United States Government Accountability Office

Report to the Chairman, Committee on Finance, U.S. Senate

July 2020

ABUSIVE TAX SCHEMES

Offshore Insurance Products and Associated Compliance Risks

GAO-20-589

GAO Highlights

Highlights of GAO-20-589, a report to the Chairman, Committee on Finance, U.S. Senate

July 2020

ABUSIVE TAX SCHEMES

Offshore Insurance Products and Associated Compliance Risks

Why GAO Did This Study

When structured in abusive ways, insurance products held offshore can be designed to aid in unlawful tax evasion by U.S. taxpayers. Two products that IRS has recently warned have the potential for such abuse include micro-captive insurance and variable life insurance policies.

GAO was asked to review how taxpayers may abuse offshore insurance products. This report describes (1) how offshore insurance tax shelters provide opportunities for income tax abuse; (2) how offshore micro-captive insurance is used and how it is used in abusive tax schemes; and (3) how offshore variable life insurance is used and how it is used in abusive tax schemes.

GAO reviewed IRS tax and information return forms, relevant U.S. case law and IRS guidance, academic and trade publications, and applicable statutes and regulations. GAO also interviewed IRS officials and professionals in the tax preparation and insurance industries.

View GAO-20-589. For more information, contact Jessica Lucas-Judy at (202) 512-9110 or LucasJudyJ@gao.gov.

What GAO Found

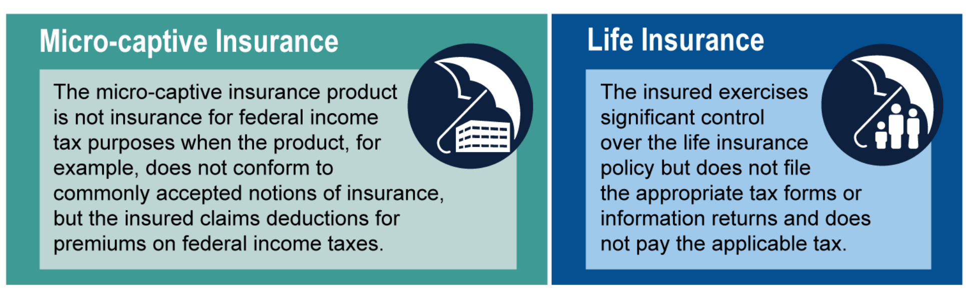
Federal law provides certain tax benefits for transactions involving genuine insurance products, including insurance products held offshore. While taxpayers may lawfully hold offshore insurance products, they contain features that make them vulnerable for use in abusive tax schemes. For example, offshore insurance products can be highly technical and individualized, making enforcement challenging, according to Internal Revenue Service (IRS) officials. Furthermore, insurance is not defined by federal statute, potentially making a determination of what constitutes genuine insurance for federal tax purposes unclear.

Offshore micro-captive insurance products, which are made by small insurance companies owned by the businesses they insure, may be abused if the corporate taxpayer improperly claims deductions for payments made to a micro-captive for federal tax purposes. Courts have applied certain considerations to determine whether these deductions can be claimed. For example, one consideration is whether the insurance legitimately distributes risk across participating entities. IRS officials said they expend significant resources reviewing these schemes because of the varied ways insurance companies may work.

Offshore variable life insurance products, which are insurance policies with investment components over which the insured has certain control, may be abused if the individual taxpayer fails to meet IRS reporting requirements or pay appropriate federal income taxes. Federal regulations require that taxpayers with certain foreign life insurance accounts report this information to IRS and the Financial Crimes Enforcement Network. The structure of life insurance products may vary and taxpayers are required to pay taxes based on the underlying type of financial product the policy represents.

The figure below shows how noncompliance may occur when taxpayers use life insurance and micro-captive insurance in abusive tax schemes.

Abusive Use of Micro-captive and Life Insurance



Source: GAO analysis of Internal Revenue Service information. | GAO-20-589

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Abbreviations

CCA	Chief Counsel Advice
IRB	Internal Revenue Bulletin
IRC	Internal Revenue Code
IRS	Internal Revenue Service
PLR	Private Letter Ruling
TAM	Technical Advice Memorandum

U.S. GOVERNMENT ACCOUNTABILITY OFFICE
441 G St. N.W.
Washington, DC 20548

July 30, 2020

The Honorable Charles E. Grassley
Chairman
Committee on Finance
United States Senate

Dear Chairman Grassley:

When structured in abusive ways, offshore insurance products can be designed to hide U.S taxpayers' assets or falsely claim federal income tax benefits.[1] Federal law generally allows U.S. taxpayers to enter into insurance policies with offshore entities and provides certain tax benefits, such as income-tax deductions for insurance premiums, for genuine offshore insurance transactions.[2]

However, when taxpayers abuse these products, they threaten our tax system's integrity and fairness. This is in part because taxpayers may believe that individuals and businesses are not paying their fair share of taxes and instead are contributing to the tax gap, which is the difference between the taxes people and businesses owe and what they annually pay voluntarily and on time in the United States. In 2019, the Internal Revenue Service (IRS) estimated the average annual gross tax gap for tax years 2011 through 2013 to be $441 billion. After taking into account its enforcement activities and late payments, IRS calculated that the average net tax gap was $381 billion per year.

While taxpayers can hold offshore insurance for a number of legitimate reasons, IRS has identified instances where taxpayers have used offshore insurance products to improperly reduce their tax liabilities. These abusive offshore insurance tax schemes can involve sophisticated tax shelters, devised and marketed to taxpayers by accountants, estate planners, and attorneys. These shelters may also be constructed or recommended by professionals that have established relationships with

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[1]We will refer to financial products that have been marketed and sold to U.S. taxpayers as insurance as "insurance products" throughout this report. These insurance products may be later determined by IRS or the courts to be arrangements that are not insurance for federal income tax purposes.

[2]For purposes of this report, genuine insurance is insurance products that are considered insurance for federal income tax purposes. The characteristics of genuine insurance may vary based on the specific type of insurance being considered.

taxpayers. IRS officials have said that when insurance is held offshore, it can be more resource intensive to identify abusive insurance tax schemes and take enforcement action.

You asked us to review how taxpayers may abuse offshore insurance products and what guidance IRS provides about complying with laws related to offshore insurance accounts. This report describes (1) how offshore insurance tax shelters provide opportunities for income tax abuse; (2) how offshore micro-captive insurance is used and how it is used in abusive tax schemes; and (3) how offshore life insurance is used and how it is used in abusive tax schemes.

To describe how offshore insurance tax shelters provide opportunities for income tax abuse, we reviewed academic and trade publications; reviewed IRS guidance on its website; summarized applicable statutes, regulations, and case law; and interviewed IRS officials and industry professionals, whom we identified from referrals from professional associations and our own literature searches. Specifically for IRS guidance, we confirmed with IRS officials what they considered to be key guidance on helping ensure compliance with offshore insurance products. We summarized this information and categorized the guidance according to our previous work, which defined types of guidance and reviewed guidance IRS communicates publicly.[3]

Additionally, to describe micro-captive insurance and life insurance tax shelters and any non-tax benefits these shelters offer and to determine how they are used in abusive tax schemes, we reviewed relevant case law and industry websites and interviewed industry professionals and IRS officials.

We conducted this performance audit from October 2019 to July 2020 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

[3]GAO, *Regulatory Guidance Processes: Treasury and OMB Need to Reevaluate Long-standing Exemptions of Tax Regulations and Guidance*, GAO-16-720 (Washington, D.C.: Sept. 6, 2016).

Background

Tax Benefits of Insurance for Businesses and Individuals

We previously reported that tax shelters can be legitimate to the extent they take advantage of various provisions in the tax code to lawfully avoid paying federal taxes; however, according to IRS, abusive tax shelters result in unlawful tax evasion.[4] Abusive offshore insurance tax schemes include transactions that are also considered scams or schemes based on erroneous interpretations of tax law.

U.S. taxpayers may qualify for tax benefits associated with certain types of insurance, but they are responsible for ensuring that (1) they accurately report assets to the U.S. government on applicable tax forms and information returns, (2) they only claim these tax benefits as appropriate, and (3) they pay appropriate taxes based on the true type of financial instrument. These principles apply whether taxpayers hold assets, income, and financial instruments in the United States or offshore.

Whether a transaction or product constitutes insurance has numerous federal tax consequences and determines whether taxpayers may claim certain tax benefits. For example, the Internal Revenue Code (IRC) provides businesses and individuals with multiple tax benefits for utilizing insurance to guard against the financial consequences of various risks, such as environmental disasters, legal issues, and mortality. Although the IRC does not define insurance, the U.S. Supreme Court has held that, "historically and commonly, insurance involves risk-shifting and risk-distribution."[5] In the decades that followed, IRS and the lower U.S. courts have applied these two factors when litigating whether certain arrangements are considered insurance for federal tax purposes.

Captive insurance. Section 162 of the IRC generally allows for the deduction of ordinary and necessary expenses associated with running a business, thereby reducing the amount of taxes owed.[6] These expenses include premiums paid for insurance against risks inherent in conducting

[4]Our report reviewed what is known about abusive tax avoidance transactions and the results of IRS enforcement efforts against such transactions. See GAO, *Abusive Tax Avoidance Transactions: IRS Needs Better Data to Inform Decisions about Transactions*, GAO-11-493 (Washington, D.C.: Mar. 12, 2011).

[5]The Court also had held that an insurance transaction must involve an actual insurance risk at the time the transaction is executed. Helvering v. Le Gierse, 312 U.S. 531, 539 (1941).

[6]26 U.S.C. § 162(a).

business. Generally, premiums that are deductible under section 162 are for insurance against risks that only have negative results—referred to as insurable risks. Risks that could have either positive or negative results—for example, a risk that a business will recuperate its investment in new equipment—is considered a speculative risk according to IRS audit guidance and is not an insurable risk.

While many businesses choose to insure their risks through commercially available insurance policies, some choose to create their own insurance companies that can provide tailored and sometimes more affordable risk coverage. These insurance entities, called captive insurance companies, are generally wholly owned by the businesses they insure. The courts first addressed the tax consequences of owning captive insurance in 1978, and captive arrangements gained popularity throughout the 1990s and 2000s.[7] One IRS enforcement official estimated that as many as 85 percent of Fortune 500 companies today utilize captive insurance arrangements.

Before 1986, the costs of forming and managing a captive insurance company were greater than the potential benefits to many small and medium-sized businesses. The Tax Reform Act of 1986 amended the IRC to revise the framework allowing certain small insurers to elect to be taxed only on their taxable investment income.[8] In this report, we use the term micro-captives to refer to small captive insurance companies—including domestic or offshore companies—that make this election under

[7]Carnation Co. v. Commissioner, 71 T.C. 400 (1978), *affd*, 640 F.2d 1010 (9th Cir. 1981). The Court held that payments made by the taxpayer to an insurance company that were then paid to the taxpayer's subsidiary for reinsurance were not deductible as a business expense.

[8]Tax Reform Act of 1986, Pub. L. No. 99-514, § 1024(a)(4), 100 Stat. 2085, 2405 (1986), *codified at* 26 U.S.C. § 831. To qualify as a small insurance company for purposes of making this election, the insurance company could not be a life insurance company and could have no more than $1.2 million in premium income. In 2015 section 831(b) was amended (1) to increase this threshold to $2.2 million and index it to inflation and (2) to impose certain diversification requirements. These requirements state that either (1) no more than 20 percent of the net or direct premiums written by the insurer are attributable to any one policyholder or (2) that no family member of an owner of an insured business have a financial interest in the micro-captive that is 2 percent or more larger than their stake in the insured business. Pub. L. No. 114-113, div. Q, § 333, 129 Stat. 2242, 3106–3108 (2015).This second requirement limits the ability of owners of insured businesses from treating micro-captives as estate planning tools.

section 831(b) or claim tax exempt status under IRC section 501(c)(15).[9] Generally, businesses that pay premiums for genuine insurance issued by or reinsured by their micro-captive insurance companies can deduct the value of these premiums under IRC section 162. To claim the tax benefits associated with micro-captives, offshore insurers making the election under section 831(b) must first elect under section 953(d) to be treated as a domestic entity for tax purposes.

Life insurance*.* The IRC provides three main tax benefits for life insurance policyholders. First, the policyholder is not taxed on growth in the value of life insurance policies.[10] Second, the policyholder may be able to access the value of the policy during their life, such as taking out a loan against the policy, tax-free.[11] Third, the beneficiary is generally not taxed on proceeds from the life insurance after the insured's death.[12] A policy will be treated as a life insurance contract for tax purposes only if it satisfies certain tests that require complex calculations involving the relationships among premium levels, mortality charges, interest rates, death benefits, and other factors.[13]

In general, even though a policyholder of a variable life insurance policy has a separate account, for federal tax purposes the assets in it are considered the life insurance company's property, not the policyholder's

[9]To qualify as a small insurance company for purposes of making an election under 26 U.S.C. § 501(c)(15) to be exempt from income taxation, the insurance company could not be a life insurance company and could have no more than $600,000 in gross receipts. Further, premiums must make up more than 50 percent of these gross receipts. Mutual insurance companies making the 501(c)(15) election must have no more than $150,000 in gross receipts, of which premiums must make up more than 35 percent.

[10]In general the insurance company is also not taxed on this growth in value.

[11]26 U.S.C. § 72(e); Atwood v. Comm'r, 77 T.C.M. 1476 (1999) (loans against an insurance policy constituted true loans, not cash advances, and were not taxable distributions when received). This benefit is not available to certain life insurance products called modified endowment contracts. 26 U.S.C. §§ 72(e)(10), 7702A. The amount the policyholder can access tax-free may be limited by the amounts paid as premiums for the policy.

[12]26 U.S.C. § 101(a).

[13]26 U.S.C. § 7702.

property.[14] While the assets held in a variable life insurance policy's separate account are sometimes called cash-value funds, in this report we refer to them as separate account assets.

The separate account assets are invested among a variety of investment products offered by the insurance company (such as stocks, bonds, and mutual funds). The policyholder is permitted to allocate the assets in the separate account among these investment products as they wish, though the insurance company may limit the policyholder's control over these separate account asset allocations.

For variable life insurance policies, the amount paid out to the beneficiary once the insured person dies generally depends on how the investments of the separate account assets perform. The beneficiary typically receives the larger of the policy's minimum death benefit value and the policy's separate account assets. In contrast, policyholders do not direct investment strategies of separate account assets in nonvariable universal or whole life insurance policies because the funds are held in general accounts of the insurance company, which manages the investment of all funds in the general account.[15]

IRS Guidance

In 2016, we found that IRS issues thousands of publications in a variety of forms to help taxpayers and their advisors understand the law.[16] IRS guidance that most directly addresses the types of offshore insurance tax schemes discussed in this report fits into three categories:

[14] While variable and variable-universal life insurance policies have some differing characteristics, in this report we refer to them both as variable life insurance policies. Variable life insurance has both a standard death benefit and a separate account asset component, some or all of which is held by the life insurance company in an account separate from the insurer's other assets.

[15] Individuals may choose to guard against their risk of mortality using a variable life insurance policy or instead they may choose to use another type of life insurance, such as nonvariable whole or universal life insurance policies.

[16] For a more detailed discussion of IRS guidance overall, see GAO, *Regulatory Guidance Processes: Treasury and OMB Need to Reevaluate Long-standing Exemptions of Tax Regulations and Guidance*, GAO-16-720 (Washington, D.C.: Sept. 6, 2016).

- Guidance published in the Internal Revenue Bulletin (IRB), such as revenue rulings, revenue procedures, notices, and other announcements.[17]
- Written determinations, including private letter rulings and technical advice memorandums.
- Other IRS information, such as forms and publications, FAQs, news releases, and videos.

Appendix I describes these types of guidance in greater detail, including examples of guidance that relate to offshore insurance tax schemes.

Certain Elements of Offshore Insurance Products Make Them Vulnerable to Use in Abusive Tax Schemes

Insurance is not defined in statute, and generally IRS and the courts have served as arbiters of what insurance products are considered genuine insurance for federal tax purposes, which requires significant resources. IRS enforcement officials said some taxpayers abuse insurance tax shelters specifically because of the complexity of conducting enforcement actions against these schemes, including those held offshore.

Officials said some abusive schemes involve sophisticated layered products.[18] These products are created specifically to evade taxes, and IRS auditors often need to sort through voluminous evidentiary documents and use subject matter experts to review technical materials. Further, IRS officials told us it can be more difficult to conduct enforcement actions against offshore insurance tax shelters because audit staff may encounter roadblocks created by bank secrecy laws when trying to obtain information about the insurance arrangement and the U.S. taxpayers involved.

[17]A revenue ruling is an official interpretation of the IRC, related statutes, tax treaties, or regulations as applied to a specific set of facts. A revenue procedure is an official statement of a procedure that affects the rights or duties of taxpayers or other members of the public under the IRC, related statutes, tax treaties, and regulations.

[18]Layered arrangements are those in which several financial products are used in combination with one another. One IRS official told us that these layered arrangements are intentionally complex and used by taxpayers to hide assets from IRS.

In response, IRS has issued public warnings about promoters offering offshore insurance products that may in fact be abusive tax schemes.[19] In abusive schemes, the insurance products lack the characteristics of genuine insurance that are required for claiming deductions and other tax benefits, such as risk shifting and risk distribution. IRS officials told us that the use of certain offshore insurance products, including micro-captive insurance and variable life insurance, started appearing in examinations involving offshore assets more frequently between 2008 and 2012.

This marked a time when U.S. federal agencies were receiving more information from foreign banks on undisclosed foreign assets held offshore in traditional bank and investment accounts and the agencies increased enforcement activity on abusive tax schemes.[20] Some offshore insurance products offered alternatives for taxpayers to hide their assets or engage in tax planning using shelters under less scrutiny.

In the next two sections, we provide examples of how taxpayers have abused insurance with micro-captive insurance and life insurance products.[21]

[19]The term "promoter" includes a person who (1) organizes an investment plan or arrangement affecting taxes or participates in selling it and (2) makes a statement about its tax benefits. *See* 26 U.S.C. § 6700. Appendix I contains more information about announcements and other communications IRS has issued about abusive tax schemes involving insurance.

[20]Appendix II describes some of the information available to IRS on offshore insurance from tax forms and information returns where taxpayers may report various aspects of their insurance, such as related deductions, assets, or taxes owed. For example, some tax forms listed require taxpayers with financial interests in offshore insurance specifically to provide information or pay relevant taxes.

[21]IRS has identified other types of offshore financial products that may be used as part of abusive tax schemes, including certain uses of trusts and annuities. For example, according to IRS, offshore private annuities are sometimes used with variable life insurance products by taxpayers to evade taxation on related income. Annuity products are used to insure against longevity risk and may be structured to pay out funds to the policyholder over the rest of their lifetime. There are numerous ways that offshore financial products, including insurance and annuity products, have been used to create abusive schemes and improperly claim various tax benefits. We do not attempt to address all permutations of abusive offshore insurance tax schemes in this report.

Offshore Micro-captive Insurance Products: Business Benefits of Proper Use and Characteristics of Abuse

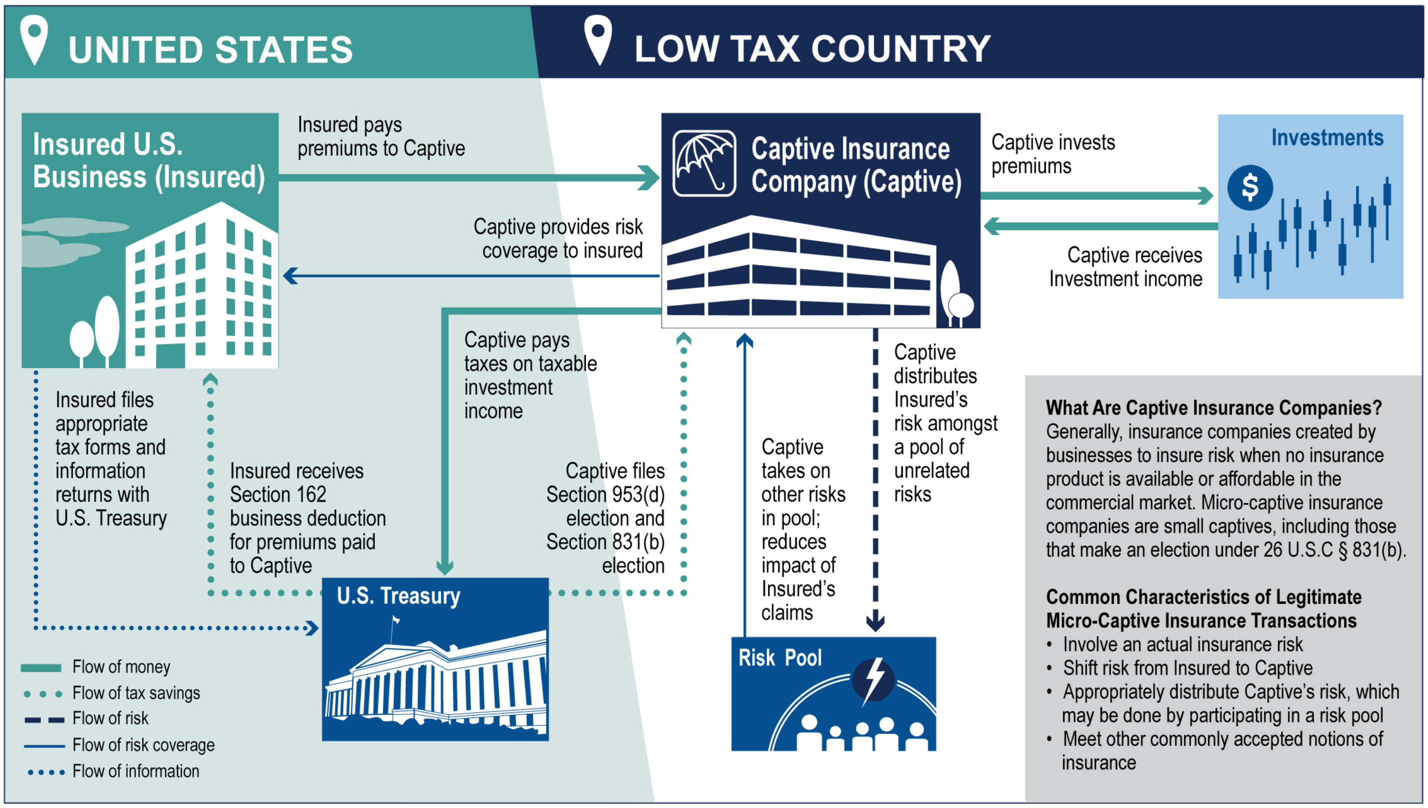
Offshore micro-captive insurance products can provide several important benefits to businesses that use them legitimately. For example, the insured businesses might benefit from

- new or better risk coverage because the insurance policies may be tailored to their needs,
- monetary savings on insurance premiums compared to commercially available policies,
- stable insurance premiums, or
- profit generated by the micro-captive if premium revenue exceeds claims.

Figure 1 depicts how an offshore 831(b) micro-captive insurance company that insures its parent may operate to ensure it meets legal requirements.[22]

[22]There are many ways that micro-captives may be structured, based on the goals of the insured business. For example, micro-captives can insure their parent's risk if the premiums and risks of the parent are adequately pooled with premiums and risks of unrelated parties. Rev. Rul. 2002-89. A micro-captive can also insure the risks of other subsidiaries of its parent. Human Inc. v. Comm'r 881 F.2d 247 (6th Cr. 1989); Rev. Rul. 2002-90. All other factors to qualify as insurance for federal tax purposes must also be met.

Figure 1: Description of Insurance Arrangement between a Parent U.S. Business and its Offshore Micro-Captive Insurance Subsidiary



Source: GAO analysis of Internal Revenue Service information. | GAO-20-589

When micro-captive insurance products are located offshore, they may provide additional benefits to the business, such as less onerous insurance regulations. One industry professional told us that offshore jurisdictions may have a simpler or faster process for establishing a micro-captive insurance company or they may have lower taxes. Additionally, some countries have laws that may provide protection for the micro-captive's funds and assets in cases involving large claims or lawsuits against the micro-captive or its parent U.S. business. Finally, some businesses may benefit from their micro-captive's ability to accumulate offshore assets.

Sometimes micro-captives are established purely for tax reasons, which generally courts have ruled is improper.[23] Indicators that businesses have established a micro-captive in an abusive tax scheme include artificially high premiums that do not make economic sense or that are not supported by actuarial science.

IRS enforcement officials told us they first came across abusive micro-captive insurance schemes in the mid-2000s. Following many years of enforcement action, IRS determined that some micro-captive insurance transactions have the potential for abuse. Subsequently, IRS required U.S. taxpayers to disclose their involvement in micro-captive insurance transactions, based on certain criteria, through IRS Notice 2016-66, *Transaction of Interest: Section 831(b) Micro-Captive Transactions*.[24]

Between November 1, 2016, and December 31, 2019, IRS processed disclosures on thousands of micro-captive insurance transactions.[25] IRS has said that the majority of micro-captive cases examined have been determined to be abusive. IRS officials told us that as the result of various enforcement actions, including a 2016 enforcement campaign, IRS offered settlements to 156 taxpayers who participated in abusive micro-captive transactions. Of those taxpayers, 76 percent had elected to accept the settlement terms as of June 2020.

Since 2017, IRS has won three micro-captive cases before the Tax Court, which supported IRS's increased enforcement actions against abusive micro-captive insurance products. At issue in these cases was whether the micro-captive or related businesses could claim various deductions and tax benefits.

[23]In the *Avrahami* and *Syzygy* cases, the intent established by the taxpayer's contemporaneous email record contributed to the Tax Court's holding that the captive did not provide genuine insurance. Avrahami v. Comm'r, 149 T.C. 144 163 (2017); Syzygy Ins. Co. v. Comm'r, 117 T.C.M. (CCH) 115 24, 33, 36, (2019).

[24]Notice 2016-66 references 2016-47 I.R.B. 745. Taxpayers who engage in these or substantially similar transactions are required to report them to IRS. 26 U.S.C. § 6111; 26 C.F.R. § 1.6011-4(b)(6). A legal challenge to this requirement is before the U.S. Supreme Court, as described in greater detail in appendix I.

[25]Based on our analysis of IRS data from individual filers of Form 8886, which were processed by IRS's Office of Tax Shelter Analysis staff between November 1, 2016, and December 31, 2019.

Below are the criteria the Tax Court used in its analyses when determining the micro-captive products were not genuine insurance. Although these criteria are not independent or exclusive, they establish a framework for determining whether insurance exists under the federal tax law.[26] In some cases, the courts have considered whether the insurer is a bona fide or sham insurance company.[27] Courts have also emphasized the need to consider all facts and circumstances in each case.[28]

Criterion 1: Is There an Actual or Insurable Risk?

When determining whether some captive insurance products were insurance for federal income tax purposes, IRS and the courts have considered whether insurance products involve actual and insurable risks.[29] Actual risks are those that are truly faced by the insured, and insurable risks are those that can only result in a loss if the event occurred.

While most speculative risks could result in either a loss or a gain, insurable risks can only result in a loss. For example, whether a business will recuperate its investment in new equipment is a type of speculative risk because the businesses could experience either a financial loss or gain. In contrast, the risk that a building will catch fire is an insurance risk.

IRS has warned that some abusive micro-captive insurance tax shelters involve insurance of implausible risks. While some such risks are clearly unlikely, others require careful analysis to determine whether the insured did not truly face the risks covered under their policy.[30] In *Reserve Mechanical Corp. v. Commissioner*, the court determined that loss events

[26]AMERCO, Inc. v. Comm'r, 96 T.C. 18, 38 (1991), *aff'd* 979 F.2d 162 (1992).

[27]Courts have generally considered this separately from applying the other criteria. Rent-a-Center, Inc. v. Comm'r, 142 T.C. 1 (2014); United Parcel Service of America v. Comm'r, 254 F.3d 1014 (11th Cir. 2001); Malone & Hyde Inc. v. Comm'r, 62 F.3d 835 (6th Cir. 1995).

[28]Rent-a-Center, 142 T.C. at 13–14; Sears, Roebuck, and Co. v. Comm'r, 96 T.C. 61, 96 (1991).

[29]*See* Harper Group and Includible Subsidiaries v. Comm'r, 96 T.C. 45, 58 (1991). *See also* Notice 2016-66 § 1.02(c)–(f).

[30]For example, one industry professional told us they had heard of a micro-captive providing insurance specifically against damages caused by satellites falling out of Earth's orbit. While technically possible, such an event is extremely unlikely.

experienced in the past do not necessarily translate to current actual risks.[31]

The case. Peak Casualty Holdings, LLC (Peak) created an Anguilla-based micro-captive insurance company, Reserve Mechanical Corp (Reserve). The agreements between Peak and Reserve purported to insure Peak against large financial losses not covered by Peak's other commercial insurance policies. These agreements identified PoolRe Insurance Corp (PoolRe) as a stop loss insurer. Reserve also entered into agreements to reinsure a share of PoolRe's risk pool. The taxpayer argued, in part, that these reinsurance agreements achieved risk distribution.

In evaluating this argument, the court analyzed whether the agreement between Reserve and PoolRe constituted bona fide insurance. Among the factors the court considered in the analysis was whether PoolRe faced actual and insurable risks. Reserve was able to point to one financial loss event in the past 10 years, which was not fully covered by Peak's commercial insurers, but the full amount of the claim was significantly below the threshold that would have triggered PoolRe's liability as a stop loss insurer.[32]

In this case, the Tax Court determined that Peak was unlikely to experience similar events in the future that could ever justify its policies' premiums.[33] As a result, PoolRe did not truly face risk under its stop loss agreement and therefore Reserve's reinsurance agreement with PoolRe was not insurance for federal income tax purposes. Since the reinsurance agreement was not bona fide insurance, the taxpayer's argument that Reserve distributed risk through them failed.

The court held that Reserve itself was not an insurance company for federal income tax purposes and was not eligible for its insurance company income tax exemption under section 501(c)(15). Therefore, it

[31]Reserve Mechanical Corp v. Comm'r, 115 T.C.M. 1475, 43-44 (2018), *appeal docketed* No. 18-9011 (10th Cir. Dec. 27, 2018).

[32]The taxpayer also argued that taxes owed after Peak's returns were reviewed by an accounting firm were the type of losses covered by Reserve and the stop loss agreements with PoolRe, but the court found no evidence of the amounts of the purported loss or the likelihood that something like that would happen again.

[33]This analysis was part of a broader discussion of whether the micro-captive properly distributed risk. We have focused on this part of the analysis to illustrate the Tax Court's application of this criterion.

was not eligible to make an election to be treated as a domestic insurance corporation under section 953(d), and as a result, was liable for a 30 percent withholding tax on income received from affiliated insured businesses.

Criterion 2: Are Both Risk Shifting and Risk Distribution Present?

Generally, the courts have determined that risk shifting occurs when the insured transfers the financial consequences of an insurable loss to the insurer. The risk is typically offset by premium payments. Risk distribution, also referred to as risk pooling, allows the insurer to reduce the possibility that a single costly claim will exceed the amount paid in premiums by the insured.

In one 1991 Tax Court case, the judge noted that captive insurance products, including micro-captive products, "straddle the fence" between self-insurance and insurance for federal income tax purposes.[34] The key distinctions between these two types of arrangements include the presence of risk shifting and risk distribution, and the court's consideration of captive insurance arrangements often revolves around analysis of risk shifting and risk distribution.

Risk shifting and risk distribution do not occur when a captive insurance company only insures the risks of its parent.[35] For risk shifting, courts noted that when the captives paid out claims, these financial losses impacted their parent corporations' balance sheets, so the economic impact of these risks was not truly transferred away from the parent.

Further, since risk distribution involves pooling many small independent risks, captives that only insured their parents' risks could not properly distribute risk. However, captives can shift and distribute risk by insuring sibling corporations, which are business entities owned by the same parent corporation, or by insuring or reinsuring unrelated entities.[36] The cases below illustrate taxpayers and their advisors crafting insurance products with this legal framework in mind; however, they were ultimately held to have failed to distribute risk.

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[34]Harper Group and Includible Subsidiaries, 96 T.C. at 46.

[35]Carnation Co. v. Comm'r, 640 F.2d 1010, 1013 (9th Cir. 1981); Stearns-Roger Corp., Inc. v. U.S., 577 F.Supp 833, 838 (D. Colo. 1984); *see also* Anesthesia Service Med. Group, Inc. v. Comm'r 85 T.C. 1031, 1041-1042 (1985).

[36]Crawford Fitting Co. v. U.S., 606 F.Supp. 136, 148 (N.D. Ohio 1985); Humana Inc. v. Comm'r, 881 F.2d 247, 257 (6th Cir. 1989).

The cases. All three of IRS's recent victories involved the determination that risk distribution did not occur. In *Avrahami v. Commissioner, Reserve Mechanical Co. v. Commissioner, and Syzygy v. Commissioner*, the taxpayers argued their captive distributed risk, in part, because the captive entered into agreements under which, the taxpayers argued, the captive provided reinsurance to unrelated insurance companies. However, in all three cases, the Tax Court held that these unrelated entities were not bona fide insurance companies; therefore, the captive did not effectively distribute risk.[37]

Secondary question. Throughout the case law, IRS and courts have sometimes considered whether an insurer or reinsurer was a sham company when determining whether a captive insurance product was insurance for federal tax purposes. In some cases, the court makes this determination independently from other characteristics of the arrangement, because a sham insurance company cannot provide insurance for federal income tax purposes.[38] However, in other cases, the court examines whether an arrangement involved a bona fide insurer as part of a more detailed analysis of risk distribution. In a 2017 Tax Court case, the court considered as part of its analysis of risk distribution whether an entity to whom the micro-captive was providing reinsurance was a bona fide insurance company.

The case. In *Avrahami v. Commissioner*, the court considered many characteristics of the company purchasing the reinsurance. It concluded that the third-party insurer was not a bona fide insurance company because the reinsurance premiums were excessively large and of a circular nature, and there was an ultralow probability of a claim ever being paid and an atypical fee structure.[39]

Criterion 3: Does the Product Fit Commonly Accepted Notions of Insurance?

While there are many ways in which a micro-captive insurance product may be structured, the product still must conform to commonly accepted notions of insurance for it to be considered insurance for federal income tax purposes. Courts have considered a variety of questions for this part of the test, including whether the insurer is regulated under the insurance laws of its jurisdiction, whether it is adequately capitalized, whether

[37] Syzygy, 117 T.C.M. at 36–37; Reserve Mech. Co., 115 T.C.M. at 45–46, 47–48; Avrahami, 149 T.C. at 190.

[38] Malone & Hyde, Inc. v. Comm'r 62 F.3d 835, 842—843 (6th Cir. 1995); United Parcel Service of America, Inc. v. Comm'r, 254 F.3d 1014, 1020 (11th Cir. 2001); Ocean Drilling & Exploration Co. v. U.S., 988 F.2d 1135, 1157 (Fed. Cir. 1993).

[39] Avrahami, 149 T.C. at 190.

premiums charged were reasonable and the result of arm's length transactions, and whether the insurer has paid any claims.

In *Syzygy v. Commissioner*, the court considered many of these factors when determining that the agreement among Syzygy, its owner, and its fronting carriers was not insurance in the commonly accepted sense. In this case, the court considered the legitimacy of agreements between a business and its domestic micro-captive, which was incorporated and regulated in Delaware.

The case. A group of related taxpayers had financial interests in a group of corporate entities collectively referred to as HT&A. HT&A created a micro-captive insurance company, Syzygy, which operated in a complex structure as a second insurer of HT&A's risks. HT&A's insurance policies were with fronting carriers, who then passed along all of HT&A's risk to Syzygy, but kept a percentage of HT&A's premiums as a fee. The court held that although Syzygy was organized and regulated as an insurance company, met Delaware's minimum capitalization requirements, and paid a claim, these insurance-like traits did not overcome the arrangement's other failings. The court gave greater weight to its findings that Syzygy was not operated like an insurance company and that the fronting carriers charged unreasonable premiums and late-issued policies with conflicting and ambiguous terms. The court held that the agreements at issue were not insurance in the commonly accepted sense.[40]

[40]Syzygy, 117 T.C.M. at 45.

Offshore Life Insurance Products: Individual Taxpayer Benefits of Proper Use and Characteristics of Abuse

IRS has also determined that offshore life insurance arrangements have the potential for tax abuse.[41] One IRS official told us that offshore variable life insurance products have been used to conceal assets from the U.S. government, including undeclared assets at risk of being discovered during investigations of foreign banks. Further, some taxpayers closely control how their premiums are invested and may direct premium funds toward illiquid assets they currently own in an attempt to convert taxable income to tax exempt income that is eventually passed on to their beneficiaries tax-free.

However, IRS also acknowledged that there are many legitimate uses of offshore life insurance products and that when used properly these products offer important benefits to taxpayers. In addition to the various tax benefits discussed in the background section, offshore policies may also offer taxpayers certain legal benefits, depending on the jurisdiction. For example, individuals or other entities wishing to sue the policyholder for assets held in an offshore life insurance policy must file the lawsuit with the offshore jurisdiction's legal authority.

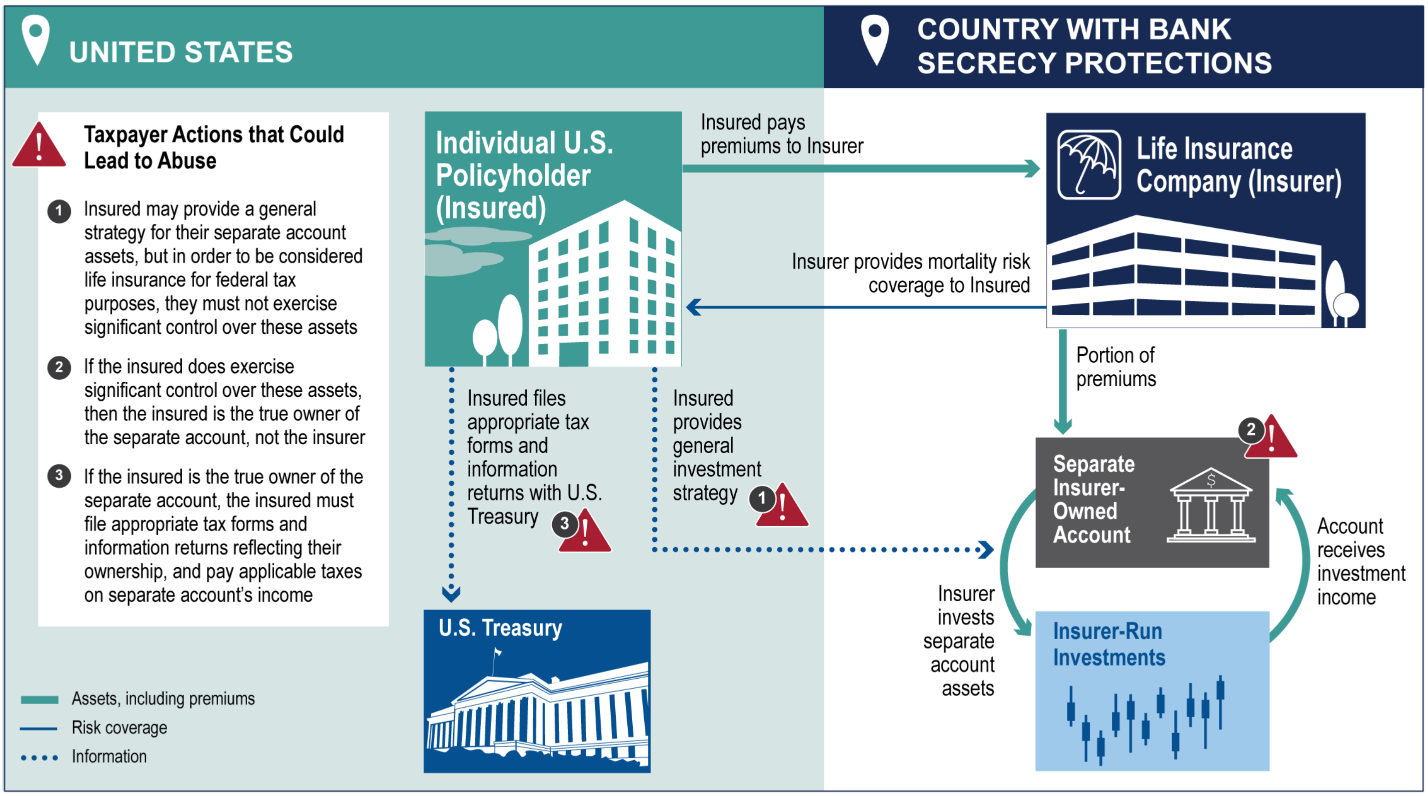
Offshore life insurers and U.S. policyholders must ensure they meet the taxpayer responsibilities described in the background section. For variable life insurance policies, the net premium funds in the separate asset account are invested among a variety of investment products offered by the insurance company (such as stocks, bonds, and mutual funds). While policyholders are permitted to allocate the funds in the separate asset account among these investment products as they wish, courts have indicated that in order to maintain tax benefits, the policyholders must not exercise significant control over the account, so the frequency of transfers and reallocations may be limited by the insurance company. For example, IRS officials told us that policyholders should not be allowed to select specific individual investments (e.g., Apple common stock).

Figure 2 depicts how offshore variable life insurance arrangements may operate to comply with these responsibilities and identifies an example of

[41]Since 2013, the U.S. Department of Justice has taken significant actions against abusive offshore life insurance products. The agency established the Swiss Bank Program, which is directed at the financial institutions themselves, and allows the banks to resolve issues related to U.S. clients with undeclared accounts. The agency's investigations have turned up abuses of life insurance products.

how a taxpayer's actions could lead to the abuse of this type of tax shelter–either intentionally or unintentionally.

Figure 2: Description of U.S Individual's Offshore Variable Life Insurance Product and an Example of How Abuse Could Occur



Source: GAO analysis of Internal Revenue Service information. | GAO-20-589

Below are the two major questions that courts have raised in deciding whether taxpayers fulfilled their responsibilities related to holding offshore life insurance products, including whether the taxpayer properly reported insurance accounts to the U.S. government and whether the taxpayer paid all required taxes based on the true type of financial vehicle.

Taxpayer Responsibility 1: Did the Taxpayer Properly Report Insurance Accounts to the U.S. Government?

Federal regulations require that U.S. taxpayers with certain foreign life insurance accounts report this information to IRS and the Financial Crimes Enforcement Network. However, because of the intricacies of the foreign financial system, it can be difficult for the U.S. government to ensure that its taxpayers have declared their foreign financial accounts and related income. Failure to file the appropriate information returns has been considered abusive by the courts.

The case. In *United States v. John Blandi*, the taxpayer pleaded guilty to charges related to failing to report the foreign financial account associated with his Swiss private placement life insurance policy, a type of variable life insurance policy.[42] The U.S. Department of Justice detailed that the taxpayer intentionally took precautions to prevent financial transactions that would alert U.S. government officials to his foreign financial account. The taxpayer also withheld information about the account's existence from his tax preparer.

This concealment resulted in the tax preparer filing false income tax returns, which stated that the taxpayer had no reportable foreign financial accounts. Additionally, by concealing the private placement life insurance separate asset account he held offshore, the taxpayer underreported his income by more than $1 million and understated his tax due by more than $500,000.

Taxpayer Responsibility 2: Did the Taxpayer Pay All Required Taxes Based on the True Type of Financial Vehicle?

As discussed above, when taxpayers display significant control over assets held offshore in separate asset accounts of their life insurance policies, they can be considered the owners of such accounts for tax purposes. Having significant control but not paying certain taxes has been considered an abuse by the courts.

The case. In *Webber v. Commissioner*, the court determined that the taxpayer had significant control over the assets held in the foreign financial account associated with his offshore private placement variable life insurance policies. As a result, the court held that the taxpayer was the owner of that account for federal income tax purposes, and any income from the assets was includable in the taxpayer's gross income.[43]

In this case, the taxpayer directed the insurance policies' assets toward various start-ups and other companies in which he had a

[42]Plea Agreement at 4–7, U.S. v. Blandi, No. 2:19-cr-0161-WFN (E.D. Wash. Oct. 22, 2019).

[43]Webber v. Comm'r, 144 T.C. 324, 368 (2015).

financial interest. More than 70,000 emails were sent between the taxpayer, investment manager, and the insurer regarding the investment strategy for the private placement life insurance policies' accounts.

Agency Comments

We provided a draft of this report to IRS. IRS provided technical comments but did not provide a letter.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies of this report to the appropriate congressional committees, the Secretary of the Department of the Treasury, the Commissioner of Internal Revenue, and other interested parties. In addition, the report is available at no charge on the GAO website at http://www.gao.gov.

If you or your staff have any questions about this report, please contact Jessica Lucas-Judy at (202) 512-9110 or LucasJudyJ@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs are on the last page of this report. GAO staff who made key contributions to this report are listed in appendix III.

Sincerely yours,

Jessica Lucas-Judy
Director, Tax Issues
Strategic Issues

Appendix I: Guidance That IRS Has Issued about Offshore Insurance

The Internal Revenue Bulletin (IRB) is one of the main ways the Internal Revenue Service (IRS) communicates official guidance to taxpayers. Through the IRB, IRS has issued four notices directly relating to abusive tax schemes involving insurance that also apply to offshore insurance accounts.

Most recently, IRS issued *Notice 2016-66, Transaction of Interest: Section 831(b) Micro-Captive Transactions*. As previously discussed, this notice outlines circumstances in which taxpayers may improperly claim deductions for premiums paid to a micro-captive insurance company. Micro-captive insurance is one type of insurance sometimes held offshore.

Three other IRS notices describe transactions that may involve offshore insurance accounts but are not restricted to offshore insurance:

- Notice 2002-70*, Certain Reinsurance Arrangements*, describes when certain income shifting among related companies to insurance companies may be noncompliant with federal income-tax laws.[1]
- Notice 2005-49*, Qualification of Certain Arrangements as Insurance*, briefly summarizes existing related revenue rulings and solicits comments on the following:
    - The factors to determine whether cell captive arrangements constitute insurance.
    - The circumstances under which related parties as insurance may be affected by a loan-back of amounts paid as premiums.
    - Whether certain aspects of risk are relevant in determining whether risks are adequately distributed for an arrangement to qualify as insurance.
    - Federal income tax issues raised by transactions involving finite risk.
- Notice 2008-19*, Cell Captive Insurance Arrangements: Insurance Company Characterization and Certain Federal Tax Elections*, sought

[1]The transaction described by Notice 2002-70 was removed as a listed transaction by Notice 2004-65.

comments about when protected cell company arrangements constitute legitimate insurance.[2]

In May 2020, the U.S. Supreme Court announced it would hear a case in which a captive insurance management company challenged the legality of Notice 2016-66. Specifically, the Court will consider whether the Anti-Injunction Act—which, in general, bars lawsuits for the purposes of restraining the assessment or collection of tax—required the dismissal of a lawsuit seeking to enjoin IRS's enforcement of the requirement to report transactions described in Notice 2016-66. The case is on appeal from the Sixth Circuit, which upheld the district court's dismissal of the case under the Anti-Injunction Act.[3]

In addition to the notices, officials from the IRS Office of Chief Counsel identified 10 revenue rulings that were released through the IRB as being relevant to abusive offshore insurance tax schemes. Table 1 shows the 10 rulings IRS identified, with a brief summary of the rulings' contents.

Table 1: Revenue Rulings Relating to Abusive Offshore Insurance Tax Schemes

Revenue ruling	What the ruling addresses
Rev. Rul. 78-338	Whether amounts paid by a domestic corporation to a foreign insurance company are deductible.
Rev. Rul. 89-96	Whether a casualty insurance company is entitled to claim a deduction under Internal Revenue Code section 832(b)(5) for losses incurred during the taxable year on insurance contracts.
Rev. Rul. 2001-31	That the Internal Revenue Service will no longer invoke the economic family theory with respect to captive insurance transactions.
Rev. Rul. 2002-89	Whether amounts paid by a domestic parent corporation to its wholly owned insurance subsidiary are deductible.
Rev. Rul. 2002-90	Whether amounts paid for professional liability coverage by domestic operating subsidiaries to an insurance subsidiary of a common parent are deductible as insurance premiums under the law.
Rev. Rul. 2002-91	Whether a group captive formed by a relatively small group of unrelated businesses involved in a highly concentrated industry to provide insurance coverage is an insurance company within the meaning of federal law.
Rev. Rul. 2005-40	Whether certain situations constitute insurance for federal income tax purposes and if so, whether amounts paid to the insurer are deductible as insurance premiums.
Rev. Rul. 2007-47	Whether a certain business arrangement may deduct insurance premiums under federal law and whether the arrangement may be accounted as an insurance contract under federal law.

[2]Generally, a protected cell company is a special legal entity granted by local jurisdictions in which a core company has a number of cell companies. The entire group is treated as a single entity for tax purposes but the cells are treated independently for other purposes, such as liability purposes.

[3]CIC Services, LLC v. Internal Revenue Service, 925 F.3d 247 (6th Cir. 2019).

Revenue ruling	What the ruling addresses
Rev. Rul. 2008-8	Whether the relationship among various entities constitutes insurance for federal income tax purposes.
Rev. Rul. 2009-26	Presents two situations to illustrate the application of insurance principles as to whether a reinsurance arrangement is sufficient for the assuming company to qualify as an insurance company under federal law.

Source: GAO analysis of Internal Revenue Service data. | GAO-20-589

Officials from the IRS Office of Chief Counsel also identified a series of determinations they said may be relevant to offshore insurance issues, which can be found on the IRS Written Determinations website.[4] Table 2 provides summaries of these determinations. These rulings are non-precedential in nature, and should not be interpreted as addressing existing noncompliance, only responding to facts and circumstances raised by taxpayers.

Table 2: Written Determinations That the Internal Revenue Service Identified as Relating to Offshore Insurance Tax Planning

Written determinations number	What the ruling addresses
PLR 201746022	Corporate taxpayers' proposed reorganization of a foreign insurance business.
PLR 201314020	Whether the taxpayer's second-level domestic subsidiaries and contracts issued by them can be treated as insurance for federal income tax purposes.
PLR 201219011	Whether a foreign company that is taxed as a domestic corporation may be considered an insurance company for federal tax purposes.
PLR 201219010	Whether a foreign company that is taxed as a domestic corporation may be considered an insurance company for federal tax purposes.
PLR 201219009	Whether a foreign company that is taxed as a domestic corporation may be considered an insurance company for federal tax purposes.
PLR 201030014	Whether a foreign company that is taxed as a domestic corporation under 953(d) election may be considered an insurance company for federal tax purposes.
PLR 200703007	Whether a corporate taxpayer's transaction selling a contract covering decommissioning costs for nuclear power plants can be treated as insurance for federal income tax purposes.
PLR 200629029	Whether a corporate taxpayer's transaction by a wholly owned subsidiary to sell a contract covering decommissioning costs can be treated as insurance for federal income tax purposes.
PLR 200629028	Whether a corporate taxpayer's transaction by a wholly owned subsidiary to sell a contract covering decommissioning costs can be treated as insurance for federal income tax purposes.
PLR 200628018	Whether a corporate taxpayer's express limited warranty provided to consumers upon purchase of taxpayer's manufactured products can be considered insurable risks for federal income tax purposes.
CCA 201702037	Whether a corporate taxpayer can qualify as an insurance company other than a life insurance company under the law.
CCA 200202002	Whether a corporate taxpayer could deduct premiums paid to a foreign but related insurance company.

[4]https://apps.irs.gov/app/picklist/list/writtenDeterminations.html.

Written determinations number	What the ruling addresses
CCA 201802014	Whether an arrangement between affiliated operating entities and a captive insurance affiliate concerning the fluctuation in the value of specified foreign currencies is insurance for federal income tax purposes.
CCA 201511021 (as reconsidered in CCA 201802014)	Whether the arrangement between related companies and their affiliated insurance company involving foreign currency fluctuations constitutes insurance for federal tax purposes.
TAM 201015030	Whether provisional indemnification receivables for incurred but not reported loss reserves are includable in the calculation of insurance income of a foreign insurer and its earnings and profits, and if so, whether the subsequent changes to the foreign insurer's income and earnings and profits are included in its income on a pro-rata basis.
TAM 200453013	Whether a corporate taxpayer domesticated outside the United States (1) would have qualified as an insurance company if it was a domestic corporation, (2) whether it was eligible to elect to be treated as a domestic corporation, and if not, how should its income be taxed, and (3) whether certain arrangements were a sham for federal income tax purposes.
TAM 200453012	Whether a corporate taxpayer domesticated outside the United States (1) would have qualified as an insurance company if it was a domestic corporation, (2) whether it was eligible to elect to be treated as a domestic corporation, and if not, how its income should be taxed, and (3) whether certain arrangements were a sham for federal income tax purposes.
TAM 200824029	A number of items related to a corporate taxpayer that is a foreign company, such as whether the company qualified as a certain type of insurance company and, if not, whether it continues to qualify for a voluntary legal election.
TAM 200824028	A number of items related to a corporate taxpayer that is a foreign company, such as whether the company qualified as a certain type of insurance company and, if not, whether it continues to qualify for its voluntary legal election.
TAM 200520035	A number of items related to a corporate taxpayer that is a foreign corporation, such as whether the company qualified as a certain type of insurance company and, if it did not and its voluntary election is invalid, how it should be taxed.

Legend: The table's abbreviations refer to Private Letter Rulings (PLR); Chief Counsel Advice (CCA); and Technical Advice Memorandum (TAM).

Source: GAO analysis of Internal Revenue Service data. | GAO-20-589

Our own search of IRS's Written Determinations website database returned more than 600 results involving the term "insurance." The issues include instances related to captive insurance tax shelters. However, we did not determine the relevancy of all these rulings to offshore insurance tax schemes.

For many years, IRS has emphasized abusive tax schemes involving insurance in various internet postings, particularly press releases and summaries of information. More recently, IRS detailed its program for settlement offers relating to micro-captive insurance schemes and plans for new audit efforts related to micro-captive insurance compliance. For example, in January 2020, IRS said in a press release that "nearly 80 percent of taxpayers who received offer letters elected to accept the settlement terms. In addition, IRS is establishing 12 new examination teams that are expected to open audits related to thousands of taxpayers in coming months."

Additionally, in a public release, IRS said it has identified abusive tax schemes involving micro-captive insurance as part of its "Dirty Dozen" list of the most prominent abusive tax schemes since 2014. IRS included abusive micro-captive insurance tax shelters most recently on its March 2019 list. The release said, "Micro-captives are on the Dirty Dozen list again, reflecting IRS's commitment to curbing abusive arrangements through audits, investigations, and litigation." The release also identifies court cases where, it says, "IRS has been successful in litigating these transactions," and identifies Notice 2016-66 reporting requirements. In a July 2020 announcement, IRS did not include micro-captives on its 2020 Dirty Dozen list due to a focus on aggressive and evolving schemes related to coronavirus tax relief. Instead, the announcement said a new series of press releases would emphasize illegal schemes and techniques and include such scams as abusive micro-captives and fraudulent conservation easements.

IRS has posted other types of guidance on its website. Two examples include the following:

- A Q&A on life insurance, which briefly describes how to report life insurance proceeds.
- A fact sheet from May 2019 on abusive offshore tax avoidance schemes, which generally describes abusive insurance arrangements in which premiums are improperly reported and income is shifted using offshore private annuities.

IRS also provides guidance on insurance compliance in various publications. Most directly, IRS Publication 535, *Business Expenses*, addresses insurance deductibility. Topics covered in this publication include deductible premiums, nondeductible premiums, capitalized premiums, and when to deduct premiums and are all related to the abusive schemes covered earlier in this report. However, this publication does not directly discuss issues relating to abusive offshore insurance tax shelters.

IRS Office of Chief Counsel officials also cited a series of court cases as potential guidance on how to make offshore insurance arrangements properly; however, legal determinations are specific to the facts and circumstances of the litigated cases and are not prepared by IRS, like the other guidance in our review.

Appendix II: Tax Forms and Information Returns Related to Offshore Insurance

When required, taxpayers often have the choice to report their offshore insurance accounts and any associated tax benefits in a way that is most convenient for them. Tables 3 and 4 describe these requirements. The exact nature and combination of forms that taxpayers must file depends on the exact nature of the insurance product and the associated tax benefits, and as a result may vary with each taxpayer. Therefore, this is not an exhaustive list of the forms taxpayers may use to report offshore insurance.

Table 3: Tax Returns Used to Report Insurance and Claim Associated Tax Benefits, Including Offshore Insurance

Form number and title	Purpose of form	Location of offshore insurance information
Form 1065 *U.S. Return of Partnership Income*	Business partnerships use this form to report: • Income • Gains and losses • Deductions and other tax benefits	Business partnerships may report information related to insurance costs on one of two places on this form. They may either report deductions taken on premiums paid for business insurance using Line 2, Cost of Goods Sold, or Line 20, Other Deductions.[a]
Form 1040 Schedule B *Interest and Ordinary Dividends*	Taxpayers use this form to report: • Interest • Ordinary dividends • Interest in or ownership of foreign accounts and trusts	Taxpayers should report financial interests or signature authority over financial accounts, including insurance policies with cash value (such as whole life insurance policies), that are located in a foreign country. Additionally, taxpayers are required to note whether they are required to file the Financial Crimes Enforcement Network Form 114.
Form 1040 Schedule C *Profit or Loss from Business (Sole Proprietorship)*	Businesses that are sole proprietors use this form to report: • Income or loss from the business • Statutory employee wages and expenses • Certain other income and deductions	Sole proprietorships may report deductions taken for insurance other than health insurance in one of two places on this form. They may either report deductions taken on premiums paid for insurance using Part II Line 15, Insurance (other than health), or using Part I Line 4, Cost of Goods Sold.
Form 1120-PC *U.S. Property and Casualty Insurance Company Tax Return*	Domestic and certain foreign non-life insurance corporations, including Section 831(b) micro-captives, use this form to report: • Income • Gains and losses • Deductions and other tax benefits	Non-life insurance corporations may report premiums earned on Schedule A Line 1. These corporations indicate their elections under section 831(b) and 953(d) elections on Section D of the form.
Form 1120 *U.S. Corporation Income Tax Return*	Corporations use this form to report: • Income • Gains and losses • Deductions and other tax benefits	Corporations may report deductions related to insurance costs on one of two places on this form. They may either report deductions taken on premiums paid for business insurance using Line 2, Cost of Goods Sold, or Line 26, Other Deductions.[b]
Form 1120-S *U.S. Income Tax Return for an S Corporation*	S-Corporations use this form to report: • Income • Gains and losses • Deductions and other tax benefits	S-Corporations may report deductions related to insurance costs on one of two places on this form. They may either report deductions taken on premiums paid for business insurance using Line 2, Cost of Goods Sold, or Line 19, Other Deductions.[c]

Form number and title	Purpose of form	Location of offshore insurance information
Form 1120-L *U.S. Life Insurance Company Income Tax Return*	Every domestic life insurance company and every foreign corporation that would qualify as a life insurance company uses this form to report: • Income • Gains and losses • Deductions and credits	Insurance companies report gross premiums on Line 1 and amount owed on Line 30.
Form 8865 *Return of U.S. Persons With Respect to Certain Foreign Partnerships*	A U.S. person qualifying under certain conditions must complete and file Form 8865 to report aspects of: • Controlled foreign partnerships • Transfers to foreign partnerships • Acquisitions, dispositions, and changes in foreign partnership interests	Filers report the name and address of foreign partnerships on Line G1.
Form 8991 *Tax on Base Erosion Payments of Taxpayers with Substantial Gross Receipts*	Certain corporate taxpayers use the form to determine the base erosion minimum tax amount for the year.	Insurance premiums are reported on the form under Schedule A, *Base Erosion Payments and Base Erosion Tax Benefits*, Line 8.

Source: GAO analysis of Internal Revenue Service data. | GAO-20-589

[a]Form and instructions indicate that the taxpayer should attach a statement that lists the type and amount of all allowable deductions that are not deductible on page 1 of Form 1065. Examples listed include insurance premiums.

[b]Form and instructions indicate that taxpayer should attach a statement that lists the type and amount of all allowable deductions that are not deductible elsewhere on Form 1120. Examples listed include insurance premiums.

[c]Form and instructions indicate that taxpayer should attach a statement that lists the type and amount of allowable trade or business deductions that are not deductible elsewhere on page 18 of Form 1120-S.

Table 4: Information Returns Used to Report Offshore Insurances

Form number and title	Purpose of form	Location of offshore insurance information
Form 8938 *Statement of Specified Foreign Financial Assets*	This form is filled out by individual taxpayers and is used to report all foreign financial assets (including cash-value insurance accounts) in which they have a financial interest and which are valued over the various reporting thresholds ($50,000 for unmarried taxpayers living inside the U.S.; $200,000 for same living abroad).	Taxpayers use three parts of the Form 8938 to report information on their offshore cash-value life insurance accounts. First, they use Part II, Other Foreign Assets Summary, to report basic information on their insurance account. Second, taxpayers use Part III, Summary of Tax Items Attributable to Specified Foreign Financial Assets, Section 2, Other Foreign Assets, to report information about tax benefits related to the insurance account. Finally, taxpayers use Part VI, Detailed Information for Each "Other Foreign Asset", to show more detailed information about the character, dollar value, and geographic location of the insurance account.
Form 8966 *Foreign Account Tax Compliance Act Report*	This form is filed by certain foreign financial institutions, to report information on their institutions' various U.S. financial accounts and U.S. financial account owners, including certain cash value insurance accounts.	Filers report various information about the cash-value insurance account throughout Form 8966. For example, filers report their own identifying information including their global intermediary identification number (Line 4) and country of origin (Line 3c) in Part I. In Parts II and III, filers provide information on the owner of the account, including country of origin (Line 3c) and Taxpayer Information Number (Line 4). In Part IV, filers provide financial information, including the cash-value insurance account's balance (Line 3a) and dividends (Line 4b).
Form 8886 *Reportable Transaction Disclosure Statement*	This form is filed by taxpayers who participated in a reportable transaction, including transactions of interest such as that described in Notice 2016-66. It is used to describe the transaction in detail, including the expected tax treatment and all potential tax benefits.	Filers report various information related to Section 831(b) micro-captive insurance transactions of interest using Form 8886. For example, filers report their identifying number in the header, the form number and year of the related tax return (Line B); the reportable transaction number (Line 1c); and the type of entity they participated through (Line 5a). Taxpayers use Lines 7a and 7b to report the expected tax treatment and benefits. They use Line 8a to describe the character of related entities, including foreign entities.
Form 8918 *Material Advisor Disclosure Statement*	This form is filed by material advisors to any reportable transaction. A material advisor can be an individual, trust, estate, partnership, or corporation. They use the form to disclose certain information about the reportable transaction. Material advisors are those who provide material aid, assistance, or advice with any reportable transaction and directly or indirectly receive or expect to receive gross income in excess of the threshold amount for this involvement.	Filers report various information related to one or more reportable transaction(s). For example, filers report their identifying number (Header block), the name of the reportable transaction(s) (Line 1), a description of the type of material aid provided (Line 6a), whether any foreign entities or individuals were needed to achieve tax benefits generated by the transaction and what their roles are (Lines 7a-b), the types of financial instruments used in the transaction (Line 9), the type of tax benefit(s) generated by the transaction (Line 10), the Internal Revenue Code section(s) used to claim tax benefits from the transaction (Line 12), and a narrative description about the transaction that includes some of the above components (Line 13).

Form number and title	Purpose of form	Location of offshore insurance information
Form 5471 Schedule M *Transactions Between Controlled Foreign Corporation and Shareholders or Other Related Persons*	This form is used by certain U.S. persons who are officers, directors, or shareholders in certain foreign corporations. The form and schedules are used to satisfy the reporting requirements of Sections 6038 and 6046 and the related regulations, as well as to report amounts related to Section 965.	Filers report various information related to transactions between controlled foreign corporations for which they are an officer, director, or shareholder. For example, filers report their identifying number (Header block), premiums received and paid for insurance or reinsurance (Lines 12 and 25 respectively), the name of other U.S. persons who are shareholders in the involved entities (Column b), and the name of any other foreign corporations which the filer controls or is a shareholder (Columns d-f).
Form 5472 *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*	Generally, a reporting corporation must file Form 5472 if it had a reportable transaction with a foreign or domestic related party.	Filers report premiums received for insurance or reinsurance and premiums paid for insurance or reinsurance on Lines 11 and 24 respectively.
Form 720 *Quarterly Federal Excise Tax Return*	This form and its attachments are used to report liability and pay the excise taxes listed on the form. If a taxpayer reports a liability on Part I or Part II, he or she may be eligible to use Schedule C to claim a credit.	Among other things, filers report premiums paid for insurance policies, such as life insurance policies, held by foreign insurers (IRS No. 30). The form also requires filers to report their identifying number (Header block).
Schedule A *(Form 8975)* *Tax Jurisdiction and Constituent Entity Information*	U.S. persons with multinational enterprises with revenues of $850 million or more file the form to report certain information about the filer's multinational enterprise group on a country-by-country basis.	Filers use Part Il, Column 4 of the form to report constituent entities' main business activities.
FinCEN Form 114 *Report of Foreign Bank and Financial Accounts*	This form is filed by U.S. persons to report a financial interest in or signature authority over a foreign financial account if its aggregate value exceeds $10,000 at any point during the calendar year.	Filers report various information related to foreign financial accounts over which the filer has a financial interest or signature authority. For example, filers must include their Taxpayer Identification Number (Part 1 Line 3). In Part II, for each account filers report the type of account (Line 16), the maximum account value (Line 15), the account number or other designation (Line 18), and the financial institution's name and address (Lines 17 and 19-23).

Source: GAO analysis of Internal Revenue Service and Financial Crimes and Enforcement Network data. | GAO-20-589

Appendix III: GAO Contact and Staff Acknowledgments

GAO Contact

Jessica Lucas-Judy, (202) 512-9110, LucasJudyJ@gao.gov

Staff Acknowledgments

In addition to the contact named above, the following staff made key contributions to the report: Tara Carter (Assistant Director), Eric Gorman (Analyst-in-Charge), Steven Flint, Topher Hoffmann, Gina Hoover, Amalia Konstas, Krista Loose, Scott E. McNulty, Ed Nannenhorn, Cynthia Saunders, Andrew J. Stephens, Leanne Violette, and Alicia White.

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