



# IRS CONTINUING ITS OFFENSIVE TOWARDS ENTERPRISE RISK CAPTIVES

**E**nterprise Risk Captives (ERCs) are once again under attack from the Internal Revenue Service (IRS). The latest sally in an on-going offensive was a letter sent to tens of thousands of captives requiring information regarding their use of the 831(b) option of the U.S. Tax Code under threat of perjury. The letter was sent in March, only a few days into the National COVID-19 Emergency Declaration.

While poorly timed, as so many businesses are working to switch to telecommuting and are letting go of staff, the letter is also aggressive towards captives, threatening more exams of ERCs. Industry professionals are up in arms by the request as it places undue burdens on captives during a time of crisis and casts a wide net over the industry under the assumption that any captive taking the 831(b) option is partaking in an abusive tax scheme.

Written by Karrie Hyatt

## TIMELINE OF IRS ACTIONS

The IRS began aggressively auditing ERCs in the early 2010s. In 2015, the IRS named micro-captives to their annual “Dirty Dozen” list. This list is released each year to warn taxpayers of potential tax abuses and scams. Called “micro captives” in the IRS press releases, the “Dirty Dozen” list claims that some captives using the 831(b) designation are using it for reasons other than insuring genuine risk.

Also in 2015, Congress passed the Protecting Americans from Tax Hikes Act of 2015 (PATH Act), although it didn't go into effect until January 1, 2017. The law created tax relief benefits for businesses and families, and, for the captive insurance industry, the PATH Act increased the limit of net annual written premiums to 2.2 million dollars for ERCs taking the 831(b) option.

The Act also changed the qualifications regarding ownership diversity for those captives, requiring any captive electing for the 831(b) designation to meet a “Diversification Requirement” in ownership. The PATH Act, while supporting ERCs, also made it more difficult for bad actors to form them. Since the law was passed, the captive industry has been waiting for guidance regarding certain provisions in the Act, now going on nearly five years, and after numerous requests from SIIA and a number of state domiciles.

In late 2016, the IRS issued Notice 2016-66 after again placing ERCs on the “Dirty Dozen” list. Notice 2016-66 named 831(b) captives as “transactions of interest” and requested specified entities to file additional financial disclosures by January 30, 2017—90 days after the Notice was issued. The deadline was moved to May 1, 2017 after vociferous outcry from the captive industry.

The Notice was an attempt by the IRS to collate as much information about ERCs as possible. However, it created a financial burden on these small captives to gather the additional materials requested. CIC Services, a Tennessee-based captive manager, filed a lawsuit against the IRS and Treasury Department arguing that Notice 2016-66 was unlawfully issued and did not meet the authority or “reasoned analysis” requirements of the Administrative Procedure Act. CIC Services lost the initial case and took it to the Appeals Court where it was denied. In May, the U.S. Supreme Court granted cert on the case, which will be heard in the upcoming term starting in October (CIC Services vs. IRS).

In August 2017, the U.S. Tax Court released its decision in the case of *Avrahami v. Commissioner*, a highly anticipated case regarding captive insurance companies electing to use the 831(b) option. The case was decided against the owners of the captive. The case was the first in a series of actions heard by the Tax Court and the decision had been much anticipated by the captive industry.



The decision did offer some guidance to the types of risk structures captives that should be used when claiming the 831(b) tax option. In mid-2019, another case, *Reserve Mechanical Corp. v. Commissioner*, was decided against the captive. In addition, there are two other cases now awaiting decisions that may have continued repercussions on the captive industry's relationship with the IRS.

Most recently, on September 16, 2019, the IRS sent a settlement letter to around 200 captives that were then under audit. The letter was part of a Global Settlement Initiative and included a one-time offer requiring the captive to pay penalties and concede a substantial portion of the tax benefits that were previously claimed. At the time it was estimated that there were more than 500 ERCs being audited or in the appeals process.

## MARCH 20, 2020

Increasing its hostility towards ERCs, on March 20th, the IRS sent Letter 6336 (3-2020) to captives that have taken the 831(b) option on their tax filings. The IRS cast a broad net with this letter, sending it to approximately 150,000 captive owners. It was sent to both currently operating and closed captives, as well as to captives that are already under exam or are in the appeals process or in litigation. In one case, an individual received a letter regarding a captive that ceased operations in 2011.

Citing Notice 2016-66, the letter is addressed to those who have, "Taken a tax deduction or other tax benefit related micro-captive insurance on a prior year tax return." The letter states that, "The IRS is increasing enforcement activity in this area and has deployed several examination teams to open additional examinations of returns that included micro-captive insurance transactions."

The letter requires captive owners to sign a "penalties of perjury statement," which is included with the letter. Additionally, the letter asks for the last tax year in which the deduction was claimed and the date the receiver "ceased participating in the micro-captive insurance transaction," if applicable. It is indicated that compliance with the request will reflect favorably on those captives. The letter ends with cautionary advice for ERCs to consult an "independent, competent tax advisor."



The March 20th letter named May 4, 2020 as the due date for the information. In light of the National COVID-19 Emergency Declaration, and after a push from SIIA, the IRS extended the deadline to June 4, 2020.

After the settlement offer from last fall, which indicated to many that the IRS was shoring up its aggressive auditing of ERCs, this letter indicates that is intensifying its examination of captives claiming the 831(b) deduction. Rather than acknowledge that most ERCs are operating in compliance with the law, the IRS seems to be working under the assumption that any captive taking the tax option is abusing tax law.

## INDUSTRY REACTION

Captive industry professionals were fuming by both the timing of the letter and the intent. SIIA led the conversation with a letter to Steven T. Mnuchin, secretary of the Department of the Treasury and Charles P. Rettig, commissioner for the IRS, sent on March 30 from Ryan Work, SIIA's vice president of Government Relations.

SIIA's letter was followed by letters from the Vermont Captive Insurance Association (VCIA), and captive insurance associations from North Carolina, Arizona, Montana, Tennessee, Georgia, Nevada, and Utah, among others—many of whom sent letters to their Congressional delegation as well. SIIA is leading a grassroots effort with captive owner engagement. Dozens of captive owners are sending letters to Congress, several of which have also had virtual phone meetings to discuss captive issues, which SIIA has helped coordinate.

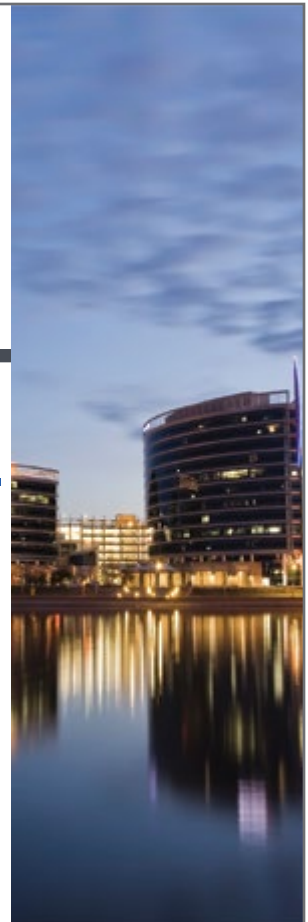


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The primary point of contention for much of the industry was the vastly inappropriate timing of the letter. While the IRS had likely been working on it for months, deciding to send it after the “Safer at Home” orders were issued, was beyond bad timing. Many, if not most, businesses in the country were shut down, inaccessible, or operating at a diminished capacity when the letter was received. This placed an undue burden on captive owners, particularly ERCs, which are generally small to medium-sized businesses.



As the due date for federal taxes being filed for individuals, families, and businesses has been delayed during this time of crisis, the captive industry is wondering why ERC owners have not been given the same grace period regarding the requests in Letter 6336. Particularly since the businesses that ERCs insure are being hit particularly hard.

Right now, ERCs are proving their now by providing relief for “supply chain and business interruption, contamination clean up, medical costs, crisis management expenses, and other high-severity, low-frequency events,” according to SIIA’s letter.

While SIIA and captive associations acknowledge that there may be a few bad actors operating in the ERC

sector, for the IRS to approach 150,000 captives assuming they are abusing tax law is heavy-handed. After spending close to a decade being critical of the captive structure, the IRS still has to offer any guidance regarding ERCs taking the 831(b) option. Industry professionals have been requesting guidance for years, especially in the last five years since the PATH Act was passed in Congress.

The letter is also considered poorly written and vague on key points. According to SIIA’s letter, “The IRS Letter, itself, is so unclear that taxpayers making good faith efforts to comply could inadvertently put themselves in a position to be accused of perjury.

For example, the IRS Letter requires taxpayers who have ceased participating in micro-captive transactions to report the date they ceased participating. Unfortunately, there are a number of dates that could provide reasonable responses to the question, including: the date the last insurance policy expired, the date the last insurance obligation was resolved, the date the captive surrendered its insurance license or the date the captive was liquidated, just to name a few.”

Captive industry professionals and associations have called for the suspension of the request until at least the national emergency is over. The Utah Captive Insurance Association’s letter called for the suspension of “This unnecessary and overly-aggressive audit and examination activity until at least a year after the national COVID-19 emergency declaration is withdrawn.”

In the letter to the IRS from VCIA's president, Richard Smith, he sums up the industry's opinion this way, "We request that the IRS withdraw this letter and suspend its audit activities of 'micro-captives' until the COVID-19 crisis is over and the nation's economy is on the road to recovery.... We also request that the IRS, when it resumes its examination of 'micro-captives,' take a more appropriate approach focusing on those organizations that show evidence of malfeasance, and not to condemn an entire industry." ■



Karrie Hyatt is a freelance writer who has been involved in the captive industry for more than ten years. More information about her work can be found at: [www.karriehyatt.com](http://www.karriehyatt.com).



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