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Insurance

Is ‘Micro-Captive’ Insurer Guidance the IRS's Nuclear Option?

BNA Snapshot

- Nearly all captive insurers may be “wound up” over next 12 months, attorney says
- Most egregious arrangements could face criminal prosecution

By Allyson Versprille

Nov. 4 — A recent IRS notice imposing reporting requirements on certain “micro-captive” insurance arrangements is likely to send a seismic wave through the industry, attorneys told Bloomberg BNA.

The Internal Revenue Service “is finally saying, ‘OK, we tried to warn you, we're fed up with it, and now enjoy this nuclear weapon,’ ” Jay D. Adkisson, a founding partner of Riser Adkisson LLP, said Nov. 4.

The guidance, Notice 2016-66, issued Nov. 2, identified certain captive insurance arrangements that qualify under tax code Section 831(b), and any similar structures, as “transactions of interest.” The notice requires micro captives that meet specified criteria and their marketers to file a Form 8886, Reportable Transaction Disclosure Statement, to the IRS.

“I would suspect that fully 90 percent plus all of the 831(b) captives are going to be wound up in the next 12 months,” said Adkisson, who specializes in general business planning with an emphasis on asset protection planning and captive insurance.

People who were considering setting up a micro-captive—even if it wasn't for the tax benefits—will likely be deterred. “Who wants to engage in any transactions and then immediately have to turn around and file the Form 8886?” he asked. “Nobody.”

The small captive industry is not the only one that could be impacted by the recent guidance. One attorney said the repercussions may spread to corporate mergers and acquisitions.

“The bottom line is that this is big news,” said David Slenn, chair of the American Bar Association's Captive Insurance Committee. “This reporting requirement is going to chill a lot of this activity.”

Mergers, Acquisitions

Captive insurance companies are formed as subsidiaries to insure the risks of a corporate parent. One of the main benefits is that a captive can insure risks that otherwise can't be insured because it would be too expensive or coverage isn't available in the commercial marketplace.

The IRS's concern is that some businesses are creating captives to insure against risks that are so improbable that the entities never have to pay claims and the premiums return to the business owners or heirs with little or no tax.

Section 831(b) allows “micro captives,” meaning insurance companies that take in less than a certain amount in premiums, to make an election so that they aren't taxed on their premium income. Under the new guidance, generally small captives that constitute a “transaction of interest” are those that have liabilities for covered losses and expenses in an amount less than 70 percent of the total premiums earned, or provide premium payments as financing to an insured or related party in a transaction nontaxable to the recipient, a recent Caplin & Drysdale Chartered alert said.

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Business owners who set up captives in the past thinking they were getting a nice tax advantage may come to regret that decision if they want to sell their business in the future, Slenn said.

In a merger or acquisition, business owners have to disclose reportable transactions in the purchase agreement, he said. “The buyer's going to see, ‘Oh, they have one of these captives. That's a reportable transaction.’ Then they're going to have to spend time investigating as part of their due diligence.”

Why Now?

When the guidance was issued, Steven Miller, a former acting IRS commissioner who now works as the national director of tax at Alliantgroup LP, questioned why the agency didn't wait for the final ruling in an ongoing U.S. Tax Court case, Avrahami v. Commissioner.

Typically, when someone establishes a captive they set it up during the year in which they want to receive the tax deduction, Adkisson said. “Then, they get the captive formed and some time in December they pay the premium for the whole 12 months” ahead, he said.

The IRS likely issued the guidance now because many taxpayers wrap up their tax planning around this time of year, Adkisson said. Taxpayers who created captives for 2015 are “locked in” because they've already had to file their 2015 tax returns, he said. However, it's still early enough to “kill off” the marketing and stop the formation of captives that were intended to come on line in 2016, he said.

“There are a lot of people out there who had paid advisers for captives to be formed in 2016 thinking they're getting a tax deduction in 2016 and they're now going back to their advisers demanding their money back,” he said.

Settlement, Criminal Litigation

Rachel L. Partain, a member of Caplin & Drysdale, said the IRS should expect a flood of captives coming under these new reporting requirements, especially since the notice is retroactive to Nov. 2, 2006. This date is consistent with Treasury Regulations Section 1.6011-4(h)(1), which provides the effective and applicability dates for “transactions of interest.”

“There's a large, large percentage of the captive industry that's going to have to report,” she said. Even now there are “large numbers of captives and managers under examination,” in appeals or in Tax Court, she said.

Partain said her gut reaction is that the IRS will pursue a settlement initiative, because there are “just too many cases for them to work.” She pointed to the Son of Boss Settlement Initiative in the early 2000s as an example. “Boss” stands for bond and option sales strategy. “Son of Boss” was a type of tax shelter promoted as a way to reduce federal income tax on capital gains.

In 2004 the IRS issued Announcement 2004-46 that offered Son of Boss investors an opportunity to “quickly close out of their tax disputes,” according to the agency's website.

Beckett Cantley, a legal consultant and associate professor at Atlanta's John Marshall Law School, said some of the most egregious actors may be looking at civil and potentially criminal litigation.

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