Client Alert: Micro-Captive Insurance Companies - New IRS Reporting Requirements

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CLIENT ALERT | 11.18.2016

On November 1, 2016, the Internal Revenue Service (IRS) issued Notice 2016-66. The Notice designates certain so-called "micro-captive" insurance company transactions as "transactions of interest" for purposes of Treas. Reg. Sec. 1.6011-4(b)(6), Code Sec. 6111, and Code Sec. 6112. Persons that have entered into such transactions after November 2, 2006, are subject to retroactive disclosure requirements. Those engaging in such transactions going forward also will be subject to disclosure requirements.

A captive insurance company is an entity formed to insure affiliated businesses. The insureds pay premiums to the captive in return for insurance coverage. Those premiums are deducted by the insureds on their federal income tax returns as business expenses. So-called micro-captives can exclude up to $1.2 million of premiums from income if they make an election to do so under Code Sec. 831(b).[1] Micro-captives are taxed only on their investment income. Given this favorable regime of deducting the premiums when paid by the insured without taking those premiums into income by the captive, the IRS is aware of, and has been concerned for some time about potential abuses. For example, in some instances the premiums far exceed what is reasonable as determined by actuarial science, or the insured "risk" has virtually no chance of ever happening.

The Notice broadly defines the captive insurance "transaction of interest" that requires disclosure to the IRS as follows:

(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 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 an election under Code Sec. 831(b) to be taxed only on taxable investment income;

(d) A, Insured, or one or more persons related (within the meaning of Code Secs. 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 Code Secs. 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.

The Notice defines the Computation Period as the most recent five years or if shorter, the entire life of the captive insurance company. Thus, the IRS is specifically scrutinizing captive insurance structures utilizing the Code Sec. 831(b) election to shield premium income where taxable transfers out of the captive are significantly less in amount.

Beginning with the 2016 tax year, taxpayers engaging in such "transactions of interest" must report annually by filing a Form 8886 with their tax return. Similarly, taxpayers involved in “transactions of interest” with captives formed **on or after November 2, 2006** will have to file separate Forms 8886 for each prior year. Those prior year forms **are due by January 30, 2017** and are filed with the Office of Tax Shelter Analysis. *See* Treas. Reg. Sec. 1.6011-4(e)(2)(i). Penalties in the amount of $50,000 or $10,000 for natural persons will be applicable for each failure to timely meet these disclosure requirements. *See* Code Sec. 6707A. Material advisors (e.g., a tax advisor providing advice regarding the tax benefits of the structure prior to formation) also must report such transactions to the IRS.

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[1] This $1.2 million limit is increased to $2.2 million beginning in 2017.