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IRS Notice 2016-66: Potential Pitfall for Dealerships in Captive or Reinsurance Programs

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The Internal Revenue Service has been quite active with regard to perceived abuses in the area of microcaptive insurance. In particular, the IRS promulgated Notice 2016-66 in November 2016, designating certain microcaptive transactions to be "transactions of interest," mandating certain reporting requirements. Counsel who know that their clients participate in captive or reinsurance programs should be mindful of this new development and advise clients accordingly.

What is a microcaptive? "Captive" insurance is an insurance relationship between an insurer that accepts the risk of its owner or related party. Captive insurance does not properly refer to arrangements where the underlying risk derives only from unrelated third parties. The use of the prefix "micro" refers to the size of the company, and primarily whether the captive makes an election under 831(b) of the Internal Revenue Code. This election is only available for property and casualty companies. It is irrevocable once made, and it permits the insurance company to be taxed only on its investment income, not its premium income. To qualify, the company must not have more than $1.2 million in annual premium ($2.2 million as of 2017).

The IRS has identified situations where it considers section 831(b) has been abused. On February 3, 2015 the IRS published its "Dirty Dozen" list of questionable tax transactions. (Notice IR-2015-19.) The IRS notes: "In the abusive structure, unscrupulous promoters persuade closely held entities to participate in this scheme by assisting entities to create captive insurance companies onshore or offshore, drafting organizational documents and preparing initial filings to state insurance authorities and the IRS."

This language was directed to two separate concerns: (1) coverages that move risks from traditional insurers to captives, especially if this results in a higher premium than would be paid in the regular market; and (2) "esoteric, implausible risks." One story involves an arrangement wherein a Midwest taxpayer took a $1 million deduction by paying a microcaptive for tsunami insurance. The Dirty Dozen listing also noted, "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."

The IRS escalated its attention to the issue in Notice 2016-66. In Section 1 of the Notice, the IRS describes in greater detail the same abusive captive insurance practices described in the "Dirty Dozen" announcement. The Service indicated its intention to raise questions about:

1. Legitimacy of the risks being insured;
2. Pricing of the premiums;
3. Risk sharing mechanism; and
4. Proper capitalization.

In Section 2 of the Notice, the Service listed the factors that would trigger a requirement to report participation as a "transaction of interest," requiring the submission of Form 8886 by participants. TOI status is determined by a three-part test:

1. The insurance company has made an election under IRC § 831(b) (Captive);
2. There is a 20% (or greater) owner of the Captive who is also an owner of a company (Insured) which transfers risks to the Captive, directly or through an Intermediary; and
3. The Captive has a loss ratio of less than 70% and/or has loaned any portion of the payments under insurance policies or reinsurance agreements to the Insured or a related party.

Although typical automotive F&I programs are well outside the extreme and obviously abusive examples described in Section 1 of the Notice, that provides little comfort to tax practitioners. Section 2 sets out the Transaction of Interest test and designation and expressly states

that it applies even if the transaction is not as described in Section 1. In other words, just because your client is not a Section 1 company does not mean it is not within Section 2.

The Service has amplified that participants in F&I reinsurance programs will be considered within the Notice if the dealership and reinsurance company have common ownership and if the dealership is an obligor or otherwise can be considered "insured" under the program structure.

This will create a significant filing requirement (filings and annual returns, along with a "catch-up" filing with the Office of Tax Shelters Analysis due by May 1, 2017), because certain components of the F&I product mix have the dealership on risk, even if briefly. A primary example will be GAP debt waiver protection. The IRS considers this product to be insurance. Even though the debt waiver obligation invariably is assigned to a financing institution, the initial contract is between the consumer and the dealership. According to the IRS, this highly transitory relationship is sufficient to bring a reinsurance program with GAP products into the ambit of Notice 2016-66.

Multiple efforts to educate the Service on this issue and dissuade them from this position have been unsuccessful to date. However, the Service has stated that it is merely in information-gathering mode and that after review, it will eventually consider the industry's arguments as to whether GAP and other F&I products merit continued treatment as TOIs.

Dealership counsel who know that their clients are involved in F&I programs are encouraged to alert their clients to the potential applicability of the Notice and have them check with their tax advisors about their obligations, if any. The Notice will not apply to all programs; if a program only utilizes third party administrator obligors and the dealership is not on the risk as to any products, the relatedness of the Insured to Insurer is not present. However, if the Notice applies, the disclosure requirements apply to not just the Captive; the related dealership, owners, and other participants will have to consider their own filing obligations.

At the time of writing this article, several issues remain obscure and there are industry efforts to limit and/or clarify various aspects of the requirements of the Notice, particularly with regard to the application of rules defining who is a "related party" for purposes of the Notice. The IRS has indicated a potential willingness to clarify but no definitive word has been received yet. ■

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