

CAPTIVE INSURANCE FEDERAL TAX DEVELOPMENTS

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Federal Tax Developments

- Why Large Captives Should Care About IRS § 831(b) Activity
- Caylor Land & Development – Tax Court (March 2021)
- IRS Activity
- Letter 6336
- IR-2020-226
- IR-2020-241
- IR-2021-82
- United States v Delaware Department of Insurance
- GAO Report: Abusive Offshore Insurance Products
- Pooling Examples

Why large captives should care about 831(b)

- IRS Activity has been with small captives
- Small captive cases are defining “insurance” for tax purposes
- Some issues are being raised in these cases (sample)
 - Disallowed premiums can also be taxed to the captive (Syzygy)
 - The pooling entity must be an insurance company for tax
 - Courts are skeptical about pools – premiums paid to pool equal premiums paid by pool (subject to ceding commissions)
 - Must captive insurance replace commercial coverages?
 - May policies be standardized?
- IRS now has large numbers of Insurance Specialists and has developed audit techniques
- Lobbying of, and letters from, Congress supporting captives

Caylor Land & Development – March 2021

- Caylor Land & Development – Tax Court – last month
- Brother-sister case, no pool
- Bottom Line – not insurance and penalties imposed
 - No risk distribution and not insurance in commonly accepted sense
 - Same result as 3 other cases: Avrahami, Reserve Mechanical (on appeal), Syzygy
 - First case to impose penalties: taxpayer received no advice upon which to rely
- Not Insurance in its commonly accepted sense
 - Calculated premiums in a fanciful way in entirely unreasonable amounts
 - Issued claims-made policies after the time to make claims expired
 - Paid the few claims that it did, on the say-so of its clients
- Much of the premium were from consulting fees paid by Caylor Construction

Caylor Land – Fact or Factor ?

- Fact or Factors? Which, if any, are factors in the decision?
- Never consulted commercial insurance agent about Captive policies
- Commercial premiums about \$60,000 per year
- Uninsured losses averaged about \$50,000 per year; premiums for which were \$1,200,000; not adjusted during four years considered
- Paid \$1.2 million for 10 days' coverage (year not in issue)
 - Premiums paid before total known or what policies were for the year
 - Premiums “backed into”
 - Premium calculation start with ISO rates, then “detour to crazy town”
 - “Captive Risk Factor” of 300%

Caylor Land – Fact or Factor ? (2)

- Claim filed; instead of supplying requested proof to manager, claim paid
- Claims filed and paid prior to policies being underwritten
- Two entities were each 30% of risk
- Risks highly dependent on Caylor Construction
- All entities part of Tucson real estate industry
 - No diversity supports no distribution
- Captive was pitched as “tax planning solution” and “tax planning tool”
- Commercial premiums paid by one entity; Captive premiums by all entities
- Court, CPA and lawyer: captives are a “legitimate concept if established correctly and operated correctly”
- Tax Court referred to arrangement as a “scheme” several times

IRS Activity

- September 2019 (IR-2019-157)
 - IRS Settlement Program for up to 200 participants (actually 156)
 - Terms are largely a concession of premium deductibility, but no tax of the captive; affidavits may eliminate penalty; gifts?
 - Allowed premiums, including closed years, are currently taxed
- January 2020 (IR-2020-26)
 - Almost 80% accepted the Settlement Program (actually 76%)
 - 12 new audit teams
 - Thousands of more audits
- March 13 and September 11, 2020 -- Offers made to certain others on similar terms as the September 2019 settlement program
- Summer 2020 – letters to material advisors for their customer lists

Letter 6336 – March 20, 2020

- Issued to EVERY (?) person who filed a Form 8886?
 - Tens of thousands of letters? More in July
 - The Letter wants no 2019 deduction
 - Amend returns for prior open years, mark “Micro-captive on the top and send to Philadelphia
 - Qualified Amended Return (no penalty?)
 - Statement (Under Penalty of Perjury)
 - Year of last deduction or tax benefit
 - Date ceased participating in the transaction
- No response – audit with maximum tax and penalties (?)

Subsequent Notices

- Notices 2020-26 (10/1/2020)
 - New audits (12 audit teams) and
 - Letters to material advisors
 - Referenced the Fraud Enforcement Office, Promoter Office, Criminal Investigation, and Office of Professional Responsibility
 - Penalties for similar programs (e.g., Puerto Rico)
- Notice 2020-241 (10/22/2020)
 - Second Settlement Program
 - Worse Tax and Penalty Terms than for the First Settlement Program
 - IRS: “relentless agencywide commitment to combat abusive transactions”
- Notice 2021-82 (4/9/2021)
 - Announced the IRS victory in Caylor
 - In addition to denying the deduction, domestic captives are taxed on the premiums, and there is withholding tax on premiums in foreign captives

US (IRS) v Delaware Department of Insurance

- United States sued the Delaware Department of Insurance to enforce a summons
 - Sought documents relating to 191 captive insurance companies
 - Related to tax shelter promoter investigation
 - Delaware provided 20,000 pages:
 - Documents related to 16 captives that authorized Delaware to provide the IRS their information
 - Documents responsive to the summons, but not specific to any captive
- IRS could have had the documents if it had agreed not to make them public
- Hearing was held March 12, 2019

GAO Report 2020-889

- GAO (General Accountability Office) [Oct 2019 to July 2020]
- “Abusive Tax Schemes: Offshore Insurance Products and Associated Compliance Risks” Report to Chairman of Senate Finance Committee
- Primarily addresses:
 - Offshore “micro-captive” (also covers onshore captives)
 - Offshore variable life insurance
- The tenor is negative towards abusive arrangements
 - Contains reasons for how arrangement can be abused
 - But it also contains recognition of acceptable arrangements
- Not binding on the IRS or the Courts

U.S. Supreme Court – CIC Services v IRS

- U.S. Supreme Court heard CIC Services, LLC v IRS
 - Nothing to do with “what is insurance” for tax
 - Challenges IRS promulgation of Notice 2016-66
 - Administrative Procedures Act v Anti-Injunction Act
 - Amicus briefs by the Industry, US Chamber of Commerce, American College of Tax Counsel, Law School Professor, etc. One Law School Professor sided with IRS
 - Oral argument was December 1, 2020
 - Decision will be in second quarter of 2021