

# Industry Reacts to IRS Offer to 831(b) Captives

Written by Karrie Hyatt

**F**ollowing three successful court cases against captives choosing the 831(b) tax option, the Internal Revenue Service (IRS) is offering a settlement to some captives currently under audit.

For the last seven years the IRS has been investigating small and medium-sized captives taking the 831(b) tax option. Referring to them as “micro captives,” the IRS suspects some of the companies of using the 831(b) designation as a tax dodge for estate planning and wealth transfer purposes. For the last five years the IRS has named these types of captives to their “Dirty Dozen” list—a list the department releases each year warning taxpayers of potential tax scams.

Small to medium-sized captives, also known as Enterprise Risk Captives (ERCs), have been the largest segment of growth in the captive space for the last decade. Their growth was spurred by several factors. By the late 2000s, most large companies had already formed captives, so the market began to look to medium and small companies. New captive structures, including cell and series captives, along with the increase in U.S. domiciles made it more affordable for smaller companies to form their own captive.



With the rapid expansion of ERCs, criticism has stemmed from two key issues—misusing the captive structure as a tax shelter or as a wealth transfer mechanism. Additionally, captives misusing the 831(b) tax designation are often set-up by promoters who may not have a background in insurance. Small captives opting for the 831(b) designation gain a hefty tax advantage which gives critics fodder for questioning their validity. The IRS being the biggest critic of them all.

It is estimated that the IRS is currently auditing or in the appeals process with about 500 captives choosing the 831(b) designation. Since late 2017, the Tax Appeals Court has decided in favor of the IRS in three key cases involving “micro captives.” Following hard on these successes, the IRS has now issued a settlement offer to some captives currently under audit.

The offer was issued by letter and was sent to up to 200 captives currently under audit, according to the IRS’s press release on September 16, 2019. The offer may be expanded to other captives at a later date. The captives who receive and accept the offer will be required to pay penalties and concede a substantial portion of the tax benefits that were previously claimed. It is a one-time offer—if a “micro captive” declines the offer, they won’t be eligible for any other offers that may become available in the future.

In the press release from the IRS, Commissioner Chuck Rettig said, “The IRS is taking this step in the interests of sound tax administration. We encourage taxpayers under exam and their advisors to take a realistic look at their matter and carefully review the settlement offer, which we believe is the best option for them given recent court cases. We will continue to vigorously pursue these and other similar abusive transactions going forward.”

The reasoning behind this offer at this time is likely that, with a few key court wins behind them, the IRS feels they are emboldened in their pursuit of “micro captives.” When their audit decisions are appealed in court, their wins come at a steep price. In making the settlement offer, and those captives accepting it, the IRS will be able to reduce their audit burden and free up some of their limited resources.

## IRS Offer to 831 (b) Captives

According to Dave Provost, the deputy commissioner of Vermont's Captive Insurance Division, "It seems like a practical approach to take care of a large number of cases at minimal cost. I think it's appropriate for the IRS to try to minimize their collection expenses. I assume that the bulk of the companies that will receive a letter are close enough in facts and circumstances to recent IRS wins that the recipients will very likely opt to settle and cut their exposure to larger losses, and continued time and expense."

"We have known for quite some time that the IRS has a large number of audits out on 831(b) captives," said Ryan Work, vice president of government relations for SIIA. "That, along with recent court wins, has provided the Service with leverage to issue various settlements in the hope of decreasing the number of outstanding audits. However, the current audit settlement continues to demonstrate that the Service still has not yet developed any appropriate guidelines to objectively distinguish between good and bad actors in the space."

According to Harry Tipper, a long-time insurance professional who has been working with SIIA since the 1980s, "If this settlement strategy succeeds in shaking out the bad actors, the ones who used captives taking an 831(b) election as the centerpiece of an abusive tax shelter, then the settlement strategy will be a good thing." He continued to say that if it is emboldened by its successes and, more importantly, the legal

precedents that they established, the the IRS might expand its sights beyond 831(b) captives to the larger insurance industry.

Jeffrey Kenneson, president of Quest Captive Management LLC, believes the IRS is trying to cast a wide net over 831(b)s. "I think the IRS is trying to lessen its burden to go after the questionable entities while ensnaring many entities that might be in the gray area and will settle to avoid the hassle and potential penalties for not settling."

"Generally, I don't like settlement offers because it's a 'catch all' for the IRS," Kenneson added. "[It] adds fear to the calculation due to the uncertainty on the taxpayers part, however, I think it might be a quicker and cleaner way to clean up this area in captives that have somewhat abused the tax election."

For Jerry D. Messick, CEO of Elevate Captives, "The problem I see is when the Service casts such a broad net, they will include owners that have absolutely every reason to have a well-structured captive to support their risk management needs. That said, if the captive in question doesn't have the normal attributes of an insurance company, I would think the offer to settle would be positive for those owners."





For the nearly 200 ERCs who received the letter from the IRS, the question is, should they settle?

“Each captive under audit who has received a settlement letter will have to decide the most appropriate approach for them,” said Work. “In talking to various recipients of these settlement letters, there are captives that have received such settlement offers that believe they are operating above and beyond standards, some of which see no reason to accept the terms, particularly shutting down their appropriate captive structure.”

Kenneson has a similar take on the question. “I think the captives that were formed properly with risk management concepts in mind and adhere to the requirements that were put in place a few years ago regarding policy spread and ownership structures should hold their ground. For others that are questionable or in the gray area, I would strongly suggest obtaining some legal advice on the matter. For those that have

followed the fact pattern of the cases that have been adjudicated unfavorable to date, I would settle.”

According to Joseph Holahan, of counsel with Morris, Manning & Martin, LLP, “Each captive owner will need to evaluate its position based on its own facts and circumstances, but my sense is that many of the captive owners who have been offered the settlement will conclude it is in their best interest to accept it and move on.”

“I’m neither a tax expert nor advisor, but if it I were to get an offer like that, I’d jump on it,” said Provost.

Captive insiders see the settlement offer as a way to eliminate many of the captives that were formed as tax shelters. Many of those captives were formed at the beginning of the small captive boom a decade ago before the industry had yet to develop guidelines for good governance of ERCs, when it became apparent to shady promoters that the 831(b) tax option could be used to create tax shelters.

“It’s clear some 831(b) arrangements were not sufficiently mindful of the principles governing economic substance and business purpose,” said Holahan. “I see the settlement offer as part of the process of recalibration and movement away from the more aggressive approaches in this area.”

“Again, I hope the 831(b) captives that were formed properly will hold their ground and defend their position if called upon,” said Kenneson. “If the highly questionable 831(b)s are removed and the proper 831(b)s remain in existence, I see little to no effect to the captive industry as a whole. I can’t say the same for the 831(b) promoters that have colored outside the lines.”

According to Provost, “I don’t see much long-term impact on large publicly-traded captive owners—they’ve been through the process already. There will be some adverse press and other pain in the short term, but over the long haul the effect will be minimal. I think this will clear out some questionable practices and practitioners.”

“Everyone in the captive industry is aware that there are bad actors out there,” said Tipper. “That is why SIIA’s Captive Committee developed the Code of Conduct as a way to differentiate between those who would push the limits beyond recognition and those who try to conduct their business and to form captives for their clients in a responsible manner.”

SIIA’s Captive Manager Code of Conduct was released in January of this year. The Code is meant to guide captive managers to a high standard of ethical conduct and to help strengthen the reputation of the captive industry. SIIA created the Code to take a proactive approach to answer any lingering questions about the validity and effectiveness of captives.

To shore up the captive industry’s reputation, particularly with the IRS, “SIIA is coalescing members on strengthening industry practices through its Captive Manager Code of Conduct, which it hopes to readdress in the near future, along with additional discussions and recommendations to regulators on principles to better ascertain appropriate captive structures and activities,” said Work.

“The audit settlement announcement demonstrates that the Service continues a careful watch over 831(b) captives,” continued Work. “At the same time, the industry should also continue to carefully address issues, strengthen practices and continue to move forward.” ■

Karrie Hyatt is a freelance writer who has been involved in the captive industry for more than ten years. More information about her work can be found at: [www.karriehyatt.com](http://www.karriehyatt.com).

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