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INSIGHT: IRS Announcement Likely Overstates True Impact of Captive Insurance Settlement

By Philip Karter and Patrick J. McCann, Jr.
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The IRS recently announced a captive insurance global settlement initiative. Philp Karter and Pat McCann of Chamberlain Hrdlicka say the announcement likely overstates the true impact of the initiative but makes clear the government's commitment to increased scrutiny of the captive insurance industry.

On Jan. 31, 2020, the IRS announced that nearly 80% of taxpayers who received an offer under a global settlement initiative related to transactions with small captive insurance companies had accepted the terms of that settlement.

The Internal Revenue Service had previously announced on Sept. 16, 2019, that it would be extending a time-limited settlement offer to up to 200 taxpayers under examination for their participation in captive insurance transactions. The settlement initiative was developed after three IRS victories in U.S. Tax Court cases that involved small captive insurance companies (*Avrahami v. Commissioner, Reserve Mechanical Corp. v. Commissioner,* (appeal pending in U.S. Court of Appeals for the 10th Circuit), and *Syzygy Insurance Company v. Commissioner).* IRS Commissioner Chuck Rettig stated, "The overwhelming acceptance rate of the private settlement offer is a reflection of the government's work to stop [abusive captive insurance arrangements]."

Under the terms of the IRS settlement, operating companies that claimed a deduction for insurance premium payments made to a related captive insurance company would concede 90% of the claimed deduction. In exchange, the IRS agreed not to assert any additional income to the captive insurance company. The terms of the agreement included a 10% penalty that could be reduced to zero upon showing that taxpayers had not previously participated in a reportable transaction and that they relied on the advice of a qualified independent professional advisor.

The settlement terms also required the owners of the captive insurance company to recognize a deemed liquidating dividend distribution if the company had not yet liquidated and the shareholders of the company to file gift tax returns in cases where the ownership of the captive insurance company did not match the ownership of the operating entities claiming the deductions.

The initial correspondence communicating the offer to eligible taxpayers required the taxpayers to accept the settlement within 30 days of receiving the offer. However, that date was later extended to Dec. 2, 2019, to allow taxpayers to more fully investigate the terms of the settlement and its potential impact on them. The terms of the settlement are to be implemented through the use of Closing Agreements (Forms 906), and the correspondence made clear that the taxpayers were not bound to the terms of the settlement agreement until the execution of a Form 906 formally memorializing the terms of the settlement. Instead, acceptance would "be considered a non-binding consent to participate" in the global settlement initiative.

Given the complexities involved with the settlement agreement and the fact that taxpayers had until Dec. 2, 2019, to conditionally accept the terms of the settlement, it is unclear how many, if any, taxpayers have executed Forms 906 fulling binding themselves to the global settlement initiative. It is possible that taxpayers who agreed to participate in the settlement initiative through their "non-binding consent" may opt not to move forward with the execution of Forms 906 once the full impact of the terms are fully understood.

IRS Enforcement Program

The IRS started its coordinated program targeting Section 831(b) captive insurance companies with their inclusion on its annual "Dirty Dozen" list starting in 2014. Those efforts increased with the release of Notice 2016-66 in November 2016. Notice 2016-66 made transactions with small captive insurance companies "Transactions of Interest" and required all taxpayers engaged in such transactions to disclose their participation in captive insurance transactions to the Office of Tax Shelter Analysis on Form 8886. Failure to properly disclose participation in such transactions can result in significant civil penalties.

The IRS has made it clear that it will continue its enforcement efforts related to small captive insurance transactions. In its Jan. 31, 2020, announcement, the IRS also announced that it is forming 12 new examination teams comprised of employees from the IRS Large Business and International and Small Business/Self-Employed divisions to examine captive insurance transactions. The IRS announcement indicated that examinations impacting "several thousand taxpayers" will be opened by the 12 new examination teams. Additionally, IRS Chief Counsel, Michael Desmond, announced at the American Bar Association Section of Taxation meeting in Boca Raton, Fla., on Jan. 31, 2020, that the IRS would be hiring an executive to coordinate promoter and material adviser investigations to oversee enforcement activities against tax shelter promoters and advisers, including those involving captive insurance arrangements.

The determination of whether an insurance company is a valid insurance company for federal tax purposes focuses on the presence of: (i) insurance risk; (ii) risk shifting; (iii) risk distribution; and (iv) whether the transactions were "insurance in the common sense." The Tax Court has repeatedly emphasized that such determination is highly fact specific and requires an objective examination of the facts and circumstances that pertain to a given transaction.

On the heels of three adverse decisions, the pendulum in the micro captive insurance world has swung heavily in favor of the government; bad facts cases tend to cause that. Moreover, by the time a taxpayer receives an examination notice, the facts are baked in, so it is essential that taxpayers contemplating these arrangements thoroughly "kick the tires" to make sure they are structured in a manner consistent with the risk minimization objectives of the business. Therefore, in the captive world, the so-called "how would it look in front of a judge" test is particularly relevant during the planning stages.

But the same type of objective scrutiny also needs to be done if an examination notice is received by a micro captive insured. Taxpayers finding themselves in that position should have an independent in-depth analysis prepared regarding their captive insurance companies' activities during the years at issue. Was the theoretical purpose of the captive when it was established borne out in practice? Any analysis of a taxpayer's captive insurance program should confirm that the operating company faced real insurable risks that shifted to the insurance company, and that the insurance company actually distributed those risks.

Judicial Guidance

The courts have also provided considerable guidance about the path toward establishing that a captive insurance company operate as an insurance company "in the commonly accepted sense." Some of the factors highlighted by the courts occur at the outset and are easy to satisfy, such as whether the company was organized, operated, and regulated as an insurance company, and whether it was adequately capitalized.

However, among the various factors identified by the courts, three are of particular importance to independently confirm how robust a captive arrangement is and the defense of that arrangement can be. This requires (i) careful scrutiny of the policies themselves, specifically whether they are commercially reasonable, unambiguous in their coverage and binding in nature, (ii) whether the premiums are reasonable and the result of arm's-length transactions, and finally (iii) whether claims were actually paid by the captive.

As for the last of these, there are good arguments to be made that actual claims should not be necessary and that insurance is just as legitimate to protect against an infrequent, yet potentially disastrous loss. Moreover, what is often lost in all the rhetoric about captives is that self-insuring can be a very effective way to modify a company's behavior and improve risk management because there is true "skin in the game." That said, in the real world of defending captives, one's job is a lot easier if you can point to what actually happened and say, "See, I told you so."

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TOP

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