Notes from the Trenches[1]
Bad Facts Result in Another IRS Captive Win – the Caylor Case
By
Michael E. Lloyd, Esq.

On March 10, 2021, the Tax Court filed its opinion in the case *Caylor Land Development, Inc. v. Commissioner*.[2] The case is another example of the IRS picking low hanging fruit to build its undefeated record in the micro-captive litigation arena.

Here are the top 5 lessons that can be learned from the bad facts of this case.

1. Get Competent Tax/Insurance Advice. If you are considering a captive, you should engage both tax and insurance professionals to advise you on the deductibility of premiums paid to the captive. Importantly, it is not enough that your CPA is willing to follow your direction to take the deduction. It is also not enough if your tax professional claims that captives can be compliant but expresses no opinion about this captive. Instead, engage a tax professional who has knowledge and experience about captives to review your captive and give it a blessing. You also want your own insurance professional to review the coverages and premiums and determine that the coverages are necessary, not duplicative, and the premiums are reasonable. In this case, the Taxpayer's CPA and Tax Lawyer were not knowledgeable of captives and offered only a weak conclusion that captives can be compliant.

2. Your Insurance Needs are the Driver. A consideration of a captive insurance company should begin and end with the business need for insurance that is currently either not covered or covered at a price that is too expensive. Also, you should have a detailed history of losses that were not covered by commercial insurance and any additional identified risks that are currently not being covered by commercial insurance with reasoning why that risk is worthy of coverage. In this case, the Court found that the Taxpayer started with the deduction and it just happened to be the largest deduction allowed under the statute.[3]

3. Risk Distribution is Key. You need to demonstrate a distribution of risk among many insured. For this, consider the number of independent risk exposures. If you are using subsidiaries to a main business, make sure to count not only the total number of related insureds, but also the independent risk exposures.[4] Although not an issue in this case, if your plan is to meet risk distribution by a risk pool recommended by the captive manager, special scrutiny should be made in determining that the risk pool itself is

[1] Michael Lloyd is an attorney who advises business owners on captive insurance programs. Mike conducts Pre-IRS Audits, and has represented captive business owners under IRS audit in Exam, Appeals and Tax Court. Mike has settled cases under the first and second settlement initiatives and is also assisting taxpayers who want to make a response to the recent IRS Warning Letter. Mike also has prepared more than 1,000 IRS Forms 8886.
[2] T.C. Memo 2021-30.
[3] At that time $1,200,000.
[4] It is clear now that it is not acceptable to simply identify 12 separate subsidiaries and be comforted that this is a safe harbor on risk distribution under *Harper v. Commissioner*.

providing real insurance.[5] In this case, there was one main business with several subsidiaries that did little or no independent business. Although there were twelve different policies, the number of independent risk exposures fell well short.

4. Watch out for Business Inconsistencies. Your captive should operate just like commercial insurance in most ways. Here are a number of inconsistencies that the Court used to conclude that the Taxpayer's captive was not providing "insurance".

- The Taxpayer paid and deducted premiums for a claims made policy for a year when the policy was not even issued until the next year.
- The Taxpayer's premiums never decreased even though the Taxpayer had few claims.
- The Taxpayer never changed its policies or negotiated its premiums even though it had few claims.
- The Taxpayer's commercial policies and premium costs stayed the same after the captive even though the captive should have been insuring some risks that were previously covered by commercial insurance.
- The Taxpayer never consulted with its commercial insurance professional to determine whether the risks could be covered by commercial insurance or whether the commercial coverage was duplicative.
- The Taxpayer did not provide requested claims information to the captive manager after filing a claim, but instead demanded that the claim be paid.

5. Pay for Good Underwriting. One of the keys to all of these micro-captive cases is the underwriting of risks. Don't purchase off-the-shelf policies that have little connection to your actual risks, and make sure that your loss history and risks are considered completely in the determination of policies and premiums. This should be a long process and should also involve a cost comparison of commercial coverage. Further, it is an annual process with new consideration every year. If no claims have been made under a policy, consider whether the policy is still needed, and if so whether the premium should be reduced. In this case, the Taxpayer took the maximum allowed deduction every year (never a good idea) and underwriting was sparse.[6]

If you are under an IRS audit and need representation or you have questions about your captive, call Mike Lloyd at (412) 454-025 or email him at mlloyd@williamscoulson.com.

[5] Note that the Tax Court has yet to find a valid risk pool in a micro-captive case. In each of the cases considering a risk pool, the Tax Court found that the pool itself did not provide insurance and thus the risk distribution requirement is not met for all of the underlying captives that use the pool.

[6] In the Taxpayer's defense, the underwriter passed away before the trial and thus could not testify, but if the underwriting was done properly, the evidence would have been created at the time of the development of the policies.