January 30, 2017

VIA Email

The Honorable Adam J. Szubin
Acting Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 2022

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1500 Pennsylvania Avenue, NW
Washington, D.C. 20224

RE: IRS NOTICE 2016-66

Dear Messrs. Szubin and Koskinen:

The Self-Insurance Institute of America, Inc. ("SIIA") respectfully submits these comments in response to Internal Revenue Service ("IRS") Notice 2016-66 ("the Notice"). Specifically, these comments respond to various portions of the Notice and offer recommendations on how the IRS may more efficiently collect the appropriate information regarding IRC § 831(b) transactions, versus the current paperwork intensive approach. SIIA intends to provide future comments on the entire IRC § 831(b) transaction and how to distinguish between the legitimate users of § 831(b) captives versus those involved in potentially abusive behavior.

SIIA is a member-based association dedicated to protecting and promoting the business interests of companies involved in the self-insurance/alternative risk transfer industry, both domestically and internationally. SIIA's membership includes captive insurance managers (who represent thousands of businesses) and industry experts, risk retention groups, third party administrators, excess/stop-loss/reinsurance carriers, and self-insured employers.

We recognize and appreciate the IRS's granting an extension to the industry of 90 days to file under the Notice. As expressed in our previous letter, additional time was needed to understand the Notice and to hear from our members on the various challenges and concerns they continue to face.

Requests Concerning Notice 2016-66

Based upon the actions taken by Congress through the passage of the *Protecting Americans from Tax Hikes Act* (the "PATH Act"), it remains our view that Congress is supportive of businesses using captives appropriately. We recognize that not all participants in the small captive industry are acting appropriately and the IRS plays an important role in enforcing Congress's intent. However, the Notice unnecessarily imposes an onerous burden and

potentially steep price in the form of excessive reporting requirements and huge penalties, on the numerous innocent parties and legitimate § 831(b) captives. Our proposals in this letter provide a balance that allows Congressional intent to move forward while providing the IRS a means to obtain the information that it desires.

As outlined in the below comments, SIIA and its members respectfully request that the IRS consider the following recommendations:

1) Suspend the Notice because it is premature. There are two significant events expected this year that may clarify the rules significantly for the captive insurance industry. Those two events are: first, the issuance of guidance on the PATH Act revisions to § 831(b), and second, the Tax Court ruling on the lead § 831(b) case, *Avrahami*.

   In the light of PATH Act guidance and an appropriate period to ascertain the impact of the *Avrahami* decision, the IRS will be in a better position to decide what features of a §831(b) captive arrangement amount to a transaction of interest and whether information already being collected by the IRS on annual tax returns and accompanying annual statements is sufficient to identify the transactions of interest. Such an approach will prevent finite IRS resources from being expended on reviewing information that may not be germane to the issues, or reviewing duplicates of information already in the IRS's possession. This approach will also prevent an enormous amount of administrative burden and cost from being placed on the industry.

2) Undertake an appropriate review of whether the captive's annual tax return and annual statement requirements may be modified so that taxpayers and the IRS may provide and review this information in one place, avoiding duplication.

3) If the Notice proceeds (now or in the future), we ask that the requested items be revised to reflect the characteristics espoused by the courts and that the IRS allow this information to be provided in an aggregated manner. In addition, the Notice should move through the normal regulatory process, including an appropriate public comment period.

4) If the Notice proceeds (now or in the future), exempt from the Notice those captives that are currently under IRS audit, at least with respect to the years being audited. In these cases, the IRS is already collecting thousands of pages of information, including the same information required under the Notice. If there are open years for the taxpayer that are not under audit, Form 8886 could be required for those years.

Notice 2016-66 Background

On November 1, 2016, the IRS issued and made immediately effective Notice 2016-66 labeling most captive[1] insurance arrangements within § 831(b) as "transactions of interest".[2] The Notice requires reporting by any taxpayers involved in these transactions with open statutes of limitations for the past 10 years, meaning a large number of taxpayers must comply with the reporting requirements. More burdensome, the filing deadline was originally set at January 30, 2017, just 90 days from the first issuance of the Notice. Upon further consideration after attention from members of Congress, the IRS extended the filing deadline by 90 days to May 1, 2017, while providing no extension for comment submission.

The stated purpose in the Notice for collecting this additional information from taxpayers is because "the Treasury Department and the IRS lack sufficient information to identify which § 831(b) arrangements should be identified specifically as a tax avoidance transaction and may lack sufficient information to define the characteristics that distinguish the tax avoidance transactions from other § 831(b) related-party transactions."

Following an introduction, the 15-page Notice includes 7 pages detailing the characteristics of the § 831(b) transaction and the IRS's concerns. Surprisingly, rather than define or tailor the transaction of interest based on the outlined characteristics that are of concern, a broad definition was used to define the transaction of interest as essentially the entire small captive industry. Under the Notice, an § 831(b) electing captive will immediately be considered a "transaction of interest" if it meets one of the following two criteria:
1) the insurance company's loss ratio is less than 70%[3]; or
2) the insurance company provides any amount of related party loans or financing.

These two criteria will cause almost all § 831(b) captives to become transactions of interest and thereby subject to the applicable IRS regulations intended for abusive tax shelters. Participants will also be required to disclose their participation on their individual and business tax returns or be subject to severe penalties,[4] regardless of whether their captive insurance arrangement contained any of the characteristics of concern identified by the IRS. Thus, thousands of taxpayers undertaking appropriate structuring mechanisms will be significantly

[1] A captive insurance company is often defined as an insurance company that has a common owner with the business being insured. The captive is given a limited purpose license to sell specific lines of insurance. Approximately 80% of all Fortune 500 businesses have their own captive insurance company. Often, a captive provides these large businesses with significant tax benefits. The use of captives by small and middle market businesses is not tracked, but rough estimates place the numbers in the thousands. These small captives typically elect the tax benefits designed for small insurance companies under §831(b).
[2] A transaction of interest is a transaction that the IRS and Treasury believe has a potential for tax avoidance or evasion, but for which the Notice asserts there is not enough information to determine should be identified as a tax avoidance transaction. The material advisors to the transaction must file Form 8918 and maintain a list of clients to be furnished to the IRS upon request.
[3] The test asks whether the amount of liabilities incurred by Captive for insured losses and claim administrative expenses is less than 70% of premiums earned by Captive less policyholder dividends.
[4] There are strict liability fines for failing to provide complete and timely filings of up to $10,000 per individual and $50,000 per business, in addition to the time and expense involved in individual business compliance.

burdened (and potentially fined) because the Notice is broadly targeted for practically all participants, instead of narrowly tailored to the abusers.

Background on Congressional Policy Changes & Intent

Since its inception in 1986, § 831(b) has served a critical policy purpose to help small and medium size businesses mitigate risks for which insurance is not available, or too expensive, in the commercial market. A secondary incentive is to mitigate or eliminate over time the insured-commercial insurer arrangement whereby premiums are forever lost and claims handling is often difficult. § 831(b) captives are used by a wide variety of American employers, including farmers, auto dealers, municipal banks, manufacturers, trucking, construction, professional services firms, and many others. One thing that they all have in common is risk; risk that some event or series of events could harm or destroy the business. Because of the strong public policy intent to help businesses mitigate risk, the federal government allows businesses to take a tax deduction for the purchase of insurance.

Captive insurance is an important component of the insurance industry and fills a needed role in safeguarding American businesses, particularly those small and medium sized businesses powering the states and federal economies. The § 831(b) captive allows small business to use captive insurance in parity with their competitors, which are large multi-national companies that have been using captives for decades as an alternative means of financing risk. Congress did not intend that captive insurance is a tool that only large businesses can use. Large businesses have the armies of attorneys and accountants to comply with the overly complex government regulations. If the § 831(b) captive is regulated out of existence, small and middle size businesses will be weaker and ultimately many jobs will be lost.

In February 2015, the U.S. Senate Finance Committee considered whether to change the § 831(b) tax election in response to requests by the industry and the IRS. During a committee hearing, a Treasury official informed the Senate that the IRS was concerned about § 831(b) captives being used in estate planning. We understand that the IRS raised other areas of concern involving captives in addition to estate planning and SIIA offered several restrictors that could be considered if Congress wished to further limit the benefit of captives for small businesses.

Numerous meetings occurred with the industry throughout the year 2015 to discuss a solution to the concerns raised by Treasury. In December 2015, Congress recognized the important role that captives play for small and medium business by increasing the premium threshold to be eligible to make the § 831(b) election. Congress also listened to the IRS's concerns and decided that the appropriate restrictor on small captives would be a new requirement aimed at restricting ownership options and estate planning, while acknowledging § 831(b) electing companies may also insure third party risks and exempting companies with less than 20% related risk from the ownership test. The new law also asked Treasury to write

reporting guidance so that the industry will be able to comply with the new requirements that start January 1, 2017.

On October 17, 2016, SIIA sent a letter, co-signed by 15 different state captive insurance associations. This letter explained that taxpayers are struggling to comply with the new §831(b) requirements because of uncertainty on how to comply. For the past 10 months, the IRS and Treasury, rather than use its finite resources to provide the industry guidance as requested by Congress, instead wrote a 15-page Notice that requires additional compliance filings originally due January 30th, 2017, 30 days after the start date of Congress's new requirements under the PATH Act.

It is our view that the IRS should first appropriately provide clarification and guidance on the newly enacted changes to § 831(b) prior to establishing new burdensome and costly requirements under an administrative notice. In addition, the IRS should also take time after enactment of the new restrictions to gauge the impacts on potentially abusive practices before taking even more steps that may prove onerous and unnecessary.

Process to Identify Abuse Underway

It is premature to ask taxpayers to report a certain set of information on these transactions when the Tax Court may soon indicate that a different set of information is applicable to decide between good and bad transactions. The IRS is currently raising a large number of issues in three separate Tax Court cases in litigation today.[5] The first of these rulings will be issued in the next few months in the *Avrahami* case. Within this ruling, it is expected that the Court will provide guiding principles that can be used in solving many of the § 831(b) issues. This case will provide helpful guidance to both the IRS and taxpayers.

It is quite possible that the Tax Court's decision will make the usefulness of the information gathered through Notice 2016-66 moot and a waste of time. This may happen because the court rules that the criteria for distinguishing good and bad arrangements turns on factors not asked about in the Notice, rendering all of the information gathered by the IRS of little value or forcing a second information request to gather the key information specified by the Court. Also, it is also possible that the court may through the *Avrahami* case narrow the scope of what the IRS may consider arrangements that are not supported by Congress.

In addition, the IRS currently has hundreds of § 831(b) captives under audit today, which are slowly making their way through the system while waiting for this lead case to clarify the rules. Both the IRS and the industry are awaiting the Tax Court's decision on the issue. Thus, issuing such a Notice is grossly premature.

[5] *Avrahami, Caylor Construction, Wilson*.

The industry expects that the combination of the restrictions placed by Congress and the upcoming guidance from the Court will provide much needed clarity on the tax law applicable to small captives, while curbing potentially abusive practices. The IRS should wait for these items to take effect to see if they solve the issues. If then the IRS wishes to prepare a similar Notice to identify past and future abusers, it should do so narrowly tailored to the Tax Court's rulings.

It is worth repeating that the stated purpose of the Notice is to gather information to help define characteristics of good and bad transactions. The Tax Court will issue a list of characteristics in a few weeks or months, long before the IRS can go through these tens of thousands of paper filings.

Contradiction of Recent Tax Court Rulings

The two main criteria the Notice uses to identify the transaction of interest (i.e., 70% loss ratio and related party loan activity) are issues that the IRS has recently litigated without success in Tax Court. It seems odd that the IRS would then use these same two criteria as litmus tests for defining a transaction of interest.

In the case *Residual Value Insurance v. Commissioner* [6], the insurance company had a loss ratio for the first four years of operation of 1.0%, 0.9%, 0.3%, and 1.3%. The year under audit had a loss ratio of 33.2%. In the case *Securitas v. Commissioner*[7], the taxpayer had losses of 11.7% and 25% in the years under audit. In both of these cases one of the main issues the IRS argued was that the low loss ratio invalidated the insurance company for tax purposes. The Tax Court ruled in the taxpayer's favor in both cases. If the court allowed such loss ratios in these cases, how can the IRS use a loss ratio of less than 70% as an indicator of an abusive transaction?[8] Furthermore, few commercial carriers or State jurisdictions would allow an underwriter to write many types of business with this loss ratio due to the inability to build capital.

[6] *RVI Guaranty v. Commissioner*. 145 T.C. No. 9 (2015).

[7] *Securitas Holdings vs. Commissioner*. T.C. Memo 2014-225 (2014).

[8] The loss ratio of an insurance company is often a function of the particular lines of risk insured. For example, an insurance company insuring workers compensation or employee medical costs often will have loss ratios above 70%. An insurance company insuring flood risk or other risks with low frequency and high severity, may have loss ratios at a very low rate for several years, until the "hundred year flood" occurs in which case the losses are very high. Another example of a low loss ratio insurance came when the federal government passed the Terrorism Risk Insurance Act of 2002 (TRIA). TRIA required that insurance companies make available terrorism risk coverage on certain lines, and created a federal backstop to those insurance companies if a large claim occurred. In the 14 years of the TRIA insurance program, there have been hundreds of millions of dollars in premiums paid by businesses for TRIA coverage and not a single claim has been made during that time period. *See* the Federal Insurance Office report on the Overall Effectiveness of Terrorism Risk Insurance Program, June 2016.

In *Rent-a-Center v. Commissioner*[9], the captive transferred a significant portion of its assets back to the related business.[10] The Tax Court ruled for the taxpayer without giving weight to this fact, and stated that all other issues argued by the IRS, which included this loan back issue, were considered "moot."[11] If a loan issue is considered "moot" by the courts, why is the IRS using this as a filter for identifying which captives it wishes to focus on?

The practice of related party investments and loans by a captive is common. A recent survey of over 1,000 big and small captives demonstrated that about 32% of the assets of captives are typically loaned back to a related company in some manner.[12] Further, the NAIC Model Act provides that insurance companies may invest up to 25% of their funds in secured loans regardless of whether or not the borrower is related.[13]

Executive Order on Federal Regulatory Actions

As you are aware, White House Chief of Staff Reince Priebus issued a memorandum on January 20, 2017 to all executive departments and agencies mandating an immediate freeze on new or pending regulations, based on an Executive Order ("Order") signed by the President. Specifically, the Order and subsequent memorandum call for:

- A halt to any new regulation being placed in the Federal Register until such proposed regulation is reviewed by a government official selected by the President;
- A withdrawal of all regulations sent, but not yet published in the Federal Register; and
- A delay of 60 days for regulations already published, but not reaching their effective date, with the potential that a reissuance of such regulation may occur.

Upon review, it is our belief that Notice 2016-66 is a regulation subject to the Administrative Procedure Act (APA), and is therefore subject to the Order based on a number of provisions contained in 26 U.S.C. and Treasury Regulations.

In reviewing these various precedents, there is a logical conclusion that the Treasury Department must in fact designate each reportable transaction by regulation, following in each instance the procedures of the APA. Therefore, the various filing requirements put forth by Notice 2016-66 should be immediately suspended and reviewed until it can more appropriately be determined whether the Notice is subject to the Executive Order.

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[9] *Rent-A-Center*, 142 T.C. No. 1 (2014).
[10] *Id*. At 9 and 11. See also the Dissent, Id. at 42-43.
[11] *Id*. at 25.
[12] See Marsh Captive Solutions Benchmarking Report, May 2016, Figure 36B at 35; 1,139 captives surveyed. *Id*. at 2.
[13] Investments of Insurers Model Act (Defined Standards Version), (April 2001) MDL–283, §7(C) and §8(A)(2).

Limiting Duplicative Reporting

The Notice requires taxpayers to report a number of items; however, the IRS already has much of these in its possession. Captives must file an annual tax return on Form 1120-PC which clearly indicates if they are a §831(b) electing company. The tax return is often required to include a copy of the insurance company's annual statement which it files with the state (or domicile) insurance regulators. The duplicative information that the IRS requires in the Notice but is already receiving includes the captive's premium, losses, loans, expenses, domicile location, assets, and the names of any shareholder with 50% or greater ownership. Often these filings also include the lines of coverages and actuarial information.[14]

Though the IRS has indicated that not all captive filers are submitting the exact same information on the tax return, much of it is the same and this issue can be easily cured going forward. Additionally, it is an extreme burden on taxpayers to review their files for the past 10 years and provide this information a second time. While the IRS has stated that it does not have the capabilities or resources to identify past owners and collect information as far back as 10 years old, it somehow expects the industry to be able to do so.

Since every captive will likely have at least one business and one shareholder that also reports, and many have dozens of each, multiplying that number by the several thousand §831(b) electing captives that are subject to this Notice, the total number of taxpayers required to file reportable transaction forms will be in the tens of thousands. The IRS is not able to accommodate or review this large number of paper filings in a timely manner.

The most efficient solution for both the IRS and the industry is to modify the annual tax return filing requirements on Form 1120-PC so that the IRS receives this information in an organized manner and avoids having taxpayers provide the same information to the IRS twice. We recognize that changing a tax form is not a small task for the IRS. However, since the IRS is already required by Congress to update the tax form to collect §831(b) owner information because of the PATH Act, adding a few more lines to collect this information is reasonable.

Requested Changes to Notice

We hope that the IRS takes the more efficient approach to tax enforcement and rescinds the Notice permanently and modifies the tax return to require any additional information the IRS desires. Whether the Notice stays or is delayed, there are several technical changes to it that should be made to promote efficiency for the IRS and the industry.

[14] The annual return does not include a discussion of how premium amounts were determined and by whom, nor does it include a description of the claims paid or all parties involved in the transaction. The importance of these items from a tax perspective is uncertain at this time. These kinds of issues are currently under review by the Tax Court in the *Avrahami v. Commissioner* case. It is expected that the Court in *Avrahami* will issue a ruling in the next few months and hopefully provide clarity on these and other issues.

First, encourage material advisors to file one aggregated filing for all of their captive insurance transactions rather than filing a separate Form 8918 for each client. The current regulations allow a material advisor to file an aggregate return presumably as a means to promote efficiencies by the Service. However, there is a restriction that such aggregation is only allowed if the transactions are the "same or substantially similar" to each other. Most captive insurance transactions are customized for a specific taxpayer and may not satisfy this standard. Without this change, material advisors will not use aggregated filings, forcing the IRS to go through hundreds of individual paper filings for the same material advisor, instead of having everything organized in one filing.

Second, allow Form 8886 filers the ability to complete aggregate filings, similar to the aggregate filings allowed for the material advisors. As an example, aggregate filing already has precedent with Form 5471. As currently required by the Notice, a Form 8886 must be filed by the captive, the insured, certain insured owners, and any intermediary companies. The Form 8886 filed by each party will provide substantially the same information for each participant with this captive. At a minimum there will be two similar forms, and since some captives are insuring hundreds of insureds or a large number of shareholders, there may be hundreds of similar Form 8886s filed for the same transaction. Much of this information will be duplicate information and prepared by the same persons. Rather than have the IRS spend its finite resources wading through multiple paper filings to match things up, it would be more efficient to allow an aggregate filing. This single aggregate filing would be prepared by the captive insurance company and would provide all of the information required by the insureds and, where filing is required, the insured owners. Since the same person will likely prepare the filings for all parties in a transaction, splitting the information out to individual filings provides the IRS with no greater cross check value, yet much more paperwork to sort through.

A concern was raised that this approach may produce old information or that certain taxpayers would have the ability to avoid "raising their hands" identifying themselves as participants. This concern is resolved if you use the same approach as you do with the aggregate filing option for material advisors. In that case, each material advisor's duty is only satisfied if the proper information is reported by the aggregate filing. In this situation, each person required to file Form 8886 is still required to file such a report, unless proper information is reported by the aggregate filer.

Third, there is no exception for owners of the insured under 20% for this filing, as the IRS has provided for similar filings in the past.[15] This omission means that persons with *de minimis* ownership amounts are required to comply, including minority owners that have no control (or even knowledge) that the majority owners used a captive. This would include owners of the insured business that do not own any portion of the captive. Thus, a provision allowing for a 20% *de minimis* ownership exception from the filing requirements would be pertinent, as the IRS has done in the past.

[15] E.g. Notice 2007-83 (non-employer individuals owning less than 20% excluded from filing).

Fourth, provide written confirmation that the years at issue for reporting are the open statute of limitations years for each applicable taxpayer and not a blanket 10 years for all. As the Notice is currently written, a reasonable interpretation could be made that taxpayers need to file for all 10 years, even if the statute of limitations is closed.

Fifth, exempt from this Notice those captives that are currently under IRS audit for their §831(b) captives. If there are open years for the taxpayers not under audit, the IRS can efficiently review those years once the prior audit is complete.

Without these clear changes or a retraction, the Notice may very well have the dilatory impact of forcing the industry, which has increasingly been domiciling captives domestically, to move to off-shore domiciles. This policy would run counter to the positive tax and economic factors of domestic domiciles, hurt state economies and small business, and run counter to the Administration's overall policy intent.

Examples of Needed Technical Corrections

To demonstrate the harm that this causes to innocent people and the overly burdensome paperwork process this is for the IRS and the industry, it is helpful to go through a few examples.

Example 1. An § 831(b) electing captive is insuring some of the risks of 350 franchise locations throughout the country, each legally formed as a separate entity and each filing its own tax return. There is sufficient common ownership between the franchises that the Notice applies. Because of the 350 entities and the dozens of related and unrelated owners of these entities, there will be over 400 Forms 8886 filed for this one captive insurance arrangement. It is a waste of the IRS's resources to review each individually. A more efficient approach would be to allow this captive to file one aggregated report for all insureds and owners. The IRS would receive all of the same information, but it would be organized efficiently on one document.

It is important to highlight that Form 8886 does not require a signature under penalties of perjury by each filer, as is required on a tax return. It is an information statement that conveys data to the IRS, nothing more. In this example, the same CPA will prepare the 400+ Forms 8886 reporting the same transaction information for each filer, only changing the names and addresses on each paper Form 8886. While preparing 400+ similar forms is a financial cost to the taxpayer, it is a greater cost for the IRS to sort through, organize, and review 400+ paper forms. A single consolidated filing could provide the same information and save IRS resources.

Example 2. Assume ABC LLC is a partnership that develops and manages real estate. Person X owns 80% of ABC and person X owns 100% of a captive insurance company that insures certain risks of ABC. There are 20 passive owners of ABC, all are unrelated to Person X and each of these persons' ownership percentages range from 0.1% to 5% of ABC. Each of these 20 passive owners will receive a schedule K-1 showing the income and expenses

(including insurance expense) of ABC. Because these 20 owners are shareholders of an insured business, Notice 2016-66 requires that each provides a Form 8886 or be subject to strict liability penalties. None of these 20 small ABC owners are owners of the captive, and so they receive no financial upside from the § 831(b) election of the captive.

In this example, there are 23 Forms 8886 that need to be filed. One by the captive, one by ABC, one by Person X, and 20 by the other investors. The 20 investors are questioning why the IRS is threatening each of them with penalties if they don't file, when they did not benefit financially from the §831(b) election. The Notice should be modified to require reporting only by those persons that are material owners that benefit from the tax election. These 20 passive investors should not be burdened with this filing.

Example 3. An engineering firm owned and utilized a captive insurance company to insure part of its professional liability risk for years, and the captive has been successful in this area. This engineering firm is owned currently by 15 engineers, and another 5 engineers at some time in the last 10 years have been owners that have either retired or moved on to different firms. Since the use of the captive indirectly flowed to each engineer's tax return, all 20 must now file disclosure forms with the IRS or face severe penalties. Without an aggregate filing option, each engineer will be required to file, subject to penalties. Some of these persons may not be locatable or may be dead. To save the IRS time from having to track down all prior owners, an aggregate filing option is needed.

We greatly appreciate your consideration of these very important issues. If you have any additional questions or would like to discuss this further, please do not hesitate to contact me at (202) 595-0642 or rwork@siia.org.

Sincerely,

Ryan C. Work
Vice President, Government Affairs
Self-Insurance Institute of America, Inc.