

March 2015

On February 3, 2015 the IRS issued the news release IR-2015-19, which lists abusive micro captive insurance companies among the 2015 “Dirty Dozen” tax scams taxpayers should be wary of. Here is the CAPTIVE INSURANCE section from the IRS:

“Another abuse involving a legitimate tax structure involves certain small or “micro” captive insurance companies. Tax law allows businesses to create “captive” insurance companies to enable those businesses to protect against certain risks. The insured claims deductions under the tax code for premiums paid for the insurance policies while the premiums end up with the captive insurance company owned by same owners of the insured or family members.

The captive insurance company, in turn, can elect under a separate section of the tax code to be taxed only on the investment income from the pool of premiums, excluding taxable income of up to \$1.2 million per year in net written premiums.

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, drafting organizational documents and preparing initial filings to state insurance authorities and the IRS. The promoters assist with creating and “selling” to the entities often times poorly drafted “insurance” binders and policies to cover ordinary business risks or esoteric, implausible risks for exorbitant “premiums,” while maintaining their economical commercial coverage with traditional insurers.

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 the Code provision. Underwriting and actuarial substantiation for the insurance premiums paid are either missing or insufficient. The promoters manage the entities’ captive insurance companies year after year for hefty fees, assisting taxpayers unsophisticated in insurance to continue the charade.”

It is important to emphasize that the IRS is not saying that all micro captive insurance arrangements are abusive.

Obviously, ERS takes the IRS identifying the abusive use of captives taking the 831(b) election on their “Dirty Dozen” list very seriously. However, it is consistent with what the IRS has been stating for the past several years.

It is overwhelming clear captives that consistently take the 831(b) election MUST be created for true risk financing and insurance reasons and not tax avoidance. In our model we work to accomplish this by:

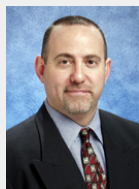
1. We collect the insured entities primary insurance policies and actually underwrite the risk;
2. We build a business plan discussing the need for the captive based on the risk management review;
3. All of our polices support the primary insurance program and are approved by the UT DOI;
4. We hired a third party actuary to build our rating model for all of our policies and these have been approved by the UT DOI;
5. The third party actuary signs off on all final premiums;
6. We hire the actuary to re-rate our policies based on our model's experience and industry experience. Most recently, because of good experience, we reduced our rates;
7. We encourage our clients to use the captive if they have an occurrence that is covered by one of the issued policies;
8. We have on retainer Sedgwick James to review all claims;
9. We have had claims in our Reinsurance or "Pooling" facility.

We feel we have created an alternative risk financing model for successful companies to conservatively pre-fund for losses in a captive.

There will be continued scrutiny of this business strategy to make sure the rules are being followed. As more information is released, we will continue to modify our model as necessary and keep you informed.

On another note, The Senate Finance Committee did pass a resolution to increase the maximum premium level from \$1.2m to \$2.2m and indexed yearly. We will continue to monitor this to see if it goes anywhere.

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