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Captive Insurance on the IRS Dirty Dozen List: What Every CPA Needs to Know

BY **STEVEN MILLER**, Former IRS Acting Commissioner and alliantgroup National Director of Tax; and **JOHN DIES**, alliantgroup Managing Director of Tax Controversy.

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The use of captive insurance by U.S. companies to manage costs and risks and realize tax benefits has been a legitimate activity for years. However, the IRS has recently focused significant audit resources on small and mid-market companies that are forming small or “micro” captive insurance companies.

These companies seek to benefit from Section 831(b) of the tax code, which allows insurance companies with less than \$1.2 million in premiums to be taxed on their investment earnings rather than on their gross income. We are seeing first-hand while representing a number of small and medium companies with captive insurance companies in audit that the IRS is emptying the bench when it comes to this issue.

At its core, the IRS’s concern is that some of these small and mid-market companies forming captive insurance companies are not engaged in true insurance. In response, the IRS recently added captive insurance to **its annual “Dirty Dozen” list of tax scams for the 2015 filing season**. That is not a list you want to be on. Translated, this means that the IRS is taking a heavy, hard look at captive insurance companies and the managers of captive insurance companies.

The language from the IRS announcement is sobering:

“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 oftentimes 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.”

Coming from our work on numerous examinations in this area, we have seen the IRS repeatedly focus on several questions:

- Why was the captive created? How did the captive manager market to the captive owner?
- Do the premiums look managed to a tax outcome? That is, do annual premiums vary in tandem with the business's taxable income for the year, or conversely, do premiums hover at or near the \$1.2 million mark year in and year out?
- Were there any claims made against policies? And were there claims made against the risk pool that is often a part of the small captive setup?
- Do coverages appear warranted and do premiums appear correctly calculated? Do the premiums vary by reason of underwriting on an annual basis?
- Who owns the captive? Is it held in trust for the benefit of others or future generations?
- What kinds of investments are present? Has life insurance been purchased?

Note: The fact that the captive insurance company may have been blessed by the state insurance commissioner will get you easily halfway to a cup of coffee with the IRS.

It is important for CPAs to understand two things: 1) while the IRS may first contact your client in the context of a promoter audit—don't kid yourself—the bell tolls for your client as well. You need to treat the contact with the IRS with utmost seriousness, even if it's initially just a third-party contact. 2) Don't forget that even if your client is doing things properly, if the client is part of a larger risk pool of insured—and if one of the other members of that pool is not squared away—the entire pool is potentially in jeopardy, including your client.

CPAs and their clients should bear in mind that the stakes are high. If the IRS finds that the captive insurance company doesn't pass muster, it means losing not only the premium deduction, but also incurring a 20 percent penalty, along with interest. Moreover, the IRS is now also considering imposing economic substance penalties as well (the 20 percent goes to 40 percent).

The best practice we believe for CPA firms with clients with captive insurance companies is to have a review conducted to ensure that the captive is conforming to tax law requirements both in form and substance—and a deep look especially at the insurance provided and the overall insurance pool. Obviously, this is best done before the IRS comes knocking on the door. The risks of adverse IRS action can be managed if done proactively on a voluntary basis.

If your client is already hearing from the IRS, have your eyes open that this is a highly technical area of tax law and involves a detailed understanding and knowledge of insurance questions from a tax law perspective. The fact that captive insurance is on the "Dirty Dozen" list means you can anticipate a thorough audit that is closely managed by technicians and senior officials at the IRS.

Our success with clients has come from not only having a good understanding of the IRS's concerns and priorities, but also from what we have seen in a number of cases. In our experience, the key is knowing what

the IRS is willing to accept, when the IRS is willing to let the taxpayer correct and what it takes to resolve an examination.

CPAs play a vital role as the most trusted financial advisor for many small and medium companies. For CPAs with clients with captive insurance companies, now is the time to tell their client they are in deep waters—and help assist them in coming safely to shore.



Steven T. Miller is the National Director of Tax at alliantgroup. Prior to joining the firm, Steven spent the last 25 years with the IRS, where he held a number of diverse and increasingly important roles before rising to become the Acting Commissioner of the IRS in 2012. Prior to his commissionership of the entire Service, he was for several years the Deputy Commissioner for Services and Enforcement, leading all IRS enforcement and service activity. He also served as the Commissioner of the Large and Mid-Size Business Division, overseeing IRS audits of large taxpayers and IRS programs relating to offshore tax compliance and international tax law enforcement. As the Commissioner of the Tax Exempt and Government Entities Division, he supervised the IRS oversight of governments, tax exempt entities and retirement programs.



John Dies is Director of Tax Controversy at alliantgroup. As an experienced trial attorney and former partner in a litigation firm, he has represented hundreds of clients and tried cases to verdict throughout the United States. John specializes in rehabilitating audits where a taxpayer requires assistance after the IRS or other taxing authority announces its intent to issue a total disallowance or other negative result.

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