

IRS Concedes Case to Captive Insurer Prior to Trial: Is it a trend bound to continue?

Written By Karrie Hyatt

The captive insurance sector got a small win against the Internal Revenue Service (the Service) last year, when the Service conceded a U.S. Tax Court petition that had been brought against it by an 831(b) captive.

While industry professionals were hoping for the case to make it to court in order to get an important legal opinion, the concession by the IRS shows that there is at least some 831(b) captive circumstances that the Service finds acceptable.

THE CASE

Puglisi Egg Farms is a family-owned agricultural business that raise hens to produce eggs for resale to grocery stores and restaurants. Finding traditional means of insurance not adequate to insure their risk, the Puglisi family established a series captive, Puglisi Egg Farms of Delaware, LLC, domiciled in Delaware utilizing an 831(b) tax election. Managed by Oxford Risk Management Group, the captive is reinsured through Oxford's risk pool.

According to Susan M. Euteneuer, Esq., General Counsel and Chief Compliance Officer with Oxford, “Years ago, [the Puglisis] were working with their risk management and insurance advisors, recognized that their business had real potential risks from avian flu, salmonella, and others, and they shopped the traditional commercial insurance market to try to obtain cover for that insurable risk. Then they explored captive insurance options and, after evaluating various structures and options, decided to form a captive insurance company with Oxford.”

Beginning in 2017, the Puglisi captive was audited by the IRS for more than two years, with the Service requiring thousands of documents. In December 2019, the IRS issued statutory notices of deficiency (SNODs) for the years 2015 and 2016, and for 2018 issued in 2020. Penalties ranged from 20 to 40 percent.

“At the end of an examination,” said Charles M. Ruchelman, member, Caplin & Drysdale Attorneys and the co-lead counsel for the case,

“The IRS can either issue a no change letter or issue a notice of deficiency. They issued notices of deficiency to both the owners of Three Puglisi Brothers, Inc. and series KF of Oxford. Once you have that notice of deficiency, that is your ticket to the U.S. Tax Court. You can either accept it and pay the tax or you can contest the determination and you can file a petition in the U.S. Tax Court, which is what we did on behalf of this client.”

The Puglisi family had decided to take the matter to the U.S. Tax Court and filed petitions for each SNOD over the course of 2020.

According to Jeffrey K. Simpson, partner, Womble Bond Dickinson (US) LLP, and who also worked on the case, “The Puglisis felt they really had followed the rules. They were in this for a bona fide risk management reason. They had insurance issues they were trying to manage and they needed a captive for that purpose. They were very careful to make sure they got good advice on the way in and as the captive operated. They followed that advice, so they were confident that they had done the right thing. The IRS either hadn’t understood or hadn’t taken the time to try to understand that during the audit process.”

In April 2021, the IRS made a motion to concede the issue, but the Puglisi’s wanted the Court to make a decision on the issue. Without a Tax Court decision, the Puglisi’s felt that the issue could reoccur years later without a precedent-setting court decision.

“As the Puglisis explained to the court, they wanted to have their case heard, because they value the insurance in their Oxford captive, and the Service could audit subsequent years of insurance premium deductions. The [Puglisi family] did not want to land in court again,” said Euteneuer.

According to Ruchelman, “On behalf of the Puglisis we contested the IRS’s motion to concede that concession. This was an important issue for the company as they continue to buy the insurance every year and need the insurance. They wanted a determination by the court as to the validity of the insurance as well as there are hundreds of other taxpayers that are in a similar arrangement and they need guidance from the court. It was a strategic concession by the IRS, because for whatever reason the Service decided they did not want to have the court decide the validity of the insurance and the insurance structure.”

In late October 2021, the Court sided on behalf of the IRS saying that the taxpayers are not owed an opinion on issues on which the IRS concedes.

While ultimately a win for the Puglisi’s and the captive insurance sector, without the guidance that a court decision would have provided, the IRS is free to continue pursuing similar captives. “As the Court noted in granting dismissal of the Puglisi’s tax court petition,” said Euteneuer, “pursuant to U.S. tax law, the IRS may decide which cases it wishes to litigate, and, in making those decisions, is permitted to dismiss those cases it does not believe it will win at trial.”

For Simpson, “We think [the IRS] concluded that they couldn’t win their case. The fact that the Puglisi family had followed the rules and, as we believe, that the [captive] arrangement did meet the elements of insurance for tax purposes meant the captive should have been respected. It just took the IRS a really long time to get to that understanding.”

THE IRS

After several high-profile Tax Court wins concerning 831(b) captives, this is the first case that the IRS has conceded. The Puglisi Egg Farm captive was being audited only because it was established as an 831(b) captive. “The IRS has been on a campaign, that’s what they call it, to examine as many 831(b) captive insurance companies as possible. The Puglisi’s were caught up in that campaign,” said Ruchelman.

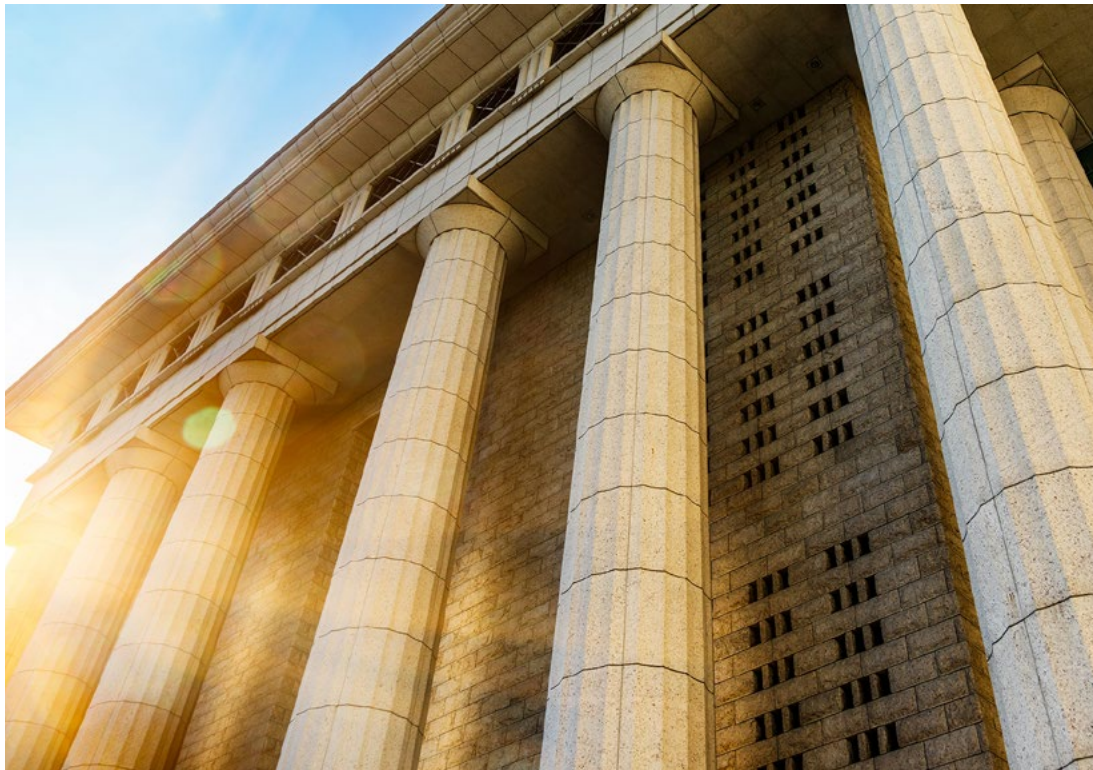
According to Charles J. Lavelle, partner with Dentons Bingham Greenebaum LLP, who also worked on the Puglisi case, “The IRS started auditing these kinds of captives several years ago, and has developed that into a formal program. The IRS has announced that it intends to audit essentially all captives that elect section 831(b). It deployed 12 audit teams to audit captives that elect section 831(b) two years ago, and recently announced that it was hiring 200 more lawyers for tax shelter issues, including microcaptives.” Lavelle is referring to the IRS’s January announcement that

it will be hiring at least 200 more lawyers to work audits on what the Service labels abusive tax schemes.

“Rather than issuing guidance, the Service instead continues to exert pressure against the entire industry through aggressive and expensive audits, both of bad and good actors, without distinguishing between the quality of the programs,” said Euteneuer.

“It appears, from the taxpayer’s point of view,” said Simpson, “That the IRS, when they audit an 831(b) captive, they have already concluded that because it is an 831(b) captive they are not going to find in favor of it. When they are looking at the records they do not seem to be genuinely considering whether the captive should be respected. Instead, they seem to be looking for details they can use to challenge a captive’s position that they have achieved insurance for tax purposes.”

Not only were the Puglis hoping for a Tax Court opinion with their petition, so was much of the captive insurance sector. The IRS has dragged its heels in issuing guidance for small and medium captives electing to take the 831(b) tax option for nearly a decade, despite continued pleas from those in the industry. An opinion in the Puglisi case would have helped create at least some guidance that captive owners could use to lawfully and successfully manage their captive.





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Despite not getting the opinion that they wanted, captive insurance professionals are optimistic that the IRS's concession could have influence over future audits.

According to Euteneuer, "The Service, as it promised it would, continues to audit many captives and has, at least so far, shown no signs of modifying this overall approach. At the audit level, though, some examiners could begin to exercise the independent judgment provided by the audit rules and decide to stop painting all captives with the same brush."

Simpson has a similar opinion, "I hope it has influence over the IRS on how it analyzes cases in that they're a little more thoughtful in challenging rather than just arbitrarily arguing with everything."

"Hopefully, this means the IRS will concede all other cases that it views as meeting the insurance tax tests, including making early decisions on programs that qualify," said Lavelle.

Lavelle added some historical context for what is happening between 831(b) captives and the IRS. "The large captive litigation occurred in the late 80's and early 90's. The IRS won the first several cases, then lost most of the next group. Through this process, the captive rules developed. I think the IRS thinks that there are still a lot of inferior arrangements (while the industry may think those arrangements qualify as insurance) ... I think the IRS will continue to litigate cases until taxpayers begin winning cases; some of those cases may be appealed. This process will develop rules for small captives, which may take more than five years to solidify."

The tides may be turning for captives electing the 831(b) option. While the Puglisi case only got the IRS's concession, it is not the only case out there in which the IRS has conceded, and the next 831(b) audit case may find its way to a favorable opinion.

The cases decided in Tax Court up until now involved 831(b) captives that were organized during the early years of captives opting for the 831(b) code, with the Court deciding on facts from a decade ago and captive arrangements that hadn't matured yet.

As Simpson put it, "The captive arrangements happening today reflect the learning that has happened over the last decade. They include lessons learned from the cases where an opinion was delivered. Today's captives, and the insurance programs in them, have matured. Where they are insuring high-severity, low-frequency events, you don't often see losses. If you look at a one

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or two year window, you may not see much action. But if you look at it over a decade, you are going to start to see more evidence that it's working the way it's supposed to work. It just takes time to bear out."

While 831(b) captives still have to contend with the IRS's campaign against them, the Puglisi Egg Farm case sets an unofficial precedent for how the future of IRS audits might turn. For

Ruchelman, "What the Puglisi case says about the future is impossible to tell, but I consider it very interesting that the IRS has conceded a case involving a structure that they have said publicly over and over again that they are going to audit every one of, going so far as to say that they don't like them. I guess they found one they like." ■

Karrie Hyatt is a freelance writer who has been involved in the captive industry for more than ten years. More information about her work can be found at: www.karriehyatt.com.

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