Steve Leimberg's Asset Protection Planning Email Newsletter - Archive Message #333

Date:	**28-Nov-16**
From:	**Steve Leimberg's Asset Protection Planning Newsletter**
Subject:	**David Neufeld on Notice 2016-66: IRS Requires Information Disclosures Regarding Certain Section 831(b) Captive Insurance Companies**

"On November 1, 2016, the IRS issued Notice 2016-66, which identified a specified captive insurance company design qualified under Internal Revenue Code section 831(b) as a 'transaction of interest.' As such, those captive insurance companies have a disclosure obligation that, if not done or not done properly, can potentially lead to significant penalties. Those taxpayers owning and using any 831(b) captive need to be aware of this obligation to determine if they might be covered by it and, if so, what they need to do now and going forward. Furthermore, Material Advisors must also disclose details of their own involvement as well as maintain lists of clients engaged in transactions identified in the Notice."

David Neufeld provides members with his analysis of Notice 2016-66.

David S. Neufeld of ***The Law Office of David Neufeld*** in Princeton, New Jersey has a 32 year long history as a tax lawyer working with clients' on their income tax planning and litigation issues, estate planning and business transactions, much of which intersects with insurance issues. A significant amount of that experience has been working with clients on the back end of entanglement in potential tax shelter issues, including Form 8886 filings, audits, appeals and litigation as counsel in tax cases and as expert witness in civil cases. David has also been working with clients in the captive insurance company world for many years; his first exposure to captives was in 1985 while assisting the US Tax Court judge for whom he was clerking on a concurring opinion to Clougherty Packing Co. v. Commissioner, 84 T.C. 948 (1985). These worlds now come together. More information on this and related topics are available at **www.DavidNeufeldLaw.com.** David can be reached at (609) 919-0919.

Now, here is David's commentary:

EXECUTIVE SUMMARY:

- The IRS has identified certain 831(b) captive insurance companies as transactions of interest, meaning transactions requiring further study to determine whether they are tax abusive or not.
- The initial criteria are (1) 20% or more of the captive is owned by the insured

company or the same family as owns the insured company, (2) claims and expenses are less than 70% of premium revenues and (3) transfers of funds, such as loans or investments, back to the insured company or the family group that owns the insured company.

- If a captive is a transaction of interest the captive and related companies and individuals need to file Form 8886 for 2016 and certain prior years by January 30, 2017.

- Failure to properly and timely file the Form 8886 can result in penalties as high as $50,000 for entities and $10,000 for natural persons for each year.

- Some states also have a similar filing requirement.

- Material Advisors have their own parallel filing requirement with Form 8918 and its own $50,000 penalty.

FACTS:

A captive insurance company as a risk management concept has been on the scene for decades and utilized by businesses of all sizes, notably most of the Fortune 500 (for an overview see **Gordon Schaller & Scott Harshman, Use of Captive Insurance in Business and Estate Planning Estate Planning Newsletter #1252)**. Stated most simply, this is a company licensed to issue insurance (typically property & casualty) and issue it predominantly for the benefit of the company that formed and owns it. Both the courts and Congress have smiled favorably on captives over the years, permitting the sponsoring company to deduct premiums paid to its own captive insurance subsidiary for what some may consider self-insurance. In a later twist Congress enacted IRC section 831(b) that allows a small property and casualty insurance company with $1.2 million or less in premium income to make an election to be taxed only on investment income ($2.2 million starting in 2017 (**Chris Riser, Jay Adkisson & David Slenn: Understanding How the PATH Act Impacts Section 831(b) Captives Asset Protection Planning Newsletter #312**)). And for almost as long as they've been around captives, large and small, onshore and offshore, have incurred the wrath of the IRS, sometimes for good reasons and sometimes resulting in notable IRS losses in court. Notice 2016-66, focusing on the structure and operations of what are called 831(b) captives or micro-captives, is the latest salvo in that battle (previously written about here **FLASH: Jay Adkisson, Chris Riser & Dave Slenn on Notice 2016-66: IRS Issues Long-Anticipated Notice of Its Intent to Combat Real and Perceived Abuses Estate Planning Newsletter #2475)**. This is the story of that battle from the front lines.

COMMENT:

The IRS, on November 1, 2016, issued Notice 2016-66 identifying a specified captive insurance company design qualified under Internal Revenue Code section 831(b) as a

"transaction of interest." *As such those captive insurance companies have a disclosure obligation that, if not done or not done properly, can potentially lead to significant penalties.* Those taxpayers owning and using any 831(b) captive need to be aware of this obligation to determine if they might be covered by it and, if so, what they need to do now and going forward. Furthermore, Material Advisors must also disclose details of their own involvement as well as maintain lists of clients engaged in transactions identified in the Notice.

What Happened?

When the IRS views a transaction as one yielding tax benefits that abuse the law to achieve ends that the IRS views as inappropriate it has a process of classifying that transaction as an abusive tax shelter, referred to as a "reportable transaction" and sometimes a "listed transaction." Sometimes, before it is capable of making the determination that it is or is not abusive the IRS identifies a transaction (and "substantially similar" transactions) as a "transaction of interest" as it gathers sufficient data. At the end of this study period it might decide that the transaction is not abusive in which case nothing more happens. Or it might conclude it is in fact abusive and will therefore subject taxpayers participating in that transaction to various reporting rules and potential penalties.

Generally, captives are insurance companies that are formed to insure related businesses, and the insureds pay premiums for that coverage. A subset of captives is governed by section 831(b) which allows certain small captives (what the IRS is calling "micro captives") and pay tax only on their investment income. Also, the premiums are deducted by the insured as a business expense.

It is important to note that *no captive insurance company has yet been classified as an abusive tax shelter* in this Notice. The captive arrangement identified in the Notice is only a transaction of interest. Also not all captives are transactions of interest, only 831(b) captives. And, while technically not all 831(b) captives are transactions of interest, as a practical matter it is likely that almost all fit within the specified, albeit broad, parameters to qualify as one. So while this might "only" be a transaction of interest, even if the transaction is ultimately determined not to be abusive there is still the disclosure filing requirement that accompanies classification as a transaction of interest and the associated failure to file penalties.

What Captives Are Covered?

The criteria that are considered to be the hallmark of the type of captive arrangement that has piqued the IRS' interest, stated broadly, are:

- At least 20% of the stock of the captive is owned directly or indirectly by the insured company or those that own the insured company (including family members and related entities).

and

- Either:

    1. For the most recent five years the captive had covered losses and claim administration expenses that together are less than 70% of premiums earned as adjusted; OR

    2. At anytime during the most recent five years the captive has conveyed in one way or another to a common owner, the insured company or a related party in a non-taxable transaction funds derived from the premiums and capital received from the owners and the insured company. This includes loans, investments and guarantees, among other transfers. This has sometimes been called round-tripping.

Parsing through all this, the captive insurance company that is now considered a transaction of interest is one owned substantially by a limited group that has either paid out claims less than 70% of premiums as adjusted or round trips the premiums it has received or its other capital. As a practical matter this would likely bring in all 831(b) captives.

What Must Be Done if a Captive Is a Transaction of Interest and When?

If a captive insurance company is structured in a manner that classifies it as a transaction of interest, then several parties related to that structure have a reporting requirement. While any transaction that has a design that is not supported by the law would have potential tax deficiencies and accuracy-related penalties separate and apart from this classification as a transaction of interest, simply having and fulfilling this new reporting requirement does not mean or even imply that there is any additional tax required or that there is any accuracy-related or other penalty at this time for underpaying tax.

However, the reporting obligation itself is fairly onerous and applies to the captive itself, its owners, the insured company and, if there is one, the fronting company. All of these may be considered participants. Each participant (potentially three or more for each captive) must file a Form 8886:

- With his/her/its 2016 tax return and with the Office of Tax Shelter Analysis for the 2016 tax year if the return is due after January 30, 2017 (and the same for subsequent years until the requirement ceases);
- With the Office of Tax Shelter Analysis for the 2016 tax year by January 30, 2017 if the return is due before January 30, 2017; and
- With the Office of Tax Shelter Analysis for all applicable prior years by January 30, 2017 (a single filing for all prior years is adequate) *even if the taxpayer was no longer in the captive on November 1, 2016 (i.e. participation ceased years earlier and the limitations period has not yet run)*.

It appears from the Notice that in determining the applicable prior years we basically have to perform a decision flow chart:

- Was the transaction *entered into* on or after November 2, 2006? If yes then:
- During any of the prior five years did the captive qualify as a transaction of interest? If yes then for each of those qualifying years:
- During any of those prior qualifying years was the person a participant? If yes then for each of those years as a participant:
- Did the statute of limitation run on any of those years for each participant? If yes then:
- File the Form 8886 as appropriate only for such years that are still open.

The Form 8886 for all participants must contain a description of the transaction in sufficient detail for the IRS to be able to understand the tax structure, including when and how the taxpayer became aware of the transaction, and the identity of all parties and advisors involved. In addition, the Form 8886 for the captive must also include detailed information including, among others, the actuarial basis for the premium, a description of the risks covered, its claims paid history and a description of its investments.

For each year that an *entity* fails to file a complete Form 8886 or files it late there can be a penalty equal to 75% of the tax reduction, but not less than $10,000 nor more than $50,000. For each year that a *natural person* fails to file a complete Form 8886 or files it late there can be a penalty equal to 75% of the tax reduction, but not less than $5,000 nor more than $10,000. As a practical matter the lowest penalty that will be incurred by a captive group, one that consists of at least one captive insurance company, one insured company and one individual owner, will be $110,000 (assuming the tax reduction resulting from the deductible premium and 831(b) exclusion (as applicable) is $66,666, which is likely to be all subject captive groups). The penalties increase with each additional insured, owner and fronting carrier.

For those tempted to ignore this filing requirement on the assumption that they might not be found, note that any captive manager or other adviser who advised participation in the captive is also required to submit a detailed disclosure of its clients (described below).

Finally, taxpayers need to check if their state has a similar filing requirement.

Material Advisor Filing Requirement

Generally, every material advisor to an 831(b) captive that is a reportable transaction is required to file Form 8918. A material advisor can be an individual, trust, estate, partnership, or corporation. One is a material advisor to a transaction who:

- Provides any material aid, assistance, or advice with respect to the organizing, managing, promoting, selling, implementing, insuring, or carrying out an 831(b) captive, and

- Directly or indirectly receives or expects to receive gross income in excess of a specified threshold amount (in this case $10,000 for fees from individuals and flow through entities and $25,000 for fees from other entities) for the material aid, assistance, or advice.

There is a $50,000 penalty for failing to file this form timely or filing it with false information or incomplete. There is zero room for error.

The rest, as they say, is commentary:

One provides material aid, assistance, or advice with respect to the organizing, managing, promoting, selling, implementing, insuring, or carrying out any transaction if one makes or provides a "tax statement" on or after November 2, 2006 (yes 2006) with respect to an 831(b) captive entered into on or after November 2, 2006 to or for the benefit of:

- A taxpayer who either is required to disclose the transaction *or would have been required to disclose the transaction if the transaction had become a listed transaction or a transaction of interest within the period of limitations*;
- A material advisor who is required to disclose the transaction.

If the italics didn't do it, it should be emphasized that one is a material advisor with respect to an 831(b) captive for a year that is not reportable by the taxpayer on his 8886 due to the running of the limitations period. And furthermore, the advice need not be given to the ultimate taxpayer but qualifies as a tax statement if given to another material advisor under certain circumstances.

Generally, a tax statement is any statement (including another person's statement), oral or written, that relates to a tax aspect of a transaction that causes the transaction to be a reportable transaction. Since, in this context, an 831(b) captive insurance company becomes a reportable transaction because the loss ratio is less than 70% or the company round-trips financing, a literal reading of this requirement might lead one to conclude that an advisor who does not advise on claims processing or round trip financing has not made a tax statement. Given the nature of this filing requirement and the potential cost for being wrong it might take a brave soul to make such an assertion.

One is not usually considered to be a material advisor if one makes a tax statement solely in his or her capacity as an employee, shareholder, partner, or agent of another person. In this case, any tax statement made will be considered to be made by the employer, corporation, partnership, or principal. However, the IRS cautions against attempting to create a shield; an advisor will be treated as a material advisor if he or she forms or uses an entity to avoid these rules and penalties. Of course when does ordinary and legitimate business planning become an avoidance technique?

It will come as some relief that an advisor is not considered to be a material advisor concerning a transaction if she do not make or provide a tax statement about the transaction

until after the first tax return reflecting tax benefit(s) of the transaction is filed with the IRS. However, before exhaling in relief keep in mind that this exception does not apply if it is expected the taxpayer will file a supplemental or amended return reflecting additional tax benefits from the transaction.

Having said all this, not every material advisor needs to actually file the Form 8918. If more than one material advisor is required to disclose an 831(b) captive under this section, a material advisor may designate by written agreement another material advisor related to that transaction to disclose the transaction. However (and there is always a however) the designation of one material advisor to disclose the transaction does not relieve the other material advisors of the obligation to disclose the transaction to the IRS if the designated material advisor fails to disclose the transaction to the IRS in a timely manner. Thus it would not be unexpected for a principal advisor, perhaps the captive manager, to offer to take these reins, but likely with a release should the filing be deemed untimely or deficient.

Since the amount of fees received will be a determining factor is qualifying an advisor as a material advisor this becomes an important computation. In figuring the amount of gross income received directly, or indirectly, for material aid, assistance, or advice, include all the following.

- Fees for a tax strategy.
- Fees for advice (whether or not tax advice) (it is unclear how fees for non-tax advice co-exist with the need for a tax statement).
- Fees for implementing the 831(b) captive.

Fees include consideration in whatever form paid, whether in cash or in kind, for:

- Services to analyze the transaction (whether or not related to the tax consequences of the transaction),
- Services to implement the transaction,
- Services to document the transaction, and
- Services to prepare tax returns to the extent return preparation fees are unreasonable.

A fee does not include amounts paid to a person, including an advisor, in that person's capacity as a party to the transaction. For example, a fee does not include reasonable charges for the use of capital or the sale or use of property. It would appear that fees do not include premiums paid to or by the captive. The IRS will scrutinize carefully all of the facts and circumstances to determine if consideration received or expected to be received in connection with a reportable transaction is gross income received directly, or indirectly, for aid, assistance, or advice.

Enough? Not so soon. In addition to the filing requirement a material advisor generally must maintain a list identifying each entity or individual with respect to who the advisor acted as a material advisor with respect to an 831(b) captive. A material advisor is not

required to identify an entity or individual on the list if the entity or individual entered into the captive earlier than November 2, 2010.

The list must be maintained for 7 years following the earlier of the date on which the material advisor last made a tax statement relating to the transaction, or the date the transaction was last entered into, if known. Upon IRS' written request, each material advisor who is responsible for maintaining a list must furnish the list to the IRS. The list must be maintained in a form that enables the IRS to determine without undue delay or difficulty the information required to be maintained for each list.

While I would strongly advise against trying to find loopholes in these rules or applying them too literally; this is not an area to test shades of grey. This is just an information return and the penalties are significant for being wrong. However if it clearly does not apply one need not volunteer. For instance, assuming each of the following receive the threshold amount of revenue within the applicable time frame:

- Captive managers would likely have a filing requirement;
- Attorneys providing tax, corporate and insurance law advice and services seem to have a filing requirement although some might not appear to be a "tax statement;"
- Accountants providing tax advice, a business plan or charging unreasonable fees for return preparation (presumably as camouflage for fees for advice) seem to have a filing requirement;
- Actuaries providing feasibility studies and underwriting services would seem to have a filing requirement;
- Property and casualty brokers placing fronting, reinsurance or retrocession arrangements would seem to have a filing requirement;
- Life insurance agents that introduced the concept and explained the tax benefits (i.e. promoting the concept) might not have a filing requirement if they do not receive the threshold fee; the issue might be how to characterize commissions if there are any and whether they are also earning fees from managing money;
- Investment managers who are managing the captive's reserves and capital might not have a filing obligation as they seem to fall outside all of the cubbyholes that apply to the others *if this is the sole interaction* (i.e. did not introduce the concept or promote it);
- Fronting or reinsurance carriers whose only fee is from premium might not have to file the Form 8918 but may nevertheless have to file the Form 8886.

Of course each interaction is different and no one involved with an 831(b) captive can conclude definitively as to one's filing obligations from this generic analysis. Just remember, making the argument that filing is not required may be costly to prove you're right.

What Does All This Mean?

Identification as a transaction of interest does not necessarily mean that the transaction is a tax abuse. While the ultimate determination of the IRS cannot be predicted it is possible, based on other information in the Notice, they might be looking for some combination of additional factors, including implausible risks, mismatch of coverage to actual risks, overpriced coverage and failure to interact in the manner expected of an insurance company.

Should I Stay or Should I Go?

There is nothing specifically in this Notice that should force any captive insurance company into immediate dissolution. Doing so will not remove the Form 8886 filing obligation for 2016 and prior years, which is already carved in stone. Staying or leaving in the short run, to put it colloquially, should not increase or reduce one's risks. Yet there may be reasons to keep the structure intact or to terminate it that differ on a case by case basis.

Where Is Help in All This?

Filing, whether the Form 8886 or the Form 8918, requires a team of those with information specific to the arrangement and those with specialized knowledge relating to these forms. In our firm's experience, the Form 8886 is best coordinated and prepared by experienced counsel with detailed input from the captive group's advisors and its captive manager who are intimately familiar with the specifics of the group's operations. The captive manager might have suggestions for qualified counsel experienced with both tax shelter filings and captives. This service is not typically included in the services normally provided by captive managers. The Form 8918 on the other hand is best coordinated and prepared by the captive manager as designated filer for all other material advisors. Whatever you do, do not underestimate the importance of doing this right or the complexity involved.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

David S. Neufeld

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Notice 2016-66.