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**Notes from the Trenches¹
IRS Sends Warning Letter to Captives
By
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If you have previously filed an IRS Form 8886 with respect to participation in a captive insurance transaction, you probably received a scary letter in your mail today from the IRS (the “Warning Letter”). The letter explains that the IRS “*is increasing enforcement activity in this area and has deployed several examination teams to open additional examinations.*” The letter warns that examinations may result in full disallowance of deductions, inclusion of income by the captive (double taxation) and the imposition of applicable penalties. The letter asks you to notify the IRS of your intention to continue participation in a captive transaction with the not very veiled threat that if you do, you are going to be audited.

If you received the IRS Warning Letter, this article is for you.

What is this Letter?

- This is a form letter that appears to be sent to all, or a percentage of taxpayers who at one time filed IRS Forms 8886 related to captive transactions.
- This letter is a further warning to the 831(b) captive industry and its customers that the IRS intends to audit more captive transactions.
- This letter provides an opportunity for taxpayers who receive it to maybe increase or decrease their chances of coming under audit (see how below).

What this Letter is Not.

- Most importantly, the Warning Letter was not written because someone at the IRS considers your captive transaction to be non-compliant or abusive. As best we can tell, this letter was sent to everyone who filed a Form 8886. For example, it was sent to

¹ 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 is currently representing taxpayers who are considering the IRS Initiative 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.

taxpayers who haven't taken a deduction for 10 years, but filed an 8886 on a protective basis. It also was sent to taxpayers who are already under audit, and taxpayers who were under audit and settled their cases with the IRS. The point is that this was a scatter-shot form letter sent to taxpayers who filed Forms 8886. If you received a letter it means nothing more than the IRS received your Form 8886 and decided to send you a letter.

- The Warning Letter is not itself an opening of an audit, nor should it be considered an examination of your return.
- The fact that you received the Warning Letter does not mean that you will or will not be audited.

Responding to the IRS Warning Letter.

- No Response. The first consideration is making no response at all. There is no response demanded by the Warning Letter. So, one option is to ignore it. The IRS suggests that if you do not respond, that they “may” open an audit of your return. But frankly, the IRS may open an audit of your return even if you do respond. The following taxpayers have a strong basis for ignoring this letter:
 - If you are already under audit, ignore the letter. What are they going to do, start a new audit?
 - If you have not taken a deduction in any year that is open under the statute of limitations (most likely after 2015), then you can probably ignore the letter (but consult with your tax advisor first as the statute of limitations can be tricky.
 - If you are actively participating in a captive transaction with a Captive Manager who is already under a promoter audit and many of their customers are already under audit and that doesn't bother you, then maybe you don't need to make a response. The fact is that if the IRS obtained the customer list from the Captive Manager, then the IRS already knows of you and has already decided not to audit you, or just hasn't gotten around to opening your audit yet. Any response you make to this letter is not likely to change that plan.
- Call it Quits. The IRS encourages you to reconsider that deduction for 2019, and complete a form under penalties of perjury that indicates that you are no longer involved in a captive transaction and are no longer taking deductions for premiums paid. For this option, you will need to indicate the last year in which you took a deduction, and the date that you ceased participating in a captive transaction. It is important to note that although there is an implication that if you send in this response that you will not be audited, a careful reading makes clear that the IRS is making no such guarantee. It is entirely possible that you can call it quits, not take a deduction for 2019, and the IRS still open an audit for years 2016 – 2018. The following taxpayers should consider this option:
 - If you already did close your captive and stop making deductible contributions, you should consider this option. It just might prevent an audit.
 - If you have been on the fence, either because your captive is not serving its purpose, or it is just getting “too hot in the kitchen”, then you should consider this option for the same reason.

- If your captive has “skeletons in its closet” or you have “mud on your shoes,” you may want to consider this option and cross your fingers that you are put into the no-audit pile.²

- Make your Case. If you are actively participating in a captive transaction, have good valid reasons for having a captive and are working with a Captive Manager who is doing the right things, you may want to respond to the IRS with information that will hopefully convince them that you are not someone to audit. There is no guarantee that this will prevent an audit, or in fact will even be read or considered. Also, there is no guarantee that what you state in your response won’t increase the IRS interest in auditing your captive. But the hope is that if you have good solid reasons for a captive and you are doing it right, that telling your story to someone who understands the difference will result in the IRS not auditing your return. This can be especially compelling if many taxpayers related to a Captive Manager submit the same story of compliance.

- Have Representation. If you are going to send any response to the IRS, you should do so under the protection of tax counsel. This is important for three reasons. The first is that your tax counsel will help you to identify the best way to frame your arguments of compliance. Second, any submission you make can become part of your administrative file and subject to questioning and attack in the event of a later audit. Third, it is much better for the IRS to call your counsel with any questions instead of calling you and catching you off guard with difficult and confusing questions.

If you have received the IRS Warning Letter and have questions about how to respond, call Mike Lloyd at (412) 454-0225 or email him at mlloyd@williamscoulson.com.

² For more information on “skeletons in the closet” and “mud on your shoes”, consider my article entitled “Notes from the Trenches – Advice for Section 831(b) Captive Owners Who Are Not Under Audit (Yet).”