

# Captive Legal and Tax Insights

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# Notice 2016-66: Transactions of Interest

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- On November 1, 2016, the IRS issued Notice 2016-66 designating most arrangements with captives electing section 831(b) as “Transactions of Interest”
- The Notice triggers disclosure requirements for both participants, material advisors, and intermediary companies.
- Failure to disclose subjects one to penalties (no additional tax)
- The original due date for the filings was January 30; the date was postponed to May 1 by Notice 2017-08

# Notice 2016-66:

## Transactions of Interest (cont'd.)

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- The Treasury and IRS recognize that transactions with captives electing section 831(b) are proper if they advance risk management purposes that do not involve tax avoidance purposes
- The IRS says it wants to collect information to distinguish between abusive and non-abusive situations
- After analysis, the IRS may determine that transactions involving companies electing section 831(b) will be deleted from Transactions of Interest, designated as “Listed Transactions,” or placed in a new category

# IRS Concerns

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- Is the captive an insurance company?
  - Inadequate capital to cover assumed risks
  - Loans from captive to insureds or affiliates
  - Insured not filing claims for losses
  - Pooled premiums do not reflect the risk
  - Ambiguous claims procedures
  - Investments solely benefitting the insured

# Notice 2016-66:

## Transactions of Interest (cont'd.)

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- Requirement to file Form 8886:
  - 831(b) Captives in which the insured company owner (and related parties) own at least 20% of the voting power or value of the stock of the insuring or reinsuring captive; and **either**:
    - The captives' losses and loss expenses are less than 70% of premiums earned less policyholder dividends, **or**
    - Captive has made loans, guarantees, etc. benefiting related parties
  - A five-year computation period (last 5 taxable years)
  - A Transaction of Interest includes a transaction "substantially similar" to the arrangement described in the Notice

# Notice 2016-66: Transactions of Interest (cont'd.)

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- Requirement to file Form 8886:
  - Participants in the described structure – captives, owners, insureds, intermediary entities
  - Persons entering into transactions on or after November 2, 2006 must have disclosed the initial “catch up” filing by May 1, 2017
  - Owner(s), Insured(s), Captive, Intermediary Company must describe the transaction in sufficient detail, including when and how the taxpayer became aware of the transaction

# Notice 2016-66:

## Transactions of Interest (cont'd.)

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- Requirement to file Form 8886:
  - The Captive must provide its domicile and include
  - The reason for reporting (less than 70% loss ratio and/or loan, guaranty, pledge, etc. for affiliates)
  - Types of risks insured
  - How premiums were determined
  - Actuary or underwriter's name and contact information
  - Description of claims paid; info on reserves
  - Investments, including identifying related parties involved in Captive investments
- Potential Penalty Under Section 6707A

# Notice 2016-66: Transactions of Interest (cont'd.)

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- Requirement to file Form 8918:
  - Material Advisor
    - Tax Statement
    - Fee Threshold
- Penalty Under § 6707



# Notice 2016-66:

## Transactions of Interest (cont'd.)

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- Participants
  - Annual filing with Federal and some State Tax Returns
  - Some States have a one-time “catch-up” filing obligation
    - First filed tax return
    - E.g., New York (Form DTF-686)
  - Some States have an annual filing obligation
- Advisors
  - Post May 1, 2017 Captive Formations
  - List Maintenance Obligations
    - IRS Form 13976
  - Post May 1, 2017 some State Filings (June 30<sup>th</sup>)
    - E.g., New York (Form DTF-664)
    - E.g., Utah (Form TC-40TS)
  - Compliance with Designation Agreements

# IRS Audits

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- The IRS had issued Notices in February 2015, 2016 and 2017 warning taxpayers involved with insurance companies that had elected to be taxed under section 831(b)
  - These are legitimate tax structures
  - The Notice warns that such an insurance company can be used abusively; e.g.:
    - *“The promoters assist with creating and “selling” to the entities often times poorly drafted “insurance” binders and policies to cover ordinary business risks or esoteric, implausible risks for exorbitant “premiums,” while maintaining their economical commercial coverage with traditional insurers.”*
    - *“Total amounts of annual premiums often equal the amount of deductions business entities need to reduce income for the year; or, for a wealthy entity, total premiums amount to \$1.2 million annually to take full advantage of the Code provision. Underwriting and actuarial substantiation for the insurance premiums paid are either missing or insufficient.”*

# IRS Audits

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- Tax Shelter Promoter Investigations:
  - One or more captive managers are being investigated to determine if they are tax shelter promoters
- No results announced yet from these investigations
- The IRS is auditing a substantial number of captives electing to be taxed under section 831(b)
- LB&I has announced that companies electing section 831(b) are one of its upcoming campaigns
- Exam often proposes to disallow premiums to the payor (and impose penalties) and simultaneously assert income for the insurance company (and impose penalties); compare: Rev. Ruls. 2005-40, 2007-47, and 2008-8

# Audits of Captives Electing Section 831(b)

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- Comprehensive Information Document Requests:
  - Information from the inception of the captive, even if it preceded the years under audit
  - All emails, marketing materials, etc.
  - Questions on how one got involved in the captive and who the taxpayer consulted
  - What commercial insurance was in place, what are the gaps and exclusions, how the captive program fit
    - What is the operating company's risk management program?
    - How were the premiums priced?

# Audits of Captives Electing Section 831(b)

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- Comprehensive Information Document Requests (cont.):
  - For the ten years prior to its inception, were there any losses that would have been covered by the captive program, had it been in place?
  - What is the loss experience of the related party and pool insurance?
  - What are the investments of the captive?
  - Three cases involving companies electing section 831(b) have been tried in the United States Tax Court and are awaiting opinions: Avrahami, Caylor and Wilson

# IRS Priority Guidance

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- For several years, the IRS included on its Priority Guidance Plan:
  - Guidance with respect to captive insurance
  - Cell regulations

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