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TaxNewsFlash

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Proposed regulations: Micro-captive listed transactions and micro-captive transactions of interest

The U.S. Treasury Department and IRS today released for publication in the Federal Register proposed regulations (REG-109309-22) identifying transactions that are the same as, or substantially similar to, certain micro-captive transactions as listed transactions, a type of reportable transaction, and certain other micro-captive transactions as transactions of interest, another type of reportable transaction.

The **proposed regulations** [PDF 292 KB] (18 pages as published in the Federal Register on April 11, 2023) would obsolete Notice 2016-66 (as modified by Notice 2017-8), under which the IRS initially identified certain micro-captive transactions as transactions of interest, and would become effective as of the date finalized.

The IRS issued the proposed regulations in response to the decision in *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), in which the court, relying on the decision in *Mann Construction v. United States*, 27 F.4th 1138, 1147 (6th Cir. 2022), vacated Notice 2016-66 on a finding that the IRS failed to comply with the notice-and-comment procedures of the Administrative Procedure Act (APA). The IRS states that in light of that decision, the IRS will not enforce the disclosure requirements or penalties that are dependent upon the procedural validity of Notice 2016-66. However, the IRS further states that the obsoletion of Notice 2016-66 has no effect on the merits of the tax benefits claimed from the transactions themselves and related litigation, or income tax examinations and promoter investigations relating to micro-captive transactions. The IRS today issued an advance version of **Announcement 2023-11** [PDF 149 KB], which explains that the regulations are being proposed in light of the court decisions.

The proposed regulations provide that material advisors and certain participants in these listed transactions would be required to file disclosures with the IRS and would be subject to penalties for failure to disclose. Taxpayers use Form 8886, *Reportable Transaction Disclosure Statement* to disclose information for each reportable transaction in they participate. Material advisors to any reportable transaction file Form 8918, *Material Advisor Disclosure Statement* to disclose certain information about the reportable transaction.

Comments on the proposed regulations are due by June 12, 2023. Requests to speak and outlines for topics to be discussed at a public hearing scheduled to be held by teleconference on July 19, 2023, at 10 a.m. ET, are also due by that date. If no outlines are received by that date, the public hearing will be cancelled.

The IRS specifically requests comments on the following:

- What are the specific and objective metrics, factors, or standards, if any, that, if reported, would allow for the IRS to better identify and distinguish abusive micro-captive transactions from other micro-captive transactions?

- With respect to Prop. Reg. §§1.6011-10(c)(2) and 1.6011-11(c), whether the loss ratio described therein, which compares "the amount of liabilities incurred by Captive for insured losses and claim administration expenses during the [applicable] Computation Period" to the "premiums earned by Captive during the [applicable] Computation Period less policyholder dividends paid by Captive during the [applicable] Computation Period," should be replaced by a combined ratio, which compares "losses incurred, plus loss adjustment expenses incurred and other underwriting expenses incurred by Captive during the [applicable] Computation Period" to "Captive's earned premiums, less policyholder dividends, for the [applicable] Computation Period," and if so, what percentage would be an effective threshold for purposes of identifying abusive transactions. For this purpose, Captive's "other underwriting expenses incurred" would equal Captive's expenses incurred in carrying on an insurance business, other than loss adjustment expenses and investment-related expenses.

- With respect to the percentage of premiums retained as commissions for contracts as described at Prop. Reg. §§1.6011-10(d)(2) and 1.6011-11(d)(2), what, if any, are the specific metrics, factors, or standards that, if reported, would allow for the IRS to better identify and distinguish abusive micro-captive transactions of this type from other such micro-captive transactions?

Read a related IRS release—**IR-2023-74**

KPMG observation

These proposed regulations clearly indicate that Treasury and the IRS will continue to challenge the validity of most micro-captive transactions (i.e., captive insurance companies that have elected to be treated under section 831(b)). Notice 2016-66 has been obsoleted. For the most part, the proposed regulations keep the definitions for micro captives that are transactions of interest from Notice 2016-66. A change has been made to lower the loss ratio from 70% to 65%, which could reduce the number of entities that need to file Form 8886. Additionally, the proposed regulations make clear that micro captives that provide consumer coverage arrangements, such as extended warranties on automobiles or consumer goods, would not be covered by these proposed regulations because the coverage is provided to unrelated third parties.

The proposed regulations create a new listed transaction for two subsets of micro captives. First, a micro captive will be a listed transaction if, over a five-year reporting period (or over the life of the micro captive entity if it has existed for less than five years) there is a financing arrangement between the micro captive and party related to the micro captive such as a loan, guarantee, or other transfer of the micro captive's capital that does not create taxable income for the related party receiving the funds. Thus, if a micro captive loans money to a related party at a market rate of interest, and the related party pays the required interest, because the recipient of the loan would not have taxable income from the transaction, the arrangement would be a listed transaction. Effectively, micro captives that wish to avoid being listed transactions cannot have related party loans or guarantees even if the financing arrangement is set-up as an arms-length transaction. Under Notice 2016-66, these financing arrangements would cause the micro captive to be a transaction of interest regardless of whether there was sufficient covered losses.

Second, a micro captive that has a loss ratio of less than 65% over a 10-year period would be a listed transaction. This provision would apply to only micro captives that have been in existence for at least 10

years. Looking to a loss ratio to determine if an entity should be considered an insurance company for federal tax purposes adds a factor outside of the four factors established through common law starting with *Helvering v. LeGierse*. It also ignores the fact that many captive insurance companies cover risks that are low in frequency but have high potential damages. Many commercial insurance companies do not provide coverage for such risks, or if they do the cost is prohibitive.

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