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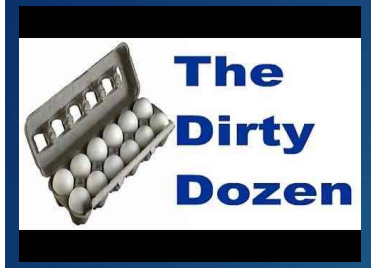
IRS CHALLENGES TO MICRO-CAPTIVES



IRS Scrutiny: The Dirty Dozen List

Beginning in 2015, the IRS included on its "Dirty Dozen" list of tax scams, what it believes are certain abusive micro-captive insurance arrangements:

- *"In the abusive structure … the policies may cover ordinary business risks or esoteric, implausible risks for exorbitant 'premiums,' while the insureds continue to maintain their far less costly commercial coverages with traditional insurers."*
- *"Annual premium amounts are frequently targeted to the amounts of deductions business entities seek in order to reduce their taxable income. … Underwriting and actuarial substantiation for the insurance premiums paid are either absent or illusory."*

Avrahami v. Commissioner

Docket Nos. 17594-13, 18274-13

- First 831(b) captive insurance case litigated in the U.S. Tax Court
- Case was tried in U.S. Tax Court before Honorable Mark V. Holmes in March 2015
- The IRS selected this case for trial.
- The case is fully briefed and awaiting an opinion
- Self Insurance Institute of America (SIIA) filed an Amicus Brief in the case
- The Tax Court's opinion is expected late 2016
- Many "commentators" misstate the facts of the case

Avrahami v. Commissioner General Facts

- The Captive Insurance company was licensed and regulated in St. Kitts
- The captive insured risks of jewelry retail businesses and real estate businesses
- The captive reinsured risks of terrorism insurance for a pool of over 100 third party insureds
- The captive collected 30 percent of its premiums from the pool of unrelated third party insureds
- The captive always maintained reserves in excess of the amount required by the regulators (30%)
- The captive made loans to an entity owned by the Avrahami children for the purchase of real estate

Avrahami v. Commissioner
Key Issues Raised by IRS

- Whether the expenses are deductible under I.R.C. 162
  - **Risk Shifting**
    - IRS claimed the captive and the fronting company were not financially capable of meeting their financial obligations
  - **Risk Distribution**
    - IRS claimed collecting 30% premiums from unrelated insureds was not sufficient for risk distribution
    - IRS claimed the insurer needs to pool a large collection of relatively small, unrelated risks
    - IRS claimed the risks of the pool of unrelated insureds were not homogeneous with the other risks insured by the captive

Avrahami, et al., v. Commissioner Key Issues Raised by IRS (Continued)

- **Insurance as commonly understood** – IRS Argued:
  - The captive was not organized or operated as an insurance company
  - The captive and fronting company were not licensed and regulated by Arizona
  - Premiums were not arms length (see below)
  - The policies were not valid and binding
    - The policy terms were vague
- **Insurance risks**
  - IRS conceded 3 of the policies were covering insurance risks – Administrative Actions, Employee Fidelity and terrorism
  - IRS argued remaining policies covered insurance risks and business risks; therefore, the entire premium deduction should be disallowed

Avrahami, et al., v. Commissioner Key Issues Raised by IRS (Continued)

- **Premium amounts**
  - IRS argued were not reasonable
  - IRS did not hire an actuary to challenge the premium amounts paid
- **Whether the amounts paid were for insurance and paid to an insurance company**
  - IRS claimed captive insurance company was never an insurance company; therefore, it never had valid 831(b) and 953(d) elections
    - Caution – If the IRS successfully invalidates a 953(d) election the IRS could assert penalties under I.R.C. 6038(b) for failing to file Form 5471
  - IRS looked at the captive arrangement from inception, which included years that preceded the years before the Court

Avrahami, et al., v. Commissioner Key Issues Raised by IRS (Continued)

- **Whether the substance of the transaction comports with the form or whether the transaction had economic substance beyond tax benefits.**
  - IRS claimed the only purpose of the captive insurance arrangement was to reduce income taxes
  - IRS argued the loans were circular flow of funds
- **Penalties asserted under I.R.C. 6662(a) (20%)**
  - IRS argued Petitioners cannot rely on substantial authority because the transaction is a tax shelter
  - IRS argued Petitioners did not reasonably rely on attorneys and CPAs
  - IRS did not address Petitioners claim penalties are unwarranted because it was a case of first impression.

The Fight for Information

- Interviews
- Information from the inception of the captive, even if it precedes the years under audit; following year activities also reviewed
- All emails, marketing materials, etc.
- Detailed questions on how one got involved in the captive and what tax advice was received
- What commercial insurance was in place, what are the gaps and exclusions, why the captive program was initiated ?
- What is the operating company's risk management program?
- How were the premiums priced?
- For the 10 years prior to its inception, were losses incurred that would have been covered by the captive had it been in place?
- What is the loss experience of the related party and pool insurance?
- How are the captive's assets utilized/invested?

Defenses to Information Production

- Attorney-Client
- IRC § 7525 Tax Practitioner-Client
- Work-product
- Information already in the possession of the IRS
- Documents not in existence or accessible
- Waiver?!

Work Product Doctrine: Materials Prepared in Anticipation of Litigation

- Primary Purpose Test: Documents are held to be prepared in anticipation of litigation "as long as the primary motivating purpose behind the creation of a document was to aid in possible future litigation."

- Because of the Prospect of Litigation Test: Under the more inclusive "because of" test, the relevant inquiry is whether the document was prepared or obtained "because of" the prospect of litigation.

IRS OFFICE OF APPEALS

- **Independent Unit of the IRS**
- **Settlement Arm**
  - May take "Hazards of Litigation" into account
    - Exam is not to take "Hazards" into account
- **Under AJAC – Appeals Judicial Approach and Culture**
  - Appeals is to evaluate the case on the basis of the facts and issues developed during the audit
  - Is not to evaluate new facts provided by Taxpayer
  - Appeals may send new Taxpayer facts, documents, etc. back to Exam
  - Appeals is not to raise new issues, not raised by exam
    - It can raise new arguments to support existing issues
  - Appeals is not to request new facts, extend the audit, etc.

IRS Office of Appeals (cont.)

- **Before the Taxpayer meets with Appeals the first time**
  - Exam (and its lawyer(s)) often meet with Appeals to explain its case
    - This is called the "Ex Parte" meeting
    - The Taxpayer and its lawyers and accountants may attend the ex parte meeting
    - Often only Exam (and its lawyer(s)) speaks at this meeting

- **After the Ex Parte Meeting Concludes**
  - Exam and its lawyer(s)) are not permitted in later Appeals meetings
  - The meetings are informal
  - In the captive arena, one or more Appeals Insurance Specialists may be involved
  - The same Insurance Specialist(s) may be involved in Appeals conferences for numerous unrelated Taxpayers for the same program
  - A common resolution approach may emerge, perhaps on a program by program basis

IRS Office of Appeals (cont.)

- **In theory other settlement tools are available**
  - "Fast Track"
    - Exam and Taxpayer present their case to an Appeals Officer Mediator(s)
    - Mediation is non-binding – both sides must agree; if "Hazards" are involved, they also need Appeals concurrence
    - Usually concluded much faster than Appeals conferences
    - Theoretically, if Fast Track does not reach settlement, a different Appeals Team can be involved in resolution
  - Post Appeals Consideration
    - If Appeals consideration does not result in settlement, a different Appeals Officer will attempt to see if the Taxpayer and original Appeals Officer can reach agreement

When Will the Audits End?

- **831(b) Captive Insurance Arrangements have been on the IRS Dirty Dozen list for past two years …**

- **We have no reported Tax Court opinions regarding 831(b) captives**
  - There are two other cases that have now been tried in the U.S. Tax Court:
    - Caylor Land & Development, Inc. v. Commissioner – Tried June 2016
    - Wilson et al., v. Commissioner – Tried August 2016

- **Revisions to 831(b), effective 2017**
  - Will this increase enforcement?