IRS HAS ITS FINAL SAY ON REGULATION OF "MICRO-CAPTIVES"

Editor's Note: *In one of the last regulatory actions taken by the outgoing Biden Administration, the IRS released final regulations on Micro-Captive Insurance arrangements, effective immediately upon its release date (January 14, 2025). This has been a multi-year legislative/regulatory process during which SIIA has played a key role in representing the interests of its members.*

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BACKGROUND AND SIIA'S ADVOCACY ROLE

Back in 2014, when the Senate Finance Committee was considering legislation that ultimately became the PATH Act, the Self-Insurance Institute of America, Inc. (SIIA) snapped into action and engaged Committee staff, along with Senators and members of the House of Representatives, to educate them on the merits and utility of captive insurance arrangements that are governed under Section 831(b) of the Internal Revenue Code (Code). SIIA also engaged IRS officials and scheduled a number of meetings with the Agency to discuss how 831(b) captive insurance arrangements could and should be regulated.

Since its addition to the Code in 1986, section 831(b) has played an essential role in supporting small- and medium-sized businesses by providing a way to manage risks that may be unavailable or too costly in the commercial insurance market. Over the years, Congress has demonstrated a clear intent for Code section 831(b) to simplify and support risk management for a wide range of businesses, including farmers, auto dealers, community banks, manufacturers, trucking companies, construction firms, professional service providers, and more. During the course of SIIA's advocacy work, we have been consistent in promoting a fair approach that would allow the IRS to combat abusive behavior, while also allowing appropriate access to captive insurance as the law provides.

PROPOSED REGULATIONS ON MICRO-CAPTIVE INSURANCE ARRANGEMENTS

In April of 2023, the IRS released proposed rule 109309-22, signaling that, in the IRS's opinion, captive insurance arrangements that make an 831(b) election should be considered "Listed Transactions" (inherently abusive tax shelters) or "Transactions of Interest" (potentially abusive, requiring further scrutiny).

In response, SIIA submitted a formal comment letter to the IRS arguing that the proposed rule was an overreach, and we further explained that the proposed requirements would significantly restrict access to captive insurance arrangements for small and medium-sized businesses. The association's comments included:

- Making a Code section 831(b) election does not automatically convert a captive insurance arrangement into an abusive transaction, nor are these types of captive insurance arrangements per se tax avoidance transactions.
- The proposed criteria for determining whether an 831(b) captive insurance arrangement should be considered a Listed Transaction, or a Transaction of Interest are overly broad, casting too wide of net and capturing arrangements that are established for risk-mitigation purposes and not tax avoidance.
- A 65% Loss Ratio for an 831(b) captive is too high, and the IRS does not have the authority under the Code to establish such an arbitrary Loss Ratio for determining whether a captive arrangement is an insurance company for Federal income tax purposes.

FINAL REGULATIONS ON MICRO-CAPTIVE INSURANCE ARRANGEMENTS

The IRS effectively finalized the proposed requirements, confirming that a captive insurance arrangement could be considered a Listed Transaction or a Transaction of Interest, requiring participants of the arrangement to file Form 8886 and material advisors to the arrangement to file Form 8918.

However, the IRS did take into account SIIA's comment on the proposed 65% Loss Ratio. More specifically, the IRS agreed that the 65% Loss Ratio factor was too high and would capture captive arrangements established in good faith for risk-mitigation purposes. As a result, the IRS agreed to lower the Loss Ratio to 30%.

A notable concern in the final regulations involves loan-back arrangements. According to the IRS, such practices conflict with the core principle of risk transfer, which is essential to legitimate insurance

operations. Although commenters sought clearer guidance and examples of loan-back arrangements, the IRS maintained that loan-back practices strongly suggest abusive behavior and should be scrutinized individually based on their specific circumstances.

According to the IRS, taxpayers involved in arrangements classified as Listed Transactions or Transactions of Interest bear the burden of proving that the arrangement serves a genuine insurance purpose and adheres to sound practices. In an effort to provide transition relief, the IRS will provide limited relief from additional disclosures for taxpayers choosing to (1) resolve disputes or (2) revoke their 831(b) elections before 2026.

Captive owners and their advisors are encouraged to consult with their own legal counsel regarding compliance questions going forward.■

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