Summary: The Final Legislative Changes to IRC 831(b)

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The IRS began forensically auditing small captive insurance arrangements around 2009-2010 and started probing large captive insurance providers sometime around 2011-2012.[3] The investigations gained momentum over the last few years, culminating with the placing of "certain" captive insurance transactions on the IRS dirty dozen tax scams list[4] and several court cases. On a conference call on November 17, 2015, the ABA's Captive Insurance Committee detailed the most fully developed case outlining the various arguments used in the *Avrahami* case. As of this writing, none of these cases have reached a verdict. However, *Avrahami's* outcome appears to hinge on the viability of a specific insurance policy and the premiums charged for that policy.

The Service opened another line of attack in the spring when the Senate Finance Committee considered amendments to the Internal Revenue Code ("IRC") 831(b) statute that would have gutted the statute. The industry responded, effectively helping influence the eventual form of the changes. But at the end of that committee hearing, Senator Hatch asked the U.S. Treasury Department's ("Treasury") representative to write a report detailing the estate planning/captive insurance nexus. While the Treasury hasn't issued the report, it's safe to say the Service determined the practice is abusive, as the newly minted changes to IRC 831(b) are clearly targeted towards that practice.

It is remarkably easy to fit a captive into a broader wealth transfer plan. The basic methodology is simple: a parent forms a captive making the children shareholders. Every premium payment accomplishes two goals: payment for insurance coverage and intra-generational wealth transfer. The theory is that since the premium represents payment for services, there are no gift tax implications. If the children own the captive outright, the premium payment effectively transfers the money outside of the parent's gross estate.

This practice was not without its detractors. Prof. Beckett G. Cantley wrote in 2012 about the potential problems derived from the business purpose doctrine:

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[2] Reserved.

[3] These dates are based on the author's knowledge of IRS activities in the industry, but could be earlier.
[4] For more on this topic, see Beckett G. Cantley & F. Hale Stewart, Captive Guidance After the 'Dirty Dozen Listing, Tax Analysts, June 6, 2015

> While this transaction is likely technically compliance the Federal Estate and Gift Tax provisions of the I.R.C., it may run afoul of the judicial and codified doctrines. Specifically, it may be difficult to explain the business purpose for having a business owner's children be the beneficial owners of an insurance company that insures the business of the father-owner. A court may have a difficult time finding that a father would actually shift real risk to his children's trust, which may make the court determine that the likelihood of a good faith insurance claim being made seem remote. In addition, a court may also determine that the real purpose of the arrangement was primarily to transfer wealth in a tax efficient manner to the next generation, not the insurance of business risks. Thus, it seems relatively certain that the I.R.S. and DOJ may put the parties in interest in the difficult position of reconciling the seemingly contradictory goals of obtaining a real insurance policy for serious business risks, and the preservation of wealth for your children's beneficial interest.[5]

And several months ago, F. Hale Stewart and Beckett G. Cantley noted the following potential problems with the practice:

> This influx of non-insurance professionals [into the captive world] has potentially opened taxpayers up to allegations that they are not forming a captive with the commensurate subjective intent to form and run an insurance company. Consider the following common fact patterns when taxpayers are typically introduced to the idea of a captive.
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> …..
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> Now consider a client visiting an estate-planning lawyer for the first time. The attorney first asks the potential client about his family and then broadly discusses probate and non-probate transfers. He mentions trusts and discusses various charitable planning options. Then, the attorney asks, "have you ever heard of captive insurance company?" Like the CPA, the attorney doesn't intend to place the client in jeopardy. However, the Service could potentially argue that a captive formed on this fact pattern wasn't incorporated to underwrite risk, but instead to pass wealth to the owner's children.[6]

The Service clearly agrees with this perspective, because recently offered amendments are clearly designed to eliminate the captive insurance/estate planning nexus.

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[5] Beckett Cantley, Steering Into the Storm; Application of Captive Insurance Company Compliance Issue in the Offshore Crackdown, Houston Business Journal, 2012

[6] Beckett Cantley and Hale Stewart, Captive Insurance Companies and the Business Purpose Doctrine, Captive Visions Magazine, http://www.captiveglobal.com/files/documents/Bus-Purp_HaleS_BeckettC.pdf

The New Statute

An explanation of two new definitions is required before describing the key addition to IRC 831(b). First is the term 'specified assets' which means, with respect to any insurance company,

- the trades or businesses, rights, or assets
- with respect to which the net written premiums (or direct written premiums) of such insurance company
- are paid.

Next, is a "specified holder," who is "with respect to any insurance company,

- any individual
- who holds (directly or indirectly)
- an interest in such insurance company and
- who is a spouse or lineal descendant (including by adoption) of
- an individual who holds an interest (directly or indirectly) in the specified assets
- with respect to such insurance company.

The bullet points aren't part of the legislation; we're including them simply to make the statute easier to read.

In essence, "specified assets" are the source of premium payments. For example, if ACME Corp. forms a captive, ACME's assets would be the "specified assets." "Specified holder" is a spouse or lineal descendent of the person who owns the source of the premium payments (the captive's parent company).

Now let's turn to the key addition of IRC 831(b). Under the new statute, all captives making the IRC 831(b) election must comply with one of the following requirements:

> "(I) no more than 20 percent of the net written premiums (or, if greater, direct written premiums) of such company for the taxable year is attributable to any one policyholder, or
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> "(II) such insurance company does not meet the requirement of subclause (I) and no person who holds (directly or indirectly) an interest in such insurance company is a specified holder who holds (directly or indirectly) aggregate interests in such insurance company which constitute a percentage of the entire interests in such insurance company which is more than a de minimis percentage higher than the percentage of interests in the specified assets with respect to such insurance company held (directly or indirectly) by such specified holder.

This section is phrased as an "either/or" proposition; the captive must comply with either "A" or "B." Making it a bit more complicated is that "B" is a negative – the captive can't comply with section "B." However, remember that one of the goals of this new statute is to prevent practitioners

from using a captive as a wealth transfer tool. If you keep that in mind as you work your way through it, you'll quickly get a handle on the statute's terms and conditions.

Let's apply these new requirements to a standard IRC 831(b) captive that participates in a risk pool where it receives 50% of its premiums from a non-parent. Under those facts, the captive clearly fails to comply with the first new section. Therefore it must now comply with the second new section to make the IRC 831(b) election. Unfortunately, the second section's language is very obtuse. Let's apply the following word substitutions to make it more understandable:

1. Insurance company = captive
2. de minimis = 2%
3. specified assets = parent company
4. specified holder = wife or child/children

Using the above substitution scheme, we arrive at the following language:

> "(II) such **captive** does not meet the requirement of subclause (I) and no person who holds (directly or indirectly) an interest in such **captive** is a **wife or child** who holds (directly or indirectly) aggregate interests in such **captive** which constitute a percentage of the entire interests in such **captive** which is more than **2%** percentage higher than the percentage of interests in the **parent company** with respect to such **captive** held (directly or indirectly) by such **wife or child**

While the language is still confusing, we can distill the section's intent down to the following sentence: **If the lineal descendants' captive ownership is greater than 2% of their ownership of the parent company, then the captive can't make an IRC 831(b) election.**

Let's apply this to a few fact patterns.

1.) Father owns 100% of the parent company and captive. **The captive can make the 831(b) election because no lineal descendants own the captive.**
2.) Father owns' 100% of the parent company; child/children/wives directly own 100% of the captive. **The captive can't make the IRC 831(b) election; the lineal descendant's captive interest is greater than 2% of their interest in the parent company.**
3.) Father owns' 100% of the parent company; child/children/wives own 100% of the captive, but through a trust/family corporation. **The captive can't make an IRC 831(b) election; the statute applies to indirect and direct ownership.**
4.) Father owns 50% of parent company and the captive; child/children/wife directly or indirectly own 50% of the parent company and captive. **The captive can make the IRC 831(b) election; lineal descendants' own the same percentage of the captive that they do of the parent company.**

We can distill these examples down to a simple maxim: **when the children do not meaningfully own the parent company, they can't own the parent company's captive.**