ iterations, the language used did not expressly threaten criminal action.

As reported on Bloombergtax.com in November, the commissioner of the Small Business/Self-Employed Division of the IRS, Eric Hylton, said during a speech at the conference for the American Institute of CPAs, that the IRS is considering sending some “micro-captive” insurance cases to the department’s Criminal Investigation office.

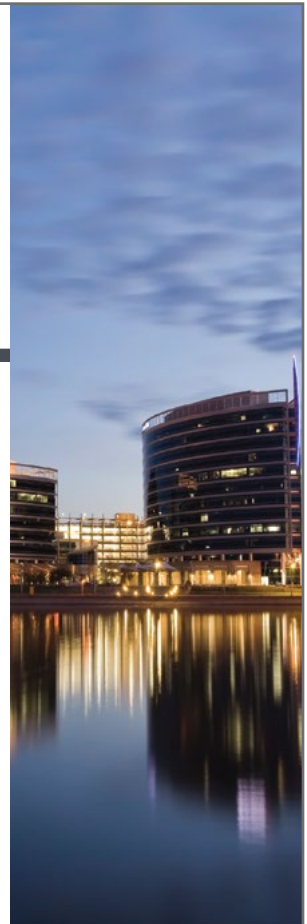


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These comments from Commissioner Hylton indicates that the IRS may become even more aggressive in pursuing what they see as an abusive tax structure.

COURT CASES TO WATCH

There are two cases regarding ERCs still waiting for a decision from the U.S. Tax Court. The pending cases are Caylor Land & Development v. Commissioner and Wilson et. al. v. Commissioner. The Wilson case is very similar to the Avrahami case, which was decided in 2017, and is being heard by the same Judge in that case. There is a report that the case might be settled before the decision is handed down.

When the Caylor decision is issued, it will be deciding on what constitutes a risk pool, which could provide important guidance for ERCs. The case was tried in May 2016 and is expected to be the next decision related to ERCs to come down the pipeline.

Another court case to watch is the appeal in Reserve Mechanical Corp. v. Commissioner. In June 2018, the Tax Court found in favor of the IRS in their case against captive insurer Reserve Mechanical. This is one of the key cases cited by the IRS in their settlement offer. The owners and managers of Reserve have appealed the case which should be heading to court sometime in early 2020. A

group Amicus brief is being put together by captive managers, SIIA, and other interested parties on behalf of Reserve Mechanical and is expected to be submitted to the court in February.

In a different type of case, a captive manager is taking their suit against the IRS to the U.S. Supreme Court. In November 2016, the IRS issued Notice 2016-66 which named captives using the 831(b) tax option as “transactions of interest”

and sought to require additional financial disclosures. The Notice requested specified entities to file additional financial disclosures. Industry disapproval was vocal and immediate. SIIA led the campaign to modify and withdraw Notice 2016-66, along with dozens of trade associations, captive managers, and regulators joining in.

CIC Services, a Tennessee-based captive manager, filed a lawsuit against the IRS and Treasury Department arguing that Notice 2016-66 was unlawfully issued and did not meet the authority or “reasoned analysis” requirements of the Administrative Procedure Act (APA). CIC Services has faced an uphill battle since the suit was filed in December 2016. The case was initially dismissed by a district court in Tennessee. CIC continued pressing the issue and last summer the Sixth District Court of Appeals found in favor of the IRS. Later



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that summer, the Sixth Circuit decline a petition for a rehearing. CIC Services is pursuing the case to the Supreme Court.

While their case was denied, one of the majority opinions and the dissenting opinion from the Sixth Circuit court offered CIC some hope. The ruling from each court cited the Anti Injunction Act (AIA), which pushes cases relating to tax concerns to the U.S. Tax Courts, overruling the APA. Judge Sutton, one of the judges applied to for a rehearing, said in his opinion that the issue should be taken up by the Supreme Court because previous cases did not offer guidance for these particular circumstances.

SIIA is supporting CIC in pursuing this case as far as it can go and will be submitting an Amicus Curiae brief on behalf of the captive manager. ■

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.



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