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Work in progress

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Assistant vice president

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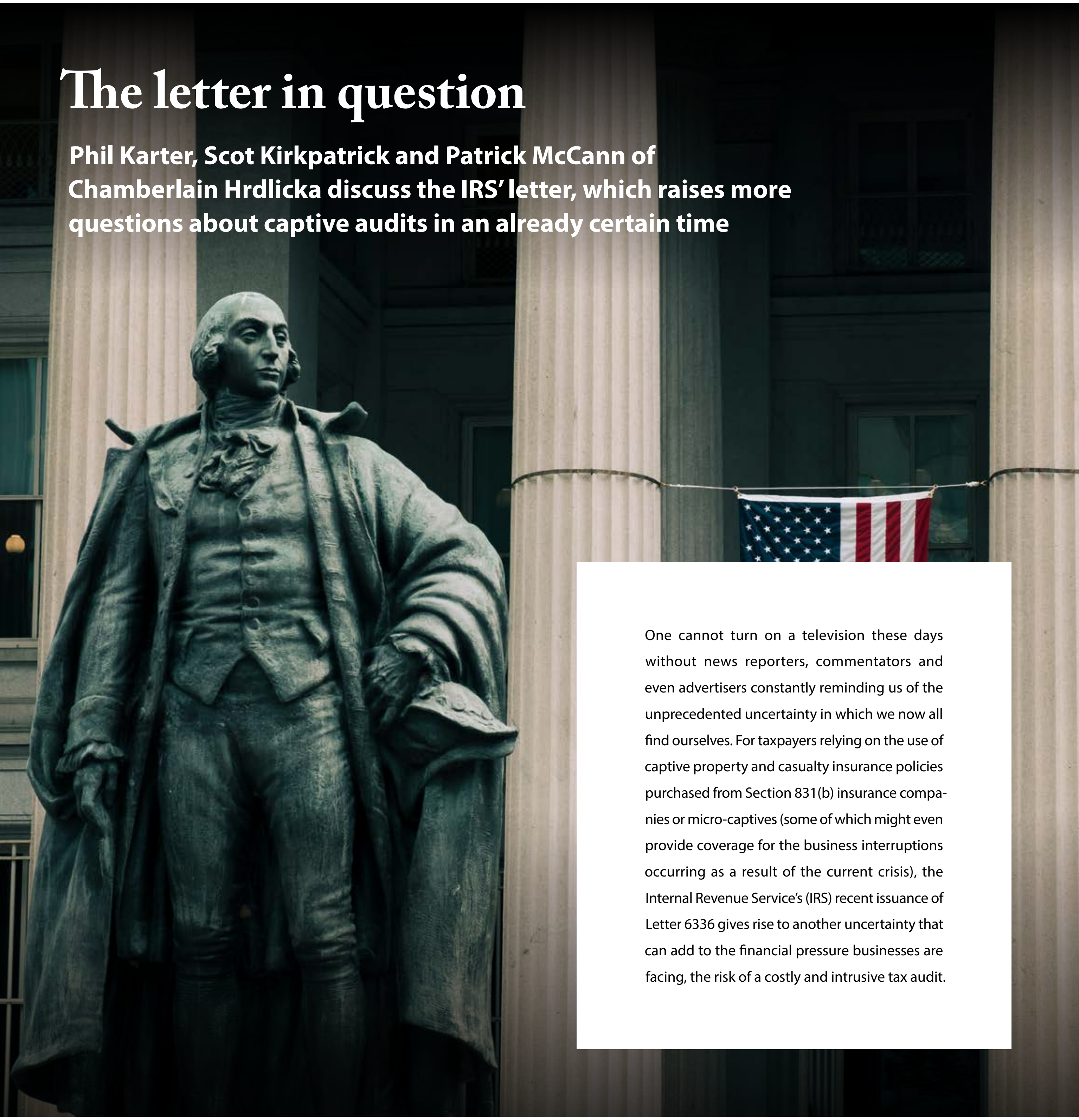
The letter in question

Phil Karter, Scot Kirkpatrick and Patrick McCann of Chamberlain Hrdlicka discuss the IRS' letter, which raises more questions about captive audits in an already certain time



One cannot turn on a television these days without news reporters, commentators and even advertisers constantly reminding us of the unprecedented uncertainty in which we now all find ourselves. For taxpayers relying on the use of captive property and casualty insurance policies purchased from Section 831(b) insurance companies or micro-captives (some of which might even provide coverage for the business interruptions occurring as a result of the current crisis), the Internal Revenue Service's (IRS) recent issuance of Letter 6336 gives rise to another uncertainty that can add to the financial pressure businesses are facing, the risk of a costly and intrusive tax audit.

"The irony is that the recipients of the letter were identified only as a result of their previous compliance with Notice 2016-66 and their filing of reportable transaction disclosure statements"

Phil Karter
Shareholder
Chamberlain Hrdlicka

On 20 March 2020, only one week after US President Trump issued his proclamation on declaring a national emergency concerning the COVID-19 outbreak, the IRS issued letters to tens of thousands of taxpayers seeking information about their participation in micro-captive insurance transactions. The irony is that the recipients of the letter were identified only as a result of their previous compliance with Notice 2016-66 and their filing of reportable transaction disclosure statements (Forms 8886), with the letter stating, "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 pursuant to Notice 2016-66 and Notice 2017-08".

On 31 January 2020, in IR-2020-26, the IRS announced the establishment of 12 new examination teams to assist in the audits of what it described as abusive small captive insurance transactions. The information release reported that "[e]xaminations 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, the inclusion of income by the captive entity and imposition of all applicable penalties." Letter 6336 appears to be the first step to opening those examinations as a tool to help the IRS identify and prioritise its targets for examination. The letter requires a statement made under penalties of perjury regarding the last year the taxpayer claimed deductions or other tax benefits related to small captive insurance transactions.

Letter 6336 stipulated an initial response date of 4 May 2020, which was extended an additional 30 days in response to the ongoing pandemic caused by COVID-19. It does not require a response or impose a penalty for failing to respond. However, the letter notes that the IRS will "take [the taxpayer's] actions in response to [Letter 6336] into account when considering future compliance activity related to [the taxpayer's] micro-captive insurance arrangement." The practical implication of that statement is left to the reader's imagination.

Letter 6336 has left many recipient taxpayers and their professional advisors struggling to determine how to best respond or even whether to respond at all. The decision will likely depend on the answer to a number of questions, such as: (i) Do the taxpayers continue to rely on captive property and casualty insurance policies as a component of their risk management strategy? (ii) If not, when did the taxpayers last participate in a captive insurance transaction? (iii) How structurally and operationally sound is (or was) the captive insurance programme utilised by the taxpayers? Finally, (iv) do the taxpayers plan to file qualified amended returns disclaiming any tax benefits related to the captive insurance transactions?

Omitted from a discussion of these considerations are taxpayers that have already been audited or are under audit for their participation

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in a micro-captive transaction, including those whose cases have gone to IRS Appeals or even the US Tax Court. Although Letter 6336 was sent indiscriminately to both unaudited and audited micro-captive taxpayers, there is little to for audited taxpayers to contemplate. Whether you respond or not should have no bearing on your situation, although a gentle reminder that "I'm already under audit" might mitigate further intrusiveness and preserve arguments that you have fully complied in good faith with all IRS requests related to your captive insurance audit. For taxpayers yet to be audited, Letter 6336 requests that if "you're no longer claiming deductions or other tax benefits for any micro-captive insurance transactions covered under Notice 2016-66 on your Federal income tax returns, please notify us by sending a letter to the address shown above." Read literally, it does not appear that a response is required for any taxpayers who continue to purchase captive property and casualty insurance policies as part of their risk management programme. The letter states that "[i]f 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." The disclosure requirement is nothing new, as it is not imposed by Letter 6336, but rather by an ongoing obligation to report under Notice 2016-66. Therefore, any taxpayers who continue to rely on captive insurance as an alternative risk management strategy must continue to disclose that participation on Form 8886 – Reportable Transaction Disclosure Statement filed with their Federal income tax returns.

What then was the objective of Letter 6336, given that a vast proportion of the recipients are already audited or are maintaining their captives currently and told they need not respond? The answer seems to be that the letter is intended to prioritise the universe of unaudited micro-captive taxpayers as targets for future examination.

So let's review the considerations that might bear on your response, or whether you should respond.

For those taxpayers who last participated in the transaction and filed their tax returns on or before 15 April 2016, the statute of limitations has expired and there is no threat of any captive related adjustments for those years. (Note that there may be a limited exception that the government tries to argue for captive insurance companies domiciled in foreign jurisdictions and failed to file an protective filings related to their status as a foreign company.) Still, responding to Letter 6336 may prevent the government from initiating an audit for later years that could contain some other non-captive insurance related issues.

Taxpayers on an extension to file their 2016 tax return or who last participated in 2017 should think more carefully about whether or not to respond. The statute of limitations remains open for those years and the government is free to initiate an audit and assert adjustments related to their captive insurance transactions. However, absent an immediate extension of the statute of limitations, the government will have only a limited opportunity to complete an audit and may prioritise taxpayers for whom more time remains before the expiration of the statute of limitations. By responding to Letter 6336, taxpayers in those circumstances may unwittingly make themselves a target for audit by sticking out from the crowd and presenting a greater sense of urgency to investigate, particularly if the claimed premium deductions were large. The phrase "discretion is the better part of valour" comes to mind for such taxpayers hoping that the statute of limitations will run its course.

The taxpayers facing the greatest uncertainty are those who last participated in captive insurance transactions in 2018 or 2019. For them, there is sufficient time remaining on the applicable statute of limitations for the government to initiate an audit and assert adjustments within the limitation period. 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 unknowable. Although a response to Letter 6336 may buy some goodwill with an auditor, for an issue being tightly controlled by IRS personnel above the audit level, one should not assume that compliance will have any bearing on the IRS' decision whether to assert the 20

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percent or 40 percent penalty in a micro-captive insurance audit.

For those with significant time remaining on the statute of limitations, a separate question is whether to file qualified amended returns for open years foregoing the captive insurance premium deductions claimed on their original returns. By filing QARs, those taxpayers can eliminate the risk of any accuracy-related penalties that might accompany an audit determination.

In the course of a QAR analysis, taxpayers no longer operating their captive should strongly consider whether their former captive insurance structure will withstand an IRS challenge and potential judicial review. Even those with strong captive insurance programmes but who claimed only small premium deductions should consider a cost-benefit analysis that takes into account the cost of a potential audit defense of a captive insurance arrangement.

There is no point in winning the battle and losing the war if the cost to defend outweighs the benefits derived from the deduction originally claimed.

Thus, in confronting what to do about Letter 6336 and the possibility of filing QARs, taxpayers may benefit from an independent third-party review of their captive insurance arrangements to evaluate how well they might stand up to scrutiny and, assuming they do, whether that battle is worth fighting. On the other hand, if your captive is still operating and continues to serve a bona-fide risk mitigation purpose integral to your business, that is a battle likely to be well worth fighting.

IRS coercion efforts notwithstanding, where the arrangement is motivated by business rather than tax considerations, taxpayers who are audited should not be reluctant to stand their ground. ■

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