Coverage for Low-Frequency Risks Is Not a Sham

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In this article, Hoard and Bunting explain why captive insurance policies are necessary to help protect the U.S. economy during disasters.

The pandemic has destroyed many small and medium-size businesses, leaving millions of Americans unemployed. Those businesses were unprepared for a pandemic even though Congress had enacted an insurance safety net — captive insurance — to protect those businesses from financial ruin resulting from foreseeable and unforeseeable remote catastrophic events.

Why don't more businesses avail themselves of the protections that captive insurance provides? Perhaps some business owners think they can't afford insurance because commercial policy premiums are cost prohibitive. Perhaps others are willing to gamble on the risk being too remote. No doubt some have been advised against captive insurance coverage to avoid the scrutiny of the IRS, which views most captive insurance policies as shams, and the Tax Court has agreed. But the COVID-19 pandemic has taught us that captive insurance, if structured appropriately, is a necessary component of risk management for every small business and the American economy.

Like commercial insurance, captive insurance is regulated by states. Still, the IRS doesn't trust state regulators to oversee insurance companies within their state and threatens to audit most small captive insurance companies and the businesses that use them after a series of Tax Court decisions that fundamentally altered time-honored principles of insurance law. The Self-Insurance Institute of America (SIIA) and insurance trade organizations from 10 states (in this article, collectively referred to as SIIA or amicus curiae) hope to change the conversation. SIIA summarized and explained the problems with the Tax Court's findings regarding fundamental insurance concepts in an amicus brief filed in the Tenth Circuit appeal of *Reserve Mechanical*.[1] It concluded that the Tax Court determinations were contrary to common insurance principles and standard insurance practices and urged the Tenth Circuit to reject the new Tax Court rules. One senator called on the IRS to postpone its planned audits until the Tenth Circuit issues an opinion.[2]

Captive insurance is a type of self-insurance funding tool that permits companies to establish and operate insurance for affiliated and controlled companies. The companies can then purchase commercial coverage or coverage, including gap coverage, through their own captive insurance company. What raises IRS concerns with captive insurance is the special tax election under section 831(b) that allows small captive insurance companies (sometimes called microcaptives) to exclude premiums below a specific threshold from income and pay tax only on investment income. Meanwhile, the affiliated insureds can deduct the premium as an ordinary and necessary business expense under section 162(a). While legally permissible, microcaptive transactions are highly suspect to the IRS, which has led to a broad-brush attack by the IRS against all companies making a section 831(b) election.

In 2014 the IRS added microcaptive insurance to its "Dirty Dozen" list of tax scams, and in 2016 it listed microcaptive transactions as transactions of interest in Notice 2016-66, 2016-47 IRB 745, requiring participants to file numerous forms with

[1] *Reserve Mechanical Corp. v. Commissioner*, No. 18-9011 (10th Cir. 2020).

[2] Letter from Sen. Cory Gardner, R-Colo., to then-Treasury Secretary Steven Mnuchin and IRS Commissioner Charles Rettig (Aug. 24, 2020).

the IRS or risk penalties.[3] One captive manager, CIC, is seeking to enjoin IRS enforcement of the notice, claiming its issuance violated the mandatory notice and comment requirements of the Administrative Procedure Act. While the district court dismissed the lawsuit and the circuit court concurred[4] — both ruling that the lawsuit violated section 7421(a), the Anti-Injunction Act, which bars suits to enjoin tax collection — the U.S. Supreme Court granted certiorari. Several stakeholders have filed amicus briefs in support of CIC. The Supreme Court case doesn't affect the IRS's ability to audit, however. It would just affect the onerous additional filing obligations that a transaction of interest imposes on small captives in 2016.

Insurance isn't defined in the Internal Revenue Code, but the Tax Court has long relied on the definition of insurance in *Le Gierse*,[5] in which the Supreme Court said an insurance transaction requires an actual insurable risk that the insured shifts to a third party that then distributes it among multiple insureds in an arm's-length transaction; otherwise, the transaction is merely a nondeductible loss reserve.[6]

Over the past few years, the Tax Court has tried to define insurance in the small captive industry, starting with its decision in *Avrahami*[7] and followed two years later by *Syzygy Insurance*.[8] In both cases the taxpayers made the section 831(b) election to exclude gains on premiums paid to the captive. In between those cases the Tax Court decided *Reserve Mechanical*,[9] a captive insurance case in which the taxpayer did not make the section 831(b) election (it made an alternate but similar election to be taxed specially).

Emboldened by its success in persuading the Tax Court to alter fundamental insurance law and practice, the IRS has expanded its targeted campaign to limit captive insurance as an available tool for the businesses that depend on it. Thus, the IRS announced the establishment of 12 new microcaptive audit teams in January 2020.[10] Ironically, the IRS rolled out the first step in the campaign at the beginning of a global pandemic. The IRS mailed threatening letters, called soft letters, to business owners with captive insurance programs, offering them the opportunity to amend insurance transactions the IRS deems abusive.

No one denies that there are abusive transactions. The concern is whether the IRS will know the difference. Unfortunately, what seems abusive to the IRS may be common business practice in the insurance industry. The fear is that IRS tactics with small captives will mirror its conservation easement initiative, which frequently makes no distinction between abusive and legitimate transactions, resulting in costly litigation for many innocent taxpayers. The issues SIIA raises in *Reserve Mechanical*[11] highlight the risks, for both small and large captive insurance companies, of the IRS's aggressive approach.

Contrary to the presumption inherent in the IRS's audit initiative, nonstandard coverages for fortuitous risks that many captives insure are not automatically sham coverages. Large companies and trade associations regularly use captive insurance to deal with difficult to insure and innovative-concept insurance. Likewise, small captives serve as an important risk management tool for small and medium-size businesses that the IRS audit initiative ignores. For example, standard commercial policies have gaps in coverage; some businesses self-insure those uncovered risks with policies issued by their captive insurance companies, in addition to purchasing commercial policies.

Consider business interruption insurance. From time to time, commercial insurers decide that some risks aren't the type that the industry wishes to insure. In one example from 2006, Insurance Services Office Inc., a trade organization that provides standard insurance

[3] The Supreme Court has agreed to hear a challenge to Notice 2016-66 in *CIC Services LLC v. IRS*, 925 F.3d 247 (6th Cir. 2019).

[4] *Id.*

[5] *Helvering v. Le Gierse*, 312 U.S. 531 (1941).

[6] *Harper Group v. Commissioner*, 96 T.C. 45, 46 (1991), *aff'd*, 979 F.2d 1341 (9th Cir. 1992).

[7] *Avrahami v. Commissioner*, 149 T.C. 144 (2017).

[8] *Syzygy Insurance Co. Inc. v. Commissioner*, T.C. Memo. 2019-34.

[9] *Reserve Mechanical Corp. v. Commissioner*, T.C. Memo. 2018-86.

[10] IRS release on microcaptive transactions and new audit teams (Jan. 31, 2020).

[11] *Reserve Mechanical*, No. 18-9011.

forms to insurance companies nationwide, added to some of those forms an endorsement that excludes coverage "for loss or damage caused by or resulting from any virus, bacterium or other microorganism that induces or is capable of inducing physical distress, illness, or disease."[12] Absent leverage to negotiate a more beneficial policy, an insured's only option for this type of coverage — business interruption insurance caused by a pandemic — would have been to purchase a policy from its captive insurance company. Would the Tax Court have respected pandemic coverage before 2020? Based on recent Tax Court jurisprudence, the likely answer is no. That is what concerns SIIA and professionals in the insurance industry.

In recent cases the Tax Court has held that absent prior claims, a policy might have no business purpose and therefore isn't legitimate insurance. According to SIIA, the Tax Court has deviated from the authority granted to it, as well as traditional insurance law. Both large and small businesses purchase insurance for risk exposures that have never generated claims. This is a prudent and typical risk management practice for businesses. Most large companies purchase hundreds of millions of dollars in excess-limits coverage every year in the event that some type of worst-case scenario claim arises. Fortunately, for many of those businesses, those types of claims never occur, yet those companies continue to buy the insurance annually to protect them and their shareholders. Lenders and shareholders of those companies recognize the business need for millions of dollars of coverage even absent prior claims, and any failure to purchase that insurance would be viewed as a lapse in duty.

According to SIIA in its *Reserve Mechanical* brief, the Tax Court misunderstands how the insurance industry has operated for hundreds of years. Ignoring whether the Tax Court erred in its conclusions about premium costs, SIIA seeks to guarantee that the Tenth Circuit, in reviewing the Tax Court's decision, does nothing to change commonly accepted principles of insurance and tax law. The industry is especially concerned with the Tax Court's misunderstanding of what constitutes an insurable risk; an arm's-length insurance agreement; and sufficient risk distribution, including how parties achieve risk distribution.

The first long-standing principle that SIIA addresses is the definition of an insurable claim. SIIA's concern stems in part from the Tax Court's holdings suggesting that there must be a legitimate business reason for acquiring the insurance in the first place. In analyzing whether there is a legitimate business purpose for the purchase, the Tax Court suggests that a prior similar claim is required. In *Avrahami*, the Tax Court expressed skepticism that a terrorism claim would ever be made, apparently because there had been no prior claims.[13] In *Reserve Mechanical*, the court found no business reason for the taxpayer to purchase insurance above its commercial policies since it had never suffered a prior loss that those policies would have covered. The Tax Court wasn't concerned with the dangerous mining business at issue or the risk of catastrophic future losses, but only whether there had been any catastrophic past losses. Absent those past catastrophic losses, the Tax Court determined that the taxpayer had no need for the insurance. In *Syzygy*, the court found that the insurance company didn't operate like an insurance operation because the taxpayer never submitted any claims.

However, a prior claim by a specific taxpayer is not a prerequisite for an insurable claim. Individuals and businesses purchase automobile, homeowners, excess, and umbrella policies every day, and many of them never file a claim. No one suggests that taxpayers don't need those policies. Therefore, the Tax Court's test requiring prior claims is wrong. All that is required under established insurance law is whether there is a fortuitous risk of a future loss. If so, that is an insurable risk. Business interruption insurance based on a virus shouldn't require a prior claim related to SARS, Ebola, Zika, H1N1, or any other recent public health scare. A prior loss isn't the test for an insurable risk. If any insured makes a claim, the coverage has done its job, and even that

[12]Larry Podoshen, Insurance Services Office circular (July 6, 2006).

[13]*Avrahami*, 149 T.C. at 192.

isn't required. A claim by the specific insured at issue is irrelevant.

SIIA's second concern is the Tax Court's suggestion that a form insurance contract isn't legitimate insurance. The Tax Court in *Reserve Mechanical* stated:

> We agree with respondent, however, that the direct written policies were "cookie cutter" policies. The policies on their face indicate that they were the copyrighted material of Capstone, and Capstone employees testified at trial that they administered many of the same policies for all of their clients. In many instances the policies were not reasonably suited to the needs of the insureds.[14]

SIIA's concern is legitimate. Form policies are the norm in commercial insurance, and small captives use them for the same reasons large commercial carriers use them. The Supreme Court has acknowledged the practice of using standard forms in the insurance industry.[15] The captive insurance industry is no different. Like commercial carriers, captive managers start with standard insurance contracts. Banks have standard forms for loan agreements. Trust companies have standard trust and estate forms. Even the Tax Court provides standard forms on its website. Whether an industry has reinvented the wheel with each new transaction isn't the test to prove a legitimate contract.

Finally, SIIA clarifies premium pricing in common reinsurance arrangements. It is the premium pricing related to risk shifting through various reinsurance methods that has caused the most confusion for the IRS. The IRS charges that many reinsurance methods reflect a circular flow of funds because premiums flow from the insured to the captive, from the captive to the pool, and from the pool back to the captive.

Generally, in tax law a circular flow of funds might indicate an impropriety. The courts use doctrines such as business purpose, substance over form, and step transaction to collapse a series of formalistic transactions undertaken to comply with sections of the IRC to achieve benefits in a manner not intended by the code. Applying the doctrines, the courts will recast the transaction based on its economic substance, thereby adjusting the tax consequences. Thus, to tax practitioners unfamiliar with the business of insurance, reinsurance could look suspect.

However, in the insurance industry these reinsurance methods are a way of achieving the benefits of the law of large numbers, a statistical probability theory that a larger pool will yield values closer to average. The insurance industry applies the law of large numbers by distributing risks over multiple insureds and multiple risks. The more insureds and risk exposures in the risk pool, the more accurate the underwriters' computations relating to losses tend to be. For the insurance industry, that means the law of large numbers helps the industry estimate the cost and frequency of future claims. As the Ninth Circuit stated in *Clougherty Packing*, "Insuring many independent risks in return for numerous premiums serves to distribute risk."[16]

By distributing risk, the insurance company can price premiums appropriately, calculate losses accurately, and still make a profit. A circular transaction isn't established because the participants are paid premiums for taking on risk that is similar in numerical exposure to their own risk that is pooled and are being paid a similar premium amount to the amount they paid. The risks and premiums associated with each of these transactions are different.

Individuals apply the law of large numbers when they diversify their retirement portfolios to reduce risks. They apply the law of large numbers when they avoid putting all their eggs in one basket.

Knowing when the transaction achieves the law of large numbers requires expert testimony and payments that might resemble a circular flow of funds. Achieving risk distribution requires some pooling of risks across multiple parties and multiple exposures. Pooling the risk reduces volatility by spreading it over those multiple parties and exposures.

[14] *Reserve Mechanical*, T.C. Memo. 2018-86 at 716.

[15] *See German Alliance Insurance Co. v. Lewis*, 233 U.S. 389, 412 (1914).

[16] *Clougherty Packing Co. v. Commissioner*, 811 F.2d 1297, 1300 (9th Cir. 1987).

In explaining risk distribution, SIIA described the three primary risk-pooling models in the captive industry: the fronting model, the retrocessional model, and the contractual exchange model. In the fronting model, a commercial insurance company will typically issue policies and then cede all or some percentage of the total risk to reinsurance companies. The premium ceded is a percentage of the total premium collected, less the expenses to operate the program if all the risk is ceded.

The retrocessional model is how the reinsurer further distributes its risk. It is structured so that reinsurance is issued to many reinsureds and then retroceded as a quota share (representing the level of participation in the transaction) to the various reinsureds. Each participant is then both a reinsured and a retrocessionaire. The risk each participant takes as a retrocessionaire is different than the risk each ceded as a reinsured.

The contractual exchange model is an indemnity pooling arrangement by contract that doesn't involve reinsurance in a technical sense but does involve a contractual exchange of risk through indemnity obligations.

The common denominator of all three risk distribution models, when done correctly, is that the amount of premium each captive pays into the pool, or is obligated to cover, is almost the same amount as the premium the pool pays to each captive as a reinsurer or retrocessionaire, less expenses and claims. The important point is this: Each captive shifts a percentage of its insured risk into the pool (or indemnity arrangement), but the risks each captive receives from the pool (or indemnity arrangement) are different than the risks each transferred to the pool.

For example, in the retrocessional model, taxpayer A purchases insurance from his insurance company, Captive A, and pays a premium of $1,000. Captive A then reinsures by entering a pooling arrangement involving multiple other captives insuring other claims and different insureds. Captive A pays $1,000 into the pool (and cedes the risk of taxpayer A to the pool) in exchange for assuming a quota share of the pool's risk. The pool is the reinsurer. When Captive A assumes a quota share of the pool's risk, it becomes both a reinsured and a retrocessionaire insuring its proportionate share of the pool. Captive A would receive $1,000 as a premium for insuring its proportionate share (quota share) of the pool's risk. The dollar amount of risk Captive A puts into the pool as a reinsured and the amount of risk Captive A takes back as a retrocessionaire must be the same because it is assuming its proportionate risk of the pool; hence the premium is the same (ultimately there is a deduction during the course of the obligation for expenses and losses).

Why would Captive A agree to take on its proportionate share of the risk without receiving its proportionate share of premium? But what Captive A is now insuring is a much different suite of risks. Captive A is insuring a proportionate share of the multiple risk exposures of all the other insureds in the pool. That is how risk distribution is achieved. The court must focus on the number and potential incidents of risk exposures and on expert testimony about whether those exposures satisfy the law of large numbers, not on the premium the parties exchanged to distribute those risks. To be fair, those premiums may be the same.

Common among *Avrahami*, *Reserve Mechanical*, and *Syzygy* appears to be the absence of sufficient actuarial expert testimony explaining the premium pricing in each case. That should be the focus of both the IRS and Tax Court and the responsibility of the insured to produce. The Tax Court only has the information before it on which to base its decision. It is imperative that taxpayers provide the government and the Tax Court with sufficient expert testimony regarding insurance practices in general and the taxpayer's insurance business in particular, including the method the taxpayer's experts used to price the risk. Doing so can help the Tax Court build a body of jurisprudence that protects taxpayers, as well as the IRS.

Perhaps the Tenth Circuit will clarify that fundamental insurance concepts must remain the same for both insurance and tax purposes so that the IRS can apply a more accurate analysis in its examinations of small captive insurance companies and the Tax Court can issue insurance-based decisions that help protect the American economy in future disasters. ■