<u>In the Crosshairs</u>

IRS Targets Captive Insurance Shelters

By: Brian J. Crepeau

Awesome, you have made it past the article title. Despite being an Attorney and CPA, reading technical tax articles makes me sleepy. Therefore, my focus here is to explain Captive Insurance and the related IRS enforcements in a non-Drowsy Nyquil sort of way.

A really smart tax professional (AKA, "tax dweeb") analyzes the tax code and comes up with an intricate scheme to avoid taxes. The scheme is likely legitimate, as to how the tax code literally reads. However, the tax code is written by Congress and the intent and/or interpretation of the tax code is often uncertain. After the aforementioned tax dweeb devises the scheme to avoid tax, people less smart, but much more sociable, take over the process and market and/or implement the tax scheme for profit. These people are called Promoters. The Promoters meet with very wealthy taxpayers and significant tax is avoided. The IRS and the Department of Justice eventually catch on and attempt to stop the tax avoidance schemes. For example, the IRS publishes a list of schemes, called the "Dirty Dozen" to notify the public of what arrangements the Service views as abusive. The 2015 "Dirty Dozen" list included Captives as an abusive tax shelter or tax avoidance scheme. So sad.

Okay, time to explain Captive Insurance. For over 60 years, large U.S. companies have formed wholly owned subsidiary captive insurance companies ("Captives"). Generally, these Captives are formed because of the difficulty in obtaining high risk insurance or a company may wish to have more control over its insurance or to save costs. From the 1950's to the early 2000's, the IRS litigated large captive insurance arrangements for a variety of reasons. The IRS has just about given up on its quest to invalidate the large Captive arrangements. You see, large companies have deep pockets, and can afford the attorneys and lobbyists (need I say more?).

Now, the IRS is targeting small or "micro" Captives. Here is how the IRS describes Captive Insurance in its "Dirty Dozen" release:

Captive Insurance

Another abuse involving a legitimate tax structure involves certain small or "micro" captive insurance companies. Tax law allows businesses to create "captive" insurance companies to enable those businesses to protect against certain risks. The insured claims deductions under the tax code for premiums paid for the insurance policies while the premiums end up with the captive insurance company owned by same owners of the insured or family members.

The captive insurance company, in turn, can elect under a separate section of the tax code to be taxed only on the investment income from the pool of premiums, excluding taxable income of up to $1.2 million per year in net written premiums.

In the abusive structure, unscrupulous promoters persuade closely held entities to participate in this scheme by assisting entities to create captive insurance companies onshore or offshore, drafting organizational documents and preparing initial filings to state insurance authorities and the IRS. The promoters assist with creating and "selling" to the entities often times poorly drafted "insurance" binders and policies to cover ordinary business risks or esoteric, implausible risks for exorbitant "premiums," while maintaining their economical commercial coverage with traditional insurers.

Total amounts of annual premiums often equal the amount of deductions business entities need to reduce income for the year; or, for a wealthy entity, total premiums amount to $1.2 million annually to take full advantage of the Code provision. Underwriting and actuarial substantiation for the insurance premiums paid are either missing or insufficient. The promoters manage the entities' captive insurance companies year after year for hefty fees, assisting taxpayers unsophisticated in insurance to continue the charade.

Whoa, a "charade." The IRS sure is dramatic. But it is quite clear that the IRS does not like these Captive Insurance structures. Let me explain how a successful structure has worked. I will use bullet points, for ease of reading:

- The owner of a successful chiropractic practice has net income of $1.3 million a year.
- The taxes the chiropractor pays cause much stress that leads to back and neck pain.
- Shockingly, chiropractic therapy does not work for the pain and he realizes that he needs to do whatever is necessary to control his tax bills or he will forever suffer with the back and neck pain.
- The chiropractor sets up a Captive through a reputable Promoter.
- He contributes $1.2 million (the maximum amount allowed without substantial justifications) into the Captive.
- An actuary reviews and signs off on the risk being insured.
- The risk being insured is that of a terrorist attack (yes, this is a risk that has been insured through at least one Captive).
- The chiropractor will be able to deduct the $1.2 million.
- The annual fee to maintain a Captive is about $50,000.
- Therefore, the chiropractor's $1.3 million of income is reduced by the $1.2 million deduction.
- The $50,000 annual fee is also a deduction.
- The chiropractor goes from an evil 1 percenter to the 47% that pay no income tax, as his taxable income is only $50,000.
- The chiropractor will be able to take a $1.2 million distribution from his Captive (assuming there is no terrorist attack) he will be taxed at the lower tax rate for qualified dividends.
- The chiropractor's stress and related back and neck pain all dissipate.
- All is happy in the chiropractor's world… until an IRS audit letter arrives.

Okay, how does this story end? Not sure. Some recent U.S. Tax Court cases have ended in favor of the taxpayer and some have not. What I can say for sure is that the IRS is targeting Captives and will likely issue a formal initiative or policy to not settle these cases with the taxpayer at the examination level.

So, if you are a wealthy business owner, have no issue with engaging in a legal dispute with the IRS, and would rather have a kidney stone than pay 40% of your income in Federal taxes, then you may be an ideal candidate for a Captive.

If you plan to create a Captive, you should meet with more than one Promoter of these plans with your eyes wide open and with professional skepticism. Remember, these Promoters earn substantial fees for a process they have completed hundreds of times. Also, have an outside tax attorney familiar with Captives review the tax structure.

If you already own a Captive, then you may want to have your plan reviewed by a tax attorney to assess potential issues and proactively attempt to modify or unwind. If you win the reverse jackpot and your Captive is selected for IRS examination, I strongly suggest you contact an experienced tax controversy attorney for representation. There could be an inherent conflict of interest with having the Promoter represent you as the Promoter may also be under investigation. Additionally, if the Captive is prohibited by the IRS, then you will have a large amount of tax, interest, and penalties to pay, but, for whatever it is worth, possibly a claim against the Promoter.

It's over. You can now check "reading a tax article in full" off your bucket list.

For any of your other tax controversy needs, please contact an attorney in our Tax Controversy & Litigation group:

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