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The IRS says taxpayers need to be wary of abusive tax shelters, which remain on its "Dirty Dozen" list of tax scams.

These sophisticated schemes, particularly those involving micro-captive insurance shelters, can be peddled by promoters and others to avoid taxes.

The annually compiled "Dirty Dozen" list describes a variety of common scams that taxpayers may encounter. Many of these schemes peak during tax season, and the agency wants taxpayers to remain on alert for them.

These scams can range from simple schemes to inflate refunds to more elaborate efforts related to tax shelters.

Through audits, litigation, published guidance and legislation, the IRS continues to address those using abusive micro-captive insurance tax shelters.

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 insurer pays tax only on its investment income.

In certain "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.

Micro-captives may invest in illiquid or speculative assets or loans 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 Avrahami v. Commissioner, the U.S. Tax Court disallowed premium deductions the taxpayer had claimed under a section 831(b) micro-captive arrangement, concluding that the arrangement was not "insurance" under long established decisional law principles. To qualify as insurance under those principles, an arrangement must involve risk shifting, risk distribution and insurance risk, and must also meet commonly accepted notions of insurance. The Avrahami court concluded that the taxpayer's arrangement failed to distribute risk and that the taxpayer's captive was not a bona fide insurance company. The court pointed to a number of facts that it found problematic, including circular flows of funds, grossly excessive premiums, non-arm's length contracts, and an ultra-low probability of claims being paid. The court also concluded that the arrangement was not insurance in the commonly accepted sense, due in part to haphazard organization and operation, the captive's investments in illiquid assets, unclear policies, and inflated premiums.

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.

Separately, Congress has also acted to curb micro-captive abuses. The Protecting

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