BUSINESS INSURANCE®
January 2018
www.businessinsurance.com

Captive investments scrutinized following key tax court ruling

Philip Karter is a shareholder and head of the Philadelphia office of Chamberlain Hrdlicka, where he specializes in representing companies in federal civil tax audits, administrative appeals and tax litigation. He may be reached at 610-772-2320 or pkarter@chamberlain.com.

Katherine Jordan is an associate attorney in the Philadelphia office of Chamberlain Hrdlicka. She is a member of the tax controversy and litigation practice and focuses on representing clients in audits and administrative appeals before the IRS. She may be reached at 610-772-2328 or kjordan@chamberlainlaw.com.

Captive insurers qualifying as small captives or "microcaptives" that are eligible for the tax benefits of Internal Revenue Code 831(b) have long had targets on their backs. This year, however, marked the first time a court has added its voice to the simmering dispute between the IRS and taxpayers over the use of microcaptives.

On Aug. 21, the U.S. Tax Court in *Benyamin Avrahami and Orna Avrahami v. Commissioner of Internal Revenue* issued its first decision in a case involving a microcaptive, and it went badly for the taxpayers. Deductions claimed for insurance premiums were disallowed, but the Tax Court concluded that no penalties should be imposed because the taxpayers still "acted reasonably and in good faith" in relying on the advice of their professional advisers.

Despite the potentially chilling effect of *Avrahami*, taxpayers engaging in microcaptive transactions should remain confident that their captive arrangements will be respected where such transactions reflect:

- bona fide insurable risks with a reasonable likelihood of generating claims (or a history of actual claims);
- arm's length, commercially reasonable policy terms;
- defensible premium pricing that roughly correlates to premiums charged in the commercial insurance marketplace for comparable coverages; and
- a sound, well-documented, nontax business purpose for undertaking and maintaining insurance coverage.

Even then, secondary aspects of a microcaptive transaction still can give rise to arguments that the transaction was carried out primarily for tax avoidance and failed one or more judicially defined tests, such as the economic substance, step transaction, substance over form or sham transaction doctrines.

An example might be a situation in which a transaction is perceived to involve a circular flow of funds that puts deductible payments back into the hands of either the payer or a related party. Circular cash flows can take a variety of forms, such as loans from the captive insurer to the insured or another affiliated entity, or, as in the case of *Avrahami*, the flow of funds from the insured to a risk pool that then pays premiums to the insured's captive through a reinsurance arrangement.

Another common captive transaction that has been scrutinized by IRS auditors is the direct or indirect investment of surplus capital by a captive in life insurance policies on the lives of related parties, such as an owner of a captive insured. The IRS could argue that the premiums collected by the captive and the premiums paid for the life insurance are little more than a single payment by a business owner to obtain a deduction they could not otherwise take if they were to purchase life insurance directly.

> There are no grounds to create an artificial distinction between captive investments in life insurance as opposed to other investment assets.

But does an investment by a captive in such policies really represent nothing more than a conduit for claiming a deduction for the purchase of life insurance, and should this affect whether the insurer-insured relationship is respected?

Life insurance policies consist of two components — an insurance or death benefit component, and an investment or cash value component. When a purchaser of life insurance pays an annual premium, the portion that is not allocated to the cost of funding the policy's death benefit is invested in an income-earning vehicle. Income that is earned inside the policy's investment account grows tax-free, and no tax is incurred upon payout of the cash value to the policy beneficiary as part of a death benefit. This is similar to the tax treatment of a Roth IRA, with the only distinction that the tax-free nature of life insurance requires death of the insured, while the tax-free nature of a Roth requires a holding period of at least five years and withdrawal after age 59½.

So why does the IRS appear to be bothered by captive-owned life insurance? Certainly, it cannot be because such policies do not represent bona fide investment assets of the captive. The benefits of an equity-indexed universal insurance policy are primarily as an investment vehicle rather than an insurance vehicle, as evidenced by the fact that banks and large public companies invest large portions of their cash reserves in life insurance.

It also cannot be that the purchase of captive-owned life insurance is just another questionable flow of cash from one related party to another, allowing transfers of wealth that produce unintended tax benefits. There is no pass-through of deductible captive insurance premiums to fund life insurance policies because there is no correlation between captive and life insurance premium amounts or the timing of payments on policies. The premiums paid on life policies purchased by captives are not captive premium dollars; they merely represent an investment of the captive's investable surplus as determined by the laws of the jurisdiction in which the captive is based.

Finally, it cannot be because it represents a way to generate a deduction with funds that can be used to purchase assets that are never taxed again. The proceeds from the death benefit must still at some point be distributed from the corporation to its shareholders, and any distributions are taxable to the extent of the shareholder's gains.

The taxation of the death benefit received by the captive's shareholders is thus comparable to a "buy and hold" investment in an appreciating asset such as marketable securities or real estate. Each of these alternative investments has the potential to grow in value over time without generating recognized income. Like any asset, the tax on the appreciated value of a life insurance policy may be deferred, but it ultimately will be paid when distributed by the captive.

Of course, the investment returns on a life insurance policy can be taxed sooner than the point at which they are distributed by the captive if the captive draws upon the policy's cash value prior to the insured's death. In that case, the captive will be taxed to the extent that the withdrawals exceed the captive's basis in the life insurance policy. Such treatment is no different than the treatment accorded any number of alternative appreciated assets such as stocks or other securities, treasuries, municipal bonds, real estate or collectibles.

For each of these alternative types of investment assets, there are ways to avoid a corporate level of taxation by borrowing against the asset rather than distributing it and paying tax on the appreciation. For instance, the captive can borrow against its stock holdings (margin borrowing) or take a loan on the equity in an appreciated real estate asset. Similarly, the captive can borrow against the life policy and avoid the tax that would otherwise apply to an outright distribution. All of these scenarios demonstrate that a captive investing in life insurance should not be treated any differently than a captive investing in other types of assets, assuming it meets requirements imposed on insurance companies by the jurisdiction in which it operates.

In sum, there are no grounds to create an artificial distinction between captive investments in life insurance as opposed to other investment assets. On the other hand, there are a number of laws, such as the McCarran-Ferguson Act, the Gramm-Leach-Bliley Act and the Dodd-Frank Wall Street Reform and Consumer Protection Act, that reaffirm it is not the province of the U.S. Department of the Treasury to exercise general supervisory or regulatory authority over how insurance companies invest their surplus capital, but rather the province of the local jurisdiction.

Captives should remain free to make decisions about how to invest their surplus capital, including the purchase of an asset long considered a safe and highly flexible investment choice, without fear that it might lead to an IRS challenge to the legitimacy of the underlying captive insurance arrangement.

The Publisher's sale of this reprint does not constitute or imply any endorsement or sponsorship of any product, service or organization. Reprinted with permission from Business Insurance.
© 2018 Claims and Litigation Management (CLM) Alliance. REPRODUCTIONS ARE NOT PERMITTED. Visit www.BusinessInsurance.com/section/reprints. #BI18004