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Insurance

In the sixth article in a series from Mayer Brown LLP discussing the Internal Revenue Service enforcement campaign effort, George Craven, Paul DiSangro, and William Schmalzl look at the IRS's focus on micro-captive insurers taxed only on investment income under Section 831(b). ''If Congress loves Section 831(b) companies, the Internal Revenue Service doesn't,'' the authors write.

LB&I's 'Campaign' Against Micro-Captives Takes An IRS Dirty Dozen Item to the Corporate Boardroom

By George Craven, Paul DiSangro, and William Schmalzl

The Internal Revenue Service has challenged captive insurance company arrangements for half a century, typically to no avail. The latest challenge is a ''campaign'' on ''micro-captive'' insurance companies. A micro-captive is a small property and casualty insurance company that under tax code Section 831(b) can elect to be taxable only on its investment income (without being taxed on its premium or underwriting income).

Micro-captives typically insure risks of related parties, which deduct the premiums paid to the micro-captive. Many corporate taxpayers rely on micro-captives to insure against risks that commercially available insurance can't feasibly cover.

The last year and a half has been the best of times and the worst of times for micro-captives. In December 2015, in the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act), Congress expanded from $1.2 million to $2.2 million the amount of premium income that a small property and casualty insurance company electing the benefit of Internal Revenue Code Section 831(b) may receive without being subject to tax on its premium or underwriting income. In addition, Congress provided for an inflation adjustment of the $2.2 million limit starting in 2016.

Paul DiSangro and William Schmalzl are partners in Mayer Brown LLP's Tax Controversy & Transfer Pricing practice, and George Craven is a partner in the firm's Tax Transactions & Consulting practice. Schmalzl and Craven are based in Chicago, and DiSangro is based in Palo Alto, Calif.

Section 831(b) clearly has legitimate uses, and powerful defenders of these legitimate uses. Senate Finance Committee member Charles Grassley (R-Iowa) has pointed out that the PATH Act changes help ''to ensure that small mutual insurance companies will continue to be able to serve rural residents who have unique circumstances, such as living far from a fire station, and so are often unable to obtain private property insurance through traditional insurance ''companies.'' (News release by Sen. Grassley, Dec. 16, 2015; https://www.grassley.senate.gov/news/news-releases/grassley-secures-victories-wind-energy-production-college-savings-plans-taxpayer.)

But if Congress loves Section 831(b) companies, the Internal Revenue Service doesn't. In November 2016, the IRS in Notice 2016-66 identified insurance transactions between Section 831(b) companies and a related person as ''Transactions of Interest'' because of ''potential for tax avoidance or evasion.'' On Jan. 31, the IRS listed micro-captive insurance as one of the 13 areas for its initial round of ''compliance campaigns.'' The IRS announced that this campaign will be conducted through ''issue-based examinations,'' which is a more direct challenge to taxpayers than many of the other campaigns, which are being implemented through published guidance or training of IRS personnel.

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And then, in February, the IRS for the third consecutive year included Section 831(b) small captive insurance companies on its annual tax filing season ''Dirty Dozen'' list of tax scams.

Although the IRS is obviously concerned that certain micro-captives could be a source of tax abuse, the announced campaign appears to be as much an exploratory expedition as a targeted offensive. Speaking at the American Bar Association meeting on May 12, Thomas J. Kane, division counsel in the IRS Office of Chief Counsel (Tax Exempt and Government Entities), indicated that the IRS doesn't view all micro-captives as bad. Learning more about how micro-captives are used and improving identification of problem areas appears to be a major thrust of the campaign.

While his general observations were seemingly benign, Kane added a concerning fact—the IRS currently has 300 pending cases against taxpayers with micro-captives. The IRS position on which micro-captives are abusive remains unstated, but the IRS did indicate during its April 20 webinar on campaigns that the captives affected by the PATH Act or described in Notice 2016-66 would be the focus of the campaign.

Micro-Captives Affected by the PATH Act

The reference to the PATH Act is likely a reference to the new limitation on the use of Section 831(b)—the ''diversification requirement.'' An electing small insurance company can satisfy the ''diversification requirement'' by having no more than 20 percent of its net written premiums (or, if greater, direct written premiums) attributable to any one policyholder.

The diversification requirement in the PATH Act addresses one of the concerns that led the IRS to place micro-captives on its ''Dirty Dozen'' list—the use of Section 831(b) companies for ''estate planning'' purposes.

If the insurance company doesn't meet the ''no more than 20 percent from any one insured'' test, the code provides that the diversification requirement is satisfied if no individual holder of an interest in the insurance company (or certain of his or her relatives) holds a percentage ownership in the insurance company that is more than a de minimis amount greater than the percentage ownership held by that individual holder (or certain relatives) in the trades or businesses, rights or assets with respect to which the insurance company receives premiums.

The diversification requirement in the PATH Act addresses one of the concerns that led the IRS to place micro-captives on its ''Dirty Dozen'' list—the use of Section 831(b) companies for ''estate planning'' purposes. The IRS concerns can be illustrated by considering a situation where the children of a business owner establish a Section 831(b) company that receives $1 million in premiums entirely from the children's father for insurance of risks in the father's business in which they have no ownership interest. Further assume that the father doesn't incur any losses covered by the policy. Assuming all of the requirements for an insurance company are met, prior to the PATH Act, the father would have been able to deduct $1 million and the children's insurance company would recognize no income on the receipt of the premium.

The IRS perceives this transaction to be an abusive means to move $1 million out of the father's estate. The validity of this IRS perception is debatable. If the insurance company had incurred $990,000 of losses leaving a profit of only $10,000, the impact on the father's estate would be no different than if the children had set up a cleaning business that earned a $10,000 profit. While having no claims under an insurance policy is hardly unusual, the assumed fact that no losses were incurred may warrant investigating whether this was a real insurance transaction. But if the insurance transaction is valid, the collateral impact on the father's estate doesn't appear to be a cause for concern.

Regardless of whether these transactions present an estate tax concern, the PATH Act responded to the IRS concern by adding the diversification requirement to Section 831(b). After the PATH Act, the insurance company in the above example would fail the diversification requirement since the children's interest in the insurance company (100 percent) is greater than their interest in the father's business (zero percent). The insurance company in this example could satisfy the diversification requirement if it was owned wholly by the father or if the father and the children each had 50 percent interests in both the insurance company and the insured business.

The diversification requirement makes the estate planning aspect less prevalent since any profit earned by the insurance company benefits the same individuals who own the underlying business. In any event, the micro-captive campaign likely will focus carefully on any variations in ownership between the micro-captive and the insured in an effort to address this perceived abuse.

Micro-Captives Designated As 'Transactions of Interest'

The reference to Notice 2016-66 is a reference to certain ''micro-captive transactions'' designated as ''Transactions of Interest.'' See Notice 2016-66, 2016-47 IRB 745, issued Nov. 1, 2016. The notice first described possible abuses of the small company exception, including such transaction features as coverage of an implausible risk, coverage not matching a business need or risk of the insured, premium amounts being determined without an underwriting or actuarial analysis conforming to insurance industry standards, or payments significantly exceeding the premium prevailing for coverage offered by unrelated commercial insurance companies.

In the notice, the IRS stated that it didn't have sufficient information to identify those transactions used for tax avoidance, or to distinguish tax avoidance transactions from legitimate transactions. The notice designated certain Section 831(b) transactions as ''Transactions of Interest'' and required participants in those transactions to disclose information about the transactions to the IRS so that the IRS may study the subject transaction. The designated transactions are those in which:

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- the insured person, or a related person, owns 20 percent or more of the voting power or value of an insurance company electing to be taxed solely on its investment income under Section 831(b); and
- the Section 831(b) company either has a less-than-70-percent loss ratio over the most recent five-year period, or has made its assets available as financing (or by other non-taxable means) to the insured or a related party over the same five-year period.

The notice requires all participants and ''material advisers'' to file Form 8886, Reportable Transaction Disclosure Statement, identifying the transaction in sufficient detail for the IRS to understand the structure of the transaction and the identity of all participants. Filers must also disclose when and how they became aware of the transaction.

The insurance company must report whether it is reporting because of a less-than-70-percent loss ratio or because it provided financing to an affiliate, or both. The insurance company must also report the type of coverage it provided, how premiums were determined (including the name of any actuary or underwriter who participated in the premium determination), the company's claims paid and reserves, and a description of the assets held by the company.

Two advisers to micro-captives sought a preliminary injunction in U.S. District Court to stop the notice's reporting requirements, but on April 21 the judge, citing the Anti-Injunction Act, upheld the reporting requirements (*CIC Services, LLC v. IRS*, No. 3:17-cv-00110 (E.D. Tenn. 2017)).

Alexis MacIvor, insurance branch chief in the IRS's Office of Associate Chief Counsel, on June 2 announced that the IRS's Office of Tax Shelter Analysis was beginning to review the data micro-captive insurers reported to the agency in May. At a Federal Bar Association event, he said of the review process: ''At the end, we may remove the transaction as a transaction of interest. We may make a listed transaction. We may do a combination of a listing notice and a transaction of interest.''

How to Handle a Micro-Captive Campaign Audit? Focus on the Facts and Business Purpose

We have represented several taxpayers in IRS audits in which agents have alleged abuses that are similar to those described in the notice (e.g., implausible risk, excessive premiums, etc.) as well as other alleged abuses not described in the notice (e.g., undercapitalization, non-homogenous risks, etc.). To develop a case against a taxpayer, agents have been issuing a standardized information document request that asks more than 30 highly detailed questions about the micro-captive transaction as well as about its genesis and all communications among all persons involved.

The allegations in micro-captive cases tend to be highly fact specific and, in our experience, are best managed by proactively providing factual documentation and business purpose context to support the elements that the agents find questionable. In IRS Appeals, we have largely sustained the original tax treatment of the parties with this approach.

In one case, what carried the day in Appeals was to show that the insured risk had resulted in losses for the taxpayer in prior periods, that the Section 831(b) company had distributed its risk among an adequate number of relatively homogenous risks, and that commercial insurance wasn't otherwise available. In another case, it was a robust third-party actuarial study and a showing that the Section 831(b) company was actively managing the risk that demonstrated the substance of a legitimate insurance transaction.

It remains to be seen whether this generally favorable playing field for taxpayers will continue in the administrative forums now that micro-captives are the subject of an IRS campaign.

Regardless of how effective the IRS's campaign is, the playing field for Section 831(b) may change soon. Two cases involving Section 831(b) have been tried in the U.S. Tax Court. *Avrahami v. Commissioner* was tried in March 2016 and *Wilson v. Commissioner* was tried in August 2016. All of the briefs have been filed in *Avrahami*, and, in theory at least, the case could be decided at any time. *Avrahami* involves a Section 831(b) micro-captive that insured a related-party jewelry business against terrorism risk. Regardless of the outcome in *Avrahami*, the fact that the IRS launched one of its 13 campaigns around Section 831(b) indicates that we may still be in the early innings of the Section 831(b) ballgame.