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Notice 2016-66: "Micro-captive insurance" identified as "transaction of interest"

The IRS today released an advance version of Notice 2016-66 that identifies a type of transaction involving a "micro-captive insurance" structure as a "transaction of interest"—i.e., a tax avoidance transaction—for purposes of Reg. section 1.6011-4(b)(6) and sections 6111 and 6112.

<u>Notice 2016-66</u> [PDF 44 KB] states that these "micro-captive transactions" have the potential for tax avoidance or evasion. Taxpayers engaged in these transactions must disclose the transactions. A failure to disclose will be subject to the penalty under section 6707A or section 6707(a).

Notice 2016-66 states that the IRS and Treasury recognize that related parties may use captive insurance companies that make elections under section 831(b) for risk-management purposes that do not involve tax avoidance. Yet, there are instances in which the use of such arrangements to claim the tax benefits of treating the transaction as an insurance contract is improper.

Background

The IRS previously identified abusive micro-captive insurance structures as involving certain small or "micro" captive insurance companies as possible tax avoidance vehicles in their "Dirty Dozen" list of tax scams. See <u>IR-2016-25</u> [PDF 39 KB]. But U.S. tax law allows businesses to create "captive" insurance companies to protect against certain risks. The IRS recognizes that not all captive insurance companies—even small or "micro" captives—are abusive.

In brief, the insured claims tax deductions for premiums paid for the insurance policies while the premiums end up with a captive insurance company owned by the owners of the insured or family members. The captive insurance company, in turn, can elect

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under section 831(b) to exclude up to \$1.2 million* of its net premium income per year, so that the captive is taxed only on its investment income.

The "abusive structure" identified by the IRS is one in which owners of closely held entities create captive insurance companies (onshore or offshore) and cause the captive to create and sell insurance policies to the closely held entities. The policies may cover ordinary business risks or may cover what the IRS termed as "…esoteric, implausible risks for exorbitant 'premiums,' while the insureds continue to maintain their far less costly commercial coverages with traditional insurers." Captive insurance policies may attempt to cover the same risks as are covered by the entities' existing commercial coverage, but as noted by the IRS, the captive policies' premiums may be double or triple the premiums of the policy owners' commercial policies.

The IRS continued by explaining that annual premium amounts are frequently targeted to the amounts of deductions that business entities seek in order to reduce their taxable income. In the abusive schemes, total premiums can equal up to \$1.2 million annually to take full advantage of the premium income exclusion provision. Underwriting and actuarial substantiation for the insurance premiums paid are, according to the IRS, either absent or illusory. Also, promoters may manage the entities' captive insurance companies for substantial fees, assisting taxpayers unsophisticated in insurance.

*Section 333 of the Protecting Americans from Tax Hikes Act of 2015 ("PATH Act") modified the section 831(b) eligibility rules for certain property and casualty insurance companies to be taxed solely on investment income rather than underwriting income. The maximum amount of written premiums was increased from \$1.2 million to \$2.2 million and indexed for inflation going forward, and a diversification rule was added. The increased section 831(b) threshold is effective for tax years beginning after December 31, 2016.

Notice 2016-66

Today's notice states that the IRS and Treasury Department lack sufficient information to identify which section 831(b) captive arrangements are to be identified specifically as a tax avoidance transaction. The IRS and Treasury also may lack sufficient information to define the characteristics that distinguish tax avoidance transactions from other section 831(b) related-party transactions.

Accordingly, Notice 2016-66 describes a transaction and states that this transaction or substantially similar transactions must be disclosed or be subject to penalty provisions. Specifically, section 2.01 of Notice 2016-66 identifies transactions of Interest to be those as follows:

a) <u>A</u>, a person, directly or indirectly owns an interest in an entity (or entities) ("Insured") conducting a trade or business.

b) An entity (or entities) directly or indirectly owned by <u>A</u>, Insured or persons related to <u>A</u> or Insured ("Captive") enters into a contract (or contracts), (the "Contracts") with Insured that Captive and Insured treat as insurance, or reinsures risks that Insured has initially insured with an intermediary, Company <u>C</u>;

c) Captive makes an election under section 831(b) to be taxed only on taxable investment income;

d) <u>A</u>, Insured, or one or more persons related to <u>A</u> or Insured directly or indirectly own at least 20% of the voting power or value of the outstanding stock of Captive; and

e) One or both of the following apply:

(1) The amount of the liabilities incurred by Captive for insured losses and claim administration expenses during the Computation Period (generally, the prior five years, or the years the captive has been in existence if less than five years) is less than 70% of the following:

- (A) premiums earned by Captive during the Computation Period, less
- (B) policyholder dividends paid by Captive during the Computation Period; or

(2) Captive has at any time during the Computation Period directly or indirectly made available as financing or otherwise conveyed or agreed to make available or to convey to <u>A</u>, Insured, or a person related or Insured in a transaction that did not result in taxable income or gain to Recipient, any portion of the payments under the Contract, such as through a guarantee, a loan or other transfer of Captive's capital.

The IRS notice also alerts promoters or persons involved in these transactions that they have certain responsibilities, and that penalties may be imposed from their involvement in these transactions.

Effective Date

Transactions that are the same as, or substantially similar to, the described transaction are identified as "transactions of interest" effective November 1, 2016. Persons entering into these transactions on or after November 2, 2006, must disclose the transaction as described. Material advisors also have disclosure and list maintenance obligations. The IRS and Treasury Department have also requested comments which are to be submitted in writing before January 30, 2017.

In subsequently issued guidance (Notice 2017-8), the IRS stated that all disclosures required by Notice 2016-66 must be made by May 1, 2017.

KPMG observation

There is risk inherent in almost any captive structure, as the IRS has historically challenged such arrangements. For captive companies that make the section 831(b) election, this risk is heightened in that the IRS has described certain of these arrangements as a "Dirty Dozen" tax scheme; has litigated to obtain customer lists from promoters of captive arrangements that the IRS considers "abusive;" and has

challenged tax claims related to section 831(b) captive insurance companies. Today's IRS notice is a formal indication of the IRS's inclination to challenge section 831(b) arrangements and to explore whether or not companies have substantial nontax business purposes for establishing these captives.

The "transaction of interest" requirements do not rely on subjective issues such as whether the coverage was properly underwritten or whether the contract covers a plausible risk. Instead, an 831(b) captive entity is considered a "transaction of interest" if its insured losses and claim administration expenses are less than 70% of its premium income less dividend payments or if the captive makes any loans to or investments in the parent. Even if the captive were properly capitalized initially, and issued contracts covering legitimate business risks that were priced using accepted actuarial principles, but had few claims, these previously established captives could now be considered to be "transactions of interest" and would need to be re-examined. Due to the significant adverse consequences of failing to identify transactions of interest, it is prudent to err on the side of over-reporting.

For more information, contact a tax professional with KPMG's Washington National Tax practice:

Sheryl Flum | +1 (202) 533-3394 | sflum@kpmg.com

Fred Campbell-Mohn | +1 (212) 954-8316 | fcampbellmohn@kpmg.com

Liz Petrie | +1 (202) 533-3125 | epetrie@kpmg.com

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