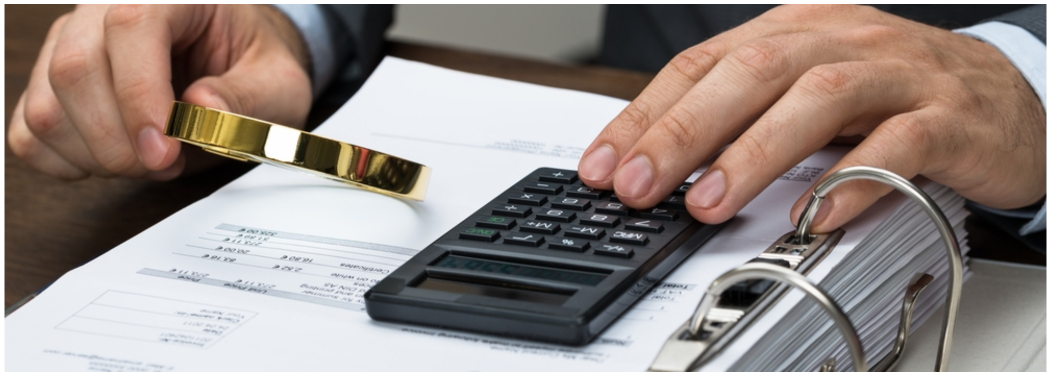
TAX SHELTERS: THE IRS IDENTIFIES MICRO-CAPTIVE INSURANCE SCHEMES AS A TRANSACTION OF INTEREST.

Posted on **November 10, 2016** by **Jim Malone**



The IRS periodically identifies tax strategies it considers abusive as "reportable transactions," a designation that triggers disclosure obligations for material advisors involved in the transactions. *See* I.R.C. § 6111(a). They also must maintain lists of participants involved in reportable transactions. *See* I.R.C. § 6112(a). And individual taxpayers must make disclosures with their returns. *See* Treas. Reg. § 1.6011-4(a).

Reportable transactions come in a variety of forms. Where the IRS determines that a particular type of transaction is a tax avoidance scheme, it will designate it as a listed transaction, making all substantially similar transactions subject to the reporting and record-keeping requirements outlined above. *See* Treas. Reg. § 1.6011-4(b)(2). In contrast, where the IRS believes that there is a potential for abuse in a particular type of transaction but lacks sufficient information to determine which specific arrangements are abusive, it will designate that type of transaction as a "transaction of interest," triggering the same disclosure and record-keeping requirements that apply to listed transactions. *See* Treas. Reg. § 1.6011-4(b)(6).

Last week, the IRS issued a notice indicating that a micro-captive transaction under section 831(b) of the Internal Revenue Code is a transaction of interest. Notice 2016-66, 2016 I.R.B. 678 (Nov. 1, 2016). Section 831(b) allows small property and casualty insurance companies to elect to be taxed solely on their investment income; to qualify, the insurers' premium income for the tax year cannot exceed $1.2 million. I.R.C. § 831(b)(1), (2)(A)(i).

When section 831(b) is utilized, the result is that the insured deducts the premiums that it pays as a business expense, but the insurance company does not recognize income on the premiums that it receives. *See* Notice 2016-66, § 1.02(a). Since a captive insures risk of a related party, there is a potential for abuse. The Notice identifies a series of characteristics of these arrangements in the area of the coverage provided, the premiums paid, claims procedure and management of the captive, and the captive's capital structure that the IRS considers problematic.

In terms of the coverage provided, areas of concern are captive arrangements that provide coverage for implausible risks, coverage that does not fit business needs or risks of the insured, vague, ambiguous or illusory coverage, and coverage that duplicates commercial coverage that is already provided at lower premiums. Notice 2016-66, § 1.02(c).

The Notice identifies several problematic issues concerning premiums, including premiums designed to provide a deduction of a specific size, premiums determined without underwriting or an actuarial analysis, premium payments that don't conform to contractual terms, premiums that an insured agrees to without looking at the cost of comparable coverage from an independent source, and premiums that exceed prevailing commercial norms. Notice 2016-66, § 1.02(d).

Claims procedures and management of the captive are also an area of concern. Potential issues include the captive's failure to comply with applicable local law and regulations, the failure to issue binders and policies on a timely basis, the captive's failure to establish claims procedures consistent with norms in the industry, and the failure of the insured to file claims. Notice 2016-66, § 1.02(e).

The final consideration is the capital structure of the captive. Here the issues include captives that lack sufficient capital to assume the risks they purport to insure, captives that invest in illiquid and speculative investments, and captives that loan or otherwise transfer capital to the insured or an affiliate of the insured. Notice 2016-66, § 1.02(f).

The Notice covers direct arrangements between an insured and a captive, as well as transactions that utilize an intermediary. Notice 2016-66, §§ 1.02; 1.03. In the intermediary situations there is frequently a relationship between the intermediary and an advisor that is promoting the arrangement. Notice 2016-66, § 1.03.

Transactions will fall within the scope of Notice 2016-66 if the insured and its affiliates own twenty percent or more the stock of the captive. Notice 2016-66, § 2.01(d). The IRS will be screening the arrangements based on financial performance; if a captive does not experience losses and administrative expenses of at least seventy percent of its premium income, net of policyholder dividends the arrangement qualifies as a transaction of interest. Notice 2016-66, § 2.01(e)(1). Performance is measured over a five year period or the life of the captive, whichever is shorter. Notice 2016-66, § 2.02. The economic performance test does not apply if the arrangement provided for either the insured or a related person to receive funds from the insured on a tax-free basis, such as a loan, as these transactions are automatically covered. Notice 2016-66, § 2.01(e)(2).

Notice 2016-66 covers transactions that closed on or after November 2, 2006. Anyone who entered into a captive transaction after that date should discuss the Notice with their tax advisor. Individuals who promoted captive arrangements should also consult their advisors.

These arrangements were actively promoted through seminars in the Philadelphia area earlier this year.

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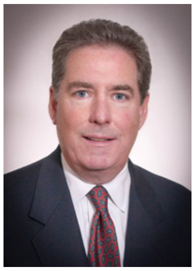

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