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IRS Increases Scrutiny of Captive Insurance - Red Flags from the IRS Playbook

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With IRS examinations of captive insurance arrangements on the rise, the time is now to revisit your captive insurance arrangement or ask targeted questions to your provider about past and proposed captive insurance transactions.

Captive insurance is a very powerful tool in insuring against business risks. In a successful captive scenario, an IRC §162 deduction is available for insurance premiums paid by the insuring business and up to $1.2 million of the captive insurance company's earnings may escape taxation. The IRS is aware of these powerful benefits and believes that numerous abusive arrangements exist that do not, in fact, offer valid insurance.

In examining a captive arrangement, the IRS will initially demand copies of all promotional materials. Throughout the IRS examination, the IRS will look for the following "red flags":

1. Materials emphasizing the income tax goals of the captive insurance arrangement. The IRS will evaluate whether such materials emphasize premium deductions as opposed to insurance needs.
2. The realistic probability of coverage applying to the business. If the likelihood of the insurable event happening is low, the IRS believes the cost of coverage should likewise be low. To illustrate, there would be little need for hurricane coverage in a land locked area or earthquake coverage where there is no fault line within hundreds of miles.
3. Reverse engineering the amount of premiums to equal exactly the $1.2 million exemption amount to the penny. The IRS believes certain taxpayers are exploiting this advantage by signing up for premiums exactly at the $1.2 million level.
4. An impermissible circular flow of funds where the premium monies, either through loans or distributions, ultimately end up in the hands of the business or a closely related party. The IRS has a history of suspicion over the "circular flow" of funds.
5. Lack of adequate risk distribution to be considered an insurance company for tax purposes. This arises where the captive insures only the single business and simply holds the premium monies in the event of a claim. The IRS is very focused on a perceived lack of risk distribution and risk shifting in certain captive arrangements.
6. Failure to obtain an actuarial study supporting the premiums charged by the captive for the insurance. The IRS will examine the underwriting process.
7. Lack of an analysis of the cost and availability of commercial insurance in the non-captive market. The IRS believes that insurance rates far in excess of commercially available rates defy common sense.
8. Materials emphasizing the estate planning benefits of the captive insurance structure. For instance, the IRS will scrutinize a captive insurance company owned by a family limited partnership or irrevocable trusts that benefits the business owners' family members. The IRS takes the position that I.R.C. §

831(b) was not enacted as an estate planning tool, but to assist taxpayers who want to manage risk.

9. The existence of guarantees. The IRS believes that guarantees may be an indication of inadequate capitalization.
10. Lack of claims history. The IRS believes that no claims may indicate that the insurance pool is insufficient and risk shifting may not exist.

The existence of these so called “red flags” by no means automatically invalidates a captive arrangement. The IRS will instead use “red flags” as indicators to argue that in substance the captive arrangement lacks risk shifting, risk distribution, and fails to qualify as insurance in the commonly accepted sense. The post hoc review of the facts by the IRS is often times limited to semantics in marketing materials and one or two technical missteps. The IRS is using the soft-doctrine of substance over form as a blunt weapon to attack certain captive insurance arrangements which the IRS perceives as one of the new dangers to the national fisc. Essentially, the IRS is taking the position that in substance, certain captives simply act as a self-insurance bank account.