

Reproduced with permission from Daily Tax Report, 107 DTR G-8, 6/3/16. Copyright © 2016 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

Insurance

Practitioner Provides Options for Preventing Use of Captive Companies as Tax Shelters

There are several alternatives that can be put in place to prevent captive insurance companies from being used as tax shelters, a practitioner said.

The 831(b) provisions could help stymie these abuses, but will not completely solve the problem, said Kristan Rizzolo, a partner at Sutherland Asbill & Brennan LLP, said June 2 at a Federal Bar Association Section on Taxation insurance tax seminar.

In the Protecting Americans from Tax Hikes (PATH) Act, Congress enacted several changes to Section 831(b), which allows an insurance company to elect to be taxed on its investment income only, so long as the company receives less than \$1.2 million in premiums each year.

The Section 831(b) election is often used by small to mid-sized businesses, but it has come to the IRS's attention that many 831(b) companies are being used as tax shelters as well. For this reason, the Internal Revenue Service plans on issuing guidance on captive insurance companies and has added such entities to its "Dirty Dozen" list of tax scams.

To prevent these abuses, in the PATH Act, Congress added two provisions to the tax section—the diversification requirement and the ownership test; a captive insurance company has to meet at least one of these new criteria. They are designed to prevent a parent from transferring wealth to a child by having the parent own the insurance company and the decedent acting as the insured.

Rizzolo offered several alternatives for preventing the abuses. The first option would be to get rid of Section 831(b) altogether, but that would be unrealistic due to opposition from members of Congress from states where individuals such as farmers need these types of insurance companies, she said.

There could also be limits placed on what the 831(b) companies are used for; however, that would create problems because there are a number of circumstances where legitimate businesses have put these types of entities into place for "real reasons," Rizzolo said.

Specify Coverage. Another option would be to specify the type of coverage that can be placed into an 831(b) company. For example, tornado coverage shouldn't be

allowed in a state where that is not required, she explained.

A fourth option would be to require a certification by an actuary to attest to the premium laid out by the company. Most of the companies contributing to the problem are charging too much premium for the amount of risk they are insuring, Rizzolo said.

Another alternative would be to devise a voluntary compliance program where companies with questionable practices could turn themselves in. The IRS could say "if you come in, we'll settle your cases at a certain level, we won't penalize you," she said.

Last, the IRS could implement a larger-scale enforcement for preventing the abuse, though that would require resources, which the agency is currently lacking, Rizzolo said.

'Avrahami' Case. This issue has gained attention due to both the congressional changes and a pending U.S. Tax Court case, *Avrahami v. Commissioner*. In the pending case, the IRS is challenging the validity of Benjamin and Orna Avrahami's private insurance company, said Adam Fisher, a tax director with PricewaterhouseCoopers LLP, who also participated in the panel.

The two Arizona jewelers created an insurance company to cover their businesses against possible chemical or nuclear terrorist attacks. The IRS is trying to prove the captive wasn't a legitimate risk management program that meets U.S. tax law requirements.

Priority Guidance Plan. Guidance relating to captive insurance companies is included in the IRS's 2015-2016 Priority Guidance Plan.

Alexis MacIvor, branch chief at the IRS Office of Chief Counsel (Financial Institutions and Products), said the scope and focus of the guidance is still being considered at this point.

"We hope to provide guidance that will provide direction to taxpayers and will result in efficient use of service resources," she said.

By ALLYSON VERSPRILLE

To contact the reporter on this story: Allyson Versprille in Washington at aversprille@bna.com

To contact the editor responsible for this story: Brett Ferguson at bferguson@bna.com