

Alert | Tax Audits & Litigation/Insurance



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IRS Offers Settlements to Some Micro-Captive Insurance Taxpayers

On Sept. 16, 2019, the IRS announced it is offering settlements to certain taxpayers with open audits of micro-captive insurance transactions. The IRS has targeted these micro-captive insurance transactions since 2014, and they were designated as transactions of interest in 2016.¹ Although micro-captive insurance transactions have gained popularity among closely held entities, the IRS has challenged such transactions as abusive, stating that they “are inconsistent with arm’s length transactions and sound business practices.”²

Following several IRS victories in the U.S. Tax Court, the IRS decided to offer settlements to taxpayers currently under examination and mailed settlement letters to up to 200 such taxpayers. This action was not unexpected given the IRS’s three recent victories, described below, and the rash of docketed cases in the Tax Court on this issue. A settlement initiative such as this one represents an effort to deal with the volume of cases. The initiative will resolve more cases without litigation and will produce finality for those accepting the fixed settlement terms.

¹ Neither the Code nor the regulations define “insurance” for U.S. federal income tax purposes. The Tax Court has articulated four factors that indicate an arrangement constitutes insurance: (1) insurance risk, (2) risk shifting, (3) risk distribution, and (4) commonly accepted notions of insurance.

² Notice 2016-66.

Micro-Captive Insurance Transactions

The tax law generally allows businesses to create “captive” insurance companies to insure against certain risks. In general, in a micro-captive transaction, a person directly or indirectly owns an interest in an entity that conducts a trade or business (the “Insured”). That same person also directly or indirectly owns or forms another entity (the “Captive”). Captive enters into a contract with Insured to provide insurance, either only to Insured or on a reinsurance or pooling arrangement basis. Captive and Insured treat the contract as an insurance contract for U.S. federal income tax purposes. Insured makes payments to Captive under the contract, treats the payments as insurance premiums, and deducts the payments as ordinary and necessary business expenses under Section 162 of the Internal Revenue Code of 1986, as amended (the “Code”).

Insurers that qualify as small insurance companies can elect to be treated as exempt organizations or to exclude limited amounts of annual net premiums from income so that the captive insurer pays tax only on its investment income. Although insurance companies are generally taxed on their receipt of premiums, small insurance companies can exclude from income up to \$2.2 million in net premiums.

If Captive is not a domestic corporation, Captive makes an Election under Code section 953(d) to be treated as a domestic corporation. Captive then makes an election under Code section 831(b) to be taxed only on taxable investment income and excludes the premiums from taxable income. The micro-captive insurance transaction is generally structured so that Captive has no more than \$2.2 million in net premiums and can exclude the entire amount from taxable income.

IRS Challenge

The IRS has challenged micro-captive insurance transactions as not qualifying as insurance for U.S. federal income tax purposes. If the transactions are not insurance, then the premium payments do not qualify as deductible business expenses to the insured and are taxable to the insurer. The IRS has had recent success in the U.S. Tax Court in challenging these transactions. In 2017, the U.S. Tax Court disallowed the “wholly unreasonable” premium deductions the taxpayer had claimed under a micro-captive arrangement, concluding that the arrangement was not “insurance” (*Avrahami v. Commissioner*, 149 T.C. No. 7 (2017)). In 2018, the Tax Court concluded that the transactions in a second micro-captive arrangement were not “insurance” (*Reserve Mechanical Corp. v. Commissioner*, T.C. Memo. 2018-86). In 2019, the IRS also prevailed in *Syzygy Ins. Co. v. Commissioner*, T.C. Memo. 2019-34.

The IRS has stated that abusive micro-captive insurance transactions have one or more of the following coverage characteristics: (1) the coverage involves an implausible risk, (2) the coverage does not match a business need or risk of the insured, (3) the description of the scope of the insurance coverage is vague, ambiguous, or illusory, or (4) the coverage duplicates coverage provided to an insured by an unrelated, commercial insurance company, and the policy with the commercial insurer has a far smaller premium.³ The IRS has also pointed out that Captive often uses its capital to invest in illiquid or speculative assets usually not held by insurance companies, does not have adequate capital to assume the risks it is insuring, or loans capital to Insured or other persons related to Insured. Finally, the IRS points to insufficient or nonexistent claim processes as evidence of an abusive transaction. All of these factors give rise to the view that the transaction is not really “insurance.”

³ Id.

IRS Settlement Offer

The IRS settlement initiative states that the IRS will continue to challenge micro-captive insurance transactions in court. However, as to a limited number of taxpayers currently under exam, the IRS is offering to settle. Taxpayers eligible for the settlement will be notified of the terms by letter from the IRS. These terms have not been publicized, although substantial taxes and appropriate penalties are to be expected unless the taxpayer can establish reasonable cause to avoid the penalties. The settlement initiative is currently limited to taxpayers with at least one open year under exam. The offer will terminate after a certain amount of time. The IRS may expand this program to make additional settlement offers. Taxpayers who are offered the settlement but decline to participate will continue to have full rights to appeal any IRS decision but will not be eligible for future settlement initiatives.

Greenberg Traurig's Tax Audits & Litigation team can assist in evaluating and responding to the offer letter and in litigation of these issues.

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