

Alert | Tax Audits, Litigation & Criminal Tax Defense



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IRS Wins Again on Micro-Captive Arrangements, Urges Taxpayers to Exit Transactions

On April 9, 2021, the IRS urged taxpayers who engage in micro-captive insurance arrangements to exit these transactions. This **announcement** follows an IRS victory in the U.S. Tax Court, which found that such arrangements are not eligible for the tax benefits claimed. The IRS had previously issued settlement initiatives following victories in Tax Court.

IRS Wins in Tax Court

On March 10, 2021, the U.S. Tax Court held in *Caylor Land & Dev. v. Commissioner*, T.C. Memo. 2021-30 (2021), that a micro-captive arrangement failed to qualify as insurance for federal tax purposes. *Caylor* involved a standard micro-captive structure, where the taxpayer incorporated a foreign micro-captive, made an election to be treated as a U.S. corporation for tax purposes, and took tax deductions on premium payments made to the micro-captive, while the micro-captive excluded such premium payments from income. U.S. Tax Court Judge Mark Holmes cited three previous IRS victories against micro-captive arrangements and stated, “we will break no new ground today.”

The IRS announced it will disallow tax benefits from transactions that are determined to be abusive, and it may also require domestic captives to include premium payments in income and assert a withholding liability on foreign captives. IRS Commissioner Chuck Rettig agreed with court characterizations of micro-captive transactions as “fanciful” and “unreasonable.”

In *Caylor*, the Tax Court also sustained the IRS's determination of accuracy-related penalties and rejected the taxpayer's claim of reliance on tax advice. The IRS announced that it will continue to assert penalties as appropriate, including the strict liability penalty that applies to transactions that lack economic substance.

Previous IRS Enforcement

Following several IRS victories in the U.S. Tax Court, the IRS previously **offered settlements** to taxpayers currently under examination and mailed settlement letters to them. A settlement initiative represents an effort to deal with a significant volume of cases. Potential settlement offers include a full disallowance of captive insurance deductions, inclusion of income by the captive, withholding tax related to any foreign captives, and imposition of all applicable penalties.

On March 20, 2020, the IRS sent Letter 6336 to certain micro-captive taxpayers requiring such taxpayers to advise the IRS if they are no longer claiming deductions or other tax benefits for covered micro-captive insurance transactions. On Oct. 22, 2020, the IRS **announced** a second time-limited settlement initiative with stricter terms than the first time-limited initiative. Future settlement initiatives may impose stricter terms. According to the IRS, early responses to its settlement initiatives indicate that a significant number of affected taxpayers have exited the transaction.

The IRS urges taxpayers who engaged in micro-captive transactions to consult an independent tax advisor prior to filing their 2020 tax returns, to consider exiting the transactions, and not to report deductions associated with the structures.

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