June 15, 2017

The Honorable Steven T. Mnuchin
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

RE: Executive Order 13789 – Identifying & Reducing Tax Regulatory Burdens

Dear Mr. Secretary:

The Self-Insurance Institute of America, Inc. ("SIIA") provides these comments in response to *Executive Order 13789 - Identifying & Reducing Tax Regulatory Burdens* ("EO"). SIIA and its members respectfully request that the Secretary of the Treasury and Director of the Office of Management & Budget identify Internal Revenue Service ("IRS") Notice 2016-66 (as amended by IRS Notice 2017-08) (the "Notice") as both a "significant tax regulation" and one that satisfies the standards under §2(a) of the EO to be included in the report generated by the Secretary.

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

The Notice imposes initial and ongoing filing requirements that apply to many SIIA members. Our members spent months preparing to comply and have been complying with the Notice since the initial filing due date of May 1, 2017. These same members have provided data related to the burden of complying with the Notice, and this data supports SIIA's comments and conclusions in this letter. The comment letter submitted by SIIA to the IRS on January 30, 2017 regarding Notice 2016-66 has previously described the burdens that we anticipated ("SIIA comments"); unfortunately we were correct.

The EO provides that satisfying any one of the three criteria of §2(a) is sufficient for identification in the interim report. SIIA members believe that the Notice should be included in the report as it meets at least two of these criteria. The Notice places an undue financial burden on U.S. taxpayers and adds undue complexity to Federal tax laws.

In addition to the inclusion of the Notice in the EO, we ask that consideration be given to rescinding the Notice due to its burdensome and onerous nature. In its place, more specific and

tailored actions could easily be taken to collect the information desired by the IRS in a manner which mitigates the burden imposed by the Notice, especially considering a substantial portion of the information is already in the tax return or financials attached to that return.

Background

Background - Captive Insurance Companies Electing §831(b)

In 1986, Congress enacted §831(b) as part of the Internal Revenue Code ("IRC") to incentivize small insurance companies of all types to build up their assets for protection against future losses and to enable them to better compete against their larger competitors. Today, the vast majority of insurers that utilize the §831(b) election are captive insurance companies owned by small and medium sized businesses ("831(b) captives"). This appears to be consistent with congressional intent based on action taken by Congress in 2015 to amend §831(b) (effective January 1, 2017) in order to increase the size eligibility limit and to address a perceived estate planning issue with captive insurance companies.

Captive insurance companies are generally defined as licensed insurance companies that insure entities that are related in some fashion to the captive.[1] Captives are also used by businesses such as auto dealers to back various insurance products offered to customers, such as extended warranties and road side assistance programs. These captive insurance companies enable businesses, employees and customers to better manage and protect against risks, even catastrophic risks that could have potentially crippling business impacts.

Because both large and small captive insurance companies offer tax benefits, the IRS and the captive insurance industry have gone back and forth for decades on what the appropriate tax rules should be. Several United States Tax Court ("Tax Court") cases in the 1990's compelled the IRS to generally accept that businesses may have captives entitled to the inherent tax benefits of insurance companies, provided that the captives were following applicable rules. In 2002 the IRS promulgated certain standards for how a captive should be structured.[2]

Once the IRS changed its public position concerning captives, it seemed to refocus its regulatory audit approach and attention on certain segments of the captive industry. In 2002 the IRS also initiated an audit program on auto dealer insurance companies (and other "producer owned insurance companies"), labeling them "listed transactions" and requiring participants to complete tax shelter reporting forms. Two years later the IRS "de-listed" these auto dealer insurance companies after sufficient inquiry proved that the industry's use of insurance

[1] A captive insurance company, or captive, is typically an insurance company that has a common owner with the business being insured. The captive is given a limited purpose license to sell insurance only to a related party, controlled group or controlled unaffiliated businesses. Approximately 80% of all *Fortune* 500 businesses have their own captive insurance company and will be taxed under IRC §831(a). Often, a captive provides these large businesses with significant tax benefits and places them at a competitive advantage because they can better buffer the unexpected catastrophic losses that occur. Small and middle market businesses typically elect for their captive the tax benefits designed for small insurance companies under IRC §831(b), in the same way that small and mid-size businesses typically elect S-corporation status. The §831(b) election exempts the insurance company's underwriting profits from C-corporation taxation, while leaving its investment income subject to double taxation. There are downsides to the election, including that a net operating loss on the insurance business cannot reduce taxable investment income and cannot be carried to another year, either backward or forward.

[2] See Revenue Rulings 2002-89, -90, -91.

companies was not abusive as originally presumed. The IRS then turned its audit attention to small non-profit captives using the §501(c)(15) election.[3]

In 2007 - 2008 the IRS proposed new tax regulations that would have effectively revoked the tax benefits captives offered to large companies filing consolidated returns. The IRS ultimately rescinded this proposed rule changes.[4]

In this decade, the IRS decided to once again broadly challenge captive insurance by disallowing the tax benefits of two large captive users.[5] In both 2014 cases the Tax Court ruled in favor of the taxpayer.

The IRS then turned its attention again to smaller captives. In February 2015, the IRS placed 831(b) captives on its annual "Dirty Dozen" watch list. At the same time, it is the industry's understanding that the IRS has initiated numerous audits of captives, businesses associated with captives, and captive service providers and professionals (styled by the IRS as "promoters"). In addition, the IRS has docketed approximately 300 cases related to captives, insureds and owners for Tax Court. These numerous pending cases pending, along with three 831(b) captive cases that have been tried and are awaiting opinions, will have a significant impact on the industry and the IRS treatment of 831(b) captives in general.

Then in December 2015, Congress amended §831(b) to increase the number of companies eligible to make the §831(b) election while curbing its use in connection with estate planning in the *Protecting Americans from Tax Hikes Act* (the "PATH Act")[6], enacted on December 18, 2015 as part of the *Consolidated Appropriations Act, 2016*. The PATH Act results in significant changes to the provisions of §831(b), all of which became effective for tax years beginning after December 31, 2016. However, over 6 months after this effective date (and 18 months after passage of the law), the industry and Congress have yet to receive the requested guidance and rulemaking by the IRS as outlined in the law, a law which was passed to both assist small and medium sized businesses in creating appropriate captive insurance vehicles, as well as to mitigate concerns from the IRS. Yet, instead of focusing on the tools Congress has passed to curb abuse in the space, the IRS has largely ignored the new law and instead opted for a burdensome Notice.

Background on Notice 2016-66

On November 1, 2016, the IRS issued and made the Notice immediately effective, *without public comment*,[7] labeling most transactions involving 831(b) captives as "transactions

[3] At the end of the audit cycle Congress, in 2004, amended the qualification of the §501(c)(15) election to address perceived abuses. See §206 of the Pension Funding Equity Act of 2004, P.L. 108-218, 118 STAT. 596, 610-611.

[4] Proposed Regulation REG-107592-00; Withdrawn Federal Register Vol 73 No. 37, 9972.

[5] See Rent-a-Center v. Commissioner, 142 T.C. No. 1 (2014) and Securitas v. Commissioner, T.C. Memo 2014-225 (2014). See also R.V.I. Guaranty Co., Ltd. v. Commissioner, 145 T.C. No. 9 (2015). While RVI is not a captive insurance case, it does address an issue very relevant to the appropriateness of insurance risk.

[6] Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029 (Rules Committee Print 114-40)*, (JCX-144-15), December 17, 2015 (hereinafter, "PATH Act").

[7] While the IRS did request public comment in the Notice regarding regulation of 831(b) captives in general, it did not explicitly ask for comments on the Notice, neither did it wait to make the Notice final until after notice and comment.

of interest”.[8] The Notice requires reporting by any taxpayers involved in these transactions for the past 10 years, principally on Form 8886 and with respect to material advisors on Form 8918.

The filing and comment deadline was originally set for January 30, 2017, just 90 days from the first issuance of the Notice. Upon further consideration and after attention from Members of Congress, the IRS extended the filing deadline by an additional 90 days to May 1, 2017, but left in place its deadline for comments. The industry appreciated the additional 90-day extension to May 1 for the Forms 8886 and 9818 filings.

The Notice cites its purpose for collecting this additional information from taxpayers in the following way: “…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.”

Significant Tax Regulation

The Notice satisfies both the letter and spirit of the EO for purposes of inclusion in the interim report as a “significant tax regulation.”

While section §2(a) of the EO directs that “earlier determinations of whether a regulation is significant pursuant to Executive Order 12866 of September 30, 1993, as amended … shall not be controlling”, the definitions, however, under Executive Order 12866 are nonetheless instructive as a starting point, because it is implicit from the expansive language of the EO that “significant tax regulation” should be interpreted more expansively than if the definitions under Executive Order 12866 were to control. Section 3(d) – (f) of Executive Order 12866 provides the following:

> *(d) ‘‘Regulation’’ or ‘‘rule’’ means an agency statement of general applicability and future effect, which the agency intends to have the force and effect of law, that is designed to implement, interpret, or prescribe law or policy or to describe the procedure or practice requirements of an agency….*
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> *(e) ‘‘Regulatory action’’ means any substantive action by an agency (normally published in the Federal Register) that promulgates or is expected to lead to the promulgation of a final rule or regulation, **including notices** of inquiry, advance notices of proposed rulemaking, and notices of proposed rulemaking. [emphasis added]*
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> *(f) ‘‘Significant regulatory action’’ means any regulatory action that is likely to result in a rule that may:*
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>> *(1) Have an annual effect on the economy of $100 million or more or adversely affect in a material way the economy, a sector of the economy, productivity,*

[8] A transaction of interest is a transaction 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 whether the transaction should be identified as a tax avoidance transaction. Material advisors to a transaction must file Form 8918 and maintain a list of clients to be furnished to the IRS upon request.

competition, jobs, the environment, public health or safety, or State, local, or tribal governments or communities;

(2) Create a serious inconsistency or otherwise interfere with an action taken or planned by another agency;

(3) Materially alter the budgetary impact of entitlements, grants, user fees, or loan programs or the rights and obligations of recipients thereof; or

(4) Raise novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in this Executive order.

The Notice clearly meets the definition of "regulation" or "rule" (interchangeable) under the EO because (1) it is a statement of the IRS, (2) the IRS intends it to have the force of law, and (3) it ostensibly designed to implement the policy of 26 U.S.C. §§6011, 6111, and 6707A.

The Notice clearly meets the definition of "regulatory action" under the EO because (1) it is a substantive action, and (2) it is promulgated into a final rule because the agency has purportedly put it into effect.[9] It is also likely a "significant regulatory action"[10] in the traditional sense because (1) it has a significant economic impact which could easily reach $100 million when taking into account both hard costs and time for compliance, and the decrease in state revenues from the chilling effect of the Notice on the captive industry. The Notice is also inconsistent with a number of tax court rulings.

Lastly, it clearly imposes a "significant tax regulation" for purposes of the EO, meeting at least two of the criteria set out in §2 of the EO (discussed below), any one of which would be sufficient to be considered a significant tax regulation and be part of the required report thereunder.

Satisfying the Standards Under §2(a) of the EO

Triggering only one of the standards under §2(a) of the EO is sufficient for identification and inclusion in the interim report. The Notice triggers the following:

Impose an undue financial burden on United States taxpayers

The financial burden imposed by the Notice on United States taxpayers is undue because the Notice is: (1) overbroad, (2) is duplicative reporting, (3) requires significant financial costs incurred to report, (4) is ongoing in nature, (5) creates uncertainty as to how to comply, and (6) is premature in context of pending tax court cases.

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[9] Whether the Notice itself is subject to the Administrative Procedures Act (APA) or complies through its parent regulations, TR §§1.6011(e)(2)(i) and 301.6111-3(e), is not relevant because either way it is an alteration of the final rule with the force of law (e.g. adding a new category of covered transactions). Interestingly, the definition of regulatory action also includes notices that are part of the process.

[10] This definition of "significant regulatory action" is not binding on the EO, and merely is the starting point to what is implicitly a more expansive definition under the EO.

(1) Overbroad

The Notice is overbroad in scope in defining which taxpayers need to provide information. Rather than requiring reporting based on the fact patterns detailed in 7 pages of the Notice that raise IRS concern, the Notice instead required reporting by a much broader range of taxpayers that essentially covered the entire small captive industry. In fact, the criteria used for reporting (less than a 70% loss ratio, or any amount of related party loans or financing) were specific issues that the IRS argued for and lost in two recent Tax Court cases.[11] This overly broad criteria subjects large numbers of lawfully-created, lawfully-managed, and state-regulated captives to provisions of the tax rules intended for abusive tax shelters.[12]

Participants were also required to disclose their participation with the IRS Office of Tax Shelter Analysis and/ or on their individual and business tax returns or be subject to severe penalties,[13] regardless of whether their captive insurance arrangement contained any of the characteristics of concern identified by the IRS in the Notice.

(2) Duplicate Reporting

As explained in the SIIA comments to the IRS, much of the information the IRS requested in the Notice is already in the IRS's possession and is filed by taxpayers with their captive's annual tax return, Form 1120-PC. The Notice not only repeats much of the same information already reported with the tax return, the Notice effectively requires at least *quadruple reporting* of the same transaction. Sometimes hundreds of similar forms are required for the same transaction. For example, the following is the minimum number of separately filed forms required by the Notice for the same captive insurance transaction:

1) The captive insurance company
2) The insured business that paid premium to the captive
3) The insured business owner (owners of S-corps and partnerships)
4) Any intermediary to the transaction or promoter

The quadruple reporting becomes exponentially higher when you consider that businesses typically have multiple entities, with some having hundreds, and each being required to file a separate form with the same information. The same issue arises for business owners. Where the insured business is organized as a partnership or S-corporation for tax purposes (i.e., the most common form for small and medium sized businesses), all owners of such businesses

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[11] E.g. In R.V.I Guaranty Co. the IRS argued that lower loss ratios (e.g. between 2000 and 2006, R.V.I annual loss ratios varied from 0.3% to 64.2%, with an average annual loss ratio of 27.7%) do not reflect a "meaningful risk of loss" and therefore is not insurance, to which the Court responded, "[w]e have no difficulty concluding that … [the] policies transferred … a meaningful risk of loss. … This argument is unpersuasive on both theoretical and evidentiary grounds." The IRS did not appeal the R.V.I. case. In Rent-a-Center, the IRS argued that the purchase of parent treasury stock constituted an impermissible circular flow of funds, to which the Court responded, "Respondent's expert, however readily acknowledged that he found no evidence of a circular flow of funds, nor have we." While it does not appear that the IRS expressly argued against a low loss ratio (e.g. 10.53% in 2003 and 27.14% in 2004) in Securitas, the Court still held that "[c]onsidering all the facts and circumstances, we find that the captive arrangement constituted insurance in the commonly accepted sense." The IRS did not appeal either Rent-a-Center or Securitas.
These examples cast significant doubt on the propriety of the broad net extended by the IRS under the Notice to include captives that have less than a 70% loss ratio or that have had any related party loans or equivalent instruments.

[12] See SIIA Comments for details on the overly broad and duplicative nature of the Notice. Even though the IRS did not ask for comments on the Notice, the IRS did ask for general comment on regulation of §831(b) captives and SIIA responded.

[13] 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.

had to file separate forms or be subject to penalties. Consolidated reporting was not allowed for insured businesses and business owners. The prohibition against consolidated filing greatly increases the IRS's internal cost to process the forms, and results in a tremendous unnecessary cost to the captive industry.

To provide a common example, the insured business is owned by a large number of passive investors. These investors had zero ownership in the captive, receive zero relevant tax benefit from the captive,[14] and typically have no idea of the captive's existence. Yet, they each had to individually file under the Notice or potentially be subject to onerous penalties.

(3) Significant Financial Costs in Money and Time for Duplicate Reporting

As SIIA outlined in comments submitted to the IRS on January 30, 2017,[15] the Notice imposes an undue financial burden and creates undue complexity for small and medium sized businesses, all for little, if any, benefit to the IRS. In contrast, however, the Notice requirements have come at a tremendous cost to many taxpayers.

According to a survey of SIIA members (only a subset of the entire industry), the burden of time and money required to File the Forms 8886 and Forms 8918 required by the Notice are as follows:

Total 831(b) captives in survey[16]	2,397
Total number of Forms 8886 and 8918	15,021
Total cost of compliance	$22,186,800
Average cost per captive to file all Forms 8886 and 8918	$9,257
Total hours of compliance	121,755
Average hours per captive for compliance	50.97

A few observations regarding the above information may be beneficial to put things in perspective. The annual cost to prepare the Form 1120PC federal tax return for a captive typically ranges from $1,000 to $4,000 a year. The average cost for a captive to complete its Notice reporting was $9,257. The instructions to Form 8886 estimate that it takes a taxpayer 10.16 hours for recordkeeping and 6.25 hours for preparation of the forms. The instructions to Form 8918 estimate that it will take a taxpayer 9.79 hours for completion. These estimates are far below the actual total incurred time by SIIA members of 50.97 hours per captive. These are unnecessary financial and time burdens the IRS is forcing the industry to bear for the purposes of receiving information that the IRS already has.

[14] If a business buys additional insurance coverage to protect itself from downside risks, it could be argued that the business has less net profit to distribute to investors at the end of the year, which consequently means that these investors pay less federal income tax. However, no passive investor would view this as a tax benefit to themselves any more than viewing a pay cut as a tax benefit to the person who earns less salary.

[15] See SIIA Comments.

[16] These numbers reported do not reflect the entire small captive industry. These numbers are from a subset of the industry that are members of SIIA participating in the survey.

(4) Ongoing Reporting Obligation

The IRS requires under the Notice a continuing reporting obligation. Form 8886 must be filed annually by captives, insureds and insured owners. And, form 8918 must be filed annually by intermediaries, for all captives formed that year. Therefore, the IRS will continue to require compilation and submission of duplicative information and will continue to receive thousands of filings.

(5) Uncertainty How to Comply

The Notice creates a great deal of uncertainly for companies who attempt to take advantage of §831(b) due to the lack of detailed instructions provided by the IRS. The IRS did not provide clear guidance for filling out Forms 8886 and 8918. SIIA and other industry participants made dozens of requests to the IRS for guidance because there are multiple possible interpretations of the requirements under these forms. Furthermore, the potential fines and penalties associated with any mistakes in completing the forms are severe, ranging from $10,000 to $50,000. Despite taking every reasonable action to comply, our members are left with significant uncertainty, receiving no guidance from the IRS during the filing process, despite numerous requests.

(6) Grossly Premature

Finally, it is worth noting that this kind of information request is grossly premature. There are a number of directly relevant Tax Court decisions pending for release, perhaps later this year. It is anticipated that the judges will provide guidance on what fact patterns constitute a good or bad captive insurance arrangement. It is plausible that the information being collected by the Notice becomes worthless in a few months if the Tax Court determines the deciding criteria to be information not collected by the Notice. SIIA requested the IRS withhold the Notice until such time as the Tax Court issues their opinion, a seemingly reasonable request, but one that was dismissed outright by the IRS.

Adds Undue Complexity to the Federal Tax Laws

As noted above, there are significant costs resulting from the uncertainty caused by lack of guidance for how to comply with the Notice and the duplicate reporting required. The Notice is causing confusion in the federal tax law because the IRS is acting contrary to recent Tax Court rulings by broadly labeling two fact patterns as potentially abusive, when the IRS argued and lost on those issues in court. Rather than provide the guidance requested by Congress in the *PATH Act* on how to comply with the estate planning restrictors, the IRS is instead using its limited resources to implement a massive information collection effort not at all associated with estate planning.

Solution: Revoke the Notice and Modify the Federal Tax Return

Notice 2016-66 should be revoked for any future filings. The first wave of filings was completed by May 1, 2017. The IRS now has thousands of filings to review and should be able to glean any information it needs from those. An ongoing filing obligation is not necessary.

If the IRS feels that the information it receives regarding a captive's annual tax return is not sufficient or not organized in the manner it wishes, there is a less burdensome approach to collect this information. The captive's annual tax return on Form 1120-PC should be modified to ask for the information that the IRS wishes to receive. This tax form already has Schedule B which is dedicated for the filers electing the §831(b) election. Reorganizing this section or expanding it would be an efficient, low cost way for the captive insurance industry to report. While we recognize that modifying a tax return is not an easy task for the IRS, in light of the burden this is causing to the industry, this seems like a reasonable and appropriate solution. Incidentally, it will also save IRS time and resources to have everything organized in one comprehensive filing.

Conclusion

Rather than taking an appropriate and reasoned regulatory course to prevent abuse within the captive space, the Notice provides a dramatic example of imposing sweeping burden, cost, complexity and uncertainty on middle market and small company business owners using 831(b) captives for the management of their business risks.

As we have outlined, the Notice is contrary to congressional action taken in 2015 as part of the *PATH Act*, which the IRS has yet to issue guidance on.[17]

We greatly appreciate your consideration of this very important issue. SIIA believes the Notice is the type of burden well within the scope of regulatory actions intended and mandated by the EO to be included in the interim report.

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 Relations
Self-Insurance Institute of America, Inc.

CC:
Hon. Mick Mulvaney, Director, Office of Management & Budget
Mr. Justin Muzinich, Counselor to the Secretary
Ms. Neomi Rao, Administrator, Office of Information and Regulatory Affairs

[17] Letter to IRS from Rep. Pete Sessions, Chair, House Committee on Rules – April 6, 2017.