Full Steam Ahead: IRS Narrowing Focus on 831(b) Captive Insurance Companies

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This article updates prior articles[3] presented to the Utah Association of CPAs and others following the mass marketing by promoters related to Internal Revenue Code ("IRC") 831(b) Captive Insurance Companies ("CIC" or "Captives"). The purpose of this article is to summarize and update our previously published guidance to professionals with recent Internal Revenue Service ("IRS") anti-abuse actions, such as the inclusion of certain CICs on the "IRS Dirty Dozen" list, IRS Notice 2016-66 ("Notice") classification of specific behavior as a Transaction of Interest ("TOI"), and inclusion—with variance from both prior Dirty Dozen and Notice language—on the 2017 Dirty Dozen list. All our previously published articles on this topic are adamant that non-compliant (or not-fully-compliant), tax motivated, and/or estate planning CICs are *ab initio* unlikely to be tolerated by the IRS. We have witnessed countless scenarios ranging from mere negligence to gross misconduct from organizations purporting to offer Captive services. Amazingly, many such organizations use "race to the bottom" pricing coupled with a blasé dismissal of the regulatory requirements governing the operation of an independent insurance company under the insurance regulations of the various states that license CICs.

In the following section I, the top paragraph is an italicized discussion of the subsequent changes since our last publication. We use the next section to describe the current IRS or Congressional stance on Captives, as well as some of the most abusive activity in that area. In the latter sections, we offer professional insights for those advising CIC owners. In prior warnings, IRS action made clear that it deems certain practices to be problematic, and perhaps criminal. While the bad actors have continued to dance in the streets, the IRS has spent its time forensically auditing and preparing its arsenal for coordinated attacks.

I. What's Past as Prologue

This section updates and summarizes each specific IRS action against the primary areas in which promoters operate, analyzes the law and policy surrounding their course of action, and the likely result of IRS attack on the taxpayer. This memo discusses some of the issues that may develop with the IRS that are typically not raised with CIC clients or their professionals.

Unfortunately, many promoters continued to operate in the described manner and drew the IRS into the 831(b) Captive Insurance Company world. Our predictions and advice were called paranoid by promoters. "Paranoia" borne out by legislation, regulation, and case law would be

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[3] Summary of Articles on Abusive Captive Insurance Companies, Prof. Beckett G. Cantley, available at http://mobile.uacpa.org/Content/Files/Utah%20CIC%20Abuses%20Memo%20[9-15-13].pdf. Last accessed February 15, 2017.

more appropriately called “Preparation”.

The previously described problem areas include:

*Life insurance as an “investment” of the CIC
*The Risks Posed by the IRS Offshore Crackdown
*Excessive Premiums & Terrorism Insurance
*Estate Planning Ownership Structures

<u>Life Insurance as an “Investment” of the CIC[4]</u>

UPDATE*: In the 2016-66 Notice, the IRS laid out its disapproval for Captives to own or be involved in investing its “capital in illiquid or speculative assets usually not held by insurance companies.”[5] Early startup companies—even if well-funded—will often choose to forego high death benefit insurance policies with large premium on its principals. Large life insurance premiums paid with the received premiums create an illiquid investment otherwise incomprehensible to a compliance officer. The sole purpose in these large life insurance policies is to generate additional commission for life insurance licensed promoters. As stated in this section, infra, it is highly unlikely an independent insurance company would choose to make use of its reserves to purchase life insurance on the life of its principal, especially before the insurance company has even proven to be a consistently profitable venture.*

The life insurance industry has long sought to deduct life insurance premiums while maintaining all existing life insurance tax-breaks. Promoters’ latest attempt to provide a tax incentive for life insurance premiums is for small business owners to create a CIC—for the supposed purpose of insuring some business risk—and then have the CIC invest in life insurance on the CIC/business owner’s life. Promoters tout this as the perfect investment for a CIC. However, the IRS likely will define this arrangement as a tax shelter,[6] and while each separate step meets the formalities of the IRC, the IRS may still attack this as an abusive tax structure.[7] A CIC is a corporation created to offer insurance to companies related to the CIC. Premiums paid to the CIC by its insured shareholder are generally deductible and IRC § 162(a) provides that there shall be allowed deductions on necessary and ordinary expenses incurred in carrying on a business.[8] Under IRC § 831(b), a CIC may receive tax-free annual premiums up to $1.2 million, although the CIC would remain liable for tax on investment earnings. To ensure the deductibility of contributions and the excludability of premiums is allowed, the IRS analyzes several factors, including but not

[4] The analysis, discussion, and research for this segment are wholly attributable to Beckett G. Cantley, Repeat as Necessary: Historical IRS Policy Weapons to Combat Conduit Captive Insurance Company Deductible Purchases of Life Insurance, 13 UC Davis Bus. L.J. 29 (2012) available at SSRN: http://ssrn.com/abstract=2315868 [hereinafter Policy Weapons].
[5] IRS Notice 2016-66.02(f)(2).
[6] Cantley at 29 (“the IRS definition of the perfect tax shelter—(i) deductible premiums into the life insurance policy; (ii) tax-free build-up inside the life insurance policy; (iii) a subsequent distribution of the life insurance policy at currently tax-advantaged capital gains rates; and (iv) an income and estate tax-free payment of the life insurance proceeds upon the death of the insured.”).
[7] Storms, infra, citing Jay Adkisson, Bad Financial Medicine for Year-End 2008: Physicians, Captive Insurance Companies and Cash-Value Life Insurance, http://www.captiveinsurancecompanies.com/captive_insurance_life_insurance.htm (last visited Sep. 11, 2013).
[8] See IRC § 162(a); Treas. Reg. § 1.162-1(a) (as amended in 1993).

limited to: (1) whether there is a non-tax business purpose for the transaction; (2) adequate capitalization of the entity; (3) commercial reasonableness and arms-length nature of the transaction; (4) whether the entity faces proper regulatory oversight; and (5) whether there exists sufficient risk shifting and risk distribution to constitute insurance.[9]

Using a CIC to fund life insurance transactions fails the deductibility analysis for all the above factors. The CIC's principle purpose becomes tax avoidance, not insurance. As it applies to a non-tax business purpose, the court looks to the economic substance of the transaction and whether the funds set aside were true business expenses.[10] In an insurance transaction, the nature of these premiums make proving the CIC was created and funded for non-tax business purposes difficult.[11] The arm's length element will likely not survive an IRS attack because it is highly questionable for an independent insurance company to "choose to make use of its reserves to purchase life insurance on the life of its owner, especially before the insurance company has even proven to be a consistently profitable venture."[12] Risk shifting and risk distribution factors will also weigh against a CIC life insurance transaction with the arm's length nature of the transaction in question. If the funding of the insurance transaction is not truly at arm's length, the IRS could argue that the transaction is not an "insurance transaction"; risk shifting and risk distribution has not occurred; and the CIC is not an insurance company at all.[13]

Congress intended for life insurance premiums to be non-deductible and the IRS will likely attack pre-tax premiums paid on the business owner's life as being against the public policy. The U.S. Government, the IRS, and Congress all agree that life insurance premiums are non-deductible and, should an audit occur, the taxpayer carries the burden of proving the deduction claimed is an ordinary and necessary expense. Thus, as a general rule, life insurance premiums are not deductible as ordinary and necessary business expenses, nor should tax-deducted funds be used to purchase life insurance.[14] In any instance of a life insurance premium deduction, the taxpayer bears the burden of proving the claimed deduction expense is deductible.[15] The IRS is extremely suspect of businesses using tax-advantaged methods of funding permanent life insurance with investment for the purpose of accumulating assets.[16] The IRS reasons that investment portions of premiums essentially funnel pre-tax business profits to an insurance investment already enjoying other tax benefits. Therefore, the IRS has clearly stated policy against diverting properly attributable income to a wholly owned company subject to little or no federal income tax.[17]

The IRS has historically gone to war with promoters and taxpayer participants seeking tax deductible life insurance premiums; e.g., (1) IRC § 419 Plans; (2) IRC § 412(e)(3) Plans; (3) COLI

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[9] William P. Elliott, A Guide to Captive Insurance Companies (Part 3) – IRS Proactivity in Captive Taxation, 16 JITAX 34 (2005).
[10] Elliott, supra note 15; see also Sears, Roebuck & Co., 972 F.2d at 41-43.
[11] Policy Weapons at 30.
[12] *Id*. at 31.
[13] Id. at 31–32.
[14] Policy Weapons at 22, quoting Howard Zaritsky & Stephan Leimberg, *Deductibility of Life Insurance Premiums, in Tax Planning with Life Insurance: Analysis with Forms § 2.08* (2011).
[15] Am. Elec. Power, Inc., 136 F.Supp.2d 726, 778 (S.D. Ohio 2001).
[16] Rev. Rul. 2004-20, 2004-1 C.B. 546, available at 2004 WL 259195. The goals and purposes of key man insurance can usually be accomplished with a term life policy and the use of whole, variable, or universal policies may add an additional and unnecessary investment portion to the arrangement.
[17] Policy Weapons at 23, quoting IRS Notice 2002-70, 2002-2 C.B. 765.

Financing Arrangements; and (4) Producer Owned Reinsurance Companies. Numerous IRS revenue rulings have been issued to attack the abusive nature of promoters and the taxpayer participant of these valid tax structures. Additionally, the IRS has sought both civil and criminal penalties for this abuse. Similarly, CICs are being widely abused by the promoter world, and over the last few years the IRS has undertaken forensic audits of CICs, and brought criminal indictments against non-compliant CIC promoters. Aside from a one-time tax advantaged Capital Gains tax on the dividend income, the CIC life insurance transaction allows the taxpayer to completely escape taxation[18] by utilizing small business pre-tax dollars through a CIC that may exclude up to $1.2 million from income to purchase the small business owners' life insurances. The IRS is expected to challenge arrangements that "divert income properly attributable to the taxpayer to a wholly owned company that is subject to little or no federal income tax."[19] The CIC life insurance transaction squarely meets this definition. In furtherance of this stated IRS policy and all others abovereferenced, the IRS is likely to use its expansive enforcement powers to plug the latest hole in the dam separating tax deductions from life insurance premiums.[20]

Risks Posed by the IRS Offshore Crackdown[21]

UPDATE: *From the very outset of the IRS attack on Captives, starting in 2015—nearly two years after we predicted the crackdown—offshore jurisdictions raised the specter of tax shelter. In the original Dirty Dozen listing, the IRS stated "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****"[22] [emphasis added]. In the 2017 Dirty Dozen listing, the emphasis on onshore versus offshore is removed[23], likely as a decision that the differentiation did not create additional liability or offer unintentional releases.*

For a business that established the insurance need and tax benefits and determined that an IRC § 831(b) CIC fits their business structure and insurance requirements, an important decision is whether the CIC should be governed by the laws of a U.S. state or foreign jurisdiction. CICs formed offshore may compound compliance risks inherent in the formation and operation of a CIC by "ending up eventually in the middle of the ongoing IRS offshore tax crackdown."[24] Working hand-in-hand with the IRS, the Department of Justice ("DOJ") used information obtained by the IRS to launch civil and criminal tax cases against U.S. domestic and offshore persons with a warning that overseas tax avoidance will receive significant scrutiny.[25] Substantial consequences for non-compliance offshore include civil and criminal tax penalties, and indictments for tax

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[18] See Policy Weapons at 33.

[19] IRS Notice 2002-70.

[20] Policy Weapons at 37.

[21] The analysis, discussion, and research for this segment are wholly attributable to Beckett G. Cantley, *Steering Into The Storm: Amplification of Captive Insurance Company Compliance Issues in the Offshore Tax Crackdown*, 12 Hous. Bus. & Tax L.J. 224 (2012) Available at SSRN: http://ssrn.com/abstract=2315896 ("Storms").

[22] IR-2015-19, Abusive Tax Shelters Again on the IRS "Dirty Dozen" List of Tax Scams for the 2015 Filing Season. https://www.irs.gov/uac/newsroom/abusive-tax-shelters-again-on-the-irs-dirty-dozen-list-of-tax-scams-for-the-2015-filing-season.

[23] IR-2017-31, IRS Warns of Abusive Tax Shelters on 2017 "Dirty Dozen" List of Tax Scams. Available at: https://www.irs.gov/uac/newsroom/irs-warns-of-abusive-tax-shelters-on-2017-dirty-dozen-list-of-tax-scams.

[24] Storms at 227.

[25] *Id.*

evasion, conspiracy to defraud, money laundering, wire fraud, and RICO Act violations.[26] Despite the perception that offshore means "not taxed", every CIC—onshore or offshore—is subject to U.S. income taxation.[27] Whether the foreign CIC makes an IRC § 953(d)[28] election or not, some element of taxation would apply to the U.S. shareholders of the CIC.[29] An additional and significant factor to consider prior to forming a foreign CIC is the very real possibility that an IRS offshore crackdown may increase the compliance burden.[30] An offshore CIC may become the subject of intrusive audits and intensified scrutiny because it receives tax-deductible payments.[31] Based on the history of IRS and DOJ focus on tax compliance in offshore entities, it is certainly possible that the IRS will broaden its focus to begin a coordinated attack on foreign IRC § 831(b) CICs—"if it has not done so already in a non-public manner."[32]

Foreign jurisdictions make themselves popular by offering more flexible investment structures than are usually permitted in a traditional domestic jurisdiction. Certain jurisdictions allow any investment vehicle "so long as such investment does not impair the capital base or undermine any foundational requirements related to the insurance arrangement"[33], including making unreasonably illiquid investments which may prevent payment of actuarially anticipated claims.[34] To be considered a bona fide insurance company, a CIC must maintain solvency requirements since the primary responsibility of an insurance company is to satisfy claims as they accrue.[35] Aggressive utilization of an offshore jurisdiction's looser investment requirements may cause the CIC to run afoul of the IRS and IRC rules defining a bona fide insurance company. A common misconception among those seeking offshore jurisdictions for the formation of a CIC involves the perception of secrecy or asset protection. While some jurisdictions may provide a friendlier venue for the CIC, prove more difficult to bring suit, or have a law less friendly to creditors, once a U.S. court has rendered a judgment against a U.S. citizen, it is always possible that the court will nullify an offshore transfer as an attempt to defeat creditors.[36] The penalties for the above U.S. criminal offenses are generally very harsh, risking the liberties and fortunes of U.S. taxpayers, advisors, bankers, accountants, and attorneys involved in non-compliant offshore investment arrangements.[37] Any offshore CIC should be very concerned with U.S. tax and regulatory compliance. Simply by being organized and operated offshore, a CIC may become cost

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[26] *Id. quoting* Jeremiah Coder & Lee A. Sheppard, *Banks Beware: IRS Criminal Investigations Expanding*, 2012 TAX NOTES TODAY 34-5 (2012).
[27] Storms at 268. Julie Goosman & Christine Lug, *Captivating! Captive Insurance Arrangements are Alive and Well*, 35 J. CORP. TAX'N 25, 28–29 (2008).
[28] Under IRC Section 953(d), an offshore CIC may elect to be treated as a domestic company for U.S. federal tax purposes. However, once this election is made, it is irrevocable without IRS consent. The problem under this theory is that the CIC is still an offshore tax-advantaged entity and may still be subject to heightened scrutiny, invasive audits, and a 953(d) election will not likely cure the taint. *See* Storms at 269.
[29] Storms at 268.
[30] *Id.*
[31] *Id.*
[32] *Id.*
[33] Storms at 272, *citing* Phillip England et al., *Captive Insurance Companies: A Growing Alternative Method of Risk Financing*, J. OF PAYMENT SYSTEMS LAW 701, 706–07 (June 2007), http://www.andersonkill.com/webpdfext/cic- riskfinancing.pdf.
[34] *Id*.
[35] Storms at 272, citing Malone & Hyde, Inc. v. Comm'r, 62 F.3d 835, 838 (6th Cir. 1995).
[36] Storms at 276, citing In re Brooks, 217 B.R. 98, 103-04 (Bankr. D. Conn. 1998) (finding that stocks transferred to an offshore account was invalid under the laws of Connecticut, and, as such, were a property of the bankruptcy estate). Bankruptcy courts are especially adept with very broad powers to invalidate and set aside transfers to include offshore asset protection arrangements. *Id*.
[37] Storms at 278, citing Jeremiah Coder & Lee A. Sheppard, Banks Beware: IRS Criminal Investigations Expanding, 2012 TAX NOTES TODAY 34-5 (2012).

prohibitive or the target of serious penalties.[38]

Excessive Premiums[39] & Terrorism Insurance

UPDATE*: As of the 2017 Dirty Dozen listing, the IRS has sharpened the knives on policy underwriting. Premiums must conform to actual and supportable business risk. Specifically, the IRS warns CIC owners, promoters, and tax professionals against premium amounts that "may be unsupported by underwriting or actuarial analysis, may be geared to a desired deduction amount, or may be significantly higher than premiums for comparable commercial coverage"[40]. Additionally, the listing specifies, as does the 2016-66 Notice, IRS displeasure for Captives whose coverage is based on "implausible risks," fails to match "genuine business needs," duplicates taxpayer's commercial coverages[41], or where the "scope of the coverage is vague, ambiguous, or illusory."[42] If not already a priority, CIC owners and their advisors should review the coverages in place to determine the extent of their misalignment with IRS standards.*

There are significant non-tax benefits for the owner of a CIC.[43] CICs have been around for decades and have been well received by the IRS when done for the right reasons and in a compliant manner. As an example, the CIC may reduce brokerage commission, marketing expenses, and administrative costs associated with commercial insurance; it may further avoid increases in insurance rates from the commercial insurance market; and often provides the parent business with a unique or specific coverage that would not otherwise be available on the commercial insurance market.[44] As an additional benefit, the premiums paid to the CIC may be invested and the parent entity may generally exercise some control over the CIC's investment decisions.[45]

Some of the arguments that Promoters raise in support of a CIC are: (1) Save on Taxes, (2) Save on Taxes, and (3) Save on Taxes. Oftentimes, we hear that a potential CIC client has been asked, "How much do you want to save on taxes?" and then the Promoter gins up an insurance policy to match the requested tax deduction—often structuring for the client to make the $1.2m maximum premium payment. The IRS, however, will not view the CIC the same way. The IRS requires, for a CIC to receive the economic benefit allowed under IRC § 831(b), that the CIC operate as an actual insurance company. Treasury Regulation 1.801-3(a) provides that an insurance company is "a company whose primary and predominant business activity . . . is the issuing of insurance or annuity contracts, or the reinsuring of risks underwritten by insurance companies."[46] It is important to remember that the $1.2m can purchase an enormous amount of commercial insurance. Clients that are not common carriers or other significant operation with numerous insurance claims incurred annually should be understandably skeptical that a Court will uphold a $1.2m deduction for a low-claim insurance policy. Most Promoter CIC policies contain coverage against terrorism. How substantive is paying a large sum of money for terrorism risk

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38 Storms at 280.
39 supra.
40 IR-2017-31, IRS Warns of Abusive Tax Shelters on 2017 "Dirty Dozen" List of Tax Scams. Available at: https://www.irs.gov/uac/newsroom/irs-warns-of-abusive-tax-shelters-on-2017-dirty-dozen-list-of-tax-scams.
41 *Id*.
42 IRS Notice 2016-66.
43 Storms at 231, citing Kimberly S. Bunting et al., *Possibilities and Pitfalls with Captive Insurance Companies*, 38 EST. PLAN.03, 03 (2011).
44 Storms at 231.
45 *Id*.
46 Storms at 230.

insurance, unless your company has assets that are very likely to be high profile targets? Sometimes economic substance comes in the form of common sense.

If a CIC does not meet the definition of an insurance company, the entity will not be granted favorable tax treatment under IRC § 831(b) and may incur C-corporation double taxation on all income.[47] Several factors interplay to evidence a bona fide insurance company. When the CIC charges commercially unreasonable or non-arms length premiums, the CIC will not be treated as bona fide insurance company.[48]

Estate Planning Ownership Structures

UPDATE*: The Tax Extenders bill closed out 2015 and further put certain Captives on notice by closing the door on "estate planning" Captives in which the insured entity owner did not own the supporting Captive in the same proportion (within a two percent differential). The rather confusing language can be simplified by saying: If the lineal descendants' Captive ownership is greater than 2% of their ownership of the parent company, then the Captive can't make an IRC 831(b) election.[49] We can further simplify this in a simple maxim: when the children do not meaningfully own the parent company, they can't own the parent company's Captive.*

By way of example, observe the following fact patterns in line with the enacted legislation:

1) Father owns 100% of the parent company and Captive. ***The Captive can make the 831(b) election because no lineal descendants own the Captive.***

2) Father owns' 100% of the parent company; child/children/wives directly own 100% of the Captive. ***The Captive cannot make the IRC 831(b) election; the lineal descendant's Captive interest is greater than 2% of their interest in the parent company.***

3.) Father owns' 100% of the parent company; child/children/wives own 100% of the Captive, but through a trust/family corporation. ***The Captive can't make an IRC 831(b) election; the statute applies to indirect and direct ownership.***

4.) Father owns 50% of parent company and the Captive; child/children/wife directly or indirectly own 50% of the parent company and Captive. ***The Captive can make the IRC 831(b) election; lineal descendants' own the same percentage of the Captive that they do of the parent company.***

Another area of CIC Insurance Company compliance that may soon be a focus of the IRS is the use of CICs to avoid Federal transfer taxes. A number of planners argue that having a CIC owned from

[47] *See* Storms at 232 *citing* Jay Adkisson, *Running a Captive Correctly*, RISSER ADKISSON LLP (Aug. 5, 2012), http://www.captiveinsurancecompanies.com/captive_insurance_taxation.htm (hereinafter *Running a Captive Correctly*).
[48] *Id*.
[49] Beckett G. Cantley, *Summary: The Final Legislative Changes to IRC 831(b)*, available at http://captiveglobal.com/wp-content/uploads/2016/10/MicroCaptiveLegislation-Stewart_Cantley.pdf

creation by a children's trust or other structure that benefits the descendants of the person who owns the premium paying insured entity shifts CIC profits to the next generation without incurring Federal Estate or Gift Tax liability.[50] This structure, while technically compliant, likely runs afoul of the judicial doctrines used to combat abusive tax structures.[51] The taxpayer/owner of the premium paying entity may have a difficult time proving the economic substance and business purpose for the business owner's children being the beneficial owners of an insurance company that insures the company of the parent-owner.[52] In determining whether the CIC is operating in good faith as a bona fide insurance company, the IRS is likely inquire as to whether a parent would actually shift *real* risk to his/her children's trust.[53] The IRS, and subsequently the Courts, is likely to view the structure as an attempt to transfer wealth in a tax avoidant manner to the next generation.[54]

II. The IRS Strikes Back

Most taxpayers have the mistaken belief that the IRS resembles the fictional "Empire" in the popular "Star Wars" franchise. To them, the IRS is a heavy-handed, invincible, autonomous entity that acts of its own volition and answers only to its own enigmatic leadership. Contrary to popular belief, the IRS does not have unlimited resources, but rather allocates them carefully by the level of concern and widespread nature of the perceived abuse. Below is a summary of the significant IRS pronouncements since our last article published on this topic. The areas we will highlight are:

*Dirty Dozen
*Legislative Changes to 831(b)
*Avrahami v. Commissioner
*2016-66 Transaction of Interest Notice
*Dirty Dozen Update in 2017[55]

Original Dirty Dozen

On February 3, 2015, the IRS placed certain abusive CIC structures on their "Dirty Dozen" list of questionable tax transactions. While not the equivalent of a listed transaction, inclusion of a transaction on the Dirty Dozen is not something to be taken lightly by advisors or clients involved in a transaction on the list. Despite the encouraging signs of Captive professionals moving toward compliance, joining the ranks of Dirty Dozen puts Captives in a proverbial holding cell with the likes of identity theft, pervasive telephone scams, phishing, false promises of "free money" from inflated refunds, return preparer fraud, hiding income offshore, impersonation of chartable organizations, and falsely claiming zero wages or using false form 1099. The listing notice did

[50] Storms at 241, *citing* Gordon A. Schaller and Scott A. Harshman, *Use of Captive Insurance Companies in Estate Planning*, 33 ACTEC J. 252, 259-61 (Spring 2008).
[51] Storms at 242.
[52] *Id*.
[53] *Id*.
[54] *Id*.
[55] IR-2017-31, February 14, 2017. Available at: https://www.irs.gov/uac/newsroom/irs-warns-of-abusive-tax-shelters-on-2017-dirty-dozen-list-of-tax-scams.

make clear that a properly structured, well-funded, and compliant CIC is still a perfectly viable transaction. The Dirty Dozen listing applies specifically to Captives with the following problems: (i) coverage issues; (ii) structured premiums; (iii) poor actuarial substantiation; and (iv) excessive fees charged to unsophisticated taxpayers. We address each of these briefly, presuming the reader has sufficient CIC experience to understand these concerns.

Coverage Issues—In explaining the potential for abuse in CIC coverages, the IRS highlighted Captives whose insurance documents covered ordinary business risks or esoteric implausible risks for exorbitant premiums. Rather than focus on pricing, practitioners should recognize the foundation of the IRS argument that the insurance coverage was not intended to insure risks, but rather to generate high deductions without claims being made.

Structured Premiums—The IRS concern over structured premiums aims at transactions where total amounts of annual premiums often equal the amount of deductions business entities need to reduce income for the year. Hallmarks of this transaction are promoter focus on deductions needed coupled with esoteric risks which would be impossible to commercially or inexpensively insure against.

Poor Acturial Substantiation—Actuarial substantiation could easily be deemed a symptom of either of the prior concerns. However, without a professional assessment of the connection between premium amount and risk potential, the entire premium deduction becomes suspect. The IRS appeared unconcerned even where a taxpayer may not be sophisticated enough to understand their own actuarial sufficiency, but might rather place the burden of knowledge on the advisors.

Excessive Fees—Finally, the IRS took aim at promoters who manage the entities' Captives year after year for "hefty" fees, assisting taxpayers unsophisticated in insurance to continue the "charade." At odds with this pronouncement is the reality that managing an independent insurance company with the responsibility for regulatory compliance, filings, and reporting is, in fact, a significant and costly endeavor.

Legislative Changes to 831(b)

The Tax Extenders bill closed out 2015 and further put certain Captives on notice by closing the door on "estate planning" Captives in which the owner of the insured entity did not own the supporting Captive in the same proportion (within a two percent differential). The rather confusing language can be simplified by saying: If the lineal descendants' Captive ownership is greater than 2% of their ownership of the parent company, then the Captive can't make an IRC 831(b) election.[56] It also raised the annual limit to $2.2 million for premiums, which may have set-off a new round of fervor by promoters. At this point, promoters were living on borrowed time and, rather than attempt to detoxify non-compliant Captives, many continued business as usual, even with the IRS responses in the *Avrahami* case.[57]

[56] Beckett G. Cantley, *Summary: The Final Legislative Changes to IRC 831(b)*, available at

[57] *Avrahami v. Comm'r,* Respondent's Answering Brief, Docket No.'s 17594-13 and 18274-13.

Avrahami v. Commissioner

In *Avrahami* (pending), the husband and wife taxpayers owned numerous entities primarily engaged in retail jewelry sales and commercial real estate investment. The taxpayers were introduced to Captive insurance through their long-time CPA, who the IRS brief notes "had no insurance experience, but understood the [taxpayers'] financials and income tax obligations, and the tax benefits of a micro-Captive insurance arrangement…[58] We have stressed previously that pre-formation and on-going formalities must be strictly observed. We have further suggested that loan-back arrangements, insurance on the Captive's principals, and issues enumerated previously were likely to invite IRS anti-abuse and judicial anti-avoidance doctrines[59]. Despite repeated warnings, promoter abuses continued. Ultimately, the IRS brief in the *Avrahami* case illuminates some of the arguments that the IRS is likely to make use of as it litigates with taxpayers and promoters over such perceived abusive transactions.

Notice 2016-66

The IRS rang in the holidays with the November 1st release of Notice 2016-66, designating certain CICs which made the 831(b) election as a "Transaction of Interest" (TOI). While the IRS is crack down on the abusive Captive promoter practices being pushed is not surprising, the TOI label startled much of the industry. Notice 2016-66 took a stab at estate planning Captives which were already on notice as well as refining the targets on (i) insurance coverage; (ii) claims procedures and Captive management; and (iii) capitalization matters. Next, the Notice listed among its insurance coverage concerns the coverage of implausible risks. When presented with vague, ambiguous, or illusory descriptions of the scope of coverage, the Notice made clear that such coverages did not match a business need or risk. The IRS then specifically called out duplicative coverages or those commercially available and less expensive insurances.

Further attack came in how Captive owners characterized payments by the insured company to the Captive under the insurance contract. Similar to concerns raised in the Dirty Dozen listing, the IRS clarified that the TOI included circumstances in which the insured's payments are designed to provide deduction of a particular amount, or that payments are determined without a conforming or standard underwriting, or actuarial analysis. The IRS rightly took issue with payments not made consistently with contract schedules. Can we fail to timely pay our auto, home or life insurance premiums and expect that the carrier will blithely permit irregular payments? Without beating a horse dead, the TOI further took issue with—now common concerns—related to comparison of premiums, excessive premium for otherwise readily available insurance, or allocation of payment by multiple insureds inconsistent with actuarial measures of risk. In the face of insurance, actuarial, and payment concerns promoters faced other censure from Captives'

[58] Resp's brief p. 221 (citations omitted). The taxpayers initially declined to form a captive, finding the CPA's recommended promoter "too slick."

[59] Including, among others, circular cash flows, lack of bona fide debt, the step transaction doctrine, the sham transaction doctrine, the business purpose doctrine, the substance over form doctrine, and the economic substance doctrine (codified in 2010).

failures to comply with some or all the insurance laws or regulations of their respective jurisdictions. Inclusive in this criticism was the failure to: issue policies or binders consistent with industry standards; have industry compliant claims administration procedures; or file claims for each loss event covered by the contract. The TOI finally included a condemnation of poorly capitalized Captives which: are unable to assume the risks of its insured; invest in illiquid assets; or engage in loan-backs to the insured or related persons.

IR-2017-31 Dirty Dozen Listing Update

After the flurry of end of year IRS activity, related to Captives and other transactions, no one seemed surprised by Captives' reappearance in the latest incarnation of the 2017 Dirty Dozen (2017 Listing). There are some key deletions and additions as the IRS focuses on specific transactional elements. First, a discussion of the deletions, then to the insertions.

While some changes are small, there are a few key deletions to highlight. "Unscrupulous Promoters" is now "promoters", the more inclusive definition is perhaps meant to give notice to all promoters who persuade "taxpayers to enter into a Captive program." "Accountants or wealth planners" remain named. The 2017 Listing removed emphasis on promoters assisting with companies onshore or offshore, as well as managing the companies for substantial fees and assisting taxpayers "unsophisticated in insurance, to continue the charade from year to year" discussed *supra*. A statement focused on the commonality between the promoters and managers was added stating, "Promoters, reinsurers and Captive insurance managers may share common ownership interests that result in conflicts of interest." Other additions include Captive formation and contract failure to match "genuine business needs." The 2017 Listing targets actuarially unsupported premiums with the additional disapproval of premiums "geared to a desired deduction amount." The 2017 Listing includes descriptions involving taxpayer intent—including those listed above—to be proven largely by the Captive's "insufficient or altogether absent" claims administration process or a failure to file claims "seemingly covered by the Captive insurance."

III. New Disclosure Requirements

With the release of Notice 2016-66 which designates Captives as a "Transaction of Interest" (TOI),[60] new disclosure requirements arise. Requirements to disclose are not newsworthy of themselves after the IRS issued broad-sweeping final tax shelter disclosure, list maintenance, and registration regulations in 2003. Noteworthy, however, was the general slow-down of Listed Transaction labels and the rapid shift from new placement of 831(b) Captive insurance companies on the Dirty Dozen list[61] in 2015 to Transaction of Interest in 2016. We have for years published the need to focus on compliance oriented solutions for taxpayers and business owners alike and warned of the consequences of irresponsible actions in the tax community.

[60] *See*, IRS Notice 2016-66.
[61] *See generally*, Beckett G. Cantley, *Interpreting The IRS & SFC Anti-§ 831(B) Actions*, originally published in Captive Visions, available at: http://tinyurl.com/cantleydietrich-DirtyDozen.

The Notice creates a new reporting requirement for the owners of companies making the 831(b) election[62] and Material Advisors to the transaction. A taxpayer involved in a CE transaction and the Captive owner must disclose their involvement in their respective transaction on Form 8886. Unfortunately for the Captive owner, the "transaction of interest" requirements do not rely on subjective issues such as whether the coverage was properly underwritten or whether the contract covers a plausible risk. Rather, an 831(b) Captive entity is considered a "transaction of interest" if its insured losses and claim administration expenses are less than 70% of its premium income less dividend payments or if the Captive makes any loans to or investments in the parent. Regrettably, this means even if a CIC were properly capitalized initially and issued contracts covering legitimate business risks which were priced using accepted actuarial principles, but had few claims, these Captives could now be considered "transactions of interest." Advisors should initiate re-examination of these factors in light of the TOI. Due to the significant adverse consequences of failing to identify taxpayer involvement in transactions of interest, it is prudent to err on the side of over-reporting on Form 8886.

Conclusion

Unfortunately for many 831(b) Captive Insurance Company owners, our predictions from our 2013 memo as related to promoter abuses were correct and have been borne out. When we began publishing warnings, promoters derided our counsel as "paranoia." Paranoia is only paranoia until you are proven right, then it is called "Preparation." Our "paranoia" was based in sound legal theory borne out over significant IRS pronouncement after pronouncement. We have written, lectured, and explained in numerous, well-documented ways that the current state of affairs with 831(b) Captive Insurance Companies was a foregone conclusion. Though promoters may seem surprised, we are not. We expect the future to include significant IRS audits. Our purpose is, and always has been, preventing CPAs and other professionals from being unwittingly drawn into an IRS battle they did not anticipate.

If you are concerned about whether your Captives will survive IRS scrutiny or the content of this article, please contact Geoff Dietrich at (801) 367-0340 or gcdietrich@cantleydietrich.com or Beckett Cantley at (404) 502-6716 or bgcantley@cantleydietrich.com.

[62] IRS Notice 2016-66, Section 3.05.

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Prof. Beckett G. Cantley consults with CPA firms, law firms, financial planning firms, individual taxpayers, and businesses regarding their clients in matters related to U.S. (domestic) and International Taxation, Captive Insurance Companies, Outside the Box Asset Protection, and Creative Trusts & Estates Structures. His clients range from Fortune 500 companies and individual taxpayers worth in excess of $1 Billion to small businesses with accelerating income. Having previously been a tenure track law professor for 13 years, Prof. Cantley continues to operate in the academic world by serving as an Adjunct Professor teaching International Taxation at Northeastern University's Masters in Taxation Program.

Prof. Cantley has authored several authoritative articles focusing on the current and future IRS strategy for attacking offshore structures, IRC 831(b) captive insurance companies, and numerous other tax structuring practices where he explains in detail the practices in tax planning that are outside what the IRS finds to be compliant. In practice, Prof. Cantley's speeches, articles, and work with the ABA (as the Chairman of the Taxation Subcommittee on the ABA Section on Captive Insurance) allow his clients to understand what is likely to be economically substantive and what the IRS likely will deem to be non-compliant.

Geoffrey C. Dietrich, JD

Geoff Dietrich focuses his practice on business development for the firm, specifically developing relationships with CPA firms, law firms, and family offices in the areas of the Taxation, Asset Protection, Business Planning, Trusts & Estates, and Probate and Trust Administration. Geoff has developed as a tax attorney through seven (7) years working closely with Prof. Cantley; his skill set and growing expertise earned him 50% ownership of our multi-million dollar, twenty (20) year firm practice.

Mr. Dietrich graduated from the United States Military Academy (West Point), then obtained his J.D. degree from Brigham Young University Law School where he served as Managing Editor of the BYU Law Review. Mr. Dietrich is also a combat veteran having served as a commissioned officer in the U.S. Army Infantry in Kuwait and Iraq.

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*** Full title, citations, and additional articles available at www.cantleydietrich.com/Articles**

U.S. Captive Insurance Law by Beckett G. Cantley, JD, LLM and F. Hale Stewart, JD, LLM, #1 Selling Book on Amazon in its category and serves as the leading legal text in the area of captive insurance with use and acceptance throughout the captive insurance industry.