THE FORGOTTEN TAXATION LANDMINE: APPLICATION OF THE ACCUMULATED EARNINGS TAX TO IRC § 831(B) CAPTIVE INSURANCE COMPANIES

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I. INTRODUCTION

An Internal Revenue Code ("IRC") § 831(b) captive insurance company ("CIC") is a corporation generally formed by a parent corporation to offer insurance to the parent's subsidiaries.[1] A CIC is either owned by the parent entity directly or by shareholders of the parent entity. Many of the largest U.S. corporations legitimately use a CIC for valid reinsurance purposes.[2] Such major corporations are diversified and well-funded enough to adequately reinsure certain risks, while using the CIC to retain insurance management, eliminate underwriting fees, claim current income tax deductions for insurance premium expense, and control the investment portfolio of the CIC.[3] Furthermore, the use of a CIC may defer the realization of ordinary income or even re-characterize ordinary income as capital gain to the parent corporation.[4] Also, a CIC may allow a company that self-insures to accelerate the tax deduction that would otherwise accrue at the time the self-insurance contingency occurs.[5] Lastly, the use of a CIC may allow the parent company to control the claims review process that potentially lowers administrative, litigation, and fraudulent claims costs to the parent company.

A parent corporation that wishes to self-insure against certain risks may face taxation on reserve investment income at the highest corporate rate.[6] To avoid this problem, a parent entity may establish a CIC that will allow the parent to accelerate its tax deduction for insurance premiums paid to the CIC.[7] Adding to the tax benefits of the CIC arrangement, an IRC § 831(b) CIC is not taxed on the premium income up

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[1] Jay Adkisson, *Bad Financial Medicine for Year-End 2008: Physicians, Captive Insurance Companies and Cash-Value Life Insurance*, *available at* http://www.captiveinsurancecompanies.com/captive_insurance_life_insurance.htm.
[2] Jay Adkisson, *Bad Financial Medicine for Year-End 2008: Physicians, Captive Insurance Companies and Cash-Value Life Insurance*, *available at* http://www.captiveinsurancecompanies.com/captive_insurance_life_insurance.htm.
[3] Jay Adkisson, *Bad Financial Medicine for Year-End 2008: Physicians, Captive Insurance Companies and Cash-Value Life Insurance*, *available at* http://www.captiveinsurancecompanies.com/captive_insurance_life_insurance.htm.
[4] *See* IRC § 831(b); Richard M. Columbik, *Captive Insurance Companies*, Inc.com, Aug. 13, 2008, *available at* http://www.inc.com/law-and-taxation/2008/08/captive_insurance_companies.html; Jay Adkisson, *Bad Financial Medicine for Year-End 2008: Physicians, Captive Insurance Companies and Cash-Value Life Insurance*, *available at* http://www.captiveinsurancecompanies.com/captive_insurance_life_insurance.htm.
[5] *See* IRC § 162; Richard M. Columbik, *Captive Insurance Companies*, Inc.com, Aug. 13, 2008, *available at* http://www.inc.com/law-and-taxation/2008/08/captive_insurance_companies.html.
[6] Richard M. Columbik, *Captive Insurance Companies*, Inc.com, Aug. 13, 2008, *available at* http://www.inc.com/law-and-taxation/2008/08/captive_insurance_companies.html.
[7] Richard M. Columbik, *Captive Insurance Companies*, Inc.com, Aug. 13, 2008, *available at* http://www.inc.com/law-and-taxation/2008/08/captive_insurance_companies.html.

to $1.2 million annually.[8] If the § 831(b) CIC invests in tax-free investments (such as municipal bonds), then no part of the arrangement would face tax consequences until earnings are returned to the shareholder parent company in the form of dividends or realization of capital appreciation from the sale of stock in the CIC.[9]

While these tax benefits are substantial, a CIC cannot defer taxation to the parent corporation shareholder indefinitely. A CIC generally must be a Subchapter C corporation to comply with local jurisdictional requirements and thus may be subject to the Accumulated Earnings Tax ("AET").[10] The AET is a penalty tax designed to prevent corporations from unreasonably retaining after-tax earnings and profits in lieu of paying current dividends to shareholders, where they would be again taxed as ordinary income at applicable shareholder tax rates.[11] If a C corporation is liable for the AET under IRC § 532(a), there will be imposed a tax for each taxable year of fifteen percent (15%) on the corporation's accumulated taxable income.[12] Accumulated taxable income is reduced by a credit for an accumulation amount sufficient to satisfy reasonable current and future anticipated business needs.[13]

Reasonable current business needs of a CIC generally include (but are not limited to): the amount needed for employee compensation and benefits for the current business cycle;[14] the amount needed for facilities overhead expenses for the current business cycle;[15] and the amount needed to fund the probable claims payable, as determined by actuarial tables.[16] Reasonably anticipated future business needs of a CIC may include (but may not be limited to) planned for expansions of facilities;[17] expansions of workforce;[18] acquisition of stock or assets for diversification or other business needs;[19] redemption of CIC shares;[20] and retiring bona fide business indebtedness of a non-shareholder creditor.[21]

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[8] IRC § 831(b).
[9] *See* Richard M. Columbik, *Captive Insurance Companies*, Inc.com, Aug. 13, 2008, *available at* http://www.inc.com/law-and-taxation/2008/08/captive_insurance_companies.html.
[10] IRC §§ 531, 532.
[11] John S. Ball & Beverly H. Furtick, *Defending the Accumulated Earnings Tax Case*, 72 Fla. Bar J. 28 (1998).
[12] IRC § 535.
[13] John S. Ball & Beverly H. Furtick, *Defending the Accumulated Earnings Tax Case*, 72 Fla. Bar J. 28 (1998).
[14] *See* John S. Ball & Beverly H. Furtick, *Defending the Accumulated Earnings Tax Case*, 72 Fla. Bar J. 28 (1998).
[15] *See* John S. Ball & Beverly H. Furtick, *Defending the Accumulated Earnings Tax Case*, 72 Fla. Bar J. 28 (1998).
[16] *See* Gazette Telegraph Co. v. C.I.R., 19 T.C. 692, 706-8 (1953).
[17] Treas. Reg. § 1.537-1(b)(1); Treas. Reg. § 1.537-2(b).
[18] Treas. Reg. § 1.537-1(b)(1); Treas. Reg. § 1.537-2(b).
[19] *See* Treas. Reg. § 1.537-2(b)(2); *See* Hughes, Inc. v. C.I.R., 90 T.C. 1, 13 (1988).
[20] *See* IRC § 537; John S. Ball & Beverly H. Furtick, *Defending the Accumulated Earnings Tax Case*, 72 Fla. Bar J. 28 (1998).
[21] Treas. Reg. § 1.537-2(b)(3).

The reasonableness of accumulations may be challenged under several scenarios. First, the IRS may claim the CIC had no specific plan outlining how the earnings accumulations are to be utilized.[22] Second, if a CIC claims that accumulations are made in accordance with a plan, but actually has no intent to carry out the plan (as shown through a lack of substantial steps to further the plan), the accumulations may be deemed unreasonable.[23] Third, if a CIC actually makes expenditures in furtherance of a plan for accumulation in fixed assets but does not use those fixed assets for business purposes, the fixed assets may be deemed liquid assets subject to the AET, since such liquid investments are considered available to satisfy the capital needs of the CIC.[24] Lastly, if accumulated earnings are received in liquid form but converted to non-liquid form, the accumulation may be deemed to be objectively unreasonable, made for tax avoidance purposes, and thus deemed liquid assets subject to the AET.[25]

This article discusses (i) the requirements, benefits, and tax attributes of an IRC § 831(b) CIC; (ii) an overview of the AET and the reasonable needs test which must be met to avoid the AET; and (iii) the potential future application of the AET to an IRC § 831(b) CIC and the negative results that could arise if the IRS chooses to do so. Given that the IRS has yet to announce any policy about applying the AET to combat the growth of this popular tax arrangement, this article seeks to analyze how the IRS may prospectively make use of this tool and how CIC owners and mangers should conduct themselves to not run afoul of the IRS.

II. IRC § 831(B) CAPTIVE INSURANCE COMPANIES

A. Requirements

The Internal Revenue Service ("IRS") will examine CIC arrangements closely and may attack a CIC based upon the individual facts and circumstances present.[26] If a CIC is undercapitalized[27] or not regulated as an insurance company under local law, the arrangement may be found to lack the characteristics of insurance.[28] Characteristics of insurance may also be lacking where guarantees remove the presence of risk shifting or distribution from the arrangement and where contracts are not entered into at arms length.[29]

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[22] Treas. Reg. § 1.537-1(b)(1); Treas. Reg. § 1.537-2(b).
[23] Otto Candies, LLC v. U.S., 288 F. Supp. 2d 730, 767 (E.D. La. 2003).
[24] Briggs v. C.I.R., TC Memo 1956-86.
[25] *See* 26 C.F.R. §§ 1.533-1(a)(2)(ii); 1.537-2(c)(4); Bardahl Manufacturing Corp. v. C.I.R., TC Memo 1965-200.
[26] Rev. Rul. 2001-31, 2001-1 C.B. 1348.
[27] A CIC must meet the capitalization requirements of local regulations relating to maintaining insurance companies. Furthermore, in order to garner favorable federal tax treatment, a CIC must meet the Internal Revenue Code capitalization requirements for valid risk shifting to take place.
[28] *See* Malone & Hyde, Inc. v. C.I.R., 62 F.3d 835, 840-1 (6th Cir. 1995); Rev. Rul. 2002-90.
[29] *See* Malone & Hyde, Inc. v. C.I.R., 62 F.3d 835, 840-1 (6th Cir. 1995); Rev. Rul. 2002-90.

The IRS may also challenge the validity of an insurance arrangement where other industry norms, as would be carried out between unrelated entities, are not met.[30] Lastly, the IRS may consider other factors in a challenge, such as: whether the insured parties truly face hazard of economic risk in an amount which justifies premium payments made at commercially reasonable rates; whether the validity of claims was established before insurance claims were paid; and whether the CIC business operations and assets are kept segregated from the business operations and assets of the parent company.[31] This article will now address some of the more important of the above areas where the IRS may challenge the efficacy of a CIC.

1. Operating as an Insurance Company

If a CIC does not meet the definition of "insurance company," the entity will not be granted the favorable tax treatment allowed for "insurance companies" and may incur C corporation double taxation on all of the entity's income.[32] In order for a CIC to be considered an insurance company, the CIC must be operated in a manner consistent with being primarily in the business of insurance. Treas. Reg. 1.801-3(a) provides that an insurance company is a company whose primary and predominant business activity is the issuance of insurance or annuity contracts, or the reinsuring of risks underwritten by insurance companies. IRC § 816(a) defines "insurance company" as any company more than half the business of which is the issuing of insurance or annuity contracts, or the reinsuring of risks underwritten by an insurance company.

A CIC will not be considered a bona fide insurance company where the CIC charges commercially unreasonable premiums or engages in other non-arms length transactions.[33] The existence of underwriting and management fees payable to the CIC is indicative of the existence of a bona fide "insurance company."[34] However, arms length dealing and the existence of separate management and underwriting fees are not dispositive—the CIC must be operated as an insurance company in various other facets as well.[35] The CIC should employ licensed professionals to handle management, underwriting, accounting, and audit roles.[36] Furthermore, the CIC must meet local licensing and capital requirements for insurance companies.[37]

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[30] *See* Malone & Hyde, Inc. v. C.I.R., 62 F.3d 835, 840-1 (6th Cir. 1995); Rev. Rul. 2002-90.
[31] Ocean Drilling & Exploration Co. v. U.S., 988 F.2d 1135, 1151 (Fed. Cir. 1993).
[32] Jay Adkisson, *Running a Captive Correctly*, *available at* http://www.captiveinsurancecompanies.com/captive_insurance_taxation.htm.
[33] Jay Adkisson, *Running a Captive Correctly*, *available at* http://www.captiveinsurancecompanies.com/captive_insurance_taxation.htm.
[34] Jay Adkisson, *Running a Captive Correctly*, *available at* http://www.captiveinsurancecompanies.com/captive_insurance_taxation.htm.
[35] Jay Adkisson, *Running a Captive Correctly*, *available at* http://www.captiveinsurancecompanies.com/captive_insurance_taxation.htm.
[36] Jay Adkisson, *Running a Captive Correctly*, *available at* http://www.captiveinsurancecompanies.com/captive_insurance_taxation.htm.
[37] Jay Adkisson, *Running a Captive Correctly*, *available at* http://www.captiveinsurancecompanies.com/captive_insurance_taxation.htm.

These requirements vary by jurisdiction, but are oftentimes minimal in "offshore" jurisdictions, such as Bermuda or the Cayman Islands.[38] Of course, a CIC may be formed under the laws of any number of domestic State jurisdictions as well, including but not limited to Delaware, Vermont, Utah and South Carolina.

2. Definition of an Insurance Contract

In order for a CIC to be an "insurance company" it must issue "insurance" through "insurance contracts." The IRC does not define what constitutes "insurance" or an "insurance contract." Generally, in order to be considered insurance for federal income tax purposes, an arrangement must transfer the risk of economic loss,[39] must contemplate the occurrence of a stated contingency,[40] and must constitute more than simply an investment or business risk.[41] The Supreme Court of the United States ("Supreme Court") has held that in order for an arrangement to constitute insurance for federal income tax purposes, both risk shifting and risk distribution must be present.[42]

3. Risk Shifting

Risk shifting occurs where a party facing the risk of a large economic loss transfers some (or all) of the financial consequences of such potential loss to the insured.[43] Risk shifting generally requires: enforceable written insurance contracts; premiums negotiated and actually paid at arms-length; and the insurance company to be a separate entity capable of meeting its obligations and formed under the laws of the applicable jurisdiction.[44] The test for risk shifting is whether the premium paying party has transferred risk of loss.[45] Applying this to a CIC, risk shifting exists where a subsidiary CIC insures sufficient risks of parties unrelated to the parent corporation in addition to insuring the risk of the parent corporation.[46]

The IRS routinely argues that an arrangement fails to be considered insurance, for lack of risk shifting, where the taxpayer pays premiums to an entity that the taxpayer owns directly or indirectly.[47] Further, the IRS has challenged the deductibility of premiums paid by a taxpayer to an entity owned by a common

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[38] Jay Adkisson, *Running a Captive Correctly*, *available at* http://www.captiveinsurancecompanies.com/captive_insurance_taxation.htm.
[39] Allied Fidelity Corp. v. C.I.R., 572 F.2d 1190, 1193 (7th Cir. 1978).
[40] C.I.R. v. Treganowan, 183 F.2d 288, 290-1 (2nd Cir. 1950).
[41] Helvering v. LeGierse, 312 U.S. 531, 542 (1941); Rev. Rul. 89-96, 1989-2 C.B. 114.
[42] Helvering v. LeGierse, 312 U.S. 531, 539 (1941).
[43] Bobbe Hirsh & Alan Lederman, "The Service Clarifies the Facts & Circumstances Approach to Captive Insurance Companies," RIA Journal of Taxation, 100 JTAX 168 (March 2004).
[44] Bobbe Hirsh & Alan Lederman, "The Service Clarifies the Facts & Circumstances Approach to Captive Insurance Companies," RIA Journal of Taxation, 100 JTAX 168 (March 2004).
[45] Clougherty Packing Co. v. C.I.R., 84 T.C. 948 (1985), decision aff'd, 811 F.2d 1297 (9th Cir. 1987).
[46] Litigation Guideline Memorandum TL-85, Jan. 24, 1990.
[47] Humana Inc. v. C.I.R. 881 F.2d 247, 257 (6th Cir. 1989).

parent corporation.[48] Similarly, the IRS has challenged, on risk-shifting grounds, arrangements in which the economic burden of loss does not move from the balance sheet of a consolidated group.[49] The IRS likens its challenges of these types of arrangements to its argument that payments made for self-insurance reserves are non-deductible.[50]

The courts have never fully accepted the validity of these IRS challenges.[51] Some courts have denied premiums paid deductions on insurance premiums paid by a parent to a CIC subsidiary, but allowed a deduction for premiums paid by a subsidiary to a "brother-sister" subsidiary CIC.[52] These courts reasoned that risk shifting did not exist between a parent and subsidiary since the parent would incur losses upon the subsidiary's losses, but there exists no similar link between a loss incurred by a CIC subsidiary and another subsidiary entity.[53] In essence, these courts have determined that a parent corporation's common ownership of subsidiaries does not preclude the existence of a valid risk shifting arrangement.[54]

4. Risk Distribution

Risk distribution utilizes the law of large numbers. The idea is that the risk that a single costly claim will exceed premium payments for a given time decreases over longer periods of time, and with a greater number of insured's in a given pool.[55] Risk distribution involves the pooling of insurance premiums from separate entities so that the insured is not paying for a significant part of its own risks.[56] In Humana, Inc. v. C.I.R.,[57] the Supreme Court held that an arrangement solely between a parent company and a subsidiary insurance company did not constitute "insurance" for federal tax purposes. However, the Supreme Court also held that an arrangement between a subsidiary insurance company and several dozen other subsidiaries of the parent corporation constituted insurance, since elements of risk shifting and risk distribution were present in the arrangement.[58]

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48 Humana Inc. v. C.I.R. 881 F.2d 247, 257 (6th Cir. 1989); Malone & Hyde, Inc. v. C.I.R., 62 F.3d 835, 838 (6th Cir. 1995).
49 Bobbe Hirsh & Alan Lederman, "The Service Clarifies the Facts & Circumstances Approach to Captive Insurance Companies," RIA Journal of Taxation, 100 JTAX 168 (March 2004).
50 Bobbe Hirsh & Alan Lederman, "The Service Clarifies the Facts & Circumstances Approach to Captive Insurance Companies," RIA Journal of Taxation, 100 JTAX 168 (March 2004).
51 Bobbe Hirsh & Alan Lederman, "The Service Clarifies the Facts & Circumstances Approach to Captive Insurance Companies," RIA Journal of Taxation, 100 JTAX 168 (March 2004).
52 Humana Inc. v. C.I.R. 881 F.2d 247, 257 (6th Cir. 1989).
53 Humana Inc. v. C.I.R. 881 F.2d 247, 257 (6th Cir. 1989); Kidde Industries, Inc., 40 Fed. Cl. 42 (Ct. Fed. Cl. 1997).
54 Rev. Rul. 2002-90.
55 Clougherty Packing Co. v. C.I.R., 811 F.2d 1297, 1300 (9th Cir. 1987).
56 Humana, Inc. v. C.I.R., 881 F.2d 247, 257 (6th Cir. 1989).
57 Humana, Inc. v. C.I.R., 881 F.2d 247, 257 (6th Cir. 1989).
58 *See* Humana, Inc. v. C.I.R., 881 F.2d 247, 257-9 (6th Cir. 1989).

Historically, the IRS may have challenged the use of the CIC on the grounds that the arrangement was not considered an insurance transaction since risk shifting and risk-distribution were arguably lacking.[59] However, the IRS has since provided broad "safe harbor" rulings in this regard, and thus only appear to challenge a CIC on these bases in the most egregious and abusive of circumstances.[60]

B. Tax Benefits

A CIC is generally a subsidiary corporation formed to reinsure the risks of a parent corporation. Premiums paid to a CIC by its parent entity are generally deductible, similar to the deductibility of premiums paid on commercial insurance. IRC § 162(a) provides that there shall be allowed deductions on necessary and ordinary expenses incurred in carrying on a business. Treas. Reg. 1.162-1(a) states that business expenses include insurance premiums on policies covering fire, storm, theft, accident, or similar losses in the course of business. However, a CIC must be considered an "insurance company" and the arrangement must be considered an "insurance contract" in order for the premiums paid to garner tax-deductible treatment.

If an IRC § 831(b) CIC is not considered an insurance company or an arrangement is not considered insurance for federal tax purposes, the premiums paid expense is non-deductible.[61] IRC § 831(a) provides that tax shall be imposed under IRC § 11 on the taxable income of any insurance company other than life insurance companies. However, IRC § 831(b) provides that a non-life or property and casualty insurance company that receives annual premiums not to exceed $1.2 million can elect to receive this premium tax-free. Therefore, as long as a CIC maintains business operations that aggregate less than $1.2 million in annual premiums paid, the CIC would incur no tax on premiums paid. The CIC would still be liable for tax on its investment earnings, but the CIC could eliminate these taxes by investing in tax-free investments (such as municipal bonds). In this scenario, the parent deducts the premium payments, the premium payments are received tax-free by the CIC, the CIC earns investment returns tax-free on pre-tax dollars, and is only taxed when either the CIC makes a dividend distribution or the CIC stock is sold. In either of these cases, the dividend or sale would be taxed under current law at long-term capital gains rates.[62] Since the value of the premiums paid tax deduction to the parent is likely at least thirty-five percent (35%),[63] the fifteen percent (15%) rate creates quite a large tax arbitrage. Obviously, these various tax breaks cumulatively create a significant tax reduction opportunity for companies that have certain significant insurance needs that fit a CIC structure.

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[59] Helvering v. Le Gierse, 312 U.S. 531, 539 (1941).

[60] Crawford Fitting Co. v. U.S., 606 F. Supp. 136, 143 (N.D. Ohio 1985).

[61] Malone & Hyde, Inc. v. C.I.R., 62 F.3d 835, 838 (6th Cir. 1995).

[62] *See* I.R.C. § 1(h).

[63] *See* I.R.C. § 162; *See* I.R.C. § 11(b).

As an example, suppose that a CIC takes in $1 million in policy premium in exchange for issuing a policy to its parent company. As discussed above, the $1 million in premium is received tax-free by the IRC § 831(b) CIC. Assuming the CIC retains all the profits on underwriting fees because it wins its insurance "gamble" with the parent company, the CIC will have most of the $1 million as accumulated retained earnings going forward at years-end. If this continues to occur year after year, the CIC will have substantial built-up earnings that were both tax deductible to the parent company and tax exempt to the CIC. When this money is retained within the CIC, the interest earned on the money is potentially non-taxable (if invested in tax-free investments). Over several years, the accumulated earnings could reach $10 million or more, all growing tax-free on pre-tax money. Under current law, the dividend distributions of these funds when finally made would only be taxed at the long-term capital gains rate of fifteen percent (15%),[64] so there is a large incentive for the CIC to keep accumulating more earnings and holding them for as long as possible. One way the IRS may seek to challenge this practice, is the application of the AET to IRC § 831(b) CIC arrangements.

III. THE ACCUMULATED EARNINGS TAX

A. Application of the AET

The Accumulated Earnings Tax ("AET") may be imposed upon any C corporation except for personal holding companies,[65] passive foreign investment companies,[66] and IRC § 501 tax-exempt entities. The AET is a penalty tax designed to prevent corporations from unreasonably retaining after-tax earnings and profits in lieu of paying current dividends to shareholders - where such income would be taxed for a second time as ordinary income at applicable shareholder tax rates.[67] If a C corporation is liable for the AET under IRC § 532(a), there will be imposed a tax for each taxable year of fifteen percent (15%) on the corporation's accumulated taxable income.[68] The AET is imposed in addition to any other taxes imposed under the Internal Revenue Code.[69] "Accumulated taxable income" is defined as taxable income modified by adjustments made under IRC § 535(b), and as reduced by the dividends paid deduction under IRC § 561 and the AET credit under IRC § 535(c).[70]

B. Reasonable Business Needs as an Accumulation Justification

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[64] *See* I.R.C. § 1(h).
[65] IRC § 542.
[66] IRC § 1297.
[67] John S. Ball & Beverly H. Furtick, *Defending the Accumulated Earnings Tax Case*, 72 Fla. Bar J. 28 (1998).
[68] IRC § 535.
[69] IRC §§ 531.
[70] John S. Ball & Beverly H. Furtick, *Defending the Accumulated Earnings Tax Case*, 72 Fla. Bar J. 28 (1998).

A C corporation will only be penalized under the AET if it retains earnings and profits in excess of reasonable business needs[71] with the intent to avoid shareholder taxes.[72] However, the fact that a corporation accumulated earnings and profits beyond the reasonable needs of the business is determinative of the purpose to avoid income tax with respect to its shareholders, unless the corporation proves the contrary by a preponderance of the evidence.[73]

This presumption cannot be rebutted merely by evidence that tax avoidance was not the primary or dominant motive for the accumulations. In order to rebut the presumption that accumulations in excess of reasonable business needs were made with the intent to avoid taxes, the corporation must prove that tax avoidance was not *one* of the purposes.[74] Furthermore, if the tax avoidance purpose is thwarted and fails to achieve the intended tax benefit, comparably speaking, then the AET is unlikely to be applied.[75] It is common for courts to examine the tax effect a dividend distribution would have had, when considering whether to apply the AET under IRC § 531.[76] For example, if the shareholders of the accumulating corporation would have been entitled to a one hundred percent (100%) dividends received deduction under IRC § 243, it would be very difficult to argue for the application of the AET.

Although the AET may technically be imposed upon publicly traded corporations, closely held corporations are the most likely targets since their shareholders are in a better position to gain board seats that would allow the shareholders to influence dividend policy. In practice, a closely held corporation with excess earnings and profits will find it extremely difficult to rebut the presumption of a tax avoidance purpose. Therefore, the retention of earnings and profits in excess of reasonable business needs is the only real requirement for holding a closely held C corporation liable under the Accumulated Earnings Tax.[77]

C. Defining Present and Future Reasonable Business Needs

The critical inquiry in every accumulated earnings tax case is whether the retention of earnings can be justified by the reasonable needs of the business. The reasonable business needs of a corporation include not only its current needs, but

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[71] The reasonable needs of the business not only are critical in determining whether the proscribed intent exists, but these needs also establish a credit amount which reduces accumulated taxable income in defining the tax base against which the penalty tax is applied, under IRC § 535(a),(c).
[72] IRC § 532(a); Otto Candies, LLC v. U.S., 288 F. Supp. 2d 730, 733 (E.D. La. 2003).
[73] IRC § 533(a).
[74] U.S. v. Donruss Co., 393 U.S. 297, 309-10 (1969).
[75] Helvering v. National Grocery Co. , 304 U.S. 282, reh'g denied, 305 U.S. 669 (1938).
[76] Ltr. Rul. 9229025 ruled that a corporation could not be liable for the AET where the shareholders avoiding the dividends were foreign corporations not subject to the U.S. income tax.
[77] John S. Ball & Beverly H. Furtick, *Defending the Accumulated Earnings Tax Case*, 72 Fla. Bar J. 28 (1998).

also its "reasonably anticipated" future business needs as well.[78] Under the Treasury Regulation standards, the needs of the business are determined at the close of the taxable year in issue.[79] The CIC should make a practice of documenting its reasonably expected current and anticipated future business needs at the end of each cycle, but will not be required to show such formal planning if a definite and feasible plan can be otherwise proven.[80] The end of the business cycle is the point at which management presumably decides how much cash is needed for normal business operations, and for future adverse risks and contingencies. The excess should be distributed to shareholders as dividends, to be taxed as ordinary income.[81]

D. Expansion

Reasonable business needs for accumulating earnings and profits include both current and anticipated future needs.[82] Current business needs, such as working capital needs, are given great deference as to corporate judgment, form, and evidence of continuous planning.[83] Current needs consist of the liquid assets required to get through a business cycle, particularly working capital in most industries.[84]

In order to qualify as a reasonably anticipated future business need, a corporation must have specific, definite, and feasible plans for the use of the accumulation. The accumulation, however, does not have to be used immediately, nor must the plans for its use be consummated within a short period after the close of a taxable year.[85] However, business plans must be updated periodically to ensure continued compliance.[86] In a closely held corporation, it is not necessary that the plans be memorialized in formal corporate minutes. Rather, the test is whether the taxpayer's intent to undertake the plan is manifested by some substantial active move toward implementation, such as incurring expenditures in furtherance of the plan.[87]

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[78] John S. Ball & Beverly H. Furtick, *Defending the Accumulated Earnings Tax Case*, 72 Fla. Bar J. 28 (1998).
[79] Treas. Reg. § 1.537-1(b)(2).
[80] However, such formal documentation of a plan may be required to shift the burden of proving the lack of reasonable business needs to the IRS under IRC § 534.
[81] John S. Ball & Beverly H. Furtick, *Defending the Accumulated Earnings Tax Case*, 72 Fla. Bar J. 28 (1998).
[82] John S. Ball & Beverly H. Furtick, *Defending the Accumulated Earnings Tax Case*, 72 Fla. Bar J. 28 (1998).
[83] John S. Ball & Beverly H. Furtick, *Defending the Accumulated Earnings Tax Case*, 72 Fla. Bar J. 28 (1998).
[84] John S. Ball & Beverly H. Furtick, *Defending the Accumulated Earnings Tax Case*, 72 Fla. Bar J. 28 (1998).
[85] Treas. Reg. § 1.537-1(b)(1).
[86] John S. Ball & Beverly H. Furtick, *Defending the Accumulated Earnings Tax Case*, 72 Fla. Bar J. 28 (1998).
[87] Otto Candies, LLC v. U.S., 288 F. Supp. 2d 730 (E.D. La. 2003).

Whether a corporation's accumulation of earnings and profits is in excess of the reasonable needs of its business is a question of fact.[88] In determining the reasonable needs of the business for purposes of the AET, the courts must give great deference to the business judgment of corporate management. According to the United States Court of Appeals for the Fifth Circuit, the determination of a corporation's reasonable business needs is properly left to the corporation's management since they are most familiar with the complexities of their business.[89]

1. Accumulations for Expansion

In Electric Regulator Corp. v. C.I.R., a corporation engaged in the manufacture of electric regulating devices planned to expand into a new business line and nearly double the size of their manufacturing plant facility.[90] The IRS challenged the accumulation of earnings for expansion of facilities to expand into a new line of business.[91] The court reasoned "the product of today is frequently outmoded tomorrow."[92] The court held that the expansion of facilities to enter a new business line was a reasonable business need.[93] The court did acknowledge the potential for misuse of the corporate form where the owner of a closely held corporation has declared no dividends.[94] However, the court decided in favor of the taxpayer corporation, stating that the purpose of the AET is to discourage retention of earnings for the purpose of lowering individual tax liability,[95] "not to award the (IRS) an ex post facto veto over the decisions of the board of directors."[96] Reasonable needs of the business are a question for the officers and directors of a corporation.[97] A corporation may finance growth and expansion by any number of means and the courts should be wary to substitute its own judgment for that of corporate officers and directors absent a clear showing that the accumulation of earnings was unreasonable and for the prohibited purpose.[98]

In John P. Scripps Newspapers v. C.I.R., a newspaper company held substantial accumulated earnings. The IRS attempted to apply the AET, and the newspaper company taxpayer argued that the reserves were reasonably necessary to provide for expansion of plant and facilities, to provide reserves to meet competition, and to provide for working capital needs.[99] The Tax Court held that the

[88] Otto Candies, LLC v. U.S., 288 F. Supp. 2d 730, 767 (E.D. La. 2003).
[89] Otto Candies, LLC v. U.S., 288 F. Supp. 2d 730, 767 (E.D. La. 2003).
[90] Electric Regulator Corp. v. C.I.R., 336 F.2d 339, 340 (2nd Cir. 1964).
[91] Electric Regulator Corp. v. C.I.R., 336 F.2d 339, 343 (2nd Cir. 1964).
[92] Electric Regulator Corp. v. C.I.R., 336 F.2d 339, 346 (2nd Cir. 1964).
[93] Electric Regulator Corp. v. C.I.R., 336 F.2d 339, 346 (2nd Cir. 1964).
[94] Electric Regulator Corp. v. C.I.R., 336 F.2d 339, 346 (2nd Cir. 1964).
[95] Electric Regulator Corp. v. C.I.R., 336 F.2d 339, 346 (2nd Cir. 1964).
[96] Electric Regulator Corp. v. C.I.R., 336 F.2d 339, 347 (2nd Cir. 1964).
[97] Crawford County Printing & Publishing Co. v. C.I.R., 17 T.C. 1404, 1414 (1952).
[98] Breitfeller Sales, Inc. v. C.I.R., 28 T.C. 1164, 1168 (1957).
[99] John P. Scripps Newspapers v. C.I.R., 44 T.C. 453, 464 (1965).

size of the surplus accumulation is not the crucial factor.[100] Rather, the nature and reasonableness of the accumulation is controlling.[101] The Tax Court held that "to the extent the surplus has been translated into plant expansion, increased receivables, enlarged inventories, or other assets related to its business, the company can accumulate surplus with impunity."[102]

In Smoot Sand & Gravel Corp. v. C.I.R., the corporation argued that it was accumulating earnings with the intent of funding a future expansion into the ready-mix concrete business.[103] The court held that the utilization of working capital by a corporation for the purpose of purchasing fixed assets does in fact decrease the amount of funds available for operating expenses.[104] The court also held that a corporation is free to accumulate earnings with impunity where earnings are invested in plant expansion, increased receivables, enlarged inventories, or other assets related to its business.[105] On the other hand, the court found that if the accumulations are held in liquid assets that are sufficient to meet the business needs for working capital, business expansion, and other contingencies, there is strong evidence that any additional surplus is beyond the reasonable needs of the business.[106]

2. Specific and Definite Expansion Plans Required

Accumulation of earnings to purchase real estate and build an office building may not be justified where the idea has received mere preliminary consideration.[107] However, the accumulation of earnings for bona fide expansion or planned expansion of business constitutes a reasonably anticipated future business need to the extent that the plans to invest in the projects are specific, definite, and feasible.[108] Where a company has a history of growth and modernization, it need not always set aside a specific planned sum to achieve a specific goal.

Specific and definite plans may be evidenced by a history of expansion and a policy of continued growth. The expansion history of the corporation should play an important role in determining whether it should be allowed to accumulate funds for expansion. A strong history of expansion is a positive indication that a corporation intends to continue expanding in the future. In the absence of a historic trend towards expansion, the appropriate inquiry is whether the company subjectively had real plans to expand at the end of the business cycle, as shown by some

[100] John P. Scripps Newspapers v. C.I.R., 44 T.C. 453, 467 (1965).
[101] John P. Scripps Newspapers v. C.I.R., 44 T.C. 453, 467 (1965).
[102] John P. Scripps Newspapers v. C.I.R., 44 T.C. 453, 466 (1965).
[103] Smoot Sand & Gravel Corp. v. C.I.R., 274 F.2d 495, 497 (4th Cir. 1960).
[104] Smoot Sand & Gravel Corp. v. C.I.R., 274 F.2d 495, 500 (4th Cir. 1960).
[105] Smoot Sand & Gravel Corp. v. C.I.R., 274 F.2d 495, 500 (4th Cir. 1960).
[106] Smoot Sand & Gravel Corp. v. C.I.R., 274 F.2d 495, 501 (4th Cir. 1960).
[107] Snow Manufacturing Co. v. C.I.R., 86 T.C. 260, 273 (1986).
[108] Treas. Reg. § 1.537-1(b)(1); Treas. Reg. § 1.537-2(b).

expenditure towards furtherance of plan.[109] However, if liquid assets have not been used in the business but instead converted to illiquid forms of investment, there may be some evidence that the accumulations are not reasonably necessary.[110] Any portion of real property that is obtained and accumulated for claimed reasonable business operations use, but which is not actually used for reasonable business purposes may be treated as liquid investment property – and since liquid assets could be utilized to satisfy the capital needs of the corporation, these assets may now be subject to the AET.[111]

3. Good Faith Requirement

When a taxpayer claims a future reasonable business need, for the purpose of accumulating earning, that the taxpayer has no intention of fulfilling, the claimed need shall be disallowed as a credit against accumulated earnings taxable income. A taxpayer's plan to bid on a solid waste collection facility and the necessity of equipment for such activity was not a justification for accumulated earnings when in fact it never made the bid, did not have a permit to engage in the activity, and there was no definite plan that it was going to make the bid.[112] The existence of such plans may justify the accumulation of earnings in some cases.[113] However, if the corporation does not make subsequent acquisitions, "a question may arise as to whether or not it really intended to make such acquisitions."[114] Such an analysis depends upon the facts and circumstances of an individual case, since changes in events may cause changes in desire for acquisitions as dictated by prudent business judgment.[115]

Courts have held that investment in land unrelated to the business is a liquid asset, making such land subject to the AET since liquid assets may theoretically be used to satisfy the capital needs of the corporation.[116] In Cataphote Corp. of Mississippi v. U.S., a corporation invested in a minority stock position in an oil and gas corporation. The court held that investment in securities of a company that is unrelated to the taxpayer's business activities may be an unreasonable accumulation.[117] A taxpayer does not become engaged in a business simply by purchasing a minority stock position.[118] The difference between a working interest

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[109] Otto Candies, LLC v. U.S., 288 F. Supp. 2d 730 (E.D. La. 2003).
[110] *See* 26 C.F.R. §§ 1.533-1(a)(2)(ii); 1.537-2(c)(4); Bardahl Manufacturing Corp. v. C.I.R., TC Memo 1965-200.
[111] Briggs v. C.I.R., TC Memo 1956-86.
[112] Petrozello Co. v. C.I.R., T.C. Memo 1983-250.
[113] Jere D. McGaffey, *Accumulated Earnings Tax: Reasonable Needs of Business-General*, 1A McGaffey Legal Forms with Tax Analysis § 4:9 (2011).
[114] Jere D. McGaffey, *Accumulated Earnings Tax: Reasonable Needs of Business-General*, 1A McGaffey Legal Forms with Tax Analysis § 4:9 (2011).
[115] Jere D. McGaffey, *Accumulated Earnings Tax: Reasonable Needs of Business-General*, 1A McGaffey Legal Forms with Tax Analysis § 4:9 (2011).
[116] Grob, Inc. v. U.S., 565 F. Supp. 391 (E.D. Wis. 1983).
[117] Cataphote Corp. of Mississippi v. U.S., 535 F.2d 1225, 1236 (C.O.F.C. 1976).
[118] Cataphote Corp. of Mississippi v. U.S., 535 F.2d 1225, 1236 (C.O.F.C. 1976).

and a mere investment interest is whether the taxpayer has direct operating and managing responsibilities due to stock ownership.[119] The court held that accumulated earnings held for investment in companies unrelated to the taxpayer's business activities are not always reasonably necessary business needs.[120] However, accumulated earnings held for the purchase of a controlling business interest is almost assuredly a reasonably necessary business need, even if the business interest purchased is not related to the taxpayer's prior business activities.[121]

E. Diversification

Even where the taxpayer plans to acquire a minority interest in a company unrelated to the taxpayer's business, accumulated earnings may be deemed reasonable if made to provide for reasonable diversification.[122] In finance, the capital asset pricing model is used to measure portfolio diversification of both systematic (market) and non-systematic (investment specific) risks.[123] Any acquisition that acts to bring a corporation's portfolio risk closer in line with the average portfolio risk of similarly situated corporation would be presumptively considered reasonable diversification. The IRS has taken a position of general deference to corporate boards of directors in assessing the reasonableness of acquisition plan decisions, absent clear evidence of unreasonable accumulation for the proscribed purpose.[124]

F. Redemptions

Reasonably anticipated future business need may also be shown through the existence of a redemption plan.[125] Redemption plans have legitimate business purposes of ensuring continuity and control of the corporation. However, redemption plans also provide for a contractual demand on the corporation for money, creating the need for additional accumulated liquid assets.[126] A redemption plan for stock of a minority shareholder is a valid business purpose, and funds retained for such a purpose are retained for the reasonable needs of a corporation's business.[127] Funds may be reserved to meet future redemption obligations long in advance of the actual circumstances triggering the redemption, where a company is bound to make future redemptions pursuant to a stock purchase agreement.

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[119] Cataphote Corp. of Mississippi v. U.S., 535 F.2d 1225, 1236 (C.O.F.C. 1976).
[120] Cataphote Corp. of Mississippi v. U.S., 535 F.2d 1225, 1237 (C.O.F.C. 1976).
[121] Cataphote Corp. of Mississippi v. U.S., 535 F.2d 1225, 1237 (C.O.F.C. 1976).
[122] Treas. Reg. § 1.537-2(b)(2); *See* Hughes, Inc. v. C.I.R., 90 T.C. 1, 13 (1988).
[123] Black, Fischer., Michael C. Jensen, and Myron Scholes (1972). *The Capital Asset Pricing Model: Some Empirical Tests*, pp. 79–121 in M. Jensen ed., Studies in the Theory of Capital Markets. New York: Praeger Publishers.
[124] Treas. Reg. § 1.537-2(b)(2); *See* Hughes, Inc. v. C.I.R., 90 T.C. 1, 13 (1988).
[125] IRC § 537.
[126] John S. Ball & Beverly H. Furtick, *Defending the Accumulated Earnings Tax Case*, 72 Fla. Bar J. 28 (1998).
[127] T.C. Memo 1985-386.

Whether the redemption of a majority stockholder's shares is a reasonable business need for the accumulation of the corporation's earnings and profits is a more difficult question though.[128]

Earnings retained for the purpose of retiring bona fide business indebtedness to a non-shareholder creditor are almost universally found to be accumulated for reasonable business needs.[129] However, accumulations held to retire debt held by shareholders is criticized more harshly by the courts.[130] In Gazette Telegraph Co., the Tax Court held that earnings accumulated for the "retirement of bona fide indebtedness created in connection with the trade or business, such as the establishment of a sinking fund for the purpose of retiring bonds issued by the corporation in accordance with contract obligations, was a reasonable business need."[131] It is well established that the corporation can retain funds to cover current indebtedness.[132] However, in Gazette, the Tax Court also permitted the accumulation of income to cover long-term indebtedness on maturities up to three years after the year in question.[133]

G. Effect of Excessive Accumulations

Factors generally indicating that the retention of earnings and profits is not for business purposes, and may be excessive, include: 1) dealings between the corporation and its shareholders for the personal benefit of the shareholders, such as personal loans, or the expenditure of funds by the corporation for the personal benefit of the shareholders; 2) the investment of earnings in businesses or assets having no connection with the business of the corporation; and 3) a poor corporate dividend record.[134]

The taxpayer normally bears the burden of proving the existence of reasonable business needs, by a preponderance of the evidence, for excessive accumulation of corporate earnings. However, this burden may be shifted to the IRS under IRC § 534, if, within 30 days of receiving notification of accumulated earnings tax penalties from the IRS, the taxpayer sends a statement on the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business.

If the taxpayer produces a statement corroborated by concrete and viable business plans, with experts concluding valid business judgment for corporate decision-making, the courts will generally defer to business judgment in analyzing

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[128] E.M.I. Corp. v. C.I.R., T.C. Memo 1985-386.
[129] Treas. Reg. § 1.537-2(b)(3).
[130] *See* Smoot Sand & Gravel Corp. v. C.I.R., 274 F.2d 495 (4th Cir. 1960).
[131] 26 C.F.R. § 1.537-2(b)(3).
[132] Gazette Telegraph Co. v. C.I.R., 19 T.C. 692, 706-8 (1953).
[133] Gazette Telegraph Co. v. C.I.R., 19 T.C. 692, 706-8 (1953).
[134] Treas. Reg. § 1.537-2(c).

whether accumulations are reasonable business needs since the burden has been shifted. It should be noted that, in practice, a taxpayer may not always be able to rely on shifting the burden of proving reasonable business needs since these decisions are often made in pre-trial hearings in a very late stage of the procedural process. If the burden of proof is not successfully shifted to the IRS to show lack of reasonable business needs, the taxpayer will face a much more difficult time showing the existence of reasonable business need, particularly in areas that are already borderline, such as majority shareholder redemptions and self-insurance for otherwise commercially insurable risks.[135]

IV. APPLICATION OF AET TO AN IRC § 831(B) CIC

A CIC generally must be a C corporation to comply with local jurisdictional requirements and thus may be subject to the AET.[136] A CIC may encounter heightened scrutiny in the context of accumulated earnings since a CIC is generally a closely held corporation of the parent corporation - meaning that the parent corporation likely has major control over CIC dividend policy.[137] Given the tax benefits of a CIC, the CIC ownership may seek to retain as many earnings as is practicable for as long as possible. The earnings are deducted when paid by the insured parent, not taxed upon receipt by the CIC, and the resulting accumulated earnings of the CIC are invested on a pre-tax basis inside the CIC until distributed as a dividend.

In preparation for an IRS audit, a CIC should develop a definite, specific, and feasible plan for use of the accumulations.[138] This feasibility plan should be updated at the end of every business cycle.[139] However, a plan alone is not enough. A CIC must also take substantive steps towards carrying the plan out, such as making expenditures in furtherance of the plan.[140] Provided there is a good feasibility plan and the plan is being faithfully executed, the IRS will often give deference in assessing what constitutes reasonable business expenditures to the board of directors, absent clear evidence of unreasonableness and intent for prohibited purpose.[141]

Procedurally, the AET is applicable to CIC taxable income retained in excess of the reasonable business needs of the CIC. To help understand the reasonable needs of a CIC, it is useful to examine the way an insurance company actually

[135] John S. Ball & Beverly H. Furtick, *Defending the Accumulated Earnings Tax Case*, 72 Fla. Bar J. 28 (1998).
[136] *See* IRC §§ 531, 532.
[137] *See* John S. Ball & Beverly H. Furtick, *Defending the Accumulated Earnings Tax Case*, 72 Fla. Bar J. 28 (1998).
[138] Treas. Reg. § 1.537-1(b)(1); Treas. Reg. § 1.537-2(b).
[139] *See* John S. Ball & Beverly H. Furtick, *Defending the Accumulated Earnings Tax Case*, 72 Fla. Bar J. 28 (1998).
[140] Otto Candies, LLC v. U.S., 288 F. Supp. 2d 730, 767 (E.D. La. 2003).
[141] Breitfeller Sales, Inc. v. C.I.R., 28 T.C. 1164, 1168 (1957).

operates as a business. Some of the principal reasons for accumulating earnings in an insurance company include, (i) the payment of insurance claims, (ii) general operational business needs, (iii) expansion, (iv) shareholder redemptions, and (v) non-shareholder debt retirement. The next section of this article provides a detailed discussion of how an insurance company operates, and how these principal reasons for accumulating earnings fit into its operation.

A. Payment of Insurance Claims

An insurance company receives premiums, pays out administrative expenses and claims, and invests excess retained earnings reserves to pay for future claims.[142] Some amount of retained invested earnings for the payment of future contingent claims is viewed as a reasonable business need of a CIC.[143] The amount of retained earnings that a CIC may validly accumulate is determined by an actuarial calculation of the nature and amount of risk covered by the CIC.[144]

In addition, the actuarial calculation for reasonable needs to pay claims must take into account the likely investment return on existing CIC earnings accumulations. Local law requirements relating to the types of allowable insurance company investments will obviously influence the potential investment options of the CIC.[145] Insurance reserve investments may be limited according to investment type and restricted according to what percentage of company assets per investment may be made.[146] The idea is that the risk and maturity of investments should match the projected claims payment data, erring on the side of liquidity and conservation of principal.[147]

B. General Operational Business Needs

The reasonable business needs of a CIC include reasonable current needs and reasonably anticipated future needs.[148] Aside from the current needs to pay claims, the CIC has traditional business expenses required for the CIC to operate now and in the future. Some of these operational expenses may include amounts for employee salaries and benefits for the period, as well as amounts for overhead incurred for

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[142] Richard M. Columbik, *Captive Insurance Companies*, Inc.com, Aug. 13, 2008, *available at* http://www.inc.com/law-and-taxation/2008/08/captive_insurance_companies.html.
[143] Richard M. Columbik, *Captive Insurance Companies*, Inc.com, Aug. 13, 2008, *available at* http://www.inc.com/law-and-taxation/2008/08/captive_insurance_companies.html.
[144] Richard M. Columbik, *Captive Insurance Companies*, Inc.com, Aug. 13, 2008, *available at* http://www.inc.com/law-and-taxation/2008/08/captive_insurance_companies.html.
[145] Richard M. Columbik, *Captive Insurance Companies*, Inc.com, Aug. 13, 2008, *available at* http://www.inc.com/law-and-taxation/2008/08/captive_insurance_companies.html.
[146] Richard M. Columbik, *Captive Insurance Companies*, Inc.com, Aug. 13, 2008, *available at* http://www.inc.com/law-and-taxation/2008/08/captive_insurance_companies.html.
[147] *See* Richard M. Columbik, *Captive Insurance Companies*, Inc.com, Aug. 13, 2008, *available at* http://www.inc.com/law-and-taxation/2008/08/captive_insurance_companies.html.
[148] John S. Ball & Beverly H. Furtick, *Defending the Accumulated Earnings Tax Case*, 72 Fla. Bar J. 28 (1998).

the period in maintaining business facilities (such as a mortgage, utilities, property taxes, insurance, etc.). These needs are similar to the working capital needs of other non-insurance businesses.[149] Reasonable current business needs are not grounds for huge amounts of accumulated earnings unless the CIC has unusually high probable current personnel and/or overhead needs.

C. Expansion

Reasonably anticipated future business needs of a CIC may also include accumulations of earnings planned for expansion of facilities (provided not made for tax avoidance purposes)[150] and expansion of workforce.[151] Each of these topics is outlined below in more detail. Note that similar tax avoidance issues could be raised in any of these topics. However, this article will only apply a tax avoidance analysis to the facilities expansion portion to avoid repetition.

1. Facilities Expansion and Tax Avoidance

The Tax Court has held that "to the extent the surplus has been translated *into plant expansion*, increased receivables, enlarged inventories, *or other assets related to its business*, the court may accumulate surplus with impunity."[152] (Emphasis added). The theory behind this ruling is that the IRS should not be able to control board decisions through ex post facto assessments of tax. However, there exists some authority that the accumulated earnings of a CIC received in liquid form but thereafter converted into fixed assets, may be considered liquid investments of a CIC for purposes of assessing the AET.[153] The liquidity of assets is important for AET purposes because the AET taxes excessive such liquid assets.

The courts appear to apply these rules in conjunction with the determination of whether tax avoidance is a motive in the transaction.[154] This tax motivation determination is made on a case-by-case basis on the facts and circumstances of the case.[155] In deciding whether a tax avoidance motive is present, the court is likely to analyze whether the CIC facilities expansion was undertaken using a definite, specific, and feasible plan. Next, the court will likely review whether the CIC actually intended to use the accumulations to expand its facilities, in keeping with the plan. One way to establish this intention is to show that the CIC took substantial steps

[149] *See* John S. Ball & Beverly H. Furtick, *Defending the Accumulated Earnings Tax Case*, 72 Fla. Bar J. 28 (1998).
[150] *See* 26 C.F.R. §§ 1.533-1(a)(2)(ii); 1.537-2(c)(4); Bardahl Manufacturing Corp. v. C.I.R., TC Memo 1965-200.
[151] Treas. Reg. § 1.537-1(b)(1); Treas. Reg. § 1.537-2(b).
[152] Smoot Sand & Gravel Corp. v. C.I.R., 274 F.2d 495, 500 (4th Cir. 1960).
[153] *See* 26 C.F.R. §§ 1.533-1(a)(2)(ii); 1.537-2(c)(4); Bardahl Manufacturing Corp. v. C.I.R., TC Memo 1965-200.
[154] *See* Electric Regulator Corp. v. C.I.R., 336 F.2d 339, 346 (2nd Cir. 1964).
[155] *See* 26 C.F.R. §§ 1.533-1(a)(2)(ii); 1.537-2(c)(4); Bardahl Manufacturing Corp. v. C.I.R., TC Memo 1965-200.

towards carrying out the facilities expansion plan, such as architectural designs commissioned in furtherance of the plan.[156]

The courts may also review the size and cost of the planned CIC facilities expansion to determine if the accumulations are tax avoidance motivated. A CIC seeking to accumulate large amounts of earned underwriting fees may attempt to do so by planning the purchase of a large asset accumulation as a headquarters or other business facility. The CIC may seek to inflate the cost of the facility land by targeting prime real estate; building with expensive, high quality materials; and front-loading utility expenses (otherwise calculated in the current needs for future business cycles) by utilizing self-sustainable systems and designs. A court may apply existing legal authority to find that the planned conversion of liquid accumulated earnings to non-liquid fixed asset form is for tax avoidance purposes.[157] If the court so finds, it will treat the illiquid assets as liquid investment accumulations subject to AET to the extent that such holdings are unreasonable and clearly for tax avoidance purposes.[158] Thus, a CIC should be wary about accumulating earnings within headquarters that are so unreasonably lavish as to suggest a tax avoidance purpose.[159]

Lastly, there is a potential issue as to whether the phrase "related to the business" limits the freedom of a corporation to accumulate assets held in a facilities expansion (as well as increased receivables or enlarged inventory). For example, it is an open question whether the expansion of the headquarters of a CIC is considered a "plant expansion" or would it instead fall into the category of "other assets related to its business."[160] Regardless of this uncertainty, it appears likely that a CIC may accumulate significant earnings for these types of expansion to the extent the earnings are held as fixed assets (such as plants or other facilities) related to CIC business for no clear tax avoidance purpose.

2. Workforce Expansion

A CIC may generally accumulate earnings for the reasonable business need of expanding its workforce.[161] As an example, hiring of tax and insurance professional may be justified to continue compliance with the Treasury Regulations that require a CIC to be run like a normal insurance company. As CIC premiums and reserves expand, in order to maintain the tax benefits afforded a CIC under IRC § 831(b), it may be necessary for a CIC to employ accountant, auditors, actuaries, and other

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[156] *See* Otto Candies, LLC v. U.S., 288 F. Supp. 2d 730, 767 (E.D. La. 2003).
[157] *See* 26 C.F.R. §§ 1.533-1(a)(2)(ii); 1.537-2(c)(4); Bardahl Manufacturing Corp. v. C.I.R., TC Memo 1965-200.
[158] *See* 26 C.F.R. §§ 1.533-1(a)(2)(ii); 1.537-2(c)(4); Bardahl Manufacturing Corp. v. C.I.R., TC Memo 1965-200.
[159] *See* Briggs v. C.I.R., TC Memo 1956-86.*; See* 26 C.F.R. §§ 1.533-1(a)(2)(ii); 1.537-2(c)(4); *See* Bardahl Manufacturing Corp. v. C.I.R., TC Memo 1965-200.
[160] *See* Smoot Sand & Gravel Corp. v. C.I.R., 274 F.2d 495, 500 (4th Cir. 1960).
[161] Treas. Reg. § 1.537-1(b)(1); Treas. Reg. § 1.537-2(b).

professionals related to the tax and insurance industries.[162] Of course, any CIC that needs to substantially expand its tax and insurance professional workforce, would necessitate a significantly larger workforce in several other more productive areas.

D. Diversification by Stock and Asset Purchase

Accumulation of earnings for the future plan of purchasing stock or assets of another entity for diversification purposes may be deemed to be a reasonable business need.[163] A CIC may face problems where such a plan involves purchasing the stock of another entity to diversify its portfolio. For example, if the purchased position in the entity is a minority position, and the entity is unrelated to the parent company's original business activities, the minority stock position may be viewed as liquid for purposes of the AET.[164] Of course, this added liquidity would likely result in a higher tax being due should the added liquidity be treated as excess earnings accumulations.

A CIC may also have a difficult time further diversifying its interests by purchasing significant positions in third party entities and assets while maintaining the tax deductions granted under IRC § 831(b). As previously discussed, an IRC § 831(b) CIC that receives less than $1.2 million annually in insurance premiums is not taxed on the receipt of the insurance premiums.[165] Significantly diversifying its assets in this manner would likely force the CIC to receive premiums in excess of the $1.2 million level.

Of course, to avoid the $1.2 million limitation, a CIC could feasibly expand its operations into an industry that does not receive premiums subject to the IRC § 831(b) limitation. However, a CIC may be prohibited from diversifying outside of the insurance industry because IRC § 816 defines an insurance company as one engaged primarily in the business of insurance. If a CIC diversifies to the point of no longer being primarily in the business of insurance,[166] then the CIC would not be eligible for the tax deductions provided by IRC § 831(b). The disallowance of CIC deductions would effectively thwart the parent corporation's purpose in establishing the CIC.

Accumulations made for the purpose of diversification that thwart the intended purpose of the business are likely to be deemed an unreasonable business need. While courts will generally defer the decision of reasonableness to the board of directors, a stated plan that would thwart company objectives likely would be deemed facially unreasonable and evidence of a tax avoidance purpose.[167] Of

[162] *See* Jay Adkisson, *Running a Captive Correctly*, *available at* http://www.captiveinsurancecompanies.com/captive_insurance_taxation.htm.
[163] *See* Treas. Reg. § 1.537-2(b)(2); *See* Hughes, Inc. v. C.I.R., 90 T.C. 1, 13 (1988).
[164] *See* Cataphote Corp. of Mississippi v. U.S., 535 F.2d 1225, 1236-7 (C.O.F.C. 1976).
[165] *See* IRC § 831(b).
[166] IRC § 816.
[167] *See* Otto Candies, LLC v. U.S., 288 F. Supp. 2d 730, 769 (E.D. La. 2003).

course, the CIC would only be able to claim the accumulation is reasonable if it had a good faith intention of actually carrying out the plan.[168] Otherwise, the lack of intent to carry out a plan would render any accumulations made under the plan liquid investment funds subject to the AET.[169] As such, if the accumulation of certain assets for diversification compromises the IRC § 831(b) status, then it is likely to result in the application of the AET to those accumulations as well.

E. Redemption and Debt Repayment Planning

1. Shareholder Redemptions

The accumulated earnings of a CIC may be deemed reasonable to the extent accumulated under a plan to redeem CIC shares to ensure continuity and maintain control.[170] A plan for accumulation of earnings to redeem the shares of a CIC minority shareholder is likely a reasonable business need.[171] However, a plan to redeem the shares of the CIC majority shareholder (likely the parent company) is much less likely to be deemed a reasonable business need.[172] The key issue is whether the CIC is accumulating under a redemption plan merely for tax avoidance purposes - something sometimes found where the redeeming majority shareholder is a founder in a closely held corporation.[173]

2. Retiring Non-Shareholder Debt

CIC earnings may be deemed reasonably accumulated where the earnings are held under a sinking fund plan, for the purpose of retiring bona fide business indebtedness of a non-shareholder creditor.[174] Earnings accumulated to retire debt held by a CIC shareholder would be scrutinized much more closely.[175] Earnings accumulated to satisfy indebtedness likely to accrue within the current business cycle (as determined by actuarial tables) is assuredly reasonable.[176]

Furthermore, earnings accumulated to satisfy non-current indebtedness have been found reasonable to the extent that the indebtedness will likely accrue within three (3) years of the current business cycle.[177] These sinking fund allowances are likely to apply to bona fide indebtedness incurred by a CIC as claims liability. Therefore, a CIC may reasonably accumulate earnings to the extent that

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[168] *See* Otto Candies, LLC v. U.S., 288 F. Supp. 2d 730, 767 (E.D. La. 2003).
[169] *See* Otto Candies, LLC v. U.S., 288 F. Supp. 2d 730, 767 (E.D. La. 2003).
[170] *See* IRC § 537; John S. Ball & Beverly H. Furtick, *Defending the Accumulated Earnings Tax Case*, 72 Fla. Bar J. 28 (1998).
[171] *See* Otto Candies, LLC v. U.S., 288 F. Supp. 2d 730, 769 (E.D. La. 2003).
[172] E.M.I. Corp. v. C.I.R., T.C. Memo 1985-386.
[173] *See* Otto Candies, LLC v. U.S., 288 F. Supp. 2d 730, 769 (E.D. La. 2003); *See* John S. Ball & Beverly H. Furtick, *Defending the Accumulated Earnings Tax Case*, 72 Fla. Bar J. 28 (1998).
[174] Treas. Reg. § 1.537-2(b)(3).
[175] *See* Smoot Sand & Gravel Corp. v. C.I.R., 274 F.2d 495 (4th Cir. 1960).
[176] *See* Gazette Telegraph Co. v. C.I.R., 19 T.C. 692, 706-8 (1953).
[177] *See* Gazette Telegraph Co. v. C.I.R., 19 T.C. 692, 706-8 (1953).

such earnings offset probable claims liability (as determined according to actuarial tables) within the current business cycle and the succeeding three (3) business cycles.

V. CONCLUSION

There are many advantages to insuring through a subsidiary CIC, rather than through commercial or self-insurance. The use of a CIC arrangement allows the corporation to retain insurance underwriting and management fees that would otherwise be profit of an unrelated commercial insurer.[178] The use of an IRC § 831(b) CIC arrangement may also accelerate tax deductions in comparison to self-insuring,[179] since the parent corporation is given a current tax deduction for insurance premiums paid to the CIC up to $1.2 million annually.[180] An IRC § 831(b) CIC may exclude premiums paid from taxable income if the CIC receives less than $1.2 million in premiums annually.[181] A CIC may still be subject to taxation on investment income, although it can minimize or eliminate this tax liability by investing in tax-free investments - such as certain municipal bonds.[182] As a result of all of these tax benefits, the entire CIC arrangement could potentially produce no taxes due from the parent or the CIC until the accumulated earnings are distributed to the CIC shareholders.[183] Thus, the use of a CIC may offer a parent company significant tax advantages if the CIC is operated as would be a bona fide, unrelated company primarily in the business of for-profit insurance.[184]

That being said, a CIC may not defer taxation indefinitely. As a C corporation, the CIC would be subject to the AET.[185] The AET subjects any liquid earnings and profits accumulated in excess of reasonable business needs to a fifteen percent (15%) penalty tax.[186] A CIC may use legitimate tax planning to avoid the application of the AET, but must generally avoid objectively unreasonable accumulations.[187] There exist many reasonable needs for a CIC to maintain liquid reserves, but a CIC

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[178] Jay Adkisson, *Bad Financial Medicine for Year-End 2008: Physicians, Captive Insurance Companies and Cash-Value Life Insurance*, *available at* http://www.captiveinsurancecompanies.com/captive_insurance_life_insurance.htm.
[179] *See* IRC § 831(b); Jay Adkisson, *Bad Financial Medicine for Year-End 2008: Physicians, Captive Insurance Companies and Cash-Value Life Insurance*, *available at* http://www.captiveinsurancecompanies.com/captive_insurance_life_insurance.htm.
[180] I.R.C. § 162; Treas. Reg. 1.162-1(a); I.R.C. § 831(b); *See* Richard M. Columbik, *Captive Insurance Companies*, Inc.com, Aug. 13, 2008, *available at* http://www.inc.com/law-and-taxation/2008/08/captive_insurance_companies.html.
[181] I.R.C. § 831(b).
[182] *See* Richard M. Columbik, *Captive Insurance Companies*, Inc.com, Aug. 13, 2008, *available at* http://www.inc.com/law-and-taxation/2008/08/captive_insurance_companies.html.
[183] *See* I.R.C. § 1(h); *See* Richard M. Columbik, *Captive Insurance Companies*, Inc.com, Aug. 13, 2008, *available at* http://www.inc.com/law-and-taxation/2008/08/captive_insurance_companies.html.
[184] Litigation Guideline Memorandum TL-85, Jan. 24, 1990; Humana Inc. v. C.I.R. 881 F.2d 247, 257 (6th Cir. 1989).
[185] *See* IRC §§ 531, 532.
[186] *See* IRC §§ 535, 537.
[187] *See* C.I.R. v. First Sec. Bank of Utah, N.A., 405 U.S. 394, 398 (1972).

should be particularly wary of accumulating earnings through purchasing a minority stock interest in an unrelated entity that is in no way related to the insurance industry.[188] The most favorable manners in which to maintain accumulated earnings are plans for plant expansion, increased receivables, enlarged inventories, or other assets related to its business.[189] Accumulated earnings may be maintained in these areas with impunity, although there may exist a limitation that these accumulations be related to the CIC business.[190] The IRS and courts appear to give significant deference to board decisions in the areas of current business needs and future business needs related to the original business of the CIC, provided these decisions are not objectively unreasonable.[191]

Given the potential for zero taxation absent the application of the AET, a CIC may encounter heightened scrutiny from the IRS in the context of accumulated earnings. This is especially true given that a CIC is generally a closely held corporation of the parent corporation, which potentially gives the parent corporation significant control over the timing and amounts of CIC dividends.[192] Therefore, it is important that all currently operating CIC arrangements be aware of the risk that the IRS may decide to revive one of its dormant weapons against tax motivated transaction, by beginning consistent application of the AET to accumulated earnings inside of a captive insurance company.

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[188] *See* Cataphote Corp. of Mississippi v. U.S., 535 F.2d 1225, 1236-7 (C.O.F.C. 1976).
[189] Smoot Sand & Gravel Corp. v. C.I.R., 274 F.2d 495, 500 (4th Cir. 1960).
[190] *See* Smoot Sand & Gravel Corp. v. C.I.R., 274 F.2d 495, 500 (4th Cir. 1960).
[191] *See* John S. Ball & Beverly H. Furtick, *Defending the Accumulated Earnings Tax Case*, 72 Fla. Bar J. 28 (1998); Breitfeller Sales, Inc. v. C.I.R., 28 T.C. 1164, 1168 (1957).
[192] *See* John S. Ball & Beverly H. Furtick, *Defending the Accumulated Earnings Tax Case*, 72 Fla. Bar J. 28 (1998).