# 2024 Tax Update

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# 2024 United States Tax Court Update

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- Seven section 831(b) and 501(c)(15) cases decided to-date
  - *Avrahami* (2017), *Reserve Mechanical* (2018), *Syzygy* (2019), *Caylor* (2021), *Keating, Swift, Patel* (2024)
- Insurance criteria addressed by the Tax Court
  - Generally Considered: Commonly Accepted Notices of Insurance and Risk Distribution
    - *Keating* only focused on Commonly Accepted Notices of Insurance
  - *Not* Considered: Risk Shifting, Insurable Risk

# Keating

- *Insured:* Risk Management Strategies, Inc. (RMS)
    - Sole employer for its clients, which were primarily banks administering special needs trusts.
- *Captive*: Risk Retention, Ltd.
    - Anguilla domiciled, Tribeca/Artex managed
    - Fronting carrier (Provincial) issued policies to RMS, and ceded risk using layering:
        - Facultative Risks – ceded to RMS
            - Worker's Compensation Deductible, EPLI Deductible, GL policies 100% to RMS
            - First $250,000 of losses under Legal Expense, Loss of Key Customer, Professional Liability-DIC policies
        - Quota Share Risks – ceded to unrelated captives
            - Ceded risk up to limits (e.g. $750,000) after Self-Insured Retention (e.g. $250,000) met

# Keating Cont.

- Commercial broker did not shop for captive policies
- Target premiums provided for all policies
- Premiums were not supported by actuarial analysis, nor was 49%/51% allocation of premiums
- Premium pricing and premium payments “completed after the fact”
- Artex backdated policy changes and permitted the late issuance of insurance contracts and late premium payments
- Artex did not obtain sufficient information to support underwriting process

# Keating Cont.

- Claims by RMS totaling $1,073,600 from 2008-2014
  - 2012-2014 claims filed against Worker's Compensation Deductible/SIR Reimbursement policy
  - RMS did not submit deductible billing invoices or other claims documents, and did not await approval from Artex to pay
  - RMS filed claims after reporting period lapsed, and Risk Retention paid claims
- Provincial loss ratio ranged from .016% to 3.019% from 2011-2014
- Related Party Loans: premium finance agreements for RMS commercial policies, life insurance policies; miscellaneous loans

# Keating Cont.

- Sale of controlling interest in RMS added Risk Retention premiums (less claims) back into earnings
- Court opinion
  - *Commonly Accepted Notions of Insurance*
    - Not *operated* as insurance company
    - Policies were not valid and binding
    - Target premiums "patently unreasonable"
    - More detailed explanation of the need for expansive policies was warranted than the ones provided by RMS
    - No explanation for allocation of 51%/49% premiums in layered approach

# Swift

- *Insureds:*
  - Texas MedClinic – 18 urgent care facilities with 75 physicians
  - Rehab – 8 physical rehabilitation centers
  - Derm Docs, PLLC – one dermatologist practice
- *Captives*:
  - Castlegate (2004-2009)
    - BVI domiciled, Celia Clark managed
    - Participated in Pan American pool at issue in *Avrahami*
  - Castlerock and Stonegate (2010-2015)
    - St. Kitts domiciled, Celia Clark managed
    - Ceded risks to two pools - Jade (2012-2013), Emerald (2014-2015)
    - Captives ceded risk to pools with differing attachment points and ceilings based on coverage type
    - Pools had "meaningful deterrents to claims against the pool."

# Swift Cont.

- Clinic continued to maintain medical malpractice insurance with commercial carrier and premiums decreased during 2012 through 2015
- Since 2004, Clinic had four claims out of approximately 2.15 million patient visits, resulting in settlements from $35k to $450k
- KPMG prepared actuarial pricing analyses for malpractice tail coverage; Dr. Swift chose the load percentage
- Allen Rosenbach (actuary in *Avrahami*) priced nonmedical malpractice policies; Clark or her employee provided total maximum premium amounts

# Swift Cont.

- Three “untimely” claims approved
- Captives invested in real estate, buying and developing property for three urgent care facilities leased to Clinic, securities
- Court opinion
  - *Risk Distribution*
    - Three entities insufficient
    - 28 locations, and workforce that ranged from 530 to 341 workers “pales in comparison” to other cases, like *RVI* (714 insureds, 754k passenger vehicles, 2k real properties, 1.3 million equipment assets), *Rent-A-Center* (14-19k employees, 7k-8k vehicles, 2-3k stores), *Harper* (30k shipments, 7k policies)
    - Number of doctors insufficient

# Swift Cont.

- Court opinion
  - *Risk Distribution (Cont.)*
    - Risk pools not insurance for risk distribution
    - Quota share retrocession agreements where Jade and Emerald "returned to the Swift captives" significant amount of reinsurance premium
    - Fact that premium payments paid to captives matched reinsurance premiums "belies the idea that the parties entered into these contracts at arm's length"
    - Swifts failed to show why percentage was reasonable, and why they perfectly aligned in light of different risks being assumed

# Swift Cont.

- Court opinion
  - *Commonly Accepted Notions of Insurance*
    - Not *operated* as insurance company
    - No due diligence into need for two captives
    - Dr. Swift communicated he wanted to add coverage in hopes of "maxing out" premiums, rather than a business need
    - Investment choices on an "unthinking insurance company would make"
    - Premiums "engineered to suit the tax needs of the moment, not to account for any risk"
    - Swift captives "displayed some attributes of insurance companies," but "failed to operate as insurance companies and their premiums were nonsense."
  - *Penalties at 20%* - failed to establish content of substantive tax advice provided by CPA

# Patel

- *Insureds:*
  - Ophthalmology Specialists of Texas (OST) – eye surgery practice
  - Integrated Clinical Research, LLC (ICR) and Strategic Clinical Research Group, LLC (SCR) – conducts clinical research trials on experimental drugs for retina diseases (98% of patients from OST)
- *Captives*:
  - Magellan (2011 forward)
    - St. Kitts domiciled, Coomes formed, CIC Services handled functions for captives
    - Issued policies to ICR, SCR in 2016
  - Plymouth Insurance Co. (2016)
    - Coomes and CIC Services formed and managed
    - Issued policies to OST in 2016

# Patel Cont.

- Captives participated in pool with Capstone
  - Capstone reinsured 51 percent of ultimate net loss of each covered policy
  - Magellan and Plymouth assumed risk from Capstone through quota share retrocession agreement
  - Quota share that Magellan and Plymouth assumed was calculated so that they received reinsurance premiums roughly equal to that paid to Capstone under the reinsurance agreement
- Parties agreed that policies contain terms one would typically see in insurance policies except policies require losses be reported before expiration of the policy, provide excess insurance to other coverage, policies cannot be canceled and premiums earned at inception
- Allen Rosenbach (actuary in *Avrahami*) priced policies
- Dr. Patel provided "target" amounts for premiums, and asked for higher premiums ("max . . . that we can pay into the captive")
- CIC employees had ownership interests in a captive that participated in Capstone pool while they also approved claims for the Capstone pool

# Patel

- Court opinion
  - *Risk Distribution*
    - Risk pool not insurance for risk distribution
    - Magellan and Plymouth received payments from Capstone that were roughly equal to the premiums Capstone was entitled to receive from Magellan and Plymouth
    - Some claims were paid in the pool during the tax years at issue, the amounts were minimal
    - No actuarial determination of the reasonableness of the 51 percent of premiums ceded to Capstone
    - One to three entities insufficient for risk distribution
    - Patel argued focus should be on patient visits (88k exposures), but Court said patient visits not relevant to most of coverages from captives
    - Five physician insufficient

# Patel

- Court opinion
  - *Commonly Accepted Notions of Insurance*
    - Not *operated* as insurance companies
    - Managed by Capstone (?) and Coomes; had no employees
    - No feasibility study; no due diligence with respect to reinsurance or quota share agreements
    - Premiums were "wholly unreasonable"; Court already determined in *Avrahami* that Rosenbach's calculations "under very similar circumstances were utterly unreasonable"
    - No direct claims; Capstone claims submitted after IRS began examining Capstone captives
  - Court requested additional briefing on economic substance penalties

# *Puglisi v. Commissioner*

First IRS Concession of Section 831(b) Captive

# *Puglisi* Background

- Puglisi Egg Farms of Delaware LLC formed a Delaware captive managed by Oxford Risk Management Group LLC in 2015
  - Captive reinsured its quota share of 80% of approved claims of unrelated entities
  - Premiums determined by independent actuaries
  - AM Best assigned Oxford Insurance Company LLC a Financial Strength Rating of A (Excellent)
  - Five claims for losses not covered by commercial insurance
- IRS began scorched-earth examination in 2017
  - Template information document requests (IDRs)
  - Template summonses for previously produced information
  - Copy and paste determinations by the IRS in 2019

# *Puglisi* in Tax Court

- Puglisi owners petitioned Tax Court in March 2020
- Puglisi owners issued comprehensive discovery requests to the IRS
- Puglisi owners responded to over 200 discovery requests (with over 100 subparts) by the IRS
  - Most documentation previously produced by Puglisi owners as part of examination
- Puglisi owners begin pushing for trial, IRS resists trial date
- IRS desperately attempts to settle case, and then seeks to unilaterally concede captive issues in full
- The Tax Court accepts IRS's full concession

# Depth of IRS concession in *Puglisi*

- IRS conceded after it reviewed discovery and consulted with its litigation experts
- IRS has "no plans to challenge the deductibility of future payments that Puglisi Egg Farms may make to Series A of Oxford with respect to Actual Net Loss Insurance Policies that are comparable in nature to the ones issued for 2015-2018"
- IRS offers Puglisi owners closing agreement for *future years*

# Proposed Regulations Micro-captive Listed Transactions and Transactions of Interest

# What does this change?

- Reduce the loss ratio from 70% to 65% and expand the computation period from the most recent 5 years to the most recent 10 years
  - If a captive has existed for fewer than 10 years and does not include a financing factor, then the transaction would automatically be considered a transaction of interest
- Reporting requirements
  - Do not have to identify how the proposed regulations apply
  - Do not have to state the authority under which the Captive is chartered
  - Do not have to describe how premiums were determined
  - Do not have to list the reserves reported by the Captive on its annual statement
  - Do not have to describe the assets held by Captive

# What does this change?

- Reporting Requirements
  - Identify the types of policies issued or reinsured
  - Identify the premiums written
  - Identify the name and contact information of actuaries and underwriters involved
  - Identify the total claims paid by Captive
  - Identify the name and percentage of interest held directly or indirectly by each person whose interest reaches the 20% threshold
    - Each insured would have to disclose the insurance premiums paid for coverage provided to Insured, directly or indirectly, by the Captive

# Reportable Transactions

- Listed Transaction
  - Transaction that is the same as, or substantially similar to, one that the IRS has determined to be a tax avoidance transaction and identified by IRS notice or other form of published guidance
  - Transactions that include a financing factor
  - Captive's loss ratio factor is less than 65% for the 10 most recent tax years
- Transaction of Interest (TOI)
  - Transaction that the IRS and the Treasury Department believe is a transaction that has the potential for tax avoidance or evasion but lack sufficient information to determine whether the transaction should be identified specifically as a tax avoidance transaction.
    - Applies to transactions entered into on or after November 2, 2006.
  - Captive's loss ratio factor is less than 65%, but has existed for fewer than 10 tax years

# Disclosure Requirements

- Every taxpayer who is required to file a tax return and has participated in a reportable transaction, must file a disclosure statement within the specified time.
- The disclosure statement must be filed **with the OTSA within 90 calendar days** after the reportable transaction occurs.
- Taxpayers who are required to disclose reportable transactions but fail to do so, are subject to penalties.

# Disclosure Requirement Penalties

- Penalty Amount
  - 75% of the decrease in the tax shown on the return as a result of the reportable transaction

| Listed Transactions | Transactions of Interest |
|---|---|
| Minimum Penalty<br>$5,000 in the case of a natural person<br>$10,000 in any other case | |
| Maximum Penalty<br>$100,000 in the case of a natural person<br>$200,000 in any other case | Maximum Penalty<br>$10,000 in the case of a natural person<br>$50,000 in any other case |

- Accuracy-related penalty imposes a 20% on any understatement related to the reportable transaction
  - Subject to an increased rate of 30% if the reportable transaction was inadequately disclosed

# How does this effect us now?

- The proposed regulations have no immediate impact.
- Although the regulations are still in the proposal stage, it is important to consider when forming a new Captive insurance company and how the tax/reporting implications will impact the parties involved.

# Future Shakeups with Chevron/ Corner Post?

- June 28, 2024 Loper Bright Enterprises vs Raimondo SCOTUS overturned the  Chevron Doctrine.
- Chevron Doctrine required courts to defer to US administrative agencies in favor of their “reasonable” interpretation of statutes even when a different interpretation was better supported.
- Sometimes the Internal Revenue Code expressly delegates authority to the IRS to write regulations but in other cases it relies on general authority under IRC 7805(a)

# Future Shakeups with Chevron/ Corner Post?

- IRS retains the ability to publish the proposed regulations but taxpayers have a much more favorable landscape to challenge them.
- Corner Post v. Board of Governors of the Federal Reserve System
  - SCOTUS rules in favor of plaintiff allowing 6 years from date of *harm* from a regulation to challenge instead of the date of issuance.
- Will the IRS release the regulations as final?
- Can they define insurance absent its definition in statute?

# Self Procurement Tax

# Self Procurement Tax Considerations

- Self Procurement Tax
  - What is Self Procurement Tax?
  - Who is responsible for Self Procurement Tax?
- Regulated by the states
  - What if not an insurance company for Federal Income Tax purposes?
  - Tax Exempt?
- State audits and inquiries
- 7 states with no direct procurement tax law
  - Range of tax from .5% - over 5.5%

# Nonadmitted and Reinsurance Reform Act

- Most relevant elements
- "No State other than the home State of an insured may require any premium tax payment for nonadmitted insurance."
- "Premium tax" includes tax on independently procured insurance
- States may enter into compact to allocate premium tax paid to home state
- Most states have amended laws to conform to NRRA and many have instructed insureds who self-procure to remit 100% of tax to home state
- No states have entered into an interstate compact to allocate premium taxes

# NRRA “Home State”

- In general
  - State in which an insured maintains principal place of business or, in the case of an individual, the individual's principal residence; or
  - If 100% of the insured risk is located outside of State referred to above, the State to which the greatest percentage of the insured's taxable premium for the insurance policy is allocated
- Affiliated group
  - If more than one insured from an affiliated group are named insureds on a single insurance policy, home state for policy is home state of affiliate with largest percentage of premium attributed to it under the policy

# Washington State

- Legislation was designed to provide "…a framework for registration by captive insurers that insure Washington-based entities and are licensed by the jurisdictions in which they are domiciled."

- Establishes an initial registration requirement for an "eligible captive insurer." Specifically, an eligible captive insurer must register with the Washington Office of Insurance Commissioner within the earlier of either 120 days after the effective date of the new law or 120 days after first issuing a policy that covers Washington risks. Section 1(5) provides for an annual renewal of the registration for a fee not to exceed $2,500.

- Eligible captive is required to remit a 2% premiums tax for net premiums collected for insuring Washington risk in the prior calendar year

# Washington State (cont'd)

Eligible captive insurer means an insurance company with the following characteristics:

- (a) It is wholly or partially owned by a captive owner;
- (b) It insures risks of the captive owner, the captive owner's other affiliates, or both;
- (c) One or more of its insureds have their principal place of business in Washington;
- (d) It has assets that exceed its liabilities by at least $1,000,000 and has the ability to pay its debts as they come due, both as verified by audited financial statements prepared by an independent certified accountant; and
- (e) It is licensed as a captive insurer by the jurisdiction in which it is domiciled."

# Other State Tax Issues

- Related party add back statutes:
  - Always check to see if there is a potential add back of related party expenses such as insurance premium. For example, Illinois adds back premiums to related party insurance companies. 35 ILCS § 5/203(b)(2)(E-14)
- Whether Captive is included in unitary filings and whether intercompany charges are eliminated. Often depends on state's interpretation of "in lieu of" statute.
  - Recent development in Illinois, New York, Minnesota, and Oregon
  - Effect of combination is to tax the captives' investment and to often disallow the deductions for premiums paid to the captives
  - NY and MN are using the federal definitions of "insurance" whereas most states follow the state law definition (ex: Leadville)
- Decoupling rules (i.e., CA DRD)