



CAPTIVES IN THE AGE OF COMPLIANCE

Asher Harris, CEO of ComplianceDNA, reflects on how the captive industry must keep pace in a world of enhanced disclosure

I knew that the world had changed the first time I saw a state income tax decision based on Facebook. Despite the taxpayer's arguments that he had moved from New York to Florida, his social media posts gave him away. The moral of the story: don't post too many pictures of yourself walking down Fifth Avenue if you don't pay New York income tax. State income tax was followed quickly by Internal Revenue Service (IRS) audits of Americans with money in foreign bank accounts. Structures that one day seemed completely innocent were suddenly deemed suspicious, where even those holding foreign accounts for the most innocuous reasons suddenly struggled to demonstrate their innocence. Transfer pricing disputes, once an arcane area of the law, now routinely hit the headlines as the amount of tax paid by profitable companies becomes the subject of everyday debate.

Identical developments are taking place throughout the financial services industry. Whether it is the US banking industry, or Solvency II requirements in Europe, the trend is unmistakable. The future business world will be subject to greater scrutiny and oversight. As additional information becomes available to regulators through an increase in the amount of public data and the analytical tools to understand their implications, businesses are forced to operate in a changed environment. Only those businesses and industries that successfully adapt to that world will flourish.



Asher Harris

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In many ways, the captive insurance industry is now in a place that is similar to where income tax was ten years ago. Captives came to being in an environment in which regulatory scrutiny could be sidestepped by carefully choosing a convenient domicile. Whether the issue was income tax, self-placement tax or corporate governance, many industry participants simply did what they wanted to, assuming that the structures would not be subjected to careful and rigorous review.

In an age of widespread disclosure, the attitude of the captive industry needs to keep up. When every email can be held up to the light of day and read out of context, everybody who works in the captive space must assume that all of their actions and intentions will be reviewed. We see this now in a number of settings. In Europe, Beps examinations start from the assumption that a captive arrangement has a tax-avoidance objective, unless a non-tax business rationale can be demonstrated.

It is not enough to assert the rationale – non-tax objectives must be supported by appropriate documentation. In the UK, the recently implemented diverted profits tax poses similar concerns. The diverted profits tax imposes a 25% tax on profits that are artificially diverted from the UK. One leg of this test applies to situations in which tax avoidance is a “main purpose” of the transaction in question. But the second test applies the tax to situations where profits in the foreign company are taxed at less than 80% of the UK corporation tax rate if there is insufficient “economic substance”. This criterion applies if the tax reduction resulting from the transaction outweighs any other financial benefit from the transactions, or where the contribution of economic value by the other company is less than the tax reduction. As applied to captives, this implies that the captive's contribution of economic value will need to be clearly defined and quantified.

Just as European tax authorities are beginning to review the tax consequences of captives more carefully, the same phenomenon is taking place in the United States. In Notice 2016-66, the IRS staked a claim to further information as to the details of Section 831(b) captives. Tellingly, the information requested went not only to the economic details of the structure, but also were intended to learn about the intentions of those who had structured and sold the transaction, and those who were the economic participants. Despite much



protest from service providers to the captive industry, it is obvious that the IRS is doing its job: trying to figure out whether captives are being used to shelter taxable income inappropriately. Also, states have begun to request the information that has been disclosed under Notice 2016-66, raising the possibility of state income tax audits, as well as potential self-placement tax deficiencies. Again, the captive industry is putting up a fight, trying to stop states from gaining access to the information provided to the IRS.

In all of these cases, the captive industry is attempting to perpetuate a position located in the shadowy corners of the risk management world, away from the harsh spotlight of regulatory scrutiny. In light of all that has taken place in the world of tax examinations over the last several decades, the captive industry needs to adjust its attitude. In today's world, there are no shadowy corners. We need to come to grips with the reality that all of our moves will be questioned, and all of our intentions scrutinized. Any corporate decision that has the

potential to be characterized as evasive of tax or regulatory rules will be so construed, unless the contrary can be adequately documented.

Does the captive industry have a future in a world of enhanced disclosure? Many would say that it does not – that it has only

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managed to thrive by staying one step ahead of the sheriff. If that is the case, captive insurance is essentially an anachronism, doomed to fade into the sunset once those charged with enforcing the rules gather up enough information to shut it down.

The alternative analysis is that the industry has a future that does not depend

on winks and nods, on pretending to have business objectives that simply do not exist. But in order to make this move, the industry must change its attitude. If the value proposition of the captive industry is actually based on risk management objectives, those need to shift to the forefront of what we do. The economic contribution of captive insurance must be clearly quantifiable and easy to demonstrate, if the industry is to continue to prosper.

As specialists in compliance, we see the future of the captive industry in identifying the objectives of regulators, determining what needs to be done to comply with those objectives, and developing a plan to continue to comply.

Adversarial relationships with regulators and tax administrators should be a thing of the past. The question is not whether a specific tax or regulatory action is effective or well-crafted. The real question is whether captive insurance, as an industry, is prepared for an era in which regulatory oversight is the norm, not the exception. It's time for us to grow up. 🌱