National Network of Accountants

RE-IMAGINING BUSINESS INSURANCE

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VICTORY FOR CAPTIVES

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The IRS received a bit of a smack down last week when the Supreme Court unanimously ruled that the IRS is *not* above the law when it comes to its overbroad and seemingly dictatorial approach at attacking micro-captives that they deem to be *abusive*.

The Court's opinion, authored by Justice Kagan, in *CIC Services v. Commissioner*, 593 U.S. ___ (2021) not only held that CIC is permitted to challenge IRS Notice 2016-66, which imposed onerous reporting requirements on certain captive service providers, but the Court also reminded the IRS and the business community that utilizing micro-captives is a legal risk management arrangement of which businesses *can* avail themselves if they are structured and managed properly.

In explaining how a micro-captive arrangement works, Justice Kagan also highlighted the legal validity of micro-captive transactions. "A micro-captive transaction is Code provides the parties to such an agreement with tax advantages. The insured party can deduct its premium payments as business expenses. See §162(a). And the insurer can exclude up to $2.2 million of those premiums from its own taxable income, under a tax break for small insurance companies. See §831(b). The result is that the money does not get taxed at all. ***"That much, for better or worse, is a congressional choice"*** [emphasis added].

In bringing suit, *CIC Services*, a captive manager, sought to enjoin the IRS from enforcing the reporting requirements of Notice 2016-66. The Notice designated "section 831(b) micro-captive transactions" as transactions of interest and imposed upon such entities and their advisors significant reporting requirements. Compliance with the Notice would cost CIC Services and other captive service providers hundreds of hours of labor and tens of thousands of dollars annually. Failure to comply could result in substantial civil tax penalties and potential criminal penalties, including imprisonment. The Notice was summarily issued by the IRS and never went through Notice and Comment or other necessary procedures that are typically required for new regulations.

Generally, anyone who believes that a rule or regulation of an administrative agency was illegally or improperly promulgated, has the right to challenge such rule or regulation under the Federal Administrative Procedure Act. They usually do not have to violate the rule first before raising its illegality as a defense when a federal agency comes after them.

However, when it comes to taxes, the Anti-Injunction Act prevents a taxpayer from going through the normal Administrative Procedure Act process and requires the taxpayer to pay its taxes. They must then sue for a refund arguing that the rule or regulation that obligated

the payment of tax was illegal or improper. The Anti-Injunction Act states that “no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person” [emphasis added]. When CIC filed its case seeking to enjoin the IRS’ enforcement of Notice 2016-66, the IRS argued that since failure to comply with Notice 2016-66 would result in the imposition of a tax penalty, the suit was brought for the purpose of avoiding the collection of taxes, and thus was prohibited by the Anti-Injunction Act. What the IRS was really saying was that it can make itself above the law simply by adding a tax penalty for failure to comply with any rule it promulgates.

The Court found that while there would be a potential tax penalty if CIC failed to comply with the Notice, there were three aspects to *CIC Services v. Commissioner*, 593 U.S. ___ (2021) that made it clear this case was not an attempt to simply challenge the payment of a tax.

- First, complying with the Notice’s “affirmative reporting obligations, [would inflict] costs separate and apart from the statutory tax penalty.”
- Second, CIC was “nowhere near the cusp of tax liability,” as it would have to fail to comply with the Notice’s reporting requirements and the IRS would have to (a) find that CIC was non-compliant and (b) exercise its discretion to impose the tax penalty.
- Finally, beyond the tax penalty associated with non-compliance, under the Internal Revenue Code, “any person who ‘willfully’ breaches an IRS reporting requirement is also subject to criminal penalties under §7203. Such a violation is a misdemeanor punishable by fines and up to one year in prison. It’s not surprising that criminal liability is not ‘deemed’ a tax.” Thus, CIC was seeking not to enjoin a tax penalty, but also to avoid criminal imprisonment.

The IRS’ brazenness and belief that it can act tyrannically in its enforcement powers was made clear during oral arguments when it tried to distinguish itself from other agencies. In pointing to the EPA, including a tax penalty as a means of enforcing its regulations, the government acknowledged that there can be “too attenuated a chain of connection in order to impute the purpose of the suit to be restraining the downstream tax…”. But they argued unsuccessfully in this case, that since they are the IRS and their role is to assess taxes, that all such suits must be for the purpose of challenging the tax and that is the end of the case.

The fact that the Court’s decision in this case was unanimous, clearly signals to the captive industry that the IRS needs to be held accountable for its aggressive enforcement actions, and it no longer can run roughshod over captive taxpayers. We now await what we expect to be a favorable decision of the District Court that Notice 2016-66 was illegally issued, and therefore can not be enforced.

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