E-MAIL Transmission via Federal eRulemaking Portal @ *https:l/www.regulations.gov*(IRS and Proposed REG-109309-220)

Joint Comments of Kenneth A. Lazarus, Esq. (a member of the D.C. Bar), Adam R. Webber, Esq. (a member of the Ohio Bar) and James F. Perna, Esq. (a member of the D.C. Bar), including Sworn Statement of Andrew J. Barile, In Response to Announcement 2023-11: Proposed Regulations that Identify Certain Micro-Captives as Transactions of Interest or as Listed Transactions;*

* Messrs. Lazarus and Webber served as co-counsel and Mr. Perna served Of Counsel to the taxpayer in *CIC Services v. IRS,* Case No. 3:17-cv-110 (E.D. Tenn. June 2, 2022), available at 2022 WL 2078036, which resulted in the set aside IRS Notice 2016-66.

Respectfully submitted,

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Proposed Regulation 109309-22, RIN 1545-BQ44 suffers from Constitutional flaws, process flaws and substantive flaws. As a result, the Internal Revenue Service (IRS) should withdraw the proposed regulation or, at a minimum, postpone further consideration of the proposed regulation pending a decision by the U.S. Supreme Court in *Loper Bright Enterprises v. Raimondo,* Sup. Ct. Dkt. No. 22-451.

I. BACKGROUND

Captive insurance companies have proven value and are widely utilized by virtually every Standard & Poors 500 company in the United States. Those large businesses recognize that a substantial portion of traditional insurance company expenses go to the payment of commissions and other sales-related fees. Their captive insurance companies afford them the opportunity to avoid such costs. Further, whatever profits are derived from a captive insurance company are returnable to the owner(s) as dividends.

All busin sses, both large and small, need flexibility to maximize their risk-management needs. Traditional domestic insurance companies often are unable to optimize such risk-management needs, or they do so at unreasonable cost. However, there does not have to be an "either/or" choice between not insuring a particular risk or insuring one at unreasonable cost. Instead, a third alternative - utilization of a captive insurance company - is available to help businesses optimize their risk management needs while also avoiding unduly burdensome expenses.

Captive insurance companies can provide an array of benefits, including:

1. Cost Reduction: The price of insurance coverage purchased in the

conventional marketplace typically reflects a significant mark-up to pay for the insurer's acquisition costs, marketing and brokerage commissions, administration expenses and profit to the insurer. Establishing a captive cannot eliminate these costs, but it can substantially reduce them. In this regard, it is especially significant to note that marketing and brokerage commissions can constitute as much as one-half of premium allocations.

2. Coverage of Otherwise Uninsurable Risks: From time to time, the commercial market is unwilling or unable to provide affordable coverage for certain risks - in particular, volatileliability and casualty risks. Examples of risks for which coverage has often been unavailable or difficult to obtain on satisfactory terms include product liability, professional liability, oil pollution, hazardous waste, fire and smoke damage to vineyards, business interruption that covers loss attributable to pandemics like COVID-19, and labor/strike insurance. The availability of a captive to underwrite such coverage can reduce or eliminate such market problems. By way of example, the taxpayer in the *Puglisi* case established a small captive insurance company to insure against fortuitous risks, such as avian influenza, because the insurance coverage was unavailable in the commercial marketplace to cover flock managers. *See Puglisi v. Comm'r,* No. 4799-20, 2 (U.S. Tax Court, Oct. 29, 2021).

3. Access to Reinsurance: Reinsurers typically do business with insurance companies and not with individual insureds, so a captive affords direct access to international reinsurance markets. By bypassing conventional insurers, the

insured is spared related mark-up costs;

4. Cash Flow Benefits: A substantial advantage of a captive stems from its ability to generate net income and then generate qualified dividends. Additional funds can be invested and accumulated if the captive is based in a tax-free domicile.

5. Reduction of Exposure to Burdensome Government Regulation: In contrast to the rigorous insurance regulation in most industrialized countries, both domestic and off-shore domiciles offer a far less onerous regulatory framework.

6. Flexibility to Customize Insurance Programs: A captive is free to insure any legitimate risk it chooses and to customize the terms and conditions of its policies. This can lead to improved loss-control efficiency and promote greater awareness of factors that commonly give rise to losses. Such flexibility in customization allows a captive's insurance to be specifically tailored to the insured's particular nuances and needs.

7. Creation of Insurance Gains: By reducing costs and expenses and implementing efficient insurance models, a captive can realize substantial cash surpluses that are returnable to the captive's owners in the form of qualified dividends while at the same time maintaining an adequate capital base.

8. Ability to Control and Direct Investment Options: When an insured buys commercial insurance, it does not control, or benefit from, the investment of unearned premiums, loss reserves and surpluses. An appropriately

established and operated captive affords a business the opportunity to directly control the details, direction and profits derived from these investment choices.

By enacting Internal Revenue Code (IRC) section 831(b), Congress made these benefits available to small businesses via a simplified process that recognizes that smaller businesses do not have access to the same resources as the largest ones.

Notwithstanding such congressional intent, the IRS has engaged in a dragnet audit program targeting the entire small captive insurance industry, contending, without adequate supporting data, that such companies are utilized as unlawful tax-evasion schemes to simply return premiums to the insured in the form of inappropriate qualified dividends taxed at lower capital rates (so called "round tripping" premiums, which often leave the captive thinly capitalized).

Very few captive cases under audit have been permitted access to good faith administrative appeal sessions for possible resolution. Pursuant to a directive from the former IRS-Commissioner, IRS examining agents will consider opening settlement discussions only if the taxpayer agrees up front to accept a resolution 90 percent in favor of the IRS and to shut down the captive. And IRS agents have threatened taxpayers and their advisors with double or triple taxation and penalties that continue to accumulate as taxpayers wait years for resolution of their claims. By some estimates, as many as 1,000 cases are pending in the U.S. Tax Court, but the IRS has completed litigation with respect to only a handful of cases involving the most obviously egregious fact patterns.

In 2016, following unsuccessful arguments that Congress should eliminate section 831(b) legislatively, the IRS issued Notice 2016-66 to impose extremely onerous and costly reporting requirements on lawful participants in small captive insurance transactions. Fortunately, Notice 2016-66 has been set aside by the federal courts. But, even though the IRS collected massive amounts of data pursuant to the Notice for seven years, it has not seen fit to utilize that information to issue guidance for taxpayers or its own agents that would help distinguish legitimate small captive insurance arrangements from potentially abusive ones. Instead, on April 10, 2023, the IRS issued a Notice of Proposed Rulemaking that identifies certain micro-captive insurance transactions as "listed transactions" and certain other micro-captive transactions as "transactions of interest." Unfortunately, the proposed regulations only serve to escalate the IRS's "war" against micro-captives.

These facts strongly suggest that the goal of the IRS is to harass legitimate small captive insurance participants in order to dissuade new entrants to the captive market and to drive out those already involved in the industry in an attempt to subvert the express will of Congress to incentivize the use of small captive insurance companies.

The proposed regulation presents a number of significant issues involving the Separation of Powers Doctrine, as incorporated in the Constitution of the United States of America; it perpetuates problems uncovered by the *CIC* litigation, which eventually resulted in the set aside of IRS Notice 2016-66; and it incorporates inherent flaws designed to undo the policy aims of legislation establishing small captive insurance. These issues are treated, in turn, below.

II. CONSTITUTIONAL FLAWS: THE PROPOSED REGULATION VIOLATES THE SEPARATION OF POWERS DOCTRINE [1]/

[1] The historical information in this section derives from THE CONSTITUTION ANNOTATED (Congressional Research Service 2022).

A. The Vesting Clauses

The Legislative Vesting Clause of the Constitution (U.S. Const. Art. I, Sec. 1) grants specific and limited legislative powers to the Congress of the United States. This Clause, together with the coordinate Executive and Judicial Vesting Clauses, delineates the powers the Framers accorded the U.S. Government's Legislative, Executive and Judicial Branches and, at the same time, limits the authority of each branch.

The Framers drafted the Legislative Vesting Clause against the backdrop of English legal tradition that viewed a "tyrannical government" as one in which the right of both *making* and *enforcing* the law is vested in one-and-the-same man or one-and-the-same body of men. 1 W. Blackstone, Commentaries on the Laws of England 144 (Lippincott Co. 1893). "Wherever these two powers are united together, there can be no public liberty." *Id.* At the same time, however, the Constitution does not prohibit the Executive or Judicial Branches from exercising properly-delegated legislative power. The Branches are not intended to be air-tight compartments.

B. Formalist v. Functional Standards

Throughout our history, difficult questions have arisen on appropriate standards to properly apply the separation of powers doctrine. Over time, the Supreme Court has formulated two different approaches: formalist and functionalist. The Court's stricter formalist approach emphasizes the need to maintain three distinct branches of government by drawing bright lines between the branches to reflect basic differences in legislative, executive and adjudicative functions.

For about fifty years, the Supreme Court generally has followed the formalist standard when the Constitution clearly commits a function or duty to a particular branch of government. *See, e.g., Buckley v. Valeo,* 424 U.S. 1, 109-43 (1976) (holding that Congress may not reserve to itself the power to appoint officers charged with enforcing a law, since that had long been considered an exclusive Executive power); *see also Bowsher v. Synar,* 478 U.S. 714, 726-27, 733-34 (1986) (Congress may not vest even a part of a law's enforcement in the Comptroller General because the Comptroller General is an officer subject to removal by Congress and law enforcement has been long-considered a core Executive function); *Immigration and Naturalization Serv. v. Chadha,* 462 U.S. 919, 951 (1983) (the so-called "legislative veto" is clearly outside the scope of legislative power and damaging to the President's constitutionally-conferred powers). However, note that in *Morrison v. Olson,* 487 U.S. 654, 670-77, 694-95 (1988), the Court sustained Congress's creation of an Independent Counsel to prosecute certain federal criminal statutes. Justice Scalia submitted a scathing dissent in that case, suggesting that the decision was aberrational in nature and constituted a clear usurpation of executive power. *Id.* (Scalia, J., dissenting).

C. Delegations of Legislative Power

By vesting Congress with "[a]ll legislative Powers," the Supreme Court has viewed the Legislative Vesting Clause as limiting the authority Congress may delegate to other branches of government. In general, the Court has held that "the legislative power of Congress cannot be delegated." *United States v. Shreveport Grain and Elevator* Co., 287 U.S. 77, 85 (1932); *see also Virginia v. Environmental Protection Agency,* No. 20-1530, slip op. at 31 (U.S. June 30, 2022) (a decision of "magnitude and consequence rests with Congress itself, or an agency acting pursuant to a clear delegation from that representative body"); *Gundy v. U.S.,* No. 17-6086, slip op. at 1

(U.S. June 20, 2019) (plurality opinion) ("The non-delegation doctrine bars Congress from transferring its legislative power to another branch of Government.").

It is also clear that the foundation for opposition to the delegation of legislative power is no longer moored only to the separation of powers doctrine - constitutional principles of due process also come into play. *Loving v.* U.S., 517 U.S. 748, 758-59 (1996) (the delegation doctrine is informed not only by separation of powers analyses but also by the provision of standards appropriate to the circumstances presented).

Another concept that has taken root in the Supreme Court is the notion that Congress has long provided for the Executive and Judicial Branches to "fill up the details" of statutes. See *In re Ko/lock,* 165 U.S. 526 (1897); *Buttfield v. Stranahan,* 192 U.S. 470 (1904), and their progeny. However, little direction is provided in terms of what constitutes a "detail."

D. Non-Delegation Doctrine

"The principle that Congress cannot delegate away its vested powers exists to protect liberty." *Dep't of Transp. v.* Ass'n *of Am. R.R.,* 575 U.S. 43, 61 (2015) (Alita, J., concurring). "When fundamental policy decisions underlying important legislation about to be enacted are to be made, the buck stops with the Congress and the President." *Indus. Union Dep't, AFL-C/O v. AP/,* 448 U.S. 607, 687 (1980). The non-delegation doctrine seeks to distinguish the constitutional delegations of power to other branches of government that may be "necessary" from unconstitutional grants of legislative power that violate separation of powers principles. *J.W. Hampton, Jr.* & Co. *v.* U.S., 276 U.S. 394,406 (1928); see a/so *Chadha,* 462 U.S. at 944 ("[T]he fact that a given law or procedure is efficient, convenient, and useful in facilitating functions of government, standing alone, will not save it if it is contrary to the Constitution.").

Convenience and efficiency are not the primary objectives, or the hallmarks, of democratic government. The non-delegation doctrine does not require complete separation of the three branches of government, but its strength is growing. Of course, Congress cannot do its job absent any ability to delegate power; the real issue is where to draw the line.

E. Intelligible Principle Standard

As a means to enforce the non-delegation doctrine, the Supreme Court required in *J.W. Hampton, Jr.* & Co., 276 U.S. at 409, that Congress must lay out an "intelligible principle" to govern, guide and restrain the delegation of legislative authority to an administrative agency. Shortly after that decision, of course, the Great Depression led to the substantial expansion of federal government power, especially Executive power, to spur economic recovery during the New Deal.

Somewhat later, in 1935, in the midst of the New Deal era, the Supreme Court struck down legislation that granted the President extensive and "unfettered" powers to regulate economic activity via its decisions in *Panama Refining* Co. *v. Ryan,* 293 U.S. 388 (1935), and A.LA. *Schechter Poultry Corp. v. United* States, 295 U.S. 495 (1935). Both those cases involved provisions of the National Industrial Recovery Act and, with respect to both, the Court found that Congress provided "no standards" for the delegation.

Panama Refining and *Schechter Poultry* represent the "high-water mark" for the non-delegation doctrine. Thereafter, the Court generally took a hands-off approach to assessing the congressional assignment of policy responsibility to administrative agencies within the Executive Branch. Keith E. Whittington & Jason Luliano, *The Myth of the Nondelegation Doctrine,* 165 U. PA. L. REV. 379,382 (2017) (citing Cass R. Sunstein, *Constitutionalism After the New Deal,* 101 HARV. L. REV. 421, 447-48 (1987)).

F. Narrow Exceptions to the "Hands-Off" Approach

Notwithstanding the general hands-off approach to the congressional delegation of power to Executive Branch administrative agencies since 1935, certain principled concerns have compelled the Supreme Court to act from time to time since then. For example, the Court has, on occasion, limited the scope of an agency's delegated authority under the so-called "major questions" doctrine. See, *e.g., FDA v. Brown* & *Williamson Tobacco Corp.,* 529 U.S. 120, 160 (2000) (Congress could not have intended to delegate a decision of such economic and political significance to an agency without a clear statement of its intention).

The Court also has taken a negative view of a delegation where it perceived that the delegated power, though cast in the guise of a fee-setting authority, actually involved the delegation of a potential taxing authority, which would be fraught with constitutional difficulties. *Nat'/ Cable Television Ass'n v. U.S.,* 490 U.S. 212, 221 (1989); *see also* Cass R. Sunstein, *Nondelegation Canons,* 67 U. CHI. L. REV. 315 (2000); *The Nondelegation Doctrine as* a *Canon of Avoidance,* 2000 SUP. CT. REV. 223 (2000).

Lastly, the Supreme Court has held that only Congress has the power to declare an act or omission a criminal offense. *See Sessions v. Dimaya,* No. 15-498, slip op. at 5 (U.S. Apr. 17, 2018) (explaining that the void-for-vagueness doctrine is a "corollary of the separation of powers" that requires "Congress, rather than the executive or judiciary branch, [to] define what conduct is [criminally] sanctionable and what is not"); *Whitman v. U.S.,* 574 U.S. 1003, 1004 (2014) ("[L]egislatures, not executive officers, define crimes").

Once Congress has exercised its power to declare certain acts criminal, the Court generally has upheld Congress's authority to delegate its power to further define what specific conduct is criminal pursuant to the statutory limits. *Touby v. U.S.,* 500 U.S. 160, 165-69 (1991) (upholding a delegation of authority to classify drugs within certain categories of "controlled substances" and various levels of criminal sanctions under the Controlled Substances Act). The Court has confessed that its "cases are not entirely clear as to whether more specific guidance is in fact required" for delegations relating to the imposition of criminal sanctions. *Id.* at 166. It is clear, however, that some essence of the power to define crimes and set a range of punishments is not delegable, but must be exercised by Congress. This conclusion derives in part from the time-honored principle that penal statutes are to be strictly construed, and that no one should be "subjected to a penalty unless the words of the statute plainly impose it." *Tiffany v. Nat'l Bank* of *Mo.,* 85 U.S. (18 Wall.) 409,410 (1873). In this regard, compare *U.S. v. Grimaud,* 220 U.S. 506 (1911), and *U.S. v. Eaton,* 144 U.S. 677 (1892). *See also M. Kraus* & *Bros. v. U.S.,* 327 U.S. 614, 621 (1946).

G. A Fundamental Change Appears to be Coming

At long last, the intelligible principle test and the broad deference it has afforded congressional delegations of authority to administrative agencies within the Executive Branch has, in fairly recent times, been met with growing skepticism and outright opposition from members of the Court.

In *Gundy v. United States,* Case No. 17-6086, slip op. (plurality opinion) (U.S. June 20, 2019), Justice Elena Kagan, writing for a plurality of the Court, including Justices Ginsburg, Breyer and Sotomayor, affirmed the petitioner's conviction, concluding that the delegation of legislative authority to the U.S. Attorney General contained in the Sex Offender Registration and Notification Act (SORNA) did not violate the non-delegation doctrine - the delegation "easily passed constitutional muster." Notably, Justice Kagan's opinion was met by a dissent, authored by Justice Neil Gorsuch and joined by Chief Justice John Roberts and Justice Clarence Thomas, which argued that the statute unconstitutionally provided the Attorney General "unfettered discretion." *Id.* at 24 (Gorsuch, J., dissenting). Further, the dissenters claimed that the modern intelligible principle test has "no basis in the original meaning of the Constitution" or in historical practice. *Id.* at 17. In response, the plurality, noting that delegations identical or similar to the one in SORNA were "ubiquitous in the U.S. Code," argued that, as a matter of pragmatism, the Court should afford deference to Congress's judgments that such broad delegations are necessary. *Id.* at 17-18 (plurality opinion). Providing the fifth vote to affirm the petitioner's conviction was Justice Samuel Alita, who, while agreeing that the plurality correctly applied the modern non-delegation case law, indicated he would "support [the] effort" of the dissenting justices to reconsider the intelligible principle test once a majority of the Court concurred in rethinking the doctrine. *Id.* at 1 (Alita, J., concurring).

Justice Brett Kavanaugh took no part in the consideration or decision in *Gundy,* as he was appointed to the Supreme Court after oral argument occurred in the case. Justice Ruth Bader Ginsburg, who was part of the plurality in *Gundy,* passed away in

September 2020, and Justice Amy Coney Barrett subsequently assumed office in her place and stead.

H. Agency Discretion and *Chevron* Deference

In *Chevron* U.S.A., *Inc. v. Nat. Res. Def. Council, Inc.,* 467 U.S. 837, 842-43 (1984), the Supreme Court gave Congress considerable leeway to delegate to administrative agencies the power to interpret statutory ambiguities within their areas of operation. The Court reasoned that:

> If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation Sometimes, however, the legislative delegation to an agency on a particular question is implicit rather than explicit. In such a case, a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency.

Id. at 844.

As noted in the above discussion of *Gundy v. United States,* a clear majority of the members of the Supreme Court now have serious reservations about the wisdom of so-called *Chevron* deference.

On May 1, 2023, the Supreme Court granted *certiorari* on Question number two presented in the Petition filed in *Loper Bright Enterprises v. Raimondo,* Sup. Ct. Dkt. No. 22-451: "Whether the Court should overrule *Chevron* or at least clarify that statutory silence concerning controversial powers expressly but narrowly granted elsewhere in the statute does not constitute an ambiguity requiring deference to the agency."

On the same date, Justice Ketanji Brown Jackson recused herself from the case since she had already heard arguments in the dispute as a D.C. Circuit Court Judge. Thus, only two of the justices on the eight-member panel that will hear the case early in the upcoming October term appear to favor retaining *Chevron:* Justices Kagan and Sotomayor. A decision is expected sometime in the summer of 2024.

A decision in *Loper* could change the entire paradigm with respect to the delegation of legislatively-related powers to executive administrative agencies.

I. Litigation Hazards

As discussed at length herein, it appears that the real purpose of the proposed regulation is to shut down the small captive insurance industry expressly authorized by IRC section 831(b). Thus, it is confiscatory in nature.

The Fifth Amendment to the Constitution prohibits the "taking" of virtually all types of property without just compensation. Constructive or regulatory "takings" restrict the owner's rights so much that the governmental action becomes the functional equivalent of a physical seizure. *Penn Cent.* Co. *v. New York City,* 438 U.S. 104, 124 (1978). While it is clear that the Fifth Amendment is not a limitation upon the taxing power of the government *(Brushaber v. Union Pac. R.R.,* 240 U.S. 1, 24 (1916)), such power does not bar an attack on tax-related regulations that have no purpose other than to close down, or effectively "take," businesses that are authorized, indeed encouraged, by repeated legislative enactments.

The proposed regulation invites litigation, which will needlessly occupy significant judicial resources over coming years. Wisdom and prudence suggest that any new regulation await the guidance to be provided by the Supreme Court in the *Loper* case.

III. PROCESS FLAWS: PROBLEMS UNCOVERED BY IRS NOTICE 2016-66 LITIGATION ALSO DOOM THE PROPOSED REGULATION

Upon the issuance of IRS Notice 2016-66 in 2016, we immediately filed suit to enjoin and set aside the notice on behalf of CIC Services, LLC ("CIC"), alleging that

Notice was filed without proper public notice and comment under the Administrative Procedure Act ("APA") and that it was "arbitrary and capricious" in nature.

Rather than engaging on the merits and defending its conduct, the IRS argued that CIC was barred from challenging its conduct, citing a Civil War-era law that it claimed prevented CIC from bringing suit unless the IRS first assessed a penalty against CIC for violating the law. The IRS thus argued that CIC should first *break the law,* face crippling financial and criminal penalties, and then sue for a refund. A *unanimous* Supreme Court found this repugnant and held that the IRS's argument failed:

> Recall what the Government would have such a party do: disobey the Notice, pay a resulting tax penalty, and then bring a refund suit. That approach ... with lawbreaking at the start subjects the party to criminal punishment. And that is not the kind of thing an ordinary person risks, even to contest the most burdensome regulation.

*CIC Services, LLC v. IRS,*_ U.S._, 141 S.Ct. 1582, 1592 (2021).

Earlier, the Sixth Circuit had bemoaned "The broader legal context in which this case has been brought is not lost on this Court. Defendants [the IRS] do not have a great history of complying with APA procedures, having claimed for several decades that their rules and regulations are exempt from those requirements." *CIC Services, LLC v. IRS,* 925 F.3d 247,258 (6th Cir. 2019).

Rather than accept the fact that it had overreached and comply with lawful rulemaking procedures, the IRS continued to defend IRS Notice 2016-66 to the bitter end, and the results were disastrous for its standing at law and its reputation.

On the question of whether the IRS failed to comply with its obligation to follow "public notice and comment" requirements with respect to Notice 2016-66, the IRS, upon remand, continued to argue to the trial court with unmitigated arrogance that it had no duty to comply with the APA because it had exempted itself from the APA. The trial court responded by ruling that the IRS clearly overstepped the plain command of its statutory authority in issuing Notice 2016-66.

On the question of whether Notice 2016-66 was "arbitrary and capricious," the IRS's various rationales all were found to be wanting. As part of the trial court's review of the legal footing for the notice, the IRS was ordered to produce its administrative record - a record which was supposed to include all of the facts, data, internal documents, emails, memoranda, meeting notes and any other documents that supported the conclusion that small captives were abusive by nature, *i.e.,* that they were more likely than other tax-preference beneficiaries to be utilized for purposes of tax evasion and fraud. The IRS's administrative record was shameful in this regard. Most of it was simply nonsensical - copies of internet print-outs of cases, pre-existing regulations, statutes, tax forms and instructions (most of which bore time stamps showing that they were printed *after* Notice 2016 was issued).

Only a two-page "Executive Summary" in the administrative record submitted by the IRS provided really substantive information, and that information was damning to the Service. First, the IRS admitted that it had pretextual reasons for issuing Notice 2016-66. Specifically, the document stated: "Notice 2016-66 should be issued ASAP. Promoters are continuing to encourage people to enter into these transactions." Thus, the Notice really was issued to frighten away potential small captive industry entrants. Second, IRS personnel anticipated that the Notice would be perceived as a "burdensome ministerial requirement" that was part of a campaign to "tarnish the entire captive insurance industry," not just the allegedly abusive ones. Of course, that was the whole point - requiring the production of duplicative materials at substantial cost to taxpayers in contravention of legislative policy determinations.

Based upon this outrageous record, the trial court found that Notice 2016-66 was arbitrary and capricious. Its reasoning is telling:

> The Notice simply states that the IRS is aware of micro-captive transactions and "believes" these transactions have the potential for tax avoidance or evasion. While the Notice goes on to describe these transactions, it does not identify any facts or data supporting its belief.... [The IRS] does not include any underlying facts or data explaining how it became aware of "a large number of these transactions" or facts regarding taxpayers under audit and in litigation that explain how this transaction has the potential for tax avoidance or evasion...... The administrative record in this case simply does not include underlying facts and data showing that micro-captive insurance arrangements have a potential for tax avoidance or evasion. As a result, the Notice must also be set aside as action that is arbitrary and capricious.

CIC Services, LLC v. IRS, E.D. Tenn., Case No. 3:17-cv-110 (March 21, 2022).

There is no reason to believe that the IRS's motivation in proposing this new regulation is any different from the pretextual motivation behind Notice 2016-66. In this respect, the proposed regulation lacks a legal foundation and will no doubt invite substantial litigation.

IV. SUBSTANCE FLAWS: THE PROPOSED REGULATION GOES TOO FAR AND WOULD EFFECTIVELY ELIMINATE THE SMALL CAPTIVE INSURANCE BENEFITS PROVIDED BY CONGRESS

The newly-proposed regulation that the IRS issued on April 10, 2023 would replace and modify Notice 2016-66. If finalized, the proposed regulation would operate to shut down the entire small captive industry. The 20 percent ownership rule disregards the fact that most small businesses own 100 percent of their captive for good reason. And the 65 to 70 percent loss-ratio rule ignores the fact that there is nothing inherently unreasonable or suspicious about a small captive insurance company having a very low claims ratio because they may properly be used to insure against infrequent but potentially catastrophic risks, such as the avian flu, discussed above, or pandemic business interruption, a recent problem for all small businesses.

Included in this presentation is the Sworn Statement of a distinguished insurance expert, Mr. Andrew J. Barile. His Sworn Statement contains detailed opinion evidence of the two fatal flaws referenced immediately above. *See* attached Sworn Statement of Andrew J. Barile, including his CV.

V. CONCLUSION

Three decades ago, the IRS conceded its battle against the big business captives qualifying under IRC section 831(a). After losing in a half dozen Federal Circuit Courts to big captives, which of course are easily able to defend themselves, the IRS conceded the legitimacy of section 831(a) large captives and shifted its focus to small captives owned by small- and medium-size businesses less able to fight a bureaucratic behemoth like the IRS. *See, e.g., United Parcel Serv. of Am. v. Comm'r,* 254 F.3d 1014 (11th Cir. 2001) (holding that taxpayer's restructuring of its excess-value business as insurance provided by an overseas affiliate had sufficient economic substance and was not a sham transaction); *Amerco, Inc. v. Comm'r,* 979 F.2d 162 (9th Cir. 1992) (holding that "it is possible to have a true insurance transaction between a corporation and its wholly owned subsidiary company if that captive company does substantial unrelated business"); *Amerco, Inc. v. Comm'r,* 96 T.C. 18 (1991); *Harper Grp. v. Comm'r,* 979 F.2d 1341 (9th Cir. 1992) (holding that a true insurance transaction occurred between a corporation and its wholly owned insurance company based on the subsidiary's substantial unrelated business); *Harper Grp. v. Comm'r,* 96 T.C. 45 (1991); *Rent-A-Center,* 142 T.C. 1 (2014) (finding agreements between brother/sister entities constituted insurance and that certain payments to the captive insurer were deductible as insurance expenses). *But see Salty Brine I, Ltd. v. U.S.,* 761 F.3d 484 (5th Cir. 2014) (affirming district court's determination that royalty interest transaction lacked economic substance, was entered into for tax avoidance and should be disregarded for tax purposes); *Clougherty Packaging* Co. *v. Comm'r,* 811 F.2d 1297 (9th Cir. 1987) (holding that premiums paid by parent corporation to its wholly owned subsidiary captive insurer may not be deducted as necessary business expenses). See *also Malone* & *Hyde, Inc. v. Comm'r,* 62 F.3rd 835 (6th Cir. 1995); *Ocean Drilling* & *Exploration* Co. *v. U.S.,* 988 F2d 1135 (Fed Cir. 1993); *Sears, Roebuck and* Co. *v. Comm'r,* 972 F.2d 858 (J1h Cir. 1992); *Gulf Oil Corp. v. Comm'r,* 914 F.2d 396 (3rd Cir. 1990); *Humana Inc. v. Comm'r,* 881 F.2d 247 (6th Cir. 1989).

It is clear that the IRS is trying to accomplish by administrative fiat what it has been unable to convince Congress to do legislatively- namely, to shut down the small captive insurance industry that Congress has authorized, accepted and approved and that has been in existence for over 25 years. The IRS has used and continues to resort to every conceivable impediment, regulatory hindrance and bureaucratic obstacle to strangle the economic life out of the small captive industry in contravention of the express will of Congress. For example, the Proposed Regulation's 65 to 70 percent loss-ratio rule would effectively preclude the growth of a substantial capital reserves, yet the IRS pointed to "thin capitalization" to argue against the taxpayer's captive in *Malone* & *Hyde, Inc. v. Commissioner,* 62 F.3rd 835 (6th Cir. 1995). What Congress made user friendly in enacting Section 831(b), the IRS seeks to make toxic by its "Dirty Dozen" dragnet audits, its bad faith industry litigation and now its latest proposed poisonous regulation.

The IRS would "throw out the baby with the bath water," rather than develop reasonable standards, in cooperation with the small captive insurance industry. There may be bad actors in the small captive industry, just as there are bad priests, ministers, doctors and lawyers, but just as those professions should not be eradicated in response, neither should small captive insurance.

The proposed regulation should be withdrawn or, at a minimum, further consideration of it should be postponed pending a decision in the *Loper* case.

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