Stretched for Resources, the IRS Sets Its Sights on Small Captive Insurers

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A "captive" insurance company is an insurer formed for the limited purpose of insuring the risks of its non-insurer owner or owners. A captive can be an effective risk-management tool, especially for costly or unconventional risks, and it can also give businesses direct access to reinsurance markets. The number of captives has increased fivefold in the last 30 years, and U.S. jurisdictions now compete with Bermuda and other offshore locations to be captive domiciles. But not everyone is enthusiastic: most notably, the IRS listed abuse of captive insurers for tax purposes in its "Dirty Dozen" list of 2015 tax scams. Captives can provide tax advantages, because parent companies can deduct the premiums they pay, while the captives may exclude premiums up to $1.2 million from their income and elect to pay tax on investment income only. The agency says "unscrupulous" promoters encourage companies to shelter income by such means as paying exorbitant premiums to offshore captives for poorly-written insurance that merely duplicates coverage the parents maintain with conventional insurers. Even before it released the 2015 list, the IRS issued what many view as confusing (if not downright inconsistent) guidance on captives. It also began a significant number of audits of persons it suspected of marketing captives for tax avoidance purposes. Such promoters often tout captives as an efficient means of estate planning and managing other property transfers. In a promoter audit, the IRS typically demands—and often obtains—a client list, which it uses to launch further inquiries, not only of the captives linked to the audited promoters, but also of affiliated entities and individuals. Recently, these audits have reached the level of a purposeful and strategic examination campaign. Thus, the latest announcement makes clear the agency's intent to ramp up pressure on captives, and the industry can expect a significant increase of related tax controversies. Currently undergoing a well-publicized downsizing, the IRS must prioritize the most efficient means of collection and enforcement, and there is "more bang for the buck" in concentrating on systemic threats than in pursuing a strategy of random audits.

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