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In this article, Karter, Kirkpatrick, and McCann consider how taxpayers engaged in microcaptive transactions should respond to an IRS Letter 6336, part of a new enforcement initiative.

One of life's more unpleasant slings and arrows is often the receipt of a letter from the IRS requesting information. For taxpayers engaged in microcaptive transactions, the IRS's long-standing effort to clamp down on what it considers abusive microcaptive arrangements has spawned a new, unwelcome outreach that could require taxpayers "to take arms against a sea of troubles."

On January 31, in IR-2020-26, the IRS announced the establishment of 12 new examination teams to assist in auditing what it described as abusive microcaptive insurance transactions. The information release reported that "examinations impacting micro-captive insurance transactions of several thousand taxpayers will be opened by these teams in the coming months. Potential civil outcomes can include full disallowance of claimed captive insurance deductions, inclusion of income by the captive entity and imposition of all applicable penalties."

In the past month, tens of thousands of taxpayers engaged in small captive arrangements who had already disclosed their participation in those transactions have received an IRS Letter 6336, which appears to be a byproduct of this new enforcement initiative. The letter gets right to the point, stating upfront: "We have information that you've taken a deduction or other tax benefit related to micro-captive insurance on a prior year tax return and disclosed" under Notice 2016-66, 2016-47 IRB 745, and Notice 2017-8, 2017-3 IRB 423. It requests information about whether the captive is still operating and if not, when it wound up.

Although common sense suggests that Letter 6336 was intended for taxpayers who have not yet been subject to a microcaptive audit, and whose identities were learned from their Form 8886, "Reportable Transaction Disclosure Statement," the letter has also been sent to many taxpayers already under captive audits, including those with cases pending in the Tax Court disputing audit adjustments, in which the IRS is already certain to have the information the letter solicits. We can ignore those circumstances for now, suggesting only that a suitable response by a taxpayer already under audit might be to advise the IRS of the audit and reference the examining agent as the person to contact if it wants further information.

But for microcaptive taxpayers who have not yet been subject to an audit examination, more questions about what to do are warranted because you are clearly on the IRS's radar screen. This new outreach likely reflects the IRS's attempt to accomplish two objectives: first, to prioritize its new microcaptive audits in which it can get the most bang for its buck, and second, to coerce taxpayers who have not been audited to rethink whether they should be claiming their insurance premium deductions given the administrative and financial burden of an IRS audit. More about that second point later.

I. A Few Q&As That Identify Key Considerations

A. When Is a Response Due?

First of all, a response to Letter 6336 is not mandatory. But that doesn't mean taxpayers in all instances should ignore it. For those who determine that responding is in their best interests, the original due date of May 4, 2020, has been extended to June 4, 2020, in consideration of the COVID-19 pandemic.

B. Who Should Respond?

1. Taxpayer last paid premiums into a microcaptive in 2016 or a prior year.

Absent an extension of time to file a 2016 return, the statute for that year expired on April 15, 2020, before a Letter 6336 response is requested. For a taxpayer who last engaged in a microcaptive transaction in a tax year that is now barred by the statute of limitations, the IRS can no longer challenge the insured's premium deductions. (Note that there may be a limited exception to the three-year statute expiration if the captive was based in a foreign jurisdiction and no protective Form 5471 was ever filed.) So although the taxpayer is not at risk if it responds to the letter (and may want to do so to stop further inquiries into an open year, in which other non-captive issues may lurk), there is also no risk of a captive-related adjustment if the taxpayer chooses not to respond.

2. Taxpayer extended its 2016 year or last paid premiums into a microcaptive in 2017.

Although the taxpayer has already been identified and it may seem reasonable to expect an audit to follow, the IRS is loath to commence audits when the statute of limitations will soon expire, unless it can secure an immediate extension. Although some might argue in favor of responding to the letter because the risk of an audit for an expiring year is perceived to be low, the best advice may still be to sit tight and not respond at all while the year remains open. In this case, discretion may be the better part of valor.

3. Taxpayer extended its pre-2018 years or last paid premiums into a microcaptive in 2019.

Here's when the decision to respond (or not to respond) to Letter 6336 is less clear-cut, given that enough time remains on the statute of limitations to commence a captive audit. Responding to the inquiry could be viewed by the IRS as a good-faith effort to cooperate, but whether that is likely to translate into more lenient treatment if an audit is commenced is unknown. Although the letter states that the IRS will "take your actions in response to this letter into account when considering future compliance activity related to your micro-captive insurance arrangement," there are no concrete promises to treat those who respond more leniently. Some practitioners have commented that a showing of good faith might reduce the risk of penalties or enhance a reasonable cause defense, but as a legal matter, good faith is determined as of the time the return is filed and not post hoc. So while a response to Letter 6336 may buy some goodwill with an auditor, for an issue being tightly controlled by persons above the audit level, one should not assume that it will bear on the IRS's decision whether to assert the 20 or 40 percent penalty in a microcaptive audit.

4. Taxpayer continues to participate in a captive arrangement.

Although many of the same considerations discussed earlier are implicated, it's not entirely clear that Letter 6336 is soliciting a response from insureds whose captives continue to operate in 2020. For example, it cautions:

> If you continue to participate in a micro-captive insurance transaction covered under Notice 2016-66, you must continue to disclose your participation in the transaction.

That's an accurate statement but not necessarily a directive to respond specifically to the letter, which is not a model of clarity. Indeed, the penalty of perjury statement in Letter 6336 contains a reference to the "date I ceased participating in the micro-captive insurance transaction (if applicable)."

Nonetheless, for taxpayers in these circumstances, it is worth recognizing that your transactions are the ones most susceptible to the commencement of a tax audit. To the extent that seems inevitable, a pre-audit response is unlikely to meaningfully increase the risk of audit and may buy some goodwill should one commence.

C. Are There Any Other Considerations?

Yes, a big one. A final consideration for recipients of Letter 6336 is whether to consider filing qualified amended returns for open years to obviate the risk of penalties. A qualified amended return in this context is an amended return that is filed after the due date of the return for the tax year (determined with regard to extensions of time to file) and before the time the taxpayer is first contacted by the IRS about an examination (including a criminal investigation) regarding the return. Letter 6336 makes clear that it does not constitute an inquiry or contact for purposes of ending the time the taxpayer can file a qualified amended return.

A taxpayer who decides to file a qualified amended return for any unaudited open tax year would be forgoing the premium deduction claimed on their original return. The decision should therefore be predicated on one's evaluation of the captive insurance arrangement and whether it can withstand an audit. However, even taxpayers with meritorious arrangements who claimed smaller premium deductions in open years may want to consider whether it is worth having to prepare and pay for an audit defense. That is the unfortunate reality of operating in a David vs. Goliath tax regime, when a cost-benefit analysis in the wake of IRS audit threats unfortunately may prevail over the right to defend deductions attributable to perfectly legitimate congressionally authorized tax inducements. The benefit of filing a qualified amended return is the avoidance of penalties, which can range from 20 to 40 percent of the tax deficiency resulting from an IRS adjustment. Although the taxpayers in the three litigated microcaptive cases were not subject to penalties, the IRS has pursued them aggressively, and it is reasonable to believe that taxpayers remain at risk for penalties in captive transactions the courts find abusive.

D. Is Captive Settlement Resolution a Factor?

In IR-2019-157 issued last September, the IRS announced a "time-limited settlement offer for certain taxpayers under audit who participated in abusive micro-captive insurance transactions." The offer was extended to about 200 taxpayers, which represents only a small percentage of those under microcaptive audits. Although there are no reports that the IRS intends to broaden the number of taxpayers to whom this offer is extended, with roughly 80 percent of taxpayers tentatively accepting it, a good deal of money is being collected with a significant reduction in the effort that IRS exam teams undertake to collect it. With federal fisc-friendly statistics in mind, it makes sense to think the IRS might broaden the number of taxpayers eligible for the captive settlement, although that is by no means certain. Recently, the IRS has even extended similar offers to taxpayers with cases pending in the Tax Court in what appears to be an effort to reduce the backlog of pending captive insurance cases.

One major inducement of the captive settlement offer for so-called bad captives that will likely fail to overcome an adverse audit is a reduction in penalties to a maximum of 10 percent down to 0 percent if conditions are met. Participating taxpayers also may retain 10 percent of their claimed captive premium deductions.

Because there is no guarantee that the IRS will offer the microcaptive settlement initiative to insureds subjected to new audits, the ability to retain 10 percent of the deduction and a reduced penalty under the settlement is unknowable at this time. If, however, that same offer was extended to taxpayers involved in new microcaptive audits arising from this initiative, the arguments for filing a qualified amended return to avoid the risk of 20 percent or 40 percent penalties would diminish.

Finally, although the IRS has offered no concrete inducements to promote more responses to Letter 6336, it is not unreasonable to speculate that taxpayers who respond to it and later get audited might be more likely to be extended the captive settlement resolution initiative than a taxpayer who chooses not to respond. Taxpayers may want to take Letter 6336 as an invitation to have an independent review of their captive insurance program to identify any potential areas of weakness and to ensure that their program is following the best practices in light of the three litigated captive insurance cases.

E. Will *CIC Services* Decision Matter?

On May 4 the Supreme Court granted certiorari in *CIC Services*,[1] a case brought by a firm advising taxpayers engaging in microcaptive transactions that challenged the IRS's right to impose microcaptive reporting and record-keeping requirements under Notice 2016-66 without first complying with the notice and comment requirements of the Administrative Procedure Act.[2] The Sixth Circuit had ruled that the petitioner's challenge to pre-enforcement review of the reporting and recordkeeping requirements was barred by the Anti-Injunction Act (section 7421). As noted above, these reporting and recordkeeping requirements are almost certainly what prompted the issuance of Letter 6336.

Although the long-term effect of a reversal in *CIC Services* could impair the IRS's ability to unilaterally undertake actions that lead to initiatives like the issuance of Letter 6336, that would happen only long after taxpayers need to make a decision about responding to the letter. ■

[1] *CIC Services LLC v. IRS*, 936 F.3d 501 (6th Cir. 2019), *cert. granted*, No. 19-930 (U.S. May 4, 2020).

[2] *See* 5 U.S.C. section 553(b) and (c).