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CORPORATE TAX - USA

Captive insurance: new IRS tax reporting has potential for penalties and examinations

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Introduction
Notice 2016-66

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On November 1 2016 the Internal Revenue Service (IRS) issued Notice 2016-66, identifying certain transactions relating to small captive insurers as 'transactions of interest'. Previously, the IRS had identified certain small captives as among its list of 'dirty dozen' tax scams. The IRS has also been examining captives and their owners and litigating cases in the US Tax Court. The new 'transaction of interest' designation throws small captive insurer transactions into a tax reporting regime that could potentially lead to significant penalties and IRS income tax and promoter examinations.

Generally, captives are insurers that are formed to insure related businesses; the insureds pay premiums in exchange for property and casualty-type coverages. Under Section 831(b) of the Internal Revenue Code, so-called 'small or micro captives' can 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 under Section 162 of the code.

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Notice 2016-66 states that small captives have the potential for tax avoidance or evasion and identifies certain small captives – and substantially similar transactions – as a transaction of interest, in order to gather more information about why and how small captives are formed and operated. Generally, small captives that constitute a transaction of interest are those:

- whose liabilities for covered losses and expenses are under 70% of the total premiums earned; or
- that provide premium payments as financing to an insured or related party in a transaction that is non-taxable to the recipient (eg, loans).

In either case, the most recent five-year taxable period is tested.

Form 8886

Each of the insureds, captives, owners and material advisers must report the transaction to the IRS, including the IRS Office of Tax Shelter Analysis. Taxpayers must report the small captive transaction of interest annually by filing a Form 8886 with their tax returns, beginning with the 2016 tax year. They must also report separate Form 8886s for each previous year, with some forms due by January 30 2017.(1) Under Section 6707A, each unfiled or late-filed Form 8886 is subject to a penalty of $50,000 or $10,000 for natural persons.

Form 8918

Material advisers must also report the transaction of interest by filing Form 8918 and are subject to additional list maintenance requirements. Under Section 6707, an unfiled or late-filed Form 8918 is subject to a penalty of $50,000 and further penalties for failure to timely supply the required list to

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the IRS upon request. According to the notice, retroactive reporting is required for described captives that were formed on or after November 2 2006 – the date that the transaction of interest regulations took effect.

Disclosure information

Finally, the notice requires that transaction participants provide detailed information on the relevant disclosure forms. The disclosure information includes:

- whether liabilities incurred are less than 70% of premiums (minus certain dividends and loans);
- whether any loan or other financing arrangement has occurred between the captive and related parties;
- the captive's jurisdiction;
- a description of the types of coverage;
- how any premiums were determined, including the names and contact information for any actuary or underwriter involved;
- a description of the claims paid; and
- a description of the captive's assets.

This detailed information should not be taken lightly, as the IRS can treat an incomplete disclosure as non-disclosure and therefore subject to penalties.

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Endnotes

(1) Treasury Regulation Section 1.6011-4(e)(2)(i).

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