

CAPTIVE TAX UPDATE

Kentucky Captive Insurance Association
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Charles J. (Chaz) Lavelle
Bingham Greenebaum Doll LLP
101 South Fifth Street, Suite 3500
Louisville KY 40202

clavelle@bgdlegal.com

502/587-3557



Today's Topics

- Anything the audience wants to discuss
- Tax Reform Act – December 2017
- Section 831(b) changes
- Other captive authorities over the last year
- Avrahami v Commissioner
- Other small captive insurance company court cases
- How we got to where we are
- “Campaigns” and GSI?
- Endgame

Tax Reform – December 2017 ⁽¹⁾

- Numerous provisions of the Tax Cuts and Jobs Act affect captive insurance companies, even though there was no direct change to:
 - Section 831(a)
 - Section 831(b)
 - No change to PATH Act provisions
 - No change to IRS Notice 2016-66 reporting
- All insurance companies are C corporations

Tax Reform – December 2017 ⁽²⁾

- Top C corp rate reduced from 35% (with graduated rates) to flat 21%
- Corporate Alt Min Tax is eliminated
- Net Operating Loss carryback is eliminated for C corps generally, but P&C companies can carryback 2 years
- Dividend Received Deduction has tightened

Computation of Reserves ⁽¹⁾

- For P&C insurance companies (not just captives), the computation of reserves has changed:
 - Will generally reduce the reserve deduction in a given year
 - Discounting will be a function of the corporate bond yield, not AFR

Computation of Reserves ⁽²⁾

- The period is extended to 14 years (from 10 years) for certain long tail coverages
 - NAIC form only contains 10 years and is source
- No change to 3-year period for short tail

Computation of Reserves ⁽³⁾

- The New Law eliminates the ability of a taxpayer to use its own loss experience in the discounting
 - The only path is to use IRS prescribed rates
- The discounting provisions are phased in

Computation of Reserves ⁽⁴⁾

- Reserves are reduced to take into account investments in tax exempt bonds and dividend paying stocks (the proration adjustment)
 - Old law (35% top rate): reduction is 15% of exempted interest and dividend received deduction (generally)
 - New law (21% top rate): 25% reduction
 - Designed to be a neutral change

International ⁽¹⁾

- Will any of the international provisions incentivize redomestications?
- Increase the number of U.S. owners that include a foreign captive's income in the owner's U.S. return
 - Based on 10% value or vote
 - Previously it was 10% vote only
- Pay tax over 8-year period for accumulated e & p

International ⁽²⁾

- PFIC (Passive Foreign Investment Company) Rules
 - Qualified Insurer – loss/LAE reserves equal or exceed 25% of insurance company assets
 - 10% if entity is in “run off” or if noncompliance results from rating agency actions
- Base Erosion Anti-Abuse Tax (BEAT) - - minimum tax for huge companies non-U.S. payments, etc.
- Global Intangible Low-Taxed Income (GILTI)

Section 831(b) Changes

- Primarily covered in the Ryan Work's session
- Cap in premiums
 - 2016 - \$1,200,000
 - 2017 - \$2,200,000
 - 2018 - \$2,300,000
 - 2019 – indexed in \$50,000 increments
- Budget act clarifications – do we need further clarifications?

Other captive authorities in the last year ⁽¹⁾

- IRS permitted late section 831(b) elections to be approved retroactively
 - 201821007 (5/25/18) – 501(c)(15) insurance company failed to recognize that gross receipts exceeded maximum limit; it filed a 990, thus it did not timely file an 1120-PC with a section 831(b) election
 - 201744009 (11/3/17) – the foreign captive made its 953(d) election with its return, rather than separately at Plantation, Florida; section 953(d) and 831(b) elections were retroactively approved

Other captive authorities in the last year ⁽²⁾

- IRS permitted late section 831(b) elections to be approved retroactively (continued)
 - 2017280018 (7/14/17) – the CPA forgot to make section 831(b) election on the first return
 - 2017280017 (7/14/17) – the CPA forgot to make section 831(b) election on the first return
- New Capital Fire Inc. – TC Memo 2017-177 – tax return of merged entities qualified as tax return for both merger partners

Other captive authorities in the last year ⁽³⁾

- CCA 201802014 – reconsideration of theory of CCA 201511021
 - Risk arising from fluctuation of currency may be an insurable risk in some circumstances
 - This arrangement was not insurance as commonly accepted
 - Coverage limit is ambiguous
 - No documentation on premiums to show that they were arm's length or based on insurance experience
 - Coverage payment could exceed the actual loss incurred

Other captive authorities in the last year ⁽⁴⁾

- The base IRS interest rate has risen to 5% (it was 3% for a long time, then 4%)
 - Underpayment interest is not deductible to individuals
 - The cost of being wrong has increased
- The latest IRS Annual Priority Guidance Plan (Business Plan) drops an item that had been on prior Business Plan: guidance on captive insurance

Avrahami v. Commissioner

- The first section 831(b) opinion
- The Court (Judge Holmes) found that the arrangement was not insurance
- No risk distribution
- Not “Insurance” in its commonly accepted sense
- Very harsh language in portions of the opinion
- No Penalties - Lawyer’s Advice and first 831(b)/162/953(d) intersection

Other Small Captive Cases ⁽¹⁾

- Four other small captive cases have been tried
- Briefs for all of these, other than Wilson, have been filed
- In each case, the IRS has asserted
 - There is no “economic substance”
 - The arrangement flunks one or more tax tests for insurance
 - Insurance Risk; Risk Shifting; Risk Distribution;
Common Notions of Insurance
 - Penalties are appropriate

Other Small Captive Cases ⁽²⁾

- Caylor (Judge Holmes)
 - Brother-Sister Arrangement
 - No pool
- Wilson (Judge Holmes)
 - Same pool as Avrahami
 - Different experts and witness
 - Last brief is due in November 2018

Other Small Captive Cases ⁽³⁾

- Syzygy

 - Delaware captive

 - IRS seeks to tax both insured and captive

- Reserve

 - Section 501(c)(15) case

How We Got To Where We Are

- Chronology of IRS pursuit of small captives
- Numerous audits and investigations
 - Very exhaustive and exhausting audits
 - Intensive tax shelter promotor investigations
 - Many cases pending at Exam, Appeals and Tax Court
- “Dirty Dozen” of 2015, 2016, 2017 and 2018
- Notice 2016-66
- Opinions issued and pending – discussed above

“Campaigns” and GSI?

- The IRS’ Large Business & International Division has redirected its audit philosophy
 - Focus resources on specific issues (“campaigns”), rather than comprehensive general audits
- On 1/31/17, LB&I announced its first 13 “campaigns”
 - “Micro-captive” was one of the first 13 campaigns
- Global Settlement Initiative?

Endgame ? – IRS concerns? ⁽¹⁾

- Non-tax business purpose
- Types of coverages
- Premium pricing
- Claims
- Investments
- Operation – accuracy and standardness
 - Regulation and regulatory compliance
 - Structure and implementation
 - Policies – imprecision, errors, standardness, etc.

Endgame ? – IRS concerns? ⁽²⁾

- Other items?
 - The fundamental tax tests – insurance risks, risk shifting, risk distribution and common notions of insurance
 - Multiple captives
 - Ownership, including estate planning aspects
 - Capitalization
 - Relationship between pre-captive insurance program and post-captive insurance program