COMMENTS OF [YOUR NAME/COMPANY]

In Response to Announcement 2023-11: Proposed

Regulations that Identify Certain Micro-Captives as Transactions of

Interest or as Listed Transactions

**I. BACKGROUND ON INSURANCE REGULATION**

**Insurance Regulation**

State-based insurance regulation has a more than 100-year history of success in the United States. Congress, in passing the McCarran-Ferguson Act of 1945, exclusively reserved to the States the power to regulate insurance. The States, the District of Columbia, and several territories each participate in this national system of state-based regulation.

The McCarran-Ferguson Act states that “No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance.” 15 U.S.C. § 1012. Since its passage, Congress has concluded that “the business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.” 15 U.S.C. § 1012. As a result, every State has comprehensive insurance regulation and oversight capabilities.

Over the past seventy years, Congress has repeatedly reaffirmed that principle. See, e.g., 15 U.S.C. § 1011 (“Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest.”); id. § 6701(b) (providing that no person may engage in the “business of insurance” unless licensed “in accordance with the relevant State insurance law”); Legal Principles Defining the Scope of the Federal Antitrust Exemption for Insurance, B-304474, March 4, 2005 available at: https://www.gao.gov/decisions/other/304474.htm (“Under current federal law, the regulation of insurance is primarily the responsibility of the States. This arrangement results, in part, from Congress’s decision, in the McCarran-Ferguson Act, 15 U.S.C. 1011 et seq., to exempt certain insurance-related activities from the federal antitrust laws.”)

At least 35 United States jurisdictions, including States, territories, and the District of Columbia permit licensing and regulation of captives. In each of these domiciles, the applicable regulator has the authority to grant an insurance license to a company, after regulatory review and subject to ongoing oversight. Many States have dedicated professional staff that exclusively regulate captive insurance.

**Robust Regulatory Standards**

All domestic domiciles that regulate captive insurance require each applicant for a license to complete background checks, maintain certain capital levels, and provide financial information on demand. The vast majority also require annual review by independent actuaries, as well as annual audits by independent CPAs and/or examinations by the regulator, among other requirements.

The standards and requirements that domestic regulators impose on insurance companies, and on captives in particular, are intended to protect policyholders by ensuring solvency. The standards and requirements are remarkably consistent across the country, and address all aspects of insurance company operation, including the subject of the insurance, the characteristics of the insurance policies, and the structure of reinsurance arrangements.

In the various United States captive jurisdictions, the insurance regulators play a very active role in regulating the captive insurance industry. For example, in order to gain licensure in any United States captive jurisdiction, every captive must submit an application and a feasibility study prepared by a credentialed actuary. Each jurisdiction’s insurance regulator closely reviews and monitors each captive to determine whether it is properly funded, has the necessary liquidity, insures only appropriate risks, and prices its premiums appropriately.

**Captive Insurance Companies**

Captive insurance is a highly regulated and formalized type of risk management that has existed for over 50 years, allowing companies, or groups of companies, to better manage their own risk. It is a common risk management tool utilized by a wide range of public, private, and not-for-profit entities, including colleges and universities, Fortune 500 companies, local businesses, hospitals, manufacturers, religious and community organizations, and virtually every other type of business. Captive insurance covers an equally diverse and important set of business risk profiles, from property, general liability, product liability, workers’ compensation, and medical stop loss insurance, to business and supply chain interruption and many other coverages.

Nearly 5,000 captives are domiciled in and regulated by at least 35 States, demonstrating a healthy and material industry in the United States. By definition, a captive is a type of insurance company formed under applicable state law that provides insurance coverage to its owners and affiliates. Captives can either be owned by one company or by numerous unrelated entities, similar to a mutual insurance company. Many of the aforementioned 5,000 captives are group captives or protected cell captives, each of which houses the captive insurance programs of any number of unrelated businesses. Indeed, there are thousands of unique business organizations that participate in captives.

Captives may take many forms. The simplest structure is a “pure” or single-owner captive created by a parent company to provide insurance to itself and its affiliates. *See* C. Anastopoulo, *“Taking No Prisoners: Captive Insurance as an Alternative to Traditional or Commercial Insurance,”* 8 Ohio St. Entrep. Bus. L.J. 209, 213, 221-23 (2013). Even in this “pure” captive arrangement, like third-party insurers, the captive receives premiums from its parent company in exchange for coverage. The only difference is that the insured (the parent) controls the insurer (the captive). *Id.,* at 221-25 (outlining the various types of captives).

Captives provide several benefits over third-party commercial insurers. In addition to more affordable coverage, a captive can underwrite more customized policies than those available on the open market. *Id.,* at 216. With actuarial support, captives can tailor deductible and premium amounts, coverage scope, and risk tolerance because these insurers “address risk positions for the parent based solely on the parent’s actual risk exposure and history, rather than an industry-wide calculation.” *Id.* This is especially important for industries where ordinary commercial insurers have a hard time evaluating the relevant risks. *Id.*, at 213-14, 216.

Captives also offer a more responsive claims process. *Id.*, at 216-17. Submitting claims to a commercial insurer that has “the incentive to deny claims or delay in paying claims” is time-consuming, adversarial, and litigious. *Id.*, at 217. By contrast, the parent and captive have “the same incentive to pay the claim from the captive’s reserves.” *Id.*, at 216.

[State] diligently regulates traditional insurance companies and recognized that businesses needed and wanted insurance that the traditional commercial market could not always deliver, and captives have proven the answer.  Since [Date] [State] has licensed [#] captive insurance companies and maintains a fulltime staff of [#] captive specific employees who diligently license and regulate each one, reporting to the Insurance Commissioner.  This process has resulted in the issuance of over [#] of insurance policies covering thousands and thousands of insureds each year.

By stating that micro-captive insurance companies that have a loss ratio of less than 65% are either a listed transaction or a transaction of interest, the IRS has essentially disregarded the insurance industry’s robust regulatory standards and state based regulation of captive insurance companies.

**II. COMMENTS**

1. **With the proposed listed transaction, the IRS is trying to impose a definition of insurance at the federal level in contravention of Federal case law.**

Federal courts have declared the framework for determining whether a transaction is insurance includes 1) risk shifting, 2) risk distribution, 3) covering insurance risk, and 4) meeting commonly accepted notions of insurance. The Supreme Court established two necessary criteria: risk shifting and risk distribution. See Helvering v. Le Gierse, 312 U.S. 531, 539 (1941). In addition, other federal cases determined the arrangement must involve insurance risk and meet commonly accepted notions of insurance. See Harper Grp. v. Commissioner, 96 T.C. at 58; AMERCO v. Commissioner, 96 T.C. at 38.

Under the listed transaction, a micro-captive could meet all four parts of the framework established by federal case law and still qualify as a listed transaction. If a micro-captive meets the four parts of the framework established by federal law, it is an insurance company under federal law and entitled to make an election under IRC § 831(b) by act of congress.

The IRS does not have the authority to overturn federal case law precedent via IRS regulations.

1. **The IRS does not have the authority to repeal IRC § 831(b) by regulation and should abide by the will of congress.**

Congress thrice reenacted IRC § 831(b) since 2005, even expanding the premium threshold to allow more companies to qualify for the election. This proposed regulation is essentially an attempt to repeal IRC § 831(b) by regulation.

On February 3, 2015, in IR-2015-19, the IRS placed micro-captive transactions on the annual “dirty dozen” list noting that an insured claims deductions under the tax code for premiums paid for the insurance policies while the premiums end up with the captive insurance company owned by the same owners of the insured or family members. The captive insurance company, in turn, can elect under a separate section of the tax code to be taxed only on the investment income from the pool of premiums, excluding taxable income of up to $1.2 million per year in net written premiums.

Nevertheless, after the IRS placed micro-captives making the 831(b) election on the “dirty dozen” list, congress responded by enacting the Protecting Americans from Tax Hikes Act (the “PATH Act”) on December 18, 2015.[[1]](#footnote-1) The Path Act included revisions to Section 831(b) to prohibit the use of captive insurance companies as estate planning tools by adding certain ownership diversification requirements. However, the Path Act also included revisions to Section 831(b) to increase the premium threshold to qualify for the Section 831(b) deduction from $1,200,000 to $2,200,000, with annual inflation adjustments. These new provisions went into effect for tax years beginning after December 31, 2016.

In the wake of this expansion of the Section 831(b) premium threshold in the PATH Act, the IRS response was to issue Notice 2016-66 on November 1, 2016, in an attempt to discourage captive insurance companies from taking advantage of the then soon to be effective newly congressionally authorized expanded deduction by making most micro-captive transactions file with the IRS as transactions of interest. Further, on August 21, 2017, the tax court decided Avrahami v. Comm'r, 149 T.C. No. 7, in favor of the IRS, holding the micro-captive in that transaction failed to meet the four-part framework established by federal case law.

Yet, after the IRS issued Notice 2016-66 and won the Avrahami case, congress, yet again, revisited IRC § 831(b) in the Consolidated Appropriations Act of 2018, Pub. L. 115–141 and made changes to the statute favorable to micro-captives 1) by clarifying that the 20% test looked through to the underlying policyholder in a pooling arrangement and 2) by eliminating spouses from the definition of specified holder.

Finally, Notice 2016-66 was invalidated nationwide on March 23, 2022 by the Federal Court in Eastern District of Tennessee on remand from the Supreme Court. See CIC Services,. LLC v. Internal Revenue Service, 141 S. Ct. 1582. As a result of this decision, micro-captives were no longer required to file with IRS as transactions of interest.

In response to this invalidation of Notice 2016-66, the IRS has issued these proposed regulations attempting again to make most micro-captive transactions file with the IRS as transactions of interest and gone a step further by making certain micro-captive transactions file with the IRS listed transactions with the knowledge that the IRS will challenge every captive transaction filing as a listed transaction.

The IRS should follow the will of congress and cease trying to repeal IRC § 831(b) by regulation.

1. **The IRS does not have the authority to impose a loss ratio on the insurance industry as that would be preempted by the McCarran Ferguson act.**

Under the McCarran Ferguson act, states have the authority to regulate insurance unless congress specifically passes a law stating otherwise. Only an act of congress can establish a loss ratio requirement on the insurance industry.

The IRS should not attempt to impose a 65% loss ratio on micro-captive transactions as only Congress has the authority to impose loss ratios on the insurance industry under the McCarran Ferguson act.

In its justification for the proposed rule, the IRS points to ACA 85% loss ratio as justification. However, the ACA 85% loss ratio was passed directly by congress and is allowable under Federal law including McCarran Ferguson. Here, the IRS’ attempt to define a loss ratio as a requirement to be considered a non-abusive insurance transaction is not supported by any act of congress, like the 85% loss ratio.

Further, the ACA 85% loss ratio only applies to companies licensed under state insurance law. The ACA 85% loss ratio does not apply to companies writing major medical health insurance that are not licensed as insurance companies, like Tennessee Farm Bureau, or to self-funded health plans. The ACA 85% loss ratio does not apply to different health lines, like short-term health or limited benefit plans. The ACA 85% loss ratio is narrowly tailored to apply only to companies writing major medical health and it was implemented for a specific purpose to keep premiums more affordable while expanding coverage through the elimination of pre-existing conditions limitations. IRS loss ratio, however, applies to all 831(b) captives regardless of the line of coverage, whether they are actually abusive transactions or not.

There is no similarity between health insurance and property and casualty insurance written by micro-captives and it is very inappropriate to compare the two lines of insurance. Comparing the micro-captive insurers to health insurers issuing major medical health insurance policies subject to the ACA expresses a profound lack of understanding of the insurance industry.

In the alternative, the IRS has asked for comments on the use of a combined loss ratio for determining whether a transaction is abusive. Establishing any such combined ratio inclusive of loss ratio and expense ratio would have the same effect under McCarran Ferguson. Only an act of congress can establish a combined ratio requirement on the insurance industry.

1. **This proposed rule, by mandating a specific loss ratio, will impair state insurance regulators from enforcing state statutes prescribing what rates may be charged in order for a micro-captive to maintain solvency.**

IRC § 831(b) exists in order to allow small insurance companies with highly variable year to year loss experience to accumulate adequate reserves and surplus to prepare for fortuitous catastrophic claims events. The whole point of IRC § 831(b) is to allow the reserves and surplus of these small insurance companies to grow sufficiently to weather catastrophic claims events by not taxing underwriting gains.

The proposed regulation presents a situation whereby a micro-captive will always be severely restrained in their ability to charge actuarially sound rates in order to build adequate reserves and surplus to weather catastrophic claims events. Under the proposed regulation, micro-captives, in order to be non-abusive, will be impaired from charging actuarially sound premiums by the 65% loss ratio requirement, severely limiting in micro captives’ ability to build reserves and surplus.

These proposed regulations would put into question whether or not micro-captive insurance companies will actually be able to continue to honor their financial obligations in the event of a catastrophic claims event thus impairing micro-captive insurance companies’ ability to comply with state insurance company solvency requirements.

The McCarran-Ferguson Act states that “[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance.” 15 U.S. Code § 1012(b).

In Saunders v. Farmers Ins. Exchange, the 8th Circuit Court of Appeals held that the McCarran-Ferguson Act barred the application Fair Housing Act, 42 U.S.C. §§ 3601 et seq., and 42 U.S.C. §§ 1981 and 1982. See Saunders v. Farmers Ins. Exchange, 537 F.3d 961, (8th Cir. 2008). In that case, the plaintiffs alleged the defendant insurance company violated the Fair Housing Act by “charg[ing] higher premium rates for the same type of homeowners’ coverage to homeowners in the Community ... than [they] charged homeowners in white communities. See Id. However, the court in Saunders v. Farmers Ins. Exchange held that **“state statutes prescribing what rates may be charged are essential to the core of Missouri's regulation of the business of insurance.”** (emphasis added) See Id at 968. In its decision, the court stated that “in Missouri, the Director of Insurance has been delegated the essentially legislative task of rate-making by reviewing Insurer risk classifications and pricing differentials. If a federal court may assess damages based upon what a non-discriminatory rate would have been, and then prescribe the future rate in an injunctive decree, ‘[a] more complete overlap with the state [agencys] pricing decisions is impossible to conceive.’” See Id., citing Dehoyos v. Allstate Corp., 345 F.3d 290, 302 (Jones, J., dissenting).

By requiring micro-captive insurance companies to maintaining a 65% loss ratio or greater, these regulations will impair insurance regulators ability to enforce state statutes prescribing what rates may be charged in order for a captive to maintain solvency.

Additionally, if an insurance regulator required a micro-captive to increase its premiums, such that the loss ratio is less than 65%, to remain solvent under state insurance laws, state insurance regulators would be triggering a tax or a fee on micro-captive insurance companies. With a loss ratio less than 65% the micro-captive would, at a minimum, incur reporting fees under the proposed regulation to report as a listed transaction or a transaction of interest due to regulators enforcing state insurance law. At worst, micro-captive insurance companies required by insurance regulators to charge a premium that results in a loss ratio of less than 65% would incur substantial additional tax liabilities and penalties if the IRS challenges their status as an insurance company. Thus by enforcing state insurance laws, these regulations would trigger a tax or a fee on micro-captive insurance companies in violation of McCarran-Ferguson Act.

The IRS should not take any actions that violate the McCarran-Ferguson Act by impairing insurance regulators ability to enforce state statutes prescribing what rates may be charged because such statutes are essential to the core of state regulation of the business of insurance.

The IRS also should not take any actions that violate the McCarran-Ferguson Act by imposing a tax or a fee on micro-captive insurance companies as a result of insurance regulators exercising their ability to enforce state statutes prescribing what rates may be charged.

In the alternative the IRS has asked for comments on the use of a combined loss ratio for determining whether a transaction is abusive suggesting micro-captive insurance companies with a combined ratio of less than 95% - 99.5% as abusive. For the same reasons as discussed above, requiring micro-captive insurance companies to have a combined ratio of greater than 95% - 99.5% will impair insurance regulators ability to enforce state statutes prescribing what rates may be charged in order for a captive to maintain solvency in violation of the McCarran-Ferguson Act.

1. **Loss Ratio should never be used as a measure of whether a micro captive is a listed transaction.**

Several P&C lines of coverage had direct losses incurred as a percent of direct premiums earned (“Direct Loss Ratio”) of less than 65% over the prior ten-year period according to the NAIC Report on Profitability by Line by State in 2021, published January 2023 (“NAIC Report”). For example, in the NAIC Report, the following lines had Direct Loss Ratios less than 65% countrywide over the prior ten-year period: inland marine – 50.6%, commercial multi-peril 54.9%, mortgage guarantee – 37.7%, financial guarantee – 17.3%, and medical professional liability – 47.6%. Mono line companies writing only one of the above lines would have a loss ratio far below 65%. Additionally, under the federal terrorism risk insurance act, the loss ratio is 0% since its inception in 2002. A micro-captive direct writing any one of the above lines and having a loss ratio below 65% over a 10 year period would be considered a listed transaction even if its Direct Loss Ratio met the NAIC calculated countrywide average for such lines.

Further, in the RVI case, RVI was a mono-line insurance company with a loss ratio of 34% for the tax years involved. In that case, the tax court ruled against the IRS, concluding that RVI was an insurance company. Had RVI been eligible and made the election to be taxed under 831(b), then RVI would have had to report as a listed transaction despite a court finding it to be insurance.

In the proposed regulations, the IRS states that they are lowering the loss ratio from 70% in Notice 2016-66 to 65% in order to ensure they are not including non-abusive transactions. However, as noted above, there are many instances where insurance companies can have loss ratios much lower than 65% and still be within the ten-year country wide average. Also, as with the RVI case, the tax court has reviewed and found an entity to be an insurance company with a loss ratio of 34%. These facts clearly demonstrate that a 65% loss ratio is not indicative of whether a transaction is abusive or not. By using a one-size fits all 65% loss ratio, the IRS will sweep in many non-abusive transactions, requiring such non-abusive transactions to report as listed transactions. The IRS should never promulgate a listed transaction if the listed transaction will require non-abusive entities to report. The IRS should not promulgate listed transactions if the listed transaction regulation cannot adequately distinguish between abusive and non-abusive transactions.

The proper measure of whether an entity is an insurance company is whether that entity complies with state insurance laws and meets the Federal four-part framework for determining whether an insurance transaction exists. The regulation of insurance business and insurance companies is primarily left up to the various states under the McCarran Ferguson act. However, federal courts have developed a parallel four-part framework for determining whether an entity is an insurance company for federal law purposes. Under this four-part framework, an entity must 1) have risk shifting, 2) have risk distribution, 3) cover insurance risk, and 4) meet commonly accepted notions of insurance. Congress has not codified the definition of an insurance company in the Internal Revenue Code. Neither state law nor federal common law define or in any way determine whether an entity is an insurance company or not based upon its loss ratio.

Instead of using the loss ratio to determine whether a micro-captive arrangement is abusive or not, the IRS should determine whether the premiums for the coverages issued by the micro-captive were determined by a currently practicing qualified actuary employing actuarial techniques to establish premium rates that appropriately reflect the risk of loss and costs of conducting an insurance business.

Further, premiums for the coverages issued by the micro-captive insurance companies that are commensurate with commercial insurance market premiums should never be considered abusive. Commercial insurers premium rates are regulated by state insurance regulators and as discussed above state statutes prescribing what rates may be charged are essential to the core of a state's regulation of the business of insurance under the McCarran-Ferguson Act. See Saunders v. Farmers Ins. Exchange, 537 F.3d 961, (8th Cir. 2008).

Additionally, micro-captive insurance companies that reinsure commercial insurance companies cannot be abusive because they do not set their own rates. A micro-captive insurance company that reinsures a commercial insurer has no ability to set the premium rates charged for the commercial coverage issued by a commercial insurer and thus has no ability to determine or control the loss ratio for the underlying block of business it is reinsuring. As discussed above, commercial insurers’ premium rates are regulated by state insurance regulators.

Nevertheless, other comments notwithstanding, if the IRS insists on moving forward with this proposed rule, the IRS should remove in its entirety the listed transaction portion of the proposed regulation and instead make micro-captive transactions with a loss ratio of less than 65% over a ten-year period be transactions of interest due the inability of a 65% loss ratio to adequately determine if a micro-captive transaction is abusive or not. Further, the 65% loss ratio should not be computed in the aggregate for the captive, but should be based on each line of coverage written by the captive.

1. **The 65% loss ratio is not appropriate because the IRS used national data for all commercial insurers in the U.S., which includes consumer lines that captives are not permitted to write under state captive insurance laws.**

States do not permit captives to write personal auto or personal homeowners insurance. Other comments notwithstanding, if the IRS insists on moving forward with this proposed rule, the IRS should not include consumer lines in their loss ratio calculation because captives are not permitted to write such consumer lines. As such, it would not be appropriate to hold captives to a loss ratio that includes business captives are not permitted to write.

1. **Captives do not write in the admitted market and should not be compared to commercial coverages generally found in the admitted market.**

Captives typically issue coverage for risks not readily available in the admitted market. Other comments notwithstanding, if the IRS insists on moving forward with this proposed rule, captive loss ratios should not be compared to traditional admitted market P&C companies; captives loss ratios should be compared to excess and surplus lines insurers or Lloyds syndicates.

1. **The 65% loss ratio is not consistent with loss ratios experienced in every state or region of the country.**

There are different loss ratios across the country from region to region or state to state. In Tennessee, for example the average loss ratio across all P&C lines calculated from NAIC data is 62% not 65%. The insurance market is not uniform and many companies only write regionally or in certain states.

Other comments notwithstanding, if the IRS insists on moving forward with this proposed rule, the IRS should consider allowing regional or state variation when setting loss ratios based on where the micro-captive operates.

1. **County mutual insurance companies in Tennessee, which also frequently take advantage of IRC § 831(b) have loss ratios of 40% which is far below the 65% loss ratio established by the IRS for captives.**

The IRS should treat companies making the 831(b) election similarly.

1. **By imposing a fixed loss ratio on micro captives, the IRS is leaving the determination of whether a micro captive is a listed transaction up to chance.**

Insurance companies, including micro captives, rely on actuaries, using all available data and modeling tools, to set rates that will support the insurance companies’ reserves and surplus and maintain its solvency.

By requiring a loss ratio of 65% or greater each year, the IRS is basically requiring actuaries to accurately predict 10 years into the future, when they are making rates for micro-captives in order for the micro captive to maintain its reserves, surplus and solvency. Actuaries can and do make rates for a 10-year average. However, actuaries cannot ensure that the one in 10 year (or even one in 5 year) bad year included in the 10-year average actually shows up in any running 10-year period. That does not mean that an actuary’s 10-year average is wrong, it is just random chance. So, rates developed by an actuary for a 10-year average using the best available actuarial data and modeling tools, would be subject to random chance. Thus, by requiring a 65% loss ratio, the IRS is setting a standard for compliance that is impossible to comply with, because setting premiums to achieve a ten-year 65% loss ratio would still be subject to random chance.

The IRS should not leave the determination of whether a transaction is a listed transaction up to chance.

1. **Under the proposed rule, a risk retention group (“RRG”) can fully comply with the LRRA and state insurance licensing laws and could still be required to file as a listed transaction based solely on the RRG’s loss ratio.**

The Federal Liability Risk Retention Act (“LRRA”), 15 U.S. Code § 3901 et seq., establishes that a risk retention group licensed in one state can transact business as an insurance company in every state. The IRS does not have the authority to repeal the Federal LRRA by IRS regulation.

Other comments notwithstanding, if the IRS insists on moving forward with this proposed rule, it should be clarified to exclude risk retention groups properly operating pursuant to the LRRA and state law from being listed transaction or transactions of interest.

1. **The IRS proposed regulation is unfairly discriminatory.**

On its face, the proposed regulation discriminates between similarly situated companies simply because an election is made.

Two insurance companies, operating identically, will receive vastly different treatment by the IRS if one elects to be taxed as an 831(b) and the other does not. If both companies have a 20% owner and loss ratios than 65%, but only one insurance company makes an 831(b) election, then just by checking a box, one company will be a listed transaction and the other will not.

Further, if an IRC § 831(a) insurance company and a micro-captive issue the same coverage, covering risks of a policyholder, at the same rate, and both suffer catastrophic losses, the IRC § 831(a) insurance company will be permitted to raise its rates as are actuarially justified, taking into account the entirety of its expense ratio, to maintain its solvency. However, a micro-captive will be constrained by the 65% loss ratio, cannot take its entire expense ratio into account and cannot raise rates as are actuarially justified to maintain its solvency. This places the micro-captive at a solvency disadvantage exposing the micro-captive to a greater risk of insolvency than an IRC 831(a) insurance company.

The IRS cannot discriminate so blatantly between similarly situated taxpayers based on making a tax election permissible under the Internal Revenue Code.

1. **The IRS proposed regulation presents a moral hazard issue to the insurance industry.**

Captives are risk management tools. When captive owners manage their risks well, it reduces claims and losses. By setting a minimum loss ratio, the IRS is disregarding the primary risk management purpose of a captive insurance company and is indirectly encouraging captive policyholders to engage in more risky behavior in order to justify the 65% loss ratio.

The IRS should recognize the risk management value of captive insurance companies.

1. **The “Transaction Description” for the 65% loss ratio is not clear.**

The IRS relies on the ACA medical loss ratio provision as justification for the 65% loss ratio. Under the ACA, if the loss ratio is under 85%, insurers are required to issue a premium refund. The medical loss ratio and premium refunds, however, do not impact the insurer’s status as an insurance company under the IRC.

The IRS proposed regulation requires premium dividends to be subtracted when calculating premiums earned for determining the loss ratio. However, the proposed regulation is not clear on whether a captive arrangement that regularly issued premium refunds to meet the 65% loss ratio would be challenged.

Other comments notwithstanding, if the IRS insists on moving forward with this proposed rule, the IRS should clarify that if a micro-captive insurance company routinely issues premium refunds to comply with the 65% loss ratio, then it will not be considered a listed transaction or a transaction of interest.

1. **The proposed IRS regulation is not clear on whether the reporting requirement applies to insurance companies that made the IRS § 831(b) election whose premiums subsequently exceeded the IRS § 831(b) premium threshold.**

Many captive insurance companies made a valid IRC § 831(b) election when the captive’s gross written premium was below the IRC § 831(b) threshold and then subsequently had gross written premiums exceeded the IRC § 831(b) threshold due to growth of the captive program.

Micro-captive insurance companies that made the IRS § 831(b) election in the past and subsequently exceeded the IRS § 831(b) premium threshold have not benefitted from the IRC § 831(b) election since exceeding the premium threshold and have and continue pay income tax on their underwriting gains just as an insurance company that had never made an election under IRC § 831(b).

Other comments notwithstanding, if the IRS insists on moving forward with this proposed rule, the IRS should clarify that insurance companies that made the IRS § 831(b) election and subsequently exceeded the IRS § 831(b) premium threshold are not subject to the reporting requirements of this proposed regulation.

1. **The proposed IRS regulation is not clear on whether the reporting requirement applies to insurance companies permitted to revoke an IRC § 831(b) election.**

Once an insurance company that makes an IRC § 831(b) election, the election is permanent and remains in place even if the insurance company’s gross written premiums exceeds the IRC § 831(b) premium threshold. An IRC § 831(b) election may only be removed by filing with and receiving approval from the Commissioner to remove the IRC § 831(b) election.

An insurance company that made an IRC § 831(b) election and whose gross written premium exceeds the 831(b) threshold is not receiving the benefit of the IRC § 831(b) election and is not leveraging the tax election in an abusive manner. Rather, premiums in excess of the IRC § 831(b) threshold is evidence that an insurance company used the election to accumulate surplus, managed to grow the program, and no longer benefits from the 831(b) election.

Other comments notwithstanding, if the IRS insists on moving forward with this proposed rule, the IRS should clarify that an insurance company that received approval from the Commissioner to remove an IRC § 831(b) election is not subject to the reporting requirements of this proposed regulation.

1. **The proposed IRS regulation is retroactive in nature and there is no way for existing companies to come into compliance with the proposed regulation.**

A company that has been in existence for 10 years and has a loss ratio of 65% or less will be completely unable to comply with the proposed regulation. Further, the captive owners cannot shut down an existing captive and open a new one seeking to comply going forward.

If the IRS insists on going forward with the proposed regulation, the proposed regulation should be revised to apply on a prospective basis only.

Other comments notwithstanding, if the IRS does insist on moving forward with this proposed regulation with retroactive enforcement, the IRS should allow captives wishing to continue operating to un-elect their 831(b) status.

1. **The proposed IRS regulation does not address whether the loss ratio applies to micro-captive insurance companies participating in pooling arrangements.**

Many micro-captive insurance companies participate in pooling arrangements to spread their risk over a larger pool of risks and over a greater geographical area to achieve risk distribution. The IRS has sought to invalidate such pooling mechanisms in every micro captive case to come before the tax court, thus far.

Other comments notwithstanding, if the IRS insists on moving forward with this proposed regulation, the IRS should specifically address whether the proposed 65% loss ratio includes losses incurred by micro-captive insurance companies through participation in pooling arrangements/reinsurance agreements/retrocession agreements.

1. **Instead of requiring the 65% loss ratio to determine if a micro captive is a transaction of interest or a listed transaction, both requiring detailed informational filings, the IRS could instead adopt additional forms to accompany the 1120PC for micro captive transactions to help the IRS focus their efforts.**

It would be within the IRS’ authority to ask more questions on forms accompanying the 1120 PC, and the captive industry would encourage a more compliant approach such as this.

The added questions on the form could include: Is the captive regulated by a Department of Insurance of one of the United States of America or the District of Columbia? Yes/No. Insert name: \_\_\_. Was the insurance premium calculated by a credentialed actuary? Yes/No. Insert name: \_\_\_\_. Also consider adding this one too: Is the insurer issuing the policy rated by a nationally recognized independent rating agency? Yes/No. Insert name and rating: \_\_\_\_\_\_\_\_\_\_\_. {As further indication that the premiums relate to the ability to pay claims as they come due – particularly helpful if the regulator is offshore but the fronting carrier is still rated}.

None of these questions would result in dispositive answers about deductibility, but they would allow the IRS to focus their efforts more effectively. In audit, if one is selected, they could ask about business purpose and for copies of licenses and actuarial pricing.

1. Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029 (Rules Committee Print 114-40), (JCX-144-15)*, December 17, 2015 (hereinafter, “PATH Act”). [↑](#footnote-ref-1)