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Micro-Captive Insurance (Notice 2016-66)

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Transaction of Interest -- Section 831(b) Micro-Captive Transactions

Notice 2016-66

The Department of the Treasury (“Treasury Department”) and the Internal Revenue Service (the “IRS”) are aware of a type of transaction, described below, in which a taxpayer attempts to reduce the aggregate taxable income of the taxpayer, related persons, or both, using contracts that the parties treat as insurance contracts and a related company that the parties treat as a captive insurance company. Each entity that the parties treat as an insured entity under the contracts claims deductions for premiums for insurance coverage. The related company that the parties treat as a captive insurance company elects under § 831(b) of the Internal Revenue Code (the “Code”) to be taxed only on investment income and therefore excludes the payments directly or indirectly received under the contracts from its taxable income. The manner in which the contracts are interpreted, administered, and applied is inconsistent with arm’s length transactions and sound business practices. The Treasury Department and the IRS believe this transaction (“micro-captive transaction”) has a potential for tax avoidance or evasion. See IR-2016-25 (discussing characteristics of an abusive micro-captive insurance structure). However, the Treasury Department and the IRS lack sufficient information to identify which § 831(b) arrangements should be identified specifically as a tax avoidance transaction and may lack sufficient information to define the characteristics that distinguish the tax avoidance

transactions from other § 831(b) related-party transactions. This notice identifies the transaction described in section 2.01 of this notice and substantially similar transactions as transactions of interest for purposes of § 1.6011-4(b)(6) of the Income Tax Regulations and §§ 6111 and 6112 of the Code. This notice also alerts persons involved in such transactions to certain responsibilities and penalties that may arise from their involvement with these transactions.

SECTION 1. BACKGROUND

.1 Overview of Transaction

In the micro-captive transaction, A, a person, directly or indirectly owns an interest in an entity (or entities) (“Insured”) conducting a trade or business. A, persons related to A, or both, also directly or indirectly own another entity (or entities) (“Captive”).

In some cases, Captive enters into a contract (or contracts) (the “Contract”) with Insured as discussed below in section 1.02 of this notice. In these cases, Captive may enter into a reinsurance or pooling agreement under which a portion of the risks covered under the

Contract are treated as pooled with risks of other entities, and Captive assumes risks from other entities as also discussed below in section 1.02 of this notice.

In other cases, Captive indirectly enters into the Contract by reinsuring risks that Insured has initially insured with an intermediary, Company C, as discussed below in section 1.03 of this notice.

.2 Cases in Which Captive Enters into the Contract with Insured

(a) In general. In cases in which Captive enters into the Contract with Insured, Captive and Insured treat the Contract as an insurance contract for federal income tax purposes. Captive provides coverage for Insured.

Captive may offer coverage only to persons related to or affiliated with Insured. If Captive also offers coverage to persons that are not related to or affiliated with Insured, Captive typically offers coverage only to other entities represented by a person who promotes the micro-captive transaction. Captive may enter into a reinsurance or pooling agreement under which a portion of the risks covered under the Contract are treated as pooled with risks of other entities and Captive assumes risks from other entities. Typically, the other entities participating in the reinsurance or pooling agreement are also represented by a person who promotes the micro-captive transaction.

Insured makes payments to Captive under the Contract, treats the payments as insurance premiums that are within the scope of § 1.162-1(a), and deducts the payments as ordinary and necessary business expenses under § 162. Captive treats the payments received from Insured under the Contract as premiums for insurance coverage. If Captive is not a domestic corporation, Captive makes an election under § 953(d) to be treated as a domestic corporation. The micro-captive transaction is structured so that 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. Captive makes an election under § 831(b) to be taxed only on taxable investment income and excludes the premiums from taxable income.

(b) Promoter. A promoter (“Promoter”) typically markets the micro-captive transaction structure to A. Promoter, persons related to Promoter, or both, typically provide continuing services to Captive, including:

- (1) providing the forms used for the Contract;
- (2) management of Captive; and
- (3) administrative, accounting, or legal services, including the filing of tax forms.

(c) Contract coverage. The coverage provided by Captive under the Contract has one or more of the following characteristics:

- (1) the coverage involves an implausible risk;
- (2) the coverage does not match a business need or risk of Insured;

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