

CAPTIVES

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Update on Captive Tax Issues, including considerations for Tax Exempt Entities

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Captive Principles from 100,000 Feet

- 1) Captives should only be formed for non-tax business purposes and should only retain a comfortable level of risk and volatility
- 2) The owners must want to be in the insurance business (willing to assume and share insurance risk)
- 3) The captive must be operated as an insurance company (observing formalities and operating at arms length with the insureds)

Tax Consequences of a Captive

- Premium deductions and captive income offset (different years?)
- The tax benefit of a captive is a deduction of reserves
 - A business can only deduct payments for damages caused to others upon payment
 - An insurance company can estimate its future claims payments and currently deduct their present value
 - Thus, if one projects a loss of \$1,000,000 in 10 years:
 - A business can only deduct it upon payment in year 10, but a captive can deduct most of it in year 1

Prerequisites for finding “insurance” for tax purposes – some courts and the statute

- Have a non-tax business purpose for establishing the captive.
- The arrangement cannot be a sham
 - Purpose other than tax benefits
 - Proper documents
 - Actions comport with the documents
- Also, have economic substance
 - Objectively, economically sound even without tax benefit
 - Subjectively, not all about tax

Court Tests for “Insurance” for Federal Income Tax Purposes

- The most recent Tax Court decisions have required the following to find “insurance” for Federal income tax – a “framework”
 - An Insurance Risk must be involved
 - Risk Shifting
 - Risk Distribution
 - Insurance in Its Commonly Accepted Sense

Insurance Risk and Risk Shifting (high level)

- Insurance Risk
 - Must be a risk – may occur or may not occur
 - Not an investment risk
 - IRS says not a business risk (but does not define business risk)
- Risk Shifting
 - Parent-Sub: there must be outside business
 - Captive has enough capital
 - No one guarantees the captive's insurance obligations

Risk Distribution & Insurance in Its Commonly Accepted Sense

- Risk Distribution
 - Parent-Sub: IRS; 50% unrelated business safe harbor and 10% fails risk distribution; Harper Group case found insurance with 30% unrelated
 - Brother-Sister: IRS wants a dozen subsidiaries, each 5 to 15% of premium
 - Two Court cases found risk distribution in brother-sister with enough exposure units
 - IRS: owner of a disregarded single member LLC (not the LLC) is the insured
- Insurance in Its Commonly Accepted Sense
 - Organized, operated and regulated like an insurance company
 - Adequate capitalization, reasonable premium, valid and binding policies, claim payments

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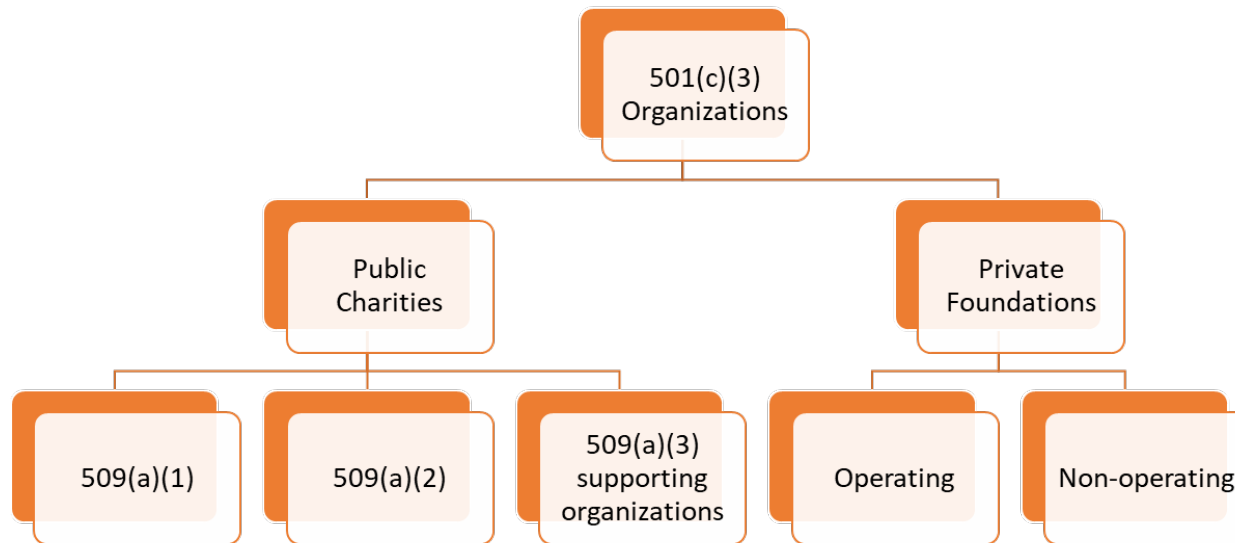
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Exempt Organization Status for Onshore Captives

Qualifying for Tax-Exempt Status

To be tax-exempt under section 501(c)(3), an organization must be organized and operated exclusively for exempt purposes set forth in section 501(c)(3), and none of its earnings may inure to any private shareholder or individual.

Types of 501(c)(3) Organizations



Supporting Organizations: The Operational Test

Section 509(a)(3)(A) requires supporting organizations to operate “exclusively” for the benefit of its supporting organizations by engaging solely in activities which support or benefit the publicly supported organization.

Types of Supporting Organizations

Type I – generally one or more supported organizations have the power to appoint/elect at least a majority of the supporting organization’s governing board

Type II – common supervision or control – generally the same persons serve as all or a majority of the directors of all of the organizations involved

Type III –

Functionally Integrated – a Type III supporting organization must constitute an integral part of one or more of its supported organizations by maintaining significant involvement in its operations and providing support on which the supported organization is dependent. The organization must:

- Pass an Activities Test

- Be the parent of its supported organizations, or

- Support one or more governmental entities

Non-Functionally Integrated – generally must satisfy a distribution requirement along with an attentiveness requirement

Section 501(m)

- Section 501(m) bars exemption for organizations that would otherwise be recognized as exempt under Section 501(c)(3) if a substantial part of the organization's activities consists of providing commercial-type insurance.
- There is no definition of "insurance" – however the Supreme Court has explained that to be "insurance", there must be risk shifting and risk distribution.

Risk shifting

“Risk shifting” is said to occur if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer, such that the loss by the insured does not affect the insured because the loss is offset by the insurance payment.

Risk distribution

- “Risk distribution” allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim.
- Risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks.

Self-Insurance Arrangements

Self-insurance arrangements, in which amounts are set aside to pay future liabilities, are not insurance because they do not shift or distribute risk.

Applying for Tax-Exempt Status

- Form 1023 – Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code
- Form 1023-EZ for eligible small organizations
- Most organizations must file the 1023 or 1023-EZ by the end of the 27th month after the organization is legally formed.

IRS Review of Form 1023

Why do you think you are not prohibited under IRC Section 501(m)?

Are you a commercial-type insurance?

Is the insurance provided at substantial below cost to charitable recipients?

How were the amount of premiums determined? Who paid the premiums? If premiums were paid in part or in full by affiliates, how were the amounts determined?

In the years ahead what types of insurance policies will be provided by the organization? Who are the entities that will be covered and by what types of insurance?

IRS Review of Form 1023

- For 20XX, what were the total claims paid?
- What do you project will be the total claims paid in the current year?
- How is your paying out of claims handled between and among the parent and the affiliates?
- What is your opinion as to whether or not you provide insurance with risk distribution?
- What is your opinion as to whether or not you meet the requirement of Section 501(m)(3)(A) with the provision of insurance at substantially below your costs?

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Considerations for Offshore Captives Owned by Exempt Organizations

Foreign Corporation Subsidiary Considerations

- Generally income from a foreign corporation subsidiary is dividend income and excluded from unrelated business income (“UBI”)
- Ownership of foreign corporations can trigger certain foreign disclosure filings (Forms 5471, 926, foreign bank account, etc.)

Subpart F Income

- Under Subpart F, certain types of income earned by a controlled foreign corporation (“CFC”) are taxable to the CFC’s U.S. shareholders in the year earned even if the CFC does not distribute the income to its shareholders in that year.
- A CFC’ Subpart F income is generally comprised of three components –
 - Foreign personal holding company income (excluded from UBI as a “deemed dividend”)
 - Insurance income
 - Foreign base company income

Section 512(b)(17)

A tax-exempt entity must treat as unrelated business income (“UBI”) the amounts that constitute insurance income currently includable in gross income under the Subpart F rules, except to the extent such income is attributable to the insurance risks of:

- The tax-exempt organization itself;
- Its tax-exempt affiliates; or
- An officer or director, or an individual who directly or indirectly performs services for, the tax-exempt organization or certain of its tax-exempt affiliates (provided that the insurance primarily covers risks associated with the individual’s performance of services in connection with the tax-exempt organization or any of its tax-exempt affiliates).

831(b) Update

- What does the code say?
- Current Events
- Public Hearing Highlights
- IRS Response
- 2024 Tax Court Cases
- Where do we go from here?

831(b) – What does the code say?

Section 831(b) of the Internal Revenue Code provides an alternative tax option for certain small insurance companies other than life insurance companies. This provision allows eligible insurance companies to elect to be taxed only on their taxable investment income, instead of being taxed on all taxable income.

2024 - the amount of the limit on net written premiums or direct written premiums (whichever is greater) is \$2,800,000 to elect the alternative tax for certain small companies.

831(b) – Current Events

1986 – enacted as a part of Tax Reform Act of 1986, PL No. 99-514.

2016 – identified as a “transaction of interest” by the IRS (Notice 2016-66).

2022 – US District Court for the Eastern District of TN vacated Notice 2016-66.

2023 – Proposed regs issued by the IRS identifying certain micro captive insurance transactions as “listed transactions” and “transactions of interest.”

2023 – APA followed. The IRS held a public hearing on proposed regulations on July 19th.

831(b) – Public Hearing Highlights

- Captives provide an alternative risk option providing cost reduction, access to reinsurance, cash flow benefits.
- Firsthand captive owner success stories
- IRS have acquiesced to the big captives 831(a) and now use penalty, interest, and cost of litigation to extract punitive asymmetric settlements from the engine of our economy, small and medium size business.
- Loss ratios proposed by IRS are not feasible or logical considering all coverage types.
- McCarren Ferguson Act grants the state regulation of the insurance industry (violating federalism)
- Insurance industry lacks capacity and the IRS continues to create barriers for companies to find coverage options.

831(b) – Public Hearing Highlights

- Historical US Congressional support
- Highlighting the difficulty to exit the election and requesting for an expeditious exit process.
- Request for a joint task force including State Insurance Regulators, industry leaders, and the IRS/US Treasury

831(b) – IRS Response

- There has been zero response from the Internal Revenue Service following the APA hearing on July 19th 2023.
- Congressional House of Representatives submit letter to IRS Commissioner Werfel supporting 831(b) legislation and urging a collaborative effort to create solutions (dated December 6, 2023).
- IRS continues to wage administrative warfare on captives with Tax Court wins:
 - Keating et al. v. Commissioner, T.C. Memo 2024-2
 - Swift v. Commissioner, T.C. Memo 2024-13
 - Patel v. Commissioner, T.C. Memo 2024-34

2024 Cases

- Keating et al. v. Commissioner, T.C. Memo 2024-2
- Swift v. Commissioner, TC. Memo 2024-13
- Patel v. Commissioner, T.C. Memo 2024-34

To determine whether an entity is performing the functions of an insurance company, consider the following factors:

- (1) whether it was created for legitimate nontax reasons;
- (2) whether there was a circular flow of funds;
- (3) whether the entity faced actual and insurable risk;
- (4) whether the policies were arm's-length contracts;
- (5) whether the entity charged actuarially determined premiums;
- (6) whether comparable coverage was more expensive or even available;
- (7) whether it was subject to regulatory control and met minimum statutory requirements;
- (8) whether it was adequately capitalized; and
- (9) whether it paid claims from a separately maintained account.

831(b) – Where do we go from here?

- Unite on branding the 831(b) code in a new, positive light
- Press for Congressional support to bring the IRS to the negotiation table
- Regulators and captive managers collaborate on industry ethics and accountability
- Tax attorneys and CPAs to collaborate on tax code amendments and legal solutions