IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

Drake Plastics Ltd. Co.; Drake Insurance Co.; and Strategic Risk Alternatives, LLC d/b/a SRA 831(b) Admin, *Plaintiffs*, v. Internal Revenue Service; the Hon. Michael Faulkender, Acting Commissioner of the Internal Revenue Service, in his official capacity; Department of the Treasury; and Scott Bessent, Secretary of the Treasury, in his official capacity, *Defendants*.	Civil Action No. _____

PLAINTIFFS DRAKE PLASTICS LTD. CO., DRAKE INSURANCE CO., AND STRATEGIC RISK ALTERNATIVES, LLC D/B/A SRA 831(B) ADMIN'S ORIGINAL COMPLAINT

1. This case is the latest salvo in the Internal Revenue Service's ("IRS") attack on small captive (or "micro-captive") insurance companies. Micro-captive insurance is a form of insurance that States carefully regulate, which Congress specifically encouraged and is now at risk of extinction by administrative fiat. In a final rule titled *Micro-Captive Listed Transactions and Micro-Captive Transactions of Interest*, 90 Fed. Reg. 3,534 (Jan. 14, 2025) (the "Final Rule") (attached as Exhibit 1), the IRS manifested an existential threat to the micro-captive insurance industry by purporting to categorize a vast swath of micro-captive insurance transactions—

which lawfully provide insurance under state law and comply with the strictures that Congress established for special income tax treatment—as not insurance at all, but rather as presumptively illegal tax shelters. The Final Rule impermissibly allocates to the IRS new powers as a de facto federal regulator of captive insurance companies and is contrary to the statutory text and basic administrative law requirements for reasoned decision making. If upheld, the Final Rule will gut the federal income tax benefit Congress created to make micro-captives economically viable, devastating small businesses' ability to leverage these necessary insurance arrangements for themselves and their employees.

2. Captive insurance is a type of risk financing in which a business or group of businesses incorporate a licensed and regulated insurance entity, colloquially known as a "captive," to insure the risks of the business or group and, occasionally, third party entities. These captive arrangements offer control over all aspects of an insurance program, including coverage, underwriting, claims management, and even the investment of reserves. This increased control allows for highly customized coverage tailored to the insureds' unique risk profiles, often filling real gaps in the commercial insurance markets or providing insurance coverages otherwise unavailable or unaffordable. Captive insurance arrangements also lower insurance premiums by providing coverage for specific risks, such as low-frequency but high-severity risks for which conventional commercial insurance coverage may be prohibitively expensive or unavailable. For example, captive insurers can provide coverage for natural disasters, like earthquakes, hurricanes, and tsunamis, or

industry-specific hazards like oil spills, and new or emerging threats like cyber and artificial intelligence risks that businesses face.

3. There is no free lunch: all small insurance companies, including captives, demand significant capital to qualify with States' minimum statutory requirements, and require skilled professionals to operate, managed insured risks, pay claims, and remit federal income taxes on taxable underwriting profits. These burdensome capital expenditures pose barriers for all small insurance companies. As a consequence, small insurance companies providing necessary coverage for farmers and other under-insured businesses fall into insolvency at a disproportionate rate and wreck the risk financing opportunities for small and middle market American businesses.

4. Recognizing this inequity and the unique challenges facing small and middle market businesses in accessing affordable and comprehensive insurance, Congress enacted Section 831(b) of the Internal Revenue Code, 26 U.S.C. § 831(b), to provide targeted relief for all small insurance companies, including micro-captives, so long as they meet certain statutory criteria.[1] Section 831(b) authorizes qualifying micro-captive insurance companies to pay federal income taxes only on investment income, without paying federal income taxes on insurance underwriting (premium) income. This relief is critical, as the viability of the micro-captive insurance industry

[1] Revenue Act of 1916, Pub. L. 64-271 § 11(a), Stat. 756 (1916). Congress re-designated this income tax exemption to different sections of the Internal Revenue Code as part of the Revenue Acts of 1918, 1924, 1926, 1928, 1934, and 1942. The Tax Reform Act of 1986 codified I.R.C. § 831 and redesignated the small insurance company income tax exemption into I.R.C. § 831(b).

pivots on businesses' ability to offset the cost of forming and operating a captive and level the playing field between small and large businesses with respect to the use of captive insurance. *See* Taylor & Sobel, *A Closer Look at Captive Insurance*, CPA J. 48 (June 2008). Section 831(b) has thus allowed small insurance companies and the nascent micro-captive insurance industry to flourish, with thousands of businesses across the United States now benefitting from micro-captive insurance companies' flexible and valuable benefits, which include lower and more predictable insurance premiums and the ability to purchase any required reinsurance at wholesale prices from the secondary market.

5. Despite these many congressionally afforded benefits, the IRS has repeatedly demonstrated hostility to captive insurance transactions. The IRS's decades-long war of attrition against these lawful vehicles has taken many forms, including designating this congressionally favored arrangement on its "Dirty Dozen" list of purported tax scams. The agency's actions reflect a persistent effort to undermine a congressionally favored insurance solution for thousands of small and middle market businesses.

6. In 2016, the IRS unlawfully bypassed congressional authority by targeting micro-captives via Notice 2016-66, which classified certain micro-captive transactions as potentially tax-abusive "transactions of interest." Without statutory basis, the IRS inflicted a designation reserved for tax shelters upon micro-captive insurance companies despite Section 831(b). A federal court rebuked the IRS and invalidated Notice 2016-66 in 2022, holding both that the IRS flouted the

Administrative Procedure Act's ("APA") notice-and-comment process and failed to provide a factual basis for its claim that micro-captive insurance transactions are abusive. *CIC Services, LLC v. IRS*, 592 F. Supp. 3d 677, 684–85 (E.D. Tenn. 2022), *as modified by* 2022 WL 2078036 (E.D. Tenn. June 2, 2022).

7. Undeterred, the IRS doubled down on its campaign to extinguish micro-captive insurance companies. In 2023, the agency issued and sought comments on a proposed rule entitled *Micro-Captive Listed Transactions and Micro-Captive Transactions of Interest*, 88 Fed. Reg. 21547 (Apr. 11, 2023) (attached as Exhibit 2). Like the invalidated Notice 2016-66, the proposed regulation identified certain micro-captives as "transactions of interest." But the proposed rule went even further and reclassified all micro-captives meeting arbitrary loss ratios as "listed transactions"—that is, presumptive tax shelters—and captured the vast majority of the micro-captive insurance industry through its non-statutory thresholds.

8. As members of the House of Representative's Ways and Means Committee explained after the IRS's proposal, the proposed rule evidences the IRS's "concerted effort" to undermine the micro-captive industry "by alleging systematic and undefined abuses," mandating "broad," "duplicative," and "expensive" reporting obligations, "failing to make any good faith effort to restrict its enforcement actions to fraudulent or abusive small captives," and relying on a "nationwide dragnet audit

program" to target the entire micro-captive industry. Letter from Rep. Beth Van Duyne, et al. to Commissioner Daniel Werfeld, IRS (Dec. 6, 2023).[2]

9. Commenters also criticized the proposed rule. Several commenters explained that the proposed rule (and, in particular, its unworkable loss ratios) would effectively eliminate the federal income tax benefit Congress provided micro-captives in Section 831(b). Others explained that the proposed rule impermissibly interfered with States' authority to regulate the business of insurance, in violation of the McCarran-Ferguson Act. *See* 15 U.S.C. §§ 1011, 1012.

10. Defying both judicial precedent and legislative authority, the IRS nevertheless promulgated the Final Rule, which perpetuates the agency's *CIC Services* defeat. The Final Rule classifies many micro-captive insurance transactions as presumptive tax-avoidance schemes using non-statutory criteria and imposes onerous reporting obligations on micro-captive insurers and their material advisors in connection with these classifications. Like the now-invalidated Notice 2016-66, the Final Rule recycles the IRS's pattern of hijacking micro-captive insurance companies, undermining the tax benefits that Congress created and deterring participation in a lawful and beneficial industry that Congress encouraged.

11. The Final Rule not only deprives businesses of the income tax benefits that Congress itself created, but chills the captive insurance industry by discouraging current and potential captive insurers and material advisors to establish and

[2] Available at https://www.taxnotes.com/research/federal/other-documents/irs-tax-correspondence/lawmakers-seek-ensure-survival-microcaptives/7hpzn (all websites last visited June 2, 2025).

maintain captive insurance companies, as well as by causing some existing captive insurance companies to cease operations. The IRS's efforts have thus undermined small businesses' ability to benefit from the advantages of captive insurance.

12. The Final Rule exceeds the IRS's statutory authority by designating insurance transactions in full compliance with both state insurance laws, as well as the Internal Revenue Code, as potentially or presumptively abusive tax avoidance schemes. Through this sweeping classification scheme, the IRS arrogates to itself newfound power to define unilaterally what constitutes insurance as per the IRS's whim. This is a role Congress reserved primarily for the States pursuant to the McCarran Ferguson Act. The States properly regulate micro-captive insurance transactions, as Congress provided.

13. Like its invalidated predecessor, the IRS's latest effort to destroy micro-captive arrangements is also arbitrary and capricious, and violates the basic reasoned decision-making requirements embodied in the APA. The IRS fails to point to any record evidence, data, or reasoned explanation for its belief that micro-captive insurance arrangements that meet its invented, non-statutory criteria pose the threat of tax evasion. It instead draws arbitrary lines for determining whether a micro-captive insurance transaction constitutes a listed transaction or a transaction of interest—lines without basis in the record and which simply serve the agency's arbitrary and capricious view concerning what constitutes legitimate insurance and what constitutes tax evasion. The IRS thus seeks to nullify the Section 831(b) transaction by bureaucratic fiat, in violation of multiple federal laws.

14. For the reasons set forth herein, the Final Rule must be set aside.

PARTIES

15. Plaintiff Drake Plastics Ltd. Co. ("Drake Plastics") is a Texas limited liability company with its principal place of business in Harris County, Texas. Drake Plastics was founded in 1996 and specializes in extruding, injection molding, post-processing, and machining ultra high-performance polymers. Drake Plastics is the owner of Plaintiff Drake Insurance Co., which is a captive insurance company.

16. Plaintiff Drake Insurance Co. ("Drake Insurance") is an unincorporated protected cell of Southern Safe Insurance Ltd., domiciled in North Carolina with its principal place of business in Harris County, Texas. Drake Insurance is a captive insurance company providing workers compensation, product liability, errors and omissions, and other types of insurance coverages for Plaintiff Drake Plastics, as well as over 30 related entities. Drake Insurance first made a Section 831(b) election in 2014, but chose to revoke that election as a result of the Final Rule in 2025.

17. The Final Rule significantly harms Drake Plastics and Drake Insurance in several ways.

18. First, the Final Rule imposes costly and untenable reporting requirements on Drake Plastics and Drake Insurance. Specifically, the Final Rule requires Drake Insurance and Drake Plastics to review their transactions for the past three years to determine the required disclosures. Although this review is ongoing, Drake Insurance, Drake Plastics, and other related entities insured by Drake Insurance have identified over thirty transactions that constitute reportable

transactions, as either "listed transactions" or "transactions of interest," under the Final Rule. The process of reviewing those past transactions—including financial and operational information related to Drake Insurance and the coverage it provides to Drake Plastics and its other insureds—and preparing or correcting the necessary disclosure forms (e.g., IRS Form 8886) to comply with the Final Rule requires substantial time, effort, and financial resources, and will greatly increase the time and expense associated with the preparation of tax returns. Further, the Final Rule could require Drake Plastics and Drake Insurance to incur costs related to the provision of additional information to the IRS, including during a subsequent audit, based on these disclosures.

19. Second, the Final Rule exposes Drake Plastics and Drake Insurance to fines and/or criminal liability if those entities fail to comply with the Final Rule's reporting requirements. *See* 26 U.S.C. §§ 6707A, 7203.

20. Third, the Final Rule subjects Drake Plastics and Drake Insurance to reputational harm and loss of goodwill resulting from the disclosure of transactions that the Final Rule deems potentially or presumptively abusive and efforts to inform relevant parties of those disclosures. Drake Plastics and Drake Insurance will also incur time and expense associated with informing relevant parties of these disclosures.

21. Fourth, Drake Plastics and Drake Insurance's disclosures of reportable transactions are likely to generate additional scrutiny from state regulators because disclosures to the IRS can trigger automatic reporting requirements in various U.S.

state tax agencies. Drake Plastics and Drake Insurance could incur further costs related to reviewing, copying, and producing additional documents and materials that state taxation authorities may ask for because of the disclosures described in the foregoing paragraphs.

22. Because the Final Rule requires that these disclosures be made on a yearly basis, these harms are ongoing. The Final Rule will continue to harm Drake Plastics and Drake Insurance because, should those entities continue to engage in transactions deemed reportable, the Final Rule will require them to continue to spend time preparing and submitting the required disclosures, and incurring costs associated with the same, on an ongoing basis.

23. As a direct result of the Final Rule, the principals of Drake Plastics chose to revoke Drake Insurance's Section 831(b) election—and consequently, its federal tax advantaged status—in April 2025, and will only reinstate that election if the Final Rule is enjoined. This is because the Final Rule characterizes many of Drake Insurance's normal and legitimate micro-captive transactions as being presumptively or potentially tax avoidant, and consequently exposes Drake Plastics and Drake Insurance to the aforementioned costly and untenable reporting requirements, loss of goodwill, enhanced regulatory scrutiny from state taxation authorities and the IRS, and potential penalties.

24. Plaintiff Strategic Risk Alternatives, LLC d/b/a SRA 831(b) Admin ("SRA"), is an Idaho limited liability company with its principal place of business in Meridian, Indiana that creates and manages micro-captive insurance plans for

closely held, private businesses in a wide array of industries. SRA provides captive insurance company management services to many clients that are subject to the Final Rule, including many clients that will have reportable transactions under the Final Rule, and receives income in return for those services.

25. SRA is a material advisor as defined by the IRS regulations. *See* 26 C.F.R. § 301.6111-3(b) (defining "material advisor" as any person that "provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction" and receives income in return).

26. As a material advisor, SRA must disclose to the IRS any reportable transaction that it assisted clients with over the past six years. *See* 26 U.S.C. § 6111; 26 C.F.R. §§ 301.6111-3(a), 1.6011-10(h)(3), 1.6011-11(h)(3). SRA must also maintain a list of the clients for whom SRA acted as a material advisor with respect to those transactions, *see* 26 U.S.C. § 6112(a), and disclose that list to the IRS upon request, 26 C.F.R. §§ 301.6112-1(e).

27. The Final Rule harms SRA in numerous ways.

28. First, the Final Rule subjects SRA to substantial compliance costs, including time and money spent reviewing the financial and operating information for the significant number of captive insurance companies SRA manages and advises, determining whether disclosures are required based on that information, and, if so, preparing and submitting disclosures of those reportable transactions to the IRS. SRA has already begun this process in order to submit required disclosures by July

31, 2025, *see* Internal Rev. Serv., Notice 2025-24,[3] and SRA therefore has already generated costs associated with compliance with the Final Rule. Further, the Final Rule could require SRA to incur costs related to the provision of additional information to the IRS, including during a subsequent audit, based on these disclosures.

29. Second, the Final Rule exposes SRA to fines and/or criminal liability if it fails to comply with the applicable reporting requirements. *See* 26 U.S.C. §§ 6112, 6707, 6708, 7203.

30. Third, the Final Rule subjects SRA to reputational harm and loss of goodwill from clients by classifying standard captive insurance transactions as presumptive tax shelters and requires SRA to incur time and expense associated with informing clients of these disclosures.

31. Fourth, the Final Rule harms SRA by subjecting SRA to additional scrutiny from state regulators because the disclosure of a reportable transaction to the IRS triggers automatic reporting requirements in various U.S. state tax agencies. SRA could incur further costs related to reviewing, copying, and producing additional documents and materials that state taxation authorities may ask for because of the disclosures described in the foregoing paragraphs.

32. Fifth, the Final Rule will harm SRA by causing a contraction in the market for captive insurance and, consequently, reducing the number of clients that will seek SRA's services related to the formation and management of captive

[3] Available at https://www.irs.gov/pub/irs-drop/n-25-24.pdf.

insurance companies. Such a market impact will cause SRA to lose revenue, profits, and goodwill. SRA has already engaged in discussions with clients expressing concerns that the Final Rule has made them hesitant to proceed with the formation or utilization of captive insurance companies.

33. Because the Final Rule requires that these disclosures be made on a yearly basis, these harms are ongoing. In this way, the Final Rule will continue to harm SRA because, as long as it continues to serve as a material advisor to clients with micro-captive transactions deemed reportable under the Final Rule, SRA will be required to report those transactions and identify those clients to the IRS, while incurring costs associated with the preparation and submission of those disclosures, on an ongoing basis.

34. SRA and its clients previously experienced similar harms when the IRS issued Notice 2016-66 in 2016, which similarly classified many legitimate micro-captive insurance transactions as reportable transactions and required those transactions to be disclosed to the IRS.

35. Defendant IRS is an agency of the United States. The IRS is within the Department of the Treasury, which is a department of the United States. The IRS issued the Rule.

36. Defendant Michael Faulkender is the acting Commissioner of the IRS. He is sued in his official capacity.

37. Defendant Department of the Treasury is a department of the United States and is the parent agency of the IRS. The Department of the Treasury co-authored and co-issued the Rule.

38. Defendant Scott K. H. Bessent is the Secretary of the Department of the Treasury. He is sued in his official capacity.

JURISDICTION AND VENUE

39. This Court has subject-matter jurisdiction under 28 U.S.C. § 1331 and the APA, 5 U.S.C. §§ 701–706.

40. Venue is proper in this District under 28 U.S.C. § 1391(e)(1) because Defendants are agencies of the United States and officers of the United States acting in their official capacity, a substantial part of the events or omissions giving rise to the claims occurred in this District, and Plaintiff Drake Plastics maintains its principal place of business in this District.

41. The APA waives the sovereign immunity of the United States for the relief sought in this Complaint. 5 U.S.C. § 702.

BACKGROUND

I. The Captive Insurance Industry

42. Captive insurance is a form of self-insurance in which an insurance company insures or reinsures the risks of its corporate parent and/or one or more related or unrelated entities.

43. In the 1950s, Youngstown Sheet and Tube established what is widely considered to be the first modern captive insurance arrangement as a way of insuring

its own mining operations. *See Avrahami v. Comm'r*, 149 T.C. 144, 177 (2017). Like today, companies during this early period formed captives to provide, *inter alia*, specialized coverage for risks specific to themselves and their affiliates (such as the risks associated with Youngstown's mining operations). Oftentimes, these are risks that are not readily insurable in the commercial market, meaning that commercial insurers are either unwilling to provide coverage or will only do so at a significant premium. *See id.*; *see also Regulation and Supervision of Captive Insurance Companies*, Int'l Ass'n of Ins. Supervisors 4 (2006).

44. Today, the "vast majority of Fortune 500 companies" use captive insurers, Chang & Chen, *Characteristics of S&P 500 Companies with Captive Insurance Subsidiaries*, 37 J. of Ins. Reg. 1, 19 (2018), as do a wide array of small businesses.

45. Captive insurance companies are closely regulated by the laws of the State in which they are formed. Captive insurance laws typically limit the types of financial transactions a captive may engage in with its policyholders, *see, e.g.*, S.C. Code. 38-90-105, mandate that a captive meet certain minimum capitalization requirements and maintain a minimum amount of surplus to ensure payment of liabilities in the case of a loss, *see, e.g.*, Tex. Ins. Code § 964.056, and require approval from the Commissioner of Insurance to pay policyholder dividends, *see, e.g.*, Vt. Stat. tit. 8 § 6005.

46. Captive insurance arrangements offer numerous benefits to insureds. Using a captive allows an insured to tailor its coverage to the specific needs of its

business, including coverage for low-frequency, high-severity risks and/or idiosyncratic risks for which commercial insurance policies would be cost prohibitive or simply unavailable. *See* Phillip England et al., *Captive Insurance Companies: A Growing Alternative Method of Risk Financing*, 2 J. Payment Sys. L. 701, 703–04 (June 2007).

47. Using a captive insurer to bypass or limit reliance on the commercial insurance market also reduces and stabilizes the cost of insurance coverage. While significant administrative- and marketing-related overhead costs are typically baked into the price of commercial insurance policy premiums—often resulting in an increase in the cost of a premium beyond that warranted by the risk insured—captives typically have lower overhead costs and are not required to generate profit for external shareholders, which conditions allow them to offer reduced premium prices to policyholders. Additionally, premium prices offered by captive insurance companies are tailored to the risks insured against and performance of the insured, rather than annual fluctuations in the volatile commercial insurance market. And unlike a purchaser of commercial insurance, an entity insured by a captive can avoid inflated premiums by placing excessive risk in the reinsurance market and procuring insurance at wholesale rates.

48. Using a captive insurer also has positive impacts on an insured's cash flow. This is a result of both the lower premium prices and the fact that insurance premiums are part of the same corporate family. A captive insurance arrangement allows the corporate family to benefit from investment income generated from

premiums paid during the policy period and from any profits related to policy underwriting, which create additional funds from which claims can be paid and reduce the need for further funding from the insured entity. Use of a captive also reduces a corporate family's overall tax burden and consequently increases its post-tax cash flows.

49. Captive insurance delivers significant public and economic benefits by fundamentally transforming the insured's relationship with risk. Because insureds are, in most cases, also the owners of the captive, the insured possesses a direct financial stake in the captive insurance company's financial performance. This alignment of interests is the most powerful risk management and loss mitigation strategy that exists. Rather than merely transferring risk to a third-party insurer, businesses operating captive insurance companies are motivated to implement robust safety protocols, invest in employee training, and adopt industry best practices for risk mitigation because there is a profit motive to do so. This organic development of a culture of accountability and continuous improvement reduces the burden of catastrophic losses on individuals, the private sector, and the broader economy.

50. Unlike commercial insurance policyholders, who face regular premium increases and volatile insurance markets with inconsistent access to many types of commercial coverage, captive insurance company owners enjoy stable pricing, customized coverage, and retained underwriting profits. Commercial carriers often exclude catastrophic risks in their entirety, forcing the private sector to absorb losses that threaten solvency. Captive insurance companies permit companies to finance

losses through tax-advantaged accumulations of reserves via premiums paid to captives that compound over time.

II. Congress Provides Federal Income Tax Benefits To Make Captive Insurance Economically Viable For Small Businesses

51. Congress has recognized the advantages associated with captive insurance by providing federal income tax benefits that enable and incentivize businesses to form and operate their own micro-captives.

52. Running a captive insurance company requires significant formation expenses and ongoing operating costs. For instance, establishing a captive insurance company requires a firm to undertake a feasibility study and pay legal costs associated with entity formation and licensing. These costs can exceed $100,000. Risk Mgmt. Advisors, *Captive Insurance Cost Considerations*.[4] Once established, the captive incurs substantial operating costs, including monthly management fees, fees for actuarial services, legal and accounting fees, state insurance taxes, and regulatory fees, all while maintaining whatever minimum capital surplus is required under governing law.

53. The significant and upfront operational costs of managing any insurance company, captive or otherwise, attracted Congress's attention. Congress enacted Section 11(a) of the Internal Revenue Code ("IRC") in 1916 to exempt farmers' or other mutual hail, cyclone, or fire insurance companies, or similar organizations from taxation. Revenue Act of 1916, Pub. L. 64-271 § 11(a), Stat. 756 (1916). The reason

[4] Available at https://www.riskmgmtadvisors.com/captive-insurance-cost-considerations.

for this is that most mutual insurance companies operated on an assessment basis, where each member was assessed for losses as they occurred, or at the end of each year. *See Mut. Fire. Ins. Co. of Germantown v. United States*, 142 F.2d 344, 347 (3d Cir. 1944). Congress re-designated this income tax exemption to different sections of the IRC as part of the Revenue Acts of 1918, 1924, 1926, 1928, 1934, and 1942.[5] The 1942 House Report explained the necessity for this income tax limitation, stating that the gross income limitation was leveraged by small, local mutual insurance companies. H.R. Rep. No. 77-2333, 77th Cong., 2d Sess. 113 (1942).

54. The root of the IRC § 831(b) congressional inducement rests on the reality that small insurance companies need financial breathing room to become operational. IRC § 11(a) addressed a wave of small mutual insurance company failures impairing farmers' ability to secure coverage for various, hard-to-place agricultural risks. This is because small insurance companies struggle to balance the need to maintain minimum statutory capital requirements with losses and the requirement to pay federal income taxes. Congress intervened to level the playing field and ensure the development of small insurance companies. However, the initial congressional inducement was limited to mutual companies.

55. The Tax Reform Act of 1986 codified 26 U.S.C. § 831 and redesignated the small insurance company income tax exemption into Section 831(b). The new version of the law expanded its income tax exemption to both mutual and stock

[5] This introduced a gross income limitation similar to the modern IRC § 501(c)(15) which permits mutual and stock property and casualty companies to claim an exemption from tax if their net premium is less than $350,000.

insurance companies. Congress made these changes in order to "eliminate the distinction between small mutual [insurance] companies and other small [insurance] companies, and extend the benefit of the small [insurance] company provision to all eligible small [insurance] companies, whether stock or mutual." H.R. Rep. No. 99-426, 99th Cong., 1st Sess. 678 (1985); S. Rep. No. 99-313, 99th Cong., 2d Sess. 512 (1986). Thus, the success of the federal income tax exclusion for mutual insurance companies was successful and Congress chose to expand the federal income tax exclusion to all insurance companies writing less than a threshold amount of premium, thereby buttressing Congress's general intent of promoting the growth of small insurance businesses for the benefit of American citizens and the American economy.

56. Congress's federal income tax relief was successful and, in the ensuing decades, directly contributed to the growth of the captive insurance industry. By 2021, business owners regularly and lawfully used micro-captive insurance companies to secure a "tax-deferred incentive for businesses to self-insure risks they could not find on the open market, giving power and assurance back to the business owner." Van Carlson, *Today's Liability Crisis And Your Risk Management Options*, Forbes.com (Dec. 1, 2021);[6] Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085; 26 U.S.C. § 831(b).

[6] Available at https://www.forbes.com/councils/forbesbusinesscouncil/2021/12/01/todays-liability-crisis-and-your-risk-management-options.

57. Section 831(b) provides valuable income tax benefits to micro-captive insurance companies that meet certain criteria, allowing them to pay federal income tax only on the income earned from investing premiums, rather than on the premium income itself. 26 U.S.C. § 831(b).

58. A different section of the IRC (Section 162) also allows companies to deduct the "ordinary and necessary" cost of insurance from their taxable income. 26 U.S.C. § 162.

59. Together, Section 162 and Section 831(b) offset the costs of forming and operating a micro-captive insurance company, making captive insurance arrangements financially viable to small businesses and leveling the playing field between small and large businesses in the context of insurance coverage. *See* Taylor & Sobel, *A Closer Look at Captive Insurance*, CPA J. 48 (June 2008).

60. Congress subsequently "signaled its intent that the benefits of captive insurance remain available to small and medium U.S. businesses" by enacting the Protecting Americans from Tax Hikes ("PATH") Act of 2015, Pub. L. 114-113, 129 Stat. 2242. The PATH Act amended Section 831(b) to make its benefits available to more small captives, while ensuring that these arrangements are not used for tax-abusive estate planning purposes with *statutory* criteria. Letter from Representative Beth Van Duyne, *supra*.

61. The PATH Act extended benefits to captive insurers that receive less than $2.2 million in inflation adjusted annual premiums (increased from $1.2 million, as originally codified, 26 U.S.C. § 831(b) (1986))—making captive insurance

arrangements accessible to a wider array of businesses. *See* 26 U.S.C. § 831(b), 831(e).

62. According to a statement by Senator Chuck Grassley on February 11, 2015, farmers in rural communities still rely heavily upon small mutual insurance companies or farm mutuals for their insurance needs, and many farm mutuals were experiencing problems running up against the $1.2 million annual limitation.[7] The PATH Act demonstrates that Congress remains convinced that there is a need for federal income tax relief to sustain the market for small insurance companies. The tripartite drain of resources through claims, statutory minimum capital requirements, state premium taxes and various fees, along with federal income taxes is overly burdensome for a market to naturally manifest. Accordingly, Section 831(b) is necessary for all small insurance companies, captive or otherwise, to survive.

63. At the same time, the PATH Act imposed a "diversification" requirement on eligible captives to address concerns about perceived abuses of captives for estate planning, rather than insurance, purposes. Drew Estes, *Captive Insurance Companies: Why Policymakers Have It All Wrong*, 44 Cap. U. L. Rev. 723, 748–49 (2016).

64. After the PATH Act, Section 831(b) allows a captive insurer to avail itself of Section 831(b)'s income tax benefits if it satisfies three criteria. First, and as

[7] *See* Transcript Of Open Executive Session Relating To *Inter Alia*, An Original Bill Relating To Modifications To Alternative Tax For Certain Small Insurance Companies at 56, Hearing Before S. Comm. On Finance, 115th Cong. (Statement of Sen. Grassley), available at https://www.finance.senate.gov/imo/media/doc/2-11-15%20--%20Misc%20Tax%20Bills.pdf.

noted, the captive insurer must not receive more than $2.2 million in net written premiums during the taxable year. 26 U.S.C. § 831(b)(2)(A)(i). Second, the captive insurer must satisfy the "diversification" requirement—either by having "no more than 20 percent of the net written premiums . . . attributable to any one policyholder," (the "risk diversification test") or by having approximately the same level of family ownership interests in the captive and in the policyholders (the "relatedness test"). *Id.* §§ 831(b)(2)(A)(ii), (2)(B)(i)(I), (2)(B)(i)(II). Third, the company must "elect[ ] the application of this subsection for [the] taxable year" for which it seeks Section 831(b)'s benefit. *Id.* § 831(b)(2)(A)(iii).

65. The PATH Act of 2015 introduced specific and detailed diversification requirements for Section 831(b) micro-captive insurance transactions, targeting perceived abuses, particularly those related to estate planning. Congress intended for its amendments to Section 831(b), particularly the diversification requirements, to address concerns related to the potential misuse of 831(b) micro-captive insurance transactions. The PATH Act paired stricter rules aimed at precluding perceived estate planning abuses while also increasing the annual premium limit, indicating a desire to support the micro-captive insurance industry while curbing illegitimate uses.

66. The Consolidated Appropriations Act of 2018's amendments to clarify the PATH Act also indicates ongoing congressional attention to ensuring the proper application of those rules. Clear congressional action in 2015 with a follow up and clarification in 2018 reflects Congress's intent for the PATH Act to serve as the

lynchpin of proper governance of micro-captive insurance transactions for federal income tax purposes.

67. Section 831(b)'s income tax benefits have made captive insurance arrangements accessible for businesses by offsetting the up-front and operations costs associated with the formation and management of small captive insurance companies. Dave Lenckus, 831(b) *Captives: 'Small' Option Is Increasingly Big Idea for Midsize Cos.*, PropertyCasualty360 (May 3, 2012).[8]

68. While Congress decided to incentivize micro-captive insurance transactions by "enable[ing] [small captives] to defer corporate income tax," *Summa Holdings, Inc. v. Commissioner*, 848 F.3d 779, 786 (6th Cir. 2017), it largely respects States' authority to *regulate* the business of insurance.

69. Enacted in 1945, the McCarran-Ferguson Act acknowledges and reinforces States' primary authority to regulate and tax the business of insurance. *See* 15 U.S.C. § 1011. Under the McCarran-Ferguson Act, the "business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business." *Id.* § 1012(a).

70. The McCarran-Ferguson Act also provides that "[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance."

[8] Available at https://www.propertycasualty360.com/2012/05/03/831b-captives-small-option-is-increasingly-big-idea-for-midsize-cos/.

Id. § 1012(b). In other words, a federal law must respect state insurance law if that state law was enacted for the purpose of regulating the business of insurance. *See id.*

71. States have used this authority to pass laws governing the formation and operation of captive insurance companies. Over 30 states have robust captive insurance legislation, and although the contours of those regulatory regimes differ by jurisdiction, they largely all limit the types of financial transactions a captive may engage in with its policyholders, *see, e.g.*, S.C. Code. 38-90-105, mandate that a captive meet certain minimum capitalization requirements and maintain a minimum amount of surplus to ensure the captive has the means to pay claims in the case of a loss, *see, e.g.*, Tex. Ins. Code § 964.056, and require approval from the state's insurance commissioner before paying policyholder dividends, *see, e.g.*, Vt. Stat. tit. 8 § 6005.

III. The IRS Mounts An Ongoing Campaign Against Micro-Captives

72. Despite Section 831(b)'s encouragement to small businesses to form micro-captives, and States' authority over the regulation of the insurance services provided by captive insurance companies, the IRS has waged a decades-long campaign against micro-captives, treating them not as legitimate insurance, but as a tax evasion scheme. *See* Estes, *supra,* at 746.[9]

[9] *See, e.g.*, *Carnation Co. v. Comm'r*, 71 T.C. 400 (1978), *aff'd*, 640 F.2d 1010 (9th Cir. 1981); *Stearns-Roger Corp. v. United States*, 774 F.2d 414 (10th Cir. 1985); *Clougherty Packing Co. v. Comm'r*, 84 T.C. 948 (1985), *aff'd*, 811 F.2d 1297 (9th Cir. 1987); *Humana Inc. v. Comm'r*, 88 T.C. 197 (1987), *aff'd in part, rev'd in part*, 881 F.2d 247 (6th Cir. 1989); *Mobil Oil Corp. v. United States*, 8 Cl. Ct. 555 (1985); *Beech Aircraft Corp. v. United States*, 797 F.2d 920 (10th Cir. 1986); *Gulf Oil Corp. v. Comm'r*, 914 F.2d 396 (3d Cir. 1990); *Amerco, Inc. v. Comm'r*, 96 T.C. 18 (1991), *aff'd*, 979 F.2d 162 (9th Cir. 1992); *Harper Group v. Comm'r*, 96 T.C. 45 (1991), *aff'd*, 979 F.2d 1341 (9th Cir. 1992); *Malone & Hyde, Inc. v. Comm'r*, 62 F.3d 835 (6th Cir. 1995); *Ocean Drilling & Exploration Co. v. United States*, 988 F.2d 1135 (Fed. Cir. 1993); *Rent-A-Center, Inc. v. Comm'r*, 142 T.C. 1 (2014); *Securitas Holdings,*

73. In 1977, the IRS issued a ruling prohibiting businesses from deducting the cost of captive insurance premiums from their taxable income, as contemplated by 26 U.S.C. § 162. IRS Rev. Rul. 77-316. The IRS based its decision on the "economic family" doctrine, which presumes that the risk distribution typical of insurance does not exist when a parent company pays insurance premiums to its subsidiary (rather than to a third party) because the risk remains held within the same economic family.

74. When courts rejected the IRS's position and affirmed that captive insurance companies do, in fact, provide insurance for federal income tax purposes, *see*, *e.g., Humana Inc. v. Comm'r*, 881 F.2d 247, 251 (6th Cir. 1989); *Harper Group v. Comm'r*, 96 T.C. 45, 57 (1991), *aff'd*, 979 F.2d 1341 (9th Cir. 1992); *Rent-A-Center, Inc. v. Comm'r*, 142 T.C. 1, 15 (2014); *Securitas Holdings, Inc. v. Comm'r,* T.C. Memo. 2014-225, the IRS turned its focus to micro-captives, arguing that micro-captives generally operate as tax shelters formed to abuse the benefits provided to them by the Internal Revenue Code, rather than providing legitimate insurance to their insureds.

75. Beginning in 2015, the IRS included Section 831(b) captives on its "Dirty Dozen" list of tax scams, using this clarification to launch an audit and investigation campaign against Section 831(b) captive promoters and operators. *See* Internal Revenue Bulletin 2015-19; Internal Revenue Bulletin 2016-25. Micro-captive

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Inc. v. Comm'r, T.C. Memo 2014-225; *R.V.I. Guar. Co. v. Comm'r*, 145 T.C. 209 (2015); *Avrahami*, 149 T.C. at 144 ; *Reserve Mech. Corp. v. Comm'r*, T.C. Memo 2018-86, *aff'd*, 959 F.3d 1324 (10th Cir. 2020); *Syzygy Ins. Co. v. Comm'r*, T.C. Memo 2019-34; *Caylor Land & Dev., Inc. v. Comm'r*, T.C. Memo 2021-30; *Keating v. Comm'r*, T.C. Memo 2024-2; *Swift v. Comm'r*, T.C. Memo 2024-13; *Patel v. Comm'r*, T.C. Memo 2024-34; *Royalty Mgmt. Ins. Co. Ltd. v. Comm'r*, T.C. Memo 2024-87.

insurance appeared on numerous iterations of the Dirty Dozen list of purportedly "[b]ogus tax avoidance strategies." Internal Rev. Serv., *Dirty Dozen: Bogus tax avoidance strategies, schemes with an international element wrap up annual taxpayer awareness campaign* (Apr. 11, 2024).[10]

76. The IRS's campaign against micro-captives continued with the publication of Notice 2016-66 in 2016. Notice 2016-66 classified certain micro-captive insurance transactions as "transactions of interest." A "transaction of interest" is a type of "reportable transaction" that "the Secretary determines as having a potential for tax avoidance and evasion" under 26 C.F.R. § 1.6011-4 and 26 U.S.C. § 6011. 26 U.S.C. § 6707A(c)(1) (defining "reportable transaction"). Put simply, a "transaction of interest" is potentially an abusive tax shelter transaction.

77. Under the Notice, a micro-captive insurance transaction was a "transaction of interest" if (1) the micro-captive insurer elected Section 831(b) status, (2) at least 20% of the micro-captive was owned by a policyholder or its affiliates, and (3) the micro-captive either provided tax-free financing to its insureds or had a loss ratio of less than 70%. Internal Rev. Serv., Notice 2016-66.[11] "Loss ratio" refers to the amount an insurance company must pay to cover its insurance claim liabilities and expenses, divided by the amount of premiums received minus policyholder dividends paid.

[10] Available at https://www.irs.gov/newsroom/dirty-dozen-bogus-tax-avoidance-strategies-schemes-with-an-international-element-wrap-up-annual-taxpayer-awareness-campaign.

[11] Available at https://www.irs.gov/pub/irs-drop/n-16-66.pdf.

78. The Notice required taxpayers and material advisors involved in a micro-captive arrangement that met this definition of "transaction of interest" to disclose the transaction to the IRS, Internal Rev. Serv., Notice 2016-66 § 3.01, and provided that persons who failed to make required disclosures "may be subject to [ ] penalty" under 26 U.S.C. §§ 6707(a), 6707A, and 6708(a), *id.* § 3.06. These statutory provisions impose financial penalties on taxpayers "who fail[ ] to include on any return or statement information with respect to a reportable transaction." 26 U.S.C. § 6707A(a); *id.* § 6707(a) (penalizing failure to furnish information about reportable transactions); § 6708(a) (penalizing material advisor's failure to identify persons involved in a reportable transaction).

79. A taxpayer that participates in a "reportable transaction," such as a listed transaction or transaction of interest, must file a "Reportable Transaction Disclosure Statement" (also known as a Form 8886) both with its tax return and directly with the IRS's Office of Tax Shelter Analysis ("OTSA"). The Form 8886 demands taxpayers disclose significant details about the transaction, including: (1) basic information about the taxpayer such as the name, address, and identification number; (2) a description of the transaction referencing the factors giving rise to the purportedly reportable transaction with details on the loss ratio or financing factors triggering the necessity to file the Form 8886; (3) information about all parties involved, including the insured business, the captive insurance company, and any parties relating in financing arrangements; and (4) total fees paid to any advisors or promotors related to the transaction. Forms 8886 provide the OTSA with

an audit roadmap, and returning a Form 8886 substantially increases the likelihood of a subsequent audit by the IRS.

80. In 2022, the Eastern District of Tennessee invalidated Notice 2016-66 under the APA on two independent grounds. First, Notice 2016-66 was an invalid "legislative rule," promulgated without adherence to the APA's mandatory notice and comment procedures. *CIC Servs., LLC,* 592 F. Supp. 3d at 682. Second, Notice 2016-66 was arbitrary and capricious because "the administrative record fails to include relevant data and facts supporting the IRS's decision to designate micro-captive arrangements as transactions of interest, and, thus, reportable transactions." *Id.* at 685. As the court explained, although the Notice provided that the "IRS believe[s]" micro-captive transactions have "a potential for tax avoidance or evasion," the Notice "does not identify any facts or data supporting its belief," *id.*, and the Notice must therefore "be set aside as agency action that is arbitrary and capricious," *id.* at 687.

81. The court thus "vacat[ed] the Notice in its entirety," *id.* at 687–88, while echoing "the Sixth Circuit's prior observations that the IRS does not have a great history of complying with APA procedures" and that the agency "does not follow the basic rules of administrative law," *id.* at 688.

IV. The IRS Promulgates The Final Rule, Which Continues The Agency's Campaign Against Small Captives

a. The Proposed Rule

82. In 2023, the IRS issued and sought comments on a proposed rule entitled *Micro-Captive Listed Transactions and Micro-Captive Transactions of*

Interest, 88 Fed. Reg. 21547 (Apr. 11, 2023), to replace the invalidated Notice 2016-66.

83. Just like Notice 2016-66, the proposed regulation purported to identify many micro-captives as "transactions of interest" subject to onerous disclosure requirements, IRS scrutiny, and potential statutory penalties if any single policyholder owns at least 20% of the captive and the captive has a loss ratio of less than 65% for the prior nine taxable years (or all taxable years if the captive has existed for less than nine years). *Id.* at 21563.

84. But the proposed rule went considerably further in attacking micro-captives. Unlike Notice 2016-66, the proposed rule also purported to classify other micro-captives as "listed transactions"—that is, reportable transactions that the "IRS has determined to be a tax avoidance transaction," *id.* at 21549; 26 U.S.C. § 6707A(c)(2)—based on similar criteria. In other words, the IRS sought to classify many micro-captive insurance transactions that Congress specifically incentivized through Section 831(b) as *presumptively* abusive tax shelter transactions, without regard for whether they were deemed lawful insurance transactions under state law and complied with all criteria and safeguards in Section 831(b).

85. Under the proposed rule, a transaction would be a "listed transaction" if any single policyholder owned at least 20% of the captive and the captive *either* engaged in related-party transactions within the last five years *or* had a loss ratio of less than 65% within the most recent ten taxable years. 88 Fed. Reg. at 21563.

86. The proposed rule would require participants in transactions carrying the attributes of "listed transactions" or "transactions of interest" to disclose to the IRS significant business operation information, including the types of policies issued, the amounts treated as premiums, identification of actuaries and underwriters involved in the transaction, and information about claims. *Id.* at 21551. Under the proposed rule, failure to provide this information triggers statutory penalties under 26 U.S.C. § 6707A and extends the statute of limitations for tax assessment until the participant furnishes the required information.

87. The proposed rule attracted significant objections from Congress, particularly the House Ways and Means Committee. As Representative Beth Van Duyne wrote, "the Notice of Proposed Rulemaking that the IRS issued on April 10 (REG-109309-22) would effectively eliminate the section 831(b) election for all or most small captive insurance companies." Letter from Rep. Beth Van Duyne, *supra*. The same letter reaffirmed that "Congress has long supported, and continues to support, the policy of providing a tax benefit to small businesses that incentivizes the formation of small captive insurance companies to manage risk. The IRS may not eliminate laws that it finds inconvenient to administer or somehow troublesome, nor may it legislate via regulation." *Id.*

88. The House Ways and Means Committee pointed out that "the IRS appears to be engaged in a concerted effort to dissuade new entrants into the small captive insurance market and drive out those already involved in the industry by alleging systematic and undefined abuses; imposing overly broad,

potentially duplicative, and expensive reporting and disclosure requirements on all participants in small captive insurance; failing to make any good faith effort to restrict its enforcement actions to fraudulent or abusive small captives; and targeting the entire industry via a nationwide dragnet audit program." *Id.*

89. The proposed rule also received significant industry criticism during the comment period.

90. For instance, Plaintiff SRA submitted comments in opposition to the proposed rule. *See* SRA 831(b) Admin Comment Letter ("SRA Comment") (attached as Exhibit 3). Plaintiff SRA challenged the proposed rule on multiple grounds that are relevant here. First, Plaintiff SRA explained that the proposed rule deviates from "the clear guidelines established by Congress" in the PATH Act's diversification requirements. SRA Comment at 1. Second, the proposed rule's Loss Ratio Factor "fail[ed] to consider several critical characteristics in" the micro captive insurance business. SRA Comment at 2. In particular, the IRS's "use of health insurance as a benchmark for comparison . . . presents an apples-to-oranges scenario," in light of the unique risks insured by micro-captives and the existence of "adverse selection" in the health insurance market. SRA Comment at 2. Plaintiff SRA further criticized the IRS's reliance on NAIC data, noting that the dataset "fails to account for the fact that participants utilizing an 831(b) plan often represent profitable risks for insurance companies, characterized by sound underwriting practices, effective risk controls, and a history of low claims." SRA Comment at 2. Third, Plaintiff highlighted the "unintended consequences" of the proposed rule, cautioning that it would "undermine

the original intent" of Section 831(b), "incentivize [micro-captives] to maintain minimal reserves," and "encourage the distribution of profits, leaving [micro-captives] with limited resources to withstand unforeseen challenges or invest in growth opportunities." SRA Comment at 3. Fourth, the proposed rule "fails to address" the IRS's "stated concerns," including because the factors identified in the proposed rule "may not accurately capture the true risk profiles and needs of business utilizing 831(b) micro-captives." SRA Comment at 3. Fifth, the "taxpayer burden" of the proposed regulations, noting that the rule's disclosure requirements would "effectively double the cost of annual tax preparation and filing for the majority" of micro-captives." SRA Comment at 4.

91. Multiple other commentors noted that the proposed rule's 65% loss ratio is arbitrary because of significant differences between the business models of property and casualty insurers versus health and life insurers, The Queen Firm Comment Letter at 2 ("Queen Comment") (attached as Exhibit 4), that create an "apples-to-oranges" comparison, 831(b) Institute Comment Letter at 1 ("831(b) Comment) (attached as Exhibit 6). Many of these commentors stressed that the use of this loss ratio will necessarily target captives "that [i]nsure [l]ow [f]requency and [h]igh [s]everity [r]isks," such as the captive covering the risk of damage from domestic terrorism. Oklahoma Dep. of Ins. Comment Letter at 2 ("Oklahoma Comment) (attached as Exhibit 5).

92. Other commentors stressed that "myriad commercial insurance coverages and companies [ ] have a loss ratio less than 65% over a 10-year period,"

and advocated for exceptions from the proposed rule's classification scheme if certain safeguards (such as an actuary's certification) are present. Self-Insurance Institute of Am. Comment Letter at 15 ("SIIA Comment") (attached as Exhibit 7). Other commentors explained that picking any specific loss ratio is inherently arbitrary because "risk transfer, and therefore variability in loss and loss adjustment expenses ratios to premium, is an essential element of insurance," "particularly . . . when insuring coverages exhibiting low claim frequency and high claim severity and also new, innovative or emerging coverages." Am. Academy of Actuaries Comment Letter at 1 ("AAA Comment") (attached as Exhibit 8).

93. Commentors also criticized the data that IRS used to attempt to justify the particular loss ratios selected in the Final Rule. To reach these particular Loss Ratio calculations, the IRS relied primarily on a dataset compiled by the National Association of Insurance Commissioners. But as commentors stressed, the NAIC dataset "includes personal lines as well as commercial lines" of insurance, and "aggregates every type of personal and commercial insurance within the property and casualty universe," and includes "myriad unrelated lines of business." Queen Comment at 5, 6; Oklahoma Comment at 5. "[U]se of a loss ratio data deriving from lines of coverage that in no way apply to captive insurance is an erroneous application of the data," Oklahoma Comment at 5, as the "entire U.S. property-casualty insurance industry . . . is capable of far more risk diversification or risk distribution than any single small insurer meeting the 831(b) election premium threshold," AAA Comment at 2.

94. These commentors also stressed that "a low combined ratio" is a sign "that the insured's risk management is good," and that "[p]unishing these middle market companies with arbitrarily high combined ratios depresses 831(b) captive insurance formation, which serves the interests of large commercial insurers and larger companies competing against the insureds within their industry." Queen Comment at 19. Put another way, a commentor explained that using this Loss Ratio "treat[]s diverse coverages across the insurance industry as somehow uniform," and "create[s] discriminatory standards across small-and medium-sized businesses, establishing a different playing field than what it expects for large commercial insurers and larger captives." SIIA Comment at 19.

95. Commentors also explained the loss ratios calculations were "unorthodox and out of step with both industry standards and regulatory practices" because the distribution of dividends is regulated by state law. Queen Comment at 2.

b. The Final Rule

96. On January 14, 2025, the IRS promulgated the Final Rule. Like the proposed rule, the Final Rule identifies many micro-captive arrangements as "transactions of interest" and "listed transactions" (with modifications to the criteria that triggers such classification), imposes onerous disclosure requirements on micro-captives that constitute either listed transactions or transactions of interest and material advisors to such transactions, and triggers substantial statutory penalties for non-disclosure.

97. The Final Rule imposes onerous disclosure requirements on a captive deemed to be a "transaction of interest" or a "listed transaction." A captive meeting the definition of a "transaction of interest" or "listed transaction" that fails to self-disclose as such is subject to statutory penalties of up to $200,000. 26 U.S.C. § 6706, 6707A, 6708, 7203.

98. Under the Final Rule, a micro-captive is a "transaction of interest" (and so potentially an abusive tax shelter transaction) if any one policyholder owns 20% or more of the captive (the "20 Percent Relationship Test"), and the micro-captive *either* provides financing to an insured (the "Financing Factor") *or* has a Loss Ratio of less than 60% for the prior 10 taxable years (the "Loss Ratio Factor"). 90 Fed. Reg. 3,534 at 3,535.

99. A micro-captive is a "listed transaction" (and so presumptively an abusive tax shelter transaction) if it meets the 20% Relationship Test and Financing Factor, *and* has a Loss Ratio Factor of less than 30% for the prior 10 taxable years. *Id.* A micro-captive must have existed for the prior 10 taxable years in order to have a listed transaction to report. *See id.* at 3,545.

100. 20 Percent Relationship Test. A micro-captive meets the "20 Percent Relationship Test" if at "least 20 percent of [its] assets or the voting power or value of its outstanding stock or equity interests is directly or indirectly owned, individually or collectively, by an Insured, an Owner, of persons Related to an Insured of an Owner." 26 C.F.R. § 1.6011-10(b)(1)(iii). In other words, as a threshold matter, the

Final Rule's obligations and consequences apply only to captives in which a single policyholder has a 20% or greater ownership stake.

101. Satisfying the 20% Relationship Test is a prerequisite to being deemed a listed transaction or transaction of interest under the Final Rule.

102. Using the 20% Relationship Test as a means of determining whether a micro-captive is a tax-abusive transaction rather than a legitimate provider of insurance is nonsensical given Congress's decision to amend Section 831(b) to allow micro-captives to qualify for federal tax benefits if *either* no policyholder owns more than a 20% stake in the captive *or* the captive's ownership structure roughly approximates the ownership structure in the insureds. 26 U.S.C. § 831(b)(2)(B).

103. Financing Factor. A captive satisfies the "Financing Factor" if it "made available as financing or otherwise conveyed" to a policyholder, a policyholder's owner, or a related party, funds "in a transaction that did not result in taxable income or gain," "any portion of the amounts" the captive earned from insurance contracts." 26 C.F.R. § 1.6011-10(c)(1)(i).

104. A captive that satisfies the Financing Factor (among other requirements), may be deemed a transaction of interest. By contrast, to qualify as a listed transaction, a captive *must* extend financing to an insured in an arrangement that does not generate taxable income for the insured.

105. Using the Financing Factor to determine whether a micro-captive engages in tax abuse rather than provides legitimate insurance is nonsensical and

ignores the fact that related-party financing is a key, *expected benefit* of a captive insurance arrangement.

106. Loss Ratio Factor. A captive meets the "Loss Ratio Factor" if, during the last ten taxable years, its "amount of liabilities incurred for insured losses and claim administrative expenses" is "less than 30 percent of" the "amount equal to premiums earned" minus policyholder dividends paid, for listed transactions, and "less than 60 perfect" of the same for transactions of interest. 90 Fed. Reg. at 3,560, 3,562.

107. Using the Loss Ratio to determine whether a micro-captive engages in tax abuse rather than provides legitimate insurance is nonsensical, because captive insurers will inherently have lower loss ratios than their peers in the commercial market and because captive insurers must (by nature and often by state regulation) maintain certain minimal capital surpluses to cover potentially catastrophic future liabilities.

108. As relevant here, the IRS attempted to respond to the numerous comments critiquing the proposed rule's Loss Ratio Factor, but those responses fall flat.

109. For instance, the IRS explained that "[t]he Loss Ratio Factor measures whether the amount of liabilities incurred for insured losses and claims administration expenses is significantly less than the amount of premiums earned, adjusted for policyholder dividends," because "[p]ricing premiums far in excess of what is reasonably needed to fund insurance operations results in a lower loss ratio and remains a strong indicator of tax avoidance." 90 Fed. Reg. at 3,540. But that

general rule fails to account for the unique characteristics of micro-captives, particularly those that insure against low frequency but high severity risks.

110. Relatedly, the IRS recognized that that low loss ratios may be the result of coverage of low-frequency, high severity risks, but explained that "inherent in insurance underwriting is the concept that by assuming numerous independent risks that will occur randomly, losses will become more predictable over time, and pricing should reflect those anticipated losses," and therefore adopted a conjunctive test to trigger classification as a listed transaction. 90 Fed. Reg. at 3,541. But this explanation fails to appropriately consider the extent to which certain captives may not incur claims within a 10 year period and fails to respond to comments explaining why that scenario would reflect good risk management on the part of an insured.

111. In light of those comments, the IRS reduced the Loss Ratio for listed transactions to 30% and required the existence of Financing Factor, while it reduced the loss ratio for transactions of interest to 60%—a mere five percent reduction from the proposed rule. But the IRS never explained why the inclusion of either factor—either individually or alone—would render a micro-captive insurance arrangement illegitimate and tax avoidant or evasive in this first place.

112. Additionally, despite these modifications, the IRS failed to support its reliance on the industry-wide NAIC data. Rather than search for an applicable dataset, the IRS relied on an apples-to-oranges comparison and complained that the commentors "did not identify any alternative published dataset" that would be more appropriate to consult. 90 Fed. Reg. at 3,542. But the lack of such a dataset does not

absolve the IRS of its obligation to consider the relevant evidence and reach a reasoned decision on the basis thereof.

113. Nor did the IRS justify its decision to include policyholder dividends in the Loss Ratio calculation. According to IRS, it included dividends in the computation for the sole purpose of giving taxpayers a way to "correct[ ] inappropriately accumulated premiums," and so prevent their micro-captive insurance transactions from being classified as either listed transactions or transactions of interest. 90 Fed. Reg. at 3,545. It concluded that "removing policyholder dividends from the computation would unfairly disadvantage Captives that choose to use policyholder dividends to correct overpriced policies," while brushing off commenters' concern that issuing policyholder dividends is not a common practice for micro-captives. *Id.*

114. If a micro-captive insurance transaction triggers a reporting requirement, then the taxpayer is mandated to file Form 8886 and disclose a significant amount of information. The IRS argues in precatory language within the Final Rule that this is merely an informational reporting requirement. This specious position is betrayed by the reality of how the IRS audits micro-captive insurance transactions.

115. The IRS employs several methods to select tax returns for an audit including but not limited to screening for returns with certain characteristics and targeted selection. The act of filing a Form 8886 dramatically increases the odds of IRS scrutiny because the act of disclosing a transaction via Form 8886 itself flags the transaction as containing tax avoidance characteristics. That triggers the attention

of the OTSA, whose primary role is to collect and analyze information regarding allegedly abusive tax shelters to inform the IRS's enforcement strategies. Accordingly, because disclosure is mandatory for reportable transactions, it inherently places the transaction under a higher level of review by the IRS.

116. Listed transactions are presumptively abusive.

117. Transactions of interest, on the other hand, are transactions with a purported "potential" for tax avoidance. While not carrying the same presumption of abuse as a listed transaction, a transaction flagged as a transaction of interest subjects taxpayers to a higher risk of audit compared to insurance company transactions that do not suffer from the IRS's arbitrary means of concocting listed transaction or transaction of interest for micro-captive insurance companies.

V. The Final Rule Will Wreak Havoc On The Micro-Captive Insurance Industry

118. The Final Rule casts a broad net that effectively classifies many micro-captive transactions either potentially or presumptively tax avoidant or tax evasive "reportable transactions."

119. For instance, because micro-captives are designed to insure against the risk of their parent companies and related entities, a small captive will often have fewer than five policyholders and therefore satisfy the 20 Percent Relationship Test, which triggers the Rule's application.

120. Most micro-captives will also easily satisfy the Financing Factor because the provision of financing by a captive to an insured is a key benefit of a captive insurance arrangement, as the IRS itself acknowledges. 90 Fed. Reg. at 3,546.

121. And most micro-captives easily satisfy the Loss Ratio Factor—whether pegged at 30 or 60 percent—because they often insure against low-frequency, high-severity risks and so are required to build large surplus reserves of capital to cover these rare but potentially catastrophic risks.

122. Thus, the Final Rule imposes onerous disclosure requirements on (and threatens to remove income tax benefits from) an enormous swath of the captive insurance industry. Complying with those disclosure obligations is costly and time consuming—it will double the cost of tax preparation for micro-captives, SRA Comment at 2, and expose micro-captives to the costs and burdens associated with subsequent, likely audits. And, given the targets of the Final Rule, these costs will ultimately be borne by businesses, many of which already operate with narrow margins. It also indirectly casts a pall on the industry and dissuades business—particularly small businesses—from availing themselves of the congressionally-approved captive insurance regime and its attendant benefits.

CLAIMS FOR RELIEF

COUNT I
Administrative Procedure Act, 5 U.S.C. § 500 et. Seq
The Final Rule Exceeds The IRS's Statutory Authority

123. Plaintiff repeats and realleges each and every allegation set forth in paragraphs 1 through 122, above.

124. Under the APA, a reviewing court must "hold unlawful and set aside agency action" that is "in excess of statutory jurisdiction, authority, or limitations" or "otherwise contrary to law." 5 U.S.C. § 7016(2)(C).

125. The IRS exceeded its statutory authority in promulgating the Final Rule in multiple respects.

126. The Final Rule exceeds the IRS's authority to identify and investigate tax abusive transactions, *see* 26 U.S.C. § 6707, because it uses non-statutory criteria (namely, the 20% Relationship Test, the Financing Factor, and the Loss Ratio Factor) to determine that most of the micro-captives that Congress itself chose to incentivize are abusive tax shelters, rather than legitimate providers of insurance.

127. For instance, Congress expressly provided that certain micro-captives who meet the Final Rule's 20% Relationship Test are nevertheless legitimate insurers entitled to federal income tax benefits.

128. In enacting Section 831(b), Congress endeavored to level the playing field between small and large businesses by providing valuable federal income tax benefits to small businesses electing to use captive insurers formed and operated under state law. 26 U.S.C. § 831(b). Indeed, "Congress designed [831(b)] to enable [small captives] to defer corporate income tax." *Summa Holdings*, 848 F.3d at 786.

129. At the same time, Congress has recognized certain risks associated with incentivizing micro-captives through federal tax benefits—specifically, the risk that micro-captives might be used for tax-evasive estate planning purposes rather than to provide legitimate insurance. To address this risk, the PATH Act added a "diversification" requirement to Section 831(b). 26 U.S.C. § 831(b)(2)(B).

130. Congress gave captives two different options for satisfying Section 831(b)'s diversification requirement. First, a captive satisfies the diversification

requirement if "no more than 20 percent" of its premiums are derived from "any one policyholder" (*i.e.*, the "risk diversification test"). 26 U.S.C. § 831(b)(2)(B)(i)(I). Second, a captive satisfies this requirement if the captive's owners and its family members hold roughly the same interest in the insured company as they do in the captive itself (*i.e.*, the "relatedness test"). *Id.* § 831(b)(2)(B)(i)(II).

131. Congress determined that both options—the risk diversification test *or* the relatedness test—were necessary because making Section 831(b) applicable only to captives that satisfy the risk diversification test (and so have "no more than 20 percent" of premiums attributable to a single policy holder) would "crippl[e] the entire § 831(b) captive industry." Estes, *supra*, at 728. Indeed, when the Joint Committee on Taxation first suggested modifying Section 831(b) in 2015, it advocated for limiting eligibility to captives with "no more than 20 percent of [their] net written premiums . . . attributable to . . . any one policyholder." Joint Committee on Taxation, Description of Modifications (Feb. 11, 2015).[12] But the Joint Committee subsequently modified its proposal to "remove [this] additional restriction intended to narrow the application of section 831(b)," *id.,* and the subsequent Senate Bill 905 did not contain this crippling modification.

132. Congress's decision to provide captives two options for satisfying Section 831(b)'s diversification requirement reflects its controlling judgment that a micro-captive that satisfies either the risk diversification test *or* the relatedness test is a

[12] Available at https://www.finance.senate.gov/imo/media/doc/JCX-44-15%20Insurance%20Modification.pdf.

legitimate provider of insurance entitled to Section 831(b)'s federal tax benefits, rather than an illegitimate tax evasion scheme.

133. The IRS lacks the authority to "reject a Code-compliant transaction in the service of general concerns about tax avoidance," nor may it "fault taxpayers for making the most of the tax-minimizing opportunities Congress created." *Summa Holdings*, 848 F.3d at 786.

134. But the Final Rule does exactly that. It "reject[s]" Congress's decision to offer "tax-minimizing opportunities," *id.*, to captives that do not satisfy the risk diversification test, but *do* satisfy the relatedness test.

135. More specifically, the Final Rule deems captive insurers that qualify for tax benefits by virtue of meeting Section 831(b)'s *relatedness* test as inherently suspect. This is so because the Final Rule applies only to captives where a single policy holder has a 20% or greater stake in the captive—which necessarily means such a captive does not qualify for benefits under Section 801(b)'s risk diversification test. 26 U.S.C. § 831(b)(2)(B)(i).

136. In other words, the Final Rule determines that captives who satisfy Section 831(b)'s relatedness test are *inherently suspect*, and that this condition, when coupled with the presence of the Financing factor and/or a low Loss Ratio, makes the captive a potentially or presumptively tax avoidant transaction that does not provide legitimate insurance to its policyholder. This is deeply troubling, particularly because the Financing Factor and low Loss Ratios are *expected* features of most micro-captive transactions.

137. The IRS is prohibited from limiting a valid option that Congress has provided via statute, *Summa Holdings*, 848 F.3d at 789, yet that is precisely what the Final Rule does by treating captives who have satisfied Section 831(b)'s relatedness test as inherently suspect, despite Congress expressly deciding that such captive insurers are worthy of preferential federal tax treatment.

138. The Final Rule's treatment of the Financing Factor and the Loss Ratio as indicative of tax abuse, rather than legitimate insurance, compounds the IRS's statutory overreach. As noted above, the Financing Factor is a key benefit of captive insurance, and captive insurers will typically have lower loss ratios than commercial insurers. Congress was aware of these conditions when it enacted and amended Section 831(b), so the Final Rule undermines Congress's policy judgment to promote the use of captive insurance by relying on criteria that Section 831(b) inherently treats as legitimate and lawful.

139. The Final Rule also exceeds IRS's statutory authority by interfering with Congress's decision to protect the state-regulated business of insurance from federal intervention under the McCarran-Ferguson Act.

140. In enacting the McCarran-Ferguson Act, Congress made clear that regulating "the business of insurance" is left to individual States, and that state laws regulating the business of insurance should be free from federal intervention and overreach. 15 U.S.C. § 1012.

141. States have exercised their insurance authority by creating comprehensive captive insurance regulatory regimes that impose specific requirements on captive insurers, including micro-captives.

142. The Final Rule exceeds the IRS's authority because it determines that most micro-captive are inherently suspect abusive tax shelters, rather than providers of legitimate insurance, despite states having blessed the formation of such entities and closely regulated their operation under the States' authority to regulate insurance as recognized and protected by the McCarran-Ferguson Act.

143. In sum, the IRS exceeded its statutory authority to investigate tax abusive schemes when it promulgated a final rule that artificially limits the scope of Section 831(b)'s diversification requirements and allows the IRS to unilaterally determine what constitutes legitimate insurance, despite Congress determining that micro-captive insurers are worthy of federal income tax benefits and protecting the business of insurance from federal intervention under the McCarran Ferguson Act.

COUNT II
Administrative Procedure Act, 5 U.S.C. § 706(2)(A)
The Final Rule Is Arbitrary And Capricious

144. Plaintiff repeats and realleges each and every allegation set forth in paragraphs 1 through 143, above.

145. Under the APA, courts must set aside "agency action, findings, and conclusions found to be . . . arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A).

146. Under this standard, agency action must be "reasonable and reasonably explained." *BNSF Ry. Co. v. Fed. R.R. Admin.*, 62 F.4th 905, 910 (5th Cir. 2023). An agency "must examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choice made," *Id.* (quoting *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983)). Reasoning that "fails to account for relevant factors or evinces a clear error of judgment" including reasoning that fails "to consider an important aspect of the problem" must be set aside." *Id.* (citations omitted).

147. The Final Rule is arbitrary and capricious because the IRS did not provide a reasoned justification for its conclusion that micro-captives that meet the Rule's non-statutory criteria are tax evasion schemes, rather than legitimate insurance arrangements. IRS points to no facts, evidence, or other data in the administrative record demonstrating that micro-captive insurance arrangements present any particular risk of tax avoidance or evasion, or that micro-captive insurers do not provide legitimate insurance to their insureds. *See* 90 Fed. Reg. at 3,538.

148. The Final Rule at most "describe[s]" the type of transactions within its scope, discusses its "previously issued notices" concerning micro-transactions, and notes that the Tax Court has, on certain occasions, found that micro-captive transactions constitute abusive transactions, 90 Fed. Reg. at 3,538, without making any effort to articulate why, in its view, micro-captives do not offer legitimate insurance.

149. For instance, IRS's conclusion that micro-captives that meet the IRS's non-statutory criteria do not provide legitimate insurance is based on "the IRS's long-standing positions with respect to abusive micro-captives as made public in annual tax scheme publication and case law." 90 Fed. Reg. at 3,538. It also notes that "[t]he existing case law with respect to micro-captives demonstrates the commonalities in the fact patterns in the [types of] transactions" identified in the Final Rule. *Id.*

150. But the Final Rules does not explain what that "long-standing position" is based on, and vague references to "case law," *id.*, are insufficient to sustain the agency's burden to set forth a "satisfactory explanation" for its actions. *State Farm*, 463 U.S. at 43.

151. The Final Rule is also arbitrary and capricious because the IRS provides insufficient evidence in the administrative record that either of the factors that trigger a micro-captive's classification as a reportable transaction—the Financing Factor and the Loss Ratio Factor—provides a legitimate basis for concluding that a micro-captive transaction is a potentially or presumptively tax abusive "transaction of interest" or "listed transaction." *See* 90 Fed. Reg. at 3539–40.

152. As a threshold matter, the IRS has not pointed to any record evidence demonstrating that the presence of related-party financing or any particular loss ratio threshold increases the likelihood that a particular micro-captive is abusing the benefits Congress provided in Section 831(b). Rather, it simply asserts that, "based on its experience, the IRS maintains that, in transactions structured as described in the proposed regulations, financing arrangements that create a tax-deferred circular

flow of funds are indicative of tax avoidance," 90 Fed. Reg. at 3,546, and that the Loss Ratio is designed to determine whether a captive "pric[e]s premiums far in excess of what is reasonable needed to fun insurance operations," which is a "strong indicator of tax avoidance," *id.* at 3,540.

153. The Final Rule's use of the Financing Factor is arbitrary and capricious because it ignores the practical reality of the captive insurance industry. Using premium income to make loans to insureds is a key *benefit* of a captive insurance arrangement that is not available between a commercial insurer and its insured. The IRS expressly recognized that such related-party financing can be a "bona fide financing arrangement between the related parties." 90 Fed. Reg. at 3,546. However, the Final Rule but offers no reasoned justification for subsequently ignoring that related-party financing is a common feature of completely legitimate captive insurance arrangements and concluding that its presence is "indicative of tax avoidance." *Id.*

154. The Final Rule's use of the Loss Ratio Factor suffers from two flaws that make its classification scheme overbroad and will result in the re-classification of a vast number of micro-captives as not legitimate insurers.

155. As an initial matter, the Final Rule's specific Loss Ratio thresholds—less than 60% (for transactions of interest) or less than 30% (for listed transactions), 90 Fed. Reg. at 3560, 3562—are not based on sufficient record evidence and reasoned decision making.

156. Micro-captive insurance companies typically provide coverage for low-frequency, high severity risks—such as global pandemics or supply-chain problems—for which coverage is cost-prohibitive or unavailable in the commercial market. Insuring against these potentially calamitous risks requires micro-captives to maintain large capital reserves for future use. Additionally, micro-captives typically have smaller written premiums and comparatively few policyholders. Because the risks against which they insure do not usually materialize in any given year, captive insurers will almost *always* have loss ratios that fall far below the loss ratios of traditional, commercial insurers who insure against high frequency but low severity risks and who need not maintain the same type of capital surplus. The IRS fails to grapple with this important distinction and fails to otherwise support its selection of the 30 and 60 percent Loss Ratios identified in the Final Rule. 90 Fed. Reg. at 3,541.

157. The IRS purported to base the 60% Loss Ratio for transactions of interest on inapplicable, industry wide data. 90 Fed. Reg. at 3,542. Specifically, the IRS purportedly calculated this Loss Ratio by analyzing industry-wide data compiled by NAIC, and drawing a comparison between the loss ratios experienced by commercial insurance companies. *Id.* But, as noted above, micro-captives operate in a unique insurance space that inherently depresses their loss ratios. However, the NAIC data the IRS considered does not reflect any of these unique circumstances or practical realities. For instance, approximately 45% of the NAIC dataset is derived from personal lines of insurance (like homeowner's insurance), which skews the data due to competitive pricing dynamics. *See* Queen Comment at 5; Oklahoma Comment

at 5. The NAIC dataset is also unrepresentative of micro-captives because most captives do not report to the NAIC. Queen Comment at 5.

158. And even if the NAIC dataset was a reasonable source from which to derive micro-captive loss ratios, the Final Rule's 60% Loss Ratio for transactions of interest is arbitrary and capricious because the IRS admits that the "average" loss ratio for insurance companies, exclusive of certain high-frequency, low severity businesses, is 66 percent, 90 Fed. Reg. at 3,542, but fails to explain why a 60% Loss Ratio—well in line with the industry standard—is evidence that a micro-captive is not providing legitimate insurance. Indeed, many legitimate insurers with have below-average loss ratios. *See V.I. Guaranty Co., Ltd. & Subsidiaries v. Commissioner*, 145 T.C. 209, 216 (2015) (tax arrangement with loss ratio below 34% constituted legitimate insurance); 90 Fed. Reg. at 3,541 (recognizing that loss ratio of 28% can constitute legitimate insurance).

159. Additionally, the IRS failed to address reasonably the consequences of predicating disclosure obligations and the subsequent loss of income tax benefits on the Loss Ratio Factor.

160. For instance, the Final Rule punishes captives for not lowering premium rates, which lower rates may be below and in conflict with actuarially determined rates, or refund premiums to the policyholders through payment of policyholder dividends (thereby reducing the denominator in the Loss Ratio calculation).

161. But in doing so, the Final Rule effectively limits the surplus level that a micro-captive insurer may accumulate, and ultimately impacts its ability to retain

assets to pay claims (potentially implicating state insurance laws governing mandatory minimum surplus reserves, *e.g.*, Tex. Ins. Code § 964.056, and jeopardizing a micro captive insurer's solvency as well). This approach forces businesses to prioritize short-term tax compliance over long-term risk preparedness, exposing them to catastrophic losses.

162. Incentivizing premium reduction and/or policyholder dividends reduces a micro-captive's capital reserves and therefore penalizes prudent financial management and undermines Congress's original goal of enabling small insurers to build financial resilience. The IRS completely ignored this "important aspect of the problem." *State Farm*, 463 U.S. at 43.

COUNT III
Administrative Procedure Act, 5 U.S.C. § 706(2)(A)
The Final Rule Is Arbitrary And Capricious: Notice and Comment

163. Plaintiff repeats and realleges each and every allegation set forth in paragraphs 1 through 162, above.

164. The IRS acted arbitrarily by failing to adequately respond to comments raised during the notice and comment process.

165. The APA requires agencies to give notice of a proposed rule, 5 U.S.C. § 553(b)(3), and afford "interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments," *id.* § 553(c). "An agency's failure to respond meaningfully to objections raised by a party renders its decision arbitrary and capricious." *PPL Wallingford Energy LLC v. FERC*, 419 F.3d 1194, 1198 (D.C. Cir. 2005).

166. The Final Rule is arbitrary and capricious because the IRS failed to respond sufficiently to a number of comments submitted during the notice and comment period.

167. The IRS failed to respond meaningfully to specific critiques about the Loss Ratio Factor. For instance, although commentors warned that "the rigid loss ration computation factors fail to consider the unique risks profiles of micro-captives, SRA Comment at 1, the IRS ignored these critiques and relied on the NAIC insurance industry report on industry-wide loss ratios, *see* 90 Fed. Reg. at 3,542. That industry report is not reflective of the unique practical realities of the micro-captive insurance industry, and the IRS failed to justify its reliance on this inapposite source of data. Rather, the IRS merely complained that the commentors "did not identify any alternative published dataset that would capture the experience of" micro-captives. 90 Fed. Reg. 3542. But it is not the commentor's burden to provide a "satisfactory explanation" for the agency's conduct, *State Farm*, 463 U.S. at 43, and the IRS's decision to ignore a significant flaw in its proposed analysis cannot be explained away in this manner. This is particularly problematic given that the IRS has collected troves of tax-related data from these institutions, from which it should be able to aggregate information specific to the micro-captive industry that would better inform its decision-making process.

168. Nor did the IRS adequately justify its rejection of commentors' suggestions that alternative factors would be more appropriate to further the proposed rule's goals. For instance, with respect to the IRS's concern about excessive

premium pricing, commentors explained that the analysis should hinge on "whether an independent, license actuary actually determines the premiums." 90 Fed. Reg. at 3,543. The IRS rejected this proposal on the basis that the Final Rule's classification scheme is based on "the totality of the circumstances" and that it does not purport to "defin[e] insurance for either Federal of State law purposes." *Id.* The IRS further explained that the commentors "provided no specific pricing methodology or reliable market source that would enable the IRS to better distinguish" between legitimate and tax-avoidant transactions. *Id.* But the IRS's position is laughable, because the obvious effect of the Final Rule is to re-classify most micro-captives as tax shelters *rather than legitimate insurers*, in the IRS's determination, and, as above, the burden is on the IRS provide a "satisfactory explanation" for ignoring pertinent comments. *See State Farm*, 463 U.S. at 43.

169. Nor did the IRS adequately respond to comments criticizing the inclusion of policy holder dividends in the Loss Ratio calculation. Despite commentor's explanations of why including policyholder dividends in this calculation is inappropriate, Queen Comment at 2, the IRS included dividends in the computation for the sole purpose of giving taxpayers a way to "correct[ ] inappropriately accumulated premiums," without discussion or appreciating the implications that may have on state laws and while generally ignoring concerns that issuing policyholder dividends is not a common practice for micro-captives. 90 Fed. Reg. at 3545.

170. The IRS's failure to address these comments, among others, makes its promulgation arbitrary and capricious in violation of the APA.

PRAYER FOR RELIEF

Plaintiffs respectfully request that this Court enter judgment in their favor and against Defendants, and specifically provide the following:

A. A declaratory judgment that Defendants violated the APA by promulgating a Final Rule that (1) exceeds their statutory authority; (2) uses arbitrary and capricious reasoning; and (3) fails to properly responds to comments in the manner the APA requires;

B. An order holding unlawful, vacating, and setting aside the Final Rule and its accompanying regulations;

C. An injunction prohibiting Defendants from enforcing the Final Rule and accompanying regulations against Plaintiffs, its clients, and affiliated entities;

D. Reasonable costs and expenses incurred in the prosecution of this action, including attorney's fees under 28 U.S.C. § 2412; and

E. All other relief, as the Court deems just and proper.

Dated: June 4, 2025

Respectfully submitted,

BY: */s/Chris Verducci*

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