October 17, 2016

VIA Email

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RE: IRC Section 831(b) Clarification Post PATH Act

Dear Messrs. Mazur, Koskinen and Wilkins:

On behalf of the undersigned associations and captive industry participants (collectively, the "Industry"), we thank you for the opportunity to comment on the recent changes to 26 U.S. Code Section 831(b) ("Section 831(b)") made by the *Protecting Americans from Tax Hikes Act* (the "PATH Act").[1] As you know, the PATH Act was enacted on December 18, 2015 as part of the *Consolidated Appropriations Act, 2016*. The PATH Act results in significant changes to the provisions of Section 831(b), all of which become effective for tax years beginning after December 31, 2016.

As previously discussed with Helen Hubbard, Associate Chief Counsel, Financial Institutions and Products, and others on her team, the Industry is pleased with the PATH Act revisions to Section 831(b) and intends to comply with the new provisions. However, the revisions to Section 831(b) include a number of provisions that require clarification and guidance, many of which are itemized below. The new provisions could be interpreted, and indeed are being interpreted by many commentators, in a manner inconsistent with prior IRS guidance or inconsistent with the expressed intent of Congress. Some provisions require taxpayers to make a calculation, but no methodology has been provided to make such calculation. Other provisions restrict transactions not apparently intended to be restricted. Many of the issues requiring

[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").

clarification and guidance are discussed within this letter along with the Industry's suggestions for appropriate interpretation.

The need for assistance is exacerbated by the virtually immediate effective date of the new provisions.[2] For many taxpayers the changes required to become compliant will involve significant restructuring, including: sale of all or part of a business, termination or formation of an insurance company, restructure of a family's estate plan, or any of a number of other sophisticated transactions. In fact, many have delayed restructuring assuming that necessary guidance would come before the start date of the new requirements. To ask taxpayers that wish to comply, but are unable to execute these very significant transactions because they are stuck in the mud of uncertainty, is at least unfair, and in the Industry's view, unreasonable.

Accordingly, the need for clarification and guidance, or some alternative accommodation, with respect to the PATH Act revisions to Section 831(b) is immediate and urgent. In light of the urgent need for clarification and guidance, the purpose of this letter is to respectfully request that the IRS issue appropriate guidance or provide accommodation to the Industry in the absence of guidance. In particular, the Industry specifically and respectfully requests that the IRS:

1. Promptly issue guidance, subject to notice and comment, interpreting the new provisions of Section 831(b) and addressing the matters raised in this letter.

The Industry recognizes that the IRS is equally aware of the urgent need for guidance and also recognizes that, notwithstanding the urgent need, promulgation of guidance in the time remaining before the end of 2016 may be unrealistic. Therefore, in the event the requested guidance cannot be promulgated with sufficient time to assist taxpayers who wish to be compliant for tax years beginning after December 31, 2016, the Industry specifically and respectfully requests that the IRS:

2. Grant transition relief to the Industry by forgoing enforcement of the new provisions until guidance can be promulgated; or

3. Allow the Industry a safe harbor for compliance based on the reasoned conclusions in this letter until guidance can be promulgated.

<u>Temporary Transition Relief Request</u>

Understanding that detailed guidance may not be forthcoming until after the December 31, 2016 enactment date, the Industry requests temporary administrative relief of the PATH Act's new requirements under Section 831(b)(2)(B) until the IRS is able to issue guidance. Such temporary relief is conditioned on taxpayers following a reasonable interpretation of the law in the interim, as discussed herein.

[2] The revisions to Section 831(b) were passed in December of 2015 and are effective for tax years beginning after December 31, 2016.

The IRS has granted this form of relief on several occasions for reasons similar to those contained within this letter, including the following: (1) to receive and consider input from interested parties in hopes of devising and implementing the most efficient and effective procedures for compliance;[3] (2) to provide additional time to make changes in business practices that are necessary for compliance;[4] and (3) to issue additional proposed guidance necessary to clarify interpretational ambiguities and determine the steps required for compliance.[5] Each of those reasons applies in this instance. As evidenced by the reasoned compliance recommendations described below, the Industry has been active in identifying not only ambiguities in the PATH Act but also solutions to promote compliance within the letter and spirit of the new law. However, the process of navigating the myriad uncertainties surrounding the PATH Act without IRS guidance has made compliance impossible for many taxpayers that wish to follow all the new requirements, but cannot do so because of lack of guidance on the issues raised in this letter, or other issues related to their particular facts.

Further, taxpayers intending to make structural changes in order to comply before the December 31, 2016 deadline face a Catch-22. Without guidance, taxpayers will be forced to guess how to comply, and if they do so, they might guess wrong. Additionally, the longer the delay in constructive guidance on how to comply, the more likely there will be a year-end rush of structural changes. This will place a great burden on state insurance regulators to timely review and permit implementation of these changes before year-end. Accordingly, more time is needed to ensure that structural changes result in compliance and to allow state insurance regulators the time to properly review and approve such changes.

Finally, the issues we raise below establish the need for guidance in order to clarify ambiguities in the new law. In the absence of such guidance, transitional relief is necessary and appropriate. On August 15, 2016, the IRS issued its Priority Guidance Plan for 2016-2017, which is a very robust list of projects that it hopes to address; included in that list are several projects in response to the PATH Act. With this many projects, it is understandable why guidance must be prioritized; transitional relief is necessary and appropriate if guidance for the section 831(b) changes cannot be forthcoming.

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[3] Pursuant to I.R.S. NOTICE 2013-45, the IRS granted transition relief—opting to forgo enforcement—for 2014 from a reporting requirement imposed on certain insurers pursuant to the Patient Protection and Affordable Care Act ("ACA"). I.R.S. NOTICE 2013-45, 2013-31 I.R.B. 116. The IRS reasoned that the "relief will provide additional time for dialogue with stakeholders in an effort to simplify the reporting requirements consistent with effective implementation of the law." *See id.*

[4] For example, in I.R.S. NOTICE 2014-33, the IRS granted relief from IRS enforcement and administration with respect to some requirements imposed by the Foreign Account Tax Compliance Act ("FATCA"). I.R.S. NOTICE 2014-33, 2014-21 I.R.B. 1033. The IRS announced a transition period spanning the first eighteen months following the effective date of FATCA, during which the IRS would not rigorously enforce certain FATCA requirements where an institution makes a good-faith effort to comply. *See id.* According to the IRS, "[t]he transition period and other guidance … is intended to facilitate … compliance with FATCA's requirements, and responds to comments regarding certain aspects of the regulations." Additionally, in I.R.S. NOTICE 2013-45, the IRS granted transition relief from certain ACA requirements in order to provide employers and insurers enough time to adapt their health coverages to comply with the minimum coverage required pursuant to the ACA. I.R.S. NOTICE 2013-45.

[5] Pursuant to I.R.S. NOTICE 2015-57, the IRS delayed the due date for filing certain statements pursuant to new reporting requirements imposed by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015. I.R.S. NOTICE 2015-57, 2015-36 I.R.B. 294. According to the IRS, "[t]his delay is to allow the Treasury Department and IRS to issue guidance implementing the reporting requirements." *Id.*

Specific Issues Requiring Guidance

I. Treatment of "Policyholder"

A. "Policyholder" Analysis

The PATH Act adds a new diversification requirement to Section 831(b), which must be satisfied before an insurance company can elect to be taxed under Section 831(b) (the "Diversification Requirement"). Generally speaking, the PATH Act provides two alternative ways in which an insurance company can satisfy the Diversification Requirement: (1) the insurance company receives no more than 20% of its net written premiums from a single policyholder (the "Risk Diversification Test");[6] or (2) the ownership of the insurance company does not facilitate estate planning (the "Ownership Test").[7]

As stated above, for an insurance company to comply with the Risk Diversification Test no more than 20% of its net written premiums may be attributable to a single policyholder. The Risk Diversification Test is as follows: "no more than 20 percent of the net written premiums (or, if greater, direct written premiums) of such company for the taxable year is attributable to any one policyholder…"[8] The language of the Risk Diversification Test continues: "in determining the attribution of premiums to any policyholder…all policyholders which are related (within the meaning of section 267(b) or 707(b)) or are members of the same controlled group shall be treated as one policyholder."[9]

What the PATH Act failed to do was specify who the "policyholder" is in the context of reinsurance arrangements. Is the first named insured viewed as the policyholder or alternatively, will the IRS consider the fronting carrier as the policyholder when the original policy is reinsured? For example, a group captive insurance company (the "Group") is formed with ten unrelated businesses in an arrangement that would be insurance for federal income tax purposes under Rev. Rul. 2002-91. The Group insures workers compensation risk and due to state law requirements, an A-rated admitted insurance company must act as a fronting issuer of the insurance policies. Therefore, the ten unrelated businesses are first named insureds on the policies issued by the fronting issuer. The fronting issuer then sends a portion of the premium and corresponding risk to the Group by way of a single reinsurance contract.

In determining risk distribution in a reinsurance arrangement, Rev. Rul. 2009-26 employs a look-through approach and finds that risk distribution exists if risk distribution would have existed if the reinsurer had directly insured the ultimate insureds.[10] Without look-through treatment

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[6] *See* PATH Act at 177:15-23.
[7] *See id.* at 178:1-16.
[8] PATH Act at 177:15-23.
[9] *Id.* at 180: 16-23.
[10] Current IRS guidance requires look-through treatment to determine who the policyholders are for risk distribution purposes. For example, Revenue Ruling 2009-26 ("Rev. Rul. 2009-26") involved 10,000 unrelated policyholders that paid premiums to an insurance company ("Company #1").[10] Company #1 then reinsured the insurance policies associated with the premiums to a second insurance company (the "Reinsurer"). The question under consideration in Rev. Rul. 2009-26 was whether, for risk distribution purposes, the Reinsurer insured one policyholder (i.e., Company #1) or alternatively, whether the Reinsurer insured 10,000 policyholders. Rev. Rul. 2009-26 concluded that for risk

for purposes of this Risk Diversification Test, the fronting issuer could be considered the policyholder from the Group's standpoint and therefore, risk diversification might not be present. Given the correct theoretical underpinnings of Rev. Rul. 2009-26, the Industry assumes that Congress meant to take a similar look-through approach for this Diversification Test.

In order to reflect this Congressional intent, the IRS should provide clear proposed guidance with respect to the definition of "policyholder" clarifying that a look-through approach is to be used in a reinsurance arrangement. Look-through treatment is utilized elsewhere in the Internal Revenue Code (the "IRC") as well[11].

B. Administrative Relief Request: "Policyholder" – Look-Through Treatment

The Industry requests that the IRS at least temporarily allow look-through treatment for purposes of the Risk Diversification Test until further proposed guidance can clarify this provision.

II. "Specified Holder" – Spousal Ownership

A. Spousal Ownership Analysis

In addition to clarifying the Risk Diversification Test, there are also numerous clarifications that are needed to the Ownership Test. As enacted, the PATH Act provides the following language regarding the Ownership Test:

> no person who holds (directly or indirectly) an interest in such insurance company is a *specified holder* who holds (directly or indirectly) aggregate interests in such insurance company which constitute a percentage of the entire interests in such insurance company which is more than a de minimis percentage higher than the percentage of interests in the *specified assets* with respect to such insurance company held (directly or indirectly) by such specified holder.[12]

Specified Holder is defined as follows:

> [t]he term 'specified holder' means, with respect to any insurance company, any individual who holds (directly or indirectly) an interest in such insurance company and who is a spouse or lineal descendant (including by adoption) of an individual

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distribution purposes, the Reinsurer should look through Company #1 to the original policyholders; therefore, despite the fact that there was a single insurance contract between Reinsurer and Company #1, the actual policyholders were the 10,000 original policyholders.

[11] IRC Section 6109(g)(1) reads in pertinent part as follows: "[i]n the administration of section 506 of the Federal Crop Insurance Act, the Federal Crop Insurance Corporation may require *each policyholder* and *each reinsured company* to furnish to the insurer or to the Corporation the employer identification number of such policy holder . . . ."[11] As demonstrated by Section 6109(g)(1), a policyholder is distinguished from a reinsured company.

[12] *Id.* at 178:1-16 (emphasis added).

> who holds an interest (directly or indirectly) in the specified assets with respect to such insurance company.[13]

Specified Assets are defined as follows:

> [t]he term 'specified assets' means, with respect to any insurance company, the trades or businesses, rights, or assets with respect to which the net written premiums (or direct written premiums) of such insurance company are paid.[14]

With respect to a Specified Holder, as written the definition places an ownership limitation on the business owner's spouse in the same manner as the business owner's lineal descendants. Considering that there is an unlimited marital deduction in the IRC, this limitation creates many unintended consequences and mirrors no similar tax policy.[15]

This dilemma is illustrated with the following example: Adam and Beth, a married couple, are doctors who each own 100% of their own medical practices. Adam is a dermatologist and Beth is an OB/GYN. Due to professional rules on the practice of medicine, only a doctor working in a practice can have ownership of that practice; thus, Adam owns 100% of his dermatology practice and Beth owns 100% of her OB/GYN practice. Adam and Beth wish to form a captive insurance company to insure some of their respective medical malpractice risks; however, due to the restriction on spousal ownership, a single captive insurance company cannot be formed because each spouse is prohibited from owning any more than a *de minimis* percentage of the captive insurance company since each owns 0% of the other's medical practice.

Ironically, if only one captive is used to insure both of these medical practices, Adam and Beth are limited to only owning 2% or less of the insurance company (the *de minimis* percentage), requiring 96% or more to be owned by others. Whereas, if Adam and Beth each had their own captive that insured only that person's business, each could own 100% of his/her captive.

The restriction on spousal ownership is further illustrated in the context of taxpayers who live in any of the nine community property states.[16] For example, James and Sally, a married couple, live in California – a community property state.[17] Prior to James' marriage to Sally, he started a business, of which he owns 100% (the "Business"); therefore, the Business is considered to be James' separate property, because he brought it into the marriage. After James marries Sally, James forms a captive insurance company to insure the Business (the "Captive"). Since the Captive was formed after James married Sally, it is considered community property to James and Sally even though James owns 100% of it. Because the Captive is community property, Sally is considered to own 50% of it by virtue of the state community property law.[18] As the PATH Act is currently written and without IRS guidance, the Captive may not satisfy the Ownership Test, as

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[13] *Id.* at 178:19-179:4.
[14] *Id.* at 179:5-12.
[15] *See* 26 U.S.C.A. § 2056.
[16] The nine community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Internal Revenue Service Manual – 25.18.1, Basic Principles of Community Property Law, available at https://www.irs.gov/irm/part25/irm_25-018-001.html.
[17] *Id.*
[18] *Id.*

defined above, because Sally might be treated as owning more of the Captive (50%) than she does of the Business (0%).

Additionally, as drafted it would appear that the PATH Act provides no limitation on ownership by stepchildren (that are not adopted) while a spouse's ownership is restricted. To reconcile the inconsistencies between the PATH Act and the unlimited marital deduction, and to address potential unintended consequences arising from these inconsistencies, the IRS should provide guidance with respect to the treatment of the spouse as a Specified Holder.

B. Administrative Relief Request: Treat Spousal Ownership as De Minimis

As discussed above, the definition of Specified Holder, as written, currently places an ownership limitation on the business owner's spouse in the same manner as the business owner's lineal descendants, creating inconsistencies with spousal treatment elsewhere in the tax code as well as unintended consequences with respect to treatment of stepchildren. It is the Industry's understanding that the intention of including the word "spouse" in the definition of Specified Holder was to capture and place ownership restrictions on a spouse's lineal descendants, who would be considered a stepchild to the business owner, and not capture and place ownership restrictions on the spouse. The Industry asks that the IRS temporarily permit that any spousal ownership be treated as *de minimis* unless such ownership is an attempt to pass assets to stepchildren. Such an interpretation should be considered reasoned compliance until further guidance is provided.

III. "Specified Assets" – Multiple Entities and Business Growth

A. Specified Assets Analysis

Guidance is also needed with respect to Specified Assets on a number of fronts. First, in order to determine whether the Ownership Test is satisfied, the "percentage of interest in the [S]pecified [A]ssets" must be calculated.[19] It is currently unclear whether, in a multiple insured entity situation, where the ownership of the spouse and/or a lineal descendant is not identical in all entities, the calculation should be based on gross revenue per entity, premiums paid per entity, fair market value, or some other method. Guidance is similarly needed regarding how to value "interest" when there is both common and preferred stock, or voting and non-voting stock, and various trust applications. Without clarification in this area, compliance with the Ownership Test cannot be determined with any degree of certainty; thus, it could not be efficiently audited by the IRS.

For example, an auto dealership company consists of two entities in different cities. Entity A, the larger entity, is owned 50% by Father and 50% by Son. Entity B, the smaller entity, is owned 100% by Father. Father and Son would like to form a captive insurance company to insure large deductibles of both Entity A and Entity B's general liability and worker's compensation risk. It is unclear which valuation method Father and Son should use to determine how much of the captive insurance company the Son may own because the captive insurance company is insuring Entity A, of which the Father owns a portion, and Entity B, which is wholly-owned by Father.

[19] PATH Act at 178:11-13.

One option would be to set up two captive insurance companies: one owned 50% by Father and 50% by Son to insure Entity A's risk; and one owned 100% by Father to insure Entity B's risk. However, because of the associated costs, this arrangement is rarely feasible. Another option would be to set up a single captive insurance company and by using a reasonable valuation method, allow the Son to own a percentage of the captive insurance company that is equal in economics to him as what he could own if the first option were implemented. However, without guidance from the IRS, it is unclear how to achieve compliance, even if the arrangement has the same economic result as the first option. The Industry seeks to comply with the law; clarification will foster compliance with the law, and more efficient auditing by the IRS.

In addition, the Industry is concerned that a taxpayer who prepares a good faith valuation of Specified Assets will later be challenged in an audit when the auditor determines that a different valuation method should have been used, which results in a decrease to a Specified Holder's calculated interest in the Specified Assets by more than what the IRS finds to be *de minimis*; therefore, the Industry asks the IRS to issue guidance with respect to permissible valuation methods.

On a similar note, as currently written, Specified Assets could be interpreted to encompass not only related insureds and assets, but unrelated insureds and assets as well. If unrelated risk is not excluded from the valuation of a Specified Holder's interest in the Specified Assets, unrelated risk would be included in the denominator of the calculation, which effectively decreases the Specified Holder's available interest that can be owned in the captive insurance company. This creates a harmful incentive for insurance companies to reduce the amount of unrelated risk inside the captive, an incentive that is completely contrary to decades of IRS guidance and court cases.[20]

Such a broad definition effectively punishes an insurance company that receives between 1% and 79% of unrelated premiums.[21] The Industry asks the IRS for guidance that Specified Assets means assets owned by a Specified Holder or lineal ancestors of a Specified Holder only, and excludes assets of unrelated insureds and the unrelated interests portion of related insureds. There are two kinds of situations in this case that require guidance. One is unrelated insureds where the insured is not controlled by the same owners of the insurance company. For example, the insured has zero to less than 50% common ownership with the insurance company ownership, relying on standard controlled entity ownership tests. Another is unrelated assets where the insured and insurance company would be considered controlled by the common ownership, but part of the ownership of the insured is by unrelated persons. For example, a mother and daughter could own 70% combined of an insured business with 30% owned by an unrelated person. The

[20] Historically, court cases and IRS guidance have taken the approach of "more is better" with respect to insuring unrelated risk. Rev. Rul. 2014-15 (providing that "[d]istributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim.") (citing *Clougherty Packing Co. v. Commissioner,* 811 F.2d 1297, 1300 (9th Cir. 1987)); *Humana, Inc. v. Commissioner,* 881 F.2d 247, 256 (6th Cir. 1989) (holding that for risk distribution the focus is on the "insurer as to whether the risk insured against can be distributed over a larger group rather than the relationship between the insurer and any single insured"); *Kidde Industries, Inc. v. U.S.,* 40 Fed. Cl. 42, 53 (1997) (holding that "[b]y increasing the total number of independent, randomly occurring risks that a corporation faces (*i.e.*, by placing risks into a larger pool), the corporation benefits from the mathematical concept of the law of large numbers . . . .").

[21] If unrelated risk is 80% or greater, then the Risk Diversification Test is likely satisfied assuming no unrelated risk is represented by more than 20% of the overall premiums received.

30% portion of the insured assets that generated the premium tied to the assets of that unrelated person would be the unrelated assets.

Another issue that arises with respect to determining percentage of Specified Assets in the case of multiple insureds relates to fluctuations in value of the insureds or changes in the insureds' respective risk profiles over time. If an insurance company insures only one entity, then presumably there will be no fluctuation in the Specified Holder's percentage of interest in the Specified Assets because the ownership amount remains constant regardless of whether the entity grows or shrinks. However, when there are multiple related entities (with varying ownerships) insured by the same insurance company, what happens when one of those related entities grows or shrinks in a given year? Will ownership of the related entities need to change on a yearly basis? Because businesses do not typically stay the same size or have the same risk profile year after year, it is impractical for the owners of an insurance company to make small adjustments to their ownership on an annual basis simply because the size of one business changed compared to the other business. Without guidance, business owners are forced to choose between making continuous ownership changes or forgoing the Section 831(b) election altogether. This issue further underscores the Industry's need for guidance for situations when two or more related businesses, with varying ownerships, are insured by the same insurance company.

B. Administrative Relief Request: Permit Reasonable Valuation Methods, Exclude Unrelated Party Insureds, Apply Provisions for Material Changes and Cure Periods

The Industry asks the IRS to temporarily permit any valuation method so long as the method is chosen in good faith and is not an attempt to circumvent the intentions behind the PATH Act's amendments to Section 831(b) – to prevent wealth transfer. To address the ambiguity as to whether "Specified Assets" includes assets owned by a Specified Holder, spouse, or lineal ancestor of a Specified Holder only, or whether unrelated insureds and assets are included in that definition, the Industry asks the IRS to interpret Specified Assets to mean assets owned by a Specified Holder or lineal ancestor of a Specified Holder and exclude the spouse's ownership as set forth above. The Industry believes that this interpretation is consistent with the intention to prevent wealth transfer and promotes risk distribution by removing a potential barrier to insuring unrelated party risk.

To permit insurance companies who are in compliance with the Ownership Test to address business and ownership fluctuations, the Industry asks the IRS to temporarily allow the following: if a Specified Holder's percentage of interest in the Specified Assets satisfies the Ownership Test in the first year, then the Ownership Test is deemed satisfied in subsequent years unless and until there is a "material change." Material Change may be defined to include the following: (1) any change in ownership of an insurance company more than a *de minimis* amount; (2) the weighted aggregate value of the Specified Holder's ownership in the Specified Assets decreases by more than 25% of the amount at last time of satisfying the Ownership Test, due to the natural course of business and not due to adding or subtracting insured businesses; and (3) the weighted aggregate value of the Specified Holder's interest in the Specified Assets decreases by more than 10% due to adding or subtracting insured businesses.

Moreover, considering that financial statements are not prepared until months after the year-end close of a business' tax year, a cure period should be provided, which would allow an insurance company that previously complied with the requirements of Section 831(b) but for which in the current year is out of compliance, to return to compliance. If the insurance company returns to compliance within this cure period, then the insurance company will be deemed to have been in compliance during the non-compliant period.

IV. "De Minimis" Exception

A. De Minimis Exception Analysis

Lastly, *de minimis* is defined as follows: "[e]xcept as otherwise provided by the Secretary in regulations or other guidance, 2 percentage points or less shall be treated as de minimis."[22] What this definition does not include is when, for what, and for whom the *de minimis* amount will be increased (or potentially decreased). In particular, there is no guidance on whether deviations will be allowed as a result of the death or disability of a person. For example, ABC business is owned 28% by Father, 12% by Son, and 60% by an unrelated person, who is Father's longtime business partner (an "Unrelated Person"). With respect to the captive insurance company, X, which provides insurance to ABC business, Father owns 70% and Son owns 30% (This matches the individual pro rata shares of father's and son's total interest in ABC). The Ownership Test is satisfied because Son's ownership of X is not greater than his ownership of ABC business, relative to a Specified Holder. Assume that the Unrelated Person dies, leaving his 60% interest to Father. The Ownership Test is no longer satisfied because Son's ownership in ABC business suddenly dropped in comparison to Father's ownership while Son's ownership in X remains the same.

Additionally, consider the following example: Father owns 100% of BCD business. BCD business pays $400,000 of insurance premium to a captive insurance company, Y, and BCD business is Y's only related insured. BCD business has three mid-level managers that are in charge of risk management for BCD business, one of which is Son, and the other two are Unrelated Persons. To promote effective risk management, Father creates an incentive by giving a 5% interest in the captive to each manager, with the remaining 85% owned by Father. The Ownership Test is not satisfied because Son has a 5% interest in Y while Son has no ownership interest in BCD business; however, if we remove the Son's 5% ownership interest incentive, the Ownership Test is satisfied because the two remaining mid-level managers are unrelated Persons.

The *de minimis* provision in the Ownership Test serves as the safety valve to ensure that broad restrictions imposed in the PATH Act do not inappropriately exclude insurance companies that were not intended to be excluded. Thus, IRS guidance is necessary to clarify whether the *de minimis* allowance may be applied to account for the death or disability of someone such as an Unrelated Person, or circumstances where a Specified Person is treated substantially equally to Unrelated Persons of similar condition.

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[22] PATH Act:179:17-21.

B. Administrative Relief Request: Permit Limited Exceptions

As outlined, the definition of *de minimis* does not include when, for what, and for whom the *de minimis* amount will be increased (or potentially decreased). With no guidance having been issued on whether deviations will be allowed as a result of the death or disability of a person, or in circumstances where a Specified Person is situated substantially the same as an unrelated person, the Industry asks the IRS to consider the following as temporary exceptions to the *de minimis* allowance: (1) the death or disability of a person that is an Unrelated Person; (2) the substantially equal treatment of a Specified Holder with Unrelated Persons in a similar condition; and (3) an insurance contract not substantially motivated by a purpose of reducing future wealth transfer taxes under Subtitle B that would be imposed on an insured shareholder or a Specified Holder.

The *de minimis* exception should be also be applied to prevent situations whereby a person becomes a "specified holder" due to a tiny amount of ownership of the insured assets by that person's lineal ancestor or spouse. This situation applies where the business is already majority owned by the children, and thus it is not an estate tax avoidance scheme to have the same children own the captive.

For example, Sally is a part owner of 50 fast food franchise locations, with ownership amounts ranging from 25% to 100%. The other owners are unrelated investors, except her father owns a 1% interest in a few of them. Sally proposes to form a captive to save on cost of the insurance for these franchises. She will put up the financial capital and expense to start the insurance company, but in return wishes to own 100% of the captive. The unrelated investors are fine with the arrangement because this should save them money. Unfortunately, Sally cannot be the 100% owner because she is considered a "specified holder" due to the fact that her father owns a *de minimis* interest in a few of the locations. To prevent this unintended consequence, the IRS's power to provide *de minimis* exceptions for specified holders would appropriately be used to prevent categorizing someone as a specified holder if that label is triggered merely due to a lineal ancestor (or spouse) owning only a *de minimis* interest in the specified assets.

Conclusion

In order to clarify several interpretational ambiguities related to the Diversification Requirement, the IRS should provide the Industry with guidance on the issues outlined above. In the absence of such guidance, administrative relief from compliance with the PATH Act's amendments to 831(b) is not only appropriate but necessary to enable the Industry to devise and implement efficient and effective procedures for compliance, and the IRS to efficiently audit. If neither guidance nor relief from compliance are available, then adopting the Industry's reasoned positions on a temporary basis would be a fair and reasonable method of enabling the Industry to comply with the letter and spirit of the new law.

The undersigned organizations greatly appreciate your consideration of these very important issues. If you have any additional questions or would like to discuss this further, please do not hesitate to contact Ryan Work at (202) 595-0642 or rwork@siia.org.

Sincerely,

SELF INSURANCE INSTITUTE OF AMERICA
By: Michael Ferguson
President & CEO

ALABAMA CAPTIVE ASSOCIATION
By: Norman Chandler
President

DELAWARE CAPTIVE INSURANCE ASSOCIATION
By: Peter E. Cavanaugh
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CAPTIVE INSURANCE COUNCIL DISTRICT OF COLUMBIA
By: Melissa Hancock
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GEORGIA CAPTIVE INSURANCE ASSOCIATION
By: Alana Mueller
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HAWAII CAPTIVE INSURANCE COUNCIL
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By: John Jones
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NEVADA CAPTIVE INSURANCE ASSOCIATION
By: Connie Akridge
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NORTH CAROLINA CAPTIVE INSURANCE ASSOCIATION
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OKLAHOMA CAPTIVE INSURANCE ASSOCIATION
By: Jerry D. Messick
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SOUTH CAROLINA CAPTIVE INSURANCE ASSOCIATION
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TENNESSSEE CAPTIVE INSURANCE ASSOCIATION
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