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INSURANCE ALERT

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Captive Insurers in IRS Cross Hairs

Both Risk Shifting and Risk Distribution are Required Characteristics

The Internal Revenue Service has privately announced, off the record, that it is concerned that many captive insurers are actually no more than risk pools operating as loss reserves for their owners. Accordingly, the Service has commenced a systematic enforcement initiative against captives and their owners.

While the IRS has finally, and reluctantly, acknowledged the legitimacy of captives, it is paying special attention to Section 831(b) "micro captives" and the promotion and use of these vehicles as tax shelters with little regard to compliance with the required insurance function.

Many promoters offer to set up and provide what they refer to as "turn key" captives without providing a suitable integration of the detailed requirements of the tax law (both state and federal) with the actual planned use of the captive insurer by the parent.

To be sure, single parent captives constitute more than 80% of all formalized risk finance vehicles. The seven most popular vehicles for providing this mechanism are, in order of popularity:

1. Single Parent
2. Group Captive
3. Rent a Captive (RAC) Protected Cell
4. Special Purpose Vehicle
5. Association
6. Risk Retention Group
7. Risk Pooling

Bermuda, Vermont, Cayman, Luxembourg and South Carolina are the top 5 domiciles for captives, although many U.S. jurisdictions, including Connecticut, have recently established legal frameworks to attract captive insurers.

The top five industries that employ captives, which represent fully 63% of the total market share, are :

Financial Institutions 21%	Health Care 17%	Retail and Consumer Products 10%	Manufacturing 8%	Power and Utilities 7%

The IRS typically challenges captives on two grounds:

1. The captive in not writing insurance. This analysis is based on the two prongs of risk *shifting* and risk *distribution*; and
2. Excess premiums are changing hands.

The first factor is particularly troublesome as the word “insurance” is not defined for these purposes in the tax code. Hence, the IRS looks to a relatively narrow body of case law and its own regulatory pronouncements.

Risk shifting is the actual transfer of the risk from the insured to the captive. A meaningful reimbursement or stop-loss provision from the insured to the captive can be seen to undermine the validity of the transfer.

Risk distribution exposure of the captive’s exposure to third party risks obtains the risk-pooling effect that renders the captive notionally like a traditional insurance company.

Because courts tend to analyze captive structure and operations together, there must be some degree of uncertainty in the actual risks being undertaken by the captive. Hence, shifting over something like tsunami risk for an Idaho insured might not be seen as a shift of any actual risk.

The Service has issued five pieces of guidance for captives.[*] This guidance addresses such issues as what percentage of business paid to the captive from unrelated businesses is sufficient to constitute risk shifting and risk distribution, the number of subsidiaries and relative portion of risk from each necessary to establish satisfactory risk shifting and risk distribution, a common ownership allowance for the subsidiary test, the general partnership exception to the previous test, and a “risk of the ultimate insured” test.

Satisfying these tests requires considerable analysis of the structure of the captive and the business of the insured(s) and should not be attempted with an off-the-shelf product.

Conclusion:

The IRS presently has at least 14 cases it has teed up in the courts to help it establish some precedent by which it may then go after other captives. It is essential, then, to obtain the exceptional tax and cash flow benefits of captive insurance that the structure and administration of the captive be entirely compliant with the law.

[*] Rev. Rul. 2002-89; Rev. Rul. 2002-90; Rev. Rul. 2005-40; TAM 200816029; and Rev. Rul. 2009-26