taxnotes federal

Volume 171, Number 4 ■ April 26, 2021

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Reprinted from *Tax Notes Federal*, April 26, 2021, p. 549

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In this article, Brewer and Liguori consider the possibility for the insured to use its own captive insurance company, or a shared captive, for select tax risks.

Tax risk insurance has been around for several decades. Captive insurance has been around even longer.[1] But for all but a few early adopters,[2] the twain have yet to meet. The purpose of this article is to explore the U.S. tax implications of that meeting. Behold: captive tax risk insurance![3]

In our experiences, the use of tax risk insurance has been most prevalent in the mergers and acquisitions context. But as we mentioned in our last article, we have seen it becoming more common in the context of large corporate groups seeking to manage their global tax risks, regardless of whether they are related to M&A.[4] In either context, the use of tax risk insurance lends itself to captive arrangements, for the same reasons that have caused captive arrangements to be desirable for other types of insurance risks.

Captive Insurance and the U.S. Tax Implications Thereof

As an alternative to traditional insurance protection, which is obtained from one or more of the many underwriters offering that coverage to the public, captive insurance is obtained from a company that is owned by, or otherwise closely related to, the insured. This company provides coverage to only a relatively small group of participating (often closely related) insureds.

In many cases, captive insurance is combined with traditional third-party insurance, with some layers of risk insured by outside underwriters and other layers insured by the captive. And regardless of whether outside underwriters are involved, outside insurance brokers are almost always involved because of their specialized knowledge.

Presumably there are good and substantial business reasons for using captive insurance, as opposed to simply self-insuring — that is, not

[1] According to the website of AlliantNational, a firm that is expert in this area, "Businesses have been creating captive insurance companies (CICs) for more than 100 years."

[2] A few large private equity firms are reportedly using captive insurance for M&A risks, including some M&A tax risks.

[3] Caveat: We are expert in neither of the twain. But since no one else seems to be talking about it yet (at least not publicly), an article seemed like a reasonable way to start a discussion.

[4] Ken Brewer, "Tax Risk Insurance: Another View on the Proper Tax Treatment," *Tax Notes Federal*, Feb. 15, 2021, p. 1087.

obtaining insurance coverage at all. Perhaps the most important of which is the ability to gain access to wholesale reinsurance markets. But there are several others — the discussion of which is beyond the scope of this article.[5] But since one of the many benefits of using captive insurance is tax savings (for example, deducting estimated future losses and shifting income to a low-tax jurisdiction), it is no wonder that captive insurance has long been a subject of controversy between taxpayers and the IRS.

From a federal tax perspective, the primary differences between self-insurance and captive insurance have to do with timing and location. Regarding timing, with self-insurance, the insured is not allowed a deduction for estimated losses. Losses are not deductible by the self-insured until the all-events test is satisfied (that is, not until the losses arise). With captive insurance, if properly structured, the insured is allowed a current deduction for insurance premiums paid to the related captive insurance company, while the captive insurance company may offset its premium income by a deduction for a reserve for estimated losses.

In contrast, for state tax purposes captives can provide permanent tax savings. This is because, as it is for federal purposes, the insured receives a deduction for premiums paid, but the captive insurance company is typically located in a favorable state or foreign jurisdiction where the premium income is not subject to state tax.

Regarding location, because captive insurance arrangements involve two separate (albeit related) operating locations, they provide an opportunity to shift income from an insured entity that may be subject to a relatively high effective tax rate to the related insurance company whose income may be subject to a lower effective tax rate.

The case law on captive insurance has evolved over the years. Before 1985, the IRS had consistently prevailed in court in its attempts to disallow deductions for premiums paid to related captive insurance companies. The tide began to turn in *Crawford Fitting Co.*[6] Through numerous subsequent cases and rulings, the law has evolved since then, so today there is little question that a properly structured captive insurance arrangement can produce the timing and location benefits described above.

To be properly structured, the case law suggests that a captive insurance arrangement must:

- involve insurable risks;
- involve a shifting of the risk of loss from the insured to the insurer;
- involve a sufficient distribution of risk; and
- be insurance in the commonly accepted sense.[7]

Regarding risk shifting, there is considerable case law support for the IRS's position that insurance premiums paid to a captive insurance company by a direct or indirect shareholder of the captive do not shift risk because any loss suffered by the captive has a corresponding negative impact on the balance sheet of the shareholder. To avoid this issue, the prudent course of action may be to not have any of the insured group companies own (directly or indirectly) shares in the captive insurance company.[8]

As for risk distribution, this excerpt from Rev. Rul. 2002-91, 2002-2 C.B. 991, provides a reasonably concise explanation of the requirement:

> Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. By assuming

[5] According to Vermont's state website, the reasons to use captive insurance include coverage tailored to meet your needs, greater control over claims, reduced operating costs, control of cash flow, funding and underwriting flexibility, access to the reinsurance market, incentive for loss control, capture underwriting profit, pricing stability, potential tax benefits, investment income, potential additional profit center, and flexibility in managing risk. Given the length of this list and that Vermont puts potential tax benefits near the bottom, it would appear safe to assume that the principal purpose for the use of captive insurance is not to obtain tax benefits.

[6] *Crawford Fitting Co. v. United States*, 606 F. Supp. 136 (N.D. Ohio 1985).

[7] *Harper Group v. Commissioner*, 96 T.C. 45, 58 (1991), *aff'd*, 979 F.2d 1341 (9th Cir. 1992); and *AMERCO v. Commissioner*, 96 T.C. 18, 38 (1991), *aff'd*, 979 F.2d 162 (9th Cir. 1992).

[8] *See, e.g.*, *Securitas Holdings Inc. v. Commissioner*, T.C. Memo. 2014-225.

numerous relatively small, independent risks that occur randomly over time, the insurer smooths out losses to match more closely its receipt of premiums. *Clougherty Packing Co. v. Commissioner*, 811 F.2d 1297, 1300 (9th Cir. 1987). Risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. *See Humana Inc. v. Commissioner*, 881 F.2d 247, 257 (6th Cir. 1989).

The other two requirements (insurable risk and insurance in the commonly accepted sense) seem to get glossed over a bit in many of the authorities. The requirement for insurable risk seems to go to the nature of the risk: It must involve some element of chance, and it must be the type of risk that bona fide insurance companies would insure. The requirement for insurance in the commonly accepted sense appears to go more to the arrangements between the insured and the insurer and whether the insurer is organized and operated as an insurance company.

The Use of Group, or Shared, Captives

An arrangement that has long been around in the context of captive insurance is that of the group, or shared, captive. In some cases, they have been formed along industry lines to manage industry-specific risks. But in many other cases, they are used by participants from multiple industries. In any case, group captives can be desirable for situations in which traditional insurance coverage may be too expensive or unavailable and in which a wholly owned captive may not be worth the cost of setup and maintenance or may not provide the necessary level of risk distribution.

The Captivity (or Not) of Tax Risk Insurance

Introduction

To obtain the federal timing and/or state permanent benefits of captive insurance, tax risk insurance must qualify as insurance for U.S. tax purposes. Given the present state of the law on captive insurance, the only thing that might prevent the use of a captive insurance arrangement for tax risk insurance is it might not satisfy one or more of the four requirements for captive insurance in general or some other requirement that the IRS might conjure up specially for tax risk insurance.

Insurable Risk

Perhaps the IRS will take the position that tax risk is not an insurable risk. That would seem to fly in the face of marketplace reality, given the number of major insurance companies that we have worked with that are issuing tax risk insurance policies and the number of major insurance brokers involved in placing that coverage. So, unless the IRS can come up with some novel argument to distinguish tax risk from the universe of other risks that have been deemed insurable, this requirement would appear to be achievable.

Risk Shifting

Nothing about tax risk appears to prevent it from being shifted in the same manner as other types of insurable risks. The fact that the insured remains primarily liable to the IRS in the event of an underpayment should not be problematic. In any type of liability insurance coverage, the insurance policy does not relieve the insured of primary liability. It just offsets that liability with a claim for indemnity from the insurance underwriter.

Risk Distribution

This requirement tends to be more difficult to satisfy than risk shifting. As explained in Rev. Rul. 2002-91, it requires a fairly large number of independent risks. But, as a theoretical matter, this requirement is one that tax risk insurance should be able to satisfy given appropriate facts and circumstances (for example, depending on the number of group companies involved and the number and magnitude of risks involved).

For groups that already have captive insurance companies for other risks, the requirement for risk distribution may already be satisfied if probability and severity of the tax risks added to the portfolio of the existing captive insurance company do not substantially outweigh the probability and severity of the other covered risks. For companies that do not already have

captive insurance for other risks, the requirement for risk distribution may be more difficult to satisfy for small and midsize groups. In that case, risk distribution might be achieved either by including other types of more traditional risks in the pool or by using a group or shared captive.

Insurance in the Commonly Accepted Sense

Just as with the requirement for an insurable risk, it would seem difficult for the IRS to prevail with the argument that tax risk insurance is not "insurance in the commonly accepted sense," provided that the arrangements are addressed with the same level of discipline required for other types of coverage to satisfy this requirement.

Potential Arbitrage

If the premiums are deemed to be tax deductible,[9] tax risk insurance would involve a type of arbitrage not afforded by many (if any) other types of insurance: a deduction for the cost of avoiding another cost that would not be deductible (in the case of federal taxes). Considering that, the IRS might argue that a principle of symmetry should apply to prevent premiums for the insurance of federal tax risks from being tax deductible. But the notion that such a principle of symmetry should apply to the cost of tax risk insurance would seem to be refuted by the fact that this principle has never precluded the deductibility of other costs of tax planning or management, such as the cost of tax advice, tax opinion letters, or expert tax return preparation services.

While the deductibility of premiums would provide a desirable arbitrage, nondeductibility would not necessarily make captive tax risk insurance undesirable. Today's marketplace demonstrates that taxpayers believe that tax risk insurance is a worthwhile investment, in appropriate circumstances, even though the deductibility of premiums may not be certain.

A Potential Red Flag?

In considering the prospect of captive tax risk insurance — just as with third-party tax risk insurance — the taxpayer may want to consider whether it would attract more attention to a tax risk by deducting a premium payment relating to a thorny tax risk that's paid to a related captive. With historical negative IRS attention to captives in general, there may be a legitimate concern that tax risk insurance, especially if captive, might be akin to shining a light on something that the company would rather keep to itself.

On the other hand, several issues are bound to come up on audit if the facts are there, with or without tax insurance, including inversions, spinoffs, other types of reorganization, valuations and transfer pricing, intellectual property migrations, purchase price allocations, Foreign Investment in Real Property Tax Act classification, real estate investment trust classification, research and experimentation credits, and charge-outs for stock-based compensation. The IRS is likely to look for things like that regardless of whether there is tax insurance, or whether the tax insurance is captive.

Regarding audit risk, the taxpayer might want to understand whether documentation created in connection with the underwriting process would qualify for the work product privilege if requested by an examining agent. A thorough analysis of that question is beyond the scope of this article, but it seems likely that this privilege could be available under the right facts, the documentation of which should be in the control of the taxpayer and its insurance broker. Under the Federal Rules of Civil Procedure, the person claiming the work product privilege must prove that the materials in question are documents and tangible things, prepared in anticipation of litigation or trial, and prepared by or for the party or the party's representative.[10]

The first and third requirements should be easy to satisfy. In contrast, the second requirement is likely to require some level of diligence to establish and document that the documents in question were truly prepared in anticipation of

[9] For an argument that tax risk insurance premiums should be tax deductible, see Brewer, "Tax Risk Insurance: Another View on the Proper Tax Treatment," *Tax Notes Federal*, Feb. 15, 2021, p. 1087.

[10] Fed. R. Civ. P. 26(b)(3)(A).

litigation, and not just "in the ordinary course of business."

Conclusion

Our discussion herein of the relevant tax law has focused on U.S. law. But it should be noted that captive insurance and tax risk insurance are not unique to the United States — both have been used in other countries to achieve similar risk management and tax benefits. Therefore, there is good reason to believe that the combination of the two will be an international phenomenon.

Given the potential tax benefits of captive tax risk insurance, it is possible that the position of the relevant tax authorities will be that "never the twain shall meet." But, in the immortal words of Justin Bieber, "never say never."[11] In situations in which there are legitimate, nontax business reasons for both captive insurance and tax risk insurance, the IRS, for one, is likely to have an uphill battle under existing law to prevent a meeting of the twain. Presumably, the same will be true in other countries. ■

[11]With all due respect to Justin Bieber, we cannot believe we are quoting from one of his songs. Although he didn't actually coin the phrase "never say never," when we Googled that phrase, the first thing to pop up was a video of the Biebs singing a song by that name. For the record, we did not click the "play" button.