

## SECTION 831(B) CAPTIVE INSURANCE COMPANIES: WHY POLICYMAKERS HAVE IT ALL WRONG

DREW D. ESTES\*

### I. INTRODUCTION

The financial crisis of 2008–2009 exposed the risks inherent in our complex and global economic system. In the wake of that crisis, U.S. policymakers have used a multitude of tools to bolster the faltering economy.<sup>1</sup> In spite of their efforts, the economy continues to underperform.<sup>2</sup>

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\* Drew Estes is a graduate of the University of Alabama School of Law and the University of Alabama Manderson School of Business. He is a portfolio manager at Banyan Capital Management in Atlanta, Georgia. This article would not have been possible without the encouragement and guidance of Dean Andrew Morriss.

<sup>1</sup> See, e.g., Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008). The Act authorized the Treasury to “purchase . . . certain types of troubled assets for the purposes of providing stability to and preventing disruption in the economy and financial system.” *Id.* This legislation established the Troubled Asset Relief Program (TARP), which would purchase “troubled assets” from institutional investors. See *id.*; Jeannette L. Nolen, *Emergency Economic Stabilization Act of 2008 (EESA)*, ENCYC. BRITANNICA, <http://www.britannica.com/topic/Emergency-Economic-Stabilization-Act-of-2008> (last visited Mar. 1, 2016). The implementation of the Federal Reserve’s expansionary monetary policy started with the “purchase [of] large quantities of agency debt and mortgage-backed securities to provide support to the mortgage and housing markets” in conjunction with a decision “to establish a target range for the federal funds rate of 0 to 1/4%.” 2008 *Monetary Policy Releases*, BD. GOVERNORS FED. RES. SYS. (Dec. 16, 2008), <http://www.federalreserve.gov/newsevents/press/monetary/20081216b.htm>. The Federal Reserve (1) “purchased \$175 billion in direct obligations of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks” between December 2008 to August 2010; (2) “purchased \$1.25 trillion in mortgage-backed securities (MBS) guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae” between January 2009 and August 2010; (3) “purchased \$300 billion of longer-term Treasury securities” between March 2009 and October 2009; (4) “purchas[ed] an additional \$600 billion of longer-term Treasury securities” between November 2010 and June 2011; (5) “increased policy accommodation by purchasing additional MBS at a pace of \$40 billion per month” beginning in September 2012; (6) “purchas[ed] longer-term Treasury securities at a pace of \$45 billion per month” beginning in January 2013; and (7) reinvested “principal payments from its holdings of agency debt and agency MBS . . . in agency MBS” beginning in September 2011. *Credit and Liquidity Programs and the Balance Sheet*, BD. GOVERNORS FED. RES. SYS., [http://www.federalreserve.gov/monetarypolicy/bst\\_openmarketops.htm](http://www.federalreserve.gov/monetarypolicy/bst_openmarketops.htm) (last updated Dec. 16, 2015) (noting the vastness of the Federal Reserve’s expansionary monetary policy since 2008).

<sup>2</sup> See *What Accounts for the Slow Growth of the Economy After the Recession?*, CONG. BUDGET OFF., Nov. 2012, at 1, 2, <http://www.cbo.gov/sites/default/files/43707-SlowRecovery.pdf>; Eric Morath, *The Worst Expansion Since World War II Was Even* (continued)

There are bright spots within the economy, however, and the captive insurance industry is among the brightest.<sup>3</sup>

The captive industry is comprised of captives, captive managers, and other professionals providing ancillary services to captives.<sup>4</sup> The core of the captive industry is comprised of the captive insurance companies, which are technically defined as “insurance or reinsurance entit[ies] created and owned, directly or indirectly, by one or more . . . entities, the purpose of which is to provide insurance or reinsurance cover for risks of the entity or entities to which [they] belong[], or for entities connected to those entities.”<sup>5</sup> In more simplistic terms, the typical captive arrangement includes one or more firms owned or controlled by a common parent entity, i.e., a corporate family, and the parent entity forms a captive to insure the risks retained by the other members of the corporate family, i.e., the captive’s corporate sisters or affiliates.<sup>6</sup> Instead of using a third-party insurer, the corporation creates its own wholly-owned insurer.

Although now mainstream, this is not a new concept.<sup>7</sup> Innovative entrepreneurs have utilized rudimentary captive arrangements for well over a century.<sup>8</sup> Captive insurance as it exists today, however, can trace its roots to the 1950s when a man by the name of Fred Reiss set out to solve a simple

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*Weaker*, WALL ST. J. (July 30, 2015), <http://blogs.wsj.com/economics/2015/07/30/the-worst-expansion-since-world-war-ii-was-even-weaker/?mod=WSJBlog>.

<sup>3</sup> See *Issues Paper on the Regulation and Supervision of Captive Insurance Companies*, INT’L ASS’N OF INS. SUPERVISORS, Oct. 2006, at 4, 4 [hereinafter *Issues Paper*], [http://www.captiveglobal.com/files/documents/Application\\_Paper\\_on\\_Captive\\_Insurers-Nov2015.pdf](http://www.captiveglobal.com/files/documents/Application_Paper_on_Captive_Insurers-Nov2015.pdf).

<sup>4</sup> See Robert E. Bertucelli, *Captive Insurance Companies*, CPA J., Feb. 2011, at 60, 61, [http://www.elevatecaptives.com/userfiles/file/Captive\\_Insurance\\_Companies.pdf](http://www.elevatecaptives.com/userfiles/file/Captive_Insurance_Companies.pdf) (providing a visual representation of a typical captive structure).

<sup>5</sup> *Issues Paper*, *supra* note 3, at 4. “Reinsurance” refers to insurance provided to an insurance company. See *Reinsurance*, INVESTOPEDIA, <http://www.investopedia.com/terms/r/reinsurance.asp> (last visited July 3, 2016).

<sup>6</sup> See Bertucelli, *supra* note 4, at 62.

<sup>7</sup> See *Issues Paper*, *supra* note 3, at 5. “There are instances as early as 1782 of mutual insurance companies being formed by members of a particular industry to provide insurance coverage.” *Id.*

<sup>8</sup> *Id.* “The concept of forming an insurance company to insure the risks of its owners can be traced to the infancy of insurance.” *Id.* The precursor of today’s group of association captives, captives owned by and insuring the risks of a particular industry’s participants, was formed as early as 1782. See *id.* A concrete example arose “[i]n 1860, in response to increased insurance rates, [when] a group of London merchants formed their own insurance company called Commercial Union.” *Id.* The first examples of pure captives, captives owned by and insuring the risk of their parent and affiliates, arose “[i]n the 1920’s [sic] and 1930’s [sic] [when] several major companies, including ICI, BP, Pilkingtons and Unilever in the UK and Lufthansa in Germany, had formed their own insurance companies.” *Id.*

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problem.<sup>9</sup> His clients needed protection from increasing insurance premiums that were threatening their companies' financial viability.<sup>10</sup> Being the innovative businessman that he was, Fred Reiss formed the first modern captive,<sup>11</sup> and other firms have followed his example ever since.<sup>12</sup>

Roughly thirty years after Fred Reiss's creation of the first modern captive, the captive industry was still no more than a sleepy niche industry comprised of slightly more than one thousand captives.<sup>13</sup> Although commonplace among the world's largest firms, captives were virtually unheard of among midmarket and small firms at the time.<sup>14</sup> Legal innovations drove costs down, however, and the popularity of captives began to rise.<sup>15</sup> As a result, the industry underwrote more than 10% of global premium income by 2002 and boasted more than 5,500 captives by 2005.<sup>16</sup> Although accurate data on the industry is hard to come by, the number of captives existing today certainly exceeds 6,000.<sup>17</sup>

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<sup>9</sup> See *id.* (acknowledging that “[t]he modern concept of captive insurance companies did not develop into a real growth industry until the 1950’s [sic], when Fred Reiss, the widely acknowledged ‘father’ of captives took a special interest and initiated the development of the current industry profile”).

<sup>10</sup> See *id.*; PETER J. STRAUSS, *THE DEFINITIVE GUIDE TO CAPTIVE INSURANCE COMPANIES* 5 (2011) (stating that Fred Reiss was prompted to take action after “one of Reiss’ largest clients[] saw its financial stability threatened by rising insurance prices”).

<sup>11</sup> See STRAUSS, *supra* note 10, at 5. “Instead of paying hefty premiums to buy insurance from a large insurance company, Reiss’ client would form a new insurance company . . . [that] would issue insurance to its parent company.” *Id.* The captive would then purchase reinsurance from Lloyds of London. See *id.*

<sup>12</sup> See *Issues Paper*, *supra* note 3, at 6.

<sup>13</sup> See *id.* at 4–5.

<sup>14</sup> See Greg Taylor & Scott Sobel, *A Closer Look at Captive Insurance*, CPA J., June 2008, at 48, 48 (noting that the beneficiaries of captive insurance have historically been large corporations with 80% of S&P 500 companies using captive insurance); Bertucelli, *supra* note 4, at 64 (noting that captives were “long favored” by *Fortune* 100 companies).

<sup>15</sup> See Taylor & Sobel, *supra* note 14, at 48. “With the enactment of favorable tax regulations and other legislation . . . captives are no longer just for large corporations.” *Id.* Robert E. Bertucelli, *The Benefits of Captive Insurance Companies*, J. ACCT. 53, 56 (Feb. 2013), <http://www.pivotalcaptive.com/wp-content/uploads/2013/03/The-Benefits-Of-Captive-Insurance-Companies.pdf> (noting that legislative innovations have created “the ability to operate a captive insurance entity at lower costs and using much smaller levels of risk and premiums, making it available to a broader spectrum of companies”); Jeff Simpson & Randall Beckie, *Warning: Do Not Try This at Home! The Series Captive Insurance Company in Delaware Takes Cell-Type Captive Structures to Another Level of Flexibility and Premium Efficiency*, CAPTIVE REV. (Apr. 2010), [http://www.elevatecaptives.com/userfiles/file/Series\\_Cell\\_Captive\\_-\\_Jeff\\_Simpson.pdf](http://www.elevatecaptives.com/userfiles/file/Series_Cell_Captive_-_Jeff_Simpson.pdf) (discussing the efficiencies of the series limited liability company within the context of captive insurance).

<sup>16</sup> See *Issues Paper*, *supra* note 3, at 50.

<sup>17</sup> See *id.* (estimating the captive industry grew 10% per year since 1998, and between 1998 and 2003, the captive industry’s net written premiums grew by 45% per year, admitted  
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In addition to legal innovations, incentives contained within the Internal Revenue Code (Tax Code) drove captive formation.<sup>18</sup> First and foremost, insurance premiums are tax deductible business expenses under 26 U.S.C. § 162.<sup>19</sup> This section allows corporations utilizing a captive to retain risk—i.e., self-insure—with pretax dollars.<sup>20</sup> Without a captive, self-insuring generally requires financing losses with free cash flows, retained earnings, or, if the firm has the foresight, from a self-insurance reserve account.<sup>21</sup> Because retained earnings are comprised of after-tax earnings, and because payments into a reserve account are not tax deductible under § 162,<sup>22</sup> firms without captives must self-insure with after-tax dollars or hope their free cash flows are sufficient to finance their losses.<sup>23</sup> This places them at a

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assets grew by 29%, and loss reserves grew by 35%); ZURICH AM. INS. CO., CAPTIVE STRATEGIES: ENHANCING VALUE AND ENSURING COMPLIANCE 1 (2014) (citing a *Business Insurance* study claiming 6,342 captives existed worldwide in 2013); A.M. BEST CO., INC., CAPTIVE UPDATE: NEWS OF THE ALTERNATIVE RISK MARKETS 14–16 (2015), <http://www.ambest.com/captive/CaptiveUpdateApr2015.pdf> (finding that Delaware enjoyed a 40% increase in licensed captives in 2013 compared to 2012, the Cayman Islands captive industry grew by 2.5% in 2014, North Carolina licensed forty-nine captives in 2014, its first full year as a captive domicile, and Oklahoma increased its number of active captives by nearly 400%); Judy Greenwald, *Smaller Companies Try Captives*, BUS. INS. (March 9, 2015), <http://www.businessinsurance.com/article/20150309/NEWS06/303159994> (citing a survey indicating the number of captives grew by 7.1% in 2014).

<sup>18</sup> See Dave Lenckus, *831(b) Captives: 'Small' Option Is Increasingly Big Idea for Midsized Cos.*, PROPERTYCASUALTY360.COM (May 3, 2012), <http://www.propertycasualty360.com/2012/05/03/831b-captives-small-option-is-increasingly-big-id?t=captives>.

“Captive experts say an 831(b) [captive] offers midsize companies an introduction to alternative risk transfer and its benefits.” *Id.* This implicitly recognizes many midsize companies would not be able to benefit from a captive without the § 831(b) election). See also Mike Tsikoudakis, *Forming 831(b) Microcaptives More Popular With Smaller Firms*, BUS. INS. (Mar. 4, 2012), <http://www.businessinsurance.com/article/20120304/NEWS06/303049999>. “The tax incentive is not necessarily driving the formation [of § 831(b) captives], but it does help make a small insurance captive program work.” *Id.* This statement implies this type of program may not work without the tax advantages).

<sup>19</sup> See, e.g., *AMERCO, Inc. v. Comm’r*, 979 F.2d 162, 164, 168 (9th Cir. 1992). “It is common ground that insurance premiums constitute ordinary and necessary business expenses which can be deducted in arriving at taxable income.” *Id.* at 164.

<sup>20</sup> See R. WESLEY SIERK, *TAKEN CAPTIVE* 28–29 (2008) (stating that a “captive gets a current deduction to fund reserves for future liabilities . . . [and] the captive gets to deduct the cost of covering these claims if it has reinsured them”).

<sup>21</sup> See *id.* at 29.

<sup>22</sup> See *Clougherty Packing Co. v. Comm’r*, 811 F.2d 1297, 1300 (9th Cir. 1987) (citing *Steere Tank Lines, Inc. v. United States*, 577 F.2d 279, 280 (5th Cir. 1978); *Spring Canyon Coal Co. v. Comm’r*, 43 F.2d 78, 80 (10th Cir. 1930)).

<sup>23</sup> See SIERK, *supra* note 20, at 28. “With traditional self-insurance, companies only get a deduction for claims paid.” *Id.* For example, “if a [company] pays \$50,000 per month into the fund and uses only \$200,000 for claims, at the end of the year, it has \$400,000 . . . in a trust that cannot be deducted and would be treated as earnings.” *Id.* “[A]fter having to fund

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disadvantage to their captive-utilizing counterparts. Accordingly, § 162 incentivizes captive formation.

The Tax Code directly incentivizes captive formation via 26 U.S.C. § 831(b).<sup>24</sup> For decades, this section permitted non-life insurance companies—i.e., captives—receiving less than \$1.2 million in annual premiums to elect to be taxed only on their investment income as opposed to on their underwriting income.<sup>25</sup> The premium limit was increased to \$2.2 million in December, 2015.<sup>26</sup> This provides a significant tax saving for corporate families with captives taking the § 831(b) election.<sup>27</sup> Without this added incentive, many small firms would find it uneconomical to pay the formation and monthly management fees required to operate a captive.<sup>28</sup> In light of that, the tax benefits provided by § 831(b) have been the primary catalyst of growth within the captive industry in recent years.<sup>29</sup>

Not everyone, however, is a fan of how the § 831(b) election is being used by captives. In 2015, the Internal Revenue Service (IRS) included § 831(b) captives on its “Dirty Dozen” list of tax scams while launching an audit and investigation campaign against § 831(b) captive promoters and

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the trust in the first place, the business then has to pay taxes on the \$400,000.00 remaining in the fund at the end of the year.” *Id.*

<sup>24</sup> See 26 U.S.C. § 831(b)(1) (2012) (entitled “Tax on insurance companies other than life insurance companies”).

<sup>25</sup> *Id.* § 831(b)(2).

<sup>26</sup> Consolidated Appropriations Act of 2016, Pub. L. No. 114-113, § 423, 129 Stat. 3123, 3123–24 (2015).

<sup>27</sup> See, e.g., STRAUSS, *supra* note 10, at 10–11. For example, think of a company with an effective tax rate of 50%. *Id.* at 10. If the company pays \$300,000 in premiums to its captive during the year, “deducting \$300,000 from [its] business income saves [it] \$150,000 in taxes.” *Id.* If the company’s captive takes the § 831(b) election, “[w]hen [the company] pays \$300,000 into [its captive], the [captive] receives this money free of income tax.” *Id.* at 11.

<sup>28</sup> See Lenckus, *supra* note 18.

<sup>29</sup> See James A. McConvill, *Of Turquoise Waters and Captivating Dreams: The Cook Islands as an International Captive Insurance Center*, 14 J. INT’L BUS. & L. 1, 22 (2015) (noting that by 2012 “approximately 21% of captives were ‘small captive companies’—meaning they had annual premiums of less than US \$1.2 million”); *IRS Names Microcaptives as Top Abusive Tax Scheme*, INS. J. (Apr. 15, 2015) (stating that “[c]aptive insurance growth today is being fueled by smaller companies and professional firms using the 831(b) provision”); Judy Greenwald, *Smaller Companies Try Captives*, BUS. INS. (March 9, 2015), <http://www.businessinsurance.com/article/20150309/NEWS06/303159994> (suggesting § 831(b) captives are generating the growth in the micro-captive space).

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operators.<sup>30</sup> Congress joined the fight with the proposal of Senate Bill 905.<sup>31</sup> In its original form, Senate Bill 905 contained severely restrictive provisions that would have crippled the § 831(b) captive industry.<sup>32</sup> Although the restrictive provisions were limited before the bill was ultimately passed on December 18, 2015,<sup>33</sup> the provisions' evolution through the process highlights the strained relationship that has existed for decades between the § 831(b) captive industry and policymakers.

The strained relationship is a result of policymakers' adversarial stance toward the industry. Although there are tax abuses at the margin, the benefits of the industry more than outweigh any costs associated with it. For that reason, policymakers' adversarial stance toward the § 831(b) captive industry is not warranted.<sup>34</sup> The changes made to § 831(b) in December, 2015 can be viewed as progress, but more is needed. With a holistic view of the costs and benefits of the industry, a more balanced debate can be fostered. And from that foundation, a less adversarial future can be forged.

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<sup>30</sup> See *Abusive Tax Shelters Again on the IRS "Dirty Dozen" List of Tax Scams for the 2015 Filing Season*, IR 2015-19 (Feb. 3, 2015), <https://www.irs.gov/uac/Newsroom/Abusive-Tax-Shelters-Again-on-the-IRS-Dirty-Dozen-List-of-Tax-Scams-for-the-2015-Filing-Season> [hereinafter "*Dirty Dozen*" List]; Alexis MacIvor et al., Branch Chief, I.R.S. Office of Chief Counsel, Presentation at the ABA Tax Section Insurance Companies Committee: Captive Insurance Update 17 (May 8, 2015), [http://apps.americanbar.org/dch/thedl.cfm?filename=/TX323000/otherlinks\\_files/ABA\\_May\\_2015\\_Captives.pdf](http://apps.americanbar.org/dch/thedl.cfm?filename=/TX323000/otherlinks_files/ABA_May_2015_Captives.pdf) (stating that "[t]he IRS has also been extremely active with captives involved with closely held companies" and "has launched tax shelter promoter-investigations against one or more captive managers"); Paul Sullivan, *I.R.S. Is Looking Into Captive Insurance Shelters*, N.Y. TIMES (Apr. 10, 2015), <http://www.nytimes.com/2015/04/11/your-money/irs-is-looking-into-captive-insurance-shelters.html> (noting that "[t]he I.R.S. is not alone in its campaign against small captives. At a Senate Finance Committee meeting in February, Charles E. Grassley, Republican of Iowa, asked Mark Mazur, Assistant Secretary for Tax Policy at the Treasury Department, to look into ways to narrow the uses of captives.").

<sup>31</sup> S. 905, 114th Cong. § 1 (2015).

<sup>32</sup> See JOINT COMM. ON TAX'N, DESCRIPTION OF THE CHAIRMAN'S MARK RELATING TO MODIFICATIONS TO ALTERNATIVE TAX FOR CERTAIN SMALL INSURANCE COMPANIES 2-3 (Feb. 11, 2015), [http://www.finance.senate.gov/imo/media/doc/JCX-21-15%20%20Insurance%20and%20162\\_f\\_pdf](http://www.finance.senate.gov/imo/media/doc/JCX-21-15%20%20Insurance%20and%20162_f_pdf).

<sup>33</sup> Consolidated Appropriations Act of 2016, Pub. L. No. 114-113, § 423, 129 Stat. 3123, 3123-24 (2015).

<sup>34</sup> See *infra* Part III.B.

## II. IS THE § 831(B) CAPTIVE INDUSTRY GOOD FOR THE ECONOMY?

Firms that utilize § 831(b) captives enjoy widely-recognized operational efficiencies.<sup>35</sup> There are also widely-unrecognized, intangible benefits derived from the effect of § 831(b) and § 162 on these firms' incentives.<sup>36</sup> Both are relevant in determining whether the § 831(b) captive industry benefits the overall economy.<sup>37</sup>

### A. *The Operational Benefits Realized by Firms Utilizing § 831(b) Captives*

Firms enjoy many operational benefits from utilizing § 831(b) captives.<sup>38</sup> Although there are many others, those particularly pertinent to this discussion are: (1) improved insurance coverage; (2) cost reductions; (3) increased cash flows; and (4) stabilized budgets.<sup>39</sup>

First, a § 831(b) captive allows its affiliates to uniquely structure their insurance coverage.<sup>40</sup> Whereas commercial insurance policies are standardized and non-negotiable, a captive's policy is determined solely by the needs of its insureds, i.e., the captive's affiliates.<sup>41</sup> One commentator cleverly compared the policies to clothing by saying that commercial insurers "offer[] small, medium or large, [while] a captive insurer measures a precise fit."<sup>42</sup> This provides an advantage over their non-captive-utilizing counterparts.<sup>43</sup> Firms utilizing captives are well protected against idiosyncratic risks, but their non-captive counterparts remain exposed to risks not covered by generic, commercial insurance policies.<sup>44</sup> This poses a potential threat to the latter's balance sheet and operations.<sup>45</sup>

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<sup>35</sup> See *infra* Part II.A. Many of the benefits discussed in this section are enjoyed by all firms utilizing captives regardless of whether their captives take the § 831(b) election. See *supra* Part I. Because this article's focus is limited to § 831(b) captives, however, this article's analysis will be from the sole perspective of firms utilizing § 831(b) captives. Mentioning that a particular benefit is enjoyed by a firm utilizing a § 831(b) captive is not necessarily intended to suggest that it is not enjoyed by firms utilizing captives that do not take the § 831(b) election.

<sup>36</sup> See *infra* Part II.B.2.

<sup>37</sup> See *infra* Part II.C.

<sup>38</sup> See, e.g., SIERK, *supra* note 20, at 23; F. HALE STEWART, U.S. CAPTIVE INSURANCE LAW 5–12 (2010).

<sup>39</sup> See STEWART, *supra* note 38, at 6–12.

<sup>40</sup> *Issues Paper*, *supra* note 3, at 13.

<sup>41</sup> See SIERK, *supra* note 20, at 16.

<sup>42</sup> *Id.*

<sup>43</sup> See STEWART, *supra* note 38, at 5–12.

<sup>44</sup> See *id.*

<sup>45</sup> Here, raw risk refers to risk that, in the event of materialization, will have a dollar-for-dollar effect on the exposed firm's financials. There is no financial buffer to reduce the financial damages felt by the firm.

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Second, a § 831(b) captive provides cost savings for its affiliates.<sup>46</sup> For one, a § 831(b) captive permits its affiliates to limit their dependence on, or bypass completely, the commercial insurance market.<sup>47</sup> The administration and sales force of a commercial insurer imposes significant overhead costs that are baked into premium prices.<sup>48</sup> This can lead to a 40–50% inflation of commercial insurance premiums beyond that actually warranted by the risk insured.<sup>49</sup> This premium inflation can be avoided by retaining the risk within a captive. Alternatively, if the captive's corporate family does not wish to retain its risk entirely, a significant portion of the inflated premiums can be eliminated by placing the excess risk in the reinsurance market.<sup>50</sup> By doing the latter, the corporate family is effectively able to procure insurance at wholesale rates.<sup>51</sup> Thus, corporate families utilizing § 831(b) captives are able to avoid padding the pockets of commercial insurers' stakeholders by retaining a portion of their risk within their captives and placing excess risk in the reinsurance market at wholesale prices.

Third, and due in part to the preceding benefit, a § 831(b) captive can significantly increase its corporate family's cash flows.<sup>52</sup> This is also accomplished by keeping the insurance premiums within the corporate family.<sup>53</sup> By retaining the premiums, the corporate family is able to benefit from the investment income generated from the premiums during the policy period.<sup>54</sup> Also, the corporate family retains any underwriting profits under the policy.<sup>55</sup> Lastly, the corporate family's overall tax burden is reduced by § 831(b) and § 162 and, thus, its after-tax cash flows are increased.<sup>56</sup>

Fourth, a captive allows its insured affiliates to stabilize their budgets.<sup>57</sup> When placing risk in the commercial insurance market, firms' income statements are exposed to the cyclicity of the commercial insurance

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<sup>46</sup> See, e.g., STEWART, *supra* note 38, at 8.

<sup>47</sup> See SIERK, *supra* note 20, at 27.

<sup>48</sup> See STEWART, *supra* note 38, at 8 (noting that Traveler's Insurance Company's and Aetna's selling, general, and administrative expenses in the second quarter of 2009 were \$839 billion and \$1.4 billion, respectively).

<sup>49</sup> See SIERK, *supra* note 20, at 23.

<sup>50</sup> See *id.* at 27.

<sup>51</sup> See *id.*

<sup>52</sup> See, e.g., STEWART, *supra* note 38, at 8–10; SIERK, *supra* note 20, at 23.

<sup>53</sup> See STEWART, *supra* note 38, at 8–10.

<sup>54</sup> See *id.*; *Issues Paper*, *supra* note 3, at 13.

<sup>55</sup> See STEWART, *supra* note 38, at 8–10.

<sup>56</sup> See *id.* This point is addressed in detail in *infra* Part II.B.1.

<sup>57</sup> See SIERK, *supra* note 20, at 25–26; *Issues Paper*, *supra* note 3, at 13.

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market.<sup>58</sup> Firms with captives can eliminate or reduce this risk by retaining all or a portion of their operational risks within their captives.<sup>59</sup> Thus, a captive's affiliates are less exposed to a "hardening" of the commercial insurance market.

Although other operational efficiencies exist, the aforementioned will suffice for these purposes. The efficiencies significantly benefit firms utilizing § 831(b) captives by improving insurance coverage, reducing costs, increasing cash flows, and increasing budget stability.

*B. The Benefits of the Altered Incentive Structure Faced by Firms Utilizing § 831(b) Captives*

Many have alluded to the notion that firms with captives face an incentive structure superior to that faced by other firms,<sup>60</sup> but none frame the argument entirely within the context of the Tax Code.<sup>61</sup> In light of that, this discussion will focus exclusively on the incentives created by the Tax Code in an attempt to highlight how it changes the behavior of firms utilizing § 831(b) captives.<sup>62</sup>

*1. The Altered Incentive Structure*

There are two sections of the Tax Code that are pertinent to § 831(b) captives. Obviously, § 831(b) is one, but it operates in conjunction with § 162.<sup>63</sup> These sections work together to alter behavior at the firm level.<sup>64</sup> Additionally, the judicial and IRS precedent under § 162 further imposes incentives—or, more precisely, legal requirements—on firms utilizing § 831(b) captives.<sup>65</sup> This discussion will address both in turn.

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<sup>58</sup> See *Issues Paper*, *supra* note 3, at 12 (noting that "[t]he insurance market is cyclical and fluctuating costs have an undesirable impact on budgeting and profit forecasting by captive owners").

<sup>59</sup> See *id.* at 12–13 (noting that "[i]n recent years the insurance market has experienced, across the board, fixed percentage increases in premium rates and these premiums are *not* felt by many captive owners to reflect the real risks for their particular organisation" (emphasis added)).

<sup>60</sup> See *id.* at 11–12.

<sup>61</sup> See *id.*

<sup>62</sup> The analysis will be from the corporate family's perspective, meaning that it will be assumed that all decisions are made with the goal of maximizing profits for the entire family without regard to the profitability of any particular affiliate within the family.

<sup>63</sup> See STEWART, *supra* note 38, at 9–10.

<sup>64</sup> See *id.*

<sup>65</sup> See *infra* Part II.B.1.b.

(continued)

*a. Incentives Created by § 831(b) and § 162*

Premiums paid by a firm to its affiliated captive are tax-deductible business expenses under § 162, but payments made to a self-insurance reserve account are not.<sup>66</sup> This means that premiums paid to an affiliated captive result in a dollar-for-dollar reduction in the firm's taxable income, and, thus, it creates a reduction in the firm's income tax burden by an amount equal to the premium payment multiplied by the firm's marginal tax rate.<sup>67</sup> Now recall that § 831(b) permits captives receiving less than \$2.2 million in annual premiums to elect to be taxed only on their investment income as opposed to their underwriting income.<sup>68</sup> Thus, the government does not make up the lost tax by taxing the captive's income, which is exempt under § 831(b).<sup>69</sup>

To illustrate, imagine a firm that generates \$100,000 in annual revenue by incurring \$70,000 in tax-deductible business expenses. Its effective and marginal tax rates are 30%, so the firm's \$30,000 of pretax earnings will result in a \$9,000 income tax bill and after-tax earnings of \$21,000.

Now imagine that the firm does *not* have a captive but has \$10,000 worth of uninsured risk exposure.<sup>70</sup> The firm could lower its income tax bill by \$3,000 by insuring the \$10,000 worth of risk with a commercial insurer, but the \$10,000 in premiums would leave the firm's corporate family. This would result in a \$7,000 reduction in the firm's contribution to its corporate family's after-tax earnings regardless of whether the insured risk materializes. In other words, every dollar of premium results in a seventy-percent reduction in the firm's contribution to its corporate family's after-tax earnings, unless the risk materializes. Because the firm cannot know *ex ante* whether the risk will materialize, the firm is incentivized not to insure the risk if financially plausible and in accordance with the firm's level of risk aversion.

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<sup>66</sup> See *Amerco, Inc. v. Comm'r*, 979 F.2d 162, 164 (9th Cir. 1992). The court noted that "amounts placed by a company into a self insurance reserve fund cannot be deducted; any deductions must await an actual payment out of that reserve." *Id.* (citations omitted). The court held that "it is possible to have a true insurance transaction between a corporation and its wholly owned subsidiary insurance company." *Id.* at 168.

<sup>67</sup> See JOEL S. NEWMAN, *FEDERAL INCOME TAXATION* 6 (5th ed. 2012) ("Deductions are subtracted from income, before you apply the [tax] rates." Thus, "[a] dollar in deductions . . . will . . . save you \$1 times your marginal rate.").

<sup>68</sup> See 26 U.S.C. § 831(b)(2)(A)(i) (2012), amended by Consolidated Appropriations Act of 2016, Pub. L. No. 114-113, § 423, 129 Stat. 3123, 3123-24 (2015).

<sup>69</sup> See *id.*

<sup>70</sup> See SIERK, *supra* note 20, at 21 (noting that "no company regardless of its size or sophistication has commercial insurance coverage for 100% of its risk").

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Now imagine that the firm has a captive. With the captive, the firm's incentive structure is very different. It has the option of insuring its uninsured risk within the captive by paying \$10,000 of premiums thereto. If the firm opts to insure the risk with the captive, the firm's pretax earnings will fall to \$20,000, its income tax bill will fall to \$6,000, and its after-tax contribution to its corporate family's earnings will fall to \$14,000.<sup>71</sup> Although this is exactly the same as in the no captive scenario, here the \$10,000 of premiums remain within the corporate family.<sup>72</sup> Thus, the firm has effectively transferred \$10,000 of pretax earnings from its income statement to the captive's income statement, and the \$10,000 of premiums will settle in the captive's reserves.

At this point, one of two outcomes can occur. One outcome is that the insured risk does *not* materialize. In that case, the firm will have succeeded in transferring \$10,000 of its pretax earnings to the captive, which translates into a \$3,000 tax saving. Because the captive is a § 831(b) captive, the captive will not be taxed on its underwriting income of \$10,000.<sup>73</sup> Thus, the firm's corporate family has succeeded in retaining an additional \$3,000 by cutting the IRS out of the transaction. Under this set of facts, insuring the risk with the captive is the best option.

The other possibility is that the insured risk does materialize, at which point the captive will indemnify the firm for its damages in accordance with the insurance policy's provisions.<sup>74</sup> The indemnity payment will flow from the captive's reserves and into the firm's coffers to offset the firm's damages arising from the loss event. This allows the firm to finance its otherwise uninsured damages with pretax dollars held within the captive's reserves, which includes the \$10,000 of premiums.

If the firm had retained the uninsured risk, however, the firm would most likely finance its losses with free cash flows, retained earnings, or funds held within a self-insurance reserve account. If the firm finances its losses from its retained earnings or a self-insurance reserve account, the firm would effectively be financing its damages with after-tax earnings.<sup>75</sup> As a result, the firm would be financing \$10,000 worth of damages with \$14,286 worth of pretax earnings.<sup>76</sup> That is a poor option, indeed.

If the firm has sufficient free cash flows to finance its damages, on the other hand, the firm will be able to deduct the damages immediately as a

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<sup>71</sup>  $\$20,000 - (\$20,000 \times 30\%) = \$14,000$ .

<sup>72</sup> See Bertucelli, *supra* note 4, at 6.

<sup>73</sup> See 26 U.S.C. § 831(b) (2012).

<sup>74</sup> See Bertucelli, *supra* note 4, at 60–61.

<sup>75</sup> See *supra* note 73 and accompanying text; Bertucelli, *supra* note 4, at 61–63.

<sup>76</sup>  $\$10,000 \div (1 - 0.3) = \$14,285.71$ .

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business expense.<sup>77</sup> This would leave the firm's corporate family in the same position as if the firm had financed its damages from the captive's reserves because the firm's income tax burden would be the same under either scenario: the \$10,000 would be lost forever. However, using free cash flows for risk-financing exposes the firm to the unnecessary risk of having to dip into its retained earnings or a self-insurance reserve account and, thus, inefficiently finance its damages if its damages exceed that which its free cash flows can support.<sup>78</sup> Because the firm cannot know the magnitude of its damages *ex ante*, it cannot know whether it will have the capability of financing its damages with its free cash flows. The firm minimizes this risk by shifting the risk to the captive, which has access to the pretax funds held within the captive's reserves.<sup>79</sup> Hence, insuring the risk with the captive is the best option under this set of facts as well.

To summarize, if the firm does *not* have the captive, its best *ex ante* option is to retain as much risk as financially plausible given the firm's level of risk aversion. If the firm has a captive, on the other hand, its best *ex ante* option is to insure its retained risks with the captive. In fact, the tax benefits of § 162 and § 831(b) are so strong that they incentivize the firm to insure as much risk as possible without exceeding the \$2.2 million threshold of the § 831(b) election.<sup>80</sup> This means that the captive incentivizes the firm to significantly increase its capital allocation toward risk-financing purposes, i.e., increase its savings. It is undeniable, then, that firms utilizing § 831(b) captives face incentives that differ materially from those faced by other firms.

*b. Incentives Created by Judicial and IRS Precedent*

An entirely separate incentive faced by firms utilizing § 831(b) captives is derived from judicial and IRS precedent developed under § 162. For premiums paid by a firm to its affiliated captive to be deductible business expenses under § 162, the transaction must satisfy the legal definition of "insurance."<sup>81</sup> This definition was first derived in *Helvering v. Le Gierse*.<sup>82</sup> In *Helvering*, the Supreme Court of the United States set forth the two requirements of "insurance" that are relevant here: (1) risk shifting; and (2)

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<sup>77</sup> See *Amerco, Inc. v. Comm'r*, 979 F.2d 162, 164 (9th Cir. 1992).

<sup>78</sup> See Bertucelli, *supra* note 4, at 61.

<sup>79</sup> See *id.*

<sup>80</sup> See 26 U.S.C. § 831(b)(2)(A)(i) (2012), amended by Consolidated Appropriations Act of 2016, Pub. L. No. 114-113, § 423, 129 Stat. 3123, 3123-24 (2015).

<sup>81</sup> See *Amerco*, 979 F.2d at 164.

<sup>82</sup> 312 U.S. 531 (1941).

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risk distribution.<sup>83</sup> What constitutes “risk shifting” and “risk distribution” has been fleshed out repeatedly,<sup>84</sup> and the implications of the definitions will be discussed below.

*i. Risk Shifting*

In determining whether the element of risk shifting is present, the issue hinges on “the economic consequences of the . . . arrangement to the ‘insured’ party to see if that party has, in fact, shifted the risk.”<sup>85</sup> This requires an examination of “the insured’s assets . . . to determine whether it has divested itself of the adverse economic consequences of a covered [event].”<sup>86</sup> Through this lens, the focus is on the economic consequences of the insurance arrangement with respect to the insured’s balance sheet.<sup>87</sup> The insured’s balance sheet must be relieved of the economic consequences posed by the insured risk.<sup>88</sup> Inherent in this requirement are the additional requirements that the captive be fully capitalized, that there be no agreement for the insured to reimburse the captive in the event of a claim, and that the insured not own 100% of the captive’s stock.<sup>89</sup>

The implications of risk shifting are significant. Before a firm can enjoy the benefits of § 162 and, thus, make § 831(b) useful, it must shift the insured risk to a fully-capitalized captive so as to relieve its balance sheet of the economic consequences of an insured risk materializing.<sup>90</sup> In other words, the captive arrangement must protect the insured’s balance sheet in the same way that insuring the risk with a commercial insurer would.<sup>91</sup> This ensures that the insured firm is obtaining protection comparable to the coverage it could obtain from the commercial insurance market.<sup>92</sup> Thus, the required element of risk shifting demands that firms utilizing § 831(b)

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<sup>83</sup> *Id.* at 539 (defining “insurance” as “involv[ing] an actual ‘insurance risk’ . . . risk-shifting and risk-distributing”).

<sup>84</sup> *See, e.g., Amerco*, 979 F.2d at 164; Rev. Rul. 77-316, 1977-2 C.B. 53.

<sup>85</sup> *Clougherty Packing Co. v. Comm’r*, 811 F.2d 1297, 1305 (9th Cir. 1987).

<sup>86</sup> *Id.*

<sup>87</sup> *See Humana Inc. v. Comm’r*, 881 F.2d 247, 251 (6th Cir. 1989) (adopting the reasoning of *Clougherty* and analyzing a brother-sister captive arrangement); *Securitas Holdings, Inc. v. Comm’r*, 108 T.C.M. (CCH) 490 (2014) (stating that “we look to what has become known as the balance sheet and net worth analysis to determine whether risk has been shifted”); Rev. Rul. 2002-89, 2002-2 C.B. 984 (adopting the reasoning of *Clougherty* and *Humana*).

<sup>88</sup> *Humana*, 881 F.2d at 249 (citing *Humana Inc. v. Comm’r*, 88 T.C. 2699, 2704–05 (1987)).

<sup>89</sup> *Id.* at 253.

<sup>90</sup> *Id.* at 249, 253.

<sup>91</sup> *Id.* at 249.

<sup>92</sup> *Id.*

(continued)

captives realize real economic protection before they can enjoy the benefits available under § 162 and § 831(b).<sup>93</sup>

From the corporate family's perspective, however, it is arguable that risk shifting between firms therein is economically irrelevant.<sup>94</sup> The argument is that "the parent of a pure captive ultimately controls and has to bear the risk of financial loss."<sup>95</sup> This argument correctly focuses on the fact that any indemnification from a captive to an insured firm will not protect the corporate family's balance sheet from damages suffered by the insured firm because the captive's indemnification payment is nothing more than moving money from one corporate pocket to another.<sup>96</sup>

Although correct in the abstract, this argument takes an overly narrow view of the transaction that ignores economically relevant facts. For one, risk shifting requires that the captive be adequately capitalized.<sup>97</sup> Consequently, risk shifting has the real effect of ensuring that the captive is capable of paying claims under the policies it has written.<sup>98</sup> Stated differently, risk shifting operates to ensure that the savings incentivized by § 162 and § 831(b) are adequate.<sup>99</sup> Although an indemnification will negatively impact the corporate family's balance sheet by an amount equal to the insured firm's damages, the element of risk shifting makes the captive's existence economically relevant in the first place.<sup>100</sup>

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<sup>93</sup> *Id.*

<sup>94</sup> See Gene C. Lai & Robert C. Witt, *The Tax Deductibility of Captive Insurance Premiums*, 62 J. RISK & INS. 230, 234 (1995) (noting the "modern financial theory suggests that there can be no risk shifting in substance within a corporate family").

<sup>95</sup> *Id.*

<sup>96</sup> *But see* STEWART, *supra* note 38, at 131 (reiterating the argument and then noting that the "argument makes an important and possibly erroneous valuation assumption: that book value . . . is always completely reflected in a stock's price").

<sup>97</sup> See *Humana*, 881 F.2d at 253; *Malone & Hyde, Inc. v. Comm'r*, 62 F.3d 835, 840 (1995) (stating that a captive "is essentially a sham corporation" and payments thereto do not entitle the taxpayer to a deduction "if the deduction is accomplished through the use of an undercapitalized foreign insurance captive that is propped-up by guarantees of the parent corporation"); *Rent-A-Center v. Comm'r*, 142 T.C. 1, 27–29 (2014).

<sup>98</sup> See Robert E. Bertucelli, *The Benefits of Captive Insurance Companies*, J. ACCT. (Mar. 1, 2013), <http://www.journalofaccountancy.com/issues/2013/mar/20126102.html>.

<sup>99</sup> *See id.*

<sup>100</sup> Kimberly S. Bunting et al., *Possibilities and Pitfalls With Captive Insurance Companies*, 38 ESTATE PLANNING 1, 3 (Aug. 2011), <https://www.naepc.org/journal/issue091.pdf>.

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ii. *Risk Distribution*

The IRS's opinion regarding risk distribution is more demanding than the judiciary's.<sup>101</sup> In light of that, this section focuses on the IRS's approach to risk distribution, which applies the following legal framework:

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 this type of claim. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smooths out losses to match more closely its receipt of premiums. Risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks.<sup>102</sup>

There is a lot to unpack in the above statement. To begin, "the statistical phenomenon known as the law of large numbers" can generally be described as the statistical law stating that the frequency with which a particular event actually occurs approaches the probability that the event occurs in a single repetition as the number of repetitions increase.<sup>103</sup> By requiring captives to distribute risk so as to recognize the benefits of this statistical phenomenon, the IRS is effectively requiring that captives "reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set

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<sup>101</sup> Compare *Harper v. Comm'r*, 96 T.C. 3925, 3930 (1991) (finding that 30% of unaffiliated risk constituted sufficient risk distribution), with Rev. Rul. 2002-89, 2002-2 C.B. 984 (suggesting at least 50% of unaffiliated risk is required to constitute sufficient risk distribution).

<sup>102</sup> See Rev. Rul. 2002-89, 2002-2 C.B. 984 (citations omitted) (concluding that risk distribution is achieved if at least 50% of a captive's gross and net premiums and total risk exposure is derived from unaffiliated insureds).

<sup>103</sup> HENK TIJMS, UNDERSTANDING PROBABILITY: CHANCE RULES IN EVERYDAY LIFE 20 (2d ed. 2004). In fact, the statistical law of large numbers is specifically defined as follows:

If a certain chance experiment is repeated an unlimited number of times under exactly the same conditions, and if the repetitions are independent of each other, then the fraction of times that a given event *A* occurs will converge with probability 1 to a number that is equal to the probability that *A* occurs in a single repetition of the experiment.

*Id.* at 20. Within the context of insurance, the statistical law of large numbers means that "[t]he greater the number of exposures, the more nearly will the actual results obtained approach the probable result expected with an infinite number of exposures." ROBERT I. MEHR & EMERSON CAMMACK, PRINCIPLES OF INSURANCE 33 (5th ed. 1972).

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aside for the payment of such a claim.”<sup>104</sup> To accomplish this, captives are usually forced to enter what are known as “pooling arrangement[s],”<sup>105</sup> which, by “assuming numerous relatively small, independent risks that occur randomly over time,” allows the captive to “smooth[] out losses to match more closely its receipt of premiums.”<sup>106</sup>

In simpler terms, the risk distribution element requires that § 831(b) captives distribute risk so as to achieve a level of distribution that makes annual losses relatively predictable.<sup>107</sup> A firm is exposed to risks that randomly occur without much predictability as to frequency and magnitude.<sup>108</sup> By utilizing a § 831(b) captive, however, the firm can distribute the risk via a pooling arrangement so as to replace “the impossibility of predicting a happening in an individual case . . . [with] the demonstrable ability to” forecast collective losses when considering a large number of cases.<sup>109</sup> This brings a level of predictability to the corporate family’s overall operations.<sup>110</sup> As a result, the corporate family’s cash flows are smoothed, and the firm is less likely to experience a negative cash flow shock.<sup>111</sup>

## 2. *The Superiority of the Altered Incentive Structure*

For convenience, it will be assumed that an incentive structure that incentivizes behavior that increases a firm’s financial stability is superior, all else equal.

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<sup>104</sup> Rev. Rul. 2002-89, 2002-52 I.R.B. 984; *but see* Scott A. Taylor, *Taxing Captive Insurance: A New Solution for an Old Problem*, 42 TAX LAW. 859, 916 (1989) (“[T]he law of large numbers and associated probability theory have little or no application for certain categories of insurance” which “are commonly insured through captives.” As a result, “the conclusion that risk distribution accomplishes risk transfer is not well-founded” with respect to captives.).

<sup>105</sup> See James Landis, *Risk Distribution—Where Is the Risk?*, INS. THOUGHT LEADERSHIP (Feb. 6, 2013), <http://insurancethoughtleadership.com/risk-distribution-where-is-the-risk/pdf> (noting that “[t]he typical way for small captives (such as those qualified under § 831(b) of the [Tax] Code) to accept risk from unrelated parties [to accomplish risk distribution] is through a pooling mechanism where a number of unrelated captives ‘swap risk.’” The author goes on to describe the following pooling arrangement as an example: “First, the captive may pay all of its premium to a single ‘fronting captive’ (usually owned by the captive manager) who then will cede 50% back to the captive as reinsurance premium and retain 50% for a year or more to potentially pay losses of the other captives who are also using this fronting mechanism.”).

<sup>106</sup> Rev. Rul. 2002-89, 2002-52 I.R.B. 984.

<sup>107</sup> See MEHR & CAMMACK, *supra* note 103, at 32.

<sup>108</sup> *Id.* at 39–40.

<sup>109</sup> *Id.* at 34.

<sup>110</sup> *Id.* at 33–34.

<sup>111</sup> Rev. Rul. 2002-89, 2002-52 I.R.B. 984.

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*a. Incentives Created by § 831(b) and § 162*

Firms utilizing § 831(b) captives are incentivized to increase their allocation of funds toward risk-financing purposes, i.e., to increase their savings.<sup>112</sup> In other words, these firms are incentivized to set aside additional funds—i.e., save enough money—to thwart risks that threaten their financial stability and long-term viability.<sup>113</sup> This increases the financial buffer available to finance losses when risks inevitably materialize. This, in turn, reduces the risk of experiencing a negative cash flow shock, which may result in downsizing or bankruptcy.<sup>114</sup> Therefore, behavior is incentivized that reduces the probability that a single adverse event will threaten the firms' viability.<sup>115</sup>

Moreover, an increased allocation of funds toward risk-financing naturally leads to an increased allocation of time and attention toward risk-financing.<sup>116</sup> This will result in a better understanding of the corporate family's risk profile and the potential effect risk materialization will have on the corporate family's operations and finances.<sup>117</sup> All else equal, this corollary will focus the attention of management and further reduce the probability that a single adverse event will threaten the firm's viability.

*b. Incentives Created by Judicial and IRS Precedent*

Firms utilizing § 831(b) captives are incentivized—or, more accurately, legally required—to shift and distribute risk.<sup>118</sup> Implicit in risk shifting is the requirement that the captive be fully capitalized, i.e., that the corporate family's savings be sufficient to thwart the risks borne by its captive.<sup>119</sup> This requirement undoubtedly leads to greater financial stability, which

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<sup>112</sup> See *Issues Paper*, *supra* note 3, at 11.

<sup>113</sup> See *id.* (stating that “[c]aptives give increased financial strength and competitiveness to their parents”).

<sup>114</sup> See *ENCYCLOPEDIA OF BUSINESS* 245 (Jane A. Malonis ed., 2d ed. 2000). “If at any time, because of a lack of cash, a corporation fails to pay an obligation when it is due, the corporation is insolvent. Insolvency is the primary reason firms go bankrupt.” *Id.* See also *JOHN DOWNES & JORDAN E. GOODMAN, BARRON’S FINANCE & INVESTMENT HANDBOOK* 225 (4th ed. 1995) (recognizing that “[c]ompanies with assets well in excess of liabilities may nevertheless go bankrupt because they cannot generate enough cash to meet current obligations”).

<sup>115</sup> See *Issues Paper*, *supra* note 3, at 12.

<sup>116</sup> See *id.* at 11–12 (noting that “[o]wning a captive has brought risk management to higher prominence in many major international companies, focusing the interest and support of company boards on reviewing and managing all risks, including uninsured risks”).

<sup>117</sup> See *id.* at 12 (noting that “[t]he operation of a captive encourages a new management awareness and better understanding of risk and its impact on group profitability”).

<sup>118</sup> See *Harper Grp. & Includible Subsidiaries v. Comm’r*, 96 T.C. 45, 58 (1991).

<sup>119</sup> *Securitas Holdings, Inc. v. Comm’r*, 108 T.C.M. (CCH) 490 (2014).

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minimizes the probability that a single adverse event will threaten the firm's viability.<sup>120</sup>

The element of risk distribution requires that firms utilizing § 831(b) captives benefit from the statistical law of large numbers.<sup>121</sup> This allows the corporate family to smooth its cash flows and reduce the likelihood of experiencing a negative cash flow shock.<sup>122</sup> This, too, leads to greater financial stability and minimizes the probability that a single adverse event will threaten the firm's viability.<sup>123</sup>

### C. *The Economic Implications of the Benefits of the § 831(b) Captive Industry*

The § 831(b) captive industry is beneficial in two broad ways. First, firms utilizing § 831(b) captives enjoy operational efficiencies not enjoyed by their non-utilizing counterparts: improved coverage, reduced costs, increased cash flows, and increased budget stability.<sup>124</sup> Second, a § 831(b) captive alters firms' incentive structures to incentivize prudent behavior.<sup>125</sup> The question now becomes whether these microeconomic benefits bleed into the macro economy and benefit the economy as a whole.

Before attempting to answer this question, a method of determining what is beneficial to the U.S. economy must be established. All can agree that growth and stability are beneficial, but what contributes to each is more controversial. This analysis will focus on fairly non-controversial factors. With respect to economic growth, this analysis will focus exclusively on owners' profits and tax revenue.<sup>126</sup> With respect to economic stability, this analysis will focus exclusively on cash flow volatility, downsizing, and bankruptcy.<sup>127</sup>

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<sup>120</sup> See *Issues Paper*, *supra* note 3, at 10.

<sup>121</sup> Rev. Rul. 2002-89, 2002-52 I.R.B. 984.

<sup>122</sup> *Id.*

<sup>123</sup> See *ENCYCLOPEDIA OF BUSINESS*, *supra* note 114, at 245.

<sup>124</sup> See *Issues Paper*, *supra* note 3, at 13.

<sup>125</sup> *Id.*

<sup>126</sup> See *DOWNES & GOODMAN*, *supra* note 114, at 348 (noting that "[t]he economic growth rate is normally determined by the growth of the gross domestic product"); J. Steven Landefeld et al., *Taking the Pulse of the Economy: Measuring GDP*, 22 *J. ECON. PERSPECTIVES* 193, 197 (2008) (noting that gross domestic product (GDP) is measured using the income approach with the following inputs: compensation, rental income, profits and proprietors' income, and taxes on production and imports less subsidies, interest, miscellaneous payments, and depreciation).

<sup>127</sup> See *CHRISTINE AMMER & DEAN S. AMMER*, *DICTIONARY OF BUSINESS AND ECONOMICS* 437 (rev. ed. 1997) (defining "stability" as "[a] condition of economic well-being without severe fluctuations of the business cycle, characterized by increasing production, growing employment, and constant price levels"); *JOHN BLACK ET AL.*, *A DICTIONARY OF ECONOMICS*

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With that framework in place, the question of whether the § 831(b) captive industry is beneficial to the U.S. economy can be addressed. To address that question, the analysis will be broken into three sections: (1) the positive economic effects of the operational efficiencies derived from § 831(b) captives; (2) the positive economic effects of the altered incentive structure derived from § 831(b) captives; and (3) the negative economic effects derived from § 831(b) captives.

*1. The Positive Economic Effects of the Operational Efficiencies Associated with § 831(b) Captives*

The benefits derived from the operational efficiencies enjoyed by firms utilizing § 831(b) captives are numerous. These operational benefits make firms utilizing § 831(b) captives more efficient, competitive, and financially stable,<sup>128</sup> which, in turn, benefits the economy as a whole, all else equal.<sup>129</sup>

Most importantly, § 831(b) captives also increase corporate families' overall cash flows.<sup>130</sup> At the end of the day, cash flows are a firm's life-blood. Firms pay employees, purchase inventory, and service their debt with cash flows. For that reason, increasing corporate families' overall cash flows increases their stability and, as a result, reduces the probability of downsizing and bankruptcy.<sup>131</sup>

Similarly, § 831(b) captives reduce insured firms' insurance costs and increase the stability of their budgets.<sup>132</sup> The former reduces insured firms' costs and places them in better competitive positions.<sup>133</sup> This increases owners' profits and, in the aggregate, positively affects the economy.<sup>134</sup> By stabilizing insured firms' budgets, on the other hand, the firms are in better positions to plan and account for future investments in profitable projects.<sup>135</sup>

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425 (3d ed. 2009) (defining "stabilization policy" as "the use of economic policies . . . to reduce fluctuations in real incomes, unemployment, inflation, or exchange rates"); ENCYCLOPEDIA OF BUSINESS, *supra* note 114, at 245.

<sup>128</sup> See Mark L. Cross et al., *Taxes, Stock Returns and Captive Insurance Subsidiaries*, 55 J. RISK & INS. 331 (1988) (finding that the stock market reacts favorably to a parent's formation of a captive, but that the tax deductibility of premiums paid to captives was the primary driver of the market's reaction); *Issues Paper*, *supra* note 3, at 11 (noting that "[c]aptives give increased financial strength and competitiveness to their parents").

<sup>129</sup> See *Issues Paper*, *supra* note 3, at 11 (arguing that "captives can also provide economic benefits in the parent's country of domicile").

<sup>130</sup> See STEWART, *supra* note 38, at 8.

<sup>131</sup> See ENCYCLOPEDIA OF BUSINESS, *supra* note 114, at 245.

<sup>132</sup> See STEWART, *supra* note 38, at 5–12; SIERK, *supra* note 20, at 26.

<sup>133</sup> See SIERK, *supra* note 20, at 26.

<sup>134</sup> See Landefeld et al., *supra* note 126, at 197 (using owners' profits as an input for GDP).

<sup>135</sup> See *Issues Paper*, *supra* note 3, at 13.

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This increased certainty will tend to increase capital expenditures in the long term.<sup>136</sup> This will improve the firms' competitive positions and, thus, it improves future performance.<sup>137</sup>

The operational benefits enjoyed by firms utilizing § 831(b) captives make these firms more profitable and financially stable.<sup>138</sup> These microeconomic benefits undoubtedly bleed into the macro economy and benefit it as a whole.<sup>139</sup> Therefore, the § 831(b) captive industry is beneficial to the overall economy, all else equal.

## 2. *The Positive Economic Effects of the Altered Incentive Structure Associated with § 831(b) Captives*

As stated above, firms utilizing § 831(b) captives face an altered incentive structure incentivizing the following behavior: (1) increasing the allocation of capital and managerial attention toward risk-financing; (2) shifting risk from insured firms' balance sheets to fully-capitalized captives; and (3) distributing risk among many firms. These benefits make firms utilizing § 831(b) captives more financially stable, which, in turn, benefits the economy as a whole.<sup>140</sup>

First, utilizing § 831(b) captives incentivizes firms to increase their allocation of capital toward risk-financing purposes, i.e., to increase their savings.<sup>141</sup> Captives' reserves operate as financial buffers guarding against economic turmoil.<sup>142</sup> With these financial buffers in place, the probability is reduced that insured firms will experience negative cash flow shocks capable of causing downsizing or bankruptcy.<sup>143</sup> The firms have a war chest, so to speak, that can operate as a first line of defense in times of financial distress.<sup>144</sup>

The corollary to an increased allocation of funds toward risk-financing purposes is an increased allocation of managerial attention toward risk-financing purposes.<sup>145</sup> This is arguably just as important. Additional attention should lead to superior, quicker decision making at the firm level.

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<sup>136</sup> See SIERK, *supra* note 20, at 29.

<sup>137</sup> See ENCYCLOPEDIA OF BUSINESS, *supra* note 114, at 245; J. Bradford DeLong & Lawrence H. Summers, *Equipment Investment and Economic Growth*, 39 Q. J. ECON. 477, 479 (finding that investments in equipment, a form of capital investment, "accounts for a substantial part of the variation in rates of growth").

<sup>138</sup> See Cross et al., *supra* note 128, at 335.

<sup>139</sup> See *Issues Paper*, *supra* note 3, at 11.

<sup>140</sup> See *id.*

<sup>141</sup> See *id.*

<sup>142</sup> See *id.*

<sup>143</sup> See ENCYCLOPEDIA OF BUSINESS, *supra* note 114, at 245.

<sup>144</sup> See *id.*

<sup>145</sup> See *Issues Paper*, *supra* note 3, at 12, 14.

(continued)

Presumably, this minimizes the chance of risks materializing in the first place or, if they do materialize, minimizes the inability to deal with the repercussions. This further reduces the probability of negative cash flow shocks capable of causing downsizing or bankruptcy.<sup>146</sup>

Risk shifting operates as a safety measure ensuring that insured firms allocate sufficient funds—i.e., save enough—for risk-financing purposes.<sup>147</sup> Thus, the element of risk shifting ensures that real economic benefits are derived from utilizing § 831(b) captives. Furthermore, risk distribution allows § 831(b) captives' corporate families to smooth their cash flows by enjoying the benefits associated with the law of large numbers.<sup>148</sup> This increases their financial stability by reducing the likelihood of experiencing negative cash flow shocks and, thus, reduces the likelihood of downsizing or bankruptcy.<sup>149</sup>

The benefits derived from the altered incentive structure makes firms utilizing § 831(b) captives more financially stable.<sup>150</sup> These microeconomic benefits bleed into the macro economy and benefit it as a whole.<sup>151</sup> This means that the § 831(b) captive industry benefits the U.S. economy, all else equal.

### 3. *The Potentially Negative Economic Effects Associated with § 831(b) Captives*

But all is not equal. Many of the benefits of § 831(b) captives have offsetting effects.<sup>152</sup> First, there is the obvious reduction in tax revenue associated with § 831(b) captives. Second, imposing incentives that distort capital allocation decisions can lead to serious consequences and can negatively affect economic growth.<sup>153</sup> Therefore, concluding that the

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<sup>146</sup> See ENCYCLOPEDIA OF BUSINESS, *supra* note 114, at 245.

<sup>147</sup> See *Issues Paper*, *supra* note 3, at 11.

<sup>148</sup> See Rev. Rul. 2002-89, 2002-52 I.R.B. 984.

<sup>149</sup> See ENCYCLOPEDIA OF BUSINESS, *supra* note 114, at 245.

<sup>150</sup> See *Issues Paper*, *supra* note 3, at 11.

<sup>151</sup> See *id.*

<sup>152</sup> See *id.* at 6.

<sup>153</sup> See, e.g., Charles I. Jones, *Misallocation, Economic Growth, and Input-Output Economics*, presentation at the 10th World Congress of the Econometric Society in Shanghai, China (July 28, 2010), <http://web.stanford.edu/~chadj/shanghai050.pdf>.

Given an economy's stock of physical capital, labor, human capital, and knowledge, the way in which those aggregate quantities of inputs are allocated across firms and industries—and even potentially within firms—determines the economy's overall level of production. The best allocation will maximize welfare and . . . output itself in the long run.

*Id.*

(continued)

§ 831(b) captive industry benefits the economy is premature unless the preceding benefits outweigh the offsetting costs.

First, there are the tax consequences of the § 831(b) captive industry. Senate Bill 905 estimates that increasing the § 831(b) election's threshold to \$2.2 million while including no restrictive provisions would reduce tax revenues by an aggregate amount of \$167 million between 2015 and 2025.<sup>154</sup> The changes actually made to § 831(b) in late 2015 include a restriction that, in essence, reduces the attractiveness of the § 831(b) election for captives being used for estate planning purposes.<sup>155</sup> Ignoring this offsetting factor, it will be assumed that the § 831(b) captive industry reduces tax revenues by \$167 million, which would result in a reduction in economic growth, all else equal.<sup>156</sup>

Again, all is not equal. The reduction in tax revenue would reduce spending or increase borrowing by the government, and that would reduce gross domestic product (GDP). However, the taxpayers—i.e., firms utilizing § 831(b) captives—would not put the saved funds under their mattresses. They would spend or invest the funds, which will be discussed below in greater detail. It is clear, however, that the economic effect of lost tax revenue would be far less than \$167 million, and it may even be positive.<sup>157</sup>

Artificially incentivizing the allocation of capital to a particular purpose may also negatively affect economic growth, because doing so may reduce the capital allocated to more economically productive purposes.<sup>158</sup> However, incentivizing savings is not as damaging to long-run output as

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<sup>154</sup> S. 905, 114th Cong. (2015).

<sup>155</sup> See Consolidated Appropriations Act of 2016, Pub. L. No. 114-113, § 423, 129 Stat. 3123, 3123–24 (2015) (requiring “no more than 20 percent of net written premiums . . . of such company for the taxable year [be] attributable to any one policyholder”).

<sup>156</sup> J. Steven Landefeld et al., *supra* note 126, at 197 (using tax revenues less subsidies as an input for GDP calculations).

<sup>157</sup> Christina D. Romer & David H. Romer, *The Macroeconomic Effect of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks*, NBER Working Paper 13264 (2007), <http://www.nber.org/papers/w13264.pdf> (finding that “exogenous tax increases have a large, rapid, and highly statistically significant negative effect on output”).

<sup>158</sup> See Charles I. Jones, *Misallocation, Economic Growth, and Input-Output Economics* 2 (10th World Cong. of the Econ. Soc’y in Shanghai, China, Preliminary Paper July 28, 2010), <http://web.stanford.edu/~chadj/shanghai050.pdf>. “Given an economy’s stock of physical capital, labor, human capital, and knowledge, the way in which those aggregate quantities of inputs are allocated across firms and industries—and even potentially within firms—determines the economy’s overall level of production.” *Id.* “The best allocation will maximize welfare and . . . output itself in the long run.” *Id.* Assuming profit maximizing firms are the most efficient allocators of capital, government incentives created by the Tax Code that alter the allocation of capital should move the economy further away from the “best allocation” and will reduce output over the long run as a result.

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incentivizing consumption.<sup>159</sup> Incentivizing savings will, at most, reduce the amount of funds invested in the *insured firms*' operations.<sup>160</sup> The majority of "saved" funds will flow through financial intermediaries to other economic actors that demand more capital than they have available.<sup>161</sup> Thus, incentivizing the allocation of funds toward risk-financing purposes will at most reduce the funds invested in the *insured's* operations. It does not keep the funds from being productively employed in the economy or force the funds into uneconomical projects.<sup>162</sup> Consequently, the distorting effect of § 831(b) is not terribly worrisome.

Moreover, firms utilizing § 831(b) captives actually have *more* funds to reinvest in their operations over the long term.<sup>163</sup> Recall that the hypothetical firm mentioned above<sup>164</sup> retained an additional \$3,000 by insuring the \$10,000 of self-insured risk with the captive when the insured risk did not materialize.<sup>165</sup> Although a tax is levied on the dividend when the funds are paid out to the captive's parent,<sup>166</sup> the captive's parent still has the majority of the \$3,000 for reinvestment in the firm's operations. In essence, the government "subsidizes" the corporate family by \$3,000 less the dividend tax.<sup>167</sup>

Therefore, the § 831(b) election reduces tax revenue, which may or may not negatively affect the economy; it also distorts capital allocation

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<sup>159</sup> See *id.*

<sup>160</sup> See *id.*

<sup>161</sup> See Murray N. Rothbard, *Fractional Reserve Banking*, FREEMAN 624, 624 (Oct. 1995), <http://www.unz.org/Pub/Freeman-1995oct-00624?View=PDF>. Rothbard explains in a rudimentary fashion:

[I]f I buy a \$10,000 CD . . . redeemable in six months, earning a certain fixed interest return, I am taking my savings and lending it to a bank, which in turn lends it out at a higher interest rate, the differential being the bank's earnings for the function of channeling savings into the hands of credit-worthy or productive borrower.

*Id.*

<sup>162</sup> But see RICHARD C. KOO, *THE ESCAPE FROM BALANCE SHEET RECESSION AND THE QE TRAP 16* (Wiley 2015) (arguing that this condition does not hold when all firms increase savings, or, in Richard Koo's words, the economy suffers from "fallacy-of-composition problems," while the government is simultaneously unwilling to sufficiently borrow to offset the "leakage from the economy's income stream" created by the lack of private sector borrowing).

<sup>163</sup> See 26 U.S.C. § 831(b) (2012).

<sup>164</sup> See *supra* Part II.B.1.a.

<sup>165</sup> See Rothbard, *supra* note 161, at 624.

<sup>166</sup> See 26 U.S.C. § 301(c)(1) (2012); but see 26 U.S.C. § 243(a)–(b) (allowing a 70% deduction for a dividend received by a corporation—e.g., the captive's parent—from another corporation—e.g., the captive).

<sup>167</sup> See Rothbard, *supra* note 161.

(continued)

decisions, which simply postpones investment in the insureds' operations. This may negatively affect the economy,<sup>168</sup> but it certainly increases economic stability by increasing the operational efficiencies and financial stability of firms. Thus, one must conclude that the § 831(b) captive industry benefits the economy as a whole.

### III. POLICYMAKERS' STANCE TOWARD THE § 831(B) CAPTIVE INDUSTRY: IS IT WARRANTED?

With an understanding of the § 831(b) captive industry and the benefits derived therefrom, policymakers' stance toward the industry can be fairly judged.

#### A. *Policymakers' Stance Today (and Some Historical Context)*

The IRS has taken an adversarial stance toward captive insurance since its inception.<sup>169</sup> The IRS long maintained that captive insurance was not "insurance" at all.<sup>170</sup> To be considered insurance, the law requires: (1) insurance risk; (2) risk shifting; and (3) risk distribution.<sup>171</sup> The IRS's argument was initially based on the "economic family" doctrine,<sup>172</sup> which essentially claimed that "the parent company of a corporate group was so in control of the intra-corporate payments that any payment between companies was essentially moot."<sup>173</sup>

After its argument repeatedly failed in court, however, the IRS's hardline stance began to fade.<sup>174</sup> In one revenue ruling, the IRS explicitly abandoned its "economic family theory" in light of the fact that "[n]o court . . . ha[d] fully accepted [the theory]."<sup>175</sup> From that point forward, the IRS analyzed captive insurance arrangements on a case-by-case basis.<sup>176</sup> The IRS further legitimized the captive industry by issuing a series of revenue rulings setting forth arrangements it would not challenge, which are

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<sup>168</sup> See Jones, *supra* note 158, at 2.

<sup>169</sup> See STEWART, *supra* note 38, at 69 (noting that "[t]he IRS spent approximately forty years . . . aggressively fighting captive insurance companies").

<sup>170</sup> Rev. Rul. 77-316, 1977-2 C.B. 53 (finding that insuring risk with a captive subsidiary that only insured the parent's risk did not constitute insurance and, thus, was not tax deductible under § 162).

<sup>171</sup> *Comm'r v. Le Gierse*, 312 U.S. 531, 539 (1941).

<sup>172</sup> See Rev. Rul. 77-316 (reasoning that "[b]ecause [premiums] remain within the economic family and under the practical control of the respective parent in each situation, there has been no amount 'paid or incurred'").

<sup>173</sup> See STEWART, *supra* note 38, at 72.

<sup>174</sup> See *Humana, Inc. v. Comm'r*, 881 F.2d 247, 257 (6th Cir. 1989) (stating that "[u]nder no circumstances do we adopt the economic family argument advanced by the government").

<sup>175</sup> Rev. Rul. 2001-31, 2001-1 C.B. 1348.

<sup>176</sup> See *id.*

(continued)

now known as the safe harbor rulings.<sup>177</sup> Today, the IRS regularly issues private letter rulings regarding the tax implications of particular captive arrangements proposed by interested parties.<sup>178</sup>

Yet, the IRS's dislike of captives continues, especially with respect to § 831(b) captives.<sup>179</sup> The IRS included § 831(b) captives in its "Dirty Dozen" list of popular tax abuses in 2015 alongside phishing, identity theft, and fake charities.<sup>180</sup> The IRS has also been aggressively auditing captive managers and promoters that focus on § 831(b) captives.<sup>181</sup>

More importantly, Congress joined the fray in 2015.<sup>182</sup> The Joint Committee on Taxation's original proposal would have landed a punishing blow to the § 831(b) captive industry.<sup>183</sup> First, the original proposal would have restricted the use of the § 831(b) election to insurance companies with "no more than 20 percent of [their] net written premiums . . . attributable to [related parties]."<sup>184</sup> This was "intended to narrow the application of [§] 831(b),"<sup>185</sup> and, had it passed, it would have undoubtedly succeeded. Current precedent requires that § 831(b) captives derive at least 50% of their risk from unrelated parties to be considered insurance under the Tax Code.<sup>186</sup> The original proposal would have increased that threshold to 80%.<sup>187</sup> Doing so would have reduced the attractiveness of the § 831(b) election by increasing the amount of unrelated risk a corporate family would have been required to place within its § 831(b) captive.<sup>188</sup>

The original proposal also threatened to prohibit § 831(b) captives from "assum[ing] . . . risks through reinsurance."<sup>189</sup> If the related party restriction would have landed a punishing blow to the § 831(b) captive industry, this restriction would have been damning.<sup>190</sup> As mentioned earlier, the majority

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<sup>177</sup> See Rev. Rul. 2002-89, 2002-2 C.B. 985 (accepting a captive arrangement where at least 50% of the captive's risk is derived from unrelated parties), Rev. Rul. 2002-90, 2002-2 C.B. 986 (accepting a captive arrangement where the captive insured at least twelve affiliates and no affiliate's risk comprised more than 15% of the captive's overall risk portfolio); Rev. Rul. 2002-91, 2002-2 C.B. 992 (arguably reducing the number of affiliates to seven).

<sup>178</sup> See, e.g., Priv. Ltr. Rul. 200724036 (June 15, 2007).

<sup>179</sup> See "Dirty Dozen" List, *supra* note 30.

<sup>180</sup> *Id.*

<sup>181</sup> See MacIvor et al., *supra* note 30.

<sup>182</sup> See S. 905, 114th Cong. (2015); 129 Stat. 2242 et seq. (2015).

<sup>183</sup> See JOINT COMM. ON TAX'N, *supra* note 32, at 2.

<sup>184</sup> See *id.*

<sup>185</sup> See *id.*

<sup>186</sup> See Rev. Rul. 2002-89, 2002-2 C.B. 985.

<sup>187</sup> See JOINT COMM. ON TAX'N, *supra* note 32, at 2.

<sup>188</sup> See *id.*

<sup>189</sup> See *id.*

<sup>190</sup> See *id.*

(continued)

of § 831(b) captives cede risk to and accept risk from reinsurance pools to obtain the required level of risk distribution.<sup>191</sup> This restriction would have prohibited § 831(b) captives from participating in these reinsurance pools, and, as a result, would have severely limited the ability of § 831(b) captives to satisfy the IRS's definition of insurance.<sup>192</sup>

By the time the proposal was introduced as Senate Bill 905 by Senator Orrin Hatch on April 14, 2015, however, both restrictive provisions had been eliminated.<sup>193</sup> All that remained from the original proposal was the increase of the § 831(b) election's net premium threshold from \$1.2 million to \$2.2 million, with the threshold indexed to increase with inflation.<sup>194</sup> Senate Bill 905 did include a provision requiring the Secretary of the Treasury to "report on the abuse of captive insurance companies for estate planning purposes . . . [and] include legislative recommendations for addressing any such abuses."<sup>195</sup>

On December 18, 2015, a final change was settled on. Congress amended § 831(b) in what must be described as a compromise.<sup>196</sup> On one hand, the net premium threshold was increased from \$1.2 million to \$2.2 million and indexed to inflation.<sup>197</sup> On the other hand, the attractiveness of using § 831(b) captives for estate planning purposes was curtailed.<sup>198</sup>

Although there has yet to be an official interpretation of the newly-minted restriction, the language is fairly clear. In essence, it is business as usual if the familial ownership of the captive does not materially differ from the ownership of the insured firm or firms.<sup>199</sup> However, if the familial ownership of the captive does differ materially from the ownership of the insured firms, then "no more than 20 percent of the net written premiums . . . of [the captive] for the taxable year [can be] attributable to [related parties]."<sup>200</sup>

The purpose of this change is clear. Policymakers reduced the attractiveness of the § 831(b) election for captives being used for estate planning purposes and increased its attractiveness for captives not being

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<sup>191</sup> See Landis, *supra* note 105, at 2.

<sup>192</sup> See JOINT COMM. ON TAX'N, note 32, at 2.

<sup>193</sup> See S. 905, 114th Cong. (2015).

<sup>194</sup> See *id.*

<sup>195</sup> *Id.* (requiring the report to be submitted to the Senate Committee on Finance by February 11, 2016).

<sup>196</sup> Consolidated Appropriations Act of 2016, Pub. L. No. 114-113, § 423, 129 Stat. 3123, 3123-24 (2015).

<sup>197</sup> *Id.*

<sup>198</sup> *Id.*

<sup>199</sup> *Id.*

<sup>200</sup> *Id.*

(continued)

used for such purposes. Thus, Congress compromised by increasing the election's attractiveness for what they deem to be legitimate purposes—i.e., risk-financing—while curtailing its attractiveness for what they deem to be illegitimate purposes—i.e., estate planning.

*B. Is That Stance Warranted?*

As the record shows, policymakers and the § 831(b) captive industry have had a checkered past, but one thing is certain: policymakers' stance toward the industry has been hostile and continues to be so to this day. The IRS continues to publicly denounce what it perceives to be abuses.<sup>201</sup> Likewise, Congress considered proposals—e.g. the original proposal—that would have arguably killed the industry.<sup>202</sup> Although the original proposal's overly restrictive provisions were watered down to very reasonable restrictions, Congress's willingness to entertain it is telling.<sup>203</sup>

This is likely because the policy discussion has been notably one-sided. There has been almost no discussion of the economic benefits derived from the industry.<sup>204</sup> Policymakers have instead limited the discussion to the industry's negatives, i.e., perceived tax abuses.<sup>205</sup> The discussion should be broadened so as to encompass the entire picture. Otherwise, additional measures that unfairly harm a unique and burgeoning industry may be adopted based on a limited understanding.

IV. MISSION ACCOMPLISHED? HAVE POLICYMAKERS AND THE  
§ 831(B) INDUSTRY RESOLVED THEIR DIFFERENCES?

The measures adopted in December, 2015, appear to be aimed at incentivizing beneficial captive formation while curbing perceived abuses. The compromise should appease both sides of the debate, policymakers and industry participants alike. Only time will tell whether this will mark a turning point in the relationship between the industry and policymakers.

Nevertheless, some additional steps could be taken to improve the relationship, and they will be discussed in Parts IV.A–B below. Conversely, there is a looming issue that may derail improvements made in the relationship between policymakers and the § 831(b) captive industry: terrorism insurance. Understanding this potential battleground before the fight takes place is important, and that will be addressed in Part IV.C below.

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<sup>201</sup> See *IRS Completes the "Dirty Dozen" Tax Scams for 2015*, IR-2015-26 (Feb. 9, 2015), <https://www.irs.gov/uac/newsroom/irs-completes-the-dirty-dozen-tax-scams-for-2015>.

<sup>202</sup> See JOINT COMM. ON TAX'N, *supra* note 32, at 2.

<sup>203</sup> See S. 905, 114th Cong. (2015).

<sup>204</sup> See *id.*

<sup>205</sup> See *id.*

A. *A Comprehensive, Unbiased Study*

There is a need for a comprehensive, unbiased study with the aim of quantifying the economic benefits and costs associated with the § 831(b) captive industry in light of the changes made to § 831(b) in December, 2015. This would be no small task, but it is possible. The IRS has the data necessary to determine the amount of captives taking the § 831(b) election,<sup>206</sup> and the IRS could easily estimate the additional lost tax revenue associated with more captives taking the election now that the net premium limit has increased to \$2.2 million.<sup>207</sup> The study should also attempt to quantify the economic benefits associated with the § 831(b) captive industry.

Only with the findings of such a study could a concrete conclusion be drawn as to the economic effect of the § 831(b) captive industry. This would provide a solid foundation for a balanced discussion. Until then, policymakers and commentators alike are left to speculation.

B. *Aligning Policy with Rhetoric*

The recent attacks by the IRS and Congress's willingness to entertain measures that threaten the industry's very existence have presented firms with a conundrum.<sup>208</sup> Policymakers have further incentivized captive formation by increasing the § 831(b) election's net premium limit to \$2.2 million while publicly denouncing those that have taken advantage of the election in the past.<sup>209</sup> This enters firms' calculus and, it can be assumed, affects captive formation at the margin. If the § 831(b) captive industry benefits the economy as argued in Part II.C, this is a harmful game policymakers are playing.<sup>210</sup> Accordingly, policymakers should stifle their rhetoric and allow their policies to affect captive formation.

C. *Understanding the Next Potential Battleground: Terrorism Insurance*

Absent from the Senate's report regarding Senate Bill 905 is any mention of insuring terrorism risk under the Terrorism Risk Insurance Program (TRIP) within a § 831(b) captive.<sup>211</sup> Yet, many commentators are

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<sup>206</sup> See IRS, *Tax Statistics*, <https://www.irs.gov/uac/Tax-Stats-2> (last visited Apr. 23, 2016).

<sup>207</sup> See Tom Cifelli, *831 B Captive Insurance Company Tax and Financial Planning Primer* (Mar. 23, 2012), [http://captiveexperts.com/uploads/831\\_b\\_\\_Captive\\_Insurance\\_Company\\_Benefits\\_-\\_Tax\\_and\\_Financial\\_Planning\\_Primer\\_-\\_Thomas\\_Cifelli.pdf](http://captiveexperts.com/uploads/831_b__Captive_Insurance_Company_Benefits_-_Tax_and_Financial_Planning_Primer_-_Thomas_Cifelli.pdf).

<sup>208</sup> See Jay Adkisson, *Tax Shelters, Nebraska Hurricanes and Other Captive Insurance Mistakes*, *FORBES* 1, 5 (July 28, 2013), <http://www.forbes.com/sites/jayadkisson/2013/07/28/captive-insurance-companies-10-pet-peeves>.

<sup>209</sup> See *id.*

<sup>210</sup> See *supra* Part II.C.

<sup>211</sup> See S. REP. NO. 114-16, at 2 (2015).

(continued)

calling foul.<sup>212</sup> For example, Beckett G. Cantley and F. Hale Stewart assert in their article, *Current Tax Issues with Captive Insurance Companies*, that “[t]he concern [with terrorism coverage] arises here because so few businesses may actually have the need for insuring against a terrorist act, making this coverage appear to be too remote to be justified for most insureds.”<sup>213</sup> Likewise, Jay Adkisson states in his article, *Tax Shelters, Nebraska Hurricanes and Other Captive Insurance Mistakes*, the following: “[A] big problem is that [some captive] policies reflect the underwriting of longshot risks. Like, really longshot, as in 10,000,000,000 to 1 an-asteroid-is-likely-to-hit-the-Earth-first longshots. Think, hurricane insurance for a business whose operations are in Lincoln, Nebraska, or terrorism insurance for a business in Little Rock, Arkansas.”<sup>214</sup>

These commentators are correct in their assertions that terrorism risk is “remote,” but to end the analysis there is to look at only one side of the coin. The magnitude of the potential losses—the other side of the coin—is enormous.<sup>215</sup> In fact, the potential losses are so large that the federal government was prompted to enter the reinsurance market with the passage of the Terrorism Risk Insurance Act of 2002 (TRIA),<sup>216</sup> which has repeatedly been reauthorized.<sup>217</sup> Within the Congressional findings of TRIA, it was noted that “the ability of the insurance industry to cover the *unprecedented financial risks* presented by potential acts of terrorism in the United States can be a major factor in the recovery from terrorist attacks, while maintaining the stability of the economy.”<sup>218</sup> Moreover, Congress found that property and casualty insurance companies dealt with the statistical uncertainties of terrorist attacks following 9/11 “either by terminating property and casualty coverage for losses arising from terrorist

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<sup>212</sup> See Sullivan, *supra* note 30; Beckett G. Cantley & F. Hale Stewart, *Current Tax Issues with Captive Insurance Companies*, BUS. L. TODAY 1, 4 (February 2015), [http://www.americanbar.org/publications/blt/2014/02/02\\_cantley.html](http://www.americanbar.org/publications/blt/2014/02/02_cantley.html); Adkisson, *supra* note 208, at 5.

<sup>213</sup> Cantley & Stewart, *supra* note 212, at 4.

<sup>214</sup> Adkisson, *supra* note 208, at 5.

<sup>215</sup> See *Terrorism and Insurance: 13 Years After 9/11 the Threat of Terrorist Attack Remains Real*, INS. INFO. INST. (Sept. 9, 2014) (stating that the insured property losses arising from the 9/11 terrorist attacks were about \$32.5 billion in 2001 dollars).

<sup>216</sup> See generally Terrorism Risk Insurance Act of 2002, Pub. L. 107-297, 116 Stat. 2322, 2322 (2002).

<sup>217</sup> See *id.*; Terrorism Risk Insurance Extension Act of 2005, Pub. L. 109-144, 119 Stat. 2660, 2660 (2005); Terrorism Risk Insurance Program Reauthorization Act of 2007, Pub. L. 110-160, 121 Stat. 1839, 1839 (2007); Terrorism Risk Insurance Program Reauthorization Act of 2015, Pub. L. 114-1, 129 Stat. 3, 3 (2015).

<sup>218</sup> Terrorism Risk Insurance Act of 2002, Pub. L. 107-297, 116 Stat. 2322, 2323 (2002) (emphasis added).

(continued)

events, or by *radically escalating premium coverage to compensate for risks of loss that are not readily predictable*.”<sup>219</sup>

Thus, TRIA evidences the very real risks faced by U.S. firms from potential terrorist attacks on U.S. soil, and TRIP was established in an attempt to counter these risks. TRIA also evidences the discretion associated with pricing terrorism coverage. If even the largest players in the commercial insurance industry “radically escalat[ed] premium coverage to compensate for risks of loss that [were] not readily predictable,” their much smaller counterparts—e.g., § 831(b) captives—are certainly justified in doing so.<sup>220</sup> In other words, it is very difficult to determine *ex ante* whether terrorism risk is overpriced or unwarranted. For example, the tragic shootings recently in San Bernardino, California, and Orlando, Florida, suggest that a terrorist attack on a firm in Little Rock, Arkansas, may not be “an-asteroid-is-likely-to-hit-the-Earth-first longshot[.]” after all.<sup>221</sup> Accordingly, commentators should not be so quick to judge the § 831(b) captive industry’s practices, and they and policymakers should recognize the difficulty in pricing terrorism insurance.

That is not to say that there are no abuses of terrorism insurance within the § 831(b) captive industry. Addressing this issue does not need more policy measures, however. Jurisprudence is already in place to appropriately address the issue of inflated premiums.<sup>222</sup> Section 162 provides, “There shall be allowed as a deduction all the *ordinary and necessary* expenses paid or incurred during the taxable year in carrying on any trade or business.”<sup>223</sup> This phrase generally operates so as to prohibit the deductibility of expenditures that are not “appropriate and helpful”<sup>224</sup> or that lack “a strain of constancy”<sup>225</sup> rendering them “normal, usual, or customary”<sup>226</sup> within the

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<sup>219</sup> *Id.* (emphasis added).

<sup>220</sup> BOOKMARK EDUCATION, INSURING COMMERCIAL RISKS CONTINUING EDUCATION FOR CALIFORNIA INSURANCE PROFESSIONALS 57 (2006), <https://www.bookmarkededucation.com/Documents/CA/California%20CE%20-%20Insuring%20Commercial%20Risks.pdf>.

<sup>221</sup> See Adkisson, *supra* note 208, at 5; Michael S. Schmidt & Richard Pérez-Peña, *F.B.I. Treating San Bernardino Attack as Terrorism Case*, N.Y. TIMES (Dec. 4, 2015), <http://www.nytimes.com/2015/12/05/us/tashfeen-malik-islamic-state.html>; Joe Mozingo, Matt Pearce & Tracy Wilkinson, ‘An Act of Terror and an Act of Hate’: The Aftermath of America’s Worst Mass Shooting, L.A. TIMES (June 13, 2016), <http://www.latimes.com/nation/nationnow/la-na-orlando-nightclub-shooting-20160612-snap-story.html>.

<sup>222</sup> See, e.g., 26 U.S.C. § 162(a) (2012).

<sup>223</sup> See *id.* (emphasis added).

<sup>224</sup> *Welch v. Helvering*, 290 U.S. 111, 113 (1933) (citing *McCulloch v. Maryland*, 17 U.S. 316, 325 (1819)).

<sup>225</sup> *Id.*

<sup>226</sup> *Deputy v. du Pont*, 308 U.S. 488, 495 (1940).

(continued)

context of a particular business's operations.<sup>227</sup> Furthermore, deductions cannot be taken under § 162 if a court finds that a transaction was not for "a bona fide business purpose" or was "for purposes of tax avoidance."<sup>228</sup>

Thus, the IRS has the legal means to curtail abuses of inflated terrorism insurance premiums. If the transaction does not meet the requirements of § 162, the IRS can ignore it and tax the offending firm accordingly.<sup>229</sup> Although it would be administratively impossible for the IRS to bring suits against all parties that are inflating premiums for terrorism coverage, abuses could be curbed with a clear interpretation of how existing precedent applies to terrorism coverage. Obviously, pricing would differ based on factors such as geography and the nature of the business in question,<sup>230</sup> but intelligent guidance regarding acceptable actuarial pricing processes is achievable. This would give firms and advisors a clear understanding of how terrorism insurance should be priced in the IRS's eyes. Regardless, clarification is all that is needed to avoid another drawn-out fight in the legislative trenches.

## V. CONCLUSION

Policymakers' stance toward the § 831(b) captive industry should be favorable rather than hostile in recognizing that the industry benefits the economy rather than hurts it. The recent changes to the § 831(b) election strike a reasonable balance between the interests of taxpayers and industry participants. Still, a study should be conducted to analyze and quantify the net benefit the industry has on the economy to frame future discussions. Furthermore, policymakers should better align their rhetoric with their policies to avoid sending mixed signals. Lastly, if another battle should break out in the § 831(b) industry, it will likely regard terrorism insurance. That discussion should be balanced from the onset rather than focused exclusively on the negative. With that, the relationship between policymakers and the § 831(b) captive industry may finally be cordial.

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<sup>227</sup> See *id.* (stating that "the transaction which gives rise to [the expense] must be of common or frequent occurrence *in the type of business involved*" (emphasis added)).

<sup>228</sup> *Id.* at 493.

<sup>229</sup> See 26 U.S.C. § 162(b) (2012); See Taxpayer Advocate Service, *Trade or Business Expenses Under IRC § 162 and Related Sections*, 1 ANN. REP. CONG. 347, 349 (2013), <http://www.taxpayeradvocate.irs.gov/2013-Annual-Report/downloads/Trade-or-Business-Expenses-Under-IRC-162-a-and-Related-Code-Sections.pdf>.

<sup>230</sup> Brian Bollen, *Tide of Cheap Capital Lowers Cost of Terrorism Insurance*, FIN. TIMES (Sept. 28, 2014), <http://www.ft.com/intl/cms/s/0/ae8241f4-2f65-11e4-83e4-00144feabdc0.html#axzz455EcxjqM>.



