TECHNICAL MEMORANDUM

Notice 2016-66

By: Jeffrey I. Bleiweis

November 2, 2016

RMC GROUP

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TO: Raymond G. Ankner, President

FROM: Jeffrey I. Bleiweis, Vice President and General Counsel

RE: Notice 2016-66

DATE: November 2, 2016

On November 1, 2016, the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS") issued Notice 2016-66. The Notice describes a certain type of captive insurance company and identifies the arrangement as a "transaction of interest" for purposes of section 1.6011-4(b)(6) of the Income Tax Regulations (the "Regulations") and sections 6111 and 6112 of the Internal Revenue Code (the "Code"). Persons who engage in a transaction of interest are required to disclose their participation in the transaction to the IRS.

In the Notice, Treasury and the IRS state that they believe the transaction may have the potential for tax avoidance or evasion. However, they do not have sufficient information to determine whether to identify the transaction as a tax avoidance transaction – i.e. a listed transaction. By identifying the transaction as a transaction of interest, Treasury and the IRS hope to obtain sufficient information to make that determination.

> *When the Treasury Department and the IRS have gathered enough information regarding potentially abusive section 831(b) arrangements, the IRS and the Treasury Department may take one or more actions, including removing the transaction from the transactions of interest category in published guidance, designating the transaction as a listed transaction, or providing a new category of reportable transaction.*

1. BACKGROUND

In the Notice, Treasury and the IRS refer to the transaction as the “micro-captive transaction”. The Notice describes the micro-captive transaction as follows:

1. A, a person, owns an entity (the “Insured”), which is engaged in a trade or business.

2. A, or a person or entity owned by or related to A, owns another entity (the “Captive”).

3. The Insured enters into one or more contracts (the “Contracts”) with the Captive, pursuant to which the Captive purports to provide insurance coverage to the Insured. Or, the Insured may obtain insurance coverage from an unrelated company (“Company C”), which then enters into a reinsurance agreement with the Captive.

4. The Insured makes payments to the Captive, which both the Insured and the Captive treat as insurance premiums under section 1.62-1(a) of the Regulations and section 162 of the Code. The Insured claims a deduction for the payments to the Captive.

5. If the Captive is not a domestic corporation, it makes an election under section 953(d) of the Code to be treated as a domestic corporation for tax purposes.

6. The micro-captive transaction is structured so that the Captive has no more than $1,200,000 in net premiums for each taxable year. This enables the Captive to pay income tax only on its investment income and not on its premium income.

7. The coverage provided by the Captive under the Contracts has one or more of the following characteristics:

    a. the coverage involves an implausible risk;

    b. the coverage does not match a business need or risk of the Insured;

    c. the description of the scope of the coverage provided under the Contract is vague, ambiguous or illusory; or

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d. the coverage duplicates coverage provided to the Insured by an unrelated, commercial insurance company, and the policy written by the Captive has higher premiums.

8. The premiums paid by the Insured to the Captive have one or more of the following characteristics:

   a. the amounts paid by the Insured are designed to provide the Insured with a deduction under section 162(a) of the Code of a particular amount;

   b. the payments are determined without an underwriting or actuarial analysis that conforms to insurance industry standards;

   c. the payments are not made consistently with the schedule in the Contract;

   d. the payments are agreed to by the Insured and the Captive without comparing the premiums that would be charged under alternative insurance arrangements providing the same or similar coverage;

   e. the payments significantly exceed the premiums prevailing for coverage offered by unrelated commercial insurance companies for risks with similar loss profiles; or

   f. if the Insured includes multiple entities, the allocation of amounts paid to the Captive among the insured entities does not reflect the actuarial or economic measure of the risk of each entity.

9. The Insured, the Captive or both does one or more of the following:

   a. the Captive fails to comply with the laws or regulations applicable to insurance companies in the jurisdiction(s) in which it is domiciled or in which it is subject to regulation;

   b. the Captive does not issue policies or binders in a timely manner consistent with industry standards;

c. the Captive does not have a defined claims administration procedure that is consistent with industry standards; or

d. the Insured does not file claims for each loss covered by the Contract.

10. The Captive's capital has one or more of the following characteristics:

a. the Captive has insufficient capital to assume the risks that the Contracts transfer from the Insured;

b. the Captive invests its capital in illiquid or speculative assets usually not held by an insurance company; or

c. the Captive loans or otherwise transfers its capital to the Insured, entities affiliated with the Insured, person A or persons related to A.

2. TRANSACTION OF INTEREST

After describing the transaction in great detail, the IRS says that a transaction with <u>each</u> of the following five characteristics is a transaction of interest.

a. A, a person, directly or indirectly owns an interest in an entity (or entities) (the "Insured") conducting a trade or business;

b. An entity (or entities) (the "Captive"), directly or indirectly owned by A, the Insured or persons related to A or the Insured, enters into one or more contracts (the "Contracts") with the Insured that the Insured and the Captive treat as insurance, including Contracts that the Insured enters into with unrelated Company C, which Company C reinsures with the Captive;

c. The Captive makes an election under section 831(b) of the Code to be taxed only on its investment income;

d. A, the Insured, or one or more persons related to A or the Insured, directly or indirectly own at least 20 percent of the voting power or value of the outstanding stock of the Captive; and

e. One or both of the following apply:

   i. the amount of the liabilities incurred by the Captive for insured losses and claim administration expenses during the Computation Period is less than 70 percent of the following:

      (A) premiums earned by the Captive during the Computation Period, less

      (B) policyholder dividends paid by the Captive during the Computation Period; or

   ii. the 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 to convey to A, the Insured or any person related to A or the Insured (collectively the "Recipient") any portion of the payments made under the Contracts, such as through a guarantee, loan or other transfer of the Captive's capital, in a transaction that did not result in taxable income or gain to the Recipient.

The term "Computation Period" is defined in the Notice as the most recent five taxable years of the Captive. If the Captive has not been in existence for five years, then the Computation Period is the entire period of the Captive's existence. A transaction that has each of the foregoing five characteristics is a transaction of interest, even if it does not have all of the characteristics described in section 1 of the Notice and section 1 of this memorandum.

3. DISCLOSURE REQUIREMENTS

A taxpayer who participates in a micro-captive transaction that is the same as or substantially similar to the transaction described in the Notice is required to disclose its participation on its tax return by attaching a Form 8886 to the tax return. In addition, the taxpayer is required to file a Form 8886 with the IRS's Office of Tax Shelter Administration for the first year of its participation. The term taxpayer includes the Insured, as well as the person or persons who own the Insured or the Captive.

The Captive is also a taxpayer and will be required to file the Form 8886. If the Captive is domiciled in a foreign jurisdiction, but has made an election under section 953(d) of the Code in order to take advantage of section 831(b), then it, too, is a taxpayer and has disclosure obligations. In order to satisfy its disclosure obligations, the Captive must provide the following information on its Form 8886:

1. whether the Captive is reporting because (i) its loss ratio is less than 70%, (ii) it has, at any time during the Computation Period, made a loan or otherwise made available the payments paid under the Contracts to A, the Insured or a person related to A or the Insured, or (iii) both (i) and (ii);

2. under what authority the Captive is chartered;

3. a description of the types of coverage provided by the Captive;

4. a description of how the premiums were determined, including the name and contact information of any actuary or underwriter;

5. a description of any claims paid by the Captive and the amount of, and reason for, any reserves reported by the Captive on its annual statement; and

6. a description of the assets held by the Captive.

It is important to keep in mind that the fact that a transaction is a reportable transaction, such as a transaction of interest, does not mean that the taxpayer cannot take the desired deduction. Section 1.6011-4(a) of the Regulations provides as follows:

> *The fact that a transaction is a reportable transaction shall not affect the legal determination of whether the taxpayer's treatment of the transaction is proper.*

4. EFFECTIVE DATE

The effective date of the Notice is November 1, 2016. This means that taxpayers must comply with the disclosure requirements with respect to any tax return due on or after November 1, 2016. In addition, the Notice provides that it applies to any transaction entered into on or after November 2, 2006. A taxpayer who participated in a micro-captive transaction described in the Notice for tax years prior to

2016, is required to file a Form 8886 with the IRS's Office of Tax Shelter Administration by January 31, 2017, even though its tax return may be due at a later date. A material advisor is required to file Form 8918 with the IRS by January 31, 2017.

RESOURCES

ABOUT THE AUTHOR

Jeffrey I. Bleiweis
Vice President & General Counsel

Jeff joined CJA & Associates, a member of the RMC Group, in 1993 and currently serves as Vice President and General Counsel. He advises senior management on legal and tax issues related to the design and administration of insurance products, employee benefit plans, and risk management services.

Mr. Bleiweis frequently speaks before professional groups on the use of insurance products in qualified and non-qualified employee benefit plans. He has addressed meetings of accountants, financial planners, and insurance professionals across the country. He advises a nationwide network of independent insurance agents on tax and ERISA issues and has written extensively in the course of that work. He has published several articles on employee benefit plan issues. He has also testified before the Internal Revenue Service.

Mr. Bleiweis currently resides in Winnetka, Illinois, with his wife and two children.

ONLINE SUPPORT INFORMATION

Customers may access support information related to captive insurance on rmcgp.com/user

IMPORTANT KNOWLEDGE BASED ARTICLES

New knowledge based articles have been posted online to assist with captive insurance company questions, as well as other areas of interest, including:

- Pension Plans & Retirement Planning
- Insurance
- Self-Insurance
- Risk Management
- Employee Benefits
- Health & Welfare Plans

INFORMATION ON ADMINISTRATIVE & CONSULTING SERVICES

For more information about RMC Group's Administrative and Consulting Services, there are three easy ways to get in contact with us.

web: www.rmcgp.com/products-services

email: rmc@rmcgp.com

call: 888.599.5553

INDUSTRY RESOURCES & GENERAL GUIDELINES

For more industry information and general guidelines on captive insurance:

Captive Insurance Companies Association (CICA):
www.cicaworld.com/Resources.aspx

Self-Insurance Institute of America (SIIA):
www.siia.org/i4a/doclibrary/

The Risk Management Society (RIMS):
www.rims.org/resources/ERM/Pages/default.aspx

ABOUT RMC GROUP

RMC Group is a global leader in providing insurance, risk management, and retirement solutions to help consumers and organizations secure and manage their risk-driven world. Our services protect against more risks at more points, more completely and efficiently, enabling confidence wherever risk is located. Headquartered in Naples, Florida, RMC Group has operations in 5 countries and our presence can be felt around the world.

More information is available at:

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For specific country offices and contact numbers, please visit our website. For product information in the U.S., call toll-free:

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