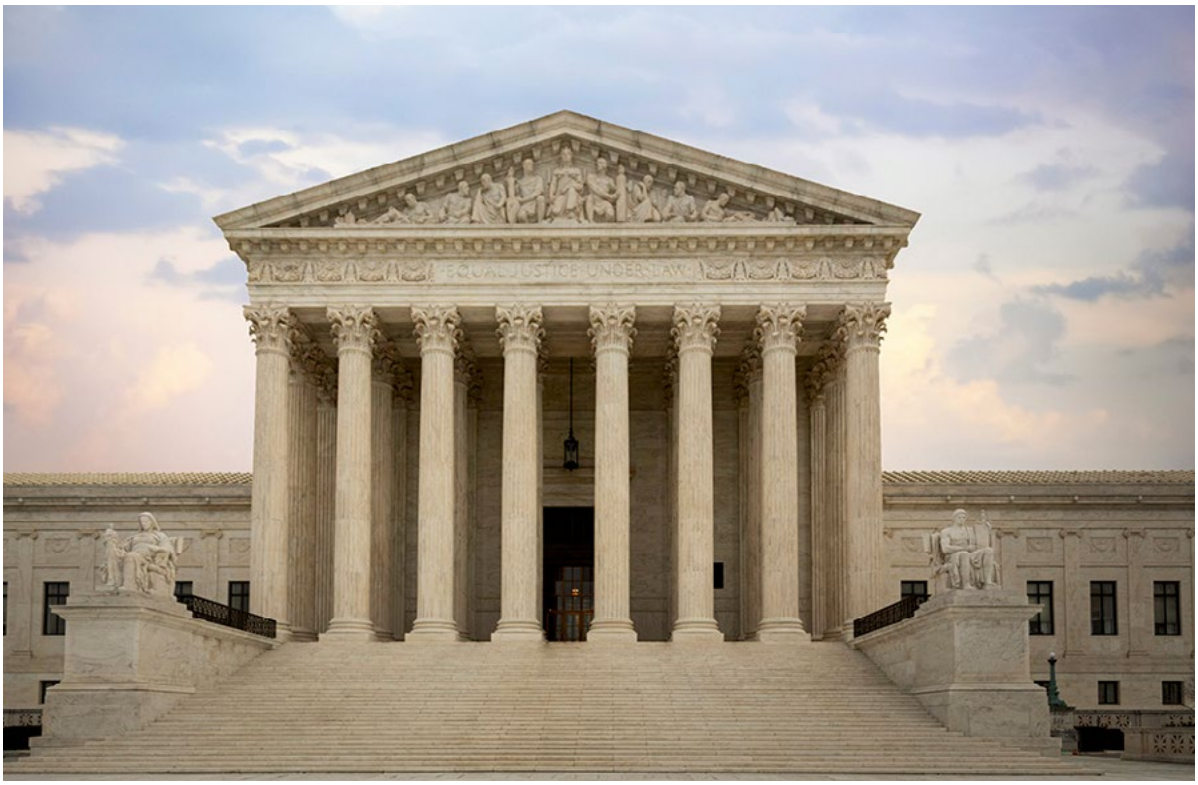


CAPTIVE INDUSTRY SEES BIG WIN IN SUPREME COURT DECISION

Written By Karrie Hyatt

In May, the U.S. Supreme Court handed down the long-awaited decision in the case of *CIC Services v. IRS Commissioner*. Deciding on behalf of the plaintiff, CIC Services, the decision threw out the IRS's defense using the Anti-Injunction Act and remanded the case back to the lower courts.

The captive industry's response was both pleased and hopeful. For John R. Capasso, president and CEO of Captive Planning Associates, LLC, "I was pleased with the Court's opinion. I thought there was a better than likely outcome that the Court would rule in favor of CIC. My surprise was that the decision was unanimous, which I think sends a very strong message back to the Service."

According to Kevin M. Doherty, attorney with Dickinson Wright, PLLC, "I think it was an excellent victory, no question. We're thrilled that the case was successful. It was a hard-fought battle, but I think the court made the right ruling, and with a unanimous decision. But, the reality is we're going back to trial and fundamental issues regarding the Notice have yet to be answered.

"It's a win but it's only a skirmish in the war," said Gary Osborne, vice president of Alternative Risk with Risk Partners. "The decision sends this [case] back down to debate the legality of the notice but the IRS already has all the information and it does nothing to help us give clear guidance on what will pass as risk transfer and risk distribution and what is insurance vs. business risk."

THE CASE

The lawsuit sprang from the IRS's Notice 2016-66, issued in November 2016, which named 831(b) captives as "transactions of interest" and sought to require additional financial disclosures. With the Notice, the IRS requested specified entities to file additional financial disclosures by January 30, 2017—90 days after the Notice was issued.

The captive industry was very vocal in its disapproval. Criticism was initially pointed towards the fact that there was no comment period before the deadline was set and that only 90 days was an unreasonable amount of time to put together the disclosures required. At the end of December, the IRS extended the deadline to May 2017.

CIC Services, a Tennessee-based captive manager, filed a lawsuit in December of that year against the IRS and Treasury Department arguing that Notice 2016-66 was unlawfully issued and did not meet the authority or "reasoned analysis" requirements of the Administrative Procedure Act.

The Notice was requiring both time and monetary investment to collect the data not only from the captives themselves, but also from captive managers and advisors. Because the IRS did not allow for any comment period, there was no chance for objections to be raised or clarifications to be requested.

Over the next four years, CIC's case was denied by the lower courts and the U.S. Court of Appeals for the Sixth Circuit due to the IRS's defense, in which they invoked the Anti-Injunction Act. Last year, the Supreme Court agreed to hear the case and arguments were made before the Court last December.

CIC received broad support from the captive industry. In a statement from Ryan Work to SIIA members, "The unique coalition of participants in the captive industry amicus brief in this case highlighted the firm, singular support of CIC's position held by a variety of state and national captive-related associations."

According to Doherty, who was instrumental in writing the brief, "We wrote the brief on behalf of virtually every active trade association in the captive industry, including SIIA. It was remarkable."

THE DECISION

The Supreme Court decision came down to whether or not the IRS's defense using the Anti-Injunction Act was appropriate. The Court unanimously decided that it was not.

The original Anti-Injunction Act dates back to 1867 and has been updated numerous times in the last century and a half. The Act describes that a lawsuit objecting to a tax (either revenue-related or regulatory) cannot be brought unless the tax has already been paid. In the case of Notice 2016-66, the regulatory tax and penalty fees threatened would be the result of not complying with the reporting requirements.

CIC Service's suit challenged the reporting mandate, not the regulatory tax. CIC's argument was that the IRS bypassed the Administrative Procedures Act by foregoing a comment period prior to requiring the additional financial information.

The decision states, "CIC's suit targets neither a regulatory tax nor a revenue-raising one; CIC's action challenges a reporting mandate separate from any tax. Because the IRS chose to address its concern about micro-captive agreements by imposing a reporting requirement rather than a tax, suits to enjoin that requirement fall outside the Anti-Injunction Act's domain."

Justice Kagan wrote the Court's opinion. In her dissection of the case she found three reasons that Notice 2016-66 was not "a tax action in disguise."

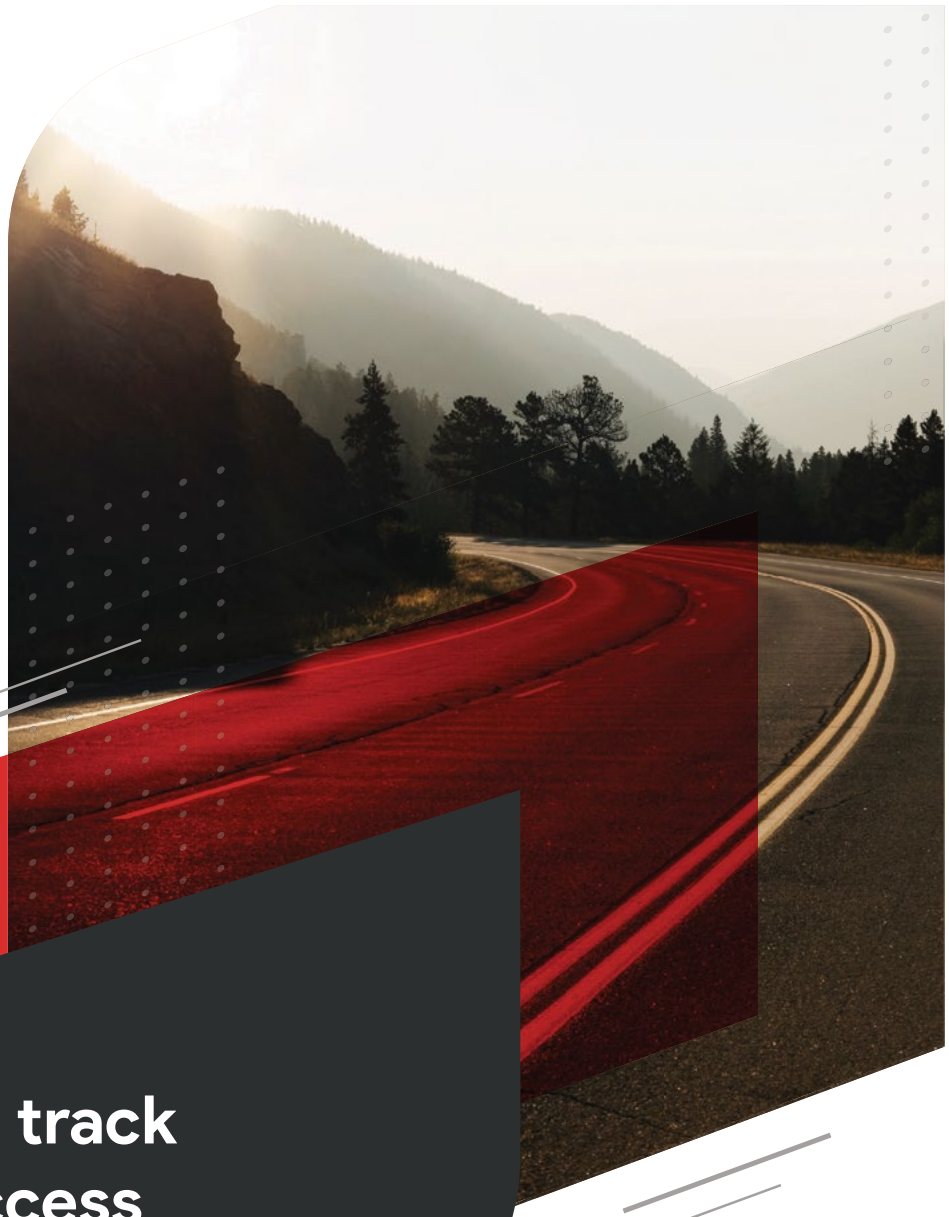
- "First, the Notice imposes affirmative reporting obligations, inflicting costs separate and apart from the statutory tax penalty."
- "Second and relatedly, the Notice's reporting rule and the statutory tax penalty are several steps removed from each other."
- "Third, violation of the Notice is punishable not only by a tax, but by separate criminal penalties."

She concluded her opinion with "CIC's action challenges, in both its substantive allegations and its request for an injunction, a regulatory mandate—a reporting requirement—separate from any tax. Or said otherwise, the suit targets not a regulatory tax, but instead a regulation that is not a tax. Here, the tax functions, alongside criminal penalties, only as a sanction for noncompliance with reporting obligation."

With the Supreme Court's decision, the case has been remanded to the lower courts.

THE OUTCOME

The Court's decision narrowly focused on the IRS's use of the Anti-Injunction Act. While it didn't offer any special support to the issues captives are facing from the IRS, it did make it clear that the IRS overstepped legal proceedings in issuing Notice 2016-66.



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In SIIA's statement, Work said, "At no point in time should a captive manager or advisor have to knowingly violate a law or Notice, under criminal and monetary penalty, in order to object to an IRS reporting requirement. Simply stated, the IRS' ongoing stance of guilty until proven innocent remains faulty. It also demonstrates the IRS' lack of willingness to impartially engage with industry participants which, should it undertake, may assist in efforts to better understand appropriate captive structures."

For Doherty, the narrow focus of the decision, "Did not address risk distribution and the validity of 831(b) from a captive standpoint. It wasn't within the scope of litigation anyway. We did win a victory but it's not as if the court ruled that 831(b) captives meet the definition of insurance."

The case was widely watched by a number of related industries as the Court's decision could have widespread ramifications in the IRS's use of the Anti-Injunction Act as a defense of its notices. "Based on what I've read, the case will become a seminal case as far as the Supreme Court is concerned because it will allow more challenges to IRS procedures," said Doherty.

The IRS feared that in allowing CIC's case to proceed that it would be opening the Service to a flood of similar litigation. The Court's decision expressed that in, "Allowing CIC's suit to proceed will not open the floodgates to pre-enforcement tax litigation."

According to Capasso, he doesn't believe the flood gates will open for similar lawsuits against the IRS, but he does see the potential for a few. "I think the Decision is somewhat narrow in scope with the type of notices the Service issues, but I do think it opens the door for other professionals to challenge onerous requirements from the service."

THE NEXT STEP

With the precedent-setting decision in place, the next question is how the IRS will respond. The Service could rescind the Notice or could find new arguments to defend it in the lower courts.

If the IRS decides to continue defending the Notice, Doherty thinks, "What they're going to have to do is prepare to argue that the Notice itself complies with the Administrative Procedures Act and honestly I don't think it does because I don't think they gave adequate notice and comment period. These are arguments we made in our brief."

"If they lose [in court] or they don't move forward on it they'll have to come back with a revised notice that does comply with

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the Act," continued Doherty. "They could give notice that they plan to issue a new regulatory filing requirement with the 831(b) filings. They could invite comments from the industry and take them into account. That would allow us to regroup and take care of it properly."

"The IRS could voluntarily rescind the notice before the lower courts have a chance to issue an opinion. However, I don't think that will happen. Because of the unanimous decision from SCOTUS, the district courts will undoubtedly follow their lead. I would not put it past the Service to issue a similar notice, but only after following protocols of a comment period," said Capasso.

According to Osborne, "It's a strong possibility they withdraw [the Notice] and issue a new one rather than defend it—it depends on what ramifications withdrawing it would have on their ability to use what has already been filed and it could be a huge expense for advisors and owners."

"The Notice is out, has been out for a long time, and it may have produced the desired effect the Service was looking for," said Capasso. "They may do nothing and just continue to send out letters, which they've been doing for better part of a year now. Instead of a new Notice, I could see the current pattern of harassment continue for the foreseeable future."

THE FUTURE/THE POSSIBILITIES

Whatever steps the IRS may take, the captive industry is hopeful that this could signal a change in IRS and 831(b) captive relations. The hope is there, but from previous experience captive professionals are wary.

"I hope it's positive but I'm not sure we aren't just poking the bear. My main hope is that it may reduce the intimidation tactics from the IRS where they are just tarring all 831(b) [captives] with the same brush," said Osborne.

For Capasso, "My hope is that after years of stonewalling, the Service will be more willing to sit down with members of the captive industry to work on establishing guidelines and best practices protocols for what may be deemed 'a good captive' arrangement as well as iron out final guidance relating back to the PATH Act of 2015."

"For years, SIIA and others in the captive community have made numerous attempts to engage the Treasury in constructive dialogue on these issues," continued Capasso. "Who know, maybe this could be the opportunity we've been waiting for."

"I don't understand how they cannot understand that their actions negatively affects [the IRS] as much as anybody else. If they want to spend all this time and effort trying to figure out through the courts who the bad guys are, they are wasting their time as much as ours," said Doherty.

He continued, "They cannot be efficient and they cannot be successful if there aren't clear guidelines so they know who is obeying the law and who is not. The industry is more than willing to comply, we just need to know what to do. I guess I would say that I am hopeful that something will change and that we'll get more guidance."