The IRS recently filed a petition to enforce summonses issued to investigate tax liability stemming from a business’s involvement in a captive insurance transaction. While captives can have many advantages—ranging from increased control, reduced costs, and favorable tax benefits—the IRS petition underscores the importance of structuring and implementing captives in accordance with all applicable laws.

Often viewed as an alternative to traditional insurance markets, a “captive” is a wholly-owned subsidiary insurance company that provides coverage for its parent company or group of related companies. Like a traditional insurer, a captive is subject to jurisdiction-specific regulations, like financial reporting, solvency and reserve requirements, and annual actuarial opinions. Each jurisdiction also provides specific guidelines for the formation and administration of captives.
As is the case with traditional insurance, the insured pays a premium to its captive insurer in exchange for coverage. However, because the captive is owned and controlled by the insured, it can offer broader or more tailored coverage than traditional insurance products, including protecting some risks that may otherwise be uninsurable. Other advantages of captives may include reduced operating costs, increased control over claims, and tax savings. For instance, captive insurers can pay dividends to owners, and premiums may be tax deductible business expenses if the captive’s risk-sharing arrangement meets certain standards.

While captives offer many advantages, they can pose additional challenges if not created and implemented correctly, as evidenced by the IRS’s petition in United States v. Prince, No. 8:22-cv-1456 (M.D. Fla. filed June 27, 2022). In Prince, the IRS issued administrative summonses as part of its examination of tax liabilities for two entities involved in a captive insurance transaction. Across two tax years, affiliated entities using the captive insurance arrangement took business expense deductions of more than $425,000 for captive insurance premium payments, all of which the captive reported on its returns as exempt from taxation. According to the petition, which was served on the individual shareholder and partnership representative for the two captive entities, the companies had failed to comply with the summonses.

Given the state of the insurance market and ongoing difficulties with high premiums, less favorable terms, and decreased capacity for many lines of coverage, companies continue to look for alternative risk transfer options—like captives, risk retention groups, and self-insurance—outside the traditional insurance market. Captives may be an attractive alternative given the potential flexibility, control, and cost savings. However, captives must be structured and implemented correctly to take advantage of those benefits, including any tax savings like those at issue in Prince. The IRS in particular scrutinizes captives to ensure that the entity is a bona fide insurance company, that it is formed for a legitimate business purpose, and that any preferential tax treatment of premium payments are permissible under applicable tax laws. Retaining experienced risk professionals at every stage of the process, including attorneys to advise not only on insurance and regulatory compliance but also corporate and tax issues, can help maximize benefits in captive formation and minimize the risk of disputes with state, federal, or foreign government agencies.

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