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IRS TARGETS ABUSIVE MICRO-CAPTIVE INSURANCE TRANSACTIONS

by Brian Clark
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On January 31, 2020, the IRS issued a [news release](#) that warns taxpayers that it has created 12 new examination teams to audit abusive micro-captive insurance transactions.

“Micro-captive” refers to a small insurance company that is controlled by the insured entity, and that meets specific statutory requirements. Legitimate micro-captives that insure commercial risks, charge market-rate premiums and otherwise act as arms’ length insurers enjoy significant income tax benefits. Although the insured entity can deduct premium payments made to the micro-captive as business expenses, micro-captives with no more than \$2.3 million in net premium income can elect not to pay income taxes on the premiums received, and are taxed only on their investment income.

Abusive micro-captive schemes typically involve insuring dubious risks while charging premiums grossly in excess of the market rates charged by commercial insurers or legitimate micro-captives. A telltale sign of an abusive micro-captive scheme is that the insured’s premium payment is tailored to match a specific amount needed to reduce the insured’s taxable income to the desired level. Because the insured risk is unlikely to occur, the result is a risk-free transaction that reduces the insured’s income tax bill to the desired level, minimizes the micro-captive’s taxable income and leaves cash within the related group that is frequently loaned back to the insured entity. Normally an unscrupulous promoter takes a healthy fee for “structuring” the transaction and for “managing” the micro-captive.

Abusive micro-captive transactions are on the IRS’ “Dirty Dozen” list of tax scams. The IRS contends that the schemes are not true insurance but are merely circular flows of cash among related entities that have no true economic substance. A taxpayer that cannot sustain the *bona fides* of the micro-captive arrangement risks not only loss of the projected income tax benefits to both the insured and the micro-captive, but also penalties of up to 40 percent of the resulting tax deficiencies. The recent news release evidences the IRS’ continuing determination to put an end to these abusive schemes.

Not all arrangements involving micro-captives are illegitimate. However, establishing a legitimate micro-captive insurance plan that will stand up to the IRS’ scrutiny is complicated and requires in-depth knowledge of various areas of tax and insurance law. Anyone considering the use of a micro-captive should obtain independent tax counsel to assist them in the process.

ABOUT THE AUTHOR



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With a unique background in business law and accounting, Brian Clark guides clients through a broad range of matters that impact their businesses, including tax planning and corporate transactions. He advises clients on the federal income tax consequences of a variety of transactions, including the acquisition and disposition of businesses and assets, structuring joint ventures and partnerships, and business succession planning. Brian is licensed to practice law in Texas and Louisiana, and he previously worked as a CPA at a Big Four accounting firm. He is a regular speaker on federal income tax issues at events throughout Texas.