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AT COURT

The Kings River Captive Insurance Case

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A petition was recently filed in U.S. Tax Court by Kings River Commodities, LLC (Kings River)[1] challenging the denial of deductions related to insurance premiums, among other items. The premiums were paid to an insurance company that made an election to be taxed on its investment income (as opposed to all of its taxable income) under Section 831(b) (referred to as a "micro-captive" by the Service in its discussion of 2017 abusive tax shelters).[2] According to the Petition, Kings River is a non-traditional feed supply company that sells poultry and dairy cattle feed. The feed is non-traditional because Kings River "acquires excess products such as nuts, crackers, cookies, fruit, and yogurt from businesses and then reprocesses that product into feed." The use of a micro-captive is implicated in the Petition, which provides that Congress "encourages the use of small captive insurance companies through Section 831(b)."[3]

The Petition briefly addresses its claim that JCH Insurance Company (the Captive) met the basic requirements of an insurance company (such requirements having been established over decades of case law) but also raises some issues specific to micro-captives.

The basic requirements, which apply to all captives seeking insurance treatment for Federal tax purposes, were recited in the *Securitas Holdings* Tax Court case:

> Neither the Code nor the regulations define "insurance". However, the Supreme Court has stated that "[h]istorically and commonly insurance involves risk-shifting and risk-distributing." Over time, courts have looked primarily to four criteria in deciding whether an arrangement constitutes insurance for Federal income tax purposes: (1) the arrangement must involve insurable risks; (2) the arrangement must shift the risk of loss to the insurer; (3) the insurer must distribute the risks among its policyholders; and (4) the arrangement must be insurance in the commonly accepted sense. Although these criteria are not independent or exclusive, they establish a framework for determining whether insurance exists under the Federal tax law.[4]

The Petition provides that risk-shifting occurred as a result of the use of policies that were legally enforceable, memorialized in writing, reflected an exchange of consideration, and created an obligation on the part of

1 Petition in Kings River Commodities, LLC, John C. Hurst, III, Tax Matters Partner, Docket No. 010448-17 (available on BNA).
2 IRS Warns of Abusive Tax Shelters on 2017 Dirty-Dozen List of Tax Scams, IR-2017-31 (Feb. 14, 2017).
3 Petition, *supra* n. 1, at 10.
4 *Securitas Holdings, Inc. v. Comm'r*, T.C. Memo 2014-25, at 18.

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the Captive to indemnify the insured against specified loss up to limits stated in the contract. It states that risk was distributed through the use of an insurance pool; however, no more information regarding the mechanics of the pool is provided.[5] Insurance in the commonly accepted sense was addressed,[6] as the Captive is a duly licensed insurance company in the State of Delaware and has met all required capital, reserve, and other regulatory requirements imposed by the State of Delaware. No information regarding the actual terms of the policies was provided (nor would that be required in the Petition). However, one could speculate as to the policies written based on the Petition's reference to rescuing the insured in the event of "overwhelming catastrophe or business interruption."[7]

The Petition sets forth several non-tax motivated and "unique business benefits" as reasons for using the Captive, including asset protection (referring to the availability of an "asset-protected reserve to rescue the insured in the event of an overwhelming catastrophe or business interruption"), obtaining "new types of coverage such as cyber coverage", "greater control over the processing of claims and minimiz[ing] unproductive disputes", and the suggestion that the opportunity to obtain insurance through a captive is "more responsive to…customers." Explaining how the Captive fits into Kings River's existing risk mitigation program, the Petition notes that the Captive's policies "provided insurance coverage to Kings River for both uninsured risks and risks that were underinsured due to the exclusions and coverage limits of its commercially purchased policies."

The Petition also makes several public policy arguments that are somewhat intertwined with the economic substance argument, at least as far as establishing congressional intent goes. For instance, the Petition provides that over 90 percent of Fortune 500 companies use captive insurance companies as part of their risk management programs, and Congress encourages the use of small captive insurance companies through Section 831(b). One of the key points that could carry over into the economic substance argument is that Congress "reaffirmed [the encouragement of Section 831(b) captives] by raising the cap on insurance premiums subject only to net investment tax from $1.2 million to $2.2 million as part of the [PATH Act.]"

The Petition addresses a few points that are somewhat specific to 831(b) captives, primarily dealing with whether the Captive should be respected under an economic substance argument. Under an economic substance argument,[8] the Service may argue that the disputed tax benefits are not what Congress intended in establishing an election to exclude underwriting income from the gross income of an insurance company. This argument necessarily stems from the use of what the Service labels as "illusory" coverages that result

5 Presumably, the risk pool allows the Captive to write a sufficient amount of third-party business. *See id. at* 25 ("The insurer achieves risk distribution when it pools a large enough collection of unrelated risks, those that are not generally affected by the same circumstance or event. 'Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as a premium * * * [because] [b]y assuming numerous relatively small, independent risks that occur randomly over time, the insurer smoothes out losses to match more closely its receipt of premiums.'"). *See also* Rev. Rul. 2002-89 (concluding that a wholly owned domestic captive with more than 50% of its premiums and liability coverage from other entities amounted to "insurance in the commonly accepted sense"); *Harper Grp. & Includible Subsidiaries v. Commissioner*, 96 T.C. 45, 59–60 (1991) (finding sufficient risk distribution when "the relatively large number of unrelated insureds comprise approximately 30 percent of [the captive's] business"), *aff'd sub nom. Harper Grp. v. Commissioner*, 979 F.2d 1341 (9th Cir. 1992).

6 *See Securities Holdings, supra* n. 4, at 27 (noting that the Court considers "whether: (1) the insurer was organized, operated, and regulated as an insurance company; (2) the insurer was adequately capitalized; (3) the insurance policies were valid and binding; (4) the premiums were reasonable; and (5) the premiums were paid and the losses were satisfied").

7 *See* I.R.S. P.L.R. 201609008 (Feb. 26, 2016) for recent Service analysis dealing with various forms of business interruption and cyber risk coverage.

8 See *Knetsch v. United States*, 364 U.S. 361, 367 (1960) ("The petitioners contend, however, that the Congress in enacting s 264 of the 1954 Code, 26 U.S.C.A. s 264, authorized the deductions."). A full discussion of Section 7701(o)'s economic substance provision, as applicable to transactions entered into after March 30, 2010, is beyond the scope of this case summary.

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in no claims, resulting, at least in some cases, in the passage of wealth through a captive without the payment of transfer taxes.

Whether a micro-captive transaction lacks economic substance is always a matter of interpretation based on facts and circumstances. From the Service's perspective, the abuse necessarily stems from the use of overpriced and unnecessary policies between related parties[9] involving the payment of premiums that provide an income tax deduction to the insured and exclusion from the captive's income. Further, since the policies chosen do not result in claims, an opportunity exists that permits wealth to be transferred (via dividend or liquidation) to third parties free of transfer tax.[10] While parked in the captive, the wealth can be utilized for various purposes, such as loans to family members or other financing transactions with ancillary benefits, all of which were highlighted in Notice 2016-66.[11] Simply put, the estate planning abuse proscribed by Congress cannot occur with the use of coverages that result in too many claims.[12] In this regard, the Service is arguing that the policies and players in prior taxpayer victories involving captive insurance companies cannot be compared to what the Service views as an abusive micro-captive structure that lacks economic substance.[13] The choice of policy is also why there does not seem to be much attention focused on captives insuring workers compensation or employee benefits.[14] The justification for utilizing

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9 The Service has challenged transfers involving related parties in various other contexts, such as the reallocation of income using standards of comparability. *See Audano v. United States*, 428 F.2d 251, 256–57 (5th Cir. 1970) (stating that satisfying the arms' length standard will not save a deduction when the sole purpose for a payment is to camouflage an assignment of income); *compare B. Forman Co. v. Commissioner*, 453 F.2d 1144, 1151 (2d Cir. 1972) (noting that transactions between controlled parties are subject to special scrutiny regarding tax avoidance) *with Simon J. Murphy Co. v. Commissioner*, 231 F.2d 639, 644 (6th Cir. 1956) (noting that the IRS cannot reallocate income among controlled organizations without justification, create income, disallow a deduction authorized by another provision, require consolidation of the incomes of separate controlled organizations, or reallocate items satisfying arms' length standards).

10 Such parties could include a non-citizen spouse.

11 *See* Notice 2016-66.

12 The payment of claims would also deplete the funds available for use in financing transactions targeted in Notice 2016-66. Focusing on overpriced policies would be only a temporary fix, since a captive could substitute 30 conservatively priced policies for 5 overpriced polices to achieve the same result. The lack of claims could be viewed as not shifting risk, in addition to resulting in the arrangement not being considered insurance in the commonly accepted sense. *See Steere Tank Lines, Inc. v. United States*, 577 F.2d 279, 283 (5th Cir. 1978) (stating that the agreement at issue did not appear to be a legitimate insurance arrangement but rather a "clever estate planning device").

13 *See United States v. Owensboro Dermatology Associates., P.S.C.*, No. CV 4:16-MC-00003-JHM, 2017 WL 2926026, at *2 (W.D. Ky. July 7, 2017) ("…the purported insurance and/or reinsurance transactions lack economic substance, the substance of the transactions do not comport with their form, the various steps involved in the transactions were engaged in for no purpose other than to avoid or evade tax, the expenses were not ordinary and necessary to Owensboro's business, and the amounts were not paid to an insurance company and were not paid for insurance…"); *Ax v. Commissioner*, 146 T.C. 153 (2016) ("After the case was stricken from a trial calendar and continued generally, [the Service] moved for leave to amend his answer to assert "that a) Petitioners' use, through solely controlled flow-through entities, of a micro-captive insurance arrangement in 2009 and 2010 lacked economic substance; and b) Amounts paid as premiums through the micro-captive arrangement were neither ordinary nor necessary" and to allege facts in support of those assertions").

14 Certain employee benefits captive arrangements for which the Employee Benefits Security Administration of the Labor Department has issued a prohibited transaction exemption are not considered a transaction of interest and thus are exempted from reporting under Section 2.03 of Notice 2016-66.

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such policies is obvious, and the ability to manipulate claims is limited. Further, the use of policies that do not pay claims and do not make sense for the insured reflects a lack of business purpose and can be considered as part of an economic substance analysis.[15]

From the taxpayer's perspective, since Congress took action based on Treasury's study of estate planning abuse, the amendments to Section 831—arguably, a vote of approval for the micro-captive through an increased exclusion from $1.2 million to $2.2 million—could be viewed as creating a statutory safe harbor: simply meet the new premium or ownership diversification test and assume such compliance cleanses the captive of abuse. Further, captive owners claim legitimate business purposes for lowering the number of claims. For example, the lack of claims and build-up of funds can permit taking on new risk and can also provide funds for distributions to shareholders, permitting them to benefit from the improved risk management. Additionally, the use of a captive as a means of providing "asset protection" highlights a non-tax motivated purpose: for some, this rekindles memories of family limited partnership disputes involving economic substance and valuation discounts.[16] Some policies address "emerging risks" that do not result in predictable claims but are still risks that should be managed. Finally, captive owners question why the government should second-guess a business owner's decision regarding a risk mitigation program.

In arguing for the viability of the Captive, the Petition highlighted the various exposures faced by the feed supply company, such as danger that the feed contains trash or chemicals posing a health risk to animals, undetected spoilage rendering the end product unpalatable, spontaneous combustion related to storage, hazardous dust emissions from storage and associated fines, and acquisition of products from food manufacturers that rely heavily on supply chain operations. It also expressed displeasure over the issuance of Notice 2016-66, accusing the Service of inappropriately issuing the Notice given congressional and state "encouragement" for captives, as evidenced by the availability of Section 831(b) and "reaffirmed" through the increase in the income exclusion from $1.2 million to $2.2 million.

Ultimately, if the basic requirements of an insurance company can be proven, the issue could come down to an economic substance analysis—something that was not a central issue in prior Service defeats. A win based on such a fact-intensive inquiry will not make things easier going forward for the Service (which already has a large number of cases in audit and pending in Tax Court); however, the same lack of certainty (and associated risk) creates a paradoxical situation for those who are promoting certain forms of risk mitigation. ■

15 *See Block Developers, LLC v. Commissioner*, T.C.M. (RIA) 2017-142 (T.C. 2017) ("Because a DISC's congressionally sanctioned purpose was tax avoidance, the Sixth Circuit held that neither the Commissioner nor the courts had any basis to recharacterize the transactions at issue according to their substance. *Summa*, 848 F. 3d at 782, 786. But Summa's facts are not the Janssons'; LLCs, unlike DISCs, are meant to have a real business purpose.").

16 *See Estate of Turner v. Commissioner*, 102 T.C.M. (CCH) 214 (T.C. 2011), *supplemented sub nom. Turner v. Commissioner*, 138 T.C. 306 (2012) (agreeing that asset protection may be a legitimate reason for forming a family limited partnership, but concluding that there was no credible argument that the company at issue was formed for that reason).

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