From *Avrahami* to *Puglisi*: The Microcaptive Landscape Has Changed

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A recent victory by a taxpayer against the IRS has dramatically changed the landscape regarding IRS audits of microcaptive insurance companies.

In August of 2017, the Tax Court in *Avrahami* held that amounts paid to certain microcaptive insurance companies are not insurance premiums for federal income tax purposes and are not deductible under I.R.C. Section 162. In June 2018, the Tax Court in R*eserve Mechanical* held that transactions that a taxpayer executed during the tax years at issue did not constitute insurance contracts for Federal income tax purposes. In April 2019, the Tax Court in *Syzygy* held that the arrangement at issue is not insurance, and that a microcaptive's IRC Section 831(b) election is invalid and it must recognize the premiums it received as income. And, lastly, in March 2021, the U. S. Tax Court determined, in *Caylor Land*, that a microcaptive insurance company structure did not meet the definition of "insurance" in its commonly accepted meaning and therefore, denied income tax deductions that the taxpayer/insured business previous took for premiums paid to its related captive insurance company. Some in the legal and tax industry regarded the IRS victory in Caylor as the 'death knell' for the microcaptive industry. Rumors of the demise of the microcaptive may have been premature.

To review, the IRS, seemingly emboldened by the Tax Court victories in *Avrahami, Reserve Mechanical* and *Syzygy*, announced it was ratcheting up its audits of the microcaptive industry. [*Caylor Land* was decided after the increase in IRS audits of microcaptives.] However, this new audit strategy appears to be nothing more than a thinly veiled attempt by the IRS to cease operation of all microcaptive structures. Based on its increased surveillance of microcaptive insurance, it appears that the IRS generally views microcaptive insurance structures as 'abusive' and is seeking to cease operation of microcaptive companies. The IRS's new audit efforts 'offer' as a settlement to any microcaptive owner and the related insured of such microcaptive the following 'deal': all IRC 162 deductions taken by the related insurance for premiums paid for captive insurance premiums are denied in full, plus interest and penalties of up to 15%; the microcaptive itself must either liquidate, or must be deemed to liquidate, leading to a potentially significant tax on liquidation (especially if premiums paid to such microcaptive in years prior to the open years under audit were significant), plus interest and penalties of up to 15%; and, for microcaptives owned in an irrevocable trust or in other, similar manners, the settlement offer requires the owner(s) of the insured business to either utilize her/his gift and estate tax exemption for such premiums paid or, if no such exemption with respect to such taxpayer remains, payment of federal gift tax of 40%, plus interest and penalties of up to 15%.

The significant issue with the IRS's proposed "settlement offers" to audited microcaptive owners is that the IRS sends these offers without having even viewed the captive's tax return nor the related insured's tax return. This author represents roughly two dozen taxpayers with respect to IRS audits of their microcaptive structure, and in each and every audit, the IRS sends this "settlement offer" without having received one ounce of information from the audited taxpayer regarding its captive structure. In fact, without any such information in hand, the IRS nonetheless sends the draconian settlement offer to a taxpayer, ostensibly in hopes of forcing the allegedly 'abusive' structure into extinction.

However, not all microcaptive structures are abusive. It has been this author's experience, not just in representing taxpayers in IRS audits of their microcaptive structures but also in representing clients in establishing and properly maintaining captive insurance structures, that the vast majority of such structures are sound and properly run. These microcaptive structures satisfy the 3 tenets of captive insurance planning: (i) risk shifting; (ii) risk distribution; and (iii) insurance in its commonly accepted usage. Far from being abusive, these structures provide real coverage for real risks that the related

insured faces. While it is true that most microcaptives offer insurance for high severity/low frequency risk, we need look no further than the current COVID-19 pandemic that is gripping the globe. Many microcaptive insurance companies provided coverage for just this type of high severity/low frequency risk, and many captive insurance companies and their management companies have paid out large (i.e., as in seven figure) claims for this type of coverage in the very recent past, with likely many more claims still pending.

Recently, and as noted above, the Tax Court accepted the IRS's Motion to Dismiss in *Puglisi*. *Puglisi* involved a microcaptive insurance company managed by Oxford Risk Management Group. The IRS spent approximately three years reviewing the Puglisi's captive insurance program, but before proceeding to trial, the IRS determined that no changes to the taxpayer's captive insurance program were warranted. It does appear that *Puglisi* marks a seismic shift in the microcaptive landscape. While *Avrahami, Reserve Mechanical, Syzygy* and *Caylor Land* were IRS victories, those cases could be regarded as "bad facts/bad law" cases. And *Puglisi*, while not representing the opinion of the Tax Court, may provide taxpayers who participate in a captive insurance program a road map on what a properly run captive insurance program truly looks like.

Now that the IRS has had the opportunity to scrutinize the Puglisi captive insurance program and decided to dismiss its case against Puglisi, there should be a 'flight to safety' for business owners who either have a captive insurance program or those who are contemplating implementing one. It is absolutely crucial that a taxpayer considering implementing a captive insurance structure, or a taxpayer currently with a captive insurance structure in place, MUST work with experienced advisors (legal/tax, accounting and, most importantly, captive insurance advisors and managers) with significant relevant experience in the microcaptive industry. This flight to safety should be undertaken immediately, regardless of whether or not a taxpayer and the related captive insurance structure is under audit. However, with respect to the taxpayers under such audits, it is this author's belief that, unless the relevant structure is truly similar (in a bad way) to the structures that were struck down in *Avrahami, Reserve Mechanical, Syzygy* and *Caylor*, such taxpayers should remain resolute in their belief that their structures are not the abusive structures that the IRS apparently believes they are. While *Puglisi*, admittedly, does not reflect the opinion of the Tax Court or any of its judges (as it was the IRS which moved to dismiss the case), it is likely in the near future that one or more Tax Court cases involving well-structured and maintained captive insurance arrangements will be resolved favorably to the taxpayer. Such cases will provide the captive industry and its advisors with a true 'road map' to determine best practices. But until such an opinion is rendered, taxpayers would be well advised, as noted above, to either maintain their flight to safety, or embark on a flight to safety.