
# Captive Insurance: IRS Knocking

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For businesses – especially small and medium businesses – that have formed captive insurance companies, the IRS has recently issued the tax equivalent of an air raid siren: placing captive insurance companies on its list of Dirty Dozen abusive tax shelters. My employer, alliantgroup, represents before the IRS a significant number of small and medium businesses that formed captive insurance companies and we have seen first-hand that the IRS is backing up words with actions — both with audits of “promoters” (companies marketing captive insurance) and scores of audits of captive insurance companies (with more coming). The IRS is investing significant time and resources in these examinations.

As seen in a recent tax court case – GS Manufacturing v. CIR (Tax Court docket no. 20407-14) – it is clear that the IRS has been building a special woodshed just for captive insurance – seeking major penalties against taxpayers who the IRS views as creating improper captive insurance companies. The taxes, fines, interest and penalties can quickly lead to hundreds of thousands of dollars for a small or medium business.

As background, captive insurance has long been recognized as a legitimate means for businesses to address insurance challenges they face. As Forbes commentator Jay Adkisson (a whiz on all things captive insurance) has noted, there are a number of good reasons why a company may wish to consider forming a captive insurance company. In addition, small captive insurance companies can benefit from Section 831(b) of the tax code which allows for preferential tax treatment on earnings.

However, because of the significant tax benefits of Section 831(b) and other preferential tax treatments, marketers have been targeting small and medium sized businesses and encouraging them to form captive insurance companies for the tax benefits. While there are certainly legitimate captive insurance companies formed by small and medium businesses, there are also captive insurance companies that are in the gray area of the tax law, often deeply gray. Many of the problems regarding captive insurance stem from a core issue: is the captive insurance company, and the entire insurance pool a captive may be a member of, really engaged in insurance or simply a vehicle for savings? For those wanting a deeper dive on why the IRS is unhappy, an article by Professor of Law Beckett Cantley is a good place to start.

So if your small or medium business has formed a captive insurance company, run—do not walk— to get your captive to an IRS happy place. That means you must be sure that not only your captive is legitimately engaged in insurance, but that it isn't dragged down by other members of any pool it's a part of playing fast and loose with the rules. A recent Accounting Today article by my alliant colleague, former IRS Commissioner Steve Miller, provides a useful checklist of things to look for (really – what is the IRS looking for) if you have a captive insurance company and best practices to follow before the IRS comes knocking.

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