The Large Business and International (LB&I) Division of the Internal Revenue Service (IRS) announced its first 13 issue-based campaigns on January 31, 2017. As discussed in a prior Eversheds Sutherland Legal Alert, these campaigns focus on tax issues that, in LB&I’s view, pose a substantial risk of non-compliance.

One of the 13 campaigns addresses “micro-captive” insurance companies, i.e., insurance companies with up to $2.2 million in annual written premiums that otherwise meet the requirements, and elect, under section 831(b), to be subject to tax only on investment income and, unlike typical insurance companies, avoid taxation on their underwriting income. The micro-captive campaign focuses on certain of these “section 831(b) companies” that are described as “transactions of interest” in Notice 2016-66.

Background

IRS Examinations

There are already numerous examinations of section 831(b) companies underway. The IRS examinations have focused on two types of IRS perceived abuses (with many situations involving both): abuses resulting in income tax evasion and those resulting in estate and gift tax evasion. In general, with respect to income taxes, the IRS has argued that certain section 831(b) companies have been formed to facilitate improper deductions for insurance premiums under section 162 for the purported insureds where the transactions are not properly characterized as insurance. With respect to estate taxes, the IRS has argued that certain section 831(b) companies have been formed to facilitate estate and gift tax evasion, where a parent (either directly or indirectly) pays insurance premiums to a section 831(b) company owned by his or her child when the transactions are not properly characterized as insurance. As a result of the fact that the premium is not paid for insurance, the transaction creates a transfer of wealth to the child without these amounts being subject to estate or gift tax.

Both LB&I and the Small Business/Self-Employed Division of the IRS have been examining section 831(b) companies. In connection with these examinations, the IRS listed abusive section 831(b) arrangements on its “Dirty Dozen” list of tax scams on February 3, 2015. Abusive section 831(b) arrangements continue to be listed on the annual IRS Dirty Dozen list.

Litigation

The IRS examinations have culminated in a number of cases docketed in the U.S. Tax Court. Among these cases, the first to be tried was Avrahami v.
Commissioner (Docket Nos. 17594-13, 18274-13), which was tried in March 2015. In the case, the IRS argued that the section 831(b) company in question was formed for income tax evasion purposes—namely, to facilitate deductions under section 162 for premiums paid for insurance that were improperly deducted because the section 831(b) company’s transactions did not qualify as insurance for federal tax purposes. A decision in this case is expected as early as this Spring.

Amendment of Section 831(b)

Congress amended section 831(b) as part of the Protecting Americans from Tax Hikes Act of 2015 enacted on December 18, 2015. Among other amendments, Congress added anti-abuse measures to address perceived abuses of the section 831(b) election. The amendments focused largely on the estate and gift tax evasion issues. The amendments are effective for all section 831(b) companies, including preexisting arrangements, for tax years beginning after December 31, 2016.

Notice 2016-66

On November 1, 2016, the IRS issued Notice 2016-66, 2017-47 IRB 745, designating transactions in which taxpayers utilize certain section 831(b) companies as “transactions of interest.” Transactions of interest are “reportable transactions,” meaning that participants in the transactions must disclose the transaction on a disclosure statement (IRS Form 8886) attached to their federal income tax return. In addition, “material advisors” to such transactions are subject to similar disclosure requirements (IRS Form 8918) and must also maintain lists of those taxpayers they have advised about these transactions. The Notice provided for a 10-year retroactive application of Notice 2016-66, which surprised many taxpayers and practitioners.

The Micro-Captive Campaign

The micro-captive campaign addresses transactions described in “Notice 2016-66, in which a taxpayer attempts to reduce aggregate taxable income using contracts treated as insurance contracts and a related company that the parties treat as a captive insurance company.” According to LB&I, the manner in which the contracts are interpreted, administered, and applied is inconsistent with arm’s-length transactions and sound business practices. The LB&I campaigns provide for the real-time training of agents and LB&I has developed a training strategy for this campaign. LB&I will administer this campaign through issue-based examinations.

The micro-captive campaign is the latest in a number of actions by the government to address perceived abuses of the section 831(b) election. Meanwhile, the IRS maintains a Priority Guidance Plan (PGP) item for guidance relating to captive insurance companies. Even though the micro-captive campaign focuses on section 831(b) companies (i.e., micro-captives only),
taxpayers should be aware that the IRS continues to scrutinize other captives. It is unclear whether in light of the micro-captive campaign the IRS will continue to pursue guidance with respect to captives under the PGP, but the President’s January 30 Executive Order and January 20 memorandum limiting regulations and sub-regulatory guidance could make it less likely that the IRS will publish additional guidance with respect to captives in the short term.

**Eversheds Sutherland Observations.**

1. The micro-captive campaign is the latest in a number of actions by the government to address perceived abuses of the section 831(b) election.
2. Although the micro-captive campaign targets section 831(b) arrangements perceived by the IRS to be abusive, this does not preclude the IRS from investigating other section 831(b) arrangements that utilize section 831(b) companies for legitimate business purposes.
3. Even though the micro-captive campaign focuses on section 831(b) companies, taxpayers should be aware that the IRS continues to scrutinize other captives.

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1 All section references are to the Internal Revenue Code of 1986, as amended.

2 The analysis of which division has authority over a particular section 831(b) company will depend upon the overall aggregate size of the section 831(b) company and the related parties for which it purports to provide insurance.

*If you have any questions about this legal alert, please feel free to contact any of the attorneys listed under 'Related People/Contributors' or the Eversheds Sutherland attorney with whom you regularly work.*