ALERT

Micro-Captive Insurance Companies: New IRS Reporting

NOVEMBER 29, 2016

On November 1, 2016, the IRS issued Notice 2016-66 identifying when a micro-captive insurance company is a "transaction of interest" that must file a disclosure statement with the IRS. Taxpayers who participate in a reportable captive after November 1, 2006 (not 2016) must file a disclosure statement each year with their original or amended tax returns. In addition, **the first disclosure statement for prior taxable years is due on May 1, 2017.** Taxpayers required to file the disclosure statement include the insured business and its owners, the captive insurance company, and any material advisors.

Captive Insurance Company

A captive insurance company is an insurance company formed by a business or a business owner to insure the risks of the business and related or affiliated businesses. A captive also may be formed by multiple businesses or business owners from different companies, which is generally referred to as a group captive.

A small (micro-captive) insurance company can make a special election under IRC Section 831(b) to be taxed only on investment income and exclude the premiums from taxable income. The election is only available when net premiums written (or, if greater, direct premiums written) for each taxable year do not exceed $1.2 Million ($2.2 Million for taxable years beginning after December 31, 2016).

Protecting Americans from Tax Hikes (PATH) Act

IRC Section 831(b) was amended by the PATH Act of 2015, which became law on December 18, 2015. Under the PATH Act, Congress:

1. Increased the amount of underwriting income that may be excluded from taxable income annually from $1.2 Million to $2.2 Million;
2. Indexed the $2.2 Million ceiling for 2016 and future years; and
3. Added a diversification requirement and an alternative ownership test.

To satisfy the diversification requirement, no one policyholder may pay more than 20% of the annual net written premiums or if greater, direct written premiums. All policyholders who are related under Sections 267(b) and 707(b) and members of the same controlled group, are treated as a single policyholder.

Alternatively, if the diversification requirement is not met, then the ownership test applies whereby the ownership of the captive must be substantially the same (within 2%) as the ownership of the business or assets insured. The intent of this provision is to prevent taxpayers from avoiding gift and estate taxes using insurance premiums paid to a small captive insurance company that is owned by a child or grandchild of the owner of the insured business.

Characteristics of an Abusive Micro-Captive

The Treasury Department and the IRS recognize that related parties may use captive insurance companies that make elections under IRC Section 831(b) for risk management purposes that do not involve tax avoidance, but believe that there are cases in which the use of such arrangements to claim the tax benefits of treating a contract as insurance is improper. If it is ultimately determined that the transaction does not constitute insurance, then the insured business is not entitled to deduct the amount of the insurance premiums paid as a business expense and the captive does not qualify as an insurance company, and its election under IRC Section 831(b) is invalid.

The Treasury Department and the IRS have identified the following characteristics of an abusive micro-captive insurance structure:

- The covered risk is highly unlikely to occur, the business doesn't need the coverage, the coverage is poorly described in the insurance contract, or the coverage is the same or similar to coverage that can be obtained from a commercial insurance company and possibly for a smaller premium.
- The premium is set at a specific amount, the premiums are determined without an underwriting or actuarial analysis using insurance industry standards, or the allocation of premiums among a group of insured's does not reflect the actuarial or economic measure of risk of each entity.
- The taxpayer doesn't follow the payment schedule in the insurance contract.
- The captive fails to comply with applicable laws or regulations in the jurisdiction where it operates, the captive does not issue policies or binders in a timely manner, or the captive does not have a defined claims administration procedure consistent with industry standards.
- The insured fails to file claims for each loss event that is covered.
- The captive does not have adequate capital, invests in illiquid or speculative assets not usually held by insurance companies, or loans or otherwise transfers its capital to insured, its owners, or related persons in a nontaxable transaction.

IRS Notice 2016-66

On November 1, 2016, the IRS issued Notice 2016-66 identifying certain transactions relating to micro-captive insurance companies as a "transaction of interest." Regardless of whether the micro-captive has any of the above characteristics of an abusive micro-captive insurance structure, a micro-captive is a "transaction of interest" if it meets the following criteria:

1. An owner of a business (Owner) or related person to the Owner, owns an interest in a captive insurance company (Captive);
2. Captive directly or indirectly insures risks of the Owner's business (Insured);
3. Captive makes the IRC Section 831(b) election;
4. Owner, Insured, or related persons own at least 20% of the voting power or value of the captive's stock; and
5. One or both of the following apply:
   - **a.** Captive's liabilities for Insured's losses and claim administrative expenses during the most recent five taxable years is less than 70% of premiums earned less dividends paid; or
   - **b.** Captive has at any time during the most recent five taxable years made capital available through a guarantee, a loan, or other transfer of captive's capital to Owner, Insured, or related persons in a nontaxable transaction.

If the captive provides insurance for employee compensation or benefits and has received a Prohibited Transaction Exemption from the Employee Benefits Security Administration of the U.S. Department of Labor, then the captive is not a transaction of interest and is exempt from disclosure.

Who Must Disclose?

Taxpayers who participate in a reportable captive after November 1, 2006 (not 2016), must file a disclosure statement each year with their original or amended tax return. Those taxpayers include the insured business and its owners, the captive insurance company, and any material advisors. A material advisor is a person who provides advice or assistance with respect to organizing, managing promoting, or carrying out any reportable transaction, and derives gross income in excess of $50,000.

How to Disclose

Form 8886, Reportable Transaction Disclosure Statement, must be attached to the taxpayer's tax return (including amended returns and loss carry back claims) for each taxable year in which the taxpayer participates in the reportable transaction. A copy of Form 8886 must be sent to the IRS' Office of Tax Shelter Analysis (OTSA) at the same time that any disclosure statement is first filed by the taxpayer. **If the taxpayer has participated in a reportable captive in a prior taxable year, then the taxpayer must file the first Form 8886 with OTSA by May 1, 2017.**

The disclosure must provide sufficient detail regarding the tax structure, the parties involved, and when and how the taxpayer became aware of the transaction.

Penalties

The penalty for failing to file Form 8886 with the return is 75% of the decrease in tax resulting from the transaction with a minimum penalty of $10,000 ($5,000 for individual taxpayers) and a maximum penalty of $50,000 ($10,000 for individual taxpayers).

Taxpayers who own an interest in a micro-captive insurance company should consult their tax advisor regarding the PATH Act amendments to IRC Section 831(b), and whether the captive is a "transaction of interest" per IRS Notice 2016-66.