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Small Captive Insurance Companies Hit the IRS Dirty Dozen List

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If your business has formed a captive insurance company that has elected small insurance status under section 831(b) of the Internal Revenue Code, you may be hearing from the IRS.

On Feb. 3, 2015, the Internal Revenue Service issued **IR 2015-19**, which added certain small captive insurance companies to the IRS “Dirty Dozen” list. The IRS publishes the Dirty Dozen list to inform the public about the areas the IRS will be focusing on and to warn tax return preparers about these same areas.

While acknowledging that these captive insurance companies may be legitimate, the IRS then states that many of these companies are being created and operated for tax versus business reasons. The IRS’ recent crackdown on small captive insurance companies has also been featured in recent pieces in *Forbes* and *The New York Times*.

With small captives continuing to be in the news, let’s take a moment to outline what the IRS is looking at and what we know about the large number of examinations now underway.

How Small Captives Work

As the IRS admits, small Captive Insurance Companies, or CICs, are permitted under the tax law. CICs insure the risks of related small businesses, and in general, captive managers assist these businesses in forming and running the CIC. Most often the captive manager also will operate a risk pool in which the CIC participates, as do many other unrelated CICs.

The IRS, however, has become increasingly concerned with how captive managers market CICs, how risk pools operate and how a small business runs its captive.

The Risks of Noncompliance

The risk is large if the IRS knocks on the door of a captive owner. If the IRS refuses to treat the CIC as an insurance company, there is a reversal of all deductions for insurance premiums for each year they are paid to the captive (that can be up to \$1.2 million per year in disallowed premiums).

In addition, the IRS will add penalties (possibly another 20% of the total) as well as interest. The IRS is also considering the use of a new economic substance penalty (increasing the accuracy penalty from 20% to 40%). As you can see, this can be devastating to a small business and its owners.

What We Know Today

- First, we know that there are several captive managers under investigation. The focus appears to be on how the CICs are being marketed and how the risk pool is designed and operated.
- Second, we know that a large number of clients of these managers have been contacted by the IRS and even placed under examination. Make no mistake—if a CIC is contacted for information about the captive manager, it should treat such contact as a precursor to a full audit.
- Third, by placing CICs on its “Dirty Dozen” list, we know that the IRS has no intention of backing off from its current efforts. In fact, the IRS is likely to ramp up such efforts.
- Fourth, we know that if the captive manager’s risk pool is found deficient by the IRS, then all CICs that participate in that pool will fail to be seen by the IRS as insurance companies. Note that this is without regard to whether a particular CIC is actually under examination at the time of the IRS finding.
- Finally, we know that the Treasury Department and Congress are actively looking at the rules involving CICs as well.

What Does It All Mean?

It comes down to this—if you have a CIC or a client with a CIC, you need to seek help to determine whether that CIC, the related small business or its owners are at risk of adverse IRS action. There are actions that can be taken even before an examination begins to manage and limit these risks.

This is a technical area of tax law and involves a detailed understanding and knowledge of insurance questions from a tax law perspective. To succeed here requires not only familiarity with the law, but an understanding of how the IRS proceeds in these cases, including what the IRS is willing to accept, when it is willing to allow for correction and what it takes to resolve an examination.

For CIC owners, now is the time to ensure their captive is compliant with IRS guidelines.



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