

Captive Soft Letter

March 31, 2020

On March 20, 2020, the IRS sent so-called “soft letters” to taxpayers who disclosed their participation in section 831(b) captive insurance arrangements identified as transactions of interest by Notice 2016-66. The IRS has heavily targeted these captive arrangements for enforcement because the IRS views them as potentially abusive. On January 31, 2020, the IRS announced a new audit initiative in which twelve new examination teams would begin new examinations for taxpayers who participated in section 831(b) captive arrangements.

Soft Letters: An IRS Tool

Soft letters are an enforcement tool that the IRS has used in other areas, where the IRS believes there is widespread misreporting of tax liability resulting from particular transactions and wants taxpayers to self-correct their tax reporting. Several of the announced LB&I compliance campaigns, each of which identify an issue with a risk of taxpayer noncompliance, have soft letters as one of the possible treatment streams, including another reportable transaction of interest called the basket option transaction.

The approach that the IRS takes with respect to a soft letter ranges between “educational” and more serious. For example, in 2009, the IRS sent soft letters to Bitcoin investors to “remind” them that taxpayers are required to pay tax on gains from cryptocurrency transactions. In contrast, in 2003, the IRS sent soft letters to taxpayers whom the IRS had identified as using an offshore financial arrangement. The IRS termed these soft letters as a “last chance compliance initiative” (LCCI), i.e. the “last chance” for taxpayers with unreported overseas income to come into compliance with US tax law.

Technically, taxpayers are not required to respond to a soft letter. However, not responding likely will result in an IRS audit and potentially may result in additional tax and significant penalties.

Soft Letters Issued For Section 831(b) Captives

The recently-issued micro-captive soft letter seeks information from taxpayers and cautions about tax reporting for the current and prior tax years. First, the letter requests that the recipient identify under penalty of perjury the last year in which the recipient claimed a tax benefit from a section 831(b) captive insurance arrangement and state whether the taxpayer is still participating in captive insurance arrangement. The letters indicate that the response is due by May 4, 2020. The IRS likely will use taxpayers’ responses to narrow the focus of its enforcement campaign against section 831(b) captive insurance companies.

The letter also recommends that the recipient consult with an independent, competent tax advisor to determine the proper tax reporting for the captive insurance arrangement and to consider filing amended returns. The letter states that it is not an enforcement action for purposes of filing qualified amended returns (QARs). Generally, a QAR is an amended return, or a timely request for an administrative adjustment for a TEFRA partnership tax year that began prior to 2018, that is filed before the IRS takes certain specified enforcement action relating to the taxpayer or the taxpayer’s advisor. If a taxpayer files a QAR, the underpayment penalty will not include the

additional tax disclosed on the QAR unless the amounts reported relate to a fraudulent position on the original return.

If a taxpayer files an amended return that does not meet the QAR technical requirements, the taxpayer may not realize any benefit with regard to the underpayment penalty, and the amended return could have other procedural consequences.

Recipients of the micro-captive soft letters have several courses of action to consider and consequences to weigh. Recipients should consult with tax advisors experienced with section 831(b) captive insurance companies to determine which response options are most advisable in light of the taxpayer's overall situation.

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