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Captive Insurance on 2017 IRS "Dirty Dozen" Listing

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For the third consecutive year, "abusive micro-captives" make an appearance on the IRS' annual "Dirty Dozen" list of tax scams in 2017. Last year's information release on abusive tax shelters, found in IR-2016-025, included abusive tax structures, misuse of trusts and captive insurance. This year, in IR-2017-31, the IRS again warns taxpayers about the abuse of captives that elect to be taxed under Section 831(b) of the Internal Revenue Code. Captives small enough to qualify for a Section 831(b) election are often called "micro-captives."

In the 2017 version of the Dirty Dozen listing, the IRS has made some interesting additions to, and deletions from, the 2016 listing, no doubt consistent with issues identified in the IRS' controversial Notice 2016-66. (Notice 2016-66, released on November 1, 2016, alerted persons involved in certain micro-captive transactions to certain disclosure requirements and penalties that may arise from involvement with such transactions.) It is interesting to note that the new listing acknowledges "traditional captives," and identifies such as insurance companies that allow a taxpayer to "reduce insurance costs." Removed terms for the 2017 listing include references to "promoters assisting with companies onshore or offshore," as well as references to managing captives for "substantial fees" and assisting taxpayers "unsophisticated in insurance, to continue the charade from year to year."

However, several new statements in the 2017 pronouncement demonstrate the issues the IRS has found to be critical during its ongoing battles with taxpayers in micro-captive insurance controversies. Among the new terms is reference to situations where "promoters, reinsurers and captive insurance managers may share common ownership interests that result in conflicts of interest." Other additions include failure to match "genuine business needs," while implausible risks and duplication of coverage are carried over from the 2016 listing as bad facts. A new description demonstrates IRS focus on premiums "geared to a desired deduction amount," while continuing the focus on captive insurance exceeding commercial coverage. The 2017 listing also focuses on policies that do not meet "industry standards" and a claims administration process that is either "insufficient or altogether absent." Another addition reflects attention to taxpayers who fail to file claims that are "seemingly covered by the captive insurance." New emphasis is placed on the investment activities of the captive, such as investments in "illiquid or speculative assets" or loans for the benefit of the insureds, the captive owners or other related parties. This is no surprise to those who are already examining their captive program for disclosure requirements related to financing transactions (in addition to a liability and expense percentage test) per Notice 2016-66. (The deadline for such disclosure was extended in Notice 2017-8.)

Finally, "inter-generational wealth transfer objectives" is a new addition featured in the 2017 pronouncement, where the taxpayers utilize a captive structure to help implement an estate plan, as well as to "avoid estate and gift taxes." The IRS is associating transfer tax planning objectives with the use of policies that pay few or no claims, with the assumption being such planning can only be effective if issued policies do not result in claims. Congress has also made its position known with respect to the estate planning abuse of captives, which led to a Section 831(b) amendment that restricts captive ownership. See Senate Report 114-16, April 14, 2015.

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