LAW OFFICE OF DAVID NEUFELD

791 ALEXANDER ROAD
PRINCETON, NEW JERSEY 08540

(609) 919-0919
FAX: (609) 919-0920
David@DavidNeufeldLaw.com
www.DavidNeufeldLaw.com

Admitted
in New Jersey,
New York and
Pennsylvania

MEMORANDUM

To: All Interested Parties

From: David Neufeld, Esq.

Date: November 8, 2016

Subject: IRS CAPTIVE INSURANCE COMPANY NOTICE—A SUMMARY ANALYSIS

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.

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 abuses 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 famiky group that owns the insured company.
- If a captive is a transaction of interest the captive and related companies and individuals need to file the 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.

WHAT HAPPENED?

When the IRS views a transaction to be 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") to elect to exclude from income up to $1.2 million of premiums received ($2.2 million beginning in 2017) 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 their 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 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 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 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 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

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 list of its clients.

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

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.

A well informed captive insurance company and related parties will seek appropriate legal advice as to filing the Form 8886, the likelihood that its structure should be respected for tax purposes and, if not, the best actions going forward. ***The Law Office of David Neufeld*** advises on reportable transaction reporting requirements and represents captives and its owners on tax compliance issues and controversies. If you would like independent advice concerning how to comply with the reporting requirements required by this IRS notice, please contact **David Neufeld** at **609-919-0919** or **David@DavidNeufeldLaw.com**.