Independent Community Bankers of America®

Captive Transactions

Community Banks Form Captive Insurance Companies

-Formed by the bank

-Covers unfunded risks

-Used to support existing commercial policies

-May be able to cover insurance risks where policies cannot be written

-Federal income tax advantages may be realized when certain elections are made (Section 831(b)(2))

-Insured pays premiums to the “captive” insurance company with corresponding tax deduction when election is made

US Treasury & IRS Have Concerns

-Federal regulation identifies transactions between the bank and its related party insurance company as micro-captive transactions

-IRS categorizes these transactions as either “listed transactions” or “transactions of interest” that require reporting (Form 8886)

-Failure to report could result in penalties under the Internal Revenue Code

-To limit tax avoidance the IRS issued a notice requiring micro-captive transactions to be reported as transactions of interest (Notice 2016-66)

- Notice computation period of last five years
- 70% loss ratio factor

Recent Court Decisions Complicate Matters

-The Administrative Procedure Act (APA) requires agencies of the Federal government to propose rules by publishing notice and allowing for public comment with publication of a final rule.

-Mann Construction v. United States—Sixth Circuit held that when IRS imposes new duties on taxpayers the APA must be followed

-CIC Services, LLC v. IRS—U.S. District Court held that Notice 2016-66 was invalid because it failed to follow APA

IRS Responds with New Proposed Rule

-Micro-captive transactions may be considered listed transactions or transactions of interest requiring disclosures

-Advisors providing material assistance to the taxpayer would also file a disclosure statement (Form 8918)

-Covers related parties where 20% or more of the assets or voting power or the equity interest in the captive is owned by the insured entity

-Needs guarantee during the financing computation period of most recent five taxable years or 65% loss ratio factor based on a computation period of 10 taxable years

Captives Respond Including Community Banking Entities

-Community banks do not realize loss events on a consistent basis as would be required under the latest proposal

-Latest loss ratio factor of 65%, while improving upon 70% does not fit the community bank pattern of loss observance

-IRS proposed action puts community banks and other enterprises at risk by reducing the ability to provide loss coverage when others can’t

-Insurance covers loss events with a low frequency of occurrence but with the potential for high loss severity

-Such proposal could trigger tax liabilities from prior years resulting in higher tax burdens and taxpayer interest and penalties