# THE IRS & SFC ANTI-§ 831(B) ACTIONS: TARGETED OR BROAD BASED?

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Recent moves by both the IRS and the U.S. Senate Finance Committee ("SFC") have made it clear that there is some level of coordinated focus on the § 831(b) captive industry. The IRS action made it clear that it deems certain practices are problematic, and perhaps criminal. The SFC action began as a broad based attack, but ended as a fact-finding mission. We discuss each below.

***The Dirty Dozen Listing***

On February 3, 2015 the IRS placed certain abusive § 831(b) captive insurance companies on their "Dirty Dozen" list of questionable tax transactions. Given the use of words like "prosecute" and "scams" in the Dirty Dozen listing notice, inclusion of a transaction on the Dirty Dozen is not something to be taken lightly by advisors or clients involved in a transaction that makes the list. This is, after all, the list that also contains 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.

Of course, the Dirty Dozen listing does not cover all § 831(b) captive insurance companies. In fact, the listing notice makes it clear that a general § 831(b) captive insurance company, done correctly, is a perfectly viable transaction. The Dirty Dozen § 831(b) transaction appears to take the § 831(b) captive chassis and add one or more of the below-described four negative attributes.

1. *Coverage Issues*. The listing notice describes § 831(b) transactions that have poorly drafted insurance documents to cover *ordinary* business risks or *esoteric*, *implausible* risks for *exorbitant* premiums, while maintaining their economical commercial coverage with traditional insurers. The IRS is clearly concerned by the use of § 831(b) captives to cover risks that either could be covered inexpensively by traditional carriers, or risks that are very unlikely to occur -- either or both -- for what it deems very high premiums. It is tempting to see this as solely a pricing issue. However, the IRS appears to be setting the table to argue that the intent of the insurance coverage is not to insure risks, but rather to generate high deductions without claims being made.

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2. *Structured Premiums*. The listing notice describes a transaction where 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 § 831(b). Thus, the IRS is concerned that promoters are structuring premiums to fit client tax deduction needs, rather than reflecting the price for needed insurance coverage.

3. *Poor Actuarial Substantiation*. Another factor described in the listing notice is where underwriting and actuarial substantiation for the insurance premiums paid are either missing or insufficient. While at first it may seem that this factor may be more of a symptom of the bigger diseases listed above, it is entirely possible that the IRS could determine that poor actuarial substantiation completely undercuts the taxpayers' good faith in taking the premium deduction. Without a professional assessment of the connection between premium amount and risk potential, the entire premium deduction becomes suspect. Even where a taxpayer may not be sophisticated enough to understand that the actuary's work is not sufficient, the taxpayer's advisors could very well be charged with this knowledge. Also, if the actuary's assessment seems sloppy or overtly aggressive, the taxpayer may be charged with the knowledge that a review of it should have elicited a more investigatory response prior to signing a tax return that relied on it.

4. *Excessive Fees Charged to Unsophisticated Taxpayers*. The listed notice also alleges that promoters manage the entities' captive insurance companies year after year for "hefty" fees, assisting taxpayers unsophisticated in insurance to continue the "charade." This factor is clearly aimed at promoters. The IRS wants to warn unsophisticated taxpayers from working with promoters on § 831(b) captive insurance companies that have one of the above negative aspects. This factor is also a warning to promoters that the IRS considers them to be conducting a fraud ("charade") in exchange for large fees. Whenever the IRS uses language like this, promoters should not disregard it as bluster.

***How could the Presence of these Factors Result in a Criminal Action?***

The first three factors above provide a good framework for bringing a civil or criminal case, depending on the intent of the parties involved. For example, if a taxpayer is filing a return with a stated deduction that deprives the IRS of owed taxes, the IRS can argue that the deducted premium is a fraud against the United States should the promoter and taxpayer know the premium is actually driven by the need for a specific tax deduction rather than the insurance need that generated the deduction. The fourth factor alone is unlikely to be enough to make the IRS challenge a transaction, but in combination with any of the above three other factors, could result in a significant escalation of the IRS' response.

***The U.S. Senate Finance Committee Hearings***

On February 11, 2015 the U.S. Senate Finance Committee ("SFC") discussed proposed legislation that would increase the § 831(b) election to $2.2 million, but would also have added new limitations that would have effectively gutted the § 831(b) election for many small businesses. Thankfully, these provisions were temporarily removed, in no

small part due to the last minute education efforts from several concerned parties, including the Self-Insurance Institute of America, Inc. ("SIIA"), and certain state insurance regulators contacting their state's U.S. Senator(s).

Unfortunately, the SFC considers the addition of some limitations as a necessary complement to raising the election to $2.2 million. Jeffrey K. Simpson, Chairman of SIIA's Alternative Risk Transfer Committee, was and continues to be a part of these discussions. Mr. Simpson advises that the discussion of raising the election is very much alive, but the IRS has advised the SFC that certain perceived estate planning abuses are high on its radar and the SFC plans on formulating offsets to curb them. U.S. Senator Charles Grassley voiced these concerns at the hearings conclusion, when he specifically asked the IRS to study the abusive use of captives in estate planning. The fall out from the IRS undertaking such an investigation is unclear, but it is entirely possible that the IRS will open a number of audits of promoters and taxpayers believed to be involved in estate planning with § 831(b) captive insurance companies.

***Conclusion***

While the above developments give rise to concerns, we also know from statements made by IRS officials that the Service does not want to "chill" the captive market. This was recently noted in a presentation to the ABA Captive Insurance Committee by Sheryl Flum, IRS Branch Chief, IRS Office of Associate Chief Counsel. Flum noted:

> *"The government is trying to walk a very thin line here because we are not trying to chill legitimate captive entities. We recognize that in a lot of cases, there are small businesses where it makes a lot more economic business sense to do self-insurance through a captive and then do a pooling arrangement."*

Thus, while it appears that the IRS is very concerned with abusive § 831(b) captive insurance practices, it is still in the investigatory stage, and is not seeking to target § 831(b) captives more broadly. The IRS knows certain practices are unacceptable (if not criminal), and has outlined them generally in the Dirty Dozen listing. However, the U.S. Senate Finance Committee call for an investigation of estate planning activities, as well as the continued proliferation of detailed IDRs in § 831(b) audits, indicate that exactly where they want to draw the line in other areas is yet to be determined.

***A more detailed and updated version of this article will appear in the next issue of Captive Visions.***