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IRS Proposed Regulations Identify Micro-Captive Transactions as Listed Transactions – Responding to CIC Services Decision

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On April 10, 2023, the U.S. Treasury Department issued proposed regulations identifying certain micro-captive transactions as listed transactions or transactions of interest for purposes of the disclosure rules for taxpayers and material advisors. The proposed regulations are in response to a taxpayer victory in *CIC Services, LLC v. IRS*, in which the U.S. District Court for the Eastern District of Tennessee invalidated Notice 2016-66 for failing to comply with the Administrative Procedure Act. (For a more detailed explanation of the holding in *CIC Services*, see March 2022 GT Alert, "Court Invalidates Notice 2016-66 on Micro-Captive Transactions, the Second Time an IRS Notice Was Vacated This Month.") The IRS continues to defend the validity of Notice 2016-66 outside of the Sixth Circuit; however, Treasury issued the proposed regulations to ensure consistent enforcement of the disclosure requirements. Since Notice 2016-66 was issued, the IRS has honed its understanding of micro-captive transactions. Based on this information, the proposed regulations modify the transactions described in Notice 2016-66. Treasury is requesting public comment by June 10, 2023.

Summary of Provisions and Differences from Notice 2016-66

- **Defines the Term "Captive**: Treasury defines the term "captive" to include any entity that: (i) makes an election under I.R.C. § 831(b) to exclude premiums from taxable income; (ii) issues a contract to the insured, reinsures a contract of an insured issued by an intermediary; or both; and (iii) has at least 20% of its assets, voting power, or outstanding stock or equity owned, directly or indirectly, by the insured, an owner of the insured, or persons related to an insured or owner. The IRS is aware that, since Notice 2016-66 was issued, promoters have been structuring transactions to avoid the 20% threshold by not giving the insured equity or voting power over the captive. The proposed regulations clarify that a person holding a derivative will be treated as indirectly owning the assets of the captive.

- **Identifies Micro-Captive Listed Transactions**: In Notice 2016-66, the IRS identified certain micro-captive transactions as transactions of interest for purpose of the disclosure rules. In the proposed regulations, Treasury goes a step further and determines that two categories of

transactions are Micro-Captive Listed Transactions:

– **Financing Factor**: Under, Prop. Reg. § 1.6011-10(c)(1), if a captive directly or indirectly conveys or loans any portion of the payments under the contract to a recipient during the financing computation period, it is a listed transaction. The arrangement may involve a guarantee, loan, or other transfer of the captive's capital to the recipient. This includes any financing issued prior to the financing computation period that has not been repaid in the year disclosure is required. An amount is presumed to be a payment under the contract to the extent the amount exceeds the captive's cumulative after-tax net investment earnings minus any outstanding financing or other conveyances. The "financing computation period" is the most recent five taxable years of the captive (or all taxable years where the captive has existed for less than five years).

– **Loss-Ratio Factor**: Under Prop. Reg. § 1.6011-10(c)(2), if a captive's liabilities for insured losses and claim administration expenses are less than 65% of the premiums earned by the captive during the loss ratio computation period minus any dividends paid by the captive during the loss ratio computation period, it is a listed transaction. The "loss ratio computation period" includes the most recent 10 taxable years of the captive. Prop. Reg. § 1.6011-10(c)(2) does not include any captive that has been in existence for less than 10 years (including taxable years of predecessor entities). Treasury reduced the loss ratio threshold from 70% to 65% to ensure that non-abusive transactions are not subject to the disclosure requirements.

Treasury is requesting public comment on whether a combined ratio would be more effective at distinguishing abusive micro-captive transactions. A combined ratio would compare: (i) losses incurred, plus loss adjustment and underwriting expenses, to (ii) the captive's earned premiums minus any policyholder dividends paid. Treasury also requests public comment on what the appropriate percentage would be if it utilized a combined ratio.

- **Identifies Micro-Captive Transactions of Interest**: A captive transaction will be treated as a transaction of interest for purposes of the disclosure rules where: (i) the captive issues a contract to the insured or reinsures a contract issued to the insured by an intermediary; and (ii) the captive's liabilities incurred for insured losses and claim administration expenses during the transaction of interest computation period are less than 65% of the premiums earned by the captive minus dividends paid to policyholders during the transaction of interest computation period. The "transaction of interest computation period" includes the nine most recent taxable years of the captive (or all taxable years where the captive has existed for less than for less than nine years.)

- **Disclosure Requirements Apply to Substantially Similar Transactions**: The disclosure requirements apply to transactions that are substantially similar to micro-captive listed transactions or micro-captive transactions of interest. Under Treas. Reg. § 1.6011-4(c)(4), a transaction is "substantially similar" if it: (i) is expected to have the same or similar types of tax consequences; and (ii) is either factually similar or based on the same or similar tax strategy. For purposes of the disclosure rules, "substantially similar" is broadly construed. For example, a transaction may be substantially similar to a listed transaction even though it relies on different provisions in the Internal Revenue Code or uses different entities.

- **Disclosure Requirements Modified for Captives and Insureds**: The proposed regulations reduce the amount of information that a captive is required to report under the disclosure rules. Captives are no longer required to: (i) identify which factors of the proposed regulations

apply; (ii) identify the authority under which the captive is chartered; (iii) describe how the premiums were determined; (iv) provide the reserves reported by the captive on its annual statement; or (v) describe the assets owned by the captive. However, the captive must report (i) the types of policies issued or reinsured; (ii) the amounts treated as premiums; (iii) name and contact information for actuaries and underwriters involved in the transaction; and (iv) the total amount of claims paid by the captive. Furthermore, to enable the IRS to apply the 20% relationship test, the proposed regulations require the captive to identify the name and percentage interest held directly or indirectly by each person who meets the 20% threshold. An insured that is subject to the disclosure requirements must identify the amounts treated as insurance premiums.

- **Disclosure Requirement Safe Harbor for Owners**: A person who is subject to the disclosure requirements solely because of his or her direct or indirect ownership interest in the insured is not required to file a disclosure statement where the person receives written or electronic acknowledgment that the insured has or will comply with its separate disclosure obligation under Treas. Reg. § 1.6011-4(a). But, where an insured fails to file a timely disclosure, the receipt of an acknowledgement will not relieve the owner of the duty to disclose.

- **Limited Exception for Consumer Coverage Arrangements**: The proposed regulations provide an exception for certain consumer coverage reinsurance arrangements. In consumer coverage arrangements, a service provider sells products or services to unrelated customers and the unrelated customers purchase an insurance contract in connection with that purchase. For example, a consumer coverage contract may cover the repair or replacement costs of a product if it is damaged, lost or stolen. An entity related to the seller may issue or reinsure the customer coverage contracts. Treasury determined that a limited exception was appropriate for consumer coverage contracts where the commissions paid are comparable commissions paid to unrelated insurance companies.

Effect of Proposed Regulations

- **Effect on Participants**: Participants who fail to disclose transactions identified by the proposed regulations may be subject to penalties under I.R.C. § 6707A. Additionally, the IRS may assert accuracy-related penalties under I.R.C. §§ 6662 and 6662A for understatements attributable to the micro-captive transactions. Moreover, where a taxpayer fails to disclose their participation a micro-captive listed transaction, the statute of limitations for assessment will be extended under I.R.C. § 6501(c)(10) until the participant furnishes the required information or a material advisor meets the disclosure requirements in I.R.C. § 6112.

- **Effect on Material Advisors**: Material advisors who fail to disclose the micro-captive transactions may be subject to a penalty under I.R.C. § 6707. Material advisors who fail to maintain the required lists of participants (or fail to provide the list to the IRS when requested to do so) may be subject to a penalty under I.R.C. § 6708(a). Additionally, the IRS may assert a return preparer penalty under I.R.C. § 6694, a penalty for promoting abusive tax shelters under I.R.C. § 6700, or a penalty for aiding and abetting understatement of tax liability under I.R.C. § 6701.

- **Amended Returns**: Treasury urges taxpayers who have filed tax returns taking advantage of micro-captive listed transactions or micro-captive transactions of interest to consider filing

amended returns prior to discovery by the IRS.

Conclusion

The proposed regulations illustrate that the IRS is responding to the Administrative Procedure Act challenges to its method of identifying listed and reportable transactions. The IRS has a deeper understanding of abusive micro-captive transactions than when it issued Noticed 2016-66 and will continue to pursue them aggressively. Taxpayers and material advisors who have participated in similar micro-captive transactions may wish to consult with their tax advisors to understand how the proposed regulations may affect them if they are adopted.

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