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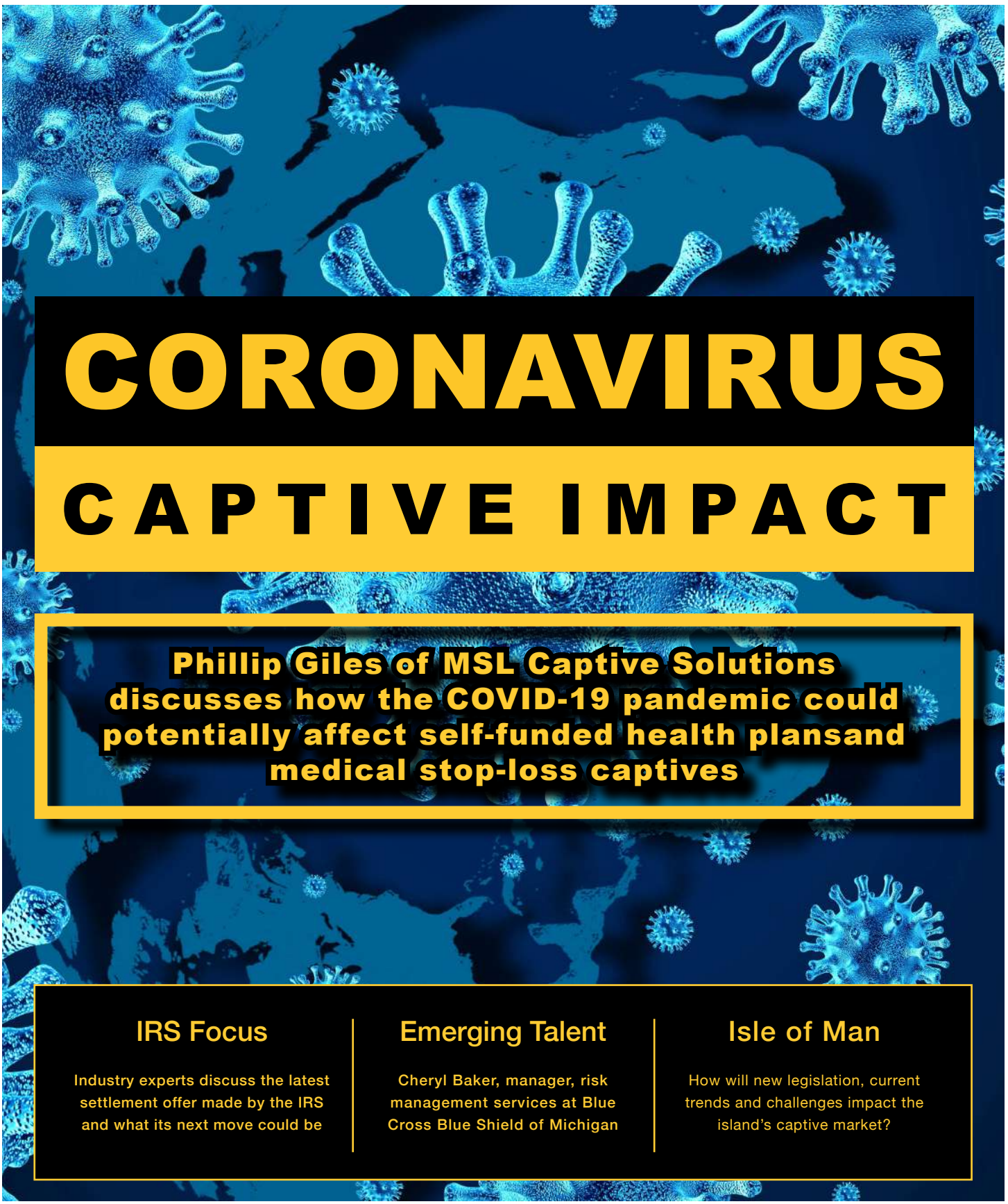

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The battle goes on

As the IRS' battle against micro-captives continues, industry experts discuss the latest settlement offer made by the IRS and what its next move could be

The Internal Revenue Service (IRS) has targeted micro captives for years, but in more recent times they have ramped up their efforts to do so, including them on its 'Dirty Dozen' list of tax scams since 2014, along with other actions.

In 2016, the Department of Treasury and IRS issued Notice 2016-66, which formally labelled micro captives as 'transactions of interest'. The IRS advised that these transactions have the potential for tax avoidance or evasion.

Under section 831(b) of the US 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.

Named as a type of "abusive tax shelter", the IRS has previously suggested that some micro captives may be used by promoters, accountants or wealth planners to persuade owners of closely-held entities to participate in schemes that lack many of the attributes of genuine insurance.

Alan Fine, tax partner and insurance industry group leader, Brown Smith Wallace, notes that the IRS' aversion to captives dates back to the late 1970s and early 1980s when they attacked a large number of captive insurance companies.

Fine says: "Those early cases, like the cases of recent years, generally resulted in victories for the government."

He explains that the IRS currently operates under the assumption that most micro-captive transactions have been entered into and conducted improperly, without sufficient non-tax business purposes for doing so.

"There are some situations in which taxpayers try to reduce their overall tax liability by utilising the micro-captive

strategy, rather than entering into it for risk management purposes," he adds.

Many major cases have made headlines as they went to US tax court against the IRS, the first case that involved a captive that made the election to be taxed solely on investment income under Section 831(b) was Avrahami v Commissioner of Internal Revenue (Avrahami).

In August 2017, the US Tax Court released its decision in the Avrahami case, backing the IRS.

Judge Mark Holmes ruled that payments made to the Avrahamis by their micro captive, Feedback, amounted to taxable dividends outside of the scope of certain tax elections.

Feedback insured the Avrahamis' Arizona jewellery stores and shopping centres against chemical and biological terrorist attacks.

But the IRS believed that the micro captive was organised to provide tax deductions under Section 831(b) of the Internal Revenue Code and lacked insurance risk, and that risk was not shifted to the captive.

Another example is Reserve Mechanical Corp v Commissioner of Internal Revenue and CIC Services LLC v. IRS, which is still ongoing in the court. CIC Services has petitioned the Supreme Court of the US to hear its lawsuit against the Internal Revenue Service (IRS) regarding IRS Notice 2016-66, while Reserve Mechanical Corp has filed the opening brief with the tenth circuit court of appeals.

Sean King, principal at CIC Services, explains that the IRS does not and has not identified all micro-captive transactions as 'abusive'. He says: "In fact, the IRS conceded in its original 'Dirty Dozen' publication that micro-captives, in general, are a "legitimate tax structure."

He adds that in Notice 2016-66, the IRS stated that it "lacks sufficient information to identify which 831(b) arrangements should be identified specifically as a tax avoidance transaction and may lack sufficient information to define the characteristics that distinguish the tax avoidance transactions from other 831(b) related-party transactions".

King says: "So, clearly, the IRS thinks that there are some, perhaps a lot, of non-abusive captive transactions."

Settle for less

In September last year, the IRS mailed a "time-limited settlement offer" for certain taxpayers under audit who participated in 'abusive' micro captive insurance transactions.

The settlement requires substantial concession of the income tax benefits claimed by the taxpayer together with appropriate penalties—unless the taxpayer can demonstrate good faith, reasonable reliance. The initiative is currently limited to taxpayers with at least one open year under exam.

Commenting on the IRS's latest move against micro-captives, Fine suggests that if the IRS were focused on pursuing taxpayers who entered into the captive transactions strictly to generate tax deductions, "I would not take exception to this move".

Fine explains that unfortunately, the IRS "is unlikely to be that focused on their new examination efforts"

He adds: "The additional issue is that there will still be a shortage of subject matter experts that understand the insurance-specific nuances of these transactions, resulting in longer, inefficient exams and increased professional fees for taxpayers defending the exams," he adds.

Phil Karter, attorney at Chamberlain Hrdlicka states he would not characterise the IRS' latest move as one "against" micro captives, but rather a recognition of the limitations on its own resources to effectively manage a large number of captive audits in the pipeline.

He explains: "In attempting to reduce the workload, the IRS has proposed a settlement that is arguably reasonable for bad captives or ones where the dollar amount at issue may not justify the expense of defending an audit, but much less so for well-organised, well-run captives that have been caught in the audited net simply because of the reporting requirement and consequent close scrutiny given to micro-captives generally."

Since the first announcement, in February, the IRS revealed that 80 percent of taxpayers who received offer letters elected to accept the settlement terms.

However, the Self-Insurance Institute of America (SIIA) has suggested that the settlement figures released by the IRS are "misleading".

SIIA stressed that the figure is misleading in that the 80 percent of the taxpayers have agreed to participate and consider a settlement, but did not actually settle.

According to SIIA, those taxpayers can indeed settle, but also have the option to go to court.

SIIA said it understands that, as of 19 February, not a single captive had engaged in a final settlement agreement, and making such an announcement is "premature".

In addition, SIIA suggested the audit teams will most likely be looking at other issues unrelated to the captive industry, not simply focusing on captives themselves.

SIIA revealed that while approximately 160 captive structures have agreed to consider settlements with the IRS, thousands of captives remain in place that are assisting America's small and medium-sized businesses to mitigate important and real risk factors.

Commenting on the benefits of accepting such offer, Fine says: "The benefit of accepting the settlement offer is it will allow affected taxpayers to move past the time and effort associated with the examinations. It provides certainty, particularly regarding the potential income inclusion at the captive level, and it reduces or potentially eliminates penalties."

At the time of announcing the settlement offer, the IRS also revealed it was establishing 12 new examination teams comprised of employees from the IRS large business/self-employed divisions that will be working to address abusive transactions and open additional exams.

Fine said he expects to see a significant number of these new examinations starting in the next 12 to 18 months.

He reveals: "Given the vast breadth of the information requests, the lack of captive insurance experts within the IRS (even within the new exam teams), and the IRS's steadfast refusal to look at these captives reasonably, the vast majority of the cases will then move to the appeals phase, followed by a large number of taxpayers moving to litigate in tax court."

The next move

Commenting on the IRS next move, King says that after decades of losing tax court case after-tax court case, the IRS has "finally managed" to win the last three in a row involving micro-captives of questionable status.

However, King states: "Knowing that they will eventually lose some important cases again and that such losses will embolden honest taxpayers to resist its attempts at extortion, the IRS is seeking to strike at its point of maximum leverage."

He adds: "The service hopes to intimidate as many taxpayers as possible in the coming months into settlements before adverse precedent undermines that leverage."

"My guess is that the Service will act quickly, or as quickly as governments do, to threaten more audits in hopes of scaring taxpayers into quick settlements."

A resolution

As the battle continues between the IRS and micro-captives, will there ever be a resolution or agreement between the IRS and its view on micro captives?

Karter discloses that many professionals who work on captive matters view the IRS' current aggressive captive audit initiatives as a "short-term pain" that will hopefully lead to a better long-term outcome in differentiating the many captives that are appropriately run to effectuate better risk management for their businesses from those that have no real business purpose but are set up principally to capitalise on tax benefits".

He adds: "When the dust finally settles, it is reasonable to expect that more clearly defined standards of what works and what doesn't will allow the many bonafide micro captive arrangements to successfully capitalise on the tax inducements congress intended in enacting section 831(b)."

However, King suggests that the IRS's hostility towards captives transcends decades, administrations and parties, and he doesn't believe this will change.

He states: "Ultimately the captive insurance industry will deal with the IRS just like they have for so long – by beating it in court. Court precedent will ultimately give the industry the guidance that the IRS refuses to. And in the meantime, the industry will continue to grow and prosper, just as it has."

Will the uncertainty remain?

As the IRS continues to focus on micro-captives, is there a possibility it will move the attention onto another form of a captive in the future?

Fine suggests that could be the case, "particularly if the Reserve Mechanical appeal is unsuccessful".

He notes that the issues the IRS is focusing on "aren't limited to micro captives".

"Concerns over the logic utilised by the tax court, such as the requirement to have a prior loss before there is a valid business purpose for purchasing insurance, 'cookie-cutter' insurance policies and what the court incorrectly referred to as "circular flow of funds" (the mechanism by which all risk-sharing pools operate) could potentially be issued for group captives, as well as the largest captives owned by fortune 500 companies."

King stresses that the IRS "loves uncertainty". He says: "Uncertainly allows it to raise revenue by arbitrarily coercing settlements from taxpayers who don't want to 'make a federal case of it.' And what qualifies as 'insurance' and what does not will probably always be somewhat uncertain."

"For that reason, I'm sure that the IRS will continue to scrutinise insurance arrangements in general, not just captives. That's just how the game is played", he adds. ■