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Recent Developments Regarding IRS Attention to § 831(b) Microcaptives – The Myths and the Reality

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On February 3, 2015, the IRS published its "Dirty Dozen" list of questionable tax transactions. Among the items included are some transactions involving insurance companies that have elected to be treated as small property and casualty insurance companies under Internal Revenue Code § 831(b). The IRS summarizes the issue as follows:

> 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.

(Notice IR-2015-19).

There have been rumors and speculation about what this means. Below is our view of the reality, based on our familiarity with the issues, communications with other practitioners, and off-the-record discussions with IRS insiders.

Review of the language of the notice gives strong clues as to what the IRS considers to be abusive practices. The first focus of the notice follows:

> [U]nscrupulous 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 often times 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.
>
> *Id.*

This language is directed to two separate issues. First, the IRS is expressing concern about coverages that move risks from traditional insurers to captives, especially if this results in a higher premium than would be paid in the regular market. Second, the IRS is concerned with what it considers "esoteric, implausible risks." One IRS official called attention to an arrangement wherein a Midwest taxpayer took a $1 million deduction by paying a microcaptive for tsunami insurance.

These questions often involve an IRS misunderstanding. As a matter of economic reality, the microcaptive must charge more premium early on due to comparatively small reserves. However, there must be sound actuarial support. Additionally, an infrequent risk but catastrophic in nature can warrant a high premium.

The second focus of the notice shows IRS concern when it appears that the arrangement has been designed precisely to take advantage of the $1.2 million limitation of §831(b). As the notice states:

> Total amounts of annual premiums often equal the amount of deductions business entities need to reduce income for the year; or, for a wealthy entity, total premiums amount to $1.2 million annually to take full advantage of the Code provision.
>
> *Id.*

Thus, the IRS will be paying close attention to structures that are promoted as being designed to maximize the use of the limitation.

The third focus of the notice states that the IRS will find a problem when "[u]nderwriting and actuarial substantiation for the insurance premiums paid are either missing or insufficient." *Id.* Proper underwriting and actuarial standards should always be available to substantiate the premiums. If the only justification for the premium level is to maximize the use of §831(b), that will be a problem.

The final focus of the notice states that IRS attention will be drawn when:

> The promoters manage the entities' captive insurance companies year after year for hefty fees, assisting taxpayers unsophisticated in insurance to continue the charade.
>
> *Id.*

This language seems intended to put promoters of captive programs on notice that attention will be paid to them as well.

Looking at the above, it is pretty clear to our professionals with whom we have spoken that the traditional reinsurance structures used by reputable F&I reinsurance programs are not the intended target of the listing. The coverages are reasonable, as shown by loss history experience; the premiums are actuarially determined on a by-vehicle basis for all dealerships and not tailored at each dealership to reach the predetermined deduction amount; and there is ample substantiation for the premiums charged. Rather, what seems to have prompted the inquiry is an IRS perception that some uses of microcaptives are overly aggressive, such as the tsunami example mentioned above.

However, even if your clients have properly designed structures, the existence of a notice of this sort means that there is an increased risk that an IRS agent may mistakenly think that if there is a §831(b) company in use, there is an issue worth examining. Dealerships and their advisors should understand that in the event of a communication from the IRS regarding a §831(b) company, it is imperative to engage experienced and knowledgeable tax advisors immediately to review the situation and respond. ■

Matthew Howard joined Moore Ingram Johnson & Steele in 1989 and currently serves as senior partner in the firm's Captive, Tax and Estate Planning Department. Matthew formed the firm's Captive Insurance Company practice in 2006. As of 2015, MIJS Captive Management manages 99 small captive insurance companies domiciled in Alabama, Kentucky, Delaware, Hawaii, Montana, Nevada, South Carolina, and Utah for privately held businesses throughout the United States.

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