

The IRS Continues to **BULLY**

“Microcaptives”



**DESPITE A CALL TO WITHDRAW THE IRS IS STILL
AGGRESSIVELY PURSUING MICROCAPTIVES**

Written By Karrie Hyatt

This year, even as many businesses are suffering due to the COVID-19 pandemic, the IRS has increased its insistent examination of what the Service refers to as microcaptives—small to medium-sized captives that elect to take IRC 831(b).

From their request for information last March to their hostile release in October, the IRS is casting a wide net over microcaptives. This was followed in late October that the IRS is issuing another round of settlement offers.

Recently, a report was released by the Government Accountability Office (GAO) regarding offshore microcaptives that moderately supported the IRS's claims, yet it didn't take into account opinions outside the IRS. However, Congressional members have raised growing concerns as to why the IRS is so focused on these captives that provide legitimate forms of risk mitigation for their owners.

THE GAO REPORT

At the beginning of September, the GAO publicly released a report titled, “Abusive Tax Schemes: Offshore Insurance Products and Associated Compliance Risks” that, ostensibly, was meant to report on certain offshore captive and life insurance products that could be misused as tax shelters. However, the report casts aspersions over microcaptives in general.

The report is a poorly executed reiteration of the Service's party line. While the GAO purports to have spoken to industry professionals, the report hits on all of the IRS's key points regarding microcaptives without regard to outside opinions.

In a statement released by SIIA regarding the report, Ryan C. Work, vice president of Government Relations, said, “SIIA is disappointed in the one-sided nature of the report and the lack of industry background included. In many instances, the GAO simply duplicated verbatim past statements from the IRS that are broad sweeping in nature, rather than providing appropriate differentiation between abusive structures and non-abusive.”

The report makes several mentions of “guidance” offered to the insurance entities in question by the IRS over the years, but, as stated in Appendix 1, makes no mention of guidance offered to microcaptives or insurance companies taking the 831(b) election.

This has long been a contentious issue. “As we have said in the past,” said Work in SIIA's statement, “Congress gave the IRS rulemaking authority back in 2015 to curb certain abusive practices, which the Service has yet to take any action upon despite numerous industry and congressional requests. The GAO also fails to make mention of the tens of thousands of data filings and dozens of data requests the IRS has imposed on the industry. Time and time again the industry has provided that data, and the IRS has failed to provide additional clarity.”

The report refers specifically to two recent Tax Court wins by the IRS. However, the second case it refers to, *Szygy v. Commissioner*, is a case regarding a Delaware-domiciled captive. This mistake shows that the GAO either did very sloppy work on this report or that the report writers were more interested in proving the IRS's talking points than creating a nuanced look at offshore microcaptive tax abuses.

The report states, “IRS has said that the majority of micro-captive cases examined have been determined to be abusive.” This statement is clearly meant to establish the Service's stance that all small to medium-sized captives are abusing the tax law.

“It is unfortunate that the report did not offer a balanced and accurate approach to the captive market, nor its importance in the current insurance market in general,” the SIIA statement summed up.

According to John R. Capasso, president and CEO of Captive Planning Associates, LLC, “It concerns me that it seems as if the GAO is repeating the same IRS talking points—that all captives electing to be taxed as a small insurance company (IRC Section 831(b)) are bad, without providing evidence that it took the time to do the research necessary to come to an independent conclusion as to distinguish between an abusive captive structure verse an non-abusive captive structure.”

IRS LETTER IR-2020-226

On October 1st, the IRS issued a formal letter that furthers their aggressive stance on microcaptives. The letter threatens expanded enforcement on “abusive microcaptive insurance schemes” and urges captive owners to fold their captive before the October 15 filing deadline. While the letter is hard-hitting, at the same time it is ambiguous. It offers no guidance on how an abusive microcaptive is structured, instead recommending consulting an independent tax advisor.

The report follows this recommendation with, “These taxpayers should seriously consider exiting the transaction and not claiming deductions associated with abusive micro-captive insurance transactions, just like many other taxpayers did who were contacted by the IRS in March and July 2020.”

According to Work, “The IRS wants to scare as many business owners away from captives as possible. They’re putting all captives into the same bucket—as abusive captives—rather than acknowledging there’s a number of good captives out there.”

“To me,” said Jeffrey K. Simpson, partner with Womble Bond Dickinson (US) LLP, “Letter 2020-226 perfectly encapsulates the IRS’ current strategy. That strategy is to threaten taxpayers into abandoning their [microcaptive] structures and to impose draconian penalties on anyone who tries to stick with it.”

Continuing the critical tone, the IRS letter states, “For those taxpayers that do not exit the transaction and continue taking such deductions, the IRS will disallow tax benefits from transactions that are determined to be abusive ...” Thus, taking an overly aggressive stance.

While the IRS is doubling down on its stance that all microcaptive structures are abusive, small to medium-sized captives are proliferating, with many states recommending businesses look into establishing captives in the wake of the current economic climate.

During the current COVID-19 pandemic, the IRS is trying to dismantle a legal and legitimate form of insurance when businesses are needing it most. Work said, “At a time when businesses are struggling, the IRS is working to scare away businesses from opportunities to mitigate real risk.”

“The Service is taking the position that all micro-captives are bad,” said Capasso. “In fairness to the Service, some of these micro-captives are not structured and operated in the true sense of an insurance company. That said, resorting to fearmongering to scare business owners into thinking they are guilty of operating an abusive scheme in the midst of a national pandemic is troubling. Especially so when considering that these captives, in some cases, are providing a life-line to businesses that insured for such a catastrophic risk.”

“We are having this fight in the middle of the COVID crisis, where numerous [microcaptives] are being called upon to cover losses that are not being addressed by the commercial insurance industry,” said Simpson. “Rather than recognize an example of the very reason [these captives] exist, the IRS is increasing its efforts to put them out of business.”





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The October 1st letter appears to be a staunch reminder to microcaptives that, even while they were not named to the Service's "Dirty Dozen" list this year (which was instead filled with scams related to the pandemic), that they are still high on its list of abusive tax structures.

"The IRS has decided that while businesses remain shuttered during the COVID-19 national emergency, many helping their own communities, the IRS is flaunting the fact that it is embarking on even more purposefully onerous and unnecessary requirements, such as Letter 6336," said Work.

"What the IRS doesn't say, but their actions indicate, is that they've already decided that if you're [a microcaptive] you are abusive," said Simpson. "We are not seeing the IRS undertaking any kind of disciplined effort to understand and evaluate captives on a case-by-case basis. Instead, in every case, the audit summarily concludes that the ERC structure is not insurance for tax purposes and throws the

burden back on the taxpayer to defend itself."

This is exactly what the IRS did at the end of October when it announced another round of settlement offers, this time with much more strict terms, which will be sent to some microcaptive insurance companies.

THE SENATOR'S LETTER

In late August, U.S. Senator Cory Gardner of Colorado sent a letter to Treasury Secretary Steven Mnuchin and IRS Commissioner Charles Rettig to express his concerns regarding



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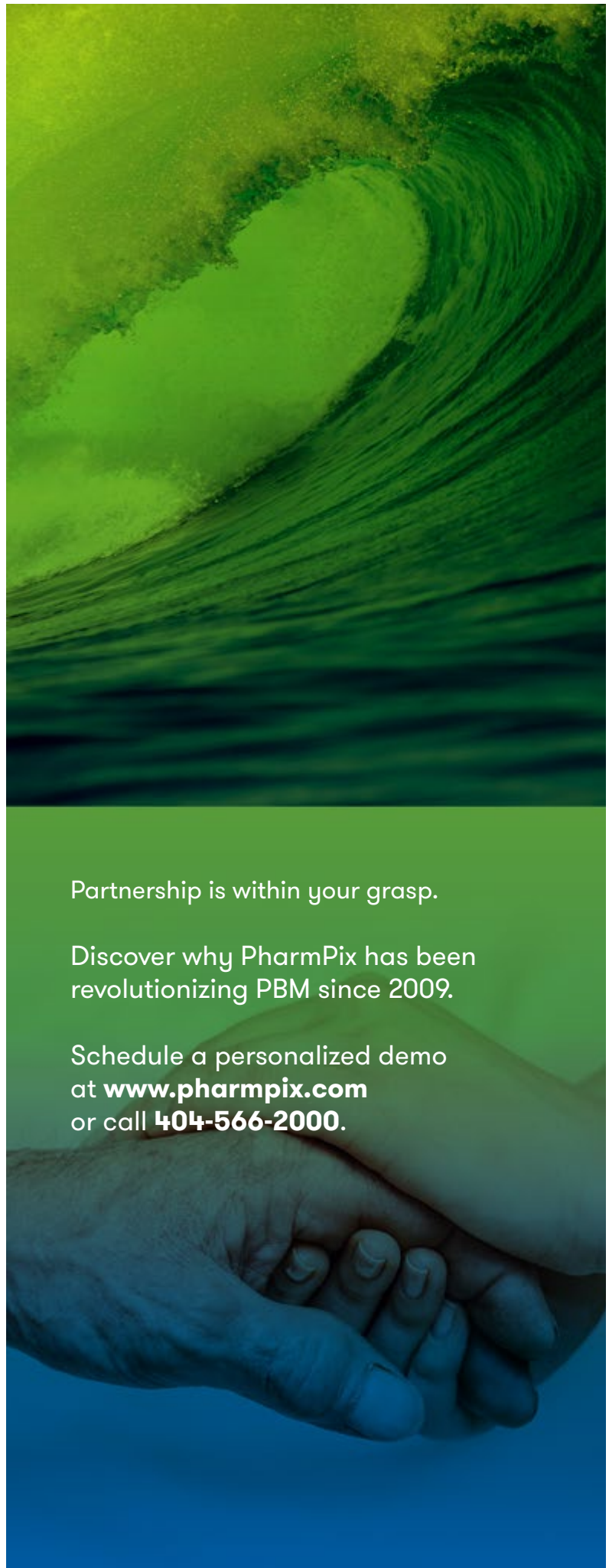
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the Service's continued scrutiny, especially in light of the current pandemic that is disrupting all levels of business.

He was especially critical of Letter 6336, issued in March to IRS-designated microcaptives. "Aside from poor timing given the fast-developing public health crisis, the letter also requested information, under penalty of perjury, that many may not be able to provide. More importantly, the Tenth Circuit is currently considering an appeal that will likely provide significant guidance for the industry," Gardner wrote in the letter.

The appeal he references is in the *Reserve Mechanical Corp. v. Commissioner* case, which was originally decided in favor of the IRS in June 2018 and which has been in the appeals process since. Gardner wrote, "The United States Tax Court's decision in *Reserve Mechanical Corp. v. Commissioner*, No. 014545-16, presents significant issues for the captive insurance industry.

As the amici curiae brief for various state agencies and the Self-Insurance Institute of America, Inc. makes clear, there is serious concern within the industry that the Tax Court's decision is contrary to established law and creates a marked change in the rules for the industry."

When the appeal is decided it should provide some guidance for captives regarding the 831(b) election and a decision that reverses the original Tax Court ruling would have an impact on the IRS's continued examination of small and medium-sized captives.

"While I support the IRS's goal of eliminating bad actors in the industry," wrote Gardner, "I respectfully request that the Service suspend its broad review of the industry until resolution of the current litigation in the United States Court of Appeals for the 10th Circuit."

The senator's letter was a result of discussions between SIIA members and Gardner. According to Ryan Work, there has been an uptick in interest from Congress regarding the IRS's fixation on microcaptives, which included a number of letters to the IRS from congressional offices asking why legitimate insurance companies are being burdened with IRS letters at this time.

"Instead of defining abuses, the Service has continued with duplicative data requests such as Letter 6336. I think members of Congress are getting wary of it. They are hearing more and more from constituents and businesses who are struggling. The last thing these businesses need right now is the IRS going after their legitimate insurance structure," said Work.



TAKING BACK THE NARRATIVE

The IRS is promoting a narrative that all microcaptives are abusing U.S. Tax law. Their rhetoric has included misinformation about how many of these captives are abusive. In October 2019, the IRS offered a global settlement to only 156 captives, with about 120 settling, yet, the IRS implies that the settlement offer was a large win.

There are thousands of captives operating in the U.S., so 156 is not a significant number. There is no indication at this time as to how many captives will receive settlement offers this year.

SIIA and other industry associations and professionals are working to wrestle back the story in support of captives. "The IRS is trying to frame microcaptives in their own way," said Work. "It's our job in the industry to cut through the IRS's narrative because it is not correct. The fact is, there are thousands of captives in this country operating within the law, yet the IRS is painting the whole industry as abusive."

According to Simpson, "Even though the current focus is on [microcaptives], the IRS has a long history of distrust of all captive insurance transactions, and has challenged them on a number of theories over several decades. They especially dislike [microcaptives] because they are novel and innovative, and the IRS simply doesn't believe that that innovation could be driven by anything other than tax motivation.

"Regarding the settlement offer from last year, the IRS cast a wide net hoping to get a few wins, but this exercise has become a very concerning expenditure of resources," continued Work. "They are using the limited time and resources of the Service to go after insurance companies that have



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very low premiums. They have spent more on court cases alone than these captives will ever pay in taxes—even if they fold their cards and pay up. The IRS is spending millions of dollars to bring up these cases in court, which far outweigh any court penalties and taxes.”

In addition, the IRS has focused on microcaptives that were formed more than ten years ago—when many microcaptives were just getting started. According to Work, “A captive established a number of years ago is going to look a lot different than ones that were established more recently.”

As more microcaptives have been formed and captive domiciles become more sophisticated in regulating them, the whole industry has matured. While there were likely some bad players in the beginning, the legitimate professionals in the industry have worked to weed them out. Things like updating captive law in onshore domiciles, trade association educational forums, and SIIA's Captive Manager Code of Conduct, all of these have helped mature the industry.

Without formal guidance by the IRS, captive professionals have been working to create their own guidance—both formal and informal. “Captive professionals pay attention to what the IRS is doing and to court decisions,” said Work. “They are changing captive management practices to do the best they can. That’s the nature of any business, and I think our members want to do what’s best for their client and they want to do it by the book. It’s hard to do because that book hasn’t been written.”

The IRS has the tools at its disposal to issue guidance for microcaptives. Congress has asked it multiple times to issue this guidance, and yet, more than five years later, the Service still hasn’t issued any. Instead, the IRS continues to demand extra information, to increase examinations, and to continue enforcement actions.

According to Capasso, “I am very much in favor of an open, honest dialogue to work towards resolving Congress’s directive to the IRS to clarify parts of the PATH Act from 2015 on curbing specific abusive practices in life insurance and captives—which SIIA has previously brought forth certain proposals; and work on an industry-wide outline of ‘Best Practices’ of what constitutes the parameters of forming and operating a microcaptive.”

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As Work said in his letter to SIIA members after the most recent letter issued by the IRS, "American taxpayers, including captive owners, deserve a fair process, one in which the IRS should set out clear guidance to provide. We have asked for that over and over again, as has Congress. Let's stop the fear-mongering press releases and have a productive conversation with the IRS and industry about what can be done to solve the impasse."

"Thankfully," said Simpson, "SIIA is there to help give us a voice in the press, in the Department of the Treasury, and in Congress. The great news is that many captive owners are now finding the forum and opportunity to tell their success stories and those stories are having an impact. But we have to continue telling them and we have to amplify them because this is an uphill battle and the IRS is a resourceful opponent." ■

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.

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