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IRS Concedes Defeat Over Notice 2016-66, Tries Second Bite At the Apple

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Thanks to a series of court victories by our firm (and others), including a unanimous decision by the United States Supreme Court, the IRS formally sat down at the dinner table earlier this week to eat a heaping helping of crow.

In Announcement 2023-11, issued earlier this week, the IRS said:

> *Recent court decisions have held that the IRS's longstanding practice of issuing notices to identify listed transactions and transactions of interest does not comply with the Administrative Procedure Act (APA), 5 U.S.C. 551-559. On March 3, 2022, the U.S. Court of Appeals for the Sixth Circuit issued an order holding that Notice 2007-83, 2007- 2 C.B. 960, which identified certain trust arrangements as listed transactions, violated the APA because the notice was issued without following the notice-and-comment procedures required by section 553 of the APA. Mann Construction v. United States, 27 F.4th 1138, 1147 (6th Cir. 2022). Subsequently, the U.S. District Court for the Eastern District of Tennessee, which is located in the Sixth Circuit, vacated Notice 2016-66 on the ground that the IRS failed to comply with the APA's notice-and-comment procedures, viewing the analysis in Mann Construction as controlling. CIC Services, LLC v. IRS, 2022 WL 985619 (E.D. Tenn. March 21, 2022), as modified by 2022 WL 2078036 (E.D. Tenn. June 2, 2022). The Court also held that the IRS acted arbitrarily and capriciously, based on the administrative record. On November 9, 2022, the U.S. Tax Court, in a reviewed decision with two judges dissenting, relied on Mann Construction in holding that Notice 2017-10, 2017-4 I.R.B. 544, which identifies certain syndicated conservation easements as listed transactions, is invalid because it was issued without following notice-and-comment rulemaking procedures. See Green Valley Investors, LLC v. Commissioner, 159 T.C. No. 5 (2022). See also Green Rock, LLC v. IRS, 2023 WL 1478444 (N.D. AL., February 2, 2023).*
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> *The Department of the Treasury (Treasury Department) and the IRS disagree with the recent court decisions holding that listed transactions cannot be identified by notice or other subregulatory guidance. However, the Treasury Department and IRS will no longer take the position that transactions of interest can be identified without complying with APA notice-*

and-comment procedures. Accordingly, the IRS is obsoleting Notice 2016-66 (as modified by Notice 2017-8), and will not enforce the disclosure requirements or penalties that are dependent upon the procedural validity of Notice 2016-66.

Consequently, to the extent there was ever any doubt after the recent court decisions as to whether taxpayers in come circuits must still comply with Notice 2016-66, that doubt is over. They don't.

Nonetheless, in the same announcement the IRS indicated that it plans to take another bite at the apple. Specifically, it has published proposed regulations that identify certain types of captive insurance arrangements as "listed transactions" and others as "transactions of interest". Interested parties have 60 days to comment on the proposed regulations, and we will be doing so. More on the details of those proposed regulations can be found below.

By proceeding with these new regulations via notice-and-comment rule making, the Service is at least pre-textually attempting to comply with the requirements of the Administrative Procedures Act (APA). That itself is a big win for taxpayers.

But whether the Service is *actually* complying with the APA remains to be seen. To be valid, regulatory actions must have a reasonable basis in fact and law, and that basis must be documented in the relevant administrative record of the agency. In other words, enforceable regulatory actions cannot be "arbitrary and capricious" in nature.

A federal court has *already* concluded that Notice 2016-66 was arbitrary and capricious, with the court noting that there was *no* evidence in the administrative record indicating that "micro-captive" transactions covered by the Notice were prone to abuse by taxpayers. Are we to believe that the IRS now has sufficient evidence documented in the administrative record to justify issuance of the newly proposed regulation?

Perhaps they do. Perhaps they don't. But what is absolutely clear is that no sane person should take the IRS' word on the matter. This is something that will, once again, likely have to be tested in court.

So, what does the new proposed regulation say? Well, assuming it becomes effective as drafted, then the following appears to be the case (please consult your tax advisor to confirm the specifics and its relevance to you):

LISTED TRANSACTION

Most every captive insurance arrangement (or series of arrangements, such as multiple captives insurance companies that existed one after the other) that has existed for at least ten consecutive years, and that involves a captive insurance company electing tax treatment under IRC Section 831(b), would be deemed to be a "listed transaction" and subject to reporting requirements that are similar to but generally less onerous than those previously imposed by the now-overturned IRS Notice 2016-66. Arrangements (or a series of them) that have *not* been in force for ten years wouldn't be "listed transactions," but most of them would nonetheless be "transactions of interest" (see below) and as such subject to essentially the same reporting requirements regardless.

However, if the captive has (1) never over the prior five years made any of its assets available to any of its owners or its primary insureds, or to persons or entities sufficiently related to either of them, in non-taxable transactions (such as via loans, investments in other entities, etc.); and (2) has not retained 35% or more of the premiums cumulatively paid to it over the prior five years, then the captive is *not* a listed transaction. Unfortunately, due to the five and ten year look back periods, this will apply to very few captives already in existence, though it may be easy enough for many captives to qualify under these exceptions.

TRANSACTIONS OF INTEREST

Assuming an existing captive avoids qualifying as a listed transaction as noted above, it would almost certainly still qualify as a “transaction of interest” provided that the proposed rule becomes final. If so, then it would be subject to reporting requirements that are similar to but generally less onerous than those previously imposed by the now-overturned IRS Notice 2016-66.

A captive transaction is a “transaction of interest” under the rule if during the prior nine years (or the life of the captive, if shorter), the captive has cumulatively retained 35% or more of the cumulative premiums paid to it. Said the opposite way, if at least 65 percent of the captives cumulative premiums over the prior nine years (or the life of the captive if shorter) have been used to cover legitimate operating expenses or to pay claims and/or “policyholder dividends,” then the captive captive transaction would not be considered a “transaction of interest.”

CONCLUSION

The IRS’ formal acquiescence to the court’s ruling overturning IRS Notice 2016-66 is welcome news. The IRS has been forced to follow proper procedure, and taxpayers are no longer subject to tyrannical rule-making.

The proposed new regulations that would replace Notice 2016-66 are substantially less onerous than the original Notice was. Under the proposed rule, taxpayers can more easily avoid engaging in a reportable transaction if they so desire. And, even if they do or have participated in a reportable transaction (a listed transaction or transaction of interest), the filing requirements under the proposed rule are *substantially* less than the original Notice 2016-66 both in terms of the quantity of information that must be provided and who must provide it. For example, owners of a captive would *not* be required to make the filings so long as the captive itself files the necessary disclosures and notifies all owners that it has.

It’s important to note that the proposed new regulation is not yet in force. It will only take effect, if at all, after it is published in final form in the Federal Register. In the meantime, taxpayers and the industry are entitled to offer substantive comments on the proposed regulations, and we will be doing so.

Finally, it's essential to remember that just because you may have engaged in a reportable transaction, or may do so in the future, that does *not* mean that you've done anything wrong. The regulations themselves provide that "the fact that a transaction is a reportable transaction shall not affect the legal determination of whether the taxpayer's treatment of the transaction is proper."

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