



TaxNewsFlash

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KPMG report: IRS expanded enforcement focus on abusive micro-captive insurance companies

The IRS released IR-2020-226 (October 1, 2020) to notify taxpayers that have participated in a micro-captive insurance transaction to consult an independent tax advisor before the October 15 filing deadline.

Read the IRS release: [IR-2020-226](#)

KPMG observation

This IRS release follows prior releases and updates concerning micro-captive insurance transactions. Read [TaxNewsFlash](#) (November 1, 2016) about the IRS identifying “micro-captive insurance” as a “transaction of interest” and read [TaxNewsFlash](#) (January 31, 2020) relating to a subsequent update from the IRS.

Background

The IRS has long viewed micro-captive insurance transactions as potentially abusive tax transactions. Micro-captives first appeared on the IRS “Dirty Dozen” list of tax schemes in 2014 and have been a priority enforcement issue for the IRS ever since. See [IR-2016-25](#) [PDF 39 KB]. In 2016, the IRS and Treasury Department issued [Notice 2016-66](#) (PDF 44 KB) that identified certain micro-captive transactions as having the potential for tax avoidance and evasion. The notice states that taxpayers who engage in these transactions must disclose them to the IRS. Failure to disclose is subject to penalty.

Although many related parties use captive insurance companies for risk-management purposes that do not involve tax avoidance, the IRS has a longstanding concern regarding the potential to use such arrangements to claim tax benefits under section 831(b) in an abusive manner.

Tax benefits in relation to section 831 include a 0% federal income tax on the captive’s underwriting profits (premium income to the captive). Only investment income of the captive is taxed provided that a 831(b) election is made. Premiums paid to a captive insurance company are deductible for income tax purposes as ordinary and necessary business expenses. If the transaction is disallowed, premiums

paid to the captive would not be considered deductible to the policyholder, and the captive insurance company would have to include the premiums received as income.

As such, the IRS generally will require the entity to report its tax structure on Form 8886. Detailed information on what is to be reported is outlined in Notice 2016-66.

Following three U.S. Tax Court decisions holding that certain micro-captive arrangements are not eligible for federal tax benefits (read [TaxNewsFlash](#) (April 2019), [TaxNewsFlash](#) (June 2018), and [TaxNewsFlash](#) (August 2017)), in 2019, the IRS issued a settlement offer that required substantial concessions of the income tax benefits claimed by the taxpayer together with appropriate penalties.

The IRS also established 12 new examination teams to address abusive micro-captive transactions, and stated that it plans to open several thousand micro-captive examinations. Potential civil outcomes could include full disallowance of claimed captive insurance deductions, inclusion of income by the captive entity, and imposition of applicable penalties.

IRS release (October 2020)

The IRS release on October 1, 2020, notifies taxpayers that have participated in a micro-captive insurance transaction to consult an independent tax advisor before the October 15 filing deadline.

According to the IRS release, any taxpayer that engaged in an abusive micro-captive insurance transaction cannot anticipate being able to settle its transaction on terms more favorable than in previously announced settlement offers. The IRS urged taxpayers that have participated in a micro-captive transaction to consult an independent tax advisor; and if they are engaged in an abusive transaction, the taxpayer “should seriously consider exiting the transaction” and not claiming the tax benefits related to the abusive transaction.

The IRS will disallow tax benefits from transactions that are determined to be abusive. The IRS may also require domestic captives to include premium payments in income and assert a withholding liability related to foreign captives.

The IRS also noted several fact situations that raised concerns. For example, the IRS highlighted using offshore captive insurance companies domiciled in Puerto Rico and elsewhere. These entities do not make the election under section 831(b). According to the IRS, these offshore structures are designed and marketed with the express intent to avoid reporting under Notice 2016-66 but have the same or similar abusive elements as abusive micro-captive insurance arrangements.

In March and July 2020, the IRS issued notices to taxpayers who participated in a Notice 2016-66 transaction, advising them that the IRS would be expanding enforcement activity and encouraging them to discontinue participation in this transaction. The IRS stated that a significant number of taxpayers have exited these types of transactions.

KPMG observation

Captive insurance structures have historically been challenged by the IRS. The IRS has identified micro-captive transactions as potentially abusive. Generally, a section 831(b) captive entity is considered a “transaction of interest” if its insured losses and claim administration expenses are less than 70% of its premium income less dividend payments or if the captive makes any loans to or investments in the parent.

To the extent a taxpayer is involved with any micro-captive transaction, that taxpayer has been advised by the IRS to seek an independent opinion from a tax professional who is experienced in dealing with captive insurance and micro-captive transactions. If a taxpayer determines that it is involved in an abusive micro-captive transaction, the IRS has recommended that the taxpayer exit that transaction.

Form 8886 needs to be filed to report any transactions, as is outlined in Notice 2016-66. Failure to properly disclose can result in civil penalties.

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