Office of Chief Counsel
Internal Revenue Service
Memorandum

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subject: Disclosure Advice in Captive Insurance Cases

This memorandum responds to your request on August 1, 2012, requesting advice as to whether certain documents received in an exam of one taxpayer may be used in the exams of other taxpayers pursuant to I.R.C. § 6103(h)(4).

Issue

Whether the Service may disclose return information of a third party in exams of unrelated taxpayers where all taxpayers and their exams involve a substantially similar transaction set up by the same individual.

Conclusion

The Service may disclose the third party return information in the exams of the unrelated taxpayers to the extent the documents satisfy the "item test" of section 6103(h)(4)(B). The documents satisfy the "item test" if they directly relate to an issue in the case, i.e. an element to be proved in the case, not just that other similarly situated taxpayers participated in similar transactions.

Facts

Individual ("A") gives presentations and distributes materials marketing a captive insurance program to businesses. The captive insurance program is designed to utilize section 831(b) of the Internal Revenue Code ("Code"), which allows small insurance companies that receive less than $1.2 million in premiums to exclude all premiums from gross income. As part of the program, A receives fees from customers ("B") to set up captive insurance companies ("C") which are owned by one of more of B's owners. Additionally, A provides management services to C for a monthly fee. A also arranges for B to purchase insurance from insurance companies ("D") which have relationships with A and hires actuaries, on behalf of C, to provide state-required reports. Once C is set up, B purchases insurance from D, which in turn purchases reinsurance from C. As such, the "insurance premiums" B pays to D (less a fee) are ultimately conveyed to a company whose owners are also the owners of B. A markets this transaction to multiple customers ("Bs") and all the transactions are substantially similar to each other except that some Bs purchase insurance from different insurance companies ("Ds") (or different insurance pools within D) or utilize different actuaries. However, all actuaries and Ds are still recommended by A and all Ds have a relationship with A.

The Service examined B-1 and C-1.[1] The issues in B-1 and C-1's exams are:

1. Whether the arrangement under the captive insurance program constituted "insurance" within the meaning of federal tax law. This issue turns on whether the arrangement had sufficient risk transfer and risk distribution and whether the arrangement was insurance in the commonly accepted sense.
2. Whether the arrangement under the captive insurance program should be disregarded for lack of economic substance. This issue turns on whether there was the likelihood of an economic benefit from the arrangement and whether the participants had a non-tax business motive for entering the transaction.
3. Whether B-1 and C-1 are liable for the accuracy-related penalty based on negligence and substantial understatements.

These same three issues are at issue in the exams of the other Bs and Cs that participated in the captive insurance program marketed by A. As part of an exam of B-1 and C-1 the Service obtained the various documents in response to Information Document Requests ("IDRs") and discovery.

Law and Analysis

Returns and return information are confidential, except as authorized under the Code. Section 6103(a). Return information is defined as any information gathered by, collected by, created by, or otherwise in the hands of the Secretary in connection with

[1] For purposes of this memorandum, a customer and its related captive insurance company will be referred to using the same number. So, for example, B-1 and C-1 are a customer and captive insurance company with common ownership who participated in the captive insurance program. No relationship is implied or exists between B-1/C-1 and other participants in the captive insurance program (i.e. B-2/C-2, B-3/C-3, etc) except for the fact that all participated in the captive insurance program marketed by A.

determining a taxpayer's liability or potential liability under the Code. Section 6103(b)(2).

When determining whether disclosure of return information is authorized under section 6103, the first step is to determine whose return information it is. The key factor is not whose tax liability may be affected by the information but rather whose liability is being determined when the information is obtained. See Martin v. IRS, 857 F.2d 722, 725-26 (10th Cir. 1988). In this case, the documents were obtained in response to IDRs and discovery during the investigation of B-1's and C-1's tax liability. Therefore, they are B-1's and C-1's return information even though the information in the documents may affect the tax liability of other taxpayers.

Under section 6103(h)(4)(B), B-1's and C-1's return information may be disclosed in a judicial or administrative tax proceeding[2], if the treatment of an item on B-1's or C-1's return is directly related to resolution of an issue in the tax proceeding (the "item test").[3] The return information is only required to affect the resolution or be germane to an element of the claim; it is not required for it to be "necessary" to or dispositive of the issue. See United States v. N. Trust Co., 210 F. Supp. 2d 955, 957 (N.D. Ill. 2001); First W. Gov't Sec., Inc. v. United States, 578 F. Supp. 212, 218 (D. Colo. 1984), aff'd, 796 F.2d 356 (10th Cir. 1986). However, whether something is directly related to the resolution of an issue in the proceeding is much narrower than the question of whether something is relevant. In re United States, 669 F.3d 1333, 1339 n.5 (Fed. Cir. 2012). Additionally, even though the documents in this case are not items from a tax return, there is other return information, such as the extrinsic evidence in the documents, that may provide pattern evidence that satisfies the "item test" if directly related to the resolution of an issue in the proceeding. Order, ACM v. Comm'r, No. 10472-93 (T.C. Aug. 18, 1995) (stating "if transactions reported on a third party return are directly related to an issue in the proceeding, not only the pertinent portions of the return but also any extrinsic information obtained by the IRS regarding the tax treatment of the reported transaction may be offered into evidence without violating section 6103").

Section 6103(h)(4)(B) permits the disclosure of third party returns and return information where the item on the third party's return directly relates to the elements for defending or proving the civil cause of action or crime at issue in the tax proceeding but not things such as impeaching a witness' creditability. See N. Trust Co., 210 F Supp. 2d at 957. An item does not directly relate to proving an element of an issue in the proceeding if the item only shows that the issue in the proceeding is substantially similar to a transaction in another case. As such, generally, information of unrelated but similarly situated taxpayers does not meet the "item test." See In re United States, 669 F.3d at

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[2] An exam is an administrative tax proceeding for purposes of section 6103(h)(4). See, e.g., Duquette v. Comm'r, 110 F. Supp. 2d 16, 20 (D.D.C. 2000).

[3] It is our understanding that no transactional relationship exists between B-1/C-1 and the other taxpayers that participated in the captive insurance program. As such, we have limited our analysis to the "item test." Nothing in this memorandum should be interpreted to limit the use of the transactional relationship test under section 6103(h)(4)(C) should it apply.

1339; Vons Cos. Inc. v. United States, 51 Fed. Cl. 1, 17 (2001); see also S. Rep. No. 94-938, at 325-26 (1976), 1976-3 C.B. (Vol. 3) 363-64. Therefore, in order to satisfy the "item test," the item must directly relate to proving an issue in the specific case in question and not simply come from an analogous case.

One of the issues in the examinations of taxpayers who participated in the captive insurance program is whether the arrangement under the captive insurance program constituted "insurance" under federal tax law and in the commonly accepted sense. This requires a determination of whether each taxpayer's specific arrangement had sufficient risk transfer and distribution. As such, documents pertaining to this issue satisfy the "item test" if the documents directly relate to whether the arrangement that the other taxpayers (B-2/C-2, B-3/C-3, etc) entered into is "insurance." It is our understanding that insurance is generally an individualized product based on each customer's risk profile. Therefore, pattern evidence demonstrating that the arrangements did not take into account each participant's risk profile could be used to show that the arrangements were not insurance. For example, if the documents demonstrated that the arrangement entered into by the other taxpayers was not tailored to those taxpayers' individual situation and risk because the other taxpayers' insurance documents were identical to B-1's and C-1's documents, this pattern evidence would demonstrate the arrangement was not "insurance" in the other taxpayers' case and would satisfy the "item test." However, the items would not satisfy the "item test" if they were used only to conclude, without more, that the transaction entered into by the other taxpayers was invalid simply because it was similar to the invalid transaction entered into by B-1 and C-1.

Another issue in the examinations of taxpayers who participated in the captive insurance program is whether the arrangements should be disregarded for lack of economic substance. This requires a determination of whether there was a likelihood of an economic benefit from the arrangement and whether the taxpayer had a non-tax business purpose for entering into the transaction. As such, pattern evidence from other participants showing that all the arrangements were designed, implemented, and operated identically can be used to demonstrate that the arrangement was not designed with a specific taxpayer's business needs in mind and therefore lacked a bona fide business purpose other than tax benefits.

We recognize that multiple, and often duplicative, pieces of third party return information may be directly related to the resolution of an identical issue in the exams of the other taxpayers. Therefore, in order to minimize the disclosure of third party return information, the amount of duplicative evidence should be limited and only those specific items needed to resolve the issue should be disclosed in the exams of the other taxpayers. For example, if documents 2 and 3 both pass the "item test" and could be used in the resolution of the same issue, but only one is needed to resolve the issue, then only one should be disclosed. The Service should also take care to only use third party return information, including pattern evidence, when the evidence received from the specific taxpayer under exam is insufficient. In this regard, consideration should be given to other methods of proof which do not require disclosure of third party return

information, such as summaries or compilations of all the information and obtaining information directly from the taxpayers under exam. See section 6103(b)(2) (return information "does not include data in a form which cannot be associated with . . . a particular taxpayer").

Additionally, any information contained in items disclosed in the other exams which does not satisfy the "item test," i.e. is not directly related to the resolution of the issue (such as third party taxpayer names and other identifiers if these items are not needed to resolve the issue), must be redacted before the item is disclosed in the other exams. See generally Chief Counsel Notice 2002-028. By taking these steps, a fair and reasonable balance is struck between the need to use the third party return information and the degree of intrusion on that third party's privacy.

Strategy and Hazards

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Please call (202) 622-7950 if you have any further questions.