**IN CASE YOU MISSED IT – May/June 2026**

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Almost every day, federal and state courts issue opinions that affect taxpayers. The IRS and state taxing authorities also publish guidance on myriad topics.

Each month, this column will review a selection of recent court cases or guidance that tax professionals should know about when advising their clients and preparing tax returns.

For more extensive detail on any of these items, please feel free to reach out to the authors.

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Increasing attention has been paid recently to the IRS's efforts to police so-called "microcaptive" insurance arrangements for abuse. Four recent cases illustrate the tools in the IRS's arsenal.

Insurance companies are generally subject to tax on insurance premiums received at normal corporate rates. However, Congress provided a special alternative methodology that may be elected by certain small insurance companies (hereinafter, "microinsurers") that earn less than a certain threshold in annual insurance premiums ($2,900,000 for 2026), under which the microinsurer is subject to tax only on its "investment income." § 831(b). Under this rule, a microinsurer that makes investments using its premiums received may effectively defer income recognition until it disposes of the investments.

Taxpayers claim deductions under § 162 for payment of insurance premiums (for insurance purchased for a trade or business) to a related "microcaptive" insurer, while the "microcaptive" insurer effectively defers the premium income. Such microcaptive arrangements have been vulnerable to two primary challenges. First, the government has challenged several such transactions as involving payments of premiums for something that was not true "insurance" but was solely for tax avoidance. Second, the government has successfully challenged several such transactions as lacking economic substance, with a particular focus on the legislative codification of the economic substance doctrine pursuant to § 7701(o), commonly referred to as the "codified economic substance doctrine."

The Microcaptive Reportable Transaction Designations: CIC and Drake Plastics

Section 6707A(c) gives the Secretary of the Treasury the authority to designate categories of transactions that have "a potential for tax avoidance or evasion" as "reportable transactions," and if it is "specifically identified by the Secretary [of the Treasury] as a tax avoidance transaction…," it may be further designated as a "listed transaction." Taxpayers are required to disclose involvement in a reportable transaction to the IRS on Form 8886, and in some cases their advisors have a disclosure requirement as well (on Form 8918, if the advisor is a "material advisor" as defined under Treas. Reg. § 301.6111-3). Section 6707A provides for penalties for failure to report a reportable transaction on Form 8886.

Section 6662A provides for additional penalties for understatement of tax resulting from either a listed transaction or "any reportable transaction (other than a listed transaction) if a significant purpose of such transaction is the avoidance or evasion of Federal income tax." Section 6501(c)(1) provides that the statute of limitations for an undisclosed listed transaction runs forever.

On Jan. 14, 2025, the IRS released final regulations designating certain microcaptive insurance transactions as "listed transactions" under Treas. Reg. § 1.6011-10 and certain others as "transactions of interest" under Treas. Reg. § 1.6011-11. As a threshold, both regulations apply only if the insurer is a "captive" insurer. A captive insurer is an insurer that 1) has at least 20% of its assets, voting power, or interests owned by the insured, its owners or certain related persons, 2) elects to be taxed as a microinsurer under § 831(b), and 3) insures or reinsures the risk of the insured.

The listed microcaptive transaction is a transaction that satisfies *both* of the following requirements (or is "substantially similar" to such a transaction): The microcaptive insurer both 1) has a percentage of insurance premiums received that are paid out for insurance claims (known as the "loss ratio") of less than 30% over the past ten full years and 2) makes any portion of the amount received as insurance premiums available to the insured (or its owners or certain related persons) in a tax-free manner, such as through a loan or guarantee, over the past five years (the "financing factor").

The microcaptive transaction of interest is a transaction that satisfies *either* of the following requirements (or is "substantially similar" to such a transaction): The microcaptive insurer either 1) has a loss ratio of less than 60% over the past ten years, or if shorter, since inception, or 2) satisfies the financing factor in the same manner as required for a listed transaction.

*CIC Services, LLC v. Internal Revenue Service* is a recent decision on a motion for summary judgment before the US District court for the Eastern District of Tennessee. CIC Services is in the business of helping taxpayers establish microinsurer arrangements, and challenged both the listed transaction rule and the transaction of interest rule as being "arbitrary and capricious" and not validly promulgated pursuant to the Administrative Procedure Act. The *CIC* court upheld both regulations, finding that the Department of Treasury (in its preamble) had adequately met its burden to show why both designations were reasonable.

*Drake Plastics Ltd. v. Internal Revenue Service* is another recent decision on a motion for summary judgment, this time before the US District court for the Southern District of Texas. In *Drake Plastics Ltd. Co.*, the court upheld Treas. Reg. § 1.6011-11 (transaction of interest status), also finding that the preamble adequately explained why it found that the transaction described as a microcaptive transaction of interest had the potential for tax avoidance or evasion. However, unlike the court in *CIC Services*, the court vacated Treas. Reg. § 1.6011-10 (Listed Transaction status) as arbitrary and capricious. The court found that a "listed transaction" designation under § 6707A(c)(2) required that the transaction be ***presumptively*** not for insurance. Although the preamble to the final regulations drew examples of abusive transactions that fit the listed transaction criteria, and explained why such transactions were likely to be abusive, the court found that Treasury failed to meet its burden to show that all transactions fitting the listed transaction criteria should be presumed to not be true insurance.

Application of "Nondisclosed Noneconomic Substance Transaction" Penalties to Microcaptive Transactions: *Kudau* and *Royalty Management*

In *Kadau v. Commissioner*, the sole shareholder of an S corporation had formed a captive insurance company, and the S corporation paid insurance premiums to a third-party insurer, organized by a promoter. The third party insurer entered into a reinsurance arrangement with the captive insurer, under which the dollar amount of the premium (minus the amount of a promoter fee) was paid to the captive insurer as a premium, and the captive insurer agreed to reinsure a slice of the third-party's risk. The funds ultimately flowed in a circle, from the S corporation to the third-party insurer to the captive insurer. The captive insurer ultimately used the premiums to buy a life insurance policy on the life of the shareholder as well as an annuity which produced annuity payments to cover the premium payments on the life insurance policy. The Tax Court had previously found that, although some aspects of the arrangement were defensible, most of the factors in the caselaw defining insurance weighed against the taxpayer, particularly given the circular flow of funds, and upheld the disallowance of the taxpayer's claimed deduction under § 162 for insurance premiums.

In *Royalty Management Insurance Company, Ltd. v. Commissioner,* the taxpayers owned all of the shares in an S corporation as well as a putative captive "reinsurer" (organized in a tribal jurisdiction having no insurance laws or insurance regulatory authority). A promoter established a third-part insurer in the same jurisdiction. The S corporation purchased a purported insurance policy from the third-party insurer, although the third-party insurer did not actually exist at the start of the policy period. The "net written premiums" were then "ceded" to the captive reinsurer as premiums for reinsurance. The captive insurer then made the funds available to the S corporation by issuing a line of credit, introducing full circularity in the flow of cash. As in *Kadau*, the Tax Court found that the arrangement lacked the indicia of true insurance.

The Tax Court deferred addressing penalties in both of these cases pending clarification of the codified economic substance doctrine in another microcaptive case that was before the Tax Court, which eventually resulted in the decision in *Patel v. Commissioner*. The primary issue relating to § 7701(o) in *Patel* was whether the introductory language in § 7701(o)(1) imposes a threshold "relevancy" determination before application of the subsequent prongs of the codified economic substance doctrine. The Tax court in *Patel* found that a threshold relevancy determination is required, and that this relevancy determination is made by determining if the pre-codification judicial economic substance doctrine would have applied to this fact pattern.

Because the judicial economic substance doctrine had been frequently applied in older insurance cases, the Tax Court held that the economic substance doctrine was relevant.

In the second round of proceedings, the Tax Court found that the arrangement lacked economic substance under the codified economic substance doctrine of § 7701(o). As neither taxpayer was found to have adequately disclosed the arrangement on any tax return, they were both subject to the enhanced 40% penalty for "nondisclosed noneconomic substance transactions."

In *Kadau*, the taxpayer conceded that the economic substance doctrine was relevant, and the court then analyzed the transaction under the two-part test for economic substance under § 7701(o), under which a transaction is treated as having economic substance only if both 1) the transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position and 2) the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction.

The *Kadau* court went on to conclude that the transaction lacked economic substance. First, the court concluded that the taxpayer's pre-tax economic position was not changed in a meaningful way, because the money effectively moved in a circle, and the ultimate payment of claims was no different than if the taxpayer had saved money in a personal bank account to draw upon in the event of losses. Second, the court concluded that the transaction lacked a substantial nontax business purpose because even putting aside the question of whether the transaction really was designed and intended to constitute insurance, the money flowed in a circular manner and was ultimately used to purchase a life insurance policy for the taxpayer. Therefore, the court found that the purpose of the arrangement was to be a "structural shell" rather than to actually hedge against risk.

In *Royalty Management Insurance Company*, the taxpayer did contest whether the relevancy requirement was met, but the court found that the relevancy requirement was met by virtue of the fact that the captive insurer was found in the earlier decision not to have been providing insurance for purposes of § 831(b). Therefore, because the premiums did not constitute insurance, Congress did not intend for § 162 to permit a deduction for the premiums paid. Since the transaction did not avail itself of a Congressionally sanctioned "inducement," the court found that the economic substance doctrine was relevant.

After dispensing with the relevance inquiry, the court proceeded with a similar analysis to that in *Kadau*. First, because the arrangement resulted in a circular flow of funds (culminating in a line of credit to the S corporation) that did not change the ultimate flow of economic benefits, and the putative insurance and reinsurance arrangements were found not to insure a risk of loss, the taxpayers' pre-tax economic position was not changed in a meaningful way from if the taxpayer had simply held the funds in their own bank account. Second, the transaction lacked a substantial nontax business purpose, because while the taxpayers intended to gain a substantial tax benefit from the arrangement, the risk insured was miniscule, and the taxpayers never seriously investigated the non-tax costs and benefits of the microcaptive arrangement.

Both taxpayers were held liable for the enhanced 40% penalty.

*Takeaway:* While insurance is often of vital importance to protect a company's going concern, it should be true insurance. Simply structuring a transaction to take advantage of tax benefits and calling it "insurance" will not serve any non-tax purpose and will make it susceptible to challenges by the IRS. And Practitioners should remember that these are now reportable transactions that must be reported on a tax return.

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