INTERNAL REVENUE SERVICE

IRS News Release

Media Relations Office | Washington, D.C. | Media Contact: 202.317.4000

www.irs.gov/newsroom | Public Contact: 800.829.1040

IRS Warns of Abusive Tax Shelters on 2017 "Dirty Dozen" List of Tax Scams

IRS YouTube Videos:
Dirty Dozen – English | Spanish | ASL

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WASHINGTON – For the third consecutive year, the IRS places abusive micro-captive insurance tax shelters on its list of "Dirty Dozen" tax scams. The list, compiled annually, describes a variety of common scams that taxpayers may encounter. Many of these schemes peak during filing season as people prepare their returns or hire others to help them.

"Taxpayers should avoid unscrupulous promoters who encourage the use of phony tax shelters designed to avoid paying what is owed," said IRS Commissioner John Koskinen. "These scams can end up costing taxpayers more in penalties, back taxes and interest than they saved in the first place."

The IRS continues to address those using abusive shelters through audits, litigation, published guidance and legislation.

Tax law generally allows businesses to create "captive" insurance companies to protect against certain risks. Traditional captive insurance typically allows a taxpayer to reduce insurance costs. The insured business claims deductions for premiums paid for insurance policies. Those amounts are paid, either as insurance premiums or reinsurance premiums, to a "captive" insurance company owned by the insured or parties related to the insured.

Under section 831(b) of the tax code, captive insurers that qualify as small insurance companies can elect to exclude limited amounts of annual net premiums from income, so that the captive pays tax only on its investment income.

In abusive "micro-captive" structures, promoters, accountants or wealth planners persuade owners of closely held entities to participate in schemes that lack many of the attributes of genuine insurance. For example, coverages may insure implausible risks, fail to match genuine business needs or duplicate the taxpayer's commercial coverages. Premium amounts may be unsupported by underwriting or actuarial analysis, may be geared to a desired deduction amount or may be significantly higher than premiums for comparable commercial coverage.

Policies may contain vague, ambiguous or deceptive terms and otherwise fail to meet industry or regulatory standards. Claims administration processes may be insufficient or altogether absent. Insureds may fail to file claims that are seemingly covered by the captive insurance.

Captives may invest in illiquid or speculative assets or loan or otherwise transfer capital to or for the benefit of the insured, the captive's owners or other related persons or entities. Captives may also be formed to advance inter-generational wealth transfer objectives and avoid estate and gift taxes. Promoters, reinsurers and captive insurance managers may share common ownership interests that result in conflicts of interest.

In Notice 2016-66 (Nov. 1, 2016), the IRS advised that micro-captive insurance transactions have the potential for tax avoidance or evasion. The notice designated transactions that are the same as or substantially similar to transactions that are described in the notice as "Transactions of Interest." The notice established reporting requirements for those entering into such transactions on or after Nov. 2, 2006, and created disclosure and list maintenance obligations for material advisors.

Congress has also acted to curb micro-captive abuses. The Protecting Americans from Tax Hikes (PATH) Act, effective Jan. 1, 2017, established diversification and reporting requirements for new and existing captives.