



IRS CONTINUES TO INVESTIGATE

Captives Choosing the 831(b) Tax Option

After five years of investigating small captives that choose the 831(b) tax option, the Internal Revenue Service has stepped up its investigations by releasing Notice 2016-66 last November and again listing captives to their annual “Dirty Dozen” list of potential tax scams.

831(b) captives are generally small to medium-sized companies that elect to take advantage of the Internal Revenue Service 831(b) tax code. Small captives are referred to by several different names—micro captives and Enterprise Risk Captives (ERCs) are two of them—but not all small captives take the 831(b) tax designation. Just like any other alternative risk transfer vehicle, these small captives must qualify as actual insurance companies. Opting for the 831(b) designation can give captives a tax advantage. What seems to be provoking the IRS’s suspicions of 831(b)s are their use for mitigating certain risks—especially regarding estate planning and wealth transfer—that may not qualify them as proper insurance companies.

By Karrie Hyatt

Smaller captives choosing the 831(b) designation are probably the fastest growing segment of the captive industry. There are a growing number of state domiciles that specialize in their formation. With their expansion in the last decade, these smaller captives have gained more criticism stemming from three main issues: some may seek to use them for tax shelter purposes; there have been a number of “promoters” engaging in setting up captives who may not have a background in insurance; and some have been used for wealth transfer planning.

In the wake of a difficult insurance market throughout the 1970's and early 1980's, Congress enacted 831(b) as part of the 1986 tax reform legislation in an effort to make it easier for rural mutual insurance companies, as well as small and medium sized business, to access insurance not readily available or too expensive in the general insurance marketplace. Captives using the designation have expanded since this time to include additional types of risks and are in wide-spread use throughout the country.

“From the IRS standpoint,” said Kevin Doherty, a lawyer with the law firm Dickinson Wright, “The current way the 831(b) designation is used was not the intention of Congress. The fact of it is that it is the law and it's permitted.”

IRS's Micro Captives

For the third year in a row, the IRS has named captives operating under the 831(b) tax designation to their “Dirty Dozen” list—a list the department releases each year warning tax payers of potential tax dodges and scams. This list, released at the beginning of tax season, highlights tax schemes that target consumers. Called “micro captives” in the IRS press releases, it says that some captives using the 831(b) designation are using it for wealth transfer rather than insuring genuine risk.



The captive industry has been swift and steady in the IRS's general and broad condemnation. According to Doherty, "It makes no sense to sweep captives up under the same category. [The industry has pushed back], but the IRS is going to have to be convinced that there are very few bad actors. It's sort of like saying that if you're in the dry cleaning business and there are maybe 15 dry cleaners across the country who have cheated on their taxes, that obviously means dry cleaning is a really bad business. That's the logic the IRS is using and we'd like to see that changed."

Les Boughner, chairman of Advantage Insurance Management, said *"The IRS has always been critical of captives and has a history of challenging captive structures. They also have a history of losing their legal challenges.... Labeling them a transaction of interest is intended to identify questionable structures and it would be more appropriate to list 'abusive captive structures' rather than 'captives' on the 'Dirty Dozen' list."*

Notice 2016-66

Last November, the IRS issued Notice 2016-66 which named 831(b) captives as "transactions of interest" and sought to require additional financial disclosures. According to the IRS website, "Transaction of Interest" (TOI) is defined as a transaction that the IRS and the Treasury Department believe is a transaction that has the potential for tax avoidance or evasion, but lack sufficient information to determine whether the transaction should be identified specifically as a tax avoidance transaction." With Notice 2016-66, the IRS requested specified entities to file additional financial disclosures by January 30, 2017—90 days after the Notice was issued.

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Once the IRS and Treasury Department have collected enough information to make a decision, Notice 2016-66 states that one or more of three actions will happen: "Removing the transaction from the transactions of interest category in published guidance, designating the transaction as a listed transaction, or providing a new category of reportable transaction."

According to Doherty, Notice 2016-66 is "an attempt by the IRS to get as much information as possible about these small captives. I think the effect of it, whether intended or not, is to create a burden on small captives, adding an extra cost. One way to look at it is the increase cost makes it more difficult for the smaller companies to justify using a captive or a cell in a captive. It effectively favors large companies and hurts the smaller companies."

The captive industry has been very vocal in its disapproval. SIIA led the campaign to modify and withdraw Notice 2016-66, along with dozens of trade associations, captive managers, and regulators joining in, including a letter from Kevin Doherty on behalf of the Tennessee Captive Insurance Association. SIIA was one of the only industry groups to meet with the IRS to discuss their concerns regarding the notice. Their meeting had a direct impact on the IRS extending the reporting deadline by 90 days.

Criticism was initially pointed towards the fact that there was no comment period before the deadline was set and that only 90 days was an unreasonable amount of time to put together the disclosures required. At the end of December, the IRS extended the deadline to May 1, 2017. Other points of complaint from the industry were the potential for duplicate financial filings and the broad requirements in Notice 2016-66 that sweeps up nearly all 831(b) captives.

CIC Services, a Tennessee-based captive manager, has filed a lawsuit against the IRS and Treasury Department arguing that Notice 2016-66 was unlawfully issued and did not meet the authority or "reasoned analysis" requirements of the Administrative Procedure Act. The original lawsuit was filed last December and a second suit was filed at the end of March with Ryan, LLC, a Texas-based tax firm, named as co-plaintiff.

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A Premature Action

Another criticism leveled at the IRS and the Treasury Department is that Notice 2016-66 was issued prematurely.

The Protecting Americans from Tax Hikes Act of 2015 (PATH Act) went into effect on January 1st of this year. The law creates tax relief benefits for business and families, and for the captive insurance industry the PATH Act increases the limit of net annual written premiums to 2.2 million dollars for 831 (b) captives. The Act also changes the qualifications regarding ownership diversity for those captives. It will require any captive electing for the 831 (b) designation to meet a "Diversification Requirement" in ownership.

The PATH Act is now in effect and should help stem many of the abuses the IRS believes to be taking place, while also allowing these smaller captives to grow. Additionally, the captive industry is looking to Congress to clarify some of the parameters of the Act, which should help to strengthen captives' standing. SIIA requested these clarifications by Congress and they were introduced at the end of last year. According to Ryan Work, vice president of Government Relations with SIIA, "Understanding that the IRS would not provide needed clarification surrounding the PATH Act, as directed by Congress, prior to its implementation, SIIA spearheaded a letter with 15 state captive associations formally requesting that the IRS do so. To this date, the IRS has yet to respond or issue this guidance. This is one of the sticking points with the Notice—if they don't have the willingness or time to issue guidance on the PATH Act, which has already gone into effect, and don't understand its implications, how can they spend time and issue the Notice without comment?"

"Here is the contradiction," said Boughner. "Unless Treasury and the IRS operate in a complete vacuum the IRS had to be aware of Treasury liberalizing the 831(b) election in the PATH act by increasing the threshold to \$ 2,200,000. The PATH act also imposes ownership restrictions which limits a captives ability for family wealth transfer, another IRS concern. These changes highlight that a captive should be used for fundamental corporate risk management purposes. My interpretation is that they worked in tandem and that, while the IRS is concerned about abuses, they support the proper application of a captive structure for risk management purposes."

A U.S. Tax Court decision in the case of "Avrahami v. Commissioner" should be decided during the next few months. In this case, a Phoenix-based jewelry company is suing the IRS in response to a multi-million dollar notice of deficiency. The captive is suspected by the IRS of misusing the 831 (b) tax designation as a tax-avoidance scheme. However the case is decided, case law will be established which will help define the tax designation.

Even with the deployment of the PATH Act and the upcoming decision in the Avrahami case, the IRS and the Treasury Department chose to list 831 (b) captives as a TOI and continued listing them to the "Dirty Dozen" list.

This has put the industry on edge. As Doherty said, "Legitimate domiciles, and most of us in the industry, are working very hard to make sure there are no abuses. Certainly there are people on the fringe who float in from time to time, captive managers that are a little bit questionable, but the regulators work hard to make sure guys like that don't get licensed."

This year will be a proving ground for 831 (b) captives. With the additional disclosures the IRS is seeking, the PATH Act requirements, and a Tax Court decision, 831 (b) captives might finally see themselves clear of their controversy.

The captive industry will be there to back them up. As Doherty said, "This is our business, we're not going to be deterred." ■

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.