Hodgson Russ LLP ATTORNEYS

CERTAIN CAPTIVE ARRANGEMENTS ARE NO LONGER UNDER THE RADAR

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Practices & Industries

Employee Benefits

Notice 2016-66, released by the IRS in November, 2016, takes aim at potentially abusive captive insurance arrangements that elect, under § 831(b) of the Internal Revenue Code, to be taxed only on investment income, thereby excluding from taxable income the insurance premiums received by the captive in return for the insurance protection it purports to provide. The Notice designates certain captive insurance arrangements that make an 831(b) election as "Transactions of Interest." In so doing, the Notice hopes to discourage the marketing of captives that are formed solely for the purpose of evading or avoiding income taxes. Toward this end, Notice 2016-66 requires participants in transactions with 831(b) captives that qualify as "Transactions of Interest" to file IRS Form 8886, Reportable Transaction Disclosure Statement. In addition, "material advisors" must disclose certain information on IRS Form 8918, Material Advisor Disclosure Statement. The forms and instructions can be found here: Form 8886; Form 8886 Instructions; Form 8918; Form 8918 Instruction.

What is a "Transaction of Interest"?

According to the Notice, a "transaction of interest" looks something like this:

- Smith, a person, directly or indirectly owns an interest in an entity (or entities) ("Insured") that conducts a trade or business. Insured seeks to purchase insurance to manage a business risk to which it is exposed.
- Smith, the Insured, or persons related to Smith or the Insured directly or indirectly own an interest in a captive insurance company ("Captive"). Instead of purchasing insurance from an independent, unrelated insurance company, Insured either (a) acquires a policy from Captive that Captive and Insured treat as insurance for tax purposes; or (b) reinsures risks that Insured has initially insured with an intermediary, Company C. Insured claims a deduction for the premiums paid to Captive, and Captive excludes the premium income from its taxable income by making a § 831(b) election to be taxed only on taxable investment income.
- Smith, the Insured, or one or more persons related to Smith or the Insured directly or indirectly own at least 20 percent of the voting power or value of the outstanding stock of Captive.

- Either (a) the amount of the liabilities incurred by Captive for insured losses and claim administration expenses is less than 70 percent of the premiums earned by Captive, less policyholder dividends paid by Captive; or (b) Captive has directly or indirectly made available as financing, or otherwise conveyed or agreed to make available or convey to Smith, Insured, or a person related Smith or the Insured (collectively, the "Recipient") in a transaction that did not result in taxable income or gain to Recipient, any portion of the payments under the Contract, such as through a guarantee, a loan, or other transfer of Captive's capital.

What Are the Characteristics of an Abusive Captive Arrangement?

If the policy of insurance issued by a captive in a "transaction of interest" is not insurance (i.e., has certain characteristics that indicate that it is more a tax avoidance and wealth building scheme than a risk management arrangement), the business entity to whom the policy is issued may not deduct the captive premium payments as insurance, and the captive's 831(b) election is not valid. According to the Notice, potentially abusive captive arrangements have one or more of the following characteristics:

- the insurance coverage provided by the captive insurance company involves an implausible risk;
- the coverage does not match a business need or risk of insured;
- the description of the scope of the coverage in the insurance policy issued by the captive is vague, ambiguous, or illusory;
- the coverage duplicates coverage provided to the insured by an unrelated, commercial insurance company, and the policy with the commercial insurer has a far smaller premium;
- the amount of the insured's payments under the insurance policy issued by the captive are designed to provide the insured with an income tax deduction under § 162 of a particular amount;
- the premium payments made by the insured to the captive are determined without an underwriting or actuarial analysis that conforms to insurance industry standards;
- the payments are not made consistently with the schedule in the insurance policy;
- the payments are agreed to by the insured and the captive insurance company without comparing the amounts of the payments to payments that would be made under alternative insurance arrangements providing the same or similar coverage;
- the payments significantly exceed the premium prevailing for coverage offered by unrelated, commercial insurance companies for risks with similar loss profiles;
- if multiple entities in the captive share risk, the allocation of amounts paid to captive among the insured entities does not reflect the actuarial or economic measure of the risk of each entity;
- the captive fails to comply with some or all of the laws or regulations applicable to insurance companies in the jurisdiction in which Captive is chartered, the jurisdiction(s) in which Captive is subject to regulation because of the nature of its business, or both;
- the captive does not issue policies or binders in a timely manner consistent with industry standards;

- the captive does not have defined claims administration procedures that are consistent with insurance industry standards;
- the insured does not file claims for each loss event covered by the insurance policy issued by the captive;
- the captive does not have capital adequate to assume the risks that the insurance policy transfers from insured;
- the captive invests its capital in illiquid or speculative assets usually not held by insurance companies; or
- the captive loans or otherwise transfers its capital to the insured, entities affiliated with insured, the owners of the insured, or persons related to the owners of the insured.

Action Steps for Captive Owners and Material Advisors

Captive owners and "material advisors" would be well-advised to have qualified tax counsel review the captive structure they manage, promote, or have adopted, to determine whether they have any reporting obligations, and to engage independent actuaries qualified to provide guidance and actuarial opinions on premium amounts. A "material advisor" is any person who (a) provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction; and (b) who directly or indirectly derives gross income in excess of a specified amount for providing the aid, assistance, or advice. Failure to disclose carries significant penalties.