Industry Update

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This week the IRS issued its 2016 list of tax scams that taxpayers should be concerned about. For the second consecutive year, captive insurance companies are among the "Dirty Dozen." News release IR2016-25 confirms the general disdain of the IRS for captive insurance companies set up for tax avoidance instead of risk financing purposes, including the "micro captive insurance strategy." It bears noting that captive insurance companies are not the only carryover from 2015; in fact 10 of the 12 items on the 2016 list are identical to that on the 2015 list.

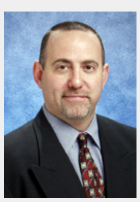
According to the IRS's release, abuse can be found whether the risks being insured are ordinary business risks or "esoteric, implausible risks for exorbitant "premiums," while the insureds continue to maintain their far less costly commercial coverages with traditional insurers." The concern is that some taxpayers are creating these entities solely to reduce taxable income while taking full advantage of the exclusion of underwriting profits from taxable income. In many of these cases there is inadequate underwriting and substantiation for the premium calculations.

There certainly may be situations involving abuse of the micro captive strategy. It is important to recognize, however that the IRS does again acknowledge that a micro captive insurance company can be a "legitimate business structure," which the Internal Revenue Code permits businesses to utilize in order to protect against certain risks.

This move by the IRS was hardly unexpected, in light of all of the activity involving captive insurance companies over the past 12 months. First there were extensive discussions both in February and December regarding the statute that provides annual premium limitation for this election, which culminated in the increase in the annual premium limitation to $2.2 million. The past 12 months have also seen an increase in IRS audit activity involving captives. So clearly the micro captive strategy has remained on the IRS's radar.

ERS has structured their model to reflect that of a commercial insurance company. ERS, along with its service providers, continually examine the model to evaluate opportunities for improvement (whether to provide more security from a compliance perspective or to make sure that their model provides the best possible structure for their clients). The captive insurance process begins with an independent risk management and underwriting review of the client's exposures prior to captive formation. The insurance premiums charged by ERSI are priced properly, on an arm's-length basis, and supported by the appropriate underwriting and actuarial studies. As part of the feasibility studies, the non-tax, business reasons for the creation of the captive and purchase of these policies are documented. Finally, ERS ensures that their policies closely resemble those utilized in the commercial marketplace and provide coverage for insurance risks, while maintaining the appropriate flexibility expected with a captive insurance arrangement. We will continue to monitor and update you on these and other events impacting the captive insurance industry.

About the author



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