When the tail wags the dog

Tax planning should be a mainstay of captive management, not a dirty secret. By Phillip England and Randall Beckie

ON THE seminar circuit, captive insurance experts are usually quick to emphasise the non-tax reasons for forming a captive and downplay the tax reasons, as if taxation was merely a tangential complication of operating a captive. Meanwhile, in the boardrooms of captive owners, the tax aspects of having a captive are quite often one of the central points of analysis about whether to form a captive and how to evaluate a captive's results of operations.

Why do the experts apparently strain to put distance between the topics of captive management and tax management? There are reasons for this; however, there may be sound reasons for expecting captive management and tax management to be two sides of the same coin. The following observations are offered to frame new questions to address at captive seminars and to stimulate discussion between the Internal Revenue Service (IRS) and captive advisers.

Objective standards

In the US at least, there is a widely held perception that acknowledging the tax motives of a captive would weaken the defensibility of the tax benefits. This perception may be an overreaction.

Tax litigation has taught that a captive, in order to justify its tax benefits, must demonstrate economic substance and business purpose independent of such tax benefits. This does not mean that a captive cannot openly pursue the tax advantages that ensue from qualifying as an insurance company. Instead it means that the simple pursuit of federal tax advantages is not enough to sustain the decision to create a captive.

Ironically, it often falls on a tax adviser to help articulate the non-tax purposes of a captive, for the tax adviser ought to be acutely aware of how to discern a reasonable balance of objectives. Conversely, it is typically a captive intermediary (such as a broker, captive manager or consulting actuary, for example) who imparts Captive Tax Education 101 to a prospective captive owner.

Talking about tax advantages adds value to the captive intermediary's role, whereas for the tax adviser, talking about captive tax law and accounting rules requires close adherence to published guidance (notable cases) in order to meet professional standards relating to giving advice to clients. Furthermore, tax departments of law firms and CPA firms operate under restrictions about marketing tax planning ideas, whereas captive intermediaries may have a freer and more generalised mission.

Citing applicable jurisprudence, the IRS has noted that determining economic substance is arguably a factual inquiry, the parameters of which can be summarised as follows:

- The determination of economic substance turns on whether the transaction is rationally related to a useful non-tax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions;

- A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the non-tax benefits would be at least commensurate with the transaction costs;

- The utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry;

- A reasonable prospect or possibility for pre-tax profit is required; nominal or *de minimis* profit potential does not imbue a transaction with economic substance.

From a careful reading of available guidance, it is amply clear what is defensible versus overly aggressive in captive tax planning. There are wide (and quite often clear) gaps between the views of the IRS and the courts. This is not to suggest that tax interpretation is a casual endeavour nor that tax advisers are all agreed. Rather, captive insurance tax interpretation builds on a sufficiently well-developed body of tax law to enable one to analyse the issues without shrouding them in mystery or resorting to mere subjective assessment.

Examples of gaps between IRS views and courts' views include the following points of potential future controversy:

- Risk distribution in the multiple policyholder sense: Rev. Rules. 2002-90 and -91 suggest that no insured may account for more than 15% of the captive's exposure to loss, whereas Harper Group suggests that no insured may account for more than 71% of the captive's exposure to loss.

- Homogeneous risk: The IRS position seems to be that risks can be "distributed" or pooled only insofar as the risks fall within the same line of business category as such categories are defined in Schedule P of a commercial insurer's statutory annual statement. Commercial insurance companies and actuaries (whose expertise the courts might heed) generally believe risk distribution is a function of the volume and independence of potential loss events, not necessarily the similitude of causes of loss.

- Loanbacks: One IRS official has long asserted that a 20% to 30% loanback of a captive's assets to a related party may be allowable. Jurisprudence would suggest that the problem (if there is one) would be that a loanback may undermine the economic substance of the insured's payment of the insurance premium to the captive. If an economically substantive quantum is generally 20% to 30% of premium, it is arguable that that may be the amount a captive should not loan back, not the amount that it can.

Thanks to recent captive insurance guidance, the limits of opportunity for many taxpayers with captives follow from the calculus of whether it is worth the trouble to litigate, not uncertainty about what the tax principles are.

Understandably, most shy away from facing the IRS in court. But there is a point at which it may not be in a taxpayer's best interest to allow its captive to completely and absolutely adhere to the sometimes untenably narrow positions that the IRS advances. The difference between 'right' and 'wrong' in captive insurance tax interpretation may be, in some situations, largely a matter of what lengths one is willing to travel to debate it.

Captive management

A convenient justification of a captive manager's role involves serving as the keeper of books and records in the captive's domicile. Not every domicile requires the captive manager to maintain an office in the domicile, but most do. There are instances in which resident captive managers outsource bookkeeping, financial statement compilation and other functions to the parent's risk manager who may be based elsewhere than the captive's domicile, but this seems to be the exception rather than the norm. The norm is that captive management consists largely of insurance company accounting. Fortunately there are plenty of service providers who offer to do that.

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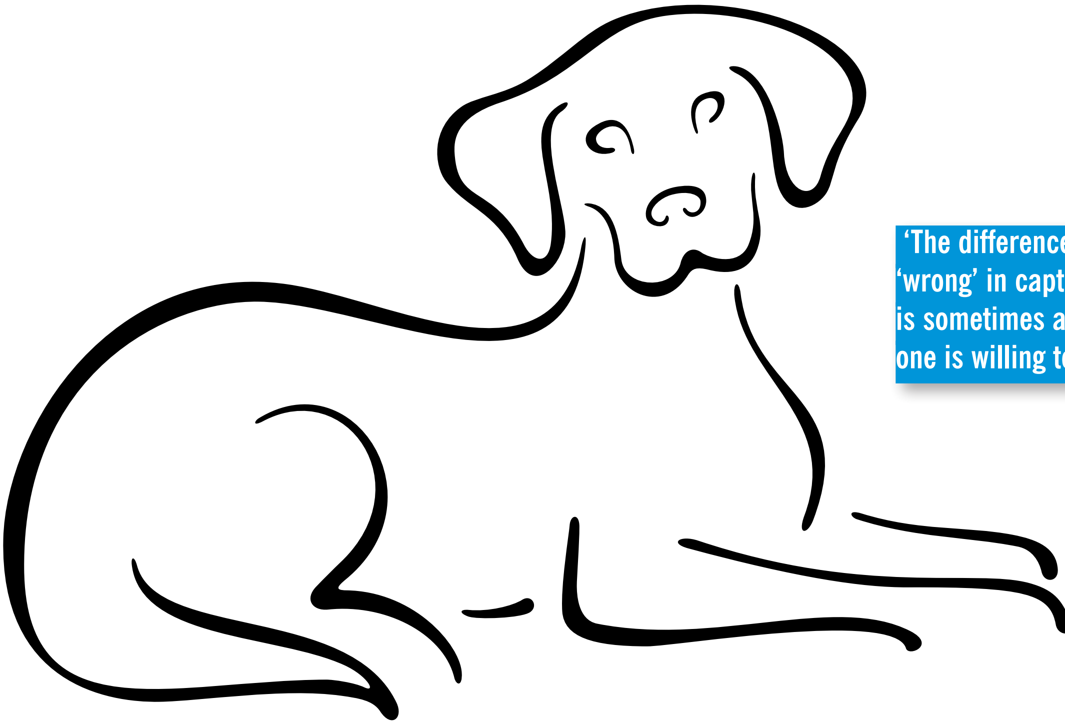
The question becomes: To what end does the captive manager maintain an accounting? There are captive regulatory reporting requirements, of course, but this should not be an end unto itself. Where a captive is in a group of companies that file a consolidated financial statement, generally the captive's separate financial statements serve a regulatory purpose only.

Nevertheless, because the captive has a separate financial statement, there is a tendency among the captive's constituents to try to read something into it. The danger is that financial statement ratios, although easy to see, are not necessarily insightful. Analysing a captive's performance in terms of its income can be self-congratulatory where the captive's owner exercises discretion over the premium pricing.

A recent captive industry survey raises the question of whether 'return on capital employed' is an effective measure of valuing a captive. The question is a good one because in many situations the tax deferral benefits of captive insurance company accounting do not outweigh the cost of capital for the captive unless half or more of the captive's assets are invested in related-party investments (for example loaned back).

If the cost of capital for the captive's owner is 10%, deploying capital in a captive's bank account at a 2% interest yield is a losing proposition; it takes a lot of tax benefits to overcome the capital opportunity cost. Which raises the issue: How much of its assets can a captive loan back (or otherwise invest in related party investments) without jeopardising its tax status as an insurance company?

Without a suitable tax strategy in defence of a loanback arrangement (or something similar), chances are that the captive would not be up and running in the first place.



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As that survey also notes, "in some countries a focus exists on generating a tax value". The US is one such country. With their tax hats on, US captive owners should analyse whether the incremental annual value of savings – tax savings on one hand, non-tax savings on the other hand – exceeds the transaction costs of operating the captive. Indeed the business purpose test for US tax purposes imposes such performance metrics.

Considering that captive management is in essence an accounting, owners of captives would do well to keep in mind that the kind of accounting they should focus on is an accounting for the tax consequences. Viewed through a tax lens, captive management would address topics such as:

- Paper trail rigour: Do the captive's files evidence a standard of conduct that achieves the formality that the IRS has focused on in technical advice memoranda and private letter rulings during the past ten years?

- Premium pricing: Does arm's length pricing support stand up to Internal Revenue Code sections 482 and 845? Within those guidelines, is the pricing appropriately advantageous to the captive's financial goals?

- Self-procurement tax strategy: In a state where self-procurement tax may apply, do the captive's operations make it clear whether the captive is conducting business in that state, according to standards adopted by Todd Shipyards and progeny?

- Underwriting programme selection: Where the captive is underwriting risks in which the owner's insurance broker has a hand, are the tax and non-tax benefits of underwriting those risks greater than the benefits of writing other types of insurable risk? For many employers, employee benefits risk is a large, captive-insurable cost centre that may confer significant tax and non-tax advantages if implemented in certain ways, yet few captives insure it. Why not?
  - Incomplete understanding of the tax aspects;
  - Misconception that a captive would need permission from the Department of Labor;
  - Employee benefits risk may be alien to the property/casualty insurance advisers.

- Mix of activity: More than half of the captive's activity must involve issuing insurance or reinsurance contracts (and functions incident thereto). What can the other half consist of, and how is activity quantified?

- Commercial insurance buying: Generally if a captive pays a state premium tax (even at a low rate), the commercial insurer is relieved from paying commercial state premium tax (at a higher rate) on reinsurance coverage provided to the captive. Letting a captive buy commercial insurance coverage can reduce the overall state premium tax burden on commercial insurance coverage.

- Tax sharing: The manner and timing of a captive's reimbursement to its parent for current tax expense attributable to the captive may be an area of tax pitfalls and also planning opportunities. Where a captive operates with funds withheld by a commercial insurer, does the reinsurance contract provide for distributions to the captive so that the captive can pay the income tax on the income that the commercial insurer is holding?

- Risk transfer analysis: The standards of sufficient risk transfer are arguably different for book versus tax purposes. But unless and until applicable accounting standards bifurcate insurance contracts into separate components of risk transfer and investment, apparently there remains some opportunity for a captive to enter into hybrid contracts.

Taxation does not merely permeate captive management; taxation is in many respects a major objective of captive management. Wisely, one should not let the tail wag the dog. When this metaphor comes up, it is presumed that risk management is the head and tax management is the tail. But what if that presumption is backwards – what if we perceived that were it not for the tax advantages, there would be far fewer captives and many more self-insurance arrangements?

A year ago, proposed captive insurance tax regulations that the IRS issued (before withdrawing them in February 2008) virtually halted new captive formations among US consolidated groups. Tax planning mattered that much. The good news is that, with care, it is fair play to acknowledge the importance of tax planning in context of captive management.

Randy Beckie is the managing director of Anderson Kill Insurance Services.

Phil England is a partner and the head of the captive and tax practice at Anderson Kill & Olick.