INTERNAL REVENUE
BULLETIN

HIGHLIGHTS OF THIS ISSUE

Bulletin No. 2023–17
April 24, 2023

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

ADMINISTRATIVE

REG 121709-19, page 789.

This document contains proposed regulations regarding supervisory approval of penalties. The proposed regulations are necessary to address uncertainty regarding various aspects of supervisory approval of penalties that have arisen due to recent judicial decisions. The proposed regulations affect the IRS and persons assessed certain penalties by the IRS.

ADMINISTRATIVE, INCOME TAX

Announcement 2023-12, page 799.

Announcement 2023-12 informs taxpayers and practitioners that the Internal Revenue Service has revised Form 3115, Application for Change in Accounting Method, and its instructions. The Form 3115 (Rev. December 2022) is the current Form 3115 (December 2022 Form 3115) and replaces the December 2018 version of the Form 3115. Announcement 2023-12 also provides guidance to allow for a reasonable period for taxpayers to transition to the December 2022 Form 3115.

ADMINISTRATIVE, SPECIAL ANNOUNCEMENT

Announcement 2023-11, page 798.

This announcement notifies the public that a proposed regulation is being issued that identifies certain micro-captive transactions as listed transactions within the meaning of § 1.6011-4(b)(2) of the Income Tax Regulations, and that certain other micro-captive transactions are being identified as transactions of interest within the meaning of § 1.6011-4(b)(6).

EXEMPT ORGANIZATIONS

Rev. Proc. 2023-12, page 768.

This revenue procedure has been drafted in order to modify specific language in Rev. Proc. 2023-5 to allow for the new electronic submission process of the Form 8940, *Request for Miscellaneous Determination*. This revenue procedure also provides a 90-day transition relief period, during which paper Form 8940 and letter applications will be accepted and processed by EO Determinations.

EXEMPT ORGANIZATIONS, INCOME TAX

Notice 2023-30, page 766.

This notice publishes the safe harbor deed language for extinguishment and boundary line adjustment clauses required by § 605(d)(1) of the SECURE 2.0 Act of 2022, enacted as Division T of the Consolidated Appropriations Act, 2023, Public Law 117-328, 136 Stat. 4459 (December 29, 2022). This notice also clarifies the process certain donors may use to amend an easement deed to substitute the safe harbor language for the corresponding language in the original deed, as provided by § 605(d)(2) of the SECURE 2.0 Act.

Finding Lists begin on page ii.

INCOME TAX

Announcement 2023-7, page 797.

This announcement informs Federal civilian employees and other civilians who are not employed by the Federal government who received certain payments in 2022 and 2023 from the Department of Defense (DOD) in reimbursement for lodging, meals, and personal property damage expenses after the release of petroleum from the Red Hill Bulk Fuel Storage Facility on O'ahu, Hawaii (Red Hill Fuel Spill) that such payments are excludable from gross income for Federal income tax purposes under § 139 of the Internal Revenue Code.

REG 109309-22, page 770.

The proposed regulations identify transactions that are the same as, or substantially similar to, certain micro-captive transactions as listed transactions and certain other micro-captive transactions as transactions of interest for purposes of §1.6011-4 and sections 6111 and 61112, and provides guidance as to the reporting requirements for participants in and material advisors to the identified transactions.

The IRS Mission

Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

The contents of this publication are not copyrighted and may be reprinted freely. A citation of the Internal Revenue Bulletin as the source would be appropriate.

Part III

Conservation Easements – Safe Harbor Deed Language for Extinguishment and Boundary Line Adjustment Clauses

Notice 2023-30

SECTION 1. OVERVIEW

.01 This notice sets forth the safe harbor deed language for extinguishment and boundary line adjustment clauses required by § 605(d)(1) of the SECURE 2.0 Act of 2022 (SECURE 2.0 Act), enacted as Division T of the Consolidated Appropriations Act, 2023, Public Law 117-328, 136 Stat. 4459 (December 29, 2022). This notice also describes the process donors may use to amend an original eligible easement deed to substitute the safe harbor language for the corresponding language in the original deed, as provided by § 605(d)(2) of the SECURE 2.0 Act.

.02 This safe harbor notice addresses only amendments to extinguishment and boundary line adjustment clauses in accordance with § 605(d) of the SECURE 2.0 Act. This safe harbor notice does not address any other deed amendments. Donors are not required to make the amendments described in this notice.

SECTION 2. BACKGROUND

.01 Section 170(a) of the Internal Revenue Code (Code) provides, subject to certain limitations and requirements, a deduction for any charitable contribution, as defined in § 170(c), payment of which is made within the taxable year.[1] Section 170(f)(3)(A) denies a deduction under § 170 in the case of a contribution of a partial interest in property, except as provided in § 170(f)(3)(B). Section 170(f)(3)(B)(iii) provides an exception to the deduction denial in the case of a qualified conservation contribution as defined in § 170(h).

.02 Under § 170(h)(1), the term *qualified conservation contribution* means a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. For this purpose, a *qualified real property interest* is defined in § 170(h)(2)(C) to include a restriction (granted in perpetuity) on the use that may be made of the real property. Under § 1.170A-14(b)(2), a perpetual conservation restriction includes an easement or other interest in real property that under state law has attributes similar to an easement. Section 170(h)(3) defines the term *qualified organization* (donee organization). Section 170(h)(4) defines the term *conservation purpose*, which must be protected in perpetuity for the qualified conservation contribution to be treated as exclusively for conservation purposes pursuant to § 170(h)(5).

.03 Section 1.170A-14 provides further guidance on qualified conservation contributions. Section 1.170A-14(g) requires that such a restriction be enforceable in perpetuity. Section 1.170A-14(g)(6)(i) provides a rule pertaining to extinguishment. It provides that if a subsequent unexpected change in the conditions surrounding the property that is the subject of a perpetual conservation restriction makes it impossible or impractical to continue to use the property for conservation purposes, the conservation purpose can nonetheless be treated as protected in perpetuity if (1) the restrictions are extinguished by judicial proceeding and (2) all of the donee's proceeds (determined under § 1.170A-14(g)(6)(ii)) from a subsequent sale or exchange of the property are used by the donee organization in a manner consistent with the conservation purposes of the original contribution.

.04 Section 1.170A-14(g)(6)(ii) provides that, for a deduction to be allowed under § 170(a), at the time of the gift, the donor must agree that the donation of the perpetual conservation restriction gives rise to a property right, immediately vested in the donee organization, with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction at the time of the gift bears to the value of the property as a whole at that time. That proportionate value of the donee's property rights must remain constant. Accordingly, under § 1.170A-14(g)(6)(ii), if a change in conditions gives rise to the extinguishment of a perpetual conservation restriction under § 1.170A-14(g)(6)(i), the donee organization, on a subsequent sale, exchange, or involuntary conversion of the subject property, must be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction, unless state law provides that the donor is entitled to the full proceeds from the conversion without regard to the terms of the prior perpetual conservation restriction.

.05 Neither the Code nor the regulations specifically address boundary line adjustments. Under § 170(h)(2)(C), however, the restriction the donor grants on the use of the real property subject to the conservation easement must be made in perpetuity. *See also* § 170(h)(5)(A).

.06 The SECURE 2.0 Act was signed into law on December 29, 2022. Section 605(d)(1) of the SECURE 2.0 Act directs the Secretary of the Treasury or her delegate (Secretary) to publish safe harbor deed language for extinguishment clauses and boundary line adjustment clauses within 120 days after the date of the enactment of the SECURE 2.0 Act (that 120th day is April 28, 2023). Section 605(d)(2) of the SECURE 2.0 Act provides that, beginning on the date the safe harbor language is published by the Secretary, donors have a 90-day period in which to amend an original eligible easement deed to substitute the safe harbor language for the corresponding language in the original deed. Since this notice is published in the Internal Revenue Bulletin on April 24, 2023, the 90th day is July 22, 2023. Because that date is a Saturday, § 7503 extends the date until Monday, July 24, 2023. The amended deed must be signed by the donor and donee and recorded by July 24, 2023, and the amendment must be treated as effective

[1] Unless otherwise specified, all "section" and "§" references are to the Internal Revenue Code or the Income Tax Regulations (26 CFR Part 1).

as of the date of the recording of the original easement deed.

.07 Section 3 of this notice describes the process donors may use to amend an eligible easement deed to substitute the safe harbor language for the corresponding language in the original eligible easement deed, and which easement deeds are eligible to be amended, as provided by § 605(d)(2) of the SECURE 2.0 Act. Section 4 of this notice sets forth safe harbor deed language for extinguishment and boundary line adjustment clauses as required by § 605(d)(1) of the SECURE 2.0 Act.

SECTION 3. PROCEDURE TO AMEND ELIGIBLE EASEMENT DEEDS

.01 *In general*. In accordance with § 605(d)(2) of the SECURE 2.0 Act, to amend an original eligible easement deed to substitute the safe harbor language in section 4.01 or 4.02 of this notice for the corresponding language in the original deed—

(1) The amended deed must be signed by the donor and donee and recorded on or before July 24, 2023; and

(2) The amendment must be treated as effective as of the date of the recording of the original easement deed. See section 3.03 of this notice.

.02 *Exceptions*. The term *eligible easement deed* does not include an easement deed relating to any contribution—

(1) Which is part of a reportable transaction (as defined in § 6707A(c)(1)), or is described in Notice 2017-10, 2017-4 I.R.B. 544;

(2) Which, by reason of § 170(h)(7), is not treated as a qualified conservation contribution;

(3) If a deduction under § 170 has been disallowed by the Secretary, and the donor is contesting such disallowance in a case that is docketed in a Federal court on a date before the date the amended deed is recorded by the donor; or

(4) If a claimed deduction for such contribution under § 170 resulted in an underpayment to which a penalty under § 6662 or § 6663 applies and either—

(i) The penalty has been finally determined administratively; or

(ii) If the penalty is challenged in court, the judicial proceeding with respect to such penalty has been concluded by a decision or judgment which has become final.

.03 *Effect of correction*. If a donor substitutes the safe harbor language in sections 4.01 or 4.02 (or sections 4.01 *and* 4.02) of this notice for the corresponding language in the original eligible easement deed and the amended deed is signed by the donor and donee and recorded on or before July 24, 2023, the amended eligible easement deed will be treated as effective for purposes of § 170, § 605(d)(2) of the SECURE 2.0 Act, and section 3.01(2) of this notice as of the date the eligible easement deed was originally recorded, regardless of whether the amended eligible easement deed is effective retroactively under relevant state law.

SECTION 4. SAFE HARBOR DEED LANGUAGE

.01 *Extinguishment clause*. The safe harbor deed language for extinguishment clauses is:

> *Pursuant to Notice 2023-30, Donor and Donee agree that, if a subsequent unexpected change in the conditions surrounding the property that is the subject of a donation of the perpetual conservation restriction renders impossible or impractical the continued use of the property for conservation purposes, the conservation purpose can nonetheless be treated as protected in perpetuity if (1) the restrictions are extinguished by judicial proceeding and (2) all of Donee's portion of the proceeds (as determined below) from a subsequent sale or exchange of the property are used by the Donee in a manner consistent with the conservation purposes of the original contribution.*
>
> <u>Determination of Proceeds.</u> *Donor and Donee agree that the donation of the perpetual conservation restriction gives rise to a property right, immediately vested in Donee, with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction, at the time of the gift, bears to the fair market value of the property as a whole at that time. The proportionate value of Donee's property rights remains constant such that if a subsequent sale, exchange, or involuntary conversion of the subject property occurs, Donee is entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction, unless state law provides that the donor is entitled to the full proceeds from the conversion without regard to the terms of the prior perpetual conservation restriction.*

.02 *Boundary line adjustments clause*. The safe harbor boundary line adjustment clause is:

> *Pursuant to Notice 2023-30, Donor and Donee agree that boundary line adjustments to the real property subject to the restrictions may be made only pursuant to a judicial proceeding to resolve a bona fide dispute regarding a boundary line's location.*

.03 *Similar terms with the same meaning*. In substituting deed language, the donor may use the precise terms used in sections 4.01 and 4.02 of this notice, or the donor may use terms that have the same meaning as the terms in sections 4.01 and 4.02. For example, if the original deed uses the terms "Grantor" and "Grantee" instead of "Donor" and "Donee," the donor can use either "Grantor" and "Grantee" or "Donor" and "Donee" because these terms have the same meaning. Also, for example, if the original deed uses the term "easement" or "servitude" instead of "restriction," the donor may use any of those terms, provided the term refers to a qualified real property interest within the meaning of § 170(h)(2)(C) and § 1.170A-14(b)(2).

SECTION 5. DRAFTING AND CONTACT INFORMATION

The principal authors of this notice are Elizabeth Boone and Hannah Kim of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this notice, contact Ms. Boone at (202) 317-5100, or Ms. Kim at (202) 317-7003 (not toll-free numbers).

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26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 2023-12

SECTION 1. PURPOSE

This revenue procedure modifies Revenue Procedure 2023-5, 2023-1 I.R.B. 265, updating the procedures for Exempt Organizations determination letters with respect to the electronically submitted Form 8940, *Request for Miscellaneous Determination*, which is the form used to request miscellaneous determinations. The modifications to Rev. Proc. 2023-5 made by this revenue procedure provide that the electronic submission process is the exclusive means of submitting a completed Form 8940, except for submissions eligible for the 90-day transition relief provided in section 4 of this revenue procedure.

Additionally, this revenue procedure modifies existing procedures so that Form 8940 will be used by government entities to request voluntary termination of exempt status under § 501(c)(3) (previously a letter request), by Canadian registered charities to request inclusion in Tax Exempt Organization Search database of organizations eligible to receive tax-deductible charitable contributions (Pub. 78 data) or a determination on public charity classification (previously a letter request), and by private foundations giving notice of intent to terminate private foundation status under § 507(b)(1)(B) (previously provided on Form 8940 or by general correspondence).

SECTION 2. CHANGED SUBMISSION PROCESS

The IRS revised and updated Form 8940 and provided for it to be electronically submitted at www.pay.gov. The electronic submission process for Form 8940 replaces the paper submission process for Form 8940 effective for Forms 8940 submitted on or after April 4, 2023, subject to the transition relief provided in section 4 of this revenue procedure. Section 3 of this revenue procedure modifies Rev. Proc. 2023-5 to set forth procedures for issuing determination letters in response to electronically submitted Form 8940 applications. Unless otherwise modified in this revenue procedure, the provisions of Rev. Proc. 2023-5 continue to apply.

SECTION 3. MODIFICATIONS TO REVENUE PROCEDURE 2023-5

.01 Section 4.02(6) of Rev. Proc. 2023-5 is modified to read as follows:

(6) **Form 8940 request for miscellaneous determination.** An organization seeking a miscellaneous determination or a request must electronically submit a completed Form 8940, *Request for Miscellaneous Determination*, at www.pay.gov. The Form 8940 is used for the following determination letter requests and notices—

(a) Advance approval of certain set-asides described in § 4942(g)(2);

(b) Advance approval of voter registration activities described in § 4945(f);

(c) Advance approval of scholarship procedures described in § 4945(g);

(d) Exception from Form 990 filing requirements;

(e) Advance approval that a potential grant or contribution constitutes an unusual grant;

(f) Change in Type (or initial determination of Type) of a § 509(a)(3) organization;

(g) Reclassification of foundation status, including a voluntary request from a public charity for private foundation status;

(h) Termination of private foundation status under § 507(b)(1)(B)—advance ruling request;

(i) Notice Only – Termination of private foundation status under section 507(b)(1)(B);

(j) Termination of private foundation status under § 507(b)(1)(B)—60-month period ended;

(k) Voluntary termination of § 501(c)(3) recognition by a government entity; and

(l) Canadian registered charities: listing on Pub. 78 Data and/or public charity classification.

.02 The first paragraph of section 4.09(1) of Rev. Proc. 2023-5 is modified to read as follows:

(1) **Procedures for requesting expedited handling**. In the case of the electronically submitted Form 1023, Form 1024, Form 1024-A, or Form 8940, a request for expedited handling must be indicated on the form and a supporting written statement must be submitted as an attachment with the completed form.

.03 Section 7.02 of Rev. Proc. 2023-5 is modified to read as follows:

.02 A request described in section 4.02(6) of this revenue procedure must be electronically submitted on Form 8940 at www.pay.gov (except where otherwise permitted, including when such request is made as part of an application for recognition of exemption), along with all information, documentation, and other materials required by Form 8940 and the instructions thereto, as well as the appropriate user fee provided in Appendix A. Form 8940 must be electronically signed by an authorized individual under penalties of perjury (see sections 4.04 and 4.06 of this revenue procedure). For complete information about filing requirements and the submission process, refer to Form 8940 and the Instructions for Form 8940.

.04 Section 14.03 of Rev. Proc. 2023-5 is modified to read as follows:

.03 Actions that do not require the payment of a user fee include—

(1) Elections pertaining to automatic extensions of time under Treas. Reg. § 301.9100-1;

(2) Confirmation of tax-exempt status (affirmation letter) (to replace lost tax-exempt status letter and to reflect name and address changes); and

(3) Notice of intent to terminate private foundation status under § 507(b)(1)(B) without a request for an advance ruling.

.05 Section 14.06(1) of Rev. Proc. 2023-5 is modified to read as follows:

(1) **Payment of user fees for applications of recognition of exemption on Form 1023, Form 1023-EZ, Form 1024, Form 1024-A, or requests on Form 8940.** User fees for applications for recognition of exemption on Form 1023, Form 1023-EZ, Form 1024, Form 1024-A, or requests on Form 8940 must be paid at www.pay.gov.

.06 Section 14.07 of Rev. Proc. 2023-5 is modified to read as follows:

.07 Form 8718 should be attached to applications or requests other than those made on Form 1023, Form 1023-EZ, Form 1024, Form 1024-A, or Form 8940,

to transmit a check in the amount of the required user fee.

.07 Section 15.01(1) of Rev. Proc. 2023-5 is modified to read as follows:

(1) The following types of requests and applications handled by the EO Determinations Office should be sent to the Internal Revenue Service Center, at the address in section 15.01(2):

(a) applications for recognition of exemption on Form 1028; and

(b) requests submitted by letter.

.08 Section 15.02 of Rev. Proc. 2023-5 is modified to read as follows:

.02 Applications for recognition of exemption on Form 1023, Form 1023-EZ, Form 1024, Form 1024-A, and requests on Form 8940 are handled by the EO Determinations Office but must be submitted electronically online at www.pay.gov. Paper submissions of Form 1023, Form 1023-EZ, Form 1024, Form 1024-A, and Form 8940 will not be accepted for processing.

.09 Section 15.03 of Rev. Proc. 2023-5 is modified to read as follows:

.03 Requests for exempt status affirmation letters should be sent to the Internal Revenue Service at the address shown below.

Internal Revenue Service
P.O. Box 2508
Cincinnati, OH 45201

.10 The Note of Appendix A, item (4) of Rev. Proc. 2023-5 is modified to read as follows:

Note: In accordance with the income tax treaty between the United States and Canada, and pursuant to a mutual arrangement between the competent authorities of the two countries, Canadian registered charities are automatically recognized as exempt under § 501(c)(3) without filing an application for recognition of exemption. For details, *see* Notice 99-47, 1999-2 CB 391. Therefore, no user fee is required when a Canadian registered charity submits a Form 8940 to request to be listed in Tax Exempt Organization Search database for organizations eligible to receive tax-deductible charitable contributions (Pub. 78 data), or to request a determination on its public charity classification. For additional information about the submission process, refer to the Form 8940 Instructions.

.11 Appendix A of Rev. Proc. 2023-5 is modified to include new item (15) as follows:

(15) Notice of intent to terminate private foundation status under § 507(b)(1)(B) without a request for an advance ruling.	None

SECTION 4. TRANSITION RELIEF

.01 Except as provided in section 4.02, an organization seeking a miscellaneous determination using Form 8940 must electronically submit the form and user fee online at www.pay.gov.

.02 The Internal Revenue Service will accept for processing a completed paper Form 8940, letter request from a government entity voluntarily terminating § 501(c)(3) recognition, letter request from a Canadian registered charity, or correspondence providing notice of intent to terminate private foundation status under § 507(b)(1)(B), accompanied by the correct user fee (if any), as described in Rev. Proc. 2023-5, if the submission is postmarked on or before the date that is 90 days after the effective date of this revenue procedure.

SECTION 5. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2023-5 is modified.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective April 4, 2023.

SECTION 7. DRAFTING INFORMATION

The principal author of this revenue procedure is Ingrid Vatamanu of the Office of Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes). For further information regarding this revenue procedure contact Ms. Vatamanu at (202) 317-4541 (not a toll-free number).

Part IV

Notice of Proposed Rulemaking

Micro-captive Listed Transactions and Micro-captive Transactions of Interest

REG-109309-22

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that identify transactions that are the same as, or substantially similar to, certain micro-captive transactions as listed transactions, a type of reportable transaction, and certain other micro-captive transactions as transactions of interest, another type of reportable transaction. Material advisors and certain participants in these listed transactions and transactions of interest are required to file disclosures with the IRS and are subject to penalties for failure to disclose. The proposed regulations affect participants in these transactions as well as material advisors. This document also provides notice of a public hearing on the proposed regulations.

DATES: Electronic or written comments must be received by June 12, 2023. The public hearing on these proposed regulations is scheduled to be held by teleconference on July 19, 2023, at 10 a.m. ET. Requests to speak and outlines of topics to be discussed at the public hearing must be received by June 12, 2023. If no outlines are received by June 12, 2023, the public hearing will be cancelled. Requests to attend the public hearing must be received by 5 p.m. ET on July 17, 2023. The telephonic public hearing will be made accessible to people with disabilities. Requests for special assistance during the telephonic hearing must be received by July 14, 2023.

ADDRESSES: Commenters are strongly encouraged to submit public comments electronically. Submit electronic submissions via the Federal eRulemaking Portal at *https://www.regulations.gov* (indicate IRS and REG-109309-22). Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish any comments to the public docket. Send paper submissions to: CC:PA:LPD:PR (REG-109309-22), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC, 20044.

For those requesting to speak during the hearing, send an outline of topic submissions, electronically via the Federal eRulemaking Portal at *https://www.regulations.gov* (indicate IRS and REG-109309-22).

Individuals who want to testify (by telephone) at the public hearing must send an email to *publichearings@irs.gov* to receive the telephone number and access code for the hearing. The subject line of the email must contain the regulation number REG-109309-22 and the word TESTIFY. For example, the subject line may say: Request to TESTIFY at Hearing for REG-109309-22. The email should include a copy of the speaker's public comments and outline of discussion topics. Individuals who want to attend (by telephone) the public hearing must also send an email to *publichearings@irs.gov* to receive the telephone number and access code for the hearing. The subject line of the email must contain the regulation number REG-109309-22 and the word ATTEND. For example, the subject line may say: Request to ATTEND hearing for REG-109309-22. To request special assistance during the telephonic hearing, contact the Publications and Regulations Branch of the Office of Associate Chief Counsel (Procedure and Administration) by sending an email to *publichearings@irs.gov* (preferred) or by telephone at (202) 317-6901 (not a toll-free number).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Elizabeth M. Hill of the Office of Associate Chief Counsel (Financial Institutions & Products), (202) 317-4458; concerning the submission of comments or the hearing, Vivian Hayes at (202) 317-6901 (not toll-free numbers) or by email at *publichearings@irs.gov* (preferred).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed additions to 26 CFR part 1 (Income Tax Regulations) under section 6011 of the Internal Revenue Code (Code) regarding transactions identified as listed transactions and transactions of interest for purposes of section 6011.

I. *Overview of the Reportable Transaction Regime*

Section 6011(a) generally provides that, when required by regulations prescribed by the Secretary of the Treasury or her delegate (Secretary), "any person made liable for any tax imposed by this title, or with respect to the collection thereof, shall make a return or statement according to the forms and regulations prescribed by the Secretary. Every person required to make a return or statement shall include therein the information required by such forms or regulations."

On February 28, 2000, the Treasury Department and the IRS issued a series of temporary regulations (TD 8877; TD 8876; TD 8875) and cross-referencing notices of proposed rulemaking (REG-103735-00; REG-110311-98; REG-103736-00) under sections 6011, 6111, and 6112. The temporary regulations and cross-referencing notices of proposed rulemaking were published in the **Federal Register** (65 FR 11205, 65 FR 11269; 65 FR 11215, 65 FR 11272; 65 FR 11211, 65 FR 11271) on March 2, 2000 (2000 Temporary Regulations). The 2000 Temporary Regulations were modified several times before March 4, 2003, the date on which the Treasury Department and the IRS, after providing notice and opportunity for public comment and considering the

comments received, published final regulations (TD 9046) in the **Federal Register** (68 FR 10161) under sections 6011, 6111, and 6112 (2003 Final Regulations). The 2000 Temporary Regulations and 2003 Final Regulations consistently provided that reportable transactions include listed transactions and that a listed transaction is a transaction that is the same as or substantially similar to one of the types of transactions that the IRS has determined to be a tax avoidance transaction and has identified by notice, regulation, or other form of published guidance as a listed transaction.

Following the 2003 promulgation of §1.6011-4, Congress passed the American Jobs Creation Act of 2004 (AJCA), Public Law 108-357, 118 Stat. 1418 (October 22, 2004), which added sections 6707A, 6662A, and 6501(c)(10) to the Code, and revised sections 6111, 6112, 6707, and 6708 of the Code. *See* sections 811-812 and 814-817 of the AJCA. The AJCA's legislative history explains that Congress incorporated in the statute the method that the Treasury Department and the IRS had been using to identify reportable transactions, and provided incentives, via penalties, to encourage taxpayer compliance with the new disclosure reporting obligations. As the Committee on Ways and Means explained in its report accompanying H.R. 4520, which became the AJCA:

> The Committee believes that the best way to combat tax shelters is to be aware of them. The Treasury Department, using the tools available, issued regulations requiring disclosure of certain transactions and requiring organizers and promoters of tax-engineered transactions to maintain customer lists and make these lists available to the IRS. Nevertheless, the Committee believes that additional legislation is needed to provide the Treasury Department with additional tools to assist its efforts to curtail abusive transactions. Moreover, the Committee believes that a penalty for failing to make the required disclosures, when the imposition of such penalty is not dependent on the tax treatment of the underlying transaction ultimately being sustained, will provide an additional incentive for taxpayers to satisfy their reporting obligations under the new disclosure provisions.

House Report 108-548(I), 108th Cong., 2nd Sess. 2004, at 261 (June 16, 2004) (House Report).

In Footnote 232 of the House Report, the Committee on Ways and Means notes that the statutory definitions of "reportable transaction" and "listed transaction" were intended to incorporate the pre-AJCA regulatory definitions while providing the Secretary with leeway to make changes to those definitions:

> The provision states that, except as provided in regulations, a listed transaction means a reportable transaction, which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011. For this purpose, it is expected that the definition of "substantially similar" will be the definition used in Treas. Reg. sec. 1.6011–4(c)(4). However, the Secretary may modify this definition (as well as the definitions of "listed transaction" and "reportable transactions") as appropriate.

Id. at 261 n.232.

Section 6707A(c)(1) defines a "reportable transaction" as "any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under section 6011, such transaction is of a type which the Secretary determines as having a potential for tax avoidance or evasion." A "listed transaction" is defined by section 6707A(c)(2) as "a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011."

Section 6111(a), as revised by the AJCA, provides that each material advisor with respect to any reportable transaction must make a return setting forth (1) information identifying and describing the transaction, (2) information describing any potential tax benefits expected to result from the transaction, and (3) such other information as the Secretary may prescribe. Such return must be filed not later than the date specified by the Secretary. Section 6111(b)(2) provides that a reportable transaction has the meaning given to such term by section 6707A(c).

Section 6112(a), as revised by the AJCA, provides that each material advisor with respect to any reportable transaction (as defined in section 6707A(c)) must (whether or not required to file a return under section 6111 with respect to such transaction) maintain a list (1) identifying each person with respect to whom such advisor acted as a material advisor, and (2) containing such other information as the Secretary may by regulations require.

On November 2, 2006, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-103038-05) in the **Federal Register** (71 FR 64488) under section 6011 (November 2006 Transaction of Interest (TOI) Regulations) proposing to add a new category of reportable transaction requiring disclosure under section 6011. The preamble to the November 2006 TOI Regulations (71 FR 64488) explains that these transactions, referred to as transactions of interest, are transactions that the Treasury Department and the IRS believe have the potential for tax avoidance or evasion, but for which the Treasury Department and the IRS lack enough information to determine whether the transaction should be identified as a listed transaction. The November 2006 TOI Regulations proposed that transactions of interest would be identified by the IRS via notice, regulation, or other form of published guidance.

On the same date that the November 2006 TOI Regulations were published, the Treasury Department and the IRS also published two separate notices of proposed rulemaking (REG-103039-05; REG-103043-05) in the **Federal Register** (71 FR 64496, 71 FR 64501) under sections 6111 and 6112, respectively (November 2006 Regulations). The November 2006 Regulations proposed to modify the then-existing regulations relating to the disclosure of reportable transactions by material advisors under section 6111, and the list maintenance requirements of material advisors with respect to reportable transactions under section 6112, in part, to account for the changes made by the AJCA and, in part, to make corresponding updates to the material advisor rules to account for the treatment of transactions of interest as

reportable transactions as proposed by the November 2006 TOI Regulations.

After providing notice and opportunity for public comment and considering the comments received, on August 3, 2007, the Treasury Department and the IRS published the November 2006 Regulations and the November 2006 TOI Regulations as final regulations (TD 9350, TD 9351, and TD 9352) in the **Federal Register** (72 FR 43146, 72 FR 43157, and 72 FR 43154) under sections 6011, 6111, and 6112.

II. *Disclosure of Reportable Transactions by Participants and Penalties for Failure to Disclose*

Section 1.6011-4(a) provides that every taxpayer that has participated in a reportable transaction within the meaning of §1.6011-4(b) and who is required to file a tax return must file a disclosure statement within the time prescribed in §1.6011-4(e).

Sections 1.6011-4(d) and (e) provide that the disclosure statement — Form 8886, *Reportable Transaction Disclosure Statement* (or successor form) — must be attached to the taxpayer's tax return for each taxable year for which a taxpayer participates in a reportable transaction. A copy of the disclosure statement must be sent to IRS's Office of Tax Shelter Analysis (OTSA) at the same time that any disclosure statement is first filed by the taxpayer pertaining to a particular reportable transaction.

Reportable transactions include listed transactions, confidential transactions, transactions with contractual protection, loss transactions, and transactions of interest. *See* §1.6011-4(b)(2) through (6). Consistent with the definitions previously provided in the 2000 Temporary Regulations and later in the 2003 Final Regulations, as promulgated in 2007, §1.6011-4(b)(2) continues to define a "listed transaction" as a transaction that is the same as or substantially similar to one of the types of transactions that the IRS has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction. Section 1.6011-4(b)(6) defines a "transaction of interest" as a transaction that is the same as or substantially similar to one of the types of transactions that the IRS has identified by notice, regulation, or other form of published guidance as a transaction of interest.

Section 1.6011-4(c)(4) provides that a transaction is "substantially similar" if it is expected to obtain the same or similar types of tax consequences and is either factually similar or based on the same or similar tax strategy. Receipt of an opinion regarding the tax consequences of the transaction is not relevant to the determination of whether the transaction is the same as or substantially similar to another transaction. Further, the term substantially similar must be broadly construed in favor of disclosure. For example, a transaction may be substantially similar to a listed transaction or a transaction of interest even though it may involve different entities or use different Code provisions.

Section 1.6011-4(c)(3)(i)(A) provides that a taxpayer has participated in a listed transaction if the taxpayer's tax return reflects tax consequences or a tax strategy described in the published guidance that lists the transaction under §1.6011-4(b)(2). Published guidance also may identify other types or classes of persons that will be treated as participants in a listed transaction. Published guidance may identify types or classes of persons that will not be treated as participants in a listed transaction. Section 1.6011-4(c)(3)(i)(E) provides that a taxpayer has participated in a transaction of interest if the taxpayer is one of the types or classes of persons identified as participants in the transaction in the published guidance describing the transaction of interest.

Section 1.6011-4(e)(2)(i) provides that if a transaction becomes a listed transaction or a transaction of interest after the filing of a taxpayer's tax return reflecting the taxpayer's participation in the transaction and before the end of the period of limitations for assessment for any taxable year in which the taxpayer participated in the transaction, then a disclosure statement must be filed with OTSA within 90 calendar days after the date on which the transaction becomes a listed transaction or transaction of interest. This requirement extends to an amended return and exists regardless of whether the taxpayer participated in the transaction in the year the transaction became a listed transaction or transaction of interest. The Commissioner of Internal Revenue may also determine the time for disclosure of listed transactions and transactions of interest in the published guidance identifying the transaction.

Participants required to disclose these transactions under §1.6011-4 who fail to do so are subject to penalties under section 6707A. Section 6707A(b) provides that the amount of the penalty is 75 percent of the decrease in tax shown on the return as a result of the reportable transaction (or which would have resulted from such transaction if such transaction were respected for Federal tax purposes), subject to minimum and maximum penalty amounts. The minimum penalty amount is $5,000 in the case of a natural person and $10,000 in any other case. For listed transactions, the maximum penalty amount is $100,000 in the case of a natural person and $200,000 in any other case. For other reportable transactions, including transactions of interest, the maximum penalty is $10,000 in the case of a natural person and $50,000 in any other case.

Additional penalties may also apply. In general, section 6662A imposes a 20 percent accuracy-related penalty on any understatement (as defined in section 6662A(b)(1)) attributable to an adequately disclosed reportable transaction. If the taxpayer had a requirement to disclose participation in the reportable transaction but did not adequately disclose the transaction in accordance with the regulations under section 6011, the taxpayer is subject to an increased penalty rate equal to 30 percent of the understatement. *See* section 6662A(c). Section 6662A(b)(2) provides that section 6662A applies to any item which is attributable to any listed transaction and any reportable transaction (other than a listed transaction) if a significant purpose of such transaction is the avoidance or evasion of Federal income tax.

Participants required to disclose listed transactions who fail to do so are also subject to an extended period of limitations under section 6501(c)(10). That section provides that the time for assessment of any tax with respect to the transaction shall not expire before the date that is one year after the earlier of the date the partic-

ipant discloses the transaction or the date a material advisor discloses the participation pursuant to a written request under section 6112(b)(1)(A).

III. *Disclosure of Reportable Transactions by Material Advisors and Penalties for Failure to Disclose*

Section 301.6111-3(a) of the Procedure and Administration Regulations provides that each material advisor with respect to any reportable transaction, as defined in §1.6011-4(b), must file a return as described in §301.6111-3(d) by the date described in §301.6111-3(e).

Section 301.6111-3(b)(1) provides that a person is a material advisor with respect to a transaction if the person provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and directly or indirectly derives gross income in excess of the threshold amount as defined in §301.6111-3(b)(3) for the material aid, assistance, or advice. Under §301.6111-3(b)(2)(i) and (ii), a person provides material aid, assistance, or advice if the person provides a tax statement, which is any statement (including another person's statement), oral or written, that relates to a tax aspect of a transaction that causes the transaction to be a reportable transaction as defined in §1.6011-4(b)(2) through (7).

Material advisors must disclose transactions on Form 8918, *Material Advisor Disclosure Statement* (or successor form), as provided in §301.6111-3(d) and (e). Section 301.6111-3(e) provides that the material advisor's disclosure statement for a reportable transaction must be filed with OTSA by the last day of the month that follows the end of the calendar quarter in which the advisor becomes a material advisor with respect to a reportable transaction or in which the circumstances necessitating an amended disclosure statement occur. A person may become a material advisor with respect to transactions that are later identified as listed transactions or transactions of interest. *See* §301.6111-3(b)(4). The disclosure statement must be sent to OTSA at the address provided in the Instructions for Form 8918 (or successor form).

Section 301.6111-3(d)(2) provides that the IRS will issue to a material advisor a reportable transaction number with respect to the disclosed reportable transaction. Receipt of a reportable transaction number does not indicate that the disclosure statement is complete, nor does it indicate that the transaction has been reviewed, examined, or approved by the IRS. Material advisors must provide the reportable transaction number to all taxpayers and material advisors for whom the material advisor acts as a material advisor as defined in §301.6111-3(b). The reportable transaction number must be provided at the time the transaction is entered into, or, if the transaction is entered into prior to the material advisor receiving the reportable transaction number, within 60 calendar days from the date the reportable transaction number is mailed to the material advisor.

Additionally, material advisors must prepare and maintain lists identifying each person with respect to whom the advisor acted as a material advisor with respect to the reportable transaction in accordance with §301.6112-1(b) and furnish such lists to the IRS in accordance with §301.6112-1(e).

Section 6707(a) provides that a material advisor who fails to file a timely disclosure, or files an incomplete or false disclosure statement, is subject to a penalty. Pursuant to section 6707(b)(2), for listed transactions, the penalty is the greater of (A) $200,000, or (B) 50 percent of the gross income derived by such person with respect to aid, assistance, or advice which is provided with respect to the listed transaction before the date the return is filed under section 6111. Pursuant to section 6707(b)(1), the penalty for other reportable transactions, including transactions of interest, is $50,000.

A material advisor may also be subject to a penalty under section 6708 for failing to maintain a list under section 6112(a) and failing to make the list available upon written request to the Secretary in accordance with section 6112(b) within 20 business days after the date of such request. Section 6708(a) provides that the penalty is $10,000 per day for each day of the failure after the 20th day. However, no penalty will be imposed with respect to the failure on any day if such failure is due to reasonable cause.

IV. *Micro-captive Transactions and Notice 2016-66*

As enacted by section 1024 of the Tax Reform Act of 1986, Public Law 99-514, 100 Stat. 2085, 2405 (October 22, 1986), section 831(a) generally imposes tax on the taxable income (determined under the special rules for calculating taxable income of insurance companies in part II of subchapter L of chapter 1 of the Code) of every insurance company other than a life insurance company (nonlife insurance company), for each taxable year computed as provided in section 11 of the Code. However, certain small nonlife insurance companies may elect to be subject to the alternative tax imposed by section 831(b).

Upon election by an eligible nonlife insurance company (eligible electing company) to be taxed under section 831(b), in lieu of the tax otherwise imposed by section 831(a), section 831(b) imposes tax on the company's income computed by multiplying the taxable investment income of the eligible electing company (determined under section 834 of the Code) for the taxable year by the rates provided in section 11(b) of the Code. Premium income of a nonlife insurance company is included in taxable income under section 831(a), but not taxable investment income under section 834. Thus, an eligible electing company pays no tax on premium income for taxable years for which its election is in effect.

Congress enacted section 333 of the Protecting Americans from Tax Hikes Act of 2015 (PATH Act), div. Q. of Public Law 114-113, 129 Stat. 2242, 3040 (December 18, 2015), to both tighten and expand the requirements for qualifying under section 831(b), effective for taxable years beginning after December 31, 2016. As amended by the PATH Act, section 831(b) requires an eligible electing company to be an insurance company (within the meaning of section 816(a) of the Code) having net written premiums or, if greater, direct written premiums, for the taxable year not exceeding $2.2 million as adjusted for inflation (net written premium limitation) and to meet the diversification requirements of section 831(b)(2)(B). The

last sentence of section 831(b)(2)(A) provides that an election under section 831(b) applies to the taxable year for which it is made and all subsequent taxable years for which the net written premium limitation and the diversification requirements are met and may be revoked only with the Secretary's consent. In addition, section 831(d) requires every eligible electing company that has a section 831(b) election in effect to furnish to the Secretary "at such time and in such manner as the Secretary shall prescribe such information for such taxable year as the Secretary may require with respect to" the diversification requirements of section 831(b)(2)(B).

On November 21, 2016, the Treasury Department and the IRS published Notice 2016-66, 2016-47 I.R.B 745, which identified certain micro-captive transactions as transactions of interest. On January 17, 2017, the IRS published Notice 2017-08, 2017-3 I.R.B. 423, which modified Notice 2016-66 by providing for an extension of time for participants and material advisors to file their disclosures.

Notice 2016-66 alerted taxpayers and their representatives pursuant to §1.6011-4(b)(6) and for purposes of §1.6011-4(b)(6) and sections 6111 and 6112, that the Treasury Department and the IRS identified as transactions of interest certain micro-captive transactions in which a taxpayer attempts to reduce the aggregate taxable income of the taxpayer, related persons, or both, using contracts that the parties treat as insurance contracts and a related company that the parties treat as an insurance company. Notice 2016-66 also alerted persons involved with the identified transactions that certain responsibilities may arise from their involvement.

Notice 2016-66 describes the following micro-captive transaction as a transaction of interest: (1) a company that the parties treat as an insurance company (Captive) elects to exclude premiums from taxable income under section 831(b); (2) at least 20 percent of the voting power or value of the outstanding stock of Captive is directly or indirectly owned by the insured entity (Insured), owners of Insured, or persons related to Insured or its owners (20-percent relationship factor); and (3) either or both of the following apply: (i) Captive has at any time during a defined Computation Period (referred to as the Notice Computation Period) directly or indirectly made available as financing, or otherwise conveyed or agreed to make available or convey, to certain related persons in a transaction that did not result in taxable income or gain to the recipient any portion of the payments treated as premiums, such as through a guarantee, a loan, or other transfer of Captive's capital (financing factor), or (ii) the amount of liabilities incurred by Captive for insured losses and claim administration expenses during the Notice Computation Period is less than 70 percent of the amount equal to premiums earned by Captive during that period less policyholder dividends paid by Captive during that period (70-percent loss ratio factor).

Notice 2016-66 defines the Notice Computation Period as the most recent five taxable years of Captive or, if Captive has been in existence for less than five taxable years, the entire period of Captive's existence. For purposes of the preceding sentence, if Captive has been in existence for less than five taxable years and Captive is a successor to one or more Captives created or availed of in connection with a transaction described in the notice, taxable years of such predecessor entities are treated as taxable years of Captive. A short taxable year is treated as a taxable year.

Notice 2016-66 also provides that the arrangement is not treated as a transaction of interest if the micro-captive arrangement provides insurance for employee compensation or benefits and the arrangement is one for which the Employee Benefits Security Administration of the U.S. Department of Labor has issued a Prohibited Transaction Exemption. A Prohibited Transaction Exemption may be granted by the U.S. Department of Labor on an individual basis or may fall under the class exemption for captives. The Prohibited Transaction Exemption procedures are published as final regulations in the **Federal Register** (76 FR 66637). The Department of Labor's proposed amendments to the Prohibited Transaction Exemption procedures were published on March 15, 2022, in the **Federal Register** (87 FR 14722).

Notice 2016-66 requires disclosure of the information specified in §1.6011-4(d) and the Instructions to Form 8886 (or successor form), which includes identifying and describing the transaction in sufficient detail for the IRS to be able to understand the tax structure of the reportable transaction and identity of all parties involved in the transaction. Notice 2016-66 provides that for all participants, describing the transaction in sufficient detail includes, but is not limited to, describing on Form 8886 (or successor form) when and how the taxpayer became aware of the transaction. The notice further provides that for Captive, describing the transaction in sufficient detail includes, but is not limited to, describing the following on Form 8886 (or successor form): (1) whether Captive is reporting because (i) the 70-percent loss ratio factor is met for the taxable year; (ii) the financing factor is met for the taxable year; or (iii) both (i) and (ii); (2) under what authority Captive is chartered; (3) all the type(s) of coverage provided by Captive during the year or years of participation (if disclosure pertains to multiple years); (4) how the amounts treated as premiums for coverage provided by Captive during the year or years of participation (if disclosure pertains to multiple years) were determined, including the name and contact information of any actuary or underwriter who assisted in these determinations; (5) any claims paid by Captive during the year or years of participation (if disclosure pertains to multiple years), and the amount of, and reason for, any reserves reported by Captive on the annual statement; and (6) the assets held by Captive during the year or years of participation (if disclosure pertains to multiple years).

V. *Comments Submitted in Response to Notice 2016-66*

Comments submitted in response to Notice 2016-66 were carefully considered in the development of these proposed regulations. Although the Administrative Procedure Act (APA), 5 U.S.C. 551-559, does not require a response to those comments, the comments are described here in an effort to assist taxpayers in understanding the provisions of the proposed regulations described in the Explanation of Provisions section.

First, some commenters suggested that changes to the Form 1120-PC, *U.S. Property and Casualty Insurance Company Income Tax Return*, would be better suited

to capture the information sought by Notice 2016-66. Other commenters indicated that the information sought could be readily obtained from the existing Forms 1120-PC being filed, so any additional reporting would be unnecessarily duplicative and burdensome. However, changes to the Form 1120-PC would at a minimum impact all nonlife insurance companies that make section 831(b) elections, not only participants in the micro-captive transactions described in the proposed regulations. Also, some of the requested information is not readily available from filed Forms 1120-PC, such as the descriptions of the types of coverages provided by a Captive and the name and contact information of any actuary or underwriter who assisted Captive in the determination of amounts treated as premiums. Additionally, limiting the collection of information to only those entities filing the Form 1120-PC would be insufficient to gather relevant information, as information regarding Insureds and promoters of the transactions would not be included.

Second, commenters also suggested that the reporting requirements under Notice 2016-66 are contrary to Congressional intent in enacting section 333 of the PATH Act, which, as noted earlier, effective for taxable years beginning after December 31, 2016, modified the section 831(b) eligibility rules for a property and casualty insurance company to elect to be taxed only on taxable investment income. The provision increased the limit on net written premiums (or, if greater, direct written premiums) from $1,200,000 to $2,200,000 and indexed that amount for inflation. The provision also added diversification requirements to the eligibility rules. However, nothing in the statutory language or legislative history of the PATH Act suggests that Congress intended to provide the benefits of section 831(b) to companies that do not qualify as insurance companies for Federal income tax purposes. As exemplified by the transactions described in *Avrahami v. Commissioner*, 149 T.C. 144 (2017), *Syzygy Insurance Co., Inc. v. Commissioner*, T.C. Memo. 2019-34, and *Caylor Land & Development, Inc. v. Commissioner*, T.C. Memo. 2021-30, some companies claiming the benefits of section 831(b) do not meet these basic eligibility requirements for such treatment. *See also Reserve Mechanical Corp. v. Commissioner*, 34 F.4th 881 (10th Cir. 2022) (concluding company filing as a tax-exempt entity under section 501(c)(15) did not qualify as an insurance company for Federal income tax purposes using similar analysis). The proposed regulations, like Notice 2016-66, would apply to entities that claim the benefits of section 831(b) when certain factors indicate that they do not or may not qualify as insurance companies for Federal income tax purposes.

Third, other commenters indicated that the reporting requirements were unduly burdensome, as well as duplicative, because the information sought could be readily obtained from a smaller subgroup of the participants in a transaction. However, the reporting and recordkeeping required for reportable transactions from each participant ensure that the Service can identify all of the participants of a particular transaction and that all participants are aware of their participation in a reportable transaction. Nevertheless, the proposed regulations significantly narrow the information sought from participants compared to that required by Notice 2016-66 and provide a disclosure safe harbor to a significant number of participants, thereby reducing the burden in reporting to the maximum extent consistent with sound tax administration. *See* proposed §1.6011-10(e)(2) and (f) and proposed §1.6011-11(e)(2) and (f).

Fourth, additional commenters on Notice 2016-66 expressed concerns regarding certain arrangements in which a service provider, automobile dealer, lender, or retailer (Seller) sells insurance contracts to its customers in connection with the products or services being sold (Consumer Coverage). These commenters recommended that such Consumer Coverage arrangements be excepted from the disclosure requirements. The proposed regulations provide a limited exception for certain participants in Consumer Coverage arrangements. *See* proposed §§1.6011-10(d)(2) and 1.6011-11(d)(2).

Finally, commenters argued that the 20-percent relationship factor and the 70-percent loss ratio factor described in sections 2.01(d) and 2.01(e)(2) of Notice 2016-66, respectively, are overly broad and arbitrary. However, the Treasury Department and the IRS have determined that the factors are objective and reasonably determined based on existing statutory provisions and available industry data. The 20-percent relationship factor was based on the diversification requirements established by section 333 of the PATH Act. While one part of the PATH Act diversification requirements is based on the percentage of premiums from related insureds, requiring that no more than 20 percent of net written premiums (or if greater, direct written premiums) for a taxable year is attributable to any one policyholder, the 20-percent threshold in Notice 2016-66 is based on concentration of ownership of stock in a Captive when Insured or Insured's owner owns Captive's stock or is related to Captive's owner. Both requirements are based on a lack of diversification and identify a threshold at which a lack of diversification may facilitate abuse.

Similarly, the 70-percent loss ratio factor was informed by, but is less burdensome than, the 85 percent medical loss ratio test enacted by Congress in section 833(c)(5) of the Code for Blue Cross and Blue Shield organizations and other health insurers that are entitled to certain tax benefits that are not available to other nonlife insurance companies, as well as the medical loss ratio computed under section 2718(b) of the Public Health Service Act, 42 U.S.C. 300gg-18. The loss ratio factor in Notice 2016-66 compares claims and expenses to premiums charged in a manner similar to the medical loss ratio test in section 833(c)(5) of the Code and the medical loss ratio computed under section 2718(b) of the Public Health Service Act. However, the medical loss ratio has a narrower focus than the Notice 2016-66 loss ratio factor and is computed as a percentage of the total premium revenue (excluding Federal and State taxes and licensing or regulatory fees) an issuer expends (1) on reimbursement for clinical services provided to enrollees under such coverage and (2) for activities that improve health care quality of enrollees.

The Treasury Department and IRS also considered data from the National Association of Insurance Commissioners (NAIC) in determining the applicable loss ratio factor. The NAIC, in its 2021 Annual Property & Casualty and Title Insurance

Industries Report (2021 NAIC P&C Report), indicated that annual loss ratios for property and casualty companies averaged 72.5 percent for that year. *See Insurance Industry Snapshots and Analysis Reports* (July 21, 2022), https://content.naic.org/cipr_topics/topic_insurance_industry_snapshots_and_analysis_reports.htm (last visited April 3, 2023). The 2021 NAIC P&C Report is "produced from insurer statutory filings and represent[s] approximately 99% of all insurers expected to file the NAIC Financial Data Repository." *Id*. The single-year average loss ratio for property and casualty companies ranged between 67.2 and 76.2 percent per year from 2012 to 2021. *See U.S. Property & Casualty and Title Insurance Industries – 2021 Full Year Results* (2022), https://content.naic.org/sites/default/files/inline-files/2021%20Annual%20Property%20%26%20Casualty%20and%20Title%20Insurance%20Industry%20Report.pdf (last visited April 3, 2023).

Commenters indicated that some Captives electing the alternative tax under section 831(b) have loss ratios that fall below the industry-wide average during a given year of operation and suggested that the loss ratio in Notice 2016-66 is set too high. However, the average loss ratio reported by the NAIC and the loss ratio factor in Notice 2016-66 are computed differently and are not directly comparable. First, the average loss ratio reported by the NAIC reflects the ratio of net losses incurred and loss expenses incurred to net premiums earned, without adjustment for policyholder dividends paid, whereas Captive's loss ratio factor under Notice 2016-66 subtracts policyholder dividends paid from premiums earned by Captive. This means that, for an entity that pays policyholder dividends, the loss ratio factor under Notice 2016-66 would be higher than its NAIC loss ratio. Second, the loss ratio factor in Notice 2016-66 reflects the ratio of insured losses and claims administration expenses during the Notice Computation Period, which may be as long as five years. By contrast, the average loss ratio reported by the NAIC is a single-year average. Accordingly, even Captives electing the alternative tax under section 831(b) that have loss ratios that fall below the industry-wide average for property and casualty companies in any particular year may not have loss ratio factors that cause a transaction to be described in Notice 2016-66 or the proposed regulations. The Treasury Department and the IRS therefore view the average loss ratio data reported by the NAIC as supportive of the loss ratio factors provided in Notice 2016-66 and in these proposed regulations. *See* proposed §§1.6011-10(c)(2) and 1.6011-11(c).

Despite commenters' objections to the 20-percent relationship factor and 70-percent loss ratio factor, the commenters did not identify different factors or industry-wide standards for small insurers that would distinguish abusive from non-abusive transactions or provide examples of non-abusive transactions for which disclosure was required as a result of these factors. These objective factors in Notice 2016-66 have been effective in identifying transactions for which disclosure should be required and are reasonable given existing statutory provisions and available industry data.

To better ensure non-abusive transactions are not required to be reported under the proposed regulations, however, the proposed regulations lower the loss ratio factor for both the micro-captive transactions identified in proposed §1.6011-10(a) as listed transactions (Micro-captive Listed Transactions) and the micro-captive transactions identified in proposed §1.6011-11(a) as transactions of interest (Micro-captive Transactions of Interest) from 70 percent to 65 percent. *See* proposed §§1.6011-10(c)(2) and 1.6011-11(c). Additionally, the computation period used to determine the loss ratio factor is extended from a Notice Computation Period of up to five taxable years to a computation period of up to nine taxable years (referred to as the Transaction of Interest Computation Period) for the Micro-captive Transaction of Interest. *See* proposed §1.6011-11(b)(2). For the Micro-captive Listed Transaction, the computation period used to determine the loss ratio factor (referred to as the Loss Ratio Factor Computation Period) is ten taxable years. *See* proposed §1.6011-10(b)(2)(ii).

For the foregoing reasons, the IRS intends to challenge the purported tax benefits from transactions identified in proposed §1.6011-10(c) as listed transactions, and the IRS may challenge the purported tax benefits from transactions identified in proposed §1.6011-11(c) as transactions of interest. The IRS may also challenge the purported tax benefits from these transactions based on the economic substance, business purpose, or other rules or doctrines if applicable based on the facts of a particular case.

VI. *Purpose of Proposed Regulation*

On March 3, 2022, the Sixth Circuit issued an order in *Mann Construction v. United States*, 27 F.4th 1138, 1147 (6th Cir. 2022), holding that Notice 2007-83, 2007-2 C.B. 960, which identified certain trust arrangements claiming to be welfare benefit funds and involving cash value life insurance policies as listed transactions, violated the APA, because the notice was issued without following the notice-and-comment procedures required by section 553 of the APA. The Sixth Circuit concluded that Congress did not clearly express an intent to override the notice-and-comment procedures required by section 553 of the APA when it enacted the AJCA. 27 F.4th at 1148. The Sixth Circuit reversed the decision of the district court, which held that Congress had authorized the IRS to identify listed transactions without notice and comment. *See Mann Construction, Inc. v. United States*, 539 F.Supp.3d 745, 763 (E.D. Mich. 2021).

In *CIC Services, LLC v. IRS*, the United States District Court for the Eastern District of Tennessee, which is located in the Sixth Circuit, viewed the analysis in *Mann Construction* as controlling and vacated Notice 2016-66, holding that the IRS failed to comply with the APA's notice-and-comment procedures. The Court also held that the IRS acted arbitrarily and capriciously based on the administrative record. *CIC Services, LLC v. IRS*, 2022 WL 985619 (E.D. Tenn. March 21, 2022), *as modified by* 2022 WL 2078036 (E.D. Tenn. June 2, 2022); *see also Green Valley Investors, LLC, et al. v. Commissioner*, 159 T.C. No. 5 (Nov. 9, 2022) (relying on *Mann Construction* in holding that Notice 2017-10, 2017-4 I.R.B. 544 (identifying certain syndicated conservation easements as listed transactions) was improperly issued because it was issued without following the APA's notice-and-

comment procedures); *Green Rock, LLC v. IRS*, No. 2:21-cv-01320-ACA, 2023 U.S. Dist. LEXIS 17670 (N.D. Ala. Feb. 2, 2023) (holding that notice and comment procedures were required before issuance of Notice 2017-10).

In light of the decision by the district court in *CIC Services*, the IRS will not enforce the disclosure requirements or penalties that are dependent upon the procedural validity of Notice 2016-66. Thus, the Treasury Department and the IRS are issuing these proposed regulations to identify certain micro-captive transactions as Micro-captive Transactions of Interest. In addition, this document obsoletes Notice 2016-66 (as modified by Notice 2017-08). The obsoletion of the notice, however, has no effect on the merits of the tax benefits claimed from the transactions themselves and related litigation, or income tax examinations and promoter investigations relating to micro-captive transactions.

The Treasury Department and the IRS disagree with the Sixth Circuit's decision in *Mann Construction* and the Tax Court's decision in *Green Valley* and are continuing to defend the validity of notices identifying transactions as listed transactions in circuits other than the Sixth Circuit. However, to help allow for consistent enforcement throughout the nation, the Treasury Department and the IRS are proposing to identify certain other micro-captive transactions as Micro-captive Listed Transactions by regulation.

Explanation of Provisions

A. *Micro-captive Listed Transactions and Micro-captive Transactions of Interest*

This section generally describes the micro-captive transactions that are the focus of the proposed regulations and why the Micro-captive Listed Transactions are abusive and the Micro-captive Transactions of Interest have the potential for abuse. This section also describes the proposed regulations identifying Micro-captive Listed Transactions and Micro-captive Transactions of Interest.

1. *In general*

The Treasury Department and the IRS are aware of a micro-captive transaction, in which a taxpayer attempts to reduce the aggregate taxable income of the taxpayer, persons related to the taxpayer, or both, using contracts that the parties treat as insurance contracts and a related Captive. In some cases, Captive enters into a contract with a related entity that the parties treat as an insurance contract. In other cases, Captive and a related entity enter into separate contracts with one or more unrelated intermediaries. For example, the related entity and an intermediary may enter into a contract that the parties treat as an insurance contract, and Captive may then enter into a separate contract with the intermediary that the parties treat as a reinsurance contract covering the "risks" under the contract between the related entity and the intermediary. Each entity that makes payments to an intermediary or Captive under these contracts treats the payments as insurance premiums that are within the scope of §1.162-1(a) and deducts the payments as ordinary and necessary business expenses under section 162. Captive treats the payments received from the related entity or intermediary under a contract treated as an insurance contract or reinsurance contract as premiums for insurance coverage.

Captive asserts that it is taxable as a nonlife insurance company under the Code and, if it is not a domestic corporation, makes an election under section 953(d) of the Code to be treated as a domestic corporation for purposes of the Code. Captive makes an election under section 831(b) to be taxed only on taxable investment income (defined in section 834). Captive accordingly excludes from the computation of its taxable income the payments received from the related entity or intermediary treated as premiums. For each taxable year in which the micro-captive transaction is in effect, the transaction is structured so that Captive does not have net premiums written (or, if greater, direct premiums written) that exceed the statutory limit. For taxable years beginning after December 31, 2016, the statutory limit is $2,200,000, adjusted annually for inflation ($2,650,000 for taxable years beginning in 2023).

Since the publication of Notice 2016-66, examinations of taxpayers and promoters and information received through disclosures filed in response to Notice 2016-66 have clarified the Treasury Department's and the IRS's understanding of micro-captive transactions, including the scope of participation. Further, in the three section 831(b) micro-captive cases decided on their merits since the publication of Notice 2016-66, the U.S. Tax Court held that the micro-captive transactions at issue did not meet the requirements for treatment as insurance for Federal income tax purposes. *See Avrahami v. Commissioner*, 149 T.C. at 144; *Syzygy v. Commissioner*, T.C. Memo. 2019-34; and *Caylor v. Commissioner*, T.C. Memo. 2021-30; *see also Reserve Mechanical Corp. v. Commissioner*, 34 F.4th at 881 (concluding transactions entered into by company filing as a tax-exempt entity under section 501(c)(15) did not meet the requirements for treatment as insurance for Federal income tax purposes using similar analysis). Taking into account only the years in issue in these decisions, the information included in the Court's opinions indicates that the transactions at issue had the elements that would require disclosure under Notice 2016-66. Accordingly, the Treasury Department and the IRS have determined that certain micro-captive transactions are abusive tax avoidance transactions and certain other micro-captive transactions have the potential for tax avoidance or evasion.

As further discussed in sections B.1. through B.3. of this Explanation of Provisions, the Treasury Department and the IRS have determined that two categories of micro-captive transactions, described in proposed §1.6011-10(c)(1) and (c)(2), are tax avoidance transactions, and thus propose to identify such transactions as listed transactions. The transactions in both categories involve related parties, including a Captive, at least 20 percent of the voting power or the value of the outstanding stock or equity interest of which is owned, directly or indirectly, by an Insured, an Owner, or persons Related to an Insured or an Owner. *See* proposed §1.6011-10(b)(1)(iii). The first category of these transactions is identified by the presence of a financing factor, described in proposed §1.6011-10(c)(1). The second category of these transactions is identified by a loss ratio factor that falls below 65 percent based on a Loss Ratio Computation Period of ten taxable years, as

described in proposed §1.6011-10(c)(2). The proposed regulations therefore identify transactions that are the same as, or substantially similar to, the Micro-captive Listed Transaction described in proposed §1.6011-10(a) as listed transactions for purposes of §1.6011-4. As noted previously, a transaction is "substantially similar" if it is expected to obtain the same or similar types of tax consequences and is either factually similar or based on the same or similar tax strategy, even though it may involve different entities or use different Code provisions.

As further discussed in sections B.1. and B.3. of this Explanation of Provisions, the Treasury Department and the IRS have also determined that a third category of micro-captive transactions, described in proposed §1.6011-11(c), has a potential for tax avoidance or evasion, and thus propose to identify such transactions as transactions of interest. This category of micro-captive transactions also involves related parties as described in proposed §1.6011-10(b)(1)(iii) and is identified by the presence of a loss ratio factor that falls below 65 percent over a shorter Transaction of Interest Computation Period, generally because Captives involved have been in operation for a shorter period of time. With respect to this third category of transactions, the Treasury Department and the IRS require more information to determine if the transactions are being used for tax avoidance or evasion. The proposed regulations therefore identify transactions that are the same as, or substantially similar to, the Micro-captive Transaction of Interest described in proposed §1.6011-11(a) as transactions of interest for purposes of §1.6011-4(b)(6).

2. *Abuses*

In Micro-captive Listed Transactions and Micro-captive Transactions of Interest, related parties claim the Federal income tax benefits of treating the contracts as insurance (or reinsurance) contracts. Insured deducts premiums paid to Captive under section 162, while the related Captive excludes the premium income from its taxable income by electing under section 831(b) to be taxed only on its taxable investment income.

Neither the Code nor the regulations thereunder define the terms "insurance" or "insurance contract." The Supreme Court has explained that for an arrangement to constitute insurance for Federal income tax purposes, both risk shifting and risk distribution must be present. *Helvering v. Le Gierse*, 312 U.S. 531 (1941). The risk transferred must be risk of economic loss. *Allied Fidelity Corp. v. Commissioner*, 572 F.2d 1190, 1193 (7th Cir. 1978). The risk must contemplate the fortuitous occurrence of a stated contingency, *Commissioner v. Treganowen*, 183 F.2d 288, 290-91 (2d Cir. 1950), and must not be merely an investment or business risk. Rev. Rul. 2007-17, 2007-2 C.B. 127. In addition, the arrangement must constitute insurance in the commonly accepted sense. *See*, *e.g.*, *Rent-A-Center, Inc. v. Commissioner*, 142 T.C. 1, 10-13 (2014).

In many micro-captive transactions, however, the manner in which the contracts are interpreted, administered, and applied is inconsistent with arm's length transactions and sound business practices. Captive typically does not behave as an insurance company commonly would, indicating that Captive is not issuing insurance contracts and the transaction does not constitute insurance for Federal income tax purposes. For example, Captive may fail to adequately distribute risk or fail to employ actuarial techniques to establish premium rates that appropriately reflect the risk of loss and costs of conducting an insurance business. Captive may also use its premium income for purposes other than administering and paying claims under the contract(s), including routing funds that have not been taxed to the Insured or a person related to the Insured or its owners. A micro-captive transaction may share other characteristics with the purported insurance transactions considered by the Tax Court in *Avrahami*, *Syzygy*, and *Caylor*, or with the transactions considered in other cases in which the courts determined the transactions were not insurance for Federal income tax purposes. *See*, *e.g.*, *Reserve Mechanical Corp. v. Commissioner*, 34 F.4th 881 (10th Cir. 2022). The net effect of participating in this transaction is that the Insured claims a tax deduction for transferring amounts treated as premiums to Captive, which is owned by parties related to Insured, and Captive is not taxed on the corresponding income.

If the transaction does not constitute insurance, Insured is not entitled to deduct under section 162 as a trade or business expense the amount treated as an insurance premium. In addition, if Captive does not actually provide insurance, it does not qualify as an insurance company and its elections to be taxed only on its taxable investment income under section 831(b) and to be treated as a domestic insurance company under section 953(d) are invalid.

These proposed regulations inform taxpayers that participate in transactions described in proposed §§1.6011-10(c) and 1.6011-11(c), and substantially similar transactions, and persons who act as material advisors with respect to these transactions, and substantially similar transactions, that they must disclose in accordance with the rules provided in §1.6011-4(a) and section 6111(a), respectively. Material advisors must also maintain lists as required by section 6112.

As previously noted, the IRS intends to challenge the claimed tax benefits from Micro-captive Listed Transactions, and may challenge the claimed tax benefits from Micro-captive Transactions of Interest. Examinations of these micro-captive transactions may result in adjustments including full disallowance of claimed micro-captive insurance premium deductions, inclusion in income of amounts received by Captive, imposition of withholding tax liability under section 1461 of the Code for failing to deduct and withhold tax on payments made to a foreign Captive, imposition of a 20 percent or 40 percent penalty for lack of economic substance under section 6662(b)(6) or (i)(1) of the Code, which may not be avoided by a reasonable cause exception, and imposition of other applicable taxes and penalties.

3. *Micro-captive Listed Transactions*

Proposed §1.6011-10(a) provides that transactions that are the same as, or substantially similar to, transactions described in proposed §1.6011-10(c) are identified as listed transactions for purposes of §1.6011-4(b)(2), except as provided in proposed §1.6011-10(d). Proposed §1.6011-10(b) provides definitions

of terms used to describe Micro-captive Listed Transactions, including Captive, Financing Computation Period, Loss Ratio Computation Period, Contract, Insured, Intermediary, Recipient, and Related. In particular, Captive is defined as an entity that elects under section 831(b) to be taxed as an insurance company only on its taxable investment income; issues a Contract to an Insured, reinsures a Contract of an Insured issued by an Intermediary, or both; and has at least 20 percent of its assets or voting power or the value of its outstanding stock or equity interests directly or indirectly, individually or collectively, owned by an Insured, an Owner, or persons Related to an Insured or Owner. The term Related is defined in proposed §1.6011-10(b)(8) by reference to sections 267(b), 707(b), 2701(b)(2)(C), and 2704(c)(2). The definition incorporates the constructive ownership rules in those sections. Proposed §1.6011-10(b) also provides the rules for persons that hold derivatives and for the treatment of beneficiaries of trusts and estates. The treatment of beneficiaries of trusts in proposed §1.6011-10(b) does not affect the application of Subpart E of Subchapter J of Chapter 1 of Subtitle A, which provides rules concerning when a grantor or another person is treated as the owner of a portion of that trust.

A transaction is described in proposed §1.6011-10(c) if it is described in proposed §1.6011-10(c)(1), or (c)(2), or both. Proposed §1.6011-10(c)(1) describes transactions that involve a Captive that, at any time during the Financing Computation Period, directly or indirectly made available as financing or otherwise conveyed or agreed to make available or convey to a Recipient, in a transaction that did not result in taxable income or gain to the Recipient, any portion of the payments under the Contract, such as through a guarantee, a loan, or other transfer of Captive's capital, including such financings or conveyances made prior to the Financing Computation Period that remain outstanding as of the taxable year in which disclosure is required. Any amounts that a Captive made available as financing or otherwise conveyed or agreed to make available or convey to a Recipient are presumed to be portions of the payments under the Contract to the extent such amounts when conveyed or made available are in excess of Captive's cumulative after-tax net investment earnings minus any outstanding financings or conveyances. *See* section B.2. of this Explanation of Provisions. The Financing Computation Period is the most recent five taxable years of Captive, or all taxable years of Captive, if Captive has been in existence for less than five taxable years. For purposes of determining the Financing Computation Period, each short taxable year is a separate taxable year and taxable years of predecessor entities are treated as taxable years of Captive.

Proposed §1.6011-10(c)(2) describes transactions that involve a Captive for which the amount of liabilities incurred for insured losses and claim administration expenses during a Loss Ratio Computation Period is less than 65 percent of the amount equal to premiums earned by Captive during the Loss Ratio Computation Period less policyholder dividends paid by Captive during the Loss Ratio Computation Period. *See* section B.3. of this Explanation of Provisions. The Loss Ratio Computation Period is the most recent ten taxable years of Captive, each short taxable year is a separate taxable year, and the taxable years of predecessor entities are treated as taxable years of Captive. Proposed §1.6011-10(c)(2) does not apply to any Captive that has been in existence for less than ten taxable years, including taxable years of predecessor entities.

Proposed §1.6011-10(d) provides that a transaction described in proposed §1.6011-10(c) is not classified as a listed transaction if the transaction (1) provides insurance for employee compensation or benefits and is one for which the Employee Benefits Security Administration of the U.S. Department of Labor has issued a Prohibited Transaction Exemption, or (2) is a Consumer Coverage reinsurance arrangement described in proposed §1.6011-10(d)(2). *See* section B.6. of this Explanation of Provisions.

Proposed §1.6011-10(e)(1) provides the rules for determining who is a participant in a listed transaction described in proposed §1.6011-10(a). Proposed §1.6011-10(e)(2) provides a safe harbor from the disclosure requirements for certain persons. *See* section B.5. of this Explanation of Provisions.

Proposed §1.6011-10(f) describes information that participants must provide to satisfy the disclosure requirements of §1.6011-4(d). *See* section B.4. of this Explanation of Provisions.

Proposed §1.6011-10(g) provides the applicability date for the proposed regulations.

4. *Micro-captive Transactions of Interest*

Proposed §1.6011-11(a) provides that transactions that are the same as, or substantially similar to, transactions described in proposed §1.6011-11(c) are identified as transactions of interest for purposes of §1.6011-4(b)(6), except as provided in proposed §1.6011-11(d). Proposed §1.6011-11(b) provides definitions of terms used to describe Micro-captive Transactions of Interest by reference to the relevant definitions in proposed §1.6011-10(b), except for the definition of the computation period. Proposed §1.6011-11(b)(2) defines the Transaction of Interest Computation Period for Micro-captive Transactions of Interest as the most recent nine taxable years, or the entire period of Captive's existence if Captive has been in existence for less than nine taxable years. For this purpose, each short taxable year is a separate taxable year, and the taxable years of predecessor entities are treated as taxable years of Captive.

A transaction is described in proposed §1.6011-11(c) if it involves the issuance of a Contract to an Insured by a Captive, or the reinsurance by a Captive of a Contract issued to an Insured by an Intermediary, and involves a Captive for which the amount of liabilities incurred for insured losses and claim administration expenses during the Transaction of Interest Computation Period is less than 65 percent of the amount equal to premiums earned by Captive during the Transaction of Interest Computation Period less policyholder dividends paid by Captive during the Transaction of Interest Computation Period. *See* section B.3. of this Explanation of Provisions.

Proposed §1.6011-11(d) provides that a transaction described in proposed §1.6011-11(c) is not classified as a "transaction of interest" if the transaction (1) provides insurance for employee compensation or benefits and is one for

which the Employee Benefits Security Administration of the U.S. Department of Labor has issued a Prohibited Transaction Exemption, or (2) is a Consumer Coverage reinsurance arrangement described in proposed §1.6011-11(d)(2). *See* section B.6. of this Explanation of Provisions. Additionally, proposed §1.6011-11(d)(3) provides that a transaction described in proposed §1.6011-11(c) is not classified as a "transaction of interest" if the transaction is identified as a "listed transaction" in proposed §1.6011-10(a). Under proposed §1.6011-11(d)(3), a transaction that would (but for that subsection) be identified as both a "listed transaction" under proposed §1.6011-10 and a "transaction of interest" under proposed §1.6011-11, is identified as a "listed transaction" only, and participants in the transaction must disclose it as such. Material advisors that are uncertain about whether the transaction they are required to disclose should be reported as a Micro-captive Listed Transaction or as a Micro-captive Transaction of Interest should disclose the transaction as a Micro-captive Listed Transaction, and will not be required to disclose the transaction a second time if it is determined later that the transaction should have been disclosed as a Micro-captive Transaction of Interest.

Proposed §1.6011-11(e)(1) provides the rules for determining who is a participant in a transaction of interest described in proposed §1.6011-11(a). Proposed §1.6011-11(e)(2) provides a safe harbor from the disclosure requirements for certain persons. *See* section B.5. of this Explanation of Provisions.

Proposed §1.6011-11(f) describes information that participants must provide to satisfy the disclosure requirements of §1.6011-4(d) by reference to the information described in proposed §1.6011-10(f). *See* section B.4. of this Explanation of Provisions.

Proposed §1.6011-11(g) provides the applicability date for the proposed regulations.

B. *Changes to Transaction Identified in Notice 2016-66*

Examinations of taxpayers and promoters and information received through disclosures filed in response to Notice 2016-66 have clarified the Treasury Department's and the IRS's understanding of micro-captive transactions, including the scope of participation. Based on such information, the Treasury Department and the IRS have determined that certain changes to the micro-captive transaction identified in Notice 2016-66 are appropriate for the proposed regulations. The transactions described in proposed §1.6011-10 and proposed §1.6011-11 share common features with the micro-captive transactions described in Notice 2016-66, but with modifications to the scope of the 20-percent relationship factor and the factors used to distinguish between listed transactions, transactions of interest, and transactions that are not reportable transactions under the proposed regulations.

1. *Changes to the Definition of Captive*

The Treasury Department and the IRS are aware that some promoters have structured transactions in which Insureds, Owners, or persons Related to an Insured or an Owner do not have a direct or indirect interest in Captive's voting power or value of its outstanding stock or equity interests, but have a relationship with Captive that provides substantially similar benefits and risks. For example, Captive may issue various types of instruments representing rights to all or a portion of the assets held by Captive but not rights to the voting power or equity interests in Captive. All equity interests and voting stock are held by individuals or entities related to the promoter, not the taxpayers. The promoters thereby seek to avoid the 20 percent related interest in the voting stock or equity interests in Captive necessary for a transaction to be described in Notice 2016-66. The proposed regulations expand the scope of the definition of Captive to clarify that derivatives and interests in the assets of Captive are taken into account. *See* proposed §§1.6011-10(b)(1)(A) – (C) and 1.6011-11(b)(1).

2. *Changes to the Financing Factor*

Transactions in which the financing factor is met based on a computation period of Captive's most recent five taxable years (or all years of Captive's existence if Captive has been in existence for less than five taxable years), referred to as the Financing Computation Period in the proposed regulations, are identified as transactions of interest in Notice 2016-66 but are identified as listed transactions in the proposed regulations. *See* proposed §1.6011-10(c)(1). Presence of the financing factor in related party micro-captive insurance transactions indicates tax avoidance and abuse of Captive's status as a section 831(b)-electing insurance company.

3. *Changes to the Loss Ratio Factor and Computation Period*

Notice 2016-66 identifies transactions in which the loss ratio factor is less than 70 percent based on a Notice Computation Period of Captive's most recent five taxable years (or all years of Captive's existence if it has been in existence for less than five taxable years) as transactions of interest. The proposed regulations, however, identify as listed transactions those transactions in which the loss ratio factor is less than 65 percent for a computation period extended to Captive's most recent ten taxable years (referred to as the Loss Ratio Computation Period). *See* proposed §1.6011-10(c)(2). Further, the proposed regulations identify transactions in which the loss ratio factor is less than 65 percent based on a Transaction of Interest Computation Period consisting of Captive's most recent nine taxable years (or all years of Captive's existence if Captive has been in existence for less than nine taxable years) as transactions of interest. *See* proposed §1.6011-11(c).

Regarding the reduction of the loss ratio threshold from 70 percent to 65 percent, the Treasury Department and the IRS are not aware of any non-abusive transactions for which disclosure was required under Notice 2016-66 as a result of the 70-percent loss ratio factor set forth therein. Nevertheless, for purposes of the proposed regulations and to ensure that disclosure is not required for non-abusive transactions, the Treasury Department and the IRS are lowering the applicable loss ratio factor to 65 percent. *See* proposed §§1.6011-10(c)(2) and 1.6011-11(c). The loss ratio factor helps to identify transactions involving circumstances inconsistent with insurance in the commonly accepted

sense, including excessive pricing of premiums and artificially low or nonexistent claims activity. The primary purpose of premium pricing is to ensure funds are available should a claim arise. The pricing of premiums should naturally reflect the economic reality of insurance operations. Pricing premiums far in excess of what is reasonably needed to fund insurance operations results in a lower loss ratio and is a strong indicator of abuse. Any Captives that would be required to disclose as a result of the loss ratio factor may consider paying policyholder dividends to increase the loss ratio and eliminate the need to disclose.

The Treasury Department and the IRS are considering whether a combined ratio may be a better indicator for distinguishing abusive transactions from other captive transactions. A combined ratio is "an indication of the profitability of an insurance company, calculated by adding the loss and expense ratios." *NAIC Glossary of Insurance Terms*, https://content.naic.org/consumer_glossary#C (last visited April 3, 2023). The 2021 NAIC P&C Report provides that the combined ratios for property and casualty insurance companies ranged from 96 percent to 103.9 percent over the ten-year period from 2012 to 2021, for a ten-year average of approximately 99.5 percent. *See U.S. Property & Casualty and Title Insurance Industries – 2021 Full Year Results* (2022), https://content.naic.org/sites/default/files/inline-files/2021%20Annual%20Property%20%26%20Casualty%20and%20Title%20Insurance%20Industry%20Report.pdf (last visited April 3, 2023). The combined ratio would compare losses incurred, plus loss adjustment expenses incurred and other underwriting expenses incurred by Captive during the relevant computation period to Captive's earned premiums, less policyholder dividends, for the relevant computation period. For this purpose, Captive's other underwriting expenses incurred would equal Captive's expenses incurred in carrying on an insurance business, other than loss adjustment expenses and investment-related expenses. Transactions in which Captive's combined ratio is less than a certain percentage for a Loss Ratio Computation Period of the most recent ten taxable years of Captive would be identified as listed transactions. Transactions in which Captive's combined ratio is less than a certain percentage for a Transaction of Interest Computation Period of the most recent nine taxable years (or all years of Captive's existence if it has been in existence for less than nine taxable years) would be identified as transactions of interest. The Treasury Department and the IRS invite comments on whether a combined ratio would better distinguish abusive transactions than the proposed loss ratio factor, and if so, what combined ratio threshold would be most effective in distinguishing abusive transactions.

Regarding the computation periods for the loss ratio factor, the Treasury Department and the IRS understand that it is possible that a Captive with a loss history of fewer than ten taxable years could have a loss ratio that falls below 65 percent solely because Captive provides coverage for low frequency, high severity losses and Insureds purchasing policies from such Captive do not incur such losses in every year. In recognition of this fact, the proposed regulations categorize transactions as either transactions of interest or listed transactions based on the length of the computation period on which the loss ratio is based. The Notice Computation Period used by Notice 2016-66 to identify transactions of interest based on a loss ratio factor was five taxable years, and it has been more than five years since Notice 2016-66 was published. The Treasury Department and the IRS have determined that extending the computation period by five years to a Loss Ratio Computation Period of ten taxable years (doubling the Notice Computation Period) allows Captives significant time to develop a reasonable loss history that supports the use of Captive for legitimate insurance purposes, and a loss ratio that remains below 65 percent for a Loss Ratio Computation Period of ten taxable years indicates a tax avoidance transaction. Accordingly, the proposed regulations identify transactions in which the loss ratio is less than 65 percent based on an extended Loss Ratio Computation Period of Captive's most recent ten taxable years as listed transactions. *See* proposed §1.6011-10(b)(2).

However, the Treasury Department and the IRS also have determined that related party transactions in which the loss ratio is less than 65 percent over a shorter period of time have a potential for tax avoidance or evasion. The proposed regulations therefore identify transactions in which Captive has a loss ratio of less than 65 percent based on a Transaction of Interest Computation Period of Captive's most recent nine taxable years (or all years of Captive's existence if it has been in existence for less than nine taxable years) as transactions of interest, provided such transactions are not otherwise characterized as listed transactions (that is, due to the presence of the financing factor described in proposed §1.6011-10(c)(1) or due to having a loss ratio factor of less than 65 percent based on a Loss Ratio Computation Period of Captive's most recent ten taxable years). *See* proposed §1.6011-11(c) and (d)(3). Identification of these transactions as transactions of interest will permit the Treasury Department and the IRS to gather more information to determine if these transactions are being used for tax avoidance or evasion.

4. *Information Sought from Participants*

The proposed regulations significantly reduce the information required to be reported by Captives under §1.6011-4(d) as compared to Notice 2016-66. *See* proposed §§1.6011-10(f) and 1.6011-11(f). Unlike Notice 2016-66, the proposed regulations do not require Captive participants to identify which factors of the proposed regulations apply, state under what authority Captive is chartered, describe how amounts treated as premiums for coverage provided by Captive were determined, provide the amounts of reserves reported by Captive on its annual statement, or describe the assets held by Captive. The proposed regulations do, however, require Captive to identify the types of policies issued or reinsured, the amounts treated as premiums written, the name and contact information of actuaries and underwriters involved, and the total amount of claims paid by Captive. Additionally, proposed §§1.6011-10(b)(1) and 1.6011-11(b)(1) include a 20-percent relationship test in the definition of Captive, and the proposed regulations require Captive participants to identify the name and percentage of interest held directly or indirectly by each person whose interest

in Captive meets the 20 percent threshold or is taken into account in meeting the 20 percent threshold under proposed §1.6011-10(b)(1)(iii). Also, the proposed regulations require each Insured (as defined in proposed §§1.6011-10(b)(4) and 1.6011-11(b)(4)) subject to the disclosure requirements set forth in §1.6011-4(d) to provide the amounts treated by Insured as insurance premiums for coverage provided to Insured, directly or indirectly, by Captive.

5. *Disclosure Requirement Safe Harbor for Owners*

The Treasury Department and the IRS believe that it is now feasible to generally limit the persons from whom reporting would be required under the proposed regulations to Captive, Insured, and material advisors to the transaction. Accordingly, the proposed regulations provide that any person who, solely by reason of their direct or indirect ownership interest in Insured, is subject to the disclosure requirements set forth in §1.6011-4 as a participant in a Micro-captive Listed Transaction or a Micro-captive Transaction of Interest, is not required under §1.6011-4 to file a disclosure statement with respect to that transaction provided that person receives written or electronic acknowledgment that Insured has or will comply with its separate disclosure obligation under §1.6011-4(a) with respect to the transaction. *See* proposed §§1.6011-10(e)(2) and 1.6011-11(e)(2). The acknowledgment can be a copy of the Form 8886, *Reportable Transaction Disclosure Statement* (or successor form), filed (or to be filed) by Insured and must be received by Owner prior to the time set forth in §1.6011-4(e) in which Owner would otherwise be required to provide disclosure. *See* proposed §§1.6011-10(e)(2) and 1.6011-11(e)(2). However, the receipt of an acknowledgment that Insured has or will comply with its disclosure obligation does not relieve the Owners of Insured of their disclosure obligations if Insured fails to disclose the transaction in a timely manner.

6. *Exception for Consumer Coverage Arrangements*

The proposed regulations provide a limited exception from classification as a Micro-captive Listed Transaction or Micro-captive Transaction of Interest for certain Consumer Coverage reinsurance arrangements. *See* proposed §§1.6011-10(d)(2) and 1.6011-11(d)(2). In Consumer Coverage arrangements, a "Seller" (that is, a service provider, automobile dealer, lender, or retailer) sells products or services to "Unrelated Customers" (that is, customers who do not own an interest in and are not wholly or partially owned by Seller, an owner of Seller, or individuals or entities related (within the meaning of one or more of sections 267(b), 707(b), 2701(b)(2)(C), or 2704(c)(2)) to Seller or owners of Seller). An Unrelated Customer may also purchase an insurance contract in connection with those products or services (Consumer Coverage contract). The Consumer Coverage contract generally provides coverage for repair or replacement costs if the product breaks down or is lost, stolen, or damaged; coverage for the customer's payment obligations if the customer dies or becomes disabled or unemployed; coverage for the difference between all or a portion of the value of the product and the amount owed on the product's financing, including a lease, if the product suffers a covered peril; or a combination of one or more of the foregoing types of coverage.

An entity related to or affiliated with Seller may issue or reinsure the Consumer Coverage contracts. In some arrangements, the Consumer Coverage contracts name an unrelated third party, which may be referred to as a "Fronting Company," as the provider of the coverage, and an entity related to or affiliated with Seller reinsures the Consumer Coverage contracts. In other arrangements, the Consumer Coverage contracts may name an entity related to or affiliated with Seller as the provider of the coverage. In these arrangements, an unrelated third party may reinsure the contracts and may also then retrocede risk under the contracts to the entity related to or affiliated with Seller. The parties may treat the entity related to or affiliated with Seller as an insurance company that elects under section 831(b) (and section 953(d) if the corporation is foreign) to exclude premium payments from taxable income.

As a general matter, participation in this type of reinsurance arrangement is neither a Micro-captive Listed Transaction nor a Micro-captive Transaction of Interest because the insured is not sufficiently related to the insurer or any reinsurer. Generally, the Consumer Coverage contracts insure Unrelated Customers of Seller, and Unrelated Customers, their owners, and persons related to Unrelated Customers or their owners do not directly or indirectly own at least 20 percent of the voting power or value of the outstanding stock of any entity issuing or reinsuring the Consumer Coverage contract. However, the 20-percent relationship factor in proposed §§1.6011-10(b)(1) and 1.6011-11(b)(1) may be met in some of these reinsurance arrangements. For instance, in "dealer obligor" arrangements in which the Seller would be legally required to pay a claim under certain conditions, such as a total loss of the covered product within a certain time frame, the Seller could potentially be considered an Insured under a Contract issued or reinsured by a Captive, and thus be required to disclose.

The Treasury Department and the IRS have determined that a limited exception for taxpayers in Consumer Coverage arrangements is appropriate, provided commissions paid for Consumer Coverage contracts issued or reinsured by the Seller's Captive are comparable to the commissions paid for Consumer Coverage contracts covering Seller's products or services that are not issued or reinsured by the Seller's Captive. *See* proposed §§1.6011-10(d)(2) and 1.6011-11(d)(2).

C. *Effect of Transaction Becoming a Listed Transaction or a Transaction of Interest Under these Regulations*

Participants required to disclose these transactions under §1.6011-4 who fail to do so are subject to penalties under section 6707A. Participants required to disclose the listed transactions under §1.6011-4 who fail to do so are also subject to an extended period of limitations under section 6501(c)(10). Material advisors required to disclose these transactions under section 6111 who fail to do so are subject to the penalty under section 6707. Material advisors required to maintain lists of investors under section 6112 who fail to do so (or who fail to provide such lists when requested by the IRS) are subject to the penalty under section 6708(a). In addi-

tion, the IRS may impose other penalties on persons involved in these transactions or substantially similar transactions, including accuracy-related penalties under section 6662 or section 6662A, the section 6694 penalty for understatements of a taxpayer's liability by a tax return preparer, the section 6700 penalty for promoting abusive tax shelters, and the section 6701 penalty for aiding and abetting understatement of a tax liability.

Taxpayers who have filed a tax return (including an amended return (or Administrative Adjustment Request (AAR) for certain partnerships)) reflecting their participation in these transactions prior to the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register** and who have not otherwise finalized a settlement agreement with the Internal Revenue Service with respect to the transaction must disclose the transactions as provided in §1.6011-4(d) and (e) provided that the period of limitations for assessment of tax, including any applicable extensions, for any taxable year in which the taxpayer participated in the transaction has not ended on or before the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**.

In addition, material advisors have disclosure requirements with regard to transactions occurring in prior years. However, notwithstanding §301.6111-3(b)(4)(i) and (iii), material advisors are required to disclose only if they have made a tax statement on or after six years before the date of the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**.

A participant in a transaction that is a Micro-captive Listed Transaction must file a disclosure statement with OTSA when required to do so under §1.6011-4(e), regardless of whether the participant has previously disclosed the transaction to OTSA pursuant to Notice 2016-66. A participant in a transaction that is a Micro-captive Transaction of Interest that has previously filed a disclosure statement with OTSA pursuant to Notice 2016-66 will be treated as having made the disclosure pursuant to the final regulations for taxable years for which the taxpayer filed returns before the final regulations are published in the **Federal Register.** However, if a taxpayer described in the preceding sentence participates in the Micro-captive Transaction of Interest in a taxable year for which the taxpayer files a return on or after the date the final regulations are published in the **Federal Register**, the taxpayer must file a disclosure statement with OTSA at the same time the taxpayer files their return for the first such taxable year.

A material advisor with respect to a transaction that is a Micro-captive Listed Transaction or Micro-captive Transaction of Interest must file a disclosure statement with OTSA when required to do so under §301.6111-3(e), regardless of whether the material advisor has previously disclosed the transaction to OTSA pursuant to Notice 2016-66.

The Treasury Department and the IRS recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the types of transactions described in these proposed regulations. Because the IRS will take the position that taxpayers are not entitled to the purported tax benefits of the listed transactions described in the proposed regulations, and may take such a position with respect to the transactions of interest described in the proposed regulations, taxpayers should consider filing amended returns or AARs for certain partnerships and ensure that their transactions are disclosed properly. Taxpayers filing an amended individual return should write "Microcaptive" at the top of the first page of the amended return and mail the amended return to:

Internal Revenue Service
2970 Market Street
Philadelphia, PA 19104

Taxpayers filing amended business returns on paper should write "Microcaptive" at the top of the first page of the amended return and mail to the address listed in the instructions for the amended return. Taxpayers filing amended business returns electronically should include "Microcaptive" when explaining the reason for the changes.

Proposed Applicability Dates

Proposed §1.6011-10(a) would identify certain micro-captive transactions described in proposed §1.6011-10(c) as listed transactions effective as of the date of publication in the **Federal Register** of a Treasury decision adopting these regulations as final regulations. Similarly, proposed §1.6011-11(a) would identify certain micro-captive transactions described in proposed §1.6011-11(c) as transactions of interest as of the date of publication in the **Federal Register** of a Treasury decision adopting these regulations as final regulations.

Effect on Other Documents

This document obsoletes Notice 2016-66 (2016-47 I.R.B. 745), as modified by Notice 2017-08 (2017-3 I.R.B. 423), as of April 11, 2023.

Special Analyses

I. *Regulatory Planning and Review*

The proposed regulations are not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget (OMB) regarding the review of tax regulations.

II. *Paperwork Reduction Act*

The collection of information contained in these proposed regulations is reflected in the collection of information for Forms 8886 and 8918 that have been reviewed and approved by OMB in accordance with the Paperwork Reduction Act (44 U.S.C. 3507(c)) under control numbers 1545-1800 and 1545-0865. Any disclosures with respect to the safe harbor for owners as provided in §§1.6011-10(e)(2) and 1.6011-11(e)(2) are in the nature of an acknowledgment per 5 CFR 1320.3(h)(1), and therefore do not constitute a collection of information under the Paperwork Reduction Act.

To the extent there is a change in burden as a result of these regulations, the change in burden will be reflected in the updated burden estimates for the Forms 8886 and 8918. The requirement to maintain records to substantiate information on Forms 8886 and 8918 is already

contained in the burden associated with the control numbers for the forms and is unchanged.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by OMB.

III. *Regulatory Flexibility Act*

The Secretary of the Treasury hereby certifies that the proposed regulations will not have a significant economic impact on a substantial number of small entities pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

As previously explained, the basis for these proposed regulations is Notice 2016-66, 2016-47 I.R.B. 745 (as modified by Notice 2017-08, 2017-3 I.R.B. 423). The following chart sets forth the gross receipts of respondents to Notice 2016-66, based on data for tax year 2020:

Notice 2016-66 Respondents by Size		
Receipts	**Firms**	**Filings**
Under 5M	78.65%	75.26%
5M to 10M	9.36%	10.20%
10M to 15M	4.39%	5.10%
15M to 20M	2.34%	2.55%
20M to 25M	1.17%	1.53%
Over 25M	4.09%	5.36%
TOTAL	100%	100%

This chart shows that the majority of respondents reported gross receipts under $5 million. Even assuming that these respondents constitute a substantial number of small entities, the proposed regulations will not have a significant economic impact on these entities because the proposed regulations implement sections 6111 and 6112 and §1.6011-4 by specifying the manner in which and time at which an identified Micro-captive Listed Transaction or Micro-captive Transaction of Interest must be reported. Accordingly, because the regulations are limited in scope to time and manner of information reporting and definitional information, the economic impact of the proposal is expected to be minimal.

Further, the Treasury Department and the IRS expect that the reporting burden is low; the information sought is necessary for regular annual return preparation and ordinary recordkeeping. The estimated burden for any taxpayer required to file Form 8886 is approximately 10 hours, 16 minutes for recordkeeping, 4 hours, 50 minutes for learning about the law or the form, and 6 hours, 25 minutes for preparing, copying, assembling, and sending the form to the IRS. The IRS's Research, Applied Analytics, and Statistics division estimates that the appropriate wage rate for this set of taxpayers is $77.50 (2020 dollars) per hour. Thus, it is estimated that a respondent will incur costs of approximately $1,667.27 per filing. Disclosures received to date by the Treasury Department and the IRS in response to the reporting requirements of Notice 2016-66 indicate that this small amount will not pose any significant economic impact for those taxpayers now required to disclose under the proposed regulations.

For the reasons stated, a regulatory flexibility analysis under the Regulatory Flexibility Act is not required. The Treasury Department and the IRS invite comments on the impact of the proposed regulations on small entities. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for the Office of Advocacy of the Small Business Administration for comment on its impact on small business.

IV. *Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a State, local, or Tribal government, in the aggregate, or by the private sector, of $100 million (updated annually for inflation). This proposed rule does not include any Federal mandate that may result in expenditures by State, local, or Tribal governments or by the private sector in excess of that threshold.

V. *Executive Order 13132: Federalism*

Executive Order 13132 (Federalism) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on State and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. This proposed rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive order.

Comments and Public Hearing

Before these proposed amendments to the regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in the preamble under the ADDRESSES section. The Treasury

Department and the IRS request comments on all aspects of the proposed regulations. The Treasury Department and the IRS specifically request comments on the following:

1. What are the specific and objective metrics, factors, or standards, if any, that, if reported, would allow for the IRS to better identify and distinguish abusive micro-captive transactions from other micro-captive transactions?

2. With respect to proposed §§1.6011-10(c)(2) and 1.6011-11(c), whether the loss ratio described therein, which compares "the amount of liabilities incurred by Captive for insured losses and claim administration expenses during the [applicable] Computation Period" to the "premiums earned by Captive during the [applicable] Computation Period less policyholder dividends paid by Captive during the [applicable] Computation Period", should be replaced by a combined ratio, which compares "losses incurred, plus loss adjustment expenses incurred and other underwriting expenses incurred by Captive during the [applicable] Computation Period" to "Captive's earned premiums, less policyholder dividends, for the [applicable] Computation Period", and if so, what percentage would be an effective threshold for purposes of identifying abusive transactions. For this purpose, Captive's "other underwriting expenses incurred" would equal Captive's expenses incurred in carrying on an insurance business, other than loss adjustment expenses and investment-related expenses.

3. With respect to the percentage of premiums retained as commissions for contracts as described at proposed §§1.6011-10(d)(2) and 1.6011-11(d)(2), what, if any, are the specific metrics, factors, or standards that, if reported, would allow for the IRS to better identify and distinguish abusive micro-captive transactions of this type from other such micro-captive transactions?

Any comments submitted will be made available at *https://www.regulations.gov* or upon request.

A public hearing is scheduled to be held by teleconference on July 19, 2023, beginning at 10:00 a.m. ET unless no outlines are received by June 12, 2023.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to comment by telephone at the hearing must submit written or electronic comments and an outline of the topics to be discussed as well as the time to be devoted to each topic by June 12, 2023, as prescribed in the preamble under the ADDRESSES section.

A period of ten minutes will be allocated to each person for making comments. After the deadline for receiving outlines has passed, the IRS will prepare an agenda containing the schedule of speakers. Copies of the agenda will be made available at *https://www.regulations.gov*, search IRS and REG-109309-22. Copies of the agenda will also be available by emailing a request to *publichearings@irs.gov*. Please put "REG-109309-22 Agenda Request" in the subject line of the email.

Announcement 2020-4, 2020-17 I.R.B. 667 (April 20, 2020), provides that until further notice, public hearings conducted by the IRS will be held telephonically. Any telephonic hearing will be made accessible to people with disabilities.

Statement of Availability of IRS Documents

The notices and revenue ruling cited in this document are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at *https://www.irs.gov*.

Drafting Information

The principal author of these proposed regulations is Elizabeth M. Hill, Office of Associate Chief Counsel (Financial Institutions & Products). However, other personnel from the Treasury Department and the IRS participated in the development of these regulations.

List of Subjects in 26 CFR Part 1

Income Taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, the Treasury Department and the IRS propose to amend 26 CFR part 1 as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

* * * * *

Section 1.6011-10 also issued under 26 U.S.C. 6001 and 26 U.S.C. 6011.

Section 1.6011-11 also issued under 26 U.S.C. 6001 and 26 U.S.C. 6011.

* * * * *

Par. 2. Section 1.6011-10 is added to read as follows:

§ 1.6011-10 Micro-captive listed transaction.

(a) *Identification as listed transaction.* Transactions that are the same as, or substantially similar to, transactions described in paragraph (c) of this section are identified as listed transactions for purposes of § 1.6011-4(b)(2), except as provided in paragraph (d) of this section.

(b) *Definitions.* The following definitions apply for purposes of this section:

(1) *Captive* means any entity that:

(i) Elects under section 831(b) of the Internal Revenue Code (Code) to exclude premiums from taxable income;

(ii) Issues a Contract to an Insured, reinsures a Contract of an Insured issued by an Intermediary, or both; and

(iii) Has at least 20 percent of its assets or the voting power or value of its outstanding stock or equity interests directly or indirectly owned, individually or collectively, by an Insured, an Owner, or persons Related to an Insured or an Owner. For purposes of this paragraph (b)(1)(iii), the following rules apply to the extent application of a rule (or rules) would increase such direct or indirect ownership:

(A) A person that holds a derivative is treated as indirectly owning the assets referenced by the derivative; and

(B) The interest of each beneficiary of a trust or estate in the assets of such trust or estate must be determined by assuming the maximum exercise of discretion by the fiduciary in favor of such beneficiary and the maximum use of the trust's or estate's interest in the company to satisfy the interests of such beneficiary.

(2) *Computation periods*—(i) *Financing Computation Period.* The Financing Computation Period is the most recent five

taxable years of Captive (or all taxable years of Captive, if Captive has been in existence for less than five taxable years).

(ii) *Loss Ratio Computation Period.* The Loss Ratio Computation Period is the most recent ten taxable years of Captive. A Captive that does not have at least ten taxable years cannot have a Loss Ratio Computation Period, and therefore is not described in paragraph (c)(2) of this section.

(iii) *Rules for computation periods.* This paragraph (b)(2)(iii) applies for purposes of determining the Financing Computation Period and the Loss Ratio Computation Period. Each short taxable year is a separate taxable year. If Captive is a successor to one or more other Captives, taxable years of each such other Captive are treated as taxable years of Captive. A successor is any of the following:

(A) A successor corporation as defined in § 1.382-2(a)(5);

(B) An entity that, directly or indirectly, acquires (or is deemed to acquire) the assets of another entity and succeeds to and takes into account the other entity's earnings and profits or deficit in earnings and profits; or

(C) An entity that receives (or is deemed to receive) any assets from another entity if such entity's basis is determined, directly or indirectly, in whole or in part, by reference to the other entity's basis.

(3) *Contract* means any contract that is treated by a party to the contract as an insurance contract or reinsurance contract for Federal income tax purposes.

(4) *Insured* means any person that conducts a trade or business, enters into a Contract with a Captive or enters into a Contract with an Intermediary that is directly or indirectly reinsured by a Captive, and treats amounts paid under the Contract as insurance premiums for Federal income tax purposes.

(5) *Intermediary* means any entity that issues a Contract to an Insured, or reinsures a Contract that is issued to an Insured, and such Contract is reinsured, directly or indirectly, by a Captive. A transaction may have more than one Intermediary.

(6) *Owner* means any person who, directly or indirectly, holds an ownership interest in an Insured or its assets. For purposes of this paragraph (b)(6), the following rules apply to the extent application of a rule (or rules) would increase such direct or indirect ownership:

(i) The interest of a person that holds a derivative must be determined as provided in paragraph (b)(1)(iii)(A) of this section; and

(ii) The interest of each beneficiary of a trust or estate in the assets of such trust or estate must be determined as provided in paragraph (b)(1)(iii)(B) of this section.

(7) *Recipient* means any Owner, Insured, or person Related to an Owner or an Insured engaged in a transaction described in paragraph (c)(1) of this section.

(8) *Related* means having a relationship described in one or more of sections 267(b), 707(b), 2701(b)(2)(C), and 2704(c)(2) of the Code.

(9) *Seller* means a service provider, automobile dealer, lender, or retailer that sells products or services to Unrelated Customers who purchase insurance contracts in connection with those products or services.

(10) *Seller's Captive* means a Captive Related to Seller, an owner of Seller, or individuals or entities Related to Seller or owners of Seller.

(11) *Unrelated Customers* means persons who do not own an interest in, and are not wholly or partially owned by, Seller, an owner of Seller, or individuals or entities Related to Seller or owners of Seller.

(c) *Transaction description.* A transaction is described in this paragraph (c) if the transaction is described in paragraph (c)(1) of this section, paragraph (c)(2) of this section, or both.

(1) The transaction involves a Captive that, at any time during the Financing Computation Period, directly or indirectly made available as financing or otherwise conveyed or agreed to make available or convey to a Recipient, in a transaction that did not result in taxable income or gain to the Recipient, any portion of the payments under the Contract, such as through a guarantee, a loan, or other transfer of Captive's capital, or made such financings or conveyances prior to the Financing Computation Period that remain outstanding or in effect at any point in the taxable year for which disclosure is required. Any amounts that a Captive made available as financing or otherwise conveyed or agreed to make available or convey to a Recipient are presumed to be portions of the payments under the Contract to the extent such amounts when made available or conveyed are in excess of Captive's cumulative after-tax net investment earnings minus any outstanding financings or conveyances.

(2) The transaction involves a Captive for which the amount of liabilities incurred for insured losses and claim administration expenses during the Loss Ratio Computation Period is less than 65 percent of the amount equal to premiums earned by Captive during the Loss Ratio Computation Period less policyholder dividends paid by Captive during the Loss Ratio Computation Period.

(d) *Exceptions.* A transaction described in paragraph (c) of this section is not classified as a listed transaction for purposes of this section and §1.6011-4(b)(2) if the transaction:

(1) Provides insurance for employee compensation or benefits and is one for which the Employee Benefits Security Administration of the U.S. Department of Labor has issued a Prohibited Transaction Exemption under the procedures provided at 76 FR 66637 (Oct. 27, 2011) (or subsequent procedures); or

(2) Is an arrangement in which a Captive meets all of the following requirements:

(i) Captive is a Seller's Captive:

(ii) The Seller's Captive issues or reinsures some or all of the Contracts sold to Unrelated Customers in connection with the products or services being sold by the Seller:

(iii) 100 percent of the business of the Seller's Captive is insuring or reinsuring Contracts in connection with products or services being sold by the Seller or persons Related to the Seller: and

(iv) With respect to the Contracts issued or reinsured by the Seller's Captive, the fee, commission, or other remuneration earned by any person or persons, in the aggregate, for the sale of the Contracts, described as a percentage of the premiums paid by the Seller's customers, is at least equal to the greater of:

(A) 50 percent; or

(B) The unrelated commission percentage (which is the highest percentage fee, commission, or other remuneration known to the Seller that is earned by any person

or persons, in the aggregate, for the sale of any extended warranty, insurance, or other similar Contract sold to a customer covering products or services sold by the Seller.

(e) *Special participation rules*—(1) *In general.* Whether a taxpayer has participated in the listed transaction identified in paragraph (a) of this section will be determined under § 1.6011-4(c)(3)(i)(A). Participants include, but are not limited to, any Owner, Insured, Captive, or Intermediary with respect to the transaction whose tax return reflects tax consequences or a tax strategy described in paragraph (a) of this section, except as otherwise provided in paragraph (e)(2) of this section.

(2) *Disclosure safe harbor for Owners.* An Owner who, solely by reason of the Owner's direct or indirect ownership interest in an Insured, has participated in the listed transaction described in this section will not be required to disclose participation in the transaction under section 6011(a), notwithstanding § 1.6011-4(c)(3), if the Owner receives an acknowledgment, in writing or electronically, from the Insured that the Insured has or will comply with the Insured's separate disclosure obligation under § 1.6011-4 with respect to the transaction and the Insured discloses the transaction in a timely manner. The acknowledgment can be a copy of the Form 8886, *Reportable Transaction Disclosure Statement* (or successor form), filed (or to be filed) by the Insured and must be received by the Owner prior to the time set forth in § 1.6011-4(e) in which the Owner would otherwise be required to provide disclosure. Owners who meet the requirements of this safe harbor will not be treated as having participated in an undisclosed listed transaction for purposes of § 1.6664-2(c)(3)(ii) or as having failed to include information on any return or statement with respect to a listed transaction for purposes of section 6501(c)(10).

(f) *Disclosure requirements*—(1) *Information required of all participants.* Participants must provide the information required under § 1.6011-4(d) and the Instructions to Form 8886 (or successor form). For all participants, describing the transaction in sufficient detail includes, but is not limited to, describing on Form 8886 (or successor form) when, how, and from whom the participant became aware of the transaction, and how the participant participated in the transaction (for example, as an Insured, a Captive, or other participant). Paragraphs (f)(2) and (3) of this section describe information required of a Captive and an Insured, respectively.

(2) *Information required of a Captive.* For a Captive, describing the transaction in sufficient detail includes, but is not limited to, describing the following on Form 8886 (or successor form):

(i) All the type(s) of policies issued or reinsured by Captive during the year of participation or years of participation (if disclosure pertains to multiple years);

(ii) The amounts treated by Captive as premiums written for coverage provided by Captive during the year of participation or each year of participation (if disclosure pertains to multiple years);

(iii) The name and contact information of each and every actuary or underwriter who assisted in the determination of the amounts treated as premiums for coverage provided by Captive during the year or each year of participation (if disclosure pertains to multiple years);

(iv) The total amount of claims paid by Captive during the year of participation or each year of participation (if disclosure pertains to multiple years); and

(v) The name and percentage of interest directly or indirectly held by each person whose interest in Captive meets the 20 percent threshold or is taken into account in meeting the 20 percent threshold under § 1.6011-10(b)(1)(iii).

(3) *Information required of Insured.* For Insured, describing the transaction in sufficient detail includes, but is not limited to, describing on Form 8886 (or successor form) the amounts treated by Insured as premiums for coverage provided to Insured, directly or indirectly, by Captive or by each Captive (if disclosure pertains to multiple Captives) during the year or each year of participation (if disclosure pertains to multiple years), as well as the identity of all persons identified as Owners to whom the Insured provided an acknowledgment described in paragraph (e)(2) of this section.

(g) *Applicability date*—(1) *In general.* This section identifies transactions that are the same as, or substantially similar to, the transactions described in paragraph (a) of this section as listed transactions for purposes of § 1.6011-4(b)(2) effective the date the regulations are published as final regulations in the **Federal Register**.

(2) *Obligations of participants with respect to prior periods.* Pursuant to § 1.6011-4(d) and (e), taxpayers who have filed a tax return (including an amended return) reflecting their participation in transactions described in paragraph (a) of this section prior to the date these regulations are published as final regulations in the **Federal Register**, who have not otherwise finalized a settlement agreement with the Internal Revenue Service with respect to the transaction, must disclose the transactions as required by § 1.6011-4(d) and (e) provided that the period of limitations for assessment of tax (as determined under section 6501 of the Code, including section 6501(c)) for any taxable year in which the taxpayer participated has not ended on or before the date the regulations are published as final regulations in the **Federal Register**.

(3) *Obligations of material advisors with respect to prior periods.* Material advisors defined in § 301.6111-3(b) of this chapter who have previously made a tax statement with respect to a transaction described in paragraph (a) of this section have disclosure and list maintenance obligations as described in §§ 301.6111-3 and 301.6112-1 of this chapter, respectively. Notwithstanding § 301.6111-3(b)(4)(i) and (iii) of this chapter, material advisors are required to disclose only if they have made a tax statement on or after the date that is six years before the date the regulations are published as final regulations in the **Federal Register**. Material advisors that are uncertain whether the transaction they are required to disclose should be reported under this section or §1.6011-11 should disclose under this section, and will not be required to disclose a second time if it is later determined that the transaction should have been disclosed under §1.6011-11.

Par. 3. Section 1.6011-11 is added to read as follows:

§ 1.6011-11 Micro-captive transaction of interest.

(a) *Identification as transaction of interest.* Transactions that are the same as, or substantially similar to, transactions described in paragraph (c) of this section

are identified as transactions of interest for purposes of § 1.6011-4(b)(6), except as provided in paragraph (d) of this section.

(b) *Definitions.* The following definitions apply for purposes of this section:

(1) *Captive* has the same meaning as provided in § 1.6011-10(b)(1).

(2) *Transaction of Interest Computation Period* means the most recent nine taxable years of a Captive (or all taxable years of Captive, if Captive has been in existence for less than nine taxable years). For purposes of this paragraph (b)(2), each short taxable year is a separate taxable year, and if Captive is a successor to one or more other Captives, taxable years of each such other Captive are treated as taxable years of Captive. A successor has the same meaning as provided in § 1.6011-10(b)(2)(iii) for purposes of this paragraph (b)(2).

(3) *Contract* has the same meaning as provided in § 1.6011-10(b)(3).

(4) *Insured* has the same meaning as provided in § 1.6011-10(b)(4).

(5) *Intermediary* has the same meaning as provided in § 1.6011-10(b)(5).

(6) *Owner* has the same meaning as provided in § 1.6011-10(b)(6).

(7) *Related* has the same meaning as provided in § 1.6011-10(b)(8).

(8) *Seller* has the same meaning as provided in § 1.6011-10(b)(9).

(9) *Seller's Captive* has the same meaning as provided in § 1.6011-10(b)(10).

(10) *Unrelated Customers* has the same meaning as provided in § 1.6011-10(b)(11).

(c) *Transaction description.* A transaction is described in this paragraph (c) if the transaction involves a Captive for which the amount of liabilities incurred for insured losses and claim administration expenses during the Transaction of Interest Computation Period is less than 65 percent of the amount equal to premiums earned by Captive during the Transaction of Interest Computation Period less policyholder dividends paid by Captive during the Transaction of Interest Computation Period.

(d) *Exceptions.* A transaction described in paragraph (c) of this section is not classified as a transaction of interest for purposes of this section and § 1.6011-4(b)(6) if the transaction:

(1) Is described in § 1.6011-10(d)(1);

(2) Is described in § 1.6011-10(d)(2); or

(3) Is identified as a listed transaction in § 1.6011-10(a), in which case the transaction must be reported as a listed transaction under § 1.6011-10.

(e) *Special participation rules*—(1) *In general.* Whether a taxpayer has participated in the transaction of interest identified in paragraph (a) of this section will be determined under § 1.6011-4(c)(3)(i)(E). Participants include, but are not limited to, any Owner, Insured, Captive, or Intermediary with respect to the transaction whose tax return reflects tax consequences or a tax strategy described in paragraph (a) of this section, except as otherwise provided in paragraph (e)(2) of this section.

(2) *Disclosure safe harbor for Owners*. An Owner who, solely by reason of the Owner's direct or indirect ownership interest in an Insured, has participated in the transaction of interest described in this section will not be required to disclose participation in the transaction under section 6011(a), notwithstanding § 1.6011-4(c)(3), if the Owner receives acknowledgment, in writing or electronically, from the Insured that the Insured has or will comply with Insured's separate disclosure obligation under § 1.6011-4 with respect to the transaction and the Insured discloses the transaction in a timely manner. The acknowledgment can be a copy of the Form 8886, *Reportable Transaction Disclosure Statement* (or successor form), filed (or to be filed) by the Insured and must be received by the Owner prior to the time set forth in § 1.6011-4(e) in which the Owner would otherwise be required to provide disclosure.

(f) *Disclosure requirements*. Participants must provide the information required under § 1.6011-4(d) and the Instructions to Form 8886 (or successor form). For all participants, describing the transaction in sufficient detail includes, but is not limited to, describing on Form 8886 (or successor form) when, how, and from whom the participant became aware of the transaction, and how the participant participated in the transaction (for example, as an Insured, a Captive, or other participant). A Captive and an Insured must also provide the information required in § 1.6011-10(f)(2) and (3), respectively.

(g) Applicability date—(1) *In general.* This section identifies transactions that are the same as, or substantially similar to, the transaction described in paragraph (a) of this section as transactions of interest for purposes of § 1.6011-4(b)(6) effective the date the regulations are published as final regulations in the **Federal Register**.

(2) *Obligations of participants with respect to prior periods.* Pursuant to § 1.6011-4(d) and (e), taxpayers who have filed a tax return (including an amended return) reflecting their participation in transactions described in paragraph (a) of this section prior to the date the regulations are published as final regulations in the **Federal Register**, who have not otherwise finalized a settlement agreement with the Internal Revenue Service with respect to the transaction, must disclose the transactions as required by § 1.6011-4(d) and (e) provided that the period of limitations for assessment of tax (as determined under section 6501, including section 6501(c)) for any taxable year in which the taxpayer participated has not ended on or before the date the regulations are published as final regulations in the **Federal Register**. However, taxpayers who have filed a disclosure statement regarding their participation in the transaction with the Office of Tax Shelter Analysis pursuant to Notice 2016-66, 2016-47 I.R.B. 745, will be treated as having made the disclosure pursuant to the final regulations for the taxable years for which the taxpayer filed returns before the final regulations are published in the **Federal Register**. If a taxpayer described in the preceding sentence participates in the Micro-captive Transaction of Interest in a taxable year for which the taxpayer files a return on or after the date the final regulations are published in the **Federal Register**, the taxpayer must file a disclosure statement with the Office of Tax Shelter Analysis at the same time the taxpayer files their return for the first such taxable year.

(3) *Obligations of material advisors with respect to prior periods.* Material advisors defined in § 301.6111-3(b) of this chapter who have previously made a tax statement with respect to a transaction described in paragraph (a) of this section have disclosure and list maintenance obligations as described in §§ 301.6111-3 and 301.6112-1 of this chapter, respectively.

Notwithstanding § 301.6111-3(b)(4)(i) and (iii) of this chapter, material advisors are required to disclose only if they have made a tax statement on or after the date six years before the date the regulations are published as final regulations in the **Federal Register**. Material advisors that are uncertain whether the transaction they are required to disclose should be reported under this section or § 1.6011-10 should disclose under § 1.6011-10, and will not be required to disclose a second time if it is later determined that the transaction should have been disclosed under this section.

Douglas W. O'Donnell,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register April 10, 2023, 8:45a.m., and published in the issue of the Federal Register for April 11, 2023, 88 FR 21547)

Notice of Proposed Rulemaking

Rules for Supervisory Approval of Penalties

REG-121709-19

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations regarding supervisory approval of certain penalties assessed by the IRS. The proposed regulations are necessary to address uncertainty regarding various aspects of supervisory approval of penalties that have arisen due to recent judicial decisions. The proposed regulations affect the IRS and persons assessed certain penalties by the IRS.

DATES: Electronic or written comments and requests for a public hearing must be received by July 10, 2023. Requests for a public hearing must be submitted as prescribed in the "**Comments and Requests for a Public Hearing**" section.

ADDRESSES: Commenters are strongly encouraged to submit public comments electronically. Submit electronic submissions via the Federal eRulemaking Portal at *www.regulations.gov* (indicate IRS and REG-121709-19) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish any comments submitted electronically and comments submitted on paper, to the public docket. Send paper submissions to: CC:PA:LPD:PR (REG-121709-19), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, David Bergman, (202) 317-6845; concerning submissions of comments and requests for a public hearing, Vivian Hayes (202) 317-5306 (not toll-free numbers) or by email at publichearings@irs.gov (preferred).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Regulations on Procedure and Administration (26 CFR part 301) under section 6751(b) of the Internal Revenue Code (Code). No regulations have previously been issued under section 6751.

1. *Legislative overview*.

Section 6751 was added to the Code by section 3306 of the Internal Revenue Service Restructuring and Reform Act of 1998 (1998 Act), Public Law 105-206, 112 Stat. 685, 744 (1998). Section 6751(a) sets forth the content of penalty notices. Section 6751(b) provides procedural requirements for the Secretary of the Treasury or her delegate (Secretary) to assess certain penalties, including additions to tax or additional amounts under the Code. *See* section 6751(c).

Section 6751(b)(1), as added by the 1998 Act, provides that "[n]o penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate." As an exception to this rule, section 6751(b)(2), as added by the 1998 Act, provides that section 6751(b)(1) "shall not apply to-- (A) any addition to tax under section 6651, 6654, or 6655 [of the Code]; or (B) any other penalty automatically calculated through electronic means."

The report of the United States Senate Committee on Finance regarding the 1998 Act (1998 Senate Finance Committee Report) provides that Congress enacted section 6751(b)(1) because of its concern that, "[i]n some cases, penalties may be imposed without supervisory approval." S. Rep. No. 105-174, at 65 (1998), 1998-3 C.B. 537, 601. The report further states that "[t]he Committee believes that penalties should only be imposed where appropriate and not as a bargaining chip." *Id.* The report provides that, to achieve this goal, section 6751(b)(1) "requires the specific approval of IRS management to assess all non-computer generated penalties unless excepted."

Section 212 of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, which was enacted as Division EE of the Consolidated Appropriations Act, 2021, Public Law 116-260, 134 Stat. 1182, 3067 (2020), expanded the list of penalties in section 6751(b)(2)(A) excepted from the supervisory approval requirement of section 6751(b)(1) by revising the end of section 6751(b)(2)(A) to read "6654, 6655, or 6662 (but only with respect to an addition to tax by reason of subsection (b)(9) thereof);" (relating to the addition to tax under section 6662(b)(9) of the Code with regard to the special charitable contribution deduction under section 170(p) of the Code for taxable years of individuals beginning in 2021). Section 605 of Division T of the Consolidated Appropriations Act, 2023, Public Law 117-328, 136 Stat. 4459, 5395 (2022), further amended section 6751(b)(2)(A) by striking "subsection (b)(9)" and inserting "paragraph (9) or (10) of subsection (b)." Section 6662(b)(10) imposes an accuracy-related penalty on underpayments attributable to

any disallowance of a deduction by reason of section 170(h)(7).

2. *Judicial treatment*.

In 2016, a United States Tax Court (Tax Court) majority read section 6751(b)(1)'s silence about when supervisory approval is required to mean that no specific timing requirement exists and, thus, the approval need only be obtained at some time, but no particular time, prior to assessment. *Graev v. Commissioner*, 147 T.C. 460, 477-81 (2016), *superseded by* 149 T.C. 485 (2017).

The United States Court of Appeals for the Second Circuit (Second Circuit) rejected the *Graev* court's interpretation of section 6751(b)(1), finding ambiguity in the statute's phrase "initial determination of such assessment." *Chai v. Commissioner*, 851 F.3d 190, 218-19 (2d Cir. 2017). The Second Circuit held that, with respect to penalties subject to deficiency procedures, section 6751(b)(1) requires written approval of the initial penalty determination no later than the date the IRS issues the notice of deficiency (or files an answer or amended answer asserting such penalty). *Id.* at 221. The Second Circuit reasoned that for supervisory approval to be given force, it must be obtained when the supervisor has the discretion to give or withhold it, and, for penalties determined in a notice of deficiency, this discretion no longer exists upon the issuance of the notice. *Id.* at 220. In *Graev III*, 149 T.C. 485 (2017), the Tax Court reversed its earlier interpretation of section 6751(b) and followed *Chai*. Since then, the Tax Court has imposed increasingly earlier deadlines by which supervisory approval of the initial penalty determination must be obtained to be considered timely under the statute, formulating tests that are difficult for IRS employees to apply.

In *Clay v. Commissioner*, 152 T.C. 223, 249-50 (2019), the Tax Court held that supervisory approval of penalties was too late where it was obtained before the IRS issued a notice of deficiency but after the revenue agent sent the petitioner a "30-day letter" proposing penalties and giving the petitioner an opportunity to request an administrative appeal. In *Belair Woods, LLC v. Commissioner*, 154 T.C. 1, 13 (2020), the Tax Court held that supervisory approval must be obtained before the IRS sends a notice that "formally communicates to the taxpayer, the [IRS] Examination Division's unequivocal decision to assert a penalty." In subsequent cases, the Tax Court has held that supervisory approval must be obtained before the first communication to the taxpayer that demonstrates that an initial determination has been made. *See*, *e.g.*, *Beland v. Commissioner*, 156 T.C. 80 (2021); *Kroner v. Commissioner*, T.C. Memo. 2020-73, *rev'd* 48 F. 4th 1272 (11th Cir. 2022); *Carter v. Commissioner*, T.C. Memo. 2020-21, *rev'd* 2022 WL 4232170 (11th Cir. Sept. 14, 2022). The Tax Court has applied this timing rule to penalties subject to pre-assessment review in the Tax Court, as well as to assessable penalties.

Recently the United States Court of Appeals for the Ninth Circuit (Ninth Circuit), the United States Court of Appeals for the Tenth Circuit (Tenth Circuit), and the United States Court of Appeals for the Eleventh Circuit (Eleventh Circuit) reversed the Tax Court's "formal communication" timing rule, noting that it has no basis in the text of the statute. *Laidlaw's Harley Davidson Sales, Inc. v. Commissioner*, 29 F.4th 1066 (9th Cir. 2022), *reh'g en banc denied*, No. 20-73420 (9th Cir. July 14, 2022); *Minemyer v. Commissioner*, Nos. 21-9006 & 21-9007, 2023 WL 314832 (10th Cir. Jan. 19, 2023); *Kroner v. Commissioner*, 48 F. 4th 1272 (11th Cir. 2022). In *Laidlaw's*, the Ninth Circuit held that the statute requires approval before the assessment of a penalty or, if earlier, before the relevant supervisor loses discretion whether to approve the penalty assessment, and noted that "[t]he statute does not make any reference to the communication of a proposed penalty to the taxpayer, much less a 'formal' communication." *Laidlaw's*, 29 F. 4th at 1072. In *Minemyer*, the Tenth Circuit, in an unpublished opinion, held that the statute requires approval before the IRS issues a notice of deficiency asserting a penalty. *Minemyer*, 2023 WL 314832 at *4-5. In *Kroner*, the Eleventh Circuit held that the statute only requires approval before assessment, finding that a deadline of assessment is "consistent with the meaning of the phrase 'initial determination of such assessment,'. . . . reflects the absence of any express timing requirement in the statute . . . [and] is a workable reading in light of the statute's purpose." *Kroner*, 48 F.4th at 1276. The Tax Court has continued to use its "formal communication" timing rule subsequent to *Laidlaw's* and *Kroner*. *See*, *e.g.*, *Simpson v. Commissioner*, T.C. Memo 2023-4; *Castro v. Commissioner*, T.C. Memo. 2022-120.

Recent cases have also addressed other issues under section 6751(b)(1), including (but not limited to) clarification as to who is an immediate supervisor, *see*, *e.g.*, *Sand Investment Co. v. Commissioner*, 157 T.C. 136 (2021); what constitutes personal, written approval, *see*, *e.g.*, *PBBM-Rose Hill, Ltd. v. Commissioner*, 900 F.3d 193 (5th Cir. 2018); whether particular Code sections impose a "penalty" subject to section 6751(b)(1), *see*, *e.g.*, *Grajales v. Commissioner*, 156 T.C. 55 (2021), *aff'd* 2022 WL 3640274 (2d Cir. 2022); and what constitutes a penalty "automatically calculated through electronic means." *See*, *e.g.*, *Walquist v. Commissioner*, 152 T.C. 61 (2019).

Explanation of Provisions

The Treasury Department and the IRS have concluded that it is in the interest of sound tax administration to have clear and uniform regulatory standards regarding the penalty approval requirements under section 6751(b). In the absence of such regulatory standards, caselaw has developed rules for the application of section 6751(b). Such judicial holdings are subject to unanticipated but frequent change, making it difficult for IRS employees to apply them in a consistent manner. The difficulty in applying or anticipating how courts will construe these rules has resulted in otherwise appropriate penalties on taxpayers not being sustained and has undermined the efficacy of these penalties as a tool to enhance voluntary compliance by taxpayers. In addition, the evolving standards regarding interpretations of section 6751(b) have served to increase litigation, which consumes significant government resources. The recent Ninth Circuit and Eleventh Circuit rulings also create a different test to satisfy the requirements of section 6751(b) in cases appealable to those circuits as opposed to other cases that come before the Tax

Court. *See Laidlaw's Harley Davidson Sales*, 29 F.4th at 1066; *Kroner v. Commissioner*,48 F. 4th at 1276. The proposed regulations are intended to clarify the application of section 6751(b) in a manner that is consistent with the statute and its legislative history, has nationwide uniformity, is administrable for the IRS, and is easily understood by taxpayers.

1. *Timing issues*

The proposed regulations would adopt three rules regarding the timing of supervisory approval of penalties under section 6751(b) that are based on objective and clear standards. One rule addresses penalties that are included in a pre-assessment notice that is subject to the Tax Court's review, such as a statutory notice of deficiency. One rule is for penalties that the IRS raises in an answer, amended answer, or amendment to the answer to a Tax Court petition. And one rule is for penalties assessed without prior opportunity for review by the Tax Court.

A. *Penalties subject to pre-assessment review in the Tax Court*

Proposed §301.6751(b)-1(c) provides that, for penalties that are included in a pre-assessment notice issued to a taxpayer that provides the basis for jurisdiction in the Tax Court upon timely petition, supervisory approval may be obtained at any time before the notice is issued by the IRS. Section 6751(b) clearly provides that there be supervisory approval before the assessment of a penalty and contains no express requirement that the "written approval be obtained at any particular time prior to assessment." *Chai*, 851 F.3d at 218. Courts have noted that there is ambiguity in the statutory phrase "initial determination of such assessment [of the penalty]" that a supervisor must approve. *See*, *e.g.*, *Chai*, 851 F.3d at 218-19 (noting that since an "assessment" is the formal recording of a taxpayer's tax liability, one can determine a deficiency and whether to make an assessment, but one cannot "determine" an assessment); *Roth v. Commissioner*, 922 F.3d 1126, 1132 (10th Cir. 2019) ("[W]e agree with the Second Circuit that the plain language of § 6751(b) is ambiguous . . . ."). But courts have not agreed that an ambiguity about what constitutes an initial determination provides an opportunity to craft a deadline for approval of an initial determination from the statute's legislative history. *Compare Chai*, 851 F.3d at 219 with *Laidlaw's Harley Davidson Sales*, 29 F.4th at 1072. Instead, courts have agreed that a supervisor can approve a penalty only at a time that the supervisor has discretion to give or withhold approval. *See*, *e.g.*, *Chai*, 851 F.3d at 220; *Laidlaw's Harley Davidson Sales*, 29 F.4th at 1074; *Cf.*, *Kroner*, 48 F. 4th at 1276, n.1 (holding that approval is required before assessment but declining to address whether the supervisor must have discretion at the time of approval because it was undisputed in that case that the supervisor did).

Prior to the Second Circuit's ruling in *Chai*, the Tax Court interpreted section 6751(b) merely to require supervisory approval prior to assessment, which is the only definitive deadline provided in the statute and which, for penalties determined in a notice of deficiency, occurs after the opportunity for Tax Court review of a penalty. *See Graev v. Commissioner*, 147 T.C. 460 (2016), *superseded by* 149 T.C. 485 (2017). The Treasury Department and the IRS acknowledge that approval of a penalty after the IRS issues a notice subject to Tax Court review is counter to the statutory scheme for Tax Court review. Once a taxpayer petitions to the Tax Court a notice that includes a penalty, section 6215(a) of the Code directs that the Tax Court decides whether the penalty will be assessed. In that case, a supervisor no longer has discretion that will control. Further, as a practical matter, the IRS has no general process for supervisory approval of a penalty after issuing a pre-assessment notice to a taxpayer subject to review by the Tax Court that includes the penalty, such as a notice of deficiency. If a taxpayer does not timely petition the Tax Court, the IRS will simply assess any penalty determined in the notice. Therefore, the Treasury Department and the IRS conclude that a penalty appearing in a pre-assessment notice issued to a taxpayer subject to Tax Court review should be subject to supervisory approval before the notice is issued. This interpretation is consistent with the Second Circuit's holding in *Chai* and provides for penalty review while the IRS still has discretion regarding penalties. *See also Laidlaw's Harley Davidson Sales*, 29 F.4th at 1074 ("Accordingly, we hold that §6751(b)(1) requires written supervisory approval before the assessment of the penalty or, if earlier, before the relevant supervisor loses discretion whether to approve the penalty assessment.").

The proposed regulations do not require written approval of an initial determination of a penalty that is subsequently included in a pre-assessment notice subject to review by the Tax Court by any deadline earlier than the issuance of the notice to the taxpayer. As already mentioned, no language in the statute imposes any such earlier deadline, and the statutory scheme for assessing such penalties does not deprive a supervisor of discretion to approve an initial determination before the issuance of a pre-assessment notice subject to review by the Tax Court.

The Treasury Department and the IRS have concluded that an earlier deadline for approval of an initial determination of a penalty would not best serve the legislative purpose of section 6751(b). The lack of any deadline in the statute other than the deadline that approval must come before assessment indicates that Congress did not intend an earlier deadline. No earlier deadline is mentioned in the legislative history. To create earlier deadlines, the caselaw relies on a single statement in the limited legislative history that "[t]he Committee believes that penalties should only be imposed where appropriate and not as a bargaining chip." *See Belair Woods*, 154 T.C. at 7 (citing S. Rep. No. 105-174, at 65 (1998)). But the earlier deadlines created by the Tax Court do not ensure that penalties are only imposed where appropriate.

First, the supervisory approval deadlines the Tax Court has created are unclear in application. One formulation sets the deadline for approval to occur before the IRS "formally communicates to the taxpayer, the Examination Division's unequivocal decision to assert a penalty." *Belair Woods*, 154 T.C. at 13. Prior to assessment, it is unclear what constitutes this unequivocal decision other than a notice that gives the taxpayer the right to petition the Tax Court. For any notice before the right to petition the Tax Court, the taxpayer is free to present more evi-

dence or arguments to the Examination Division as to why a penalty should not apply, which could lead the IRS supervisor charged with approving an initial determination to conclude that a penalty should not be asserted.

Second, if the "Examination Division's unequivocal decision to assert a penalty," *id.*, means that the Examination Division was finished with its work and could or would not change its mind upon receiving further information, there is no harm in delaying approval in writing until sometime after that moment. There would be no possibility of a change to the penalty during the period after the Examination Division has completed its work. The Tax Court's imposition of an approval deadline immediately after the Examination Division has completed its work rather than sometime later would do nothing to prevent an attempt to bargain because the Examination Division could not consider a bargain if it has already completed its work

Third, none of the deadlines the Tax Court has imposed actually ensure that penalties could never be used as a bargaining chip because each formulation of what constitutes an "initial determination" has been tied to a written communication. Although it would violate longstanding IRS Policy Statements and would contradict the Internal Revenue Manual's (IRM) instructions, in theory a penalty could be used as a bargaining chip if conveyed orally, and the deadlines the Tax Court has created do not come into play without written communication. As a result, the Tax Court opinions imposing deadlines are not effective to prevent bargaining.

Fourth, the courts' struggles to determine a consistent deadline has undermined the legislative purpose that penalties be imposed "where appropriate." S. Rep. No. 105-714 at 65. The Tax Court has found no evidence that an IRS employee actually attempted to use a penalty as a bargaining chip in any of the cases in which it invalidated a penalty for section 6751(b) noncompliance. Instead, the Tax Court has consistently removed penalties when IRS employees simply obtained written supervisory approval after deadlines the Tax Court created and applied retroactively without any indication that the penalty was improper. *See*, *e.g.*, *Kroner*, T.C. Memo. 2020-73, *rev'd* 48 F. 4th 1272 (11th Cir. 2022); *Carter*, T.C. Memo. 2020-21, *rev'd* 2022 WL 4232170 (11th Cir. Sept. 14, 2022). In one case, the Tax Court explicitly noted that imposition of the penalty would be proper but for the IRS's failure to obtain written supervisory approval by the deadline created by the Tax Court. *See Becker v. Commissioner*, T.C. Memo. 2018-69 (stating that "Mr. Becker's fraud is evident" and that, but for section 6751(b) compliance, the court's analysis "would normally lead to a holding that sustains the Commissioner's civil fraud penalty determinations. . .").

In contrast, by allowing a supervisor to approve the initial determination of a penalty up until the time the IRS issues a pre-assessment notice subject to review by the Tax Court, the proposed rule ensures that penalties are "only [ ] imposed where appropriate." S. Rep. No. 105-714 at 65. With this deadline, the supervisor has the opportunity to consider a taxpayer's defense against a penalty, if applicable, and decide whether to approve the penalty. If the facts of the case suggest that a penalty should have been considered but none is imposed, the supervisor's later review would allow the supervisor to question why none was recommended. Furthermore, this bright-line rule relieves supervisors from having to predict whether approval at a certain point will be too early or too late, thereby risking that an otherwise appropriate penalty may not be upheld by a court. Pre-assessment notices that provide a basis for Tax Court jurisdiction are well known to supervisors, and the proposed rule will be clear in application to both IRS employees and taxpayers.

Finally, the rule in proposed §301.6751(b)-1(c) is consistent with longstanding IRS Policy Statements. Penalty Policy Statement 20-1 has, since 2004, included the following direction to IRS employees:

"The [IRS] will demonstrate the fairness of the tax system to all taxpayers by:

a. Providing every taxpayer against whom the [IRS] proposes to assess penalties with a reasonable opportunity to provide evidence that the penalty should not apply;
b. Giving full and fair consideration to evidence in favor of not imposing the penalty, even after the [IRS]'s initial consideration supports imposition of a penalty; and
c. Determining penalties when a full and fair consideration of the facts and the law support doing so.

Note: This means that penalties are not a "bargaining point" in resolving the taxpayer's other tax adjustments. Rather, the imposition of penalties in appropriate cases serves as an incentive for taxpayers to avoid careless or overly aggressive tax reporting positions."

IRM 1.2.1.12.1 (9). As reflected in this Policy Statement and the language of section 6751(b) itself, it may not be until the IRS has had the opportunity to develop the facts in support of or against the penalty that a supervisor is in the best position to approve an initial determination to assert a penalty as appropriate. Therefore, the Treasury Department and the IRS have concluded that the deadline for providing approval for penalties appearing in a pre-assessment notice that entitles a taxpayer to petition the Tax Court should be no earlier than issuance of such notice.

B. *Penalties raised in the Tax Court after a petition*

Proposed §301.6751(b)-1(d) provides that, for penalties raised in the Tax Court after a petition, supervisory approval may be obtained at any time prior to the Commissioner requesting that the court determine the penalty. The proposed rule gives full effect to the language in both sections 6214 and 6751(b)(1) because once a penalty is raised, the Tax Court decision will control whether it is assessed. Section 6214(a) permits the Commissioner to raise penalties in an answer or amended answer that were not included in a notice that provides the basis for Tax Court jurisdiction upon timely petition. The proposed rule allows the exercise of this statutory grant of independent judgment by the IRS Office of Chief Counsel (Counsel) attorney, while maintaining the intent of Congress that penalties be imposed only where appropriate, and with meaningful supervisory review. Any concern about a Counsel attorney using penalties raised in an answer or amended answer as a bargain-

ing chip is mitigated by the requirement in proposed §301.6751(b)-1(d) for supervisory approval within Counsel before the answer or amended answer is filed. Moreover, by raising a penalty on answer, amended answer, or amendment to the answer to , the Commissioner will likely bear the burden of proof at trial regarding the application of the penalty, thus reducing further the possibility that Counsel will attempt to use a penalty as a bargaining chip in a docketed case. *See* Tax Court Rule 142. Furthermore, Tax Court Rule 33(b) provides that signature of counsel on a pleading constitutes a certificate by the signer that the pleading is not interposed for any improper purpose, thus diminishing the potential for abuse. No case has found that a penalty raised on answer, amended answer, or amendment to the answer was untimely under section 6751(b).

C. *Penalties not subject to pre-assessment review in the Tax Court*

Proposed §301.6751(b)-1(b) provides that supervisory approval for penalties that are not subject to pre-assessment review in the Tax Court may be obtained at any time prior to assessment. This includes penalties that could have been included in a pre-assessment notice that provides the basis for Tax Court jurisdiction upon timely petition, but which were not included in such a notice because the taxpayer agreed to their immediate assessment.

Unlike penalties subject to deficiency procedures before assessment, there is no Tax Court or potential Tax Court decision that would make approval of an immediately assessable penalty by an IRS supervisor meaningless. Instead, consistent with the language of section 6751(b), supervisory approval can be made at any time before assessment without causing any tension in the statutory scheme for assessing penalties.

The proposed rule is also consistent with congressional intent that penalties not be used as a bargaining chip. Most penalties not subject to pre-assessment review in the Tax Court cannot be used as a bargaining chip because they are not in addition to a tax liability. Rather, the penalty is the sole liability at issue.

2. *Exceptions to the rule requiring supervisory approval of penalties*

Proposed §301.6751(b)-1(a)(2) provides a list of penalties excepted from the requirements of section 6751(b). Proposed §301.6751(b)-1(a)(2) excepts those penalties listed in section 6751(b)(2)(A), along with penalties imposed under section 6673 of the Code. Penalties under section 6673 are imposed at the discretion of the court and are designed to deter bad behavior in litigation and conserve judicial resources. Section 6673 penalties are not determined by the Commissioner, and the applicable Federal court may impose them regardless of whether the Commissioner moves for their imposition. The proposed rule excepts penalties under section 6673 from the requirements of section 6751(b)(1) because section 6751(b)(1) was not intended as a mechanism to restrain Federal courts. This rule is consistent with the Tax Court's holding in *Williams v. Commissioner*, 151 T.C. 1 (2018).

3. *Definitions*

A. *Immediate supervisor and designated higher level officials*

Section 6751(b)(1) requires approval by "the immediate supervisor" of the individual who makes the initial penalty determination, or such higher level official as the Secretary may designate. The statute does not define the term immediate supervisor. The 1998 Senate Finance Committee Report only provides that section 6751(b) requires the approval of "IRS management." In *Sand Investment*, the Tax Court held that for purposes of section 6751(b) the "immediate supervisor" is the individual who directly supervises the examining agent's work in an examination. In the Tax Court's view, the legislative history of section 6751(b) supports the conclusion that the person with the greatest familiarity with the facts and legal issues presented by the case is the immediate supervisor. 157 T.C. at 142.

Proposed §301.6751(b)-1(a)(3)(iii) defines the term "immediate supervisor" as any individual with responsibility to approve another individual's proposal of penalties without the proposal being subject to an intermediary's approval. The proposed rule does not limit the term immediate supervisor to a single individual. To limit the term to a single individual within the IRS would restrict section 6751(b)(1) in a way that does not reflect how the IRS operates and would invite unwarranted disputes about which specific individual was most appropriate in situations where multiple individuals could fairly be considered an "immediate supervisor." Instead, the term is better understood to refer to any person who, as part of their job, directly approves a penalty proposed by another. This includes acting supervisors operating under a proper delegation of authority. This approach is consistent with the intent of Congress to prevent IRS examining agents from operating alone. The proposed rule further ensures that the person giving the approval has appropriate supervisory responsibility with respect to the penalty.

Proposed §301.6751(b)-1(a)(4) designates as a higher level official authorized to approve an initial penalty determination for purposes of section 6751(b)(1) any person who has been directed via the IRM or other assigned job duties to approve another individual's proposal of penalties before they are included in a notice prerequisite to Tax Court jurisdiction, an answer to a Tax Court petition, or are assessed without need for such inclusion. Proposed §301.6751(b)-1(a)(3)(iv) defines a higher level official as any person designated as such under proposed §301.6751(b)-1(a)(4).

With respect to "higher level officials" who may provide penalty approval in lieu of the immediate supervisor, the statute does not specify whether the official needs to be at a "higher level" than the individual making the initial penalty determination, or at a higher level than that individual's supervisor. Read in light of the statute's legislative purpose and the structure and operations of the IRS, it is appropriate to understand that term as referring to an official at a higher level than the individual making the initial penalty determination. To do otherwise would be to exclude a large group of individuals the IRS has assigned to review proposed penalties. This approach is consistent with the legislative history and allows IRS employees to operate within the scope of their assigned duties.

To be able to identify which supervisor should approve an initial penalty determination, it must be clear which individual made the "initial determination of [a penalty] assessment." Proposed §301.6751(b)-1(a)(3)(ii) provides that the individual who first proposes a penalty is the individual who section 6751(b)(1) references as the individual making the initial determination of a penalty assessment. Proposed §301.6751(b)-1(a)(3)(ii) also provides that a proposal includes those made either to a taxpayer or to the individual's supervisor or a designated higher level official. This approach will allow for easy identification of the appropriate supervisor or higher level official. Proposed §301.6751(b)-1(a)(3)(ii) also makes clear that the assessment of a penalty must be attributable to an individual's proposal for that individual to be considered as the individual who made the "initial determination of such assessment." If a proposal of a penalty is not tied to an ultimate assessment, then it should not be treated as the "initial determination of such assessment." This approach allows the IRS the flexibility to pursue penalties when new information is received that alters earlier thinking on whether a penalty is appropriate. It also allows for more than one set of an individual employee and supervisor to exercise independent judgment about whether a penalty should be assessed. This situation is illustrated by an example in proposed §301.6751(b)-1(e)(4).

B. *Personally approved (in writing)*

Section 6751(b)(1) requires that the immediate supervisor "personally approve (in writing)" the initial determination to assert a penalty. Proposed §301.6751(b)-1(a)(3)(v) provides that "personally approved (in writing)" means any writing, including in electronic form, that is made by the writer to signify the writer's assent and that reflects that it was intended as approval. The proposed rule reflects a straightforward, plain language interpretation of the term, and is consistent with the legislative history's requirement that "specific approval" be given. The plain language of the statute requires only personal approval in writing, not any particular form of signature or even any signature at all. The plain language of the statute also contains no requirement that the writing contain the supervisor's substantive analysis, nor does the statute require the supervisor to follow any specific procedure in determining whether to approve the penalty. Thus, for example, a supervisor's signature on a cover memorandum or a letter transmitting a report containing penalties is sufficient approval of the penalties contained in the report. The proposed rule is consistent with existing caselaw on this issue. *See PBBM-Rose Hill*, 900 F.3d at 213; *Deyo v. Commissioner*, 296 Fed. Appx. 157 (2d Cir. 2008); *Thompson v. Commissioner*, T.C. Memo. 2022-80; *Raifman v. Commissioner*, T.C. Memo. 2018-101.

C. *Automatically calculated through electronic means*

Section 6751(b)(2) exempts from the penalty approval requirements penalties under sections 6651, 6654, 6655, 6662(b)(9), and 6662(b)(10) and "any other penalty automatically calculated through electronic means." The term is not defined in the statute and the legislative history only provides that approval is required of "all non-computer generated penalties."

Proposed §301.6751(b)-1(a)(3)(vi) provides that a penalty is "automatically calculated through electronic means" if it is proposed by an IRS computer program without human involvement. Proposed §301.6751(b)-1(a)(3)(vi) provides that a penalty is no longer considered "automatically calculated through electronic means" if a taxpayer responds to a computer-generated notice proposing a penalty and challenges the penalty or the amount of tax to which the penalty is attributable, and an IRS employee works the case.

Current IRS computer software, including but not limited to the Automated Correspondence Exam (ACE) program using Report Generation Software (RGS) and the Automated Underreporter (AUR) program, is capable of automatically proposing certain penalties to taxpayers without the involvement of an IRS examiner. Penalties that can be proposed in this way are then assessed without review by an IRS examiner. Requiring supervisory approval for these penalties would disrupt the automated process of determining a penalty and would not square with the statutory text requiring approval by the immediate supervisor of the "individual" making an initial penalty determination.

When an IRS computer program sends a taxpayer a notice proposing a penalty and the taxpayer responds to that notice, an IRS examiner often considers the taxpayer's response. If the taxpayer's response questions the validity of the penalty or the adjustments to which the penalty relates, and an examiner considers the response, any subsequent assessment of the penalty would not be based solely on the automatic calculation of the penalty by the computer program. Instead, it would be at least partially based on a choice made by an IRS employee as to whether the penalty is appropriate. Therefore, the exception for penalties automatically calculated through electronic means does not apply, and supervisory approval is required in that situation. This rule is consistent with the Tax Court's holding in *Walquist*, 152 T.C. at 73.

Proposed Applicability Dates

The proposed rules are proposed to apply to penalties assessed on or after the date of publication of the Treasury decision adopting the proposed rules as final regulations in the **Federal Register**.

Special Analyses

I. Regulatory Planning and Review

It has been determined that this notice of proposed rulemaking is not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations.

II. Regulatory Flexibility Act

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that this regulation will not have a significant economic impact on a substantial number of small entities. This certification is based on this regulation imposing no obligations on small entities and the effectiveness of the regulation in having supervisors ensure that penalties for

violations of other provisions of tax law are appropriate and not used as a bargaining chip. Because only appropriate penalties will apply with the proper application of this regulation, the proposed regulations do not impose a significant economic impact on a substantial number of small entities.

Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for the Office of Advocacy of the Small Business Administration for comment on its impact on small business.

III. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a State, local, or Tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. This rule does not include any Federal mandate that may result in expenditures by State, local, or Tribal governments, or by the private sector in excess of that threshold.

IV. Executive Order 13132: Federalism

Executive Order 13132 (Federalism) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on State and local governments, and is not required by statute, or preempts State law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. These proposed regulations do not have federalism implications and do not impose substantial direct compliance costs on state and local governments or preempt State law within the meaning of the Executive order.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the **ADDRESSES** heading. The Treasury Department and the IRS request comments on all aspects of the proposed rules. All comments will be available at *www.regulations.gov* or upon request.

A public hearing will be scheduled if requested in writing by any person who timely submits electronic or written comments. Requests for a public hearing also are encouraged to be made electronically. If a public hearing is scheduled, notice of the date and time for the public hearing will be published in the **Federal Register**. Announcement 2020-4, 2020-17 I.R.B 1, provides that, until further notice, public hearings conducted by the IRS will be held telephonically. Any telephonic hearing will be made accessible to people with disabilities.

Drafting Information

The principal author of these regulations is David Bergman of the Office of the Associate Chief Counsel (Procedure and Administration). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.

Proposed Amendment to the Regulations

Accordingly, the Treasury Department and the IRS propose to amend 26 CFR part 301 as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read in part as follows:

Authority: 26 U.S.C. 7805.

Par. 2. Section 301.6751(b)-1 is added to read as follows:

§301.6751(b)-1 Supervisory and higher level official approval for penalties.

(a) *Approval requirement*--(1) *In general*. Except as provided in paragraph (a)(2) of this section, section 6751(b) of the Internal Revenue Code (Code) generally bars the assessment of a penalty unless the initial determination of the assessment of the penalty is personally approved (in writing) by the immediate supervisor of the individual making the initial determination or such higher level official as the Secretary of the Treasury or her delegate (Secretary) may designate. Paragraph (a)(2) of this section lists penalties not subject to section 6751(b)(1) and this paragraph (a)(1). Paragraph (a)(3) of this section provides definitions of terms used in section 6751(b) and this section. Paragraph (a)(4) of this section designates the higher level officials described in this paragraph (a)(1). Paragraphs (b), (c), and (d) of this section apply section 6751(b)(1) and this paragraph (a)(1) to penalties not subject to pre-assessment review in the Tax Court, penalties that are subject to pre-assessment review in the Tax Court, and penalties raised in the Tax Court after a petition, respectively. Paragraph (e) of this section provides examples illustrating the application of section 6751(b) and this section. Paragraph (f) of this section provides dates of applicability of this section.

(2) *Exceptions*. Under section 6751(b)(2), section 6751(b)(1) and this section do not apply to:

(i) Any penalty under section 6651, 6654, 6655, 6673, 6662(b)(9), or 6662(b)(10) of the Code; or

(ii) Any other penalty automatically calculated through electronic means.

(3) *Definitions*. For purposes of section 6751(b) and this section, the following definitions apply--

(i) *Penalty*. The term *penalty* means any penalty, addition to tax, or additional amount under the Code.

(ii) *Individual who first proposed the penalty*. Except as otherwise provided in this paragraph (a)(3)(ii), the *individual who first proposed the penalty* is the individual who section 6751(b)(1) and paragraph (a)(1) of this section reference as the individual making the initial determination of a penalty assessment. A proposal of a penalty can be made to either a taxpayer (or the taxpayer's representative) or to the individual's supervisor or designated higher level official. A proposal of a penalty, as defined in paragraph (a)(3)(i) of this section, to a taxpayer does

not include mere requests for information relating to a possible penalty or inquiries of whether a taxpayer wants to participate in a general settlement initiative for which the taxpayer may be eligible, but does include offering the taxpayer an opportunity to agree to a particular penalty in a particular amount other than a penalty under a settlement initiative offered to a class of taxpayers. An individual who first proposed the penalty is not the individual whom section 6751(b)(1) and paragraph (a)(1) of this section reference as the individual making the initial determination of a penalty assessment if the assessment of the penalty is attributable to an independent proposal made by a different individual.

(iii) *Immediate supervisor*. The term *immediate supervisor* means any individual with responsibility to approve another individual's proposal of penalties, as defined in paragraph (a)(3)(i) of this section, without the proposal being subject to an intermediary's approval.

(iv) *Higher level official*. The term *higher level official* means any person designated under paragraph (a)(4) of this section as a higher level official authorized to approve a penalty for purposes of section 6751(b)(1).

(v) *Personally approved (in writing)*. The term *personally approved (in writing)* means any writing, including in electronic form, made by the writer to signify the writer's assent. No signature or particular words are required so long as the circumstances of the writing reflect that it was intended as approval.

(vi) *Automatically calculated through electronic means*. A penalty, as defined in paragraph (a)(3)(i) of this section, is *automatically calculated through electronic means* if an IRS computer program automatically generates a notice to the taxpayer that proposes the penalty. If a taxpayer responds in writing or otherwise to the automatically-generated notice and challenges the proposed penalty, or the amount of tax to which the proposed penalty is attributable, and an IRS employee considers the response prior to assessment (or the issuance of a notice of deficiency that includes the penalty), then the penalty is no longer considered "automatically calculated through electronic means."

(4) *Higher level official*. Any person who has been directed by the Internal Revenue Manual or other assigned job duties to approve another individual's proposal of penalties before they are included in a pre-assessment notice prerequisite to United States Tax Court (Tax Court) jurisdiction, an answer, amended answer, or amendment to the answer to a Tax Court petition, or are assessed without need for such inclusion, is designated as a higher level official authorized to approve the penalty for purposes of section 6751(b)(1).

(b) *Penalties not subject to pre-assessment review in the Tax Court*. The requirements of section 6751(b)(1) and paragraph (a)(1) of this section are satisfied for a penalty that is not subject to pre-assessment review in the Tax Court if the immediate supervisor of the individual who first proposed the penalty personally approves the penalty in writing before the penalty is assessed. Alternatively, a person designated as a higher level official as described in paragraph (a)(4) of this section may provide the approval otherwise required by the immediate supervisor.

(c) *Penalties subject to pre-assessment review in the Tax Court*. The requirements of section 6751(b)(1) and paragraph (a)(1) of this section are satisfied for a penalty that is included in a pre-assessment notice that provides a basis for Tax Court jurisdiction upon timely petition if the immediate supervisor of the individual who first proposed the penalty personally approves the penalty in writing on or before the date the notice is mailed. Alternatively, a person designated as a higher level official as described in paragraph (a)(4) of this section may provide the approval otherwise required by the immediate supervisor. Examples of a pre-assessment notice described in this paragraph (c) include a statutory notice of deficiency under section 6212 of the Code, a notice of final partnership administrative adjustment under former section 6223 of the Code, and a notice of final partnership adjustment under section 6231 of the Code.

(d) *Penalties raised in the Tax Court after a petition*. The requirements of section 6751(b)(1) and paragraph (a)(1) of this section are satisfied for a penalty that the Commissioner raises in the Tax Court after a petition (*see* section 6214(a) of the Code) if the immediate supervisor of the individual who first proposed the penalty personally approves the penalty in writing no later than the date on which the Commissioner requests that the court determine the penalty. Alternatively, a person designated as a higher level official as described in paragraph (a)(4) of this section may provide the approval otherwise required by the immediate supervisor.

(e) *Examples*. The following examples illustrate the rules of this section.

(1) *Example 1*. In the course of an audit regarding a penalty not subject to pre-assessment review in the Tax Court, Revenue Agent A concludes that Taxpayer T should be subject to the penalty under section 6707A of the Code for failure to disclose a reportable transaction. A sends T a letter giving T the options to agree to the penalty; submit additional information to A about why the penalty should not apply; or request within 30 days that the matter be sent to the Independent Office of Appeals (Appeals) for consideration. After T requests that Appeals consider the case, A prepares the file for transmission, and B (who is A's immediate supervisor, as defined in paragraph (a)(3)(iii) of this section) signs a cover memorandum informing Appeals of the Office of Examination's proposed penalty and asking Appeals to consider it. The Appeals Officer upholds the penalty, and it is assessed. The requirements of section 6751(b)(1) are satisfied because B's signature on the cover memorandum is B's personal written assent to the penalty proposed by A and was given before the penalty was assessed.

(2) *Example 2*. In the course of an audit, Revenue Agent A concludes that Taxpayer T should be subject to an accuracy-related penalty for substantial understatement of income tax under section 6662(b)(2). A sends T a Letter 915, Examination Report Transmittal, along with an examination report that includes the penalty. The Letter 915 gives T the options to agree to the examination report; provide additional information to be considered; discuss the report with A or B (who is A's immediate supervisor, as defined in paragraph (a)(3)(iii) of this section); or request a conference with an Appeals Officer. T agrees to assessment of the penalty and signs the examination report to consent to the immediate assessment and collection of the amounts shown on the report. B provides written supervisory approval of the penalty after T signs the examination report, but before the penalty is assessed. Paragraph (b) of this section applies because T's agreement to assessment of the penalty excepts it from pre-assessment review in the Tax Court. Because B provided written supervisory approval before assessment of the penalty, the requirements of section 6751(b) are satisfied.

(3) *Example 3*. In the course of an audit of Taxpayer T by a team of revenue agents, Revenue Agent A concludes that T should be subject to an accuracy-related penalty for negligence under sections 6662(b)(1) and 6662(c). Supervisor B is the issue manager and is assigned the duty to approve the Notice of Proposed Adjustment for any penalty A would propose. A reports to B, but B is not respon-

sible for the overall management of the audit of T. C is the case manager of the team auditing T and is responsible for the overall management of the audit of T. C may assign tasks to A and other team members, and has responsibility for approving any examination report presented to T.

(i) Only B approves the penalty in writing before the mailing to T of a notice of deficiency that includes the penalty. Under paragraph (a)(3)(iii) of this section, B qualifies as the immediate supervisor of A with respect to A's penalty proposal, and the requirements of section 6751(b)(1) are met.

(ii) Only C approves the penalty in writing before the mailing to T of a notice of deficiency that includes the penalty. Because C has responsibility to approve A's proposal of the penalty as part of approving the examination report, C qualifies as a higher level official designated under paragraph (a)(4) of this section to approve the penalty proposed by A, and the requirements of section 6751(b)(1) are met.

(4) *Example 4*. In the course of an audit, Revenue Agent A concludes that Taxpayer T should be subject to a penalty for negligence under section 6662(c). A recommends the penalty to her immediate supervisor B, who thinks more factual development is needed to support the penalty but must close the audit immediately due to the limitations period on assessment expiring soon. The IRS issues a statutory notice of deficiency without the penalty and T petitions the Tax Court. In reviewing the case file and conducting discovery, IRS Chief Counsel Attorney C concludes that the facts support imposing a negligence penalty under section 6662(c). Attorney C proposes to her immediate supervisor, D, that the penalty should apply and should be raised in an Answer pursuant to section 6214(a). D agrees and signs the Answer that includes the penalty before it is filed. The section 6662(c) penalty at issue is subject to pre-assessment review in the Tax Court and was raised in the Tax Court after a petition under paragraph (d) of this section. Therefore, written supervisory approval under paragraph (d) of this section was required prior to filing the written pleading that includes the penalty. Attorney C is the individual who first proposed the penalty for purposes of section 6751(b)(1) and paragraphs (d) and (a)(3)(ii) of this section, and she secured timely written supervisory approval from D, the immediate supervisor, as defined in paragraph (a)(3)(iii) of this section, so the requirements of section 6751(b)(1) are met. Revenue Agent A did not make the initial determination of the penalty assessment because any assessment would not be attributable to A's proposal but would be based on the independent proposal of Attorney C raised pursuant to section 6214(a).

(5) *Example 5*. The IRS's Automated Underreporter (AUR) computer program detects a discrepancy between the information received from a third party and the information contained on Taxpayer T's return. AUR automatically generates a CP2000, Notice of Underreported Income, that includes an adjustment based on the unreported income and a proposed penalty under section 6662(d) that is mailed to T. The CP2000 gives T 30 days to respond to contest the proposed adjustments and the penalty. T submits a response to the CP2000, asking only for more time to respond. More time is granted but no further response is received from T, and a statutory notice of deficiency that includes the adjustments and the penalty is automatically generated and issued to T. The section 6662(d) penalty at issue is automatically calculated through electronic means under paragraphs (a)(2)(ii) and (a)(3)(vi) of this section. The penalty was proposed by the AUR computer program, which generated a notice to T that proposed the penalty. Although T submitted a response to the CP2000, the response did not challenge the proposed penalty, or the amount of tax to which the proposed penalty is attributable. Therefore, the penalty was automatically calculated through electronic means and written supervisory approval was not required.

(f) *Applicability date*. The rules of this section apply to penalties assessed on or after [the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**].

Douglas W. O'Donnell,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register April 10, 2023, 8:45a.m., and published in the issue of the Federal Register for April 11, 2023, 88 FR 21564)

FEDERAL TAX TREATMENT OF CERTAIN RED HILL FUEL SPILL PAYMENTS

Announcement 2023-7

This announcement informs Federal civilian employees and other civilians who are not employed by the Federal government who received certain payments in 2022 and 2023 from the Department of Defense (DOD) in reimbursement for lodging, meals, and personal property damage expenses after the release of petroleum from the Red Hill Bulk Fuel Storage Facility on O‘ahu, Hawaii (Red Hill Fuel Spill) that such payments are excludable from gross income for Federal income tax purposes under § 139 of the Internal Revenue Code.

On November 28, 2021, the United States Navy detected the Red Hill Fuel Spill and subsequent contamination of the Joint Base Pearl Harbor-Hickam (JBPHH) Water System servicing Red Hill and surrounding areas. On December 3, 2021, the Commander, Navy Region Hawaii issued an evacuation authorization (CNRH Evacuation Authorization) for DOD civilian employees and their dependents, civilians nonaffiliated with DOD, and dependents of active-duty personnel not accompanying such personnel living in communities serviced by the JBPHH Water System. The duration of the order was extended twice, on December 14, 2021, and December 23, 2021. On December 9, 2021, the Commanding General of U.S. Army Pacific issued an evacuation authorization (CG USARPAC Evacuation Authorization) for residents of the Aliamanu Military Reservation, Red Hill, and surrounding areas, effective December 2, 2021, in light of unusual and emergency circumstances arising from the Red Hill Fuel Spill. The CG USARPAC Evacuation Authorization applied to all DOD personnel and civilian employees and their dependents living in the relevant areas. Additional communities were added to the CG USARPAC Evacuation Authorization pursuant to addenda issued on December 10, 2021, and December 11, 2021. The CG USARPAC Evacuation Authorization authorized but did not direct evacuation, allowing individuals to choose to remain in their residences without use of potable water utilities.

On February 18, 2022, the Commander, Navy Installations Command sought authority from the Secretary of the Navy (SECNAV) to make payments to the civilians who were covered by the CNRH Evacuation Authorization and the CG USARPAC Evacuation Authorization and addenda thereto (collectively, Affected Civilians) pursuant to SECNAV's "Emergency and Extraordinary Expense" authority under 10 U.S.C. § 127 (EEE Payments). SECNAV approved the making of EEE Payments to Affected Civilians in a memorandum dated February 25, 2022.

Starting in 2022, DOD made three types of EEE Payments to Affected Civilians. First, DOD made EEE Payments to reimburse lodging and meal expenses of Affected Civilians who did not have potable water in their homes and who opted to relocate pursuant to the CNRH Evacuation Authorization and CG USARPAC Evacuation Authorization. Second, DOD

made EEE Payments to reimburse meal expenses of Affected Civilians who opted to remain in their housing without the use of potable water utilities. Third, DOD made EEE Payments to reimburse personal property damage expenses of some Affected Civilians.

To respond to questions raised concerning the Federal income tax treatment of EEE Payments made by DOD to Affected Civilians, this announcement explains that Affected Civilians receiving EEE Payments may exclude such payments from gross income, to the extent the cost reimbursed by the EEE Payment was not also compensated for by insurance or otherwise, because they are qualified disaster relief payments within the meaning of § 139 of the Internal Revenue Code.

Specifically, the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) have determined that the Red Hill Fuel Spill is a qualified disaster for purposes of § 139(c)(4) that was determined by SECNAV (an applicable Federal authority) to warrant assistance from DOD (a Federal agency or instrumentality). Additionally, the Treasury Department and the IRS have determined that the EEE Payments are qualified disaster relief payments for purposes of § 139(b)(4), as they are amounts paid to or for the benefit of an Affected Civilian (an individual) by DOD (a Federal agency or instrumentality) in connection with the Red Hill Fuel Spill (a qualified disaster) in order to promote the general welfare (and are not compensation for services).

Accordingly, EEE Payments made by DOD to Affected Civilians in connection with the Red Hill Fuel Spill, including reimbursement of lodging and meal expenses for those Affected Civilians who did not have potable water in their homes and who opted to relocate, reimbursement for meal expenses for those Affected Civilians who opted to remain in their homes, and reimbursement for personal property damage expenses of some Affected Civilians, are qualified disaster relief payments within the meaning of § 139(b)(4) that are excludable from the gross income of Affected Civilians to the extent not compensated for by insurance or otherwise.

INSTRUCTIONS FOR AFFECTED CIVILIANS WHO HAVE NOT YET FILED TAXABLE YEAR 2022 INDIVIDUAL FEDERAL INCOME TAX RETURNS

Affected Civilians who have not filed their taxable year 2022 individual Federal income tax returns should not include any EEE Payment amounts (reflected on Form 1099-MISC, *Miscellaneous Income*) in gross income on their taxable year 2022 returns, except to the extent the cost reimbursed by the EEE Payment was also compensated for by insurance or otherwise.

INSTRUCTIONS FOR AFFECTED CIVILIANS WHO ALREADY HAVE FILED TAXABLE YEAR 2022 INDIVIDUAL FEDERAL INCOME TAX RETURNS

Affected Civilians may amend their taxable year 2022 Federal income tax returns by filing Form 1040-X, *Amended U.S. Individual Income Tax Return*, to exclude EEE Payment amounts (reflected on Form 1099-MISC, *Miscellaneous Income*) that were previously included on original taxable year 2022 individual Federal income tax returns, to the extent the cost reimbursed by the EEE Payment was not also compensated for by insurance or otherwise. The IRS accepts paper and electronically filed Forms 1040-X.

- If filing Form 1040-X electronically, include "Red Hill Relief" at the beginning of Part IV, Explanation of Changes.
- If filing Form 1040-X on paper:
  - Include "Red Hill Relief" at the top of Form 1040-X. Also, include "Red Hill Relief" at the beginning of Part III, Explanation of Changes, and
  - Mail the Form 1040-X to:
Department of the Treasury
Internal Revenue Service
Austin, TX 73301-0052

The principal author of this announcement is Jonathan A. Dunlap of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this announcement contact Mr. Dunlap at 202-317-4718 (not a toll-free number).

Listed Transactions and Transactions of Interest

Announcement 2023-11

The identification of "listed transactions"—transactions that the Internal Revenue Service (IRS) has determined to be abusive tax avoidance transactions within the meaning of § 1.6011-4(b)(2) of the Income Tax Regulations—and "transactions of interest"—transactions that the IRS has determined have the potential for tax avoidance or evasion within the meaning of § 1.6011-4(b)(6)—is an important tool in combatting the use of abusive tax avoidance transactions. Since 2000, the IRS has identified more than 30 of these transactions by publishing a notice or other subregulatory guidance as provided in § 1.6011-4. One of these notices, Notice 2016-66, 2016-47 I.R.B. 745 (as modified by Notice 2017-8, 2017-3 I.R.B. 423), identified certain micro-captive transactions as transactions of interest.

Recent court decisions have held that the IRS's longstanding practice of issuing notices to identify listed transactions and transactions of interest does not comply with the Administrative Procedure Act (APA), 5 U.S.C. 551-559. On March 3, 2022, the U.S. Court of Appeals for the Sixth Circuit issued an order holding that Notice 2007-83, 2007-2 C.B. 960, which identified certain trust arrangements as listed transactions, violated the APA because the notice was issued without following the notice-and-comment procedures required by section 553 of the APA. *Mann Construction v. United States*, 27 F.4th 1138, 1147 (6th Cir. 2022). Subsequently, the U.S. District Court for the Eastern District of Tennessee, which is located in the Sixth Circuit, vacated Notice 2016-66 on the ground that the IRS failed to comply with the APA's notice-and-comment procedures, viewing the analysis in *Mann Construction* as controlling. *CIC Services, LLC v. IRS*, 2022 WL 985619 (E.D. Tenn. March 21, 2022), *as modified by* 2022 WL 2078036 (E.D. Tenn. June 2, 2022). The Court also held that the IRS acted arbitrarily and capriciously, based on the administrative record. On November 9, 2022, the U.S. Tax Court, in a reviewed

decision with two judges dissenting, relied on *Mann Construction* in holding that Notice 2017-10, 2017-4 I.R.B. 544, which identifies certain syndicated conservation easements as listed transactions, is invalid because it was issued without following notice-and-comment rulemaking procedures. *See Green Valley Investors, LLC v. Commissioner*, 159 T.C. No. 5 (2022). *See also Green Rock, LLC v. IRS*, 2023 WL 1478444 (N.D. AL., February 2, 2023).

The Department of the Treasury (Treasury Department) and the IRS disagree with the recent court decisions holding that listed transactions cannot be identified by notice or other subregulatory guidance. However, the Treasury Department and IRS will no longer take the position that transactions of interest can be identified without complying with APA notice-and-comment procedures. Accordingly, the IRS is obsoleting Notice 2016-66 (as modified by Notice 2017-8), and will not enforce the disclosure requirements or penalties that are dependent upon the procedural validity of Notice 2016-66. Consistent with this determination, the Treasury Department and the IRS are today issuing proposed regulations that identify certain micro-captive transactions as transactions of interest. The proposed regulations also identify certain other micro-captive transactions as listed transactions.

The Treasury Department and the IRS continue to take the position that listed transactions can be identified by notice or other subregulatory guidance because Congress, in enacting the American Jobs Creation Act of 2004, exempted the identification of such transactions from the APA's notice-and-comment procedure. As stated in Announcement 2022-28, 2022-52 I.R.B. 659 (Dec. 27, 2022), the Treasury Department and IRS will continue to defend existing listing notices in cases in which *Mann Construction* is not controlling precedent. Consistent with the aim expressed in Announcement 2022-28 of avoiding confusion and preventing disruption of the IRS's ongoing efforts to identify and examine abusive tax shelters, the Treasury Department and the IRS are following notice and comment procedures in identifying certain micro-captive transactions as listed transactions in order to eliminate any confusion and ensure that the IRS's efforts to combat abusive tax shelters throughout the nation continue undisrupted.

The Treasury Department and the IRS intend to finalize these regulations, after due consideration of public comments, in 2023 and intend to issue proposed regulations identifying additional listed transactions in the near future.

Taxpayers should take note that, if a transaction becomes a listed transaction or a transaction of interest after a taxpayer files a tax return (including an amended return) reflecting the taxpayer's participation in the transaction, § 1.6011-4(e)(2)(i) generally requires the participant to file a disclosure statement (Form 8886, *Reportable Transaction Disclosure Statement*) with the Office of Tax Shelter Analysis (OTSA) within 90 days of the transaction becoming a listed transaction or a transaction of interest if the assessment limitations period remains open for any taxable year in which the taxpayer participated in the transaction. Accordingly, any taxpayer who has participated in a transaction in any year for which the assessment limitation period remains open when the regulation identifying the transaction as a listed transaction or a transaction of interest is finalized will have an obligation to disclose the transaction, unless otherwise provided in the final regulations. Failure to disclose will subject the taxpayer to the penalty under section 6707A of the Internal Revenue Code (Code). Participants required to disclose listed transactions who fail to do so are also subject to an extended period of limitations under section 6501(c)(10) of the Code. That section provides that the time for assessment of any tax with respect to the transaction will not expire before the date that is one year after the earlier of the date the participant discloses the transaction or the date a material advisor discloses the participation pursuant to a written request under section 6112(b)(1)(A) of the Code.

Likewise, if a regulation identifying a transaction as a listed transaction or a transaction of interest is finalized after the occurrence of the events described in § 301.6111-3(b)(4)(i) of the Procedure and Administration Regulations, a material advisor will be treated as becoming a material advisor on the date the regulation is finalized pursuant to § 301.6111-3(b)(4)(iii) (if not deemed a material advisor earlier pursuant to a valid listing notice). A material advisor is required to file a Form 8918, *Material Advisor Disclosure Statement*, with OTSA by the last day of the month that follows the end of the calendar quarter in which the advisor became a material advisor with respect to the transaction. *See* § 301.6111-3(d) and (e).

In addition, a material advisor must maintain a list identifying each person with respect to whom the advisor acted as a material advisor with respect to a listed transaction or transaction of interest, if the person advised by the material advisor entered into the transaction within six years before the date the transaction was identified as a listed transaction or transaction of interest in published guidance. *See* § 301.6112-1(b)(2).

Drafting Information

The principal author of this announcement is Stephanie W. Chernoff of the Office of the Associate Chief Counsel (Procedure & Administration). For further information regarding this announcement, contact Stephanie W. Chernoff at (202) 317-5670 (not a toll-free number).

Announcement 2023-12

The Internal Revenue Service (IRS) has revised Form 3115, *Application for Change in Accounting Method*, and its instructions. The Form 3115 (Rev. December 2022) is the *current* Form 3115 (December 2022 Form 3115) and replaces the December 2018 version of the Form 3115 (December 2018 Form 3115). Consistent with sections 3.07 and 6.01 of Rev. Proc. 2015-13, 2015-5 I.R.B. 419, as clarified and modified by Rev. Proc. 2015-33, 2015-24 I.R.B. 1067, and as modified by Rev. Proc. 2021-34, 2021-35 I.R.B. 337, Rev. Proc. 2021-26, 2021-22 I.R.B. 1163, Rev. Proc. 2017-59, 2017-48 I.R.B. 543, and section 17.02 of Rev. Proc. 2016-1, 2016-1 I.R.B. 1; and with § 601.602 of the Statement of Procedural Rules, a taxpayer generally must apply for consent to change a method of accounting for federal income tax purposes by completing and

filing a *current* Form 3115 with the Commissioner of Internal Revenue.

The IRS encourages all taxpayers to use the December 2022 Form 3115. However, to allow for a reasonable period for taxpayers to transition to the December 2022 Form 3115, the IRS will accept either the December 2022 Form 3115 or the December 2018 Form 3115 if filed by a taxpayer on or before April 18, 2023, unless the use of the December 2022 Form 3115 is specifically required by guidance published in the Internal Revenue Bulletin. Taxpayers filing Forms 3115 after April 18, 2023, must use the December 2022 Form 3115. Regardless of the version of Form 3115 used, taxpayers must provide all the information required by Rev. Proc. 2015-13. *See* section 6.02(2) of Rev. Proc. 2015-13.

Section 6.03(1)(a)(i) of Rev. Proc. 2015-13 requires a taxpayer filing a request for an automatic change to file its original Form 3115 with its return and a duplicate of that Form 3115 with the IRS in Ogden, Utah. See the Address Chart for Form 3115 on page 2 of the Instructions for the December 2022 Form 3115. For duplicate Forms 3115 that are mailed, the address is:

Internal Revenue Service
Ogden, UT 84201
M/S 6111

For duplicate Forms 3115 that are delivered by private delivery service, the address is:

Internal Revenue Service
1973 N. Rulon White Blvd.
Ogden, UT 84201
Attn: M/S 6111

For duplicate Forms 3115 that are delivered by facsimile, the number is (844) 249-8134. Delivery by encrypted electronic mail is not available for automatic change requests.

If prior to April 19, 2023, a taxpayer filed its duplicate copy of Form 3115 with the IRS in Ogden, Utah, using the December 2018 Form 3115, the taxpayer may file its original Form 3115 with its return using either the December 2018 Form 3115 or the December 2022 Form 3115, even if the taxpayer files the completed original Form 3115 after April 18, 2023. See, however, section 6.03(1)(e) of Rev. Proc. 2015-13 for correspondence regarding a previously filed Form 3115.

Taxpayers may download the December 2022 Form 3115 and its instructions from the IRS website, *https://www.irs.gov/forms-pubs/about-form-3115*, or order them from the IRS website *www.irs.gov/orderforms*.

The principal author of this announcement is Christian Lagorio of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this announcement contact Mr. Lagorio at (202) 317-7005 (not a toll-free number).

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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If you have comments concerning the format or production of the Internal Revenue Bulletin or suggestions for improving it, we would be pleased to hear from you. You can email us your suggestions or comments through the IRS Internet Home Page *www.irs.gov*) or write to the Internal Revenue Service, Publishing Division, IRB Publishing Program Desk, 1111 Constitution Ave. NW, IR-6230 Washington, DC 20224.