

# THE LATEST ON CAPTIVE INSURANCE COMPANIES

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# Notice 2016-66: Transactions of Interest

- On November 1, 2016, the IRS issued Notice 2016-66 designating certain arrangements with captives electing section 831(b) as “Transactions of Interest”
- The Notice triggers disclosure requirements for both participants and material advisors; 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.)

- 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
- 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

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

- IRS is concerned about premiums
  - Designed to provide a deduction of a particular amount
  - Determined without underwriting or actuarial analysis that conforms to industry standards
  - Not paid according to the policy
  - Made without getting market quotes
  - That exceed market pricing
  - That are not properly allocated among affiliates

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

- IRS is concerned if
  - Captive does not comply with regulatory requirements
  - Policies and binders are issued later than industry standards
  - Captive claims administration is not consistent with industry standards
  - Insured does not file claims for each loss

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

- IRS is concerned if
  - Captive's capital is inadequate for the risks assumed
  - Captive invests in illiquid or speculative assets that are not typical of an insurance company
  - Captive loans to insureds or affiliates
  - Premiums for pooling do not reflect the risk
  - Pooling terms result in losses being allocated almost exclusively to related party risk

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

- Requirement to file Form 8886:

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



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

- Requirement to file Form 8886:

- A Transaction of Interest includes a transaction substantially similar to the prior slide
- Persons entering into transactions on or after November 2, 2006 must disclose by May 1, 2017 (originally January 30, 2017)
- Owner(s), Insured(s) and Captive 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.)

- Requirement to file Form 8886:

- The Captive must provide the following:
  - Its domicile
  - 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 and actuary or underwriter's name and contact information
  - Description of claims paid; info on reserves
  - Investments, including identifying related parties involved in Captive investments

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

- Requirement to file Form 8886:
  - Substantial penalties arise for failure to report
  - Material advisors must file Form 8918 and maintain a list
  - The Notice requested comments on “how the transaction might be addressed in published guidance.”
    - Several comments were received that addressed the Notice or compliance with the Notice
- By the time of this presentation, the IRS would have received the filings due May 1

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

- In December 2016, CIC Services, LLC v Internal Revenue Service, et al. sought a preliminary injunction against requiring the filings under the Notice
- The case was voluntarily dismissed by the plaintiff a few days later; this was after the IRS had issued Notice 2017-08
- CIC Services, LLC, et al. v. Internal Revenue Service, et al., Docket 3:17cv-00110-TRM-HBG (E.D. Tenn.) was filed in April 2017, also seeks a preliminary injunction
- The hearing on the preliminary injunction was held on April 19
- The preliminary injunction was denied

# IRS Audits

- 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 (cont'd.)

- Tax Shelter Promoter Investigations (information obtained from non-IRS source):
  - 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 (the subject of another panel today.)
- 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)

## • **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) (cont'd.)

- **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



# IRS Priority Guidance/Pending Cases

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

## **Avrahami v. Commissioner, Docket No. 17594-13, 18724-13 (Tax Court)**

- Benyamin and Orna Avrahami
  - Arizona jewelry store owners. Owned multiple entities engaged in property and commercial real estate ventures.
- Feedback Insurance Company, Ltd. (captive insurance)
  - Incorporated by Orna Avrahami in St. Kitts in 2007
  - Filed a section 953(d) election
  - Provided direct P&C insurance coverage to Avrahami's entities
  - Reinsured terrorism coverage through Pan American Reinsurance Ltd.

# **Avrahami v. Commissioner, Docket No. 17594-13, 18274-13 (Tax Court) (cont'd)**

- Pan American Reinsurance, Ltd. (“Pan Am”)
  - Unrelated entity incorporated in Nevis
  - Provided terrorism insurance to various insured’s including Avrahami entities
    - Pooling arrangement
  - Filed a section 953(d) election
  - Feedback reinsured Pan Am on a quota share basis for a portion of the terrorism risks
- Belly Button Center, LLC
  - Three Avrahami children are each 1/3 members
  - The company owns land in Arizona

## **Avrahami v. Commissioner, Docket No. 17594-13, 18274-13 (Tax Court) (cont'd)**

- Taxpayer Position: Insurance policies issued by Feedback qualify as insurance
  - Contracts cover insurable risks based on fortuitous events
  - Risks from affiliated entities were shifted to Feedback, an adequately capitalized, brother-sister entity
    - Reinsurance contract shifted risk from Pan Am to Feedback
  - Direct insurance risks were adequately distributed through “...seven types of policies...[and] several risk exposures.”
    - Risk distribution among sufficient third party risks
  - Arrangement qualified as insurance in its commonly accepted sense
    - Regulated as insurance companies, separate books & records, adequate capitalization, valid and binding policies

# **Avrahami v. Commissioner, Docket No. 17594-13, 18274-13 (Tax Court) (cont'd)**

- IRS Position: Insurance contracts issued by Feedback do not qualify as insurance
  - Contracts are not insurance in the commonly accepted sense as Feedback was organized and operated to provide tax deductions
  - Lack of insurance risk as the contracts lack fortuity (excluding administrative actions, employee fidelity, and terrorism policies)
  - Lack of risk distribution resulting from insufficient pooling of risks, number of insureds, and homogeneous risks
  - Risk was not shifted to Feedback as the company was incapable of meeting its financial obligations and claims were not filed for potential covered losses.
  - Pan Am was not adequately capitalized to shift risk

# **Avrahami v. Commissioner, Docket No. 17594-13, 18274-13 (Tax Court) (cont'd)**

- Awaiting decision
  - Review by entire Tax Court?
- How can a section 831(b) insurance company demonstrate that its policies qualify as insurance for tax purposes?
  - Detailed feasibility studies and actuarial reports pricing premiums?
- IRS position appears to focus more on insurance risk and common notions of insurance than risk shifting and distribution
  - What will be the focus of the opinion in light of Rent-A-Center, Securitas and RVI?