

**Notes from the Trenches<sup>1</sup>**  
**New IRS Notice Urges Taxpayers to Exit Abusive Micro Captives**  
**By**  
**Michael E. Lloyd, Esq.**

On April 9, 2021, the IRS used its latest win in *Caylor Land Development, Inc. v. Commissioner*<sup>2</sup> to urge taxpayers to exit from abusive micro-captive insurance arrangements as soon as possible.<sup>3</sup> The IRS puts taxpayers on notice that they have stepped up examinations on these arrangements and that such arrangements are not eligible for the tax benefits claimed.

Taxpayers are “encouraged to consult an independent tax advisor prior to filing their 2020 tax returns” and “should consider exiting the transaction and not reporting deductions associated with abusive micro-captive insurance transactions.”<sup>4</sup> The Commissioner of Internal Revenue is quoted as stating that:

*“In multiple cases before the courts, judges have held that these ‘fanciful’ and ‘unreasonable’ arrangements don’t add up to insurance in the commonly accepted sense, “I strongly urge participants in these arrangements to get independent legal advice separate from those who helped steer them into these abusive arrangements.”*

The unspoken message in this News Release is that the IRS is winning these abusive captive cases and will be very aggressive in its examinations and application of accuracy related penalties.

Business owners who participate in micro captives should take heed of the many IRS warnings<sup>5</sup> The challenge for business owners is to determine whether their micro-captive is on the good side of the tax law, or likely to be considered abusive by the IRS.

Here are some tips for business owners who paid premiums to a micro-captive in 2020, and are deciding whether to deduct those premiums:

1. **Independent Review.** Seek an independent review of the captive transaction from a tax professional who is knowledgeable about the tax law that applies to captives. It is important that the professional be both independent from the captive manager and all

---

<sup>1</sup> Michael Lloyd is an attorney who advises business owners on captive insurance programs. Mike conducts Pre-IRS Audits, and has represented captive business owners under IRS audit in Exam, Appeals and Tax Court. Mike has settled cases under the first and second settlement initiatives and is also assisting taxpayers who want to make a response to the recent IRS Warning Letter. Mike also has prepared more than 1,000 IRS Forms 8886.

<sup>2</sup> T.C. Memo 2021-30. See description of case at <https://williamsconson.com/wp-content/uploads/2021/03/IRS-Announces-Second-Captive-Initiative-.pdf>

<sup>3</sup> IRS News Release 2021-82

<sup>4</sup> Id.

<sup>5</sup> The IRS has several warnings about abusive micro-captives, including individual letters to taxpayers, its annual “Dirty Dozen List” and IRS Notice 2016-66. See IR Notice 2020-160 at <https://www.irs.gov/newsroom/irs-unveils-dirty-dozen-list-of-tax-scams-for-2020-americans-urged-to-be-vigilant-to-these-threats-during-the-pandemic-and-its-aftermath> and IRS Notice 2016-66 at <https://www.irs.gov/pub/irs-drop/n-16-66.pdf>.

parties related to the transaction and knowledgeable about the IRS position on micro-captives.

2. Review the Insurance. Every year, a business owner should consider all commercial insurance to make sure it is needed and priced accordingly. The insurance offered by the captive should be considered in the same way. Is it meeting an insurance need of the business and is it fairly priced. Have claims been filed and have premiums been adjusted to reflect claims history? One of the first questions asked in an IRS interview is “why do you need this insurance.” A business owner should have very clear answers on this point.

3. Ask the Hard Questions. There are some hard questions that should be asked of the captive manager:

- Is the captive manager under an IRS promoter audit? If so, what is the status?<sup>6</sup>
- Has the captive manager provided a customer list to the IRS?
- Are any of the customers of the captive manager under an IRS audit?<sup>7</sup>
- Who is determining the underwriting of the policies issued by the Captive?<sup>8</sup>
- What are their skills and experience? Do they have any customers under an IRS audit?<sup>9</sup>
- How is the captive manager satisfying risk distribution?<sup>10</sup>
- If the captive manager is using a “risk pool,” how is that risk pool better than the risk pools that have been on the wrong end of the recent tax court decisions?<sup>11</sup>
- Who is responsible for the viability of the captive transaction?<sup>12</sup>
- Ask about an exit strategy.<sup>13</sup>

---

<sup>6</sup> The IRS practice is to audit a captive manager, and if it doesn't like its practice, to seek a customer list and audit some percentage of its customers. If a captive manager is already under audit and has provided a customer list, it likely means that the IRS is adverse to the captive transactions of its customers.

<sup>7</sup> The IRS often first learns of a captive manager by way of a random audit of one of its customers. For this reason, it is important to ask not only if the manager is under audit, but also if any of its customers are under audit. It is common that a captive manager audit will follow the first random audit of a customer of the captive manager.

<sup>8</sup> This should be an independent company that is skilled and licensed in underwriting insurance. They should have skilled insurance underwriters and should stand behind their determinations.

<sup>9</sup> This is another way that the IRS finds abusive captives. They audit a taxpayer, find the underwriter and then open a promoter audit on the underwriter. The underwriter leads them to the captive manager and the customer list is obtained from the manager.

<sup>10</sup> Risk distribution is probably the biggest issue in these cases. The captive insurance company must have sufficient risk exposure units to satisfy the law of large numbers required to constitute insurance and not merely “self-insurance.” To date, none of the recent micro-captive cases have demonstrated an acceptable method of satisfying risk distribution.

<sup>11</sup> Many captive managers attempt to satisfy risk distribution by using a risk pool. The risk pools that have been considered by the Tax Court in the recent micro-captive cases have all been found to be deficient.

<sup>12</sup> This may be the hardest question of all. Most common, the engagement documents with the captive manager or other professionals will state that they are not giving tax advice and putting the determination of tax viability in the hands of the business owner and its professionals. The problem is that while the business owner does have responsibility for determining part of the tax viability relating to its own motives and claims practices, the majority of the viability rests on the underwriting and risk pool which should be owned by the captive manager and its professionals.

<sup>13</sup> Sometimes it can be very difficult to leave a captive transaction. A business owner should know the process for stopping a captive transaction and any fees or penalties that may apply from the captive manager.

4. File Forms 8886. Every business, captive and possibly each business owner should be filing an IRS Form 8886 with every tax return that has a tax effect of the captive transaction. IRS Notice 2016-66 makes most micro-captive transactions a “transaction of interest” that requires Form 8886. The failure to file Forms 8886 can result in substantial penalties.<sup>14</sup>

If you are interested in an independent review of a captive transaction, or are under an IRS audit and need representation, call Mike Lloyd at (412) 454-025 or email him at [mlloyd@williamscoulson.com](mailto:mlloyd@williamscoulson.com).

---

<sup>14</sup> The failure to file a Form 8886 (i) delays the commencement of the statute of limitation which may increase the number of years under audit, (ii) can increase the accuracy related penalty or make it more difficult to be waived, and/or (iii) create liability for a separate penalty under Code Section 6707A.