

## Captive Insurance: New IRS Tax Reporting Regime Potential for Penalties and Examinations

November 3, 2016

On November 1, 2016, the Internal Revenue Service (“IRS”) issued Notice 2016-66 identifying certain transactions relating to small captive insurance companies as a “transaction of interest.” Prior to this notice, the IRS had identified certain small captives as amongst its list of “Dirty Dozen Tax Scams.” Also, the IRS has been actively examining captives and their owners and litigating cases in the U.S. Tax Court. ***The new “transaction of interest” designation throws small captive insurance company transactions into a tax reporting regime that can potentially lead to significant penalties and IRS income tax and promoter examinations.***

Generally, captives are insurance companies that are formed to insure related businesses, and the insureds pay premiums in exchange for property and casualty-type coverages. Under section 831(b) of the Internal Revenue Code (the “Code”), so-called small or “micro” captives can elect to exclude from income up to \$1.2 million of premiums received (\$2.2 million beginning in 2017) and only pay tax on their investment income. Also, the premiums are deducted by the insured as a business expense under section 162 of the Code.

Notice 2016-66 states that small captives have the potential for tax avoidance or evasion and identifies certain small captives, and substantially similar transactions, as a “transaction of interest” in order to gather more information about why and how small captives are being formed and operated. Generally, small captives that constitute a “transaction of interest” are those that (1) have liabilities for covered losses and expenses in an amount less than 70 percent of the total premiums earned, or (2) provide premium payments as financing to an insured or related party in a transaction nontaxable to the recipient (e.g., loans). In either case, the period tested is the most recent 5-year taxable period.

Each of the insureds, captives, and any material advisors must report the transaction to the IRS, including the IRS Office of Tax Shelter Analysis. Taxpayers will have to report the small captive “transaction of interest” annually by filing a Form 8886 with their tax returns beginning with the 2016 tax year, and will have to report separate Forms 8886 for each prior year, some forms due by January 30, 2017. See Treas. Reg. § 1.6011-4(e)(2)(i). Under section 6707A, each unfiled or late-filed Form 8886 is subject to a penalty in the amount of \$50,000 or \$10,000 for natural persons. Material advisors must also report the transaction of interest by filing Form 8918 (and are subject to additional list maintenance requirements). Under section 6707, an unfiled or late-filed Form 8918 is subject to a penalty in the amount of \$50,000 (and further penalties for failure to timely supply the required list to the IRS upon request). According to the Notice, retroactive reporting is required for described captives that were formed on or after November 2, 2006 (not 2016), which is the date the “transaction of interest” regulations first went into effect.

Finally, the Notice requires that transaction participants provide detailed information on the relevant disclosure forms. The disclosure information includes (1) whether liabilities incurred are less than 70 percent of premiums (minus certain dividends and loans); (2) whether any loan or other financing arrangement has occurred between the captive and related parties; (3) the captive's jurisdiction; (4) a description of the types of coverage(s); (5) how the premium(s) was/were determined, including the names and contact information for any actuary or underwriter involved; (6) a description of the claims paid; and (7) a description of the captive's assets. This detailed information should not be taken lightly as the IRS can treat an incomplete disclosure as nondisclosure and therefore, subject to penalties.

[Caplin & Drysdale's Tax Controversies Group](#) advises on reportable transaction reporting requirements and represents businesses, captives, and managers under IRS examination. If you would like independent advice concerning how to comply with the reporting requirements required by this IRS notice, please contact:

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