
# THE IRS'S ATTACK ON 831(b) CAPTIVE INSURANCE

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Recently, the Internal Revenue Service (IRS) issued its annual "Dirty Dozen" list of perceived tax scams. The list included micro captive insurance companies, better known as 831(b) captive insurance arrangements. This article provides an overview of the IRS's assault on deemed abusive 831(b) arrangements,[1] including audits of captive managers and their clients.[2]

## Micro-Captives and 831(b)

A micro-captive insurance company, one that elects treatment under Internal Revenue Code (IRC) 831(b), provides insurance to operating businesses while benefiting from favorable income tax provisions that can have the effect of deferring income tax and converting ordinary income into capital gain income. Interestingly, while the IRS is vigorously challenging micro-captives, Congress has increased the premium income exempt from income tax.

### *The Players*

The typical micro-captive insurance arrangement involves three parties: the captive manager, a closely held operating company and the captive insurance company. The transaction may also involve additional insureds through a risk pool.[3]

### *The Transaction*

The initial step in this transaction typically includes a feasibility analysis of the proposed insured by or through the captive manager. This study evaluates current insurance coverages as well as uninsured risks. Assuming the feasibility study identifies a business need for the captive, the formation of the captive insurance company is undertaken. This captive may be domiciled in the U.S. or a foreign jurisdiction, and is typically owned by the individuals who own the operating company. The captive manager typically handles the formation and licensing requirements, prices the coverages, drafts the insurance policies and

*continued on page 30*

continued from page 29

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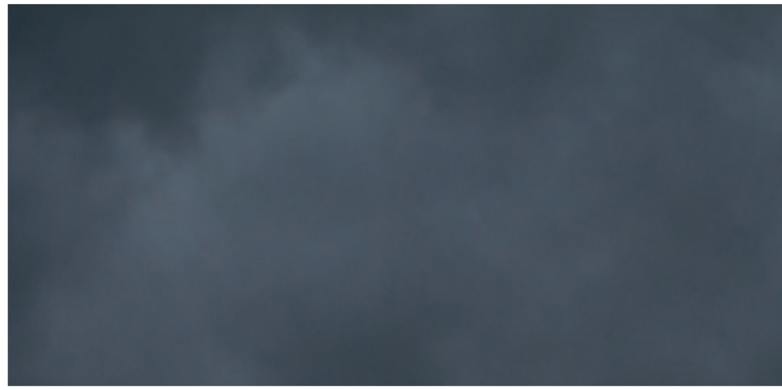

administers the claims process. In turn, the operating company purchases policies from its captive covering the previously uninsured risks.

## IRS's Attacks

The IRS, unhappy with the tax advantages of 831(b) [current year deduction by insured and deferral by captive] and the perception of abuse, began extensive audits of these arrangements.

The IRS purports to focus its attacks on what it unilaterally perceives as abusive 831(b) transactions. It defines the highlights of abusive structure as:

"[an] 'unscrupulous promoter' … charging excessive fees persuades closely held entities to participate in a scheme to create unnecessary captive insurance companies. The promoters assist with creating and 'selling' poorly drafted 'insurance' binders and policies to cover implausible risks for exorbitant 'premiums,' while maintaining their economical commercial coverage with traditional insurers.

Total amounts of annual premiums often equal the deductions needed to eliminate taxable income; or, for a wealthy entity, total premiums amount to $1.2 million annually to take full advantage of the [Internal Revenue] Code's favorable tax provisions irrespective of the coverage deemed necessary."

The IRS's perspective is that underwriting and actuarial substantiation for the insurance premiums paid are either missing or insufficient. IR-2015-19, Feb. 3, 2015.

***Promoter Audits***

Many of the current audits originate with the captive managers. The IRS's primary goal in the captive manager audits is to secure the captive manager's client list. Frequently, the IRS conducts these audits as IRC 6700 tax shelter promoter audits.

The IRS has been particularly aggressive in setting arguably unreasonably short deadlines under which to secure records from the captive manager. If the captive manager is perceived to have failed to timely comply with broad information document requests, the IRS resorts to broad summonses. Unlike standard audits, the IRS liberally uses summons enforcement procedures when dealing with captive manager audits.

Similarly, the IRS is working hard to more fully develop the case prior to litigation. As such, the IRS has been much more aggressive in securing documentation directly from the captive and demanding that its principals submit to taped interviews. The documents requested include: promotional items used in the sale of the captive insurance program; underwriting documents used for premium pricing, insurance contracts, documents involving claims against the captive, agreements between the captive manager and the insured, risk pool information, feasibility studies and all communications between the insured and the captive manager.

***Taxpayer Audits***

Upon securing the client lists, the IRS begins audits of the captive manager's clients, a.k.a. the insureds. The IRS tends to use a standardized information document request. The goal in these audits is the disallowance of the insured's claimed insurance premium deductions. If the taxpayer audit arises in connection with an investigation of the captive manager, there is seemingly very little deviation among the insureds as to how the claimed deductions are treated. This may be a result of the IRS seeking to coordinate a penalty case against the captive manager.

As with the promoter audits, the IRS uncharacteristically resorts to summons enforcement proceedings when the IRS perceives that the insured fails to adequately respond to its information document requests.

When the audit concludes, the IRS issues a Notice of Deficiency or 30 Day Letter, generally depending upon the statute of limitations for assessment. These notices take several alternative positions.

The notices disallow the insurance premiums based upon a standard "ordinary and necessary" business expense theory. IRC. 162. In the context of ordinary and necessary, the IRS argues the premiums were not paid to an insurance company or paid for insurance. Alternatively, the

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IRS argues that the transaction lacks economic substance, the substance of the transaction does not comport with the form, and the various steps involved in the transaction were engaged in for no purpose other than to avoid or evade taxes. The IRS typically uses these theories: the economic substance, substance over form and step transaction doctrine in tax shelter cases. Based upon the audit techniques, the "Dirty Dozen" listing and the significant resources expended to attack "abusive" 831(b) programs, the IRS treats these arrangements as tax shelters.

Interestingly, the IRS doesn't argue that the premium payments are income to the captive. Rather, the IRS generally takes the position that the payments are a capital contribution. If the deductions are ultimately disallowed, this characterization may minimize the ultimate tax impact if the captive arrangement is terminated and its assets distributed.

***Tax Court Cases***

The Tax Court heard the first "abusive" 831(b) captive case in early 2015.[4] The Tax Court's queue includes several additional 831(b) cases scheduled for trial in 2016. Based on the briefing schedule in *Avrahami*, our expectation is that the court will begin providing its view of the micro captive arrangements in late 2016.

## What's Next?

Regardless of who wins or loses the initial cases, appeals are anticipated. Ultimately, the courts will provide the captive community with guidance on what it perceives to be proper 831(b) captive arrangements. Should the IRS be dissatisfied with the courts' determinations, it may seek legislative changes. Unfortunately for all parties involved, there may not be a final resolution to this battle until 2018. Until then, expect a long, hard fight. **NL**

1. This article does not suggest the IRS is attacking all 831(b) captive insurance arrangements. The focus of this article is the portion of the 831(b) captive insurance industry the IRS perceives as abusive. Numerous 831(b) captive insurance managers and companies are not under scrutiny.
2. At times, the author uses generalizations describing the IRS's actions in audits and court cases. The IRS's procedure in individual cases may differ.
3. *See* Adkisson's Captive Insurance Companies, ISBN-13: 978-0595422371, for a more detailed description of captive insurance arrangements.
4. *Avrahami v. Commissioner*, U.S. Tax Court dockets 17594-13, 18274-13.

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