Setting the truth free

Phillip England of Anderson Kill and Randall Beckie of Frontrunner Captive Management examine current tax advice about captives and explain how to extract only the most accurate information

Much captive insurance tax interpretation is delivered in a casual way, which prompts the question of how to evaluate it as knowledge. Lack of expertise, ulterior motives, and plain old sloppiness are all too common in the field. Below, we highlight some commonly bruited pieces of misinformation regarding captives. We then consider how an executive seeking advice regarding captives may sharpen his 'bosh detector' and ensure that he is getting accurate information.

As tax interpretations go, captive insurance interpretations are peculiar in that (1) formation of pure captives (as distinguished from group captives) is significantly tax-inspired; and (2) advocates of captives (including for the tax advantages thereof) often lack training in taxation. By comparison, in the field of partnership taxation or corporate mergers & acquisitions, one does not hear, "My broker said our company could avoid tax recognition upon a reverse triangular D reorganisation", yet among captives it is routine for non-tax professionals to volunteer interpretation about esoteric aspects of insurance taxation.

It has become fashionable to assert that a captive should not be formed from a tax motivation; rather, one should first decide to form a captive for non-tax reasons, and only thereafter should one optimise the captive's tax efficiency. This is prudent practical advice, but it is not exactly true. Nowhere does tax law say that a captive must evidence a preponderance of non-tax motives or non-tax benefits. Instead, applicable tax arguably law suggests a captive's non-tax benefits must be substantial (precedent tells how to measure 'substantial'). Although there are indeed rules in the consolidated tax return regulations that impose a predominant non-tax purpose requirement for certain types of planning transactions, the predominant non-tax purpose test historically has not been applied to captives (and rightly so).

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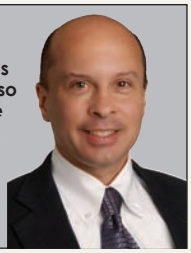

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Another trendy assertion is to say planning based on tax code §831(b) will cause legislative repeal if planners continue recommending §831(b). However, no such legislation has been introduced; instead, legislation has been introduced (but not passed) that would enlarge the tax benefit of §831(b) by increasing the amount of premiums that an insurance company could write while qualifying to exclude its underwriting income from tax recognition. Foretellers of doom for §831(b) may be recollecting 2004 amendments to tax code §501(c)(15), which (before 2004) made an insurance company tax exempt on all its income – including unlimited

investment income – if the company's annual premiums did not exceed $350,000. To prevent using small insurance companies to shield large amounts of investment income, Congress imposed a $600,000 gross receipts limitation on an insurance company's §501(c)(15) eligibility for tax exemption – thereby sometimes increasing the attractiveness of §501(c)(15).

> "Toward our purpose of outlining a theory of knowledge for evaluating tax interpretation, we must also consider the primary tools of the trade"

Both of the foregoing statements about captive tax interpretation have been stated by laymen and tax professionals alike.

'Bosh' and captives

Why do arguably inaccurate assertions about captive insurance taxation proliferate? For insight, let's turn to an essay by Princeton University professor Henry Frankfurt, who explores the essence of an all-too-common mode of discourse that he bluntly, if indelicately, dubs 'BS' – which, let us say, stands for 'bosh'. Per Frankfurt's analysis, bosh is unavoidable whenever circumstances require someone to talk without knowing what he is talking about. When an honest man speaks, he says only what he believes to be true; for the liar, it is correspondingly indispensable that he considers his statements to be false. The bosh-master, however, is on the side neither of the true nor of the false. His eye is not on the facts at all, except insofar as they may be pertinent to his interest in getting away with what he says. He does not care whether the things he says describe reality correctly. He just picks them out or makes them up to suit his purpose.

Thus, a commentator's purpose tells whether an assertion about captive insurance taxation is bosh. We cannot know everyone's purpose, but we may speculate that for some, their purpose is making you think they have something to contribute to the topic. This is an inevitable consequence of the value-added aspect of captive insurance tax planning, which naturally motivates people to associate themselves with value. Bosh about captives is widespread, which lets commentators expect to get away without research to support what they say. Furthermore, bosh about captive insurance taxation is often cloaked by its truthfulness. Frankfurt explains: "(…) the essence of BS is not that it is false but that it is phony. In order to appreciate this distinction, one must recognise that a fake or a phony need not be in any respect inferior to the real thing. It may be, after all, an exact copy. What is wrong with a counterfeit is not what it is like, but how it was made. This points to a similar and fundamental aspect of the essential nature of BS: although it is produced without concern with the truth, it need not be false. The BSer is faking things. But this does not mean that he necessarily gets them wrong."

Lack of research accounts for the phoniness of some captive insurance tax comments, mostly from non-tax professionals. While tax professionals are also capable of bosh, inaccuracy or incompleteness of advice on their part will more likely result from professional bias. Where a tax adviser is also the taxpayer's auditor, the incentive is to err on the side of caution. Where an adviser is known for a particular interpretation, his reputation may constrain new thinking that would depart from that interpretation. Also, an adviser might exaggerate the ambiguity of issues as a way of generating engagement opportunity or to cultivate a cautious image. Such biases are distinguishable from bosh; they may harbor an intention to keep you away from a truth that the adviser has in mind. A bias may be well-intentioned, even in the client's best interests, but how would a client discover being under-informed for his own good? Tax interpretation rife with subtleties may require two advisers: one to explain it, another to challenge the explanation. The outcome of bias and bosh may appear identical (accurate or inaccurate). To uncover bosh, ask to see the research; to uncover bias, ask for a competing point of view.

Claiming to be completely unbiased is probably lying, for where one stands generally depends on where one sits. In our tax consulting practice, we find taxpayers are usually well-served by revisiting their presumptions and prior advice about how a captive insurance arrangement may be advantageous. If a client asks about the tax defensibility of a captive arrangement that saves $100 of tax at an opportunity cost of $110, we would be pleased to describe the defensibility, but we would have to wonder whether this is the appropriate question.

Frankfurt's distinction between BS and lies leaves much more to be said. Incomplete or skewed tax advice is rarely 'lies'; 'bias' may better explain the usual cause. Also, incomplete tax advice often results because in captive insurance taxation truth may be relative; also potentially somewhat negotiable.

Finding an answer

Toward our purpose of outlining a theory of knowledge for evaluating tax interpretation, we must also consider the primary tools of the trade, namely tax opinion analysis and counter-argument.

Opinion and counter-argument should be two sides of the same coin. A judge decides a tax case by trying to fit a proposed interpretation against existing precedent, statutory construction, legislative intent, and the facts. If some aspect of interpretation does not fit, the interpretation is rejected and a new one is tried. Arrival at an opinion follows from the search for a flaw in the tax interpretation. This is why it is vital to build tax advice from articulating (and rejecting) counter-arguments. An appropriate theory of knowledge could be borrowed from the philosophy of Karl Popper (see, for example, *Science as Falsification*, suggesting that knowledge advances via the effort of disproof).

In the tax analysis business, FIN 48 has led some to emulate science in the way tax interpretations are evaluated, as we observe from the tendency to assign probabilities of correctness to tax interpretations. Unfortunately, there is only false science to be found. Although a 'should' opinion is understood to mean '70% likelihood of prevailing in court,' hardly ever does the opinion-giver explain why two of three circuit court judges would concur while the third dissents. More meaningfully, what one can really know (and decide) about a tax interpretation is whether it is supported by the better argument.