

Urgent Captive Insurance Alert: IRS Lists 831(b) Micro-Captives as “Transaction of Interest”

Articles November 2, 2016

On November 1, 2016, via Notice 2016-66 (2017-47 IRB) ([link to notice](#)), the Treasury Department and IRS declared certain captive insurance transactions under Code section 831(b) as “transactions of interest.” Commonly referred to as micro-captive transactions, the IRS believes these transactions have the “potential for tax avoidance or evasion,” and therefore it has now implemented significant reporting responsibilities on taxpayers, material advisors and promoters, coupled with potentially substantial penalties for non-compliance.

In summary, while conceding that some related parties use captive insurance companies pursuant to section 831(b) for “legitimate risk management purposes that do not involve tax avoidance,” the IRS is identifying the following type of transaction — and substantially similar transactions — as reportable transactions under Sections 6111 and 6112 of the Code, as of November 1, 2016:

- (a) A, 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 A, Insured, or persons related to A 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 C;
- (c) Captive makes and election under § 831 (b) to be taxed only on taxable investment income;
- (d) A, Insured, or one or more persons related (within the meaning of § 267(b) or 707(b)) to A or Insured directly or indirectly own at least 20 percent 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 (defined in section 2.02 of the notice) is less than 70 percent 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 convey to A, Insured, or a person related (within the meaning of §267(b) or 707(b)) to A or Insured (collectively, the “Recipient”) 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.

Importantly, any person who entered into such a transaction on or after **November 2, 2006** must disclose the transaction as described in Treas. Reg. 1.6011-4, and further, material advisors who were involved in the transaction(s) on or after **November 2, 2006**, have disclosure and list maintenance obligations under Code sections 6111 and 6112. The IRS further notifies taxpayers that it may also challenge positions taken as part of a micro-captive “transaction of interest” pursuant to other relevant sections of the Code, as well as common law doctrines of economic substance and sham transaction.

In short, taxpayers who have established or operated a captive insurance company or companies, which elected to be taxed pursuant to section 831(b), must contact their advisors immediately to determine whether they must report their participation via Form 8886 Reportable Transaction Disclosure Statement with the Office of Tax Shelter Analysis (OTSA) in Ogden, Utah as well as include the form with the applicable income tax return(s) for the year(s) at issue. Captive managers, their counsel, tax preparers and others must also determine if they are “material advisors,” giving rise to certain record-keeping obligations in addition to any potential reporting obligations via Form 8918 or otherwise.

Failure to timely report as required will subject the party to potential section 6707A penalties as well as possible accuracy related penalties under sections 6662 or 6662A.

Act Now: The deadline for filing(s) with OTSA will be on or before January 30, 2017.J

If you have questions regarding Notice 2016-66, and how it might impact your captive insurance company, please contact William T. Harvey or Brian J. Kahle.