BUSINESS INSURANCE

# WORLD CAPTIVE FORUM

# US Benefits – It's a Better Year

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JANUARY 30 – FEBRUARY 1, 2019

# Our Panel

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# Agenda

- 2018 (and beyond) Captive Issues
- The IRS Perspective
- Benefits Captives Market: Where We Are Now & Where We're Headed

# DOL Updates

- At the end of 2012, the U.S Department of Labor's (DOL) expedited process for securing a prohibited transaction exemption (PTE) or ExPro process was sunseted. As of August 2013, there was a new "fast track" for captives. Coke and Intel were approved on an individual basis after the previous fast track process sunseted and are now being used as examples of substantially similar transactions for businesses seeking ExPro. To date, Sealed Air Corporation, Healthcare Services Group and Hormel Foods Corporation, have secured PTEs via the renewed ExPro process.
- In 2017, Hyatt and others have had PTEs issued through ExPro.
- In 2018, The DOL has been slow to get address multiple open applications including PTE and individual exemption applications. At this point, there have been no other PTEs that have been approved.
- The Trump Administration's slow start in appointing officials to run the sub-Cabinet agencies, combined with the Senate's slow pace in confirming the President's nominees has effectively slowed the organization's speed in making policy decisions.
  - For example, from January of 2016 to the present, only two advisory opinions were issued, both of which addressed health plan issues related to a Presidential Executive Order.

# Developing Landscape

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  - *Ouwinga v. Benistar 419 Plan Services* - Employers brought putative class action against insurance companies, attorneys, and insurance agents who marketed and sold purported tax-deductible welfare benefit plan, alleging violations of the Racketeer Influenced and Corrupt Organizations Act (RICO) as well as several state-law claims.
  - *Deutsche Bank AG, et. al., v. Defendants* - Investors filed state court action against accountant, tax return preparer, and bank to recover damages arising from abusive tax shelter in which they had convinced them to participate.

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# Dodd-Frank

- Because of Dodd-Frank, more states have attempted to impose direct procurement taxes on captive transactions.
- Since the enactment of the Non-admitted and Reinsurance Reform Act (the "NRRA") as part of the Dodd-Frank Act, captive owners and advisors around the country have been engaged in discussion and debate over the impact of the NRRA on the state tax profile of captive insurance arrangements. Most believe that NRRA now applies to captive arrangements and captive owners would be well advised to review their existing structure and policies and consider whether certain state tax risks can be minimized or eliminated.
- Meanwhile, states have attempted to impose direct procurement taxes or have encouraged organization to redomesticate captives to their domicile.

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# IRS CCA 201350008 (Dec. 13, 2013)

Our review of the materials that Company submitted in connection with its letter ruling request led us to identify three areas of concern:

- 1. [Risk shifting/distribution] In particular, we were concerned that the reinsurance agreements between Company and the Pool contained provisions whose net effect might be to negate risk shifting and risk distribution.
- 2. [Insurance risk v business risk].
- 3. [Premiums charged were arms-length.]

The Company did not provide sufficient information for us to address these concerns. Accordingly, we are unable to rule pursuant to sections 10.06 and 15.10(1)(c) of Rev. Proc. 2012-1.

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# Notice 2016-66

- The Treasury Department and the IRS believe this transaction ("micro-captive transaction") has a potential for tax avoidance or evasion. *** This notice identifies the transaction described in section 2.01 of this notice and substantially similar transactions as transactions of interest for purposes of § 1.6011–4(b)(6) of the Income Tax Regulations and § § 6111 and 6112 of the Code. This notice also alerts persons involved in such transactions to certain responsibilities and penalties that may arise from their involvement with these transactions.
- There may be limited circumstances in which a captive insurance company arrangement that provides insurance for employee compensation or benefits is described in this section and accordingly is identified as a transaction of interest under this notice. However, if such an arrangement is one for which the Employee Benefits Security Administration of the U.S. Department of Labor has issued a Prohibited Transaction Exemption, it is not treated as an arrangement identified as a transaction of interest under this notice.

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# Avrahami vs. Commissioner

- Centers around an Arizona jewelry and real estate company whose captive meets the criteria of the IRS's "dirty dozen" list
- The following were the key arguments of the commissioner:
  - Risk distribution: The commissioner argued that Feedback's* policies included uninsurable risks and that it failed to distribute risk because it had an insufficient pool of insureds. Feedback had three affiliated entities insured in PY 2009 and four in PY 2010.
  - Operations and Premium: Feedback and Pan American** did not operate like insurance companies and their premium were not determined at arm's length and were excessive.
  - The commissioner also had other claims about lack of insurance risk and lack of risk shifting although these were not pointed out in judge Holmes' final ruling
- The ruling, passed by Judge Holmes, states the Avrahami's captive was not being operated as an insurance company, that its policies were vague, its risk distribution was insufficient and that its premiums were abnormally high.

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# Johnson & Johnson

- New Jersey-based organization with a captive, Middlesex Assurance Company, domiciled in Vermont
- In NJ, the Independent Procurement Tax (IPT) is imposed upon the premiums paid by a business for insurance that is procured other than through an insurance broker
  - Lower for premiums paid to in-state insurance companies
- J&J paid IPT to NJ only for its risks covered in the state, and not for the premiums paid to insure its global operations
- The State of New Jersey recently contended that according to Non-admitted and Reinsurance Reform Act (NRRA), Johnson & Johnson should be paying taxes on premiums written for all risks within the US, not just for those residing in the state.
- Johnson & Johnson argued that the language in NRRA is vague, unclear and only relates to surplus lines of business. They ultimately lost the battle and did not receive the $55M of refunds they requested for. We believe other states will follow suit because of the success out of New Jersey and Washington.

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# Reserve Mechanical

- Reserve, an Anguilla-domiciled captive, wrote 11 to 13 policies over the three tax years in question and had direct policies for 3 insureds. Peak Mechanical & Components, Inc. ("Peak"), an S Corp for Federal income tax purposes, was owned in equal 50% shares by two individuals and was the primary insured under all policies.
- The court outlined the following criteria in its argument to prove that Reserve did not have sufficient risk distribution:
  - The arrangement must involve insurable risk
  - The arrangement must shift the risk of loss to the insurer
  - The insurer must distribute the risk among its policy holders
  - The arrangement is insurance in the commonly accepted sense
- The court found there was no risk distribution since the risk pooling failed, and Reserve's transactions were not insurance transactions in the commonly accepted sense. Further, the premium payments to Reserve were treated as income to Reserve, despite a finding that Reserve was not transacting insurance for tax purposes.

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# Microsoft

- In May of 2018, the Insurance Commissioner of Washington state issued a cease-and-desist to Microsoft.
- This order required that Cypress (Microsoft's AZ-based captive) stop selling insurance to its parent company and asked for about $1.4M in unpaid premium taxes.
- The Insurance Commissioner believed that Microsoft was in non-compliance as it did not pay 2% premium taxes for the business that Cypress had underwritten. It was further contended that as Cypress did not hold a certificate of authority to sell insurance in the State of Washington, and the coverage should have been placed through a surplus lines broker licensed in Washington.
- In response, Microsoft began using a surplus lines broker and settled the case with the commissioner in August by paying $867,820.

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# Artex Class-Action Suit

- Former clients of Artex Risk Solutions have joined together, alleging that Artex committed a breach of fiduciary duty, negligence/professional malpractice, breach of the duty of good faith and fair dealing, violation of RICO, etc
- Artex allegedly induced clients into setting up 831(b) captives that they knew or should have known were just abusive tax shelters
- The IRS concluded that the money paid into the clients' captives was not deductible to the same clients' businesses that paid them

# IRS Focus Points

- Coverages
- Pricing
  - Overpriced/arms-length
  - Pool pricing
- Risk distribution
  - Pooling entity
  - Sufficient independent exposures
- Insurance in the commonly accepted sense
  - Claims
- Economic substance – 10 years prior
  - Promoter exam / taxpayer audit

# Where We Stand Today

- Many insurers to fund but now issue with DOL
- Working through DOL slowdown

# Our Panel

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