Office of Chief Counsel
Internal Revenue Service
memorandum

Number: **202422010**
Release Date: 5/31/2024

CC:INTL:B01
POSTS-120376-20

UILC: 881.00-00, 953.06-00

date: April 8, 2024

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subject: Proposed FDAP Tax Adjustment in Abusive Foreign Micro-captive Cases

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

Facts

In an abusive micro-captive arrangement involving a foreign entity, the following facts are present:[1]

- In Year 1, a foreign regarded entity ("**Captive**") made a § 953(d) election to be treated as a domestic corporation.

- In Year 1 and following years,

    - A domestic entity ("**Insured**") directly or (when Captive is claimed to be a reinsurer) indirectly made payments to Captive that were claimed to be deductible insurance premiums;
    - Insured (and intermediary, when Captive purports to be a reinsurer in the arrangement) did not deduct or withhold any tax under § 1442 (requiring withholding on payments of fixed or determinable annual or periodical

[1] The facts presented here are exemplary of abusive micro-captive arrangements involving foreign entities, but particular abusive fact patterns may differ from those described in this memorandum.

("**FDAP**") income) on the payments made to Captive pursuant to the arrangement;
- Captive filed a U.S. Federal income tax return as a domestic insurance company (Form 1120-PC); and
- Captive reported the payments received pursuant to the arrangement as income on its Form 1120-PC and excluded the payments from taxable income under § 831(b).

As a result of examinations of Insured and Captive, neither established that payments to Captive were insurance premiums (because the arrangement lacked insurance risk, risk distribution, or risk shifting, or was not insurance in its commonly accepted sense) and a revenue agent denied Insured's claimed deduction. Because the payments to Captive were not for insurance, more than half of the business of Captive was not insurance, meaning that Captive did not qualify as an insurance company under § 831(c) and 816(a) and was ineligible to make a § 953(d) election.

Law

Under § 881(a), foreign corporations generally are subject to a 30-percent tax on amounts of FDAP income received from sources within the United States that are not effectively connected with the conduct of a trade or business in the United States. In general, whether a foreign corporation is treated as engaged in a trade or business within the United States "shall be determined on the basis of the facts or circumstances in each case." Treas. Reg. § 1.864-2(e). Absent evidence that shows that payments received by a foreign corporation are not FDAP income subject to the 30-percent tax under § 881(a), the Tax Court has sustained the IRS's proposed § 881(a) tax liabilities on a purported captive insurer.[2] In Reserve Mechanical Corp. v. Commissioner, the purported insured made payments to a foreign entity that purported to be a captive and made an election under § 953(d) to be treated as a domestic corporation.[3] The Tax Court found that (1) the captive was not an insurance company, (2) the captive was therefore ineligible to make an election under § 953(d), and (3) the premiums received by the captive were U.S.-source FDAP income taxable under § 881.[4] The Tax Court held that the captive could not meet its burden to show that premiums received from the insured were not U.S.-source FDAP income required to be reported on Form 1120-F.[5] Having failed to meet that

[2] See Reserve Mechanical Corp. v. Commissioner, T.C. Memo. 2018-86, aff'd, 34 F.4th 881 (10th Cir. 2022).

[3] Reserve, T.C. Memo. 2018-86, at *28-29.

[4] Id. at *62-66. Accord Keating v. Commissioner, T.C. Memo. 2024-2, at *71-73 (holding that a § 953(d) election is invalid in any year in which the electing entity is not an insurance company); Swift v. Commissioner, T.C. Memo. 2024-13, at *44 (holding that the captives' § 953(d) elections were invalid because the captives were not insurance companies, and noting that, as a result, the "captives must recognize the premiums they received as income for the years at issue").

[5] Reserve, T.C. Memo. 2018-86, at *62-66.

burden, the captive was liable for tax on FDAP income under § 881.[6] In an opinion echoing the Tax Court's reasoning, the Tenth Circuit affirmed.[7]

Analysis

In the arrangement described in the above facts, a revenue agent may properly assert that Captive has the burden to prove that payments Captive received and reported as income on its Form 1120-PC are of a type excluded from income (e.g., capital contribution, loan proceeds) or otherwise of a type not subject to tax under § 881 (e.g., income from sources without the United States, income effectively connected with a § 864(b) U.S. trade or business). Absent facts allowing Captive to meet this burden, it is appropriate for the revenue agent to propose an adjustment to include the payments in U.S.-source FDAP income subject to the 30-percent gross tax under § 881 ("**FDAP Adjustment**").

The revenue agent may propose the FDAP Adjustment to Captive even if a denial of Insured's claimed deduction for the same payments has been asserted.[8] It is also appropriate for the revenue agent to propose the FDAP Adjustment even if a § 1442 withholding tax liability, as described in CCA 202134017, has been asserted against Insured (or intermediary, when Captive purports to be a reinsurer) with respect to the same payments. Insured (or intermediary) against whom withholding tax has been asserted would, however, be entitled to relief from its withholding tax liability to the extent Captive pays its FDAP liability (and vice versa). See Treas. Reg. § 1.1463-1. For purposes of completing Form 886-A, *Explanation of Items*, as part of a notice of proposed adjustment, sample language for the FDAP Adjustment is provided below. If, however, the facts differ from those described above in any manner other than Captive's receipt of payments from multiple Insureds, or if Captive asserts an alternative characterization of the payments, the agent should contact counsel for assistance.

Sample Language

As a result of an examination, it has been determined that the amounts Insured paid were not insurance premiums for Federal tax purposes because for [**INSERT TAX YEARS**],

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[6] Id.

[7] Reserve, 34 F.4th at 917-19.

[8] If an arrangement between a captive and an insured does not constitute insurance, it is appropriate to impose an income-related adjustment, such as the FDAP Adjustment, as well as denying deductions claimed by the insured. See Syzygy v. Commissioner, T.C. Memo. 2019-34, at *48 ("Petitioners also argue that if the payments to Syzygy are not deductible they should not be taxable to Syzygy. While [Rev. Rul. 2008-8 and Rev. Rul. 2005-40] suggest the possibility that an arrangement that purports to be an insurance contract may instead be characterized as a deposit arrangement, a loan, a contribution to capital, or otherwise, there is no evidence that any such recharacterization is appropriate."). Further, any argument by Captive that the payments constitute income effectively connected with a U.S. trade or business of a foreign corporation would be inconsistent with its § 953(d) election.

the arrangements failed to meet [**LIST RELEVANT FACTORS: the risk shifting requirement, risk distribution requirement, insurable risk requirement, and/or the insurance in the commonly accepted sense requirement**] and that Captive did not qualify as an insurance company for Federal tax purposes for [**INSERT TAX YEARS**]. Further, Captive has failed to establish that it ever qualified as an insurance company for Federal income tax purposes. As a result, Captive never met the requirements of § 953(d) to be treated as a domestic corporation and as such, for Federal income tax purposes, Captive was at all times a foreign corporation.

Under § 881(a), foreign corporations generally are subject to a 30-percent tax on amounts of fixed or determinable annual or periodical ("FDAP") income received from sources within the United States. Captive has not established that it meets any exception to this rule. In Reserve Mechanical Corp. v. Commissioner, 34 F.4th 881 (10th Cir. 2022), the Tenth Circuit affirmed the Tax Court's holding that a foreign entity that purported to be a captive was not an insurance company for Federal income tax purposes, and therefore had made an invalid § 953(d) election and was liable for tax on FDAP income under § 881 with respect to the purported premiums it had received. The Tax Court found that the captive had not met its burden to show that premiums reported as income from the insured were not U.S.-source FDAP income required to be reported on Form 1120-F, and the Tenth Circuit agreed. See Reserve Mechanical Corp. v. Commissioner, T.C. Memo. 2018-86, aff'd, 34 F.4th 881 (10th Cir. 2022).

Captive has failed to establish that the payments it received in [**INSERT TAX YEARS**] and reported as income on Form(s) 1120-PC were the kind of payments that would not be subject to tax under § 881. Because Captive did not establish that fact, Captive is liable for a § 881 tax of [**INSERT 30 percent OF AGGREGATE PAYMENTS MADE TO CAPTIVE IN ALL TAX YEARS AT ISSUE**].