Tax Alert

Micro-Captive Transactions Under Scrutiny in New IRS Reporting Requirements



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The Internal Revenue Service (IRS) has increased efforts focusing on abusive tax shelters and structures which the IRS is aware of that have been used by taxpayers to avoid paying taxes. These tax schemes remain on its annual list of tax scams known as the "Dirty Dozen" list. Included in the Abusive Tax Shelter category is the use of legitimate tax structures involving small or "micro-captive" insurance companies (see IR-2016-25). To help aid the IRS in identifying which arrangements should be identified as tax avoidance transactions versus legitimate insurance arrangements, the IRS issued Notice 2016-66 ("Notice") on November 1, 2016, which imposes significant disclosure requirements for certain "micro-captive" transactions. For those taxpayers participating in this newly identified Transaction of Interest, disclosure will be required by January 30, 2017. The disclosure is intended to help the IRS identify those transactions that are tax avoidance structures. When the Treasury Department and the IRS have gathered enough information regarding potentially abusive Internal Revenue Code ("IRC") § 831(b) arrangements, they may take one or more actions, including removing the transaction from the transactions of interest category in published guidance, designating the transaction as a listed transaction, or providing a new category of reportable transaction.

Overview

A typical micro-captive structure consists of a person ("A") who, directly or indirectly, owns an interest in an entity, or entities, ("Insured") conducting a trade or business. A, or persons related to A, or both, also directly or indirectly own another entity, or entities ("Captive").



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Exactly Right.

Through various types of insurance or reinsurance contracts, the Captive assumes the business risks of the Insured. The Insured makes payments to the Captive under the Contract, treats the payments as insurance premiums and deducts the payments as ordinary and necessary business expenses under Internal Revenue IRC § 162. The Captive treats the payments received from the Insured under the Contract as premium income for insurance coverage. If the Captive is not a domestic corporation, the Captive makes an election under IRC § 953(d) to be treated as a domestic corporation. The micro-captive transaction is structured so that the Captive has no more than \$1,200,000 in net premiums written (or, if greater, direct premiums written) for each taxable year (\$2,200,000 for taxable years beginning after December 31, 2016) in which the transaction is in effect, which meets the criteria of IRC § 831(b), to be treated as a small insurance company, which if elected, then taxes the Captive only on its taxable investment income and excludes the premiums from the taxable income.

Potential Tax Avoidance or Evasive Insurance Transactions

The notice lists the criteria for a "micro-captive transaction" that is considered to have potential for tax avoidance or evasion. However, the IRS lacks sufficient information to identify IRC § 831(b) arrangements that are considered to be structured as tax avoidance transactions. Some of the criteria, not all inclusive, that are part of the micro-captive transaction are as follows:

1) Promotor:

- a. Promoter markets the micro-captive transaction to A
- b. Promoter and persons related to the Promotor provide services to the captive, which includes:
 - i. Contract forms, captive management and back office services including tax filings.

2) Contract Coverage

- a. Coverage involves implausible risk
- b. Coverage does not match business need or insured's risk
- c. Coverage scope in Contract is vague
- d. Coverage duplicates coverage already provided to insured by unrelated party

3) Payments (premiums) to Captive

- a. Insured's payments are designed to provide the insured with a tax deduction of a particular amount
- b. Payments are determined without an underwriting/actuarial analysis that conforms to industry standards
- c. Payments significantly exceed prevailing rates by unrelated third party insurers.
- d. If insured includes multiple entities, the allocation amongst insured entities does not reflect the actuarial or economic measure of the risk in each entity

4) Claim Procedures and Management of Captive

- a. Captive fails to comply with some or all of the laws applicable to insurers in the jurisdiction where the Captive is domiciled
- b. Captive fails to issue policies/binders in a timely manner that is consistent with industry standards
- c. Claims administration procedures

5) Captive's Capital

- a. Inadequate capital to assume risks
- b. Capital invested in illiquid or speculative assets not normally held by insurers
- c. Captive loans or otherwise transfers capital to Insured or affiliates of the Insured, A or persons related to A





Also, note in certain cases the Captive indirectly enters into a contract by reinsuring risks that the Insured has initially insured with an intermediary Company C. In these cases, if the criteria above are present in this arrangement and the promoter markets the transaction to A, that transaction is of interest to the IRS as well.

If some or many of the factors above are present, the insurance transaction may not constitute a valid insurance contact and accordingly the insured would be denied an insurance deduction. Additionally, if the captive does not provide insurance, the captive does not qualify as an insurance company and its election under IRC § 831(b) would be invalid.

It is worth noting that while many legitimate Captives may very well meet the Transaction of Interest criteria, subjecting them to the new disclosure requirements, but that does not taint legitimate Captives.

Transaction of Interest

In order to aid the IRS in determining if a micro-captive transaction risk exists, Notice 2016-66 identifies specific IRC § 831(b) Captives the IRS would like to gather additional information about. This Transaction is as follows:

- 1. A, a person, directly or indirectly owns an interest in an entity (or entities), the "Insured," conducting a trade or business;
- 2. An entity (or entities) directly, or indirectly owned by A, Insured, or persons related to A or Insured, Captive then enters into a contract(s) with Insured that Captive and Insured treats as insurance, or reinsures risk the Insured insures with an intermediary with the captive;
- 3. Captive makes an IRC §831(b) election to be taxed only on its investment income;
- 4. Captives where the owner or persons related to the owner of the insured parent, directly or indirectly, owns at least 20 percent of the voting power in the Captive (the attribution rules under IRC § 267(b) apply); *and*
- 5. One or both of the following apply:
 - a. The amount of liabilities incurred by the Captive for insured losses and claim administration expenses over a five-year period is less than 70 percent of:
 - i. Premiums earned by the Captive during that period, minus
 - ii. Policyholder dividends paid by the Captive during that period, or
 - b. The Captive that has made available as financing to A, the insured or related persons (the "Recipient") in a transaction that did not result in taxable income or a gain to the Recipient, any portion of the payments in the contract, such as a guarantee, loan or other transfer of the Captive's capital.

Under Treasury Regulation § 1.6011-4(c)(3)(i)(E), A, Insured, Captive, and, if applicable, Company C are participants in the transaction of interest for each year in which their respective tax returns reflect tax consequences or a tax strategy of a transaction of interest described in the notice.

Information Requested

The disclosure is satisfied by submitting Form 8886, *Reportable Transaction Disclosure Statement*. For Material Advisor's this is satisfied by filing Form 8918, *Material Advisor Disclosure Statement*. For all participants, Form 8886 must describe the transaction in sufficient detail, including, but not limited to when and how the taxpayer became aware of the transaction.





The Captive's reporting requirements include additional information, but are not limited to the following:

- 1) Reason for reporting;
- 2) Describing the authority under which the Captive is chartered;
- 3) A description of the types of coverage provided by the Captive;
- 4) A description of any claims paid by the Captive during the year(s) of participation and the amount of, and reason for any loss reserves reported by the Captive on the annual statement;
- 5) Descriptions of how the amounts treated as premiums during the year(s) of participation were determined, including the name and contact of any actuary or underwriter who assisted in these determinations, and
- 6) A description of the assets held by the Captive during the year(s) of participation, and identification of related parties involved in any transactions with respect to those assets.

Time Period for Disclosure

Effective November 1, 2016, persons entering into these transactions on or after November 2, 2006, <u>must</u> disclose the transaction by **January 30, 2017** (90 days after the IRS issued this Notice per Treasury Regulation §1.6011-4(e)(2)) for all open tax years by filing Form 8886 with Office of Tax Shelter Analysis (OTSA). What this means is that disclosure is required for all open tax years ending after November 1, 2006 that include a Transaction of Interest.

In addition, going forward, pursuant to Treasury Regulation §1.6011-4(e), "the disclosure statement for a reportable transaction must be attached to the taxpayer's tax return for each taxable year for which a taxpayer participates in a reportable transaction. In addition, a disclosure statement for a reportable transaction must be attached to each amended return that reflects a taxpayer's participation in a reportable transaction. A copy of the disclosure statement must be sent to the OTSA at the same time that any disclosure statement is first filed by the taxpayer pertaining to a particular reportable transaction." As such, for a calendar year taxpayer, with a timely filed extension, this would be September 15, 2017, for the 2016 tax year.

Penalties

Under the penalty regime of IRC § 6707A, Persons who are required to disclose these transactions and fail to do so may be subject to a maximum penalty of \$50,000 and a minimum of \$10,000. In addition, the IRS may impose other penalties on parties involved in these transactions, including the accuracy-related penalty under IRC Sections 6662 or 6662A.

If you are involved in an § 831(b) Captive or plan to be in the future, you should contact your tax advisor immediately as the clock is ticking in meeting the disclosure deadline. Please contact your WeiserMazars tax professional for additional information and to find out how we can help.





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