

THE TEAM WITH THE BEST PLAYERS

WINS..... Jack Welch

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KEEPING YOUR CAPTIVE “CLEAN”

By William York, VP of Marketing



The IRS's Dirty Dozen List sounds scary. Why would anyone want to enter into an arrangement when considering such a “sinister” list? The truth is quite different though. A closer look at the list shows that many of the items they highlight are quite common areas of business and tax planning, such as business deductions, taking tax credits, donating to charities, and other perfectly reasonable and acceptable areas of personal and business tax planning.

However, the IRS positions these items in a very different way. They talk about inflated refund claims, falsifying income in order to claim credits, falsely padding deductions on returns, fake charities, excessive claims for business credits, offshore tax avoidance, and abusive tax shelters. The key words here are “inflated”, “falsifying”, “fake”, “excessive”, “avoidance”, and in the case of 831(b) Captives – “abusive”. Does anyone believe the service is telling taxpayers not to claim a tax refund? No, just don't inflate those refund claims or pad deductions. Is the service telling taxpayers not to take a deduction for a donation to a charity? No, just not a fake charity. Similarly, the Service is not telling taxpayers not to utilize an 831(b) Captive but just to make sure it's not abusive. The takeaway is clear – if you follow the rules and don't abuse the concept, a legitimate Captive Insurance

Company can provide significant risk management and tax benefits to its owners.

There are technical components that need to be present for a captive structure to be considered a legitimate insurance company such as risk shifting, risk distribution, capitalization, and the overall operation of the captive. While certain arrangements can be analyzed as to their structures and actuarial assumptions, here we would like to focus on the abusive nature of the captives that the Service has successfully challenged in tax court. When you look at the rules in general and the facts and circumstances of these cases specifically, it is easy to see why the IRS prevailed in *Avrahami*, *Reserve Mechanical*, and *Szygy*. By avoiding the egregious mistakes and abuses made by the taxpayers and their captive managers in these cases, owners of 831(b) Captives can avoid making similar mistakes and feel secure in their captive arrangement.

Avrahami is a clear example of the type of arrangement that the IRS is attacking and rightfully so. The court found that the taxpayers had coverage that would never result in a claim and there were actually no claims submitted until the IRS audit of the captive began. The taxpayers borrowed back all premiums paid to the captive through another corporation they owned, and the premiums they paid were considered inflated as they were found by the tax court to be multiples of what could be considered reasonable premiums in the commercial insurance market.

In Szygy, there were also blatant abuses including the fact that the taxpayers didn't bother to submit claims to their captive because they were “too busy” (this is while they were not too busy to submit claims to their commercial carrier). When their captive manager informed them that premiums for the following year would be reduced by \$200,000 due to the lack of claims, they fired the captive manager. (Can you imagine changing your commercial insurance carrier because your premiums went down?), And finally, the

bulk of the assets of the captive were “invested” in loans to pay premiums on large life insurance policies benefiting the owners of Syzygy (utilizing a “split dollar” arrangement”) That left the captive with almost no liquid reserves to pay potential claims because Syzygy didn’t have the right to call the loans at any time under the split dollar arrangement (they had to wait for one of the owners to die to get their money back).

Reserve Mechanical Corp. while not as blatantly abusive as *Avrahami* and *Syzygy*, made significant mistakes during formation. The risk sharing/distribution approach was to make premium payments to a risk pool (with many other companies) that insured risks in excess of commercial coverage limits. The problem was that historically Reserve had only submitted one very small claim against its commercial insurance policy that had a \$1,000,000 limit. Because of this loss history, the court found no insurable risk for the risk pool to have assumed as there was no evidence that significant losses had or would ever occur that would surpass commercial coverage limits. Finally, their risk pool agreement was structured to basically guarantee that all participants would get paid back, to their captive, an amount that was roughly what they had paid in premiums and therefore really not “insuring” any risks at all.

It is also worth noting that two of these three captives were domiciled offshore (as mentioned earlier, IRS the Dirty Dozen list refers to “offshore tax avoidance”). While not a determining factor in the disallowance of the tax deductions, clearly the optics are better when a captive is domiciled domestically and filed with and overseen by the department of insurance in the state of its domicile. These three cases fall into the category of “don’t let this happen to you”. They are emblematic of the “abusive” types of structures and operations that the service is detailing on their Dirty Dozen list. By following the rules and operating a captive as a true insurance company, taxpayers can feel safe and enjoy the benefits to which they and their companies are entitled.

Given the large amount of negative press surrounding the 831(b) Captive market, practitioners, advisors, and clients need to know the rules and avoid the pitfalls that exist today. The IRS is clearly on the attack. The reality is that despite all of these scare tactics, if an 831(b) Captive is structured, implemented, and run properly, the owners of these captives should have nothing to worry about and should enjoy all of the benefits that are inherently available to them under this section of the tax code.

Call Independent Captive Associates, LLC to learn how to get started.

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