PRESENTED AT

The University of Texas School of Law
69th Annual Taxation Conference

December 1-2, 2021
Austin, TX

Micro-Captive Insurance (Outline)

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MICRO-CAPTIVES vs. INTERNAL REVENUE SERVICE
OR
"HOLD THAT TIGER"

by Charles J. Muller III and Leo Unzeitig

INTRODUCTION

We are all subject to risks of loss. Our cars can be stolen, our houses flood, or our businesses lose money due to a pandemic. Some of those risks, the IRS argues, are foreseeable and insurable. Others, the IRS argues, are not.

Congress passed section 831(b) at a time when the insurance industry was in turmoil. The goal: make the business and cost of insurance more feasible. Like many other provisions in the Code, section 831(b) is intended to provide a tax benefit to small insurance companies. It allows them to exclude premiums from taxable income *only if* the premiums received are less than $1.2 million per year. The effect of not having to pay tax is that small insurance companies can accrue capital and reserves more quickly to cover losses. An exposure that may otherwise be deemed prohibitively expensive to insure is now more feasible because of the tax benefit.

Section 831(b) insurance companies are thus generally formed to insure risks that would be too expensive or otherwise unavailable in the commercial insurance market. Think insurance for covering terrorism risks (including nuclear, chemical, and biological attacks) pandemics, administrative actions, and business income protection. These are what actuaries refer to as low-frequency, but high-severity risks. They don't happen often, but when they do, they're expensive.

These types of policies are generally available but they are usually expensive and only available in the "excess and surplus lines" market (think Lloyds of London or Bermuda)--whereas your automobile insurance is typically found in the "standard" market (think Allstate and Progressive).

Because of the tax benefits provided by section 831(b) (i.e., not having to pay tax on underwriting income), an insurance company can more quickly accrue capital and reserves to cover potential losses. However, because insurance companies are limited to writing just over $2 million in income before losing a section 831(b) election, insurance companies often must engage in reinsurance arrangements. This is where risk they assume from writing insurance is ceded (or shifted) to other insurance companies thus making the underwriting losses more predictable. They in turn assume similar risks from other geographically and economically divers insureds on similar terms for a reinsurance premium. These types of reinsurance and pooling arrangements date back to the maritime industry in the 1500s and have evolved over the centuries to meet the insurance industry needs. The IRS disagrees and argues that reinsurance contracts are just shams.

STATUTORY AUTHORITIES

Under section 831(b), insurance premiums *received* by an insurance company are excluded from taxable income so long as the net written premiums are less than $1.2 million (or $2.2 million adjusted for inflation after 2016).

In 2015, Congress reaffirmed its commitment to benefit section 831(b) insurance companies by increasing the limit on nontaxable net written premiums from $1,200,000 to $2,200,000 and indexed the change for inflation. Staff of the Joint Committee on Taxation, General Explanation of the Tax Legislation Enacted in 2015, at 292 (J. Comm. Print. 2016).

RELEVANT CASES

Rent-A-Center v. Commissioner, 142 T.C. 1 (2014).

Rent-A-Center formed a wholly owned insurance subsidiary (Legacy) to insure the risks of its various operating subsidiaries. Legacy wrote policies covering workers' compensation, automobile, and general liability claims. The IRS challenged the arrangement as not insurance for tax purposes. The chief complaint was that Legacy did not have sufficient risk distribution. The IRS argued that Legacy did not insure any outside business, and in certain years only insured three subsidiaries of Rent-A-Center with the vast majority of risk (approximately 67%) being in one single subsidiary. Rent-A-Center argued that the true measure of risk distribution was the underlying risks being insured (i.e., the numerous workers, trucks and stores covered by the policies, and not a mere counting of three insured subsidiaries). In a 10-6 decision, the Tax Court held in favor of Rent-A-Center, finding that Legacy was an insurance company with an adequate level of risk distribution.

Securitas v. Commissioner, T.C. Memo. 2014-225.

Shortly after Rent-A-Center, the Tax Court again held in favor of the taxpayer in Securitas. In Securitas, the taxpayer formed a captive to insure it operations. The Securitas captive insured numerous subsidiaries; however, the vast majority of premiums were attributable to a single operating subsidiary. The IRS claimed that the concentration of risk undermined the risk distribution of the captive. The taxpayer argued that the proper metric of risk distribution is not the number of insureds, but rather the number of risk exposures insured. The Tax Court adopted the taxpayer's position and found that "by insuring various risks of U.S. and non-U.S. subsidiaries, the captive arrangement achieved risk distribution.

IRS RESPONSE TO MICRO-CAPTIVES

Title search: Micro-Captives vs. Internal Revenue Service or "Hold that Tiger"

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First appeared as part of the conference materials for the
69th Annual Taxation Conference session
"What Does Enforcement Look Like Today?"