



Notice 2016-66: IRS Identifies Certain "Micro- Captive" Transactions as Transactions of Interest

Situation presented:

On November 1, 2016, the IRS released Notice 2016-66 (the "Notice"), which alerts taxpayers and their representatives that certain "Micro-Captive" transactions have been identified as "Transactions of Interest."

The Notice covers certain captive insurance transactions designed to take advantage of the IRC section 831(b)¹i election to be taxed on investment income only. The IRS previously identified certain Micro-Captive transactions as abusive schemes in its Dirty Dozen list of tax scams for the 2016 filing season (see IR-2016-25 (Feb. 16, 2016)). However, the Notice indicates that the Treasury Department and the IRS lack sufficient information to identify which IRC section 831(b) arrangements should be identified specifically as a tax avoidance transaction and accordingly, they are designating the transactions

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identified in the Notice as Transactions of Interest in an effort to gather such information.

Suggested action:

Taxpayers should evaluate whether they have participated in a transaction or transactions described in the Notice, or substantially similar transactions. Taxpayers who have participated in such transactions are now subject to certain reporting requirements under Reg. § 1.6011-4(d). In addition, advisors to those taxpayers may be subject to disclosure and list maintenance requirements under IRC sections 6111 and 6112, respectively.

Issue:

What constitutes a designated Micro-Captive Transaction of Interest

The IRS’s description of the Micro-Captive Transaction of Interest, found in section 2.01 of the Notice is as follows:

1. A person (“A”) directly or indirectly owns an interest in an entity (or entities) conducting a trade or business and the business entity is the “Insured”;
2. An entity or entities (“Captive”) directly or indirectly owned by A, Insured, or persons related to A or Insured, 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”);
3. Captive elects under IRC section 831(b) to be taxed only on taxable investment income (the net premium written threshold for the election is \$1.2 million through 2016 and increases to \$2.2 million beginning in 2017);
4. A, Insured, or one or more persons related (within the meaning of IRC section 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
5. One or both of the following apply:
 - a. The amount of liabilities incurred by Captive for insured losses and claim administration expenses during (in general) Captive’s most recent five taxable years is less than 70 percent of Captive’s premiums earned, less policyholder dividends paid during that period; OR
 - b. Captive has at any time during (in general) its most recent five taxable years directly or indirectly made financing available or otherwise “conveyed or agreed to make available or convey to A, Insured, or a person related (within the meaning of IRC section 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 the Recipient, any portion of the payments [premiums] under the Contract, such as through a guarantee, a loan, or other transfer of Captive’s capital.”

The Notice makes it clear that a transaction described in section 2.01 of the Notice is identified as a Transaction of Interest regardless of whether the transaction has the characteristics of the abusive transactions described by the IRS in its Dirty Dozen list.

Note that the relevant reporting obligations can reach back 10 years (i.e., to transactions entered into on or after November 2, 2006) but reporting is

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required only for taxable years for which the statute of limitations on assessment is still open, i.e., “open” tax years.

Who is a “participant” in a Micro-Captive Transaction of Interest

The Notice indicates that A, Insured, Captive, and, if applicable, Company C, are participants in a reportable Micro-Captive Transaction of Interest for each year in which their respective tax returns reflect tax consequences or a tax strategy of a transaction described in section 2.01 of the Notice.

Disclosure required

Participants in a Micro-Captive Transaction of Interest are required to report such participation on Form 8886, Reportable Transaction Disclosure Statement. The required disclosure 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 the identity of all parties involved in the transaction. To that end, the Notice specifies certain information which must be included in the disclosure.

Specifically, all participants must describe on Form 8886 when and how the taxpayer became aware of the transaction, and the Captive must describe: (1) whether the Captive is reporting because it is described in section 2.01(e)(1) of the Notice (i.e., fails the 70% test) or section 2.01(e)(2) of the Notice (i.e., provides loanbacks or certain other financial benefits to related parties); (2) under what authority the Captive is chartered; (3) a description of all the types of coverage provided by the Captive during the year or years of participation; (4) a description of how the premium amounts were determined during the year or years of participation, along with the name and contact information of any actuary or underwriter who assisted with premium determinations; (5) a description of any claims paid and reserves reported by the Captive during the year or years of participation; and (6) a description of the assets held by the Captive during the year or years of participation.

Timing of disclosure

Form 8886, Reportable Transaction Disclosure Statement, should be attached to the taxpayer’s tax return for each taxable year in which the taxpayer participates in the transaction. A copy of the disclosure statement must be sent to the Office of Tax Shelter Analysis (OTSA) at the same time that any disclosure statement is first filed by the taxpayer pertaining to a particular reportable transaction. The Notice was recently modified by Notice 2017-8 to provide that disclosures for prior, open tax years should be made by sending Forms 8886 to OTSA on or before May 1, 2017.

Further, if a taxpayer is required to file a disclosure statement with respect to a transaction described in the Notice after November 1, 2016, and prior to May 1, 2017, that disclosure statement will be considered timely filed if filed with OTSA by May 1, 2017.

Potential penalties for noncompliance

Participants required to disclose Micro-Captive Transactions of Interest under Reg. § 1.6011-4 who fail to do so may be subject to penalties under IRC section 6707A. In addition, the IRS may impose other penalties on participants in these transactions, including the accuracy-related penalty under IRC sections 6662 or 6662A.

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- i All references herein to “IRC section” are to the Internal Revenue Code of 1986, as amended (“the Code”), and all references to “Reg. §,” “Temp. Reg. §” or “Prop. Reg. §” are respectively to the final, temporary or proposed regulations promulgated thereunder.

Contact:

For questions with respect to the substantive tax provisions and principles raised by the Notice, please contact:

Jean Baxley

WNT – Corporate – Insurance Tax

Tel: +1 202 713 0403

Mobile: +1 202 713 0403

Email: jebaxley@deloitte.com

Jim Mannello

Deloitte Tax – Stamford – Insurance Tax Specialist

Tel: +1 203 564 6078

Mobile: +1 203 564 6078

Email: jmannello@deloitte.com

John Keenan

WNT – Tax Controversy

Tel: +1 202 879 5605

Mobile: +1 202 294 1531

Email: jkeenan@deloitte.com

Howard Berman

WNT – Tax Controversy

Tel: +1 212 436 2242

Mobile: +1 516 456 9415

Email: hberman@deloitte.com

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