Chamberlain Hrdlicka
Attorneys at Law

CAPTIVE AUDITS AND LITIGATION

Presented by

Charles J. (Chad) Muller

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Notice 2016-66, 2016-47 IRB 745

- The IRS has identified certain micro-captive transactions as "transactions of interest."
- The IRS contends that these transactions are tax avoidance transactions.
- The characteristics of the transaction may include "a reinsurance or pooling agreement under which a portion of the risks covered under the Contract are treated as pooled with risks of other entities, and the Captive assumes risks from other entities…"
- Typically, there is a promoter who promotes the transaction to the other participating entities.

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- Other factors that may indicate a tax avoidance transaction include:

1. Insurance coverage that involves implausible risks (such as a zombie apocalypse).
2. Coverage that duplicates commercial insurance coverage.
3. Premiums determined without underwriting or actuarial analysis.
4. Payments that significantly exceed the cost of prevailing commercial coverage.

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5. The Captive fails to comply with the laws were chartered.
6. The absence of defined claims procedures.
7. Inadequate reserves.

Notice 2016-66 Cont.

- Persons who enter these transactions on or after November 2, 2006, must disclose the transactions as described in Reg. Section 1.6011-4.
- Material advisors who make a tax statement with respect to the transaction have disclosure and list maintenance obligations under IRC Sections 6111 and 6112.

The Captive Audit

- The IRS has taken an aggressive approach to the audit of micro-captives considered to be abusive avoidance strategies.
- The audit approach includes broad and detailed document and information requests. The audit may take more than one year and involve hundreds of separate questions and the production of virtually thousands of documents.
- Judge Holmes has described the IRS approach as an "omphaloskeptical review." Avrahami, *infra*, at page 44.