TALKING ON THE "DIRTY DOZEN"

Ernie Achtien of Captive Resources and Matthew J. Howard of Moore Ingram Johnson & Steele, LLP discuss Matthew's editorial in Captive Review's Tennessee Report 2015 regarding the IRS' "Dirty Dozen" list and the practices of unscrupulous captive managers

Captive Review (CR): Does the US captive market have an issue with 'unscrupulous promoters', as identified by the IRS?

Matthew Howard (MH): A few promoters that have gotten into this business space have no liability insurance expertise. They are doing it for their own fees, which, in some cases are exorbitant, for example, we have seen as high as 50% of premiums paid into the captive taken by the promoter as fees. Alternatively, they are doing it to sell products other than liability insurance, inside the captive, such as life insurance.

In my August editorial for *Captive Review* on the IRS' Dirty Dozen listing, I agreed with the notion that there needs to be a clean-up. However, I would certainly say that, overall, the majority of captive managers around the country are scrupulous rather than unscrupulous. This is clear from domicile meetings from around the country with the departments of insurance and associations in those states. For the most part, the managers know what they are doing, they have liability expertise and are trying to do everything correctly.

CR: What sort of practices are the IRS identifying when they refer to these illegitimate captive programmes?

Ernie Achtien (EA): There are a number of practices that the IRS are referring to and that we encounter.

The first can be seen in the pricing of the premiums. Some practitioners are not using an independent actuary to price the business. This is a red flag.

Second, captives are being formed in a foreign domicile with very low capital; such as with $40,000 - $60,000 of capital, for example. These domiciles may not have the regulatory restrictions that are required for an insurance company.

Ernie Achtien

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Matthew J. Howard

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Another common practice in this respect can be seen in the promoter, as the IRS would call them, encouraging the client not to file claims with their captive insurance company.

The IRS is also very concerned about what is known as 'circular cash flow'. This is the process by which a captive is formed at the end of the year and in January of the following year it has loaned all the money back to the operating company. In this way, the cash just goes around in a circle back to the company that formed the captive.

An unscrupulous promoter may also have what we call a 'cookie cutter approach'. This is where it uses the same policies and virtually the same premiums for different clients. We take a very separate approach to all of our clients, starting with a clean slate each time.

CR: In the formation and operations of a micro captive, what are the most important considerations with regard to perceived legitimacy by the IRS?

EA: In my opinion there are three main considerations:

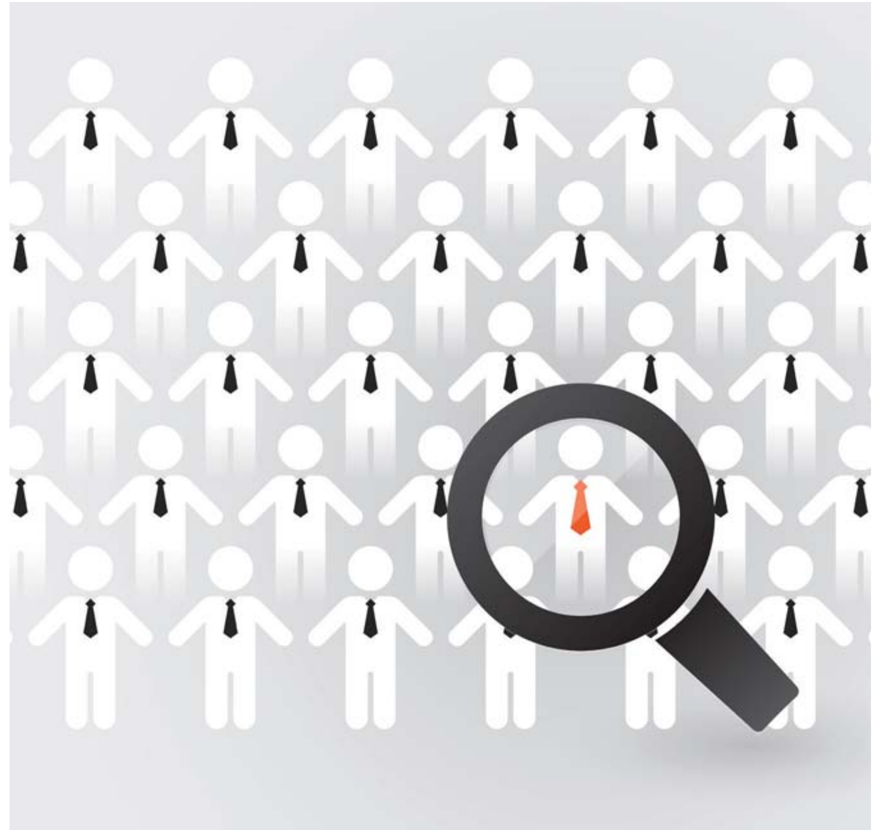
1. Foremost in the IRS' mind is that there has to be a business purpose for forming the insurance company. Tax, while a nice benefit of a captive, should not be the driving factor in setting up the insurance company.
2. As alluded to previously, actuarially determined premiums are needed. You cannot simply determine premiums out of thin air. An independent actuary should determine those premiums.
3. To operate as a legitimate insurance company the captive must be run as a legitimate business. You need to have board meetings, for example, and do all the things that a well-run insurance company does. We have seen some captives that we have taken over that had not held a board meeting in a couple of years; as a corporation, you need to have these meetings.

MH: I would identify two items that the IRS always focuses on, audit and in many cases take to court:

1. The initial capital has to be sufficient. This applies to offshore-domiciled micro captives. We get inquiries all the time for the offshore formation of 831(b) captives, because the owner only has to commit $40,000 - $60,000 dollars of capital. That is a non-starter. The IRS is looking for capital of somewhere between three-to-five-to-one as far as premium to capital. All the US states

that have legitimate insurance programmes require $250,000 of capital. You have to commit a legitimate amount of capital to be a legitimate insurance company and, frankly, if you are working with an actuary worth working with, it will tell you the same – it would not take on the engagement unless you were putting in the requisite capital.

2. With regard to the cycling of money that Ernie identified, both Captive Resources and MIJS constantly tell clients that the purpose of 831(b), which has been part of the Internal Revenue Code since 1987, is as a congressional inducement whereby the federal, state and local governments will not tax the premium paid into the captive for the purpose of allowing you to build up surplus in order to pay potential claims on your coverage. This is as opposed to requiring small-to-mid-sized businesses, whom these captives are for, to come up with $5m or $10m of capital initially. Instead, they put in a small amount of initial capital, at least $250,000, and allow the growth of the insurance company by not taxing those dollars. So if you have a business paying the premium and then borrowing it back out again, essentially, it is never growing the insurance company's surplus, flying right in the face of the purpose of the statute. You can pull money out by way of dividends later; "later" differs and varies, but certainly not in the first year. Best practice is at least three years of accumulation before money is pulled out.



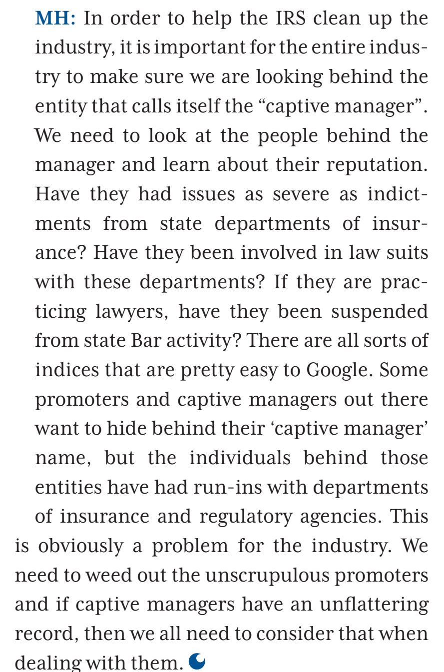
CR: What kind of support and communication has the US captive industry received from the IRS with regard to this clampdown?

MH: About five years ago, we were told by the IRS that there would be an initiative primarily focused on small offshore domiciles that were not policing captives appropriately. We initiated and had discussions with the IRS regarding the appropriate structure and management of these captives.

Both our companies have been beating the drum for years about this initiative. A lot of people did not believe us initially because there was not the same level of activity we see now. We are now seeing a great migration of micro captives coming from offshore to onshore domiciles as a result. The IRS has known about this problem for a while and I believe it when it says that it has turned a corner. It realises that 'captive' is not a bad word and there are legitimate captives out there, operating appropriately. However, it will continue to weed out the unscrupulous promoters as quickly as possible. I think the Dirty Dozen article was just a way of alerting tax payers that it is doing something about the problem.

> "In order to help the IRS clean up the industry, it is important for the entire industry to make sure we are looking behind the entity that calls itself the 'captive manager'"

EA: I would say that part of the reason for the publishing the Dirty Dozen article is that the IRS' resources are constrained. So if it can reach out to the press, mention these issues and stop them before they are even implemented, it puts much less strain on its resources.



CR: What role does the insurance industry have to play to help the IRS combat these unscrupulous practices?

MH: In order to help the IRS clean up the industry, it is important for the entire industry to make sure we are looking behind the entity that calls itself the "captive manager". We need to look at the people behind the manager and learn about their reputation. Have they had issues as severe as indictments from state departments of insurance? Have they been involved in law suits with these departments? If they are practicing lawyers, have they been suspended from state Bar activity? There are all sorts of indices that are pretty easy to Google. Some promoters and captive managers out there want to hide behind their 'captive manager' name, but the individuals behind those entities have had run-ins with departments of insurance and regulatory agencies. This is obviously a problem for the industry. We need to weed out the unscrupulous promoters and if captive managers have an unflattering record, then we all need to consider that when dealing with them.