Office of Chief Counsel
Internal Revenue Service
Memorandum

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SB/SE Examination
LB&I Examination

from: Office of Chief Counsel, IRS
SB/SE Area 5: Las Vegas
110 N. City Parkway, Ste. 301
Las Vegas, NV 89106

Subject I.R.S. Notice 2016-66, Transaction of Interest – Section 831(b) Micro-Captive Transactions

Promoter:

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Question Presented

Whether the captive insurance transactions promoted by , are the same as, or substantially similar to, the "section 831(b) micro-captive transactions" identified as transactions of interest in I.R.S. Notice 2016-66, 2016-47 I.R.B. 745 (Nov. 21, 2016) ("Notice 2016-66"), and modified by Notice 2017-8, 2017-3 I.R.B. 423 (December 30, 2016).

Brief Answer

Yes, we conclude that the variant of the micro-captive insurance transactions promoted by are the same as, or substantially similar to, the transaction of interest described in Notice 2016-66.

In addition, this memorandum summarizes the disclosure rules under Treas. Reg. § 1.6011-4 for participants as well as under I.R.C. §§ 6111 and 6112 for material advisors, as well as associated penalties. As a transaction of interest, participants and material advisors with respect to the transaction are subject to disclosure requirements. Participants are required to disclose the transaction under I.R.C. § 6011, and failure to comply with the disclosure obligation may support a penalty under I.R.C. § 6707A. Material advisors with respect to the transaction are required to disclose the transaction under I.R.C. § 6111 and maintain a list of their advisees under I.R.C. § 6112. Failure by material advisors to disclose the transaction may support a penalty under I.R.C. § 6707, and failure to comply with the list maintenance obligations may support a penalty under I.R.C. § 6708. Other penalties may also be applicable to parties involved in the transaction, including the reportable transaction understatement penalty under I.R.C. § 6662A. The determination of whether a person is a participant or a material advisor and whether they have a disclosure obligation must be made separately for each potential participant or material advisor.

Background

I. Overview of Reportable Transactions and Penalty Regime

The American Jobs Creation Act of 2004 (AJCA), Public Law 108-357, substantially enhanced the statutory tools available to the Service to combat abusive non-compliant tax shelter transactions. The AJCA substantially revised rules requiring disclosure by persons that facilitate and sell tax shelters as well as their clients, and also expanded and enhanced the penalties for failure to comply with the disclosure rules. The AJCA disclosures and penalty regime applies to a broad range of transactions referred to as “reportable transactions”. Treas. Reg. §§ 1.6011-4(a) and (b). Among the categories of reportable transactions are “listed transactions”, “confidential transactions”, “transactions with contractual protection”, “loss transactions”, and “transactions of interest”. Treas. Reg. § 1.6011-4(b).

Consistent with Notice 2016-66, the focus of this memorandum is the transaction of interest. The following describes the disclosure requirements applicable to a transaction of interest and the associated penalties.

A. Disclosure By Participants

Every taxpayer that has participated, as described in Treas. Reg. § 1.6011-4(c)(3), in a reportable transaction within the meaning of Treas. Reg. § 1.6011-4(b) and who is required to file a tax return must file within the time prescribed in Treas. Reg. § 1.6011-4(e) a disclosure statement in the form prescribed by Treas. Reg. § 1.6011-4(d). Treas. Reg. § 1.6011-4(a).

The Treasury Regulations under § 1.6011-4 specify the types of transactions

that are considered reportable transactions. Among these transactions are transactions of interest, *i.e.*, transactions that are the same or substantially similar to a transaction the IRS has identified as a transaction of interest by notice, regulation, or other published guidance. Treas. Reg. § 1.6011-4(b)(1) and (6).

A transaction is "substantially similar" if it is expected to obtain the same or similar types of tax consequences and is factually similar or based on the same or similar tax strategy. Treas. Reg. § 1.6011-4(c)(4). "Substantially similar" is broadly construed in favor of disclosure. *Id.*

A taxpayer has participated in a transaction of interest if the taxpayer is one of types or classes of persons identified as participants in the published guidance describing the transaction of interest. Treas. Reg. § 1.6011-4(c)(3)(i)(E).

The disclosure requirement applies to individuals, partnerships, trusts, estates, and corporations (both subchapter S and subchapter C corporations). I.R.C. § 7701(a)(1); Treas. Reg. § 1.6011-4(c)(1).

A taxpayer required to file a disclosure statement under Treas. Reg. § 1.6011-4 must file a completed Form 8886, "Reportable Transaction Disclosure Statement" (or successor form), in accordance with Treas. Reg. § 1.6011-4(d) and the instructions to the form. The form must be attached to the appropriate tax return(s) as provided in Treas. Reg. § 1.6011-4(e). If a copy of the disclosure statement is required to be sent to the Office of Tax Shelter Analysis (OTSA) under Treas. Reg. § 1.6011-4(e), it must be sent in accordance with the instructions to the form. To be considered complete, the information provided on the form must describe the expected tax treatment and all potential tax benefits expected to result from the transaction, describe any tax result protection (as defined in Treas. Reg. § 301.6111-3(c)(12)) with respect to the transaction, and identify and describe the transaction in sufficient detail for the IRS to be able to understand the tax structure of the reportable transaction and the identity of all parties involved in the transaction. An incomplete Form 8886 (or successor form) containing a statement that information will be provided upon request is not considered a complete disclosure statement. If the form is not completed in accordance with the provisions of Treas. Reg. § 1.6011-4(d) and the instructions to the form, the taxpayer will not be considered to have complied with the disclosure requirements of Treas. Reg. § 1.6011-4. If a taxpayer receives one or more reportable transaction numbers for a reportable transaction, the taxpayer must include the number(s) on the Form 8886 (or successor form). Treas. Reg. § 1.6011-4(d).

If a taxpayer is uncertain about whether a transaction must be disclosed under Treas. Reg. § 1.6011-4, the taxpayer may disclose the transaction in accordance with the requirements of Treas. Reg. § 1.6011-4 and comply with all the provisions of Treas. Reg. § 1.6011-4, and indicate on the disclosure statement that the disclosure statement is being filed on a protective basis. The IRS will not treat disclosure statements filed on a protective basis any differently than other disclosure statements filed under Treas. Reg. § 1.6011-4. For a protective

disclosure statement to be effective, the taxpayer must comply with Treas. Reg. § 1.6011-4 by providing to the IRS all information requested by this IRS under Treas. Reg. § 1.6011-4. Treas. Reg. § 1.6011-4(f)(2).

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 taxpayer's disclosure must also be sent to OTSA simultaneously with the taxpayer's first disclosure filing pertaining to a particular reportable transaction. If a reportable transaction results in a loss which is carried back to a prior taxable year, the disclosure statement for the reportable transaction must be attached to the taxpayer's application for tentative refund or amended tax return for that prior year. The Commissioner in his discretion may issue in published guidance other provisions for disclosure under Treas. Reg. § 1.6011-4. Treas. Reg. § 1.6011-4(e)(1).

If a transaction becomes a transaction of interest after the filing of a taxpayer's tax return (including an amended return) reflecting the taxpayer's participation in the transaction of interest and before the end of the period of limitations for assessment for any taxable year in which the taxpayer participated in the transaction of interest, then a disclosure statement must be filed, regardless of whether the taxpayer participated in the transaction in the year the transaction became a transaction of interest, with OTSA within 90 calendar days after the date on which the transaction becomes a transaction of interest. The Commissioner may also determine the time for disclosure of transactions of interest in the published guidance identifying the transaction. Treas. Reg. § 1.6011-4(e)(2)(i).

B. Disclosure by Material Advisors

Section 301.6111-3(a) provides that each material advisor, as defined in Treas. Reg. § 301.6111-3(b), with respect to any reportable transaction, as defined in Treas. Reg. § 1.6011-4(b), must file a return, as described in Treas. Reg. § 301.6111-3(d) by the date described in Treas. Reg. § 301.6111-3(e). Treas. Reg. § 301.6111-3(a).

A person is a material advisor with respect to a transaction if the person provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and directly or indirectly derives gross income in excess of the threshold amount as defined in Treas. Reg. § 301.6111-3(b)(3) for the material aid, assistance or advice. The term transaction includes all of the factual elements relevant to the expected tax treatment of any investment, entity, plan or arrangement, and includes any series of steps carried out as part of a plan. Treas. Reg. § 301.6111-3(b)(1).

Except as provided in Treas. § 301.6111-3(b)(5), a person provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any transaction if the person makes or

provides a tax statement to or for the benefit of a person described in Treas. Reg. § 301.6111-3(b)(2)(i)(A)-(D). Treas. Reg. § 301.6111-3(b)(2)(i).

A tax statement is any statement (including another person's statement), oral or written, that relates to a tax aspect of a transaction that causes the transaction to be a reportable transaction as defined in Treas. Reg. § 1.6011-4(b)(2) through (7). A tax statement under this section includes that result protection that insures some or all of the tax benefits of a reportable transaction. Treas. Reg. § 301.6111-3(b)(2)(ii).

For transactions of interest, the threshold amounts in Treas. Reg. § 301.6111-3(b)(3)(i)(A) may be reduced as identified in the published guidance identifying the transaction. Treas. Reg. § 301.6111-3(b)(3)(i)(B).

A material advisor required to file a disclosure statement must file a completed Form 8918, "Material Advisor Disclosure Statement" (or successor form) in accordance with Treas. Reg. § 301.6111-3(d)(1) and the instructions to the form. To be considered complete, the form must describe the expected tax treatment and all potential tax benefits expected to result from the transaction, describe any tax result protection with respect to the transaction, and identify and describe the transaction in sufficient detail for the IRS to be able to understand the tax structure of the reportable transaction and identify any material advisor(s) whom the material advisor knows or has reason to know acted as a material advisor as defined in Treas. Reg. § 301.6111-3(b) with respect to the transaction. An incomplete form containing a statement that information will be provided upon request is not considered a complete disclosure statement. A material advisor may file a single form for substantially similar transactions. An amended form must be filed if information previously provided is no longer accurate, additional information becomes available, or if there are material changes to the transaction. If the form is not completed in accordance with the provisions in Treas. Reg. § 301.6111-1(d) and the instructions to the form, the material advisor will not be considered to have complied with disclosure requirements of Treas. Reg. § 301.6111-3. Treas. Reg. § 301.6111-3(d)(1).

Generally the material advisor's disclosure statement for a reportable transaction must be filed with OTSA by the last day of the month that follows the end of the calendar quarter in which the advisor becomes a material advisor with respect to a reportable transaction or in which the circumstances necessitating an amended disclosure statement occur. That disclosure statement must be sent to OTSA at the address provided in the instructions for Form 8918 (or successor form). Treas. Reg. § 301.6111-3(e).

Each material advisor, as defined in Treas. Reg. § 301.6111-3(b), with respect to any reportable transaction, as defined in Treas. Reg. § 1.6011-4(b), shall prepare and maintain a list in accordance with Treas. Reg. § 301.6112-1(b) and shall furnish such list to the IRS in accordance with Treas. Reg. § 301.6112-1(e). Treas. Reg. § 301.6112-1(a).

Section 301.6112-1(b)(1) provides that a separate list must be prepared and maintained for each reportable transaction. However, one list must be maintained for substantially similar transactions. A material advisor will have 30 calendar days from the date the list maintenance requirement first arises (see Treas. Reg. § 301.6111-3(b)(4) and § 301.6112-1(a)) with respect to a reportable transaction to prepare the list that must be maintained under Treas. Reg. § 301.6112-1 with respect to that transaction. A list must be maintained in a form that enables the IRS to determine without undue delay or difficulty the information required in Treas. Reg. § 301.6112-1(b)(3).

Section 301.6112-1(b)(2) provides that the list must identify each person with which the material advisor acted as a material advisor with respect to a reportable transaction. The list also must include certain other information and documentation relating to the transaction, as detailed in Treas. Reg. § 301.6112-1(b)(3).

The material advisor must maintain each component of the list in a readily accessible form for seven years following the earlier of the date the advisor last made a tax statement relating to the transaction, or the date the transaction was last entered into (if known). Treas. Reg. § 301.6112-1(d).

Each material advisor responsible for maintaining a list must, upon written request by the IRS, make each component of the list described in Treas. Reg. § 301.6112-1(b)(3) available to the IRS. Each component of the list must be furnished to the IRS in a form that enables the IRS to determine without undue delay or difficulty the information required in Treas. Reg. § 301.6112-1(b)(3). If any component of the list is not in a form that enables to the IRS to determine without undue delay or difficulty the information required in Treas. Reg. § 301.6112-1(b)(3), the material advisor will not be considered to have complied with the list maintenance provisions in I.R.C. § 6112 and Treas. Reg. § 301.6112-1. A material advisor must make the list or each component of the list available to the IRS within the period prescribed in I.R.C. § 6708 or published guidance relating to I.R.C. § 6708. Treas. Reg. § 301.6112-1(e)(1).

C. Penalties for failing to comply with the disclosure requirements

1. Participant penalty: I.R.C. § 6707A

Under I.R.C. § 6707A(a), any person who fails to include on any return or statement any information with respect to a reportable transaction which is required under I.R.C. § 6011 to be included with such return or statement shall pay a penalty determined under I.R.C. § 6707A(b). Disclosure is made on Form 8886 (or successor form).

For penalties assessed after December 31, 2006, the amount of the penalty is 75 percent of the decrease in tax shown on the return as a result of the reportable transaction (or which would have resulted from such transaction if such transaction were respected for Federal tax purposes), subject to minimum and maximum penalty amounts. *See* I.R.C. § 6707A(b). The minimum penalty amount is $5,000 in the case

of a natural person, and $10,000 in any other case. *See* I.R.C. § 6707A(b)(3). The maximum penalty amount is $10,000 in the case of a natural person and $50,000 in any other case, (or in the case of a listed transaction, $100,000 and $200,000, respectively). *See* I.R.C. § 6707A(b)(2). As enacted in 2004 under the AJCA, the I.R.C. § 6707A penalty was set at higher amounts, which apply for penalties assessed prior to December 31, 2006.

The penalty under I.R.C. § 6707A ("section 6707A penalty") is not subject to deficiency procedures, which means that it is not asserted in a notice of deficiency. Upon the close of an examination on an unagreed basis, after the opportunity for review by the Appeals Office, the penalty is assessed if applicable. *See* Smith v. Commissioner, 133 T.C. 424 (2009).

The section 6707A penalty is sometimes referred to as a strict liability penalty, because there is no reasonable cause exception available as a defense. *See* I.R.C. § 6664(d); *see also* Interior Glass Systems, Inc. v. United States, 2016 WL 4717765 (N.D. Cal. August 12, 2016).

A section 6707A penalty applies in addition to other penalties with respect to a given taxable period. I.R.C. § 6707A(f). Accordingly, for example, the Service may assess a penalty under I.R.C. § 6662A for a particular period, and also assess a section 6707A penalty for failure to disclose relating to the same item for which the I.R.C. § 6662A penalty is asserted.

The section 6707A penalty is not a joint and several liability, even where the penalty is assessed due to a failure to disclose associated with a joint return. The requirement to file a disclosure statement under I.R.C. § 6011 is imposed on those who participate in reportable transactions. If only one spouse is a participant, then only that spouse will be subject to a penalty under I.R.C. § 6707A for failing to make the required disclosure. If each spouse is a participant, then each spouse is subject to a separate section 6707A penalty.

The Service has determined that the statute of limitations on assessment of the section 6707A penalty is determined by reference to the generally applicable statute of limitations with respect to the taxable year to which the return relates. Thus, if disclosure is required under I.R.C. § 6011 as to an individual's timely filed Form 1040 for the taxable year ended December 31, 2007, the statute of limitations on assessment of a penalty under I.R.C. § 6707A expires on April 15, 2011. To extend the statute of limitations on assessment of the section 6707A penalty, it is necessary that the waiver executed by the taxpayer specifically refer to I.R.C. § 6707A. Extension of the assessment statute for the related income tax year does not automatically extend the statute as to the section 6707A penalty. Accordingly, examination should take precautions to protect the assessment statute for the section 6707A penalty at the earliest possible time that a penalty is contemplated.

2. *Material Advisor penalties*

a. Penalty for failing to disclose: I.R.C. § 6707

I.R.C. § 6707 provides that any person required to file a return under I.R.C. § 6111(a) with respect to a reportable transaction who either fails to file such return or files a return with false or incomplete information is subject to a penalty of $50,000 (except in the case of a listed transaction, for which the penalty is the greater of $200,000 or 50 percent of the gross income derived by such person with respect to aid, assistance or advice provided with respect to the listed transaction before the date the return is filed). *See* I.R.C. § 6707(a) and (b).

b. Penalty for failing to maintain list of advisees: I.R.C. § 6708

I.R.C. § 6708(a) provides that if any person required to maintain a list under I.R.C. § 6112(a) with respect to a reportable transaction fails to make such list available to the Secretary upon written request in accordance with I.R.C. § 6112(b) within 20 business days after the date of such request, such person is subject to a penalty in the amount of $10,000 for each day of such failure, after the 20th day. A reasonable cause exception is provided for the I.R.C. § 6708 penalty. *See* I.R.C. § 6708(a)(2). We observe that there is no maximum penalty amount that can be assessed, and there is no statute of limitations on assessment of a penalty under I.R.C. § 6708.

3. Other penalties applicable to reportable transactions

a. Reportable transaction understatement penalty under I.R.C. § 6662A

The reportable transaction understatement penalty provided under I.R.C. § 6662A ("the section 6662A penalty") is effective for tax years ending after October 22, 2004. The reportable transaction understatement penalty is applied at a 30 percent rate where the taxpayer was required to disclose his or her participation in the transaction pursuant to Treas. Reg. § 1.6011-4 and failed to do so. I.R.C. § 6662A(c). The section 6662A penalty is applied at a 20 percent rate where the taxpayer properly disclosed his or her participation or where the taxpayer was not required to disclose his or her participation pursuant to Treas. Reg. § 1.6011-4. I.R.C. § 6662A(a). The section 6662A penalty is subject to deficiency procedures, which means that the penalty is asserted in a notice of deficiency unless the taxpayer waives deficiency procedures.

The section 6662A penalty is triggered by an understatement of tax due that is attributable to a reportable transaction, and the penalty applies to all of such understatement, including the portion of the understatement resulting from automatic computational adjustments to taxable income. For example, where disallowance of a deduction associated with a reportable transaction results in an increase to taxable income, which in turn results in reductions in allowable itemized deductions and exemption allowances, the section 6662A penalty applies to the portion of the understatement resulting from the computational adjustments as well as the amount of the disallowed deduction. The section 6662A penalty is triggered by any adjustment "attributable to" a reportable transaction, whether or not the taxpayer had a disclosure obligation with respect to the transaction under I.R.C. § 6011.

The penalty is applied to the amount of any understatement attributable to the reportable transaction without regard to other items on the return. The amount of the understatement is determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item. I.R.C. § 6662A(b)(1).

We note that the penalty under I.R.C. § 6662A imposed at a 20% rate is not equivalent to the penalty under I.R.C. § 6662(a), because in many instances, due to the special manner in which the section 6662A penalty is computed, the 20% rate under I.R.C. § 6662A typically results in a larger penalty than the accuracy-related penalty under I.R.C. § 6662(a). One common reason for this is that the section 6662A penalty is computed with respect to the reportable transaction understatement multiplied by the highest tax rate (individual or corporate, as the case may be) in effect during the relevant tax year, whereas the I.R.C. § 6662(a) penalty is computed with respect to the amount of the actual understatement in tax resulting from the adjustment(s) to which the penalty applies, taking into account the benefit of graduated tax rates. We also note that the penalty under I.R.C. § 6662A is imposed with respect to a reportable transaction understatement, and may apply even in the absence of a deficiency or underpayment in tax.

The following summarizes the applicability of the section 6662A penalty to disclosed and undisclosed transactions:

Disclosed transactions. In general, a 20% reportable transaction understatement penalty is imposed on any understatement attributable to an adequately disclosed reportable transaction. I.R.C. § 6662A(a). The penalty can be avoided only if the taxpayer satisfies a more stringent reasonable cause and good faith exception (the "strengthened reasonable cause exception") under I.R.C. § 6664(d).

Undisclosed transactions. If the taxpayer had a requirement to disclose participation in the transaction but did not adequately disclose the transaction in accordance with the regulations under I.R.C. § 6011, the taxpayer is subject to an increased penalty rate equal to 30% of the understatement. I.R.C. § 6662A(c). In the case of an undisclosed transaction, the reasonable cause exception does not apply even if the taxpayer is otherwise able to demonstrate good faith. I.R.C. §6664(d)(3)(A). If the taxpayer did not have a requirement to disclose the transaction in accordance with the regulations under I.R.C. § 6011, the reportable transaction understatement is applied at a rate of 20% of the reportable transaction understatement.

b. Return Preparer Penalty: I.R.C. § 6694

If a return preparer prepares any return or claim for refund with respect to which any part of an understatement of liability is due to an unreasonable position, the return preparer is subject to a penalty in an amount equal to the greater of $1,000 or 50

percent of the income derived or to be derived by the return preparer with respect to the return or claim. *See* I.R.C. § 6694(a).

One category of unreasonable positions includes reportable transactions to which I.R.C. § 6662A applies. Understatements attributable to reportable transactions are treated as unreasonable positions subject to penalty unless it is reasonable to believe that the position would more likely than not be sustained on the merits. *See* I.R.C. § 6694(a)(2)(C). An exception is provided where there is reasonable cause for the understatement and the tax return preparer acted in good faith. *See* I.R.C. § 6694(a)(3).

II. Notice 2016-66: Section 831(b) Micro-captive Transactions

A. Notice 2016-66, generally

Notice 2016-66 identified a transaction (a "micro-captive" transaction) as a transaction of interest for purposes of Treas. Reg. § 1.6011-4(b)(6) and I.R.C. §§ 6111 and 6112. Treasury and the IRS believe that micro-captive transactions have the potential for tax avoidance or evasion, but presently lack sufficient information to identify which arrangements are tax avoidance transactions and may lack sufficient information to define the characteristics that distinguish avoidance transactions from legitimate micro-captive arrangements. For these reasons, Notice 2016-66 identified certain micro-captive transactions meeting characteristics described in Section 2 of the notice, and substantially similar transactions, as a transaction of interest for purposes of Treas. Reg. § 1.6011-4(b)(6) and I.R.C. §§ 6111 and 6112.

B. The Transaction of Interest

1. *The 5 factors*

Section 2.01 of Notice 2016-66 identifies as a transaction of interest, a transaction with the following five factors:

> Factor 1: A, a person, directly or indirectly owns an interest in an entity (or entities) ("Insured") conducting a trade or business;
>
> Factor 2: 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) (the "Contracts") with Insured that Captive and Insured treat as insurance, or reinsures risks that Insured has initially insured with an intermediary, Company C;
>
> Factor 3: Captive makes an election under I.R.C. § 831(b) to be taxed only on taxable investment income;
>
> Factor 4: A, Insured, or one or more persons related (within the meaning of I.R.C. §§ 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

Factor 5: 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 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 I.R.C. §§ 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.

2. *The Computation Period*

The applicable Computation Period is defined at section 2.02 of the Notice as the most recent 5 taxable years of the Captive, or if the captive has been in existence for less than 5 taxable years, the entire period the Captive's existence.

C. Rules of Application

Generally, the filing of the disclosure statements under Notice 2016-66 follow the rules set forth in Treas. Reg. § 1.6011-4 and Treas. Reg. § 301.6111-3. In addition to the general rules set forth in the Treasury regulations, Notice 2016-66 provided specific guidance with respect to the completeness of the disclosures and the time for filing the disclosures.

1. *Completeness of the Disclosure*

Generally, the required disclosures by a participant must identify and describe the transaction in sufficient detail for the IRS to be able to understand the tax structure of the reportable transaction and identify all the parties involved in the transaction. Treas. Reg. § 1.6011-4(d).

Notice 2016-66, at section 3.05(c), provides some specifics as to the information that a Captive must disclose, as directly quoted below:

(1) Whether Captive is reporting because (i) the amount of the liabilities incurred by Captive for insured losses and claim administration expenses during the Computation Period is less than 70 percent of the amount specified in section 2.01(e)(1) of this notice; (ii) Captive has at any time during the Computation Period made available as financing or otherwise conveyed or agreed to make available or convey any portion of the payments under the Contract to A, Insured, or a person related (within the meaning of § 267(b) or 707(b)) to A or Insured through a separate transaction, such as a guarantee, a loan, or other transfer; or (iii) both (i) and (ii);

(2) Under what authority Captive is chartered;

(3) A description of all the type(s) of coverage provided by Captive during the year or years of participation (if disclosure pertains to multiple years);

(4) A description of how the amounts treated as premiums for coverage provided by Captive during the year or years of participation (if disclosure pertains to multiple years) were determined, including the name and contact information of any actuary or underwriter who assisted in these determinations;

(5) A description of any claims paid by Captive during the year or years of participation (if disclosure pertains to multiple years), and of the amount of, and reason for, any reserves reported by Captive on the annual statement; and

(6) A description of the assets held by Captive during the year or years of participation (if disclosure pertains to multiple years); that is, the use Captive has made of its premium and investment income, including but not limited to, securities (whether or not registered), loans, real estate, or partnerships or other joint ventures, and an identification of the related parties involved in any transactions with respect to those assets.

2. *Time for Disclosure*

After Notice 2016-66 was issued, the IRS extended the time for disclosing the transaction of interest for participants under Treas. Reg. § 1.6011-4(e) and material advisors under Treas. Reg. § 301.6111-3(e) in Notice 2017-8. Under Notice 2017-8, the time for filing the disclosures with OTSA was extended from January 30, 2017 to May 1, 2017.

Analysis

III. The Arrangement

A. Captives, generally

A captive insurance company is an insurance company that insures the risks of companies related to it by ownership. *See* Avrahami v. Commissioner, 149 T.C. No. 7, at *18.

I.R.C. § 831(b) provides that a "small" insurance company other than a life insurance company, with annual net or direct written premiums not exceeding $1,200,000 (or $2,200,000 for taxable years beginning after December 31, 2016), is entitled to make an election to be taxed only on its investment income (a "section 831(b) election").

B. The Micro-Captive Transaction

is an -based captive insurance manager and headquartered in the greater area. Prior to being in , formed and managed micro-captive insurance companies . For simplicity, " " as used herein, will refer to .

provides " " to " " by forming captives eligible to make an election under I.R.C. § 831(b).

It appears the micro-captive insurance transactions share common traits, including: (1) an individual who owns a successful, closely-held business through one or more business entities is introduced to ; (2) the individual enters into an engagement letter with and forms an entity which the individual and treat as a captive insurance company (the "Captive"); (3) the captive enters into Contracts to insure purported risks of the individual's business entity or entities (the "Insured"); (4) the captive files a section 831(b) election to be taxed only on taxable investment income; and (5) the individual or the Insured(s), sometimes with one or more other related persons, own at least 20% of the voting power or value of the outstanding stock of the Captive.

A majority of the captives formed by also entered into reinsurance and risk pooling arrangements facilitated through entities related to :

.

was a captive insurance company incorporated as a in which acted as a fronting carrier in the transaction. Insureds entered into Contracts with and paid premiums to , which in return ceded the policies to the Captive in a reinsurance arrangement and remitted the premiums to the Captive

.

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In , formed in the for the purpose of

. utilized different structures, depending upon factors such as the domicile of the Captive and the location of the Insured's risk exposures. Generally, irrespective of , the Insureds paid premiums to for coverage, which then ceded the related risks to the Insured's Captive in a form of reinsurance and remitted premiums to the Captive .[1]

retained to perform annual actuarial reviews of the reserve levels associated with . The last annual reports for , respectively, were prepared by for the period ending , and were released in . The actuarial reports contained information about the amount of premiums received under the programs, the allocation of the premiums , and the losses sustained by the respective risk pools. For , also provided information about the loss history .

1. loss history

Although the risk pool has been in existence since ,

. The total amount of premiums earned by , the allocation of the premiums , and the amount of claims paid are summarized below in Table 1:

1 .

In addition,
. The report did not specify the reason for
, but provided
, as summarized in Table 2 below:

2. loss history

The report contained information about the premium received, claims history, and the loss reserves of the risk pools associated with for pool years [2]. Unlike the report for , the report for did not include comprehensive data

.

[2] A pool year under the program
. For example,

The total amount of premiums and claims/losses from the pools, as well as 's reserve estimates, are summarized below in Tables :

[3]

[3]

The combined premiums, claims, and reserve estimates from all pools are set forth below in Table :

Rev.

Rev. Rul. 2002-90, 2002-2 C.B. 985.

Due to the factual differences between Captives that pooled risks under the programs and the non-pooling captives under Rev. Rul. 2002-90, the scope of this memorandum is limited to analyzing whether the typical or routine captive arrangement involving reinsurance arrangements through are a TOI under Notice 2016-66.

IV. Application of Notice 2016-66 to the transaction

A. The Factors

Under Notice 2016-66, a transaction is a TOI if the Captive meets all of the five factors identified in section 2.01.

1. **Factor 1: The micro-captive transaction involves a person who directly or indirectly owned an interest in an entity (or entities) conducting a trade or business**

marketed its micro-captive transaction to . The audits of the participants of the transactions appear to confirm that the transaction involved a business owner who conducted his trade or business through one or more entities.

Accordingly, Factor 1 is satisfied.

2. **Factor 2: The micro-captive transaction involves a Captive (which is directly or indirectly owned by the owner(s) of Insured, Insured, or persons related to the owners or Insured) who entered into Contracts with the Insureds that the Captive and Insureds treated as insurance, or reinsures risks that Insured initially insured with an intermediary company**

The transaction involved the formation of a Captive that reinsures risks that the Insureds initially insured with . The audits of the participants of the transactions confirm the existence of a Captive, Contracts treated as insurance contracts, and the reinsurance of risks through (again, the are not covered in this memorandum).

Accordingly, Factor 2 is satisfied.

3. **Factor 3: The Captive makes a section 831(b) election**

As revealed by its marketing materials, the transaction was a tax-motivated transaction organized around a captive with a section 831(b) election. Further, the participant audits have not revealed any captives that did not make a section 831(b) election.

Accordingly, Factor 3 is satisfied.

4. **Factor 4: 20% of voting power or value.**

The transaction involves captives formed by business owners to purportedly insure risks of their business entities. The participant examinations confirm

the commonality of ownership and voting interests between the insureds and captive. If there are multiple owners, then an owner or person related to that owner (within the meaning of §§ 267(b) or 707(b)) or Insured must directly or indirectly own at least 20 percent of the voting power or value of the outstanding stock of Captive for this factor to be met with respect to that owner.

Accordingly, Factor 4 is satisfied if the 20 percent test is met.

5. **<u>Factor 5</u>: The micro-captive transaction involves Captives that must satisfy either a 70% loss ratio test <u>or</u> a circular flow of funds test.**

Section 2.01(e) provides the fifth factor -- that the transaction must meet either a 70% loss ratio test or a circular flow of funds test.

a. Loss Ratio Test – Methodology for Computing

The first of the two tests in section 2.01(e) is that the amount of the liabilities incurred by Captive for insured losses and claim administration expenses is less than 70 percent of the premiums earned by Captive less policyholder dividends (the "Loss Ratio Test"). Expressed algebraically, the Loss Ratio Test is satisfied for a Captive when:

$$\frac{\text{(Losses + Claim Administration Expenses)}}{\text{(Premiums – dividends paid)}} < \text{70 Percent}$$

The applicable computation period for the Loss Ratio Test, as defined in section 2.02, is the most recent 5 years of the captive (or if the captive has been in existence for less than 5 years, the entire period of the captive's existence). However, since persons entering into the transactions on or after November 2, 2006 are required to make the required disclosures (and there could be some captives formed after November 2, 2006 that ceased participating in the transaction at some point between 2007 and 2018), we applied the Loss Ratio Test from the period between years 2007 to the present.

As defined in section 2.01(e), the Loss Ratio Test is designed to be computed on a captive-by-captive basis. Nevertheless, since the transaction involved the use of reinsurance and risk pools, the Loss Ratio Test can be applied using the data collected from the actuarial reports, which allows us to ascertain the total amount of premiums paid to , the allocation of the premiums , and the amount of losses incurred by the risk pools (including reserves set aside for potential losses). While we may not have comprehensive information about each individual captive's loss history, the reports reveal a minimal amount of losses from . Given the minimal amount of claims, we can mathematically determine if it was impossible for any captive to have a loss ratio in excess of the 70%

threshold by taking the known losses and assuming that all premiums were paid out as claims.

In addition to assuming that 100% of premiums were paid out to satisfy claims, our methodology for applying the Loss Ratio Test also made the following assumptions:

- Loss Reserves. Since booked loss reserves to account for potential future losses, our methodology assumes that 100% of the loss reserves materialized into losses from the risk pools. Further, since ’s loss reserves had , to be as conservative as possible, we used the and assumed that they all became actual losses to the pool for years .
- Dividends to Policyholder. We also assumed that there were no dividends paid to the policyholder. Given that , it is reasonable to assume there were no policyholders who received dividends paid by their captive.
- Claim Administration Expenses. We do not have sufficient information with respect to claim administration expenses. However, it is reasonable to assume that they were minimal in comparison to the amount of premiums and, as such, highly unlikely to impact the results. We, therefore, we did not factor claim administration expenses in our Loss Ratio Test methodology. If the results the Loss Ratio Test are sufficiently close to 70%, we can re-run the test with a conservative estimate of claim administration expenses.

i. **Loss Ratio Test for**

Using the methodology set forth above, including the assumptions that (a) all premiums allocated to the were fully paid out in claims and (b) that the entire reserves estimate was paid out in claims, we computed the Loss Ratio for . The result of the Loss Ratio Test is set forth below in Table :

As shown by Table , in the scenario presented by the assumptions, the loss ratios for every year between through would have been well less than 70%, with an average loss ratio of %. Since the risk pools, which accounted for % of all premiums under the program, sustained such minimal losses, our methodology demonstrates that it was impossible for any captive to have an overall loss ratio in excess of 70%.

Therefore, we conclude that the transaction satisfied Factor 5 of the TOI factors during years , during which time the transaction used

as a reinsurance and risk pooling mechanism.

ii. – Loss Ratio Test

A similar methodology for computing the Loss Ratio Test was applied to the captives who entered into reinsurance agreements with from years , and during . As described earlier, the report for included the premium and loss history for the risk pools associated with , but did not include data with respect to . However, since we know the allocation of the liabilities and premiums , we were able to compute the total amount of premiums received .[4] We then assumed that (a) 100% the premiums were paid out as claims and (b) 100% of the reserves from each pool were paid out as claims in .

4

The result of the Loss Ratio Test for each pool is set forth in Tables , below:

To compute the Loss Ratio Test, we combined the results from the individual pools, to obtain the overall loss ratio, as summarized below in Table :

As shown by Table , in the scenario presented by our assumptions, the combined

loss ratios would have been % for years , respectively. As with the Loss Ratio Test for , the results for conclusively demonstrate that it was impossible for any captive could have a loss ratio in excess of the 70% threshold for years . In sum, since there were so few claims paid from risk pools, even if we assume that a particular captive (a) paid out 100% of its premiums and (b) the entire loss reserve from was paid out to satisfy claims, it was impossible any captive in the program to achieve a loss ratio greater than 70%.

In sum, we conclude that the transaction satisfies Factor 5 of the TOI factors.

b. Circular Flow of Funds Test

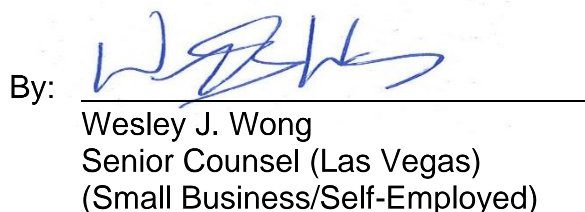
Since the Loss Ratio test of section 2.01(e)(1) is satisfied, we do not need to analyze the circular flow of funds test on a captive-by-captive basis under section 2.01(e)(2) of Notice 2016-66.

V. **Conclusion**

Based upon our analysis of the 5 factors outlined in section 2.01 of Notice 2016-66, we conclude that the transaction promoted by is the same as, or substantially similar to, the TOI described in Notice 2016-66.

Please call (702) 868-5171 if you have any further questions.

EDWIN A. HERRERA
Area Counsel
(Small Business/Self-Employed:Area 5)

By: 
Wesley J. Wong
Senior Counsel (Las Vegas)
(Small Business/Self-Employed)