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KPMG report: Tax Court holds microcaptive insurance company arrangement fails; accuracy-related penalties warranted

The U.S. Tax Court in a memorandum opinion found that a microcaptive insurance company arrangement failed to qualify as an insurance company for federal income tax purposes.

The Tax Court reviewed the microcaptive's risk distribution and operating structure, among other attributes, and determined that the company did not satisfy the risk distribution requirement. In addition, the court found that the company did not operate like an insurance company. The court agreed with an assessment of accuracy-related penalties for substantial understatement under section 6662(a).

The case is: *Caylor Land & Development, Inc. v. Commissioner,* T.C. Memo 2021-30 (March 10, 2021). Read the **memorandum opinion** [PDF 204 KB]

KPMG observation

The IRS has long viewed microcaptive insurance transactions as potentially abusive tax transactions. Microcaptives first appeared on the IRS "Dirty Dozen" list of tax schemes in 2014 and have been a priority enforcement issue for the IRS ever since. Captives that make an election under section 831(b) are taxed on their investment income and not on their underwriting income or losses. Although many related parties use section 831(b) captive insurance companies for non-tax risk-management purposes, the IRS has a longstanding concern regarding section 831(b) captives, and issued Notice 2016-66 identifying many section 831(b) captives as "transactions of interest."

Background

In *Caylor Land & Development, Inc. v. Commissioner*, the issue was whether a captive insurance company satisfied the requirements to be an insurance company for federal tax purposes.

The taxpayer had been in the construction business since 1958 and had grown from a sole proprietorship to a large multi-entity company with several subsidiaries and affiliates. The taxpayer in 2007 formed a captive insurance company (Consolidated, Inc.) under the laws in Anguilla. The company made a section 953(d) election and a section 831(b) election. These elections were intended to allow the company to be treated as a domestic insurance company for federal tax purposes and to be taxed only on its investment income as long as premiums did not exceed $1.2 million. In the same year, the taxpayer paid to Consolidated $1.2 million of premiums, and deducted these as an expense on its tax return.

Tax Court's opinion

To determine whether the insurance premium deduction was an ordinary and necessary business expense under section 162, the Tax Court evaluated whether Consolidated was an insurance company. Specifically, the Tax Court considered the four criteria of insurance as previously discussed in case law—risk shifting, risk distribution, insurance in the commonly accepted sense, and insurable risk—to determine whether the transactions at issue constituted insurance for federal tax purposes. All four criteria had to be met for a company to be considered an insurance company.

The Tax Court focused on two criteria—risk distribution and insurance in the commonly accepted sense (discussed in more detail below)—to concluded that the taxpayer had failed to meet either requirement.

- **Risk distribution**

The Tax Court found that Consolidated did not have adequate risk distribution. The taxpayer argued that there were three ways to establish risk distribution, but the court found that Consolidated failed all three tests. One test—that 30% of the insured risks are from unrelated third parties—was not applicable. The taxpayer argued that it met the safe harbor as put forth in Rev. Rul. 2002-90 by having risks from at least 12 affiliated companies, none of which had liability coverage of less than 5% nor more than 15% of the total risk insured. The court found that Consolidated did not satisfy this test. Two of the companies each had more than 30% of the risk exposure, and seven of the companies had less than 5%.

Finally, the taxpayer argued that it had sufficient independent risk exposures to satisfy risk distribution. The Tax Court, however, found that Consolidated did not satisfy risk distribution by insuring a number of unrelated risk sufficient to allow the law of large numbers to predict expected losses. The court, on reviewing the case law in this area, noted that prior cases found distribution when the number of insureds was in the thousands. Although the court recognized that there was no precise count of the number of independent risks necessary for risk distribution, the court found that Consolidated's independent risks were 12 or fewer (depending on the policy), and that such numbers were not sufficient for risk distribution. In addition, the court noted that Consolidated's risks were not independent—that is, the risks of several entities were dependent on the main operating company. As such, the Tax Court determined that Consolidated was not providing insurance.

- **Insurance in the commonly accepted sense**

Although the Tax Court relied on the lack of risk distribution for its holding, the court provided an alternative ground for its conclusion—finding that the microcaptive did not offer insurance in the commonly accepted sense.

The taxpayer argued that Consolidated was regulated, adequately capitalized, paid claims, and had actuarially determined premiums. The Tax Court, however, determined that Consolidated handled claims differently from how typical insurance companies respond to their policy holders. For instance, Consolidated did not require documentation to be provided in order to pay out claims. The Tax Court found premiums were not calculated consistently with industry practices nor were they substantially actuarially determined. As a result, the Tax Court determined the microcaptive did not actually provide insurance because it failed to distribute risk and did not act as an insurer commonly would. As such, the microcaptive did not qualify for tax treatment under section 831(b).

- **Penalty**

Lastly, the Tax Court agreed with the imposition of a section 6662(a) penalty against the taxpayer—that is, the 20% underpayment penalty on the amount of understatement of tax if the taxpayer is found to have substantially understated its income tax or if the taxpayer is found to be negligent. The court determined that the taxpayer both understated income tax and was negligent.

The Tax Court determined that the taxpayer did not make a reasonable attempt to determine that the captive insurance arrangement and its related deductions were legitimate and operated correctly. Further, the court observed the original tax advice received by the taxpayer seemed "too good to be true," and the court determined that the taxpayer did not receive any advice beyond that from the insurance-management company about the insurance arrangement.

KPMG observation

This case represents the fourth time that the Tax Court has agreed with the IRS in disallowing section 831(b) insurance company status for such microcaptive arrangements. However, this case differs from prior cases in several important aspects. First, the taxpayer did not rely on a pooling arrangement to satisfy risk distribution. Second, the court's application of the risk distribution requirement added nuances to the prior guidance. The Tax Court emphasized both factors of the absolute number of risks and whether the risks were independent. Finally, this was the first case to apply penalties to a section 831(b) microcaptive arrangement.

Tax professionals believe that the IRS is likely to use the *Caylor* decision to bolster its settlement and litigation positions. In the past, the IRS has taken the position that taxpayers have been over-optimistic in their evaluation of the IRS's hazards of litigation. The *Caylor* case is unlikely to change the IRS's assessment of these litigation hazards.

Captive insurance structures have historically been challenged by the IRS. To the extent taxpayers are involved with any microcaptive transaction, they need to consider consulting with an advisor to determine whether the insurance company materially meets the four common notions of insurance.

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