UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF TENNESSEE
NORTHERN DIVISION (KNOXVILLE)

CIC Services, LLC, *Plaintiff*, v. INTERNAL REVENUE SERVICE; MELANIE KRAUSE, in her official capacity as Acting Commissioner of the Internal Revenue Service; U.S. DEPARTMENT OF TREASURY; and UNITED STATES OF AMERICA, *Defendants*.	**COMPLAINT** Case No. 3:25-cv-146

CIC Services, LLC brings this action against Defendants under the Administrative Procedure Act to set aside the IRS's Final Rule published in the Federal Register on January 14, 2025, entitled *Micro-Captive Listed Transactions and Micro-Captive Transactions of Interest*, and accompanying regulations.

INTRODUCTION

1. Captive insurance companies play a vital role in the United States economy. They provide coverage for low-frequency, high-severity risks that commercial insurance companies often will not underwrite. Even where commercial coverage is available, placing these large but uncertain liabilities with a captive lowers the price of insurance premiums and improves the stability of commercial markets. Because of these public and private benefits, captive insurance is ubiquitous among large corporations, including most of the Fortune 500. And after Congress provided tax benefits for small captives in 1986, captive insurance has become an indispensable tool for American small businesses too.

2. The IRS does not share Congress's positive view of small captives. The IRS has long viewed them with ire, seeing captive insurance companies as illicit shelters for income that the agency ought to have power to tax. Even after Congress expanded tax benefits for small captives in 2015, the IRS continued to include them in its "Dirty Dozen" list of transactions used by tax cheats.

3. In 2016, the IRS's attack on small captives went full scale. That year, the IRS issued Notice 2016-66, which declared that the mine-run of captives used by small businesses are potential tax avoidance schemes. The Notice imposed on these captives and their material advisors onerous and costly reporting requirements that largely offset the tax benefits that Congress provided to make small captives economically viable and put a cloud on the industry that dissuaded many small businesses from using captives.

4. CIC Services, a key player in the small-captives industry, challenged Notice 2016-66 under the Administrative Procedure Act and won. After the Supreme Court unanimously rejected the IRS's jurisdictional defense, this Court agreed with CIC Services that the Notice was arbitrary and capricious and that the IRS issued it without the required rulemaking procedures. *See CIC Services, LLC v. Internal Revenue Service*, 592 F.Supp.3d 677 (E.D. Tenn. 2022).

5. None of this deterred the IRS from pursuing its war on small captives. Shortly after this Court vacated Notice 2016-66, the IRS promulgated new regulations to replace it. These regulations target small captives in much the same way as Notice 2016-66 and suffer many of the same defects.

6. Most strikingly, the IRS failed to correct the critical flaw this Court identified in Notice 2016-66. Just as before, the IRS offered no facts or data to support its conclusion that small captives are potential tax avoidance transactions. The agency also exceeded its statutory authority by issuing regulations that sharply curtail tax benefits that Congress provided by statute. And it imposed other irrational limits on small captives too.

7. The APA forbids this arbitrary, capricious, and unlawful agency action. The IRS's latest battle against small captives is yet another example of its failure to "follow the basic rules of administrative law." *Id.* at 688. The new regulations, and the IRS's rule that promulgated them, must be set aside.

PARTIES

8. Plaintiff, CIC Services, LLC, is an industry-leading manager of captive insurance companies. It is based in Knoxville, Tennessee.

9. Defendants are the United States, two agencies of the United States, and employees or officers of the United States.

JURISDICTION AND VENUE

10. This Court has subject-matter jurisdiction under 28 U.S.C. §1331 and 5 U.S.C. §702 because Plaintiff brings claims under the Administrative Procedure Act, including claims that a federal agency exceeded its authority under federal law.

11. Venue is proper under 28 U.S.C. §1391(e) because Defendants are the United States and agencies, officers, or employees of the United States, this case does not involve real property, a substantial number of the relevant events occurred here, and Plaintiff resides here.

12. The United States waived sovereign immunity. *See* 5 U.S.C. §702.

13. The Anti-injunction Act does not bar this action. *See CIC Services, LLC v. Internal Revenue Service*, 593 U.S. 209 (2021).

BACKGROUND AND FACTUAL ALLEGATIONS

A. Captive Insurance Companies

14. Captive insurance companies provide property and casualty insurance to businesses that own the captive, directly or indirectly. They differ from commercial insurance companies, which provide insurance to third parties.

15. States have primary responsibility for regulating captive insurance companies, which operate according to the laws of the jurisdiction where they are licensed. States police captives closely. They impose strict rules on financing agreements between a captive and its policyholders, capitalization requirements to ensure liabilities are covered in the event of loss, and restrictions that limit how

captives can earn income from investing premiums. State regulators generally require captives to file annual financial statements, actuarial certifications, and detailed audits.

16. Captive insurance has private benefits for firms and public benefits for the economy. Insuring through a captive benefits firms by allowing them to design policies tailored to their specific needs, and to obtain coverage for low-frequency, high-severity risks that commercial insurance companies often do not underwrite. Where coverage is available through commercial insurance markets, captives can offer lower premiums because they do not bear the overhead costs of a commercial insurance company.

17. Captives also reduce a firm's exposure to the volatility of commercial insurance markets, where premium prices can fluctuate widely year to year. Because firms control the price of premiums charged by their captive, captive insurance stabilizes the firms' cash flows and makes the business environment more predictable.

18. Captives offer firms other benefits too. Unlike commercial insurance, where a firm's efforts to mitigate risk create profits for the outside insurer, captives keep those profits within the corporate family. If a risk is too great for the corporate family to bear, captives can purchase reinsurance at wholesale prices from the secondary market, which firms seeking direct insurance cannot legally access.

19. The public benefits of captive insurance are equally important. Captive insurance alleviates the moral hazard inherent in third-party insurance. When a firm insures through a captive, it has a financial incentive to mitigate risk, as liability ultimately remains within the corporate family. That incentive creates a safer environment for employees, customers, and members of the public effected by the firm's operations. And because captives can provide coverage where policies are otherwise unavailable, firms that use captives are less likely to rely on taxpayer bailouts if catastrophe strikes.

20. The extreme flooding and forest fires and that have ravaged the United States in recent years are a prime example of why captive insurance is needed and useful. Many commercial insurance companies have curtailed or eliminated policies that cover losses from these catastrophes. Captive insurance can thus be the only way for property owners that are vulnerable to extreme flooding and fire to insure against such risks.

21. Congress is aware of these benefits, but it recognized they inure mostly to large captives and the big businesses they insure. To extend the benefits of captive insurance to small businesses, Congress provided tax benefits to offset the administrative cost and promote the profitability of small captives.

B. Federal Tax Incentives for Captive Insurance

22. Captive insurance is not a new concept. It traces its roots to 18th-century business practices and took its modern form in the 1950s, when American businesses experienced steep rises in the price of commercial insurance. *Regulation and Supervision of Captive Insurance Companies*, Int'l Ass'n of Ins. Supervisors 4 (2006). Today, the world's largest firms use captives, including "the vast majority of Fortune 500 companies" and many listed on the New York Stock Exchange. Chang & Chen, *Characteristics of S&P 500 Companies with Captive Insurance Subsidiaries*, 37 J. of Ins. Reg. 1, 19 (2018).

23. Despite offering many benefits, captive insurance long remained out of reach for small businesses. The cost of lawyers, accountants, and actuaries needed to form and manage a captive meant that captive insurance was mostly a tool for big corporations.

24. That changed when Congress passed, and the President signed, the Tax Reform Act of 1986. Pub. L. 99-514, 100 Stat. 2085. The Act created §831(b) of the Internal Revenue Code, which provides tax benefits for businesses that insure through a small captive. *See* 26 U.S.C. §831(b). A captive that elects §831(b) taxation pays no federal income tax on the premiums it receives from its corporate affiliates, so long as total premium payments fall below $1.2 million. Instead, the captive pays

federal tax only on the income it earns from investing premiums. Firms that use a captive likewise pay no federal tax on the money used for premium payments because another provision of the Code, §162(a), allows businesses to deduct the cost of insurance from their taxable income. *See* 26 U.S.C. §162(a). The resulting tax savings defray the costs of forming and managing a captive and make captive insurance economically viable for small businesses. Because of these tax benefits, "captives are no longer just for large corporations." Taylor & Sobel, *A Closer Look at Captive Insurance*, CPA J. 48 (June 2008).

25. Congress expanded tax benefits for small captives in the Protecting Americans from Tax Hikes Act of 2015. Pub. L. 114-113, 129 Stat. 2242. The PATH Act increased §831(b)'s ceiling on premiums to an inflation-adjusted $2.2 million. §831(b)(2)(A)(i). In response to concerns expressed by some legislators over the use of small captives for estate planning, the Act also added a diversification requirement that makes captives less attractive for that purpose. §831(b)(2)(B); *see* Estes, *Captive Insurance Companies: Why Policymakers Have It All Wrong*, 44 Cap. U. L. Rev. 723, 748-49 (2016) (reviewing the legislative history). But for captives' original purpose of more efficiently managing business risk, the PATH Act's increased premium ceiling makes captive insurance available to a broader set of small businesses.

26. As amended by the PATH Act, the Internal Revenue Code imposes just three requirements on captive insurance companies that elect to receive §831(b)'s tax benefits. First, the captive's written premiums must not exceed $2.2 million in inflation-adjusted dollars. §831(b)(2)(A)(i). Second, the captive must satisfy the diversification requirement—either by having the same level of family ownership interests in the captive and in the policyholders, or, if the family ownership structure differs among those entities, by having no more than twenty percent of written premiums attributable to any one policyholder. §831(b)(2)(A)(ii), (B). Third, the captive must earn more than half its revenue in a given tax year by issuing insurance or annuity contracts. §831(c); *see* §816(a).

C. The IRS's Long Running Efforts to Stymie Captive Insurance

27. While Congress has repeatedly encouraged small businesses to form captives, the "IRS has taken an adversarial stance toward captive insurance since its inception." Estes 746. In 1977, the IRS issued a ruling that disallowed businesses from deducting the costs of captive insurance premiums from their taxable income. *See* Rev. Rul. 77-316. Under that ruling, the IRS assessed captive insurance arrangements under an "economic family" doctrine, which held that captives do not provide genuine insurance for federal tax purposes because liability for the insured risks remains within related corporate entities. *Id.* The ruling effectively eliminated the tax benefits provided by §162(a) for businesses that insure through captives.

28. Courts rejected the IRS's economic family doctrine, however, and held that captives can provide genuine insurance for federal tax purposes. *See, e.g., Humana Inc. v. Commissioner*, 881 F.3d 247, 251 (6th Cir. 1989) ("Under no circumstances do we adopt the economic family argument advanced by the government."); *Clougherty Packing Co. v. Commissioner*, 811 F.2d 1297 (9th Cir 1987); *see also Rent-A-Center, Inc. v. Commissioner*, 142 T.C. 1, 15-20 (2014) (en banc). Despite those rulings, the IRS continued using the economic family doctrine to deny tax deductions for premiums paid to captive insurance companies. The agency finally abandoned that position in 2001, after recognizing that "[n]o court … has fully accepted the economic family theory." Rev. Rul. 2001-31. Going forward, the IRS pledged to assess captive insurance arrangements "based on the facts and circumstances of each case." *Id.*

29. The IRS's case-by-case approach did not last long. The agency pivoted from attacking large captives—owned by the likes of Humana and Rent-A-Center—to attacking captives that insure small businesses. This new front in the IRS's war on captive insurance began in 2016, one year after Congress expanded tax benefits for small captives in the PATH Act.

30. That year, the IRS published Notice 2016-66, which identified a broad swath of small captives—which the IRS calls "micro-captives"—as "reportable transactions"—meaning they have "a potential for tax avoidance or evasion." 2016-47 I.R.B. 745 (Nov. 2, 2016); *see* 26 U.S.C. §6706A(c)(1). Participants in captive insurance arrangements that met the Notice's criteria, along with their material advisors, had to file onerous and costly reports describing the arrangement. Beyond the costs of complying with Notice 2016-66, labeling a transaction as a "reportable transaction" is a scarlet letter in the tax world. It frightens would-be market entrants, unnerves existing captive owners, and drives up malpractice premiums for professionals who advise them.

31. A captive insurance arrangement triggered Notice 2016-66's reporting requirement if it met three criteria that are relevant here: (1) The captive elected §831(b) taxation; (2) the captive's policyholders or their affiliates owned at least twenty percent of the captive's equity or voting power; and (3) either the captive provided tax-free financing to its policyholders or the captive's loss ratio was less than seventy percent. *Id.* §2.01(c), (d), (e).

32. A loss ratio is the amount that an insurance company pays to cover liabilities and expenses divided by the amount of premium income it receives. Insurance companies that insure low-frequency, high-severity risks have low loss ratios because, in most years, the insured risk does not materialize. Instead, the insurance company accumulates premium income so it can cover liabilities when an insured risk materializes.

33. Notice 2016-66's criteria covered most captives used by small businesses. The Notice thus undermined Congress's policy of encouraging small businesses to form captive insurance companies in at least two ways.

34. First, the costs of complying with Notice 2016-66's onerous reporting requirements largely neutralized the tax benefits that Congress provided in §831(b) that make captive insurance economically viable for small businesses.

35. Second, Notice 2016-66 cast a pall on the captive insurance industry and dissuaded small businesses from insuring through a captive. Indeed, in a bulletin published while Congress debated whether to expand §831(b)'s tax benefits in the PATH Act, the IRS listed §831(b) captives on its annual "Dirty Dozen" list of tax scams, likening businesses that use them to identity thieves, fake charities, and other tax cheats. *See* Internal Revenue Service, *Abusive Tax Shelters Again on the IRS "Dirty Dozen" List of Tax Scams for the 2015 Filing Season*, IR 2015-19 (Feb. 3, 2015).

36. Notice 2016-66 was challenged immediately and soon invalidated. After its release, CIC Services sued the IRS in the Eastern District of Tennessee, asserting that the Notice was arbitrary and capricious and that the IRS failed to conduct required notice and comment rulemaking. *See CIC Services, LLC v. Internal Revenue Service*, No 3:17-cv-110 (E.D. Tenn.).

37. The Supreme Court, in a unanimous decision, rejected the IRS's argument that the Anti-Injunction Act shielded Notice 2016-66 from pre-enforcement review. *See CIC Services, LLC v. Internal Revenue Service*, 593 U.S. 209 (2021).

38. On remand, this Court agreed with CIC Services that Notice 2016-66 was unlawful and set it aside. *CIC Services, LLC v. Internal Revenue Service* (*CIC Services II*), 592 F. Supp. 3d 675 (E.D. Tenn. 2022). Notice 2016-66 was arbitrary and capricious because the IRS failed to "identify any facts or data supporting its belief" that small captives have the potential for tax evasion. *Id.* at 685. Instead, the agency attempted to justify the Notice by offering "'cases in which a court found the taxpayer engaged in an abusive transaction.'" *Id.* But the Court rejected that argument, explaining that the IRS cannot satisfy arbitrary-and-capricious review by "[s]imply including cases in the administrative record that suggest certain tax structures could be abusively employed." *Id.* at 687.

39. The Court also concluded that the IRS failed to conduct the necessary notice-and-comment rulemaking before issuing Notice 2016-66, citing *Mann Construction, Inc. v. United States*, 27 F.4th 1138 (6th Cir. 2022). *Id.* at 683.

40. To remedy these APA violations, the Court "vacat[ed] the Notice in its entirety." *Id.* at 688. When granting this relief, the Court echoed "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.*

41. In the wake of all this, the IRS publicly "disagree[d]" with the Sixth Circuit's decision in *Mann Construction* and announced that it will "continue to defend [listed-transaction] notices" issued without notice-and-comment rulemaking "except in the Sixth Circuit." IRS.gov, *Abusive Tax Shelters and Transactions*, www.irs.gov/businesses/corporations/abusive-tax-shelters-and-transactions (last viewed Apr. 1, 2025).

D. The IRS's 2023 Rulemaking

42. After this Court's judgment in *CIC Services II*, the IRS proposed new regulations to replace Notice 2016-66 and invited public comment. *See Micro-Captive Listed Transactions and Micro-Captive Transactions of Interest*, 88 Fed. Reg. 21547 (Apr. 11, 2023).

43. The proposed regulations largely mirrored Notice 2016-66's criteria for identifying small captives that the IRS believes are improper, and they imposed equally costly and burdensome reporting requirements. But while Notice 2016-66 identified these captives as having a *potential* for tax avoidance, the proposed regulations designated many of them as "listed transactions"—meaning "the IRS *has determined* [them] to be a tax avoidance transaction." *Id.* at 21,548 (emphasis added); *see also* 26 U.S.C. §6707A(c)(2) (defining "listed transaction").

44. In IRS lingo, a tax avoidance transaction is a transaction that has "no business purpose beyond reducing or avoiding taxes." *See Stobie Creek Investments LLC v. United States*, 608 F.3d 1366, 1375 (Fed. Cir. 2010). The IRS disregards tax avoidance transactions when assessing a taxpayer's liability. The IRS thus pledged "to challenge the purported tax benefits" of captives that elect §831(b) taxation and meet the regulations' other criteria for listed transactions. 88 Fed. Reg. at 21,554.

45. After receiving over one hundred, mostly negative public comments, the IRS issued a rule to promulgate the new regulations. *Micro-Captive Listed Transactions and Micro-Captive Transactions of Interest*, 90 Fed. Reg. 3534 (Jan. 14, 2025) ("Final Rule"), attached as Exhibit A. The Final Rule made some changes to the proposed regulations but kept intact the basic criteria for targeting small captives.

46. The Final Rule designates a small captive as a listed transaction—*i.e.*, a transaction that the IRS "has determined to be a tax avoidance transaction"—if the captive elects §831(b) taxation and meets three criteria, which the IRS calls the "20 Percent Relationship Test," the "Financing Factor," and the "Loss Ratio Factor." 90 Fed. Reg. at 3,534-35.

47. A captive meets the 20 Percent Relationship Test if at "least 20 percent of the [captive's] 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, or persons Related to an Insured or an Owner." 26 C.F.R. §1.6011-10(b)(1)(iii).

48. A captive meets the Financing Factor if the "Captive made available as financing or otherwise conveyed … to" a policyholder, a policyholder's owners, or related entities "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).

49. A captive meets the Loss Ratio Factor if the "amount of liabilities incurred for insured losses and claim administrative expenses" is "less than 30 percent of" the "amount equal to premiums earned by the Captive" minus policyholder dividends, during the last ten tax years. 26 C.F.R. §1.6011-10(c)(2)(i), (ii).

50. The Final Rule designates small captives as transactions of interest—*i.e.* transactions "that the Treasury Department and the IRS believe have the potential for tax avoidance or evasion"—if the captive elects §831(b) taxation, meets the 20 Percent Relationship Test, and meets either the

Financing Factor or an adjusted Loss Ratio Factor of sixty percent. 90 Fed. Reg. at 3541, 3546; *see also* 88 Fed. Reg. at 21,549 (defining "transaction of interest").

51. The criteria for listed transactions and transactions of interest in the Final Rule and accompanying regulations cover the mine-run of captive insurance companies that small businesses use. By dint of simple division, small captives readily meet the 20 Percent Relationship Test because they typically insure the risks of, and thus are owned by, five or fewer businesses. They also meet the Financing Factor because small captives routinely provide financing to their policyholders, so long as they retain adequate cash reserves to meet liabilities. Indeed, that is one of the key benefits of captive insurance, *see supra* ¶18, and even the IRS acknowledges that related-party financing is a legitimate feature of captive insurance, 90 Fed. Reg. at 3,546. Finally, small captives frequently meet the Loss Ratio Factor because they insure low-frequency, high-severity risks that often do not materialize in a ten-year span. *See supra* ¶32.

52. The regulations' purported effective date was January 14, 2025, the day the IRS issued the Final Rule.

53. Under the Final Rule, participants in captive insurance arrangements, and their material advisors, must comply with onerous and costly reporting requirements for transactions that meet the regulations' criteria. *See* 26 C.F.R. §1.6011-4. A failure to report a listed transaction or transaction of interest gives rise to fines and criminal liability. 26 U.S.C. §§6707, 6707A, 6708, 7203.

54. Under the Final Rule, captives that are classified as listed transactions will not receive the benefits that Congress provided in §831(b), because the IRS believes it can disregard transactions that it considers tax avoidant. *See supra* ¶44.

E. The Harms of the IRS's Attacks on Small Captives

55. The Final Rule and accompanying regulations have caused small businesses to end their captive insurance arrangements and dissuaded many others from forming captives in the first

place. They have also caused the small-captives industry to shrink, harming captive managers and advisors, including CIC Services, by reducing demand for their services.

56. The Final Rule and accompanying regulations also harm small captives and their material advisors, including CIC Services, by imposing costly reporting requirements that are backed by fines and criminal liability for non-compliance.

CLAIMS FOR RELIEF

COUNT I
Administrative Procedure Act, 5 U.S.C. §500 *et seq.*
Agency Action Contrary to Law

57. Plaintiff repeats and realleges each of the prior allegations.

58. The APA requires a court to "hold unlawful and set aside agency action" that is "arbitrary [or] capricious," "in excess of statutory jurisdiction, authority, or limitations," or "otherwise not in accordance with law." 5 U.S.C. §706(2)(A), (C).

59. The Final Rule and accompanying regulations are final agency action subject to APA review.

60. Defendants have authority to, and are responsible for, enforcing the Final Rule and accompanying regulations.

61. Compliance with the Final Rule and accompanying regulations has and will continue to injure Plaintiff, subjecting it to hours of recordkeeping and reporting on an ongoing basis, as well as reputational harms, reduced business opportunities, and exposure to fines and criminal liability.

62. The Final Rule and accompanying regulations exceed the IRS's statutory authority to designate listed transactions. *See* 26 U.S.C. §6707A(c)(2).

63. Countless small captives that meet the criteria in the Final Rule and accompanying regulations for listed-transaction status satisfy the Internal Revenue Code's requirements for §831(b)'s tax benefits. Yet, by designating these captives as listed transactions, the IRS "has determined [them]

to be … tax avoidance transaction[s]" that are not entitled to those benefits. 90 Fed. Reg. at 3,534; *see also* 88 Fed. Reg. at 21,555 (pledging to "challenge the claimed tax benefits").

64. The IRS cannot "reject a Code-compliant transaction in the service of general concerns about tax avoidance." *Summa Holdings, Inc. v. Commissioner*, 848 F.3d 779, 787 (6th Cir. 2017). Nor can it "override statutory provisions" or "fault taxpayers for making the most of the tax-minimizing opportunities Congress created." *Id.* at 789-90. There is no "patriotic duty to increase one's taxes." *Helvering v. Gregory*, 69 F.2d 809, 810 (2nd Cir. 1934) (Hand, J.)

65. But that is exactly what the Final Rule and accompanying regulations do. They declare many small captives to be tax avoidance transactions that are not entitled to §831(b)'s benefits just because the IRS fears they allow "the indefinite deferral of tax" on premium income. 90 Fed. Reg. at 3,546. But "Congress designed [§831(b)] to enable [small captives] to defer corporate income tax" on premium payments, and neither courts nor the IRS may disregard that policy choice. *Summa Holdings*, 848 F.3d at 786.

66. Accordingly, the Final Rule and accompanying regulations exceed the IRS's statutory authority. The Court should hold them unlawful and set them aside. 5 U.S.C. §706(2).

COUNT II
Administrative Procedure Act, 5 U.S.C. §500 *et seq.*
Arbitrary and Capricious Agency Action

67. Plaintiff repeats and realleges each of the prior allegations.

68. The Final Rule and accompanying regulations are arbitrary and capricious for several reasons. *See* 5 U.S.C. §706(2)(A).

69. In issuing the Final Rule and accompanying regulations, the IRS failed to "'examin[e] the relevant data'" and "'articulat[e] a satisfactory explanation for its decision, including a rational connection between the facts found and the choice made.'" *CIC Services II*, 592 F.Supp.3d at 684 (quoting *Dep't of Com. v. New York*, 588 U.S. 752, 773 (2019)).

70. In *CIC Services II*, this Court held that Notice 2016-66—the predecessor to the Final Rule and accompanying regulations—was arbitrary and capricious because the IRS did not support its conclusion that §831(b) captives were tax avoidant or potentially tax avoidant with "facts or data," as the APA requires. *Id.* at 685-86.

71. The IRS repeated that error when issuing the Final Rule and accompanying regulations. Instead of supplying facts and data to support its conclusions, the IRS offered the same justifications that this Court found lacking in *CIC Services II*. The Final Rule merely "describe[s] th[e] transactions," references its "previously issued notices" that targeted small captives, and "compile[s] cases in which a court found the tax payer engaged in an abusive transaction." *Id.*; *see* 90 Fed. Reg. at 3,538. Arbitrary-and-capricious review requires more. *CIC Services II*, 592 F.Supp.3d at 686-87.

72. The IRS's failure to correct the errors this Court identified in *CIC Services II* was not simply an oversight. Commenters flagged the IRS's failure to support its rulemaking with facts and data and predicted that the Final Rule and accompanying regulations "will be challenged and set aside just as Notice 2016-66 was set aside." 90 Fed. Reg. at 3,538. Although the IRS acknowledged that this Court vacated Notice 2016-66 both for lack of notice-and-comment rulemaking and for arbitrary and capricious reasoning, the agency made no attempt to explain how the Final Rule cures Notice 2016-66's substantive defects, instead stating only that the "APA notice-and-comment procedures [were] followed." *Id.*

73. If anything, the IRS needed *more* facts and data to support the Final Rule and accompanying regulations than it needed to support Notice 2016-66. The Notice was based on the IRS's asserted "belief" that §831(b) captives have a *potential* for tax avoidance or evasion. 592 F.Supp.3d at 685 (quoting Notice 2016-66). In the Final Rule, however, the IRS's belief has ripened into a firm conclusion that many of these captives *are* tax avoidance transactions. 90 Fed. Reg. at 3,534. Greater degrees of certainty in an agency's conclusions require greater degrees of proof. But in the Final Rule,

the IRS merely repeated the same bald assertions and unelaborated citations to case law that this Court held were insufficient to support Notice 2016-66.

74. The IRS thus fell far short of its duty under the APA to offer "facts and data" to support its conclusions that the mine-run of §831(b) captives are tax avoidance transactions and that many more are potentially tax avoidance transactions. *CIC Services II*, 592 F.Supp.3d at 687.

75. The IRS's repeated failures to justify its suspicion of §831(b) captives show that the Final Rule and accompanying regulations are mere "pretext." *Dep't of Com.*, 588 U.S. at 782. The IRS's true aim is *not* to police abuses of §831(b), but to attack captive insurance itself. The agency's criteria for identifying supposedly abusive captives lay this bare. According to the IRS, captives that meet the 20 Percent Relationship Test, Financing Factor, and Loss Ratio Factor are abusive no matter what role, if any, §831(b)'s tax benefits play in the arrangement. There is no inherent relation between the IRS's criteria and §831(b) taxation, nor has the IRS identified one in its rulemaking. *But see id.* at 773 (requiring a "rational connection between the facts found and the choice made"). The IRS's criteria thus "cannot be adequately explained in terms of" the agency's purported concern over §831(b) abuse. *Id.* at 783. Instead, the Final Rule and accompanying regulations make §831(b) taxation a precondition for listed-transaction status just to give the IRS a veneer of statutory authority to combat whatever segment of the captive insurance industry the agency can get its hands on.

76. The APA requires agencies to give "genuine justifications" for their actions. *Id.* at 785. Despite the IRS's bolt-on reference to §831(b)'s tax benefits, the Final Rule and accompanying regulations are a veiled attempt to target small captives writ large.

77. The Final Rule and accompanying regulations are arbitrary and capricious. The Court should hold them unlawful and set them aside. 5 U.S.C. §706(2).

COUNT III
Administrative Procedure Act, 5 U.S.C. §500 *et seq.*
Agency Action Contrary to Law

78. Plaintiff repeats and realleges each of the prior allegations.

79. The Final Rule and accompanying regulations exceed the IRS's statutory authority because they impose a diversification requirement that Congress rejected in the PATH Act, and that fundamentally changes the scope of §831(b)'s tax benefits.

80. A captive can meet the PATH Act's diversification requirement in one of two ways. To satisfy option one, "no more than 20 percent" of the captive's premiums may be "attributable to any one policyholder." §831(b)(2)(B)(i)(I). For option two, the captive's owners and their family members must hold roughly the same interest in the insured companies, in percentage terms, as they do in the captive. §831(b)(2)(B)(i)(II). Under the Internal Revenue Code, a small captive that satisfies either option is qualified to receive section 831(b)'s tax benefits. *Id.*

81. The Final Rule and accompanying regulations require captives to satisfy the PATH Act's first diversification option. To avoid being classified as a listed transaction or transaction of interest, captives must now meet the IRS's 20 Percent Relationship Test, which requires that a captive has less than "20 percent of [its]" assets, voting power, or equity interests "directly or indirectly owned" by the insured company, its owners, or related corporate entities. 90 Fed. Reg. at 3,554; 26 C.F.R. §§1.6011-10(b)(1)(iii), 1.6011-11(b)(1). The 20 Percent Relationship Test is functionally equivalent to the PATH Act's twenty-percent policyholder rule. *See* §831(b)(2)(B)(i)(I). Because captive insurers are owned by their policyholders, the percentage of premiums attributable to a single policyholder will generally match that policyholder's ownership stake in the captive. Thus, by sleight of hand, the IRS regulations force small captives to reduce the concentration of its policyholders even though the PATH Act gives captives a second way to satisfy the diversification requirement. *See* §831(b)(2)(B)(i)(II).

82. Agencies cannot eliminate by regulation options that Congress provides by statute. *Summa Holdings*, 848 F.3d at 789. The PATH Act's legislative history shows why. In the original proposal, captives had only one way to satisfy the diversification requirement: "[N]o more than 20 percent of [a captive's] net written premiums … can be attributable to any one policyholder." *See* Joint Comm. on Tax'n, *Description Of The Chairman's Mark Relating To Modifications To Alternative Tax For Certain Small Insurance Companies*, JCX-21-15, at 2 (Feb. 9, 2015). That restriction was "intended to narrow the application of section 831(b)." *Id.* The proposal, if enacted, would have "crippled the § 831(b) captive industry." *Estes*, at 728.

83. Congress rejected the proposal, however, choosing instead to expand §831(b) while making small captives less attractive for estate planning to address the concerns of some legislators. *See supra* ¶25. In the version of the PATH Act that Congress enacted, companies that do not use captives for estate planning readily meet option two of the diversification requirement and need not satisfy option one's limits on policyholder concentration. For them, the PATH Act meant "business as usual." Estes 478. The Act's diversification requirement has bite only "if the familial ownership of the captive … differ[s] materially from the ownership of the insured firms." *Id.*

84. The Final Rule and accompanying regulations upset the PATH Act's legislative compromise by requiring captives to reduce the concentration of policyholders even if they are not being used for estate planning. The IRS acknowledged that its diversification requirement differs from what the PATH Act provides. 90 Fed. Reg. at 3,554. In the IRS's view, however, "the PATH Act diversification requirements are not sufficient to eliminate the possibility that a transaction is or may be a tax avoidance transaction." *Id.* The IRS misunderstands its statutory authority. It cannot use its regulatory power to "nullif[y] a Code-supported tax-minimizing transaction" just because it disagrees with Congress's policy choice. *Summa Holdings*, 848 F.3d at 787.

85. By adding limits to §831(b) that Congress rejected, the Final Rule and accompanying regulations exceed the IRS's statutory authority. Accordingly, the Final Rule and accompanying regulations must be vacated and set aside.

COUNT IV
Administrative Procedure Act, 5 U.S.C. §500 *et seq.*
Arbitrary and Capricious Agency Action

86. Plaintiff repeats and realleges each of the prior allegations.

87. For similar reasons why the IRS exceeded its statutory authority in altering the PATH Act's diversification requirement, the Final Rule and accompanying regulations are arbitrary and capricious.

88. In imposing a diversification requirement that is different from the diversification requirement in the PATH Act, the IRS "relied on factors which Congress has not intended it to consider." *CIC Services II*, 592 F.Supp.3d at 684 (quoting *Atrium Medical Center v. U.S. Dep't of Health & Hum. Servs.*, 766 F.3d 560, 567 (6th Cir. 2014)). Congress settled on the degree of diversification required of small captives to qualify for §831(b)'s tax benefits, and the IRS cannot alter Congress's policy judgment by administrative fiat.

89. Moreover, the IRS failed to consider the effects of its diversification requirement on the scope of §831(b) as Congress designed it. Countless small captives fail the diversification requirement of the Final Rule and accompanying regulations but would otherwise qualify for §831(b)'s tax benefits under the Internal Revenue Code. The Final Rule and accompanying regulations classify vast numbers of these captives as listed transactions, meaning they will not receive the tax benefits that Congress enacted. And they classify many more as transactions of interest, meaning that small businesses adopt these arrangements at their peril.

90. The IRS offered no rational justification for dramatically limiting the scope of §831(b)'s tax benefits. Instead, the IRS stated that the Final Rule and accompanying regulations "do

not hinder" what the IRS considers to be "valid captives." 90 Fed. Reg. at 3,557. But that explanation flouts Congress's authority to determine what captives are valid. The IRS cannot "override" Congress's decision with its own views of good tax policy. *Summa Holdings*, 848 F.3d at 789.

91. Accordingly, the Final Rule and accompanying regulations are arbitrary and capricious. The Court should hold them unlawful and set them aside. 5 U.S.C. §706(2).

COUNT V
Administrative Procedure Act, 5 U.S.C. §500 *et seq.*
Arbitrary and Capricious Agency Action

92. Plaintiff repeats and realleges each of the prior allegations.

93. The Final Rule and accompanying regulations are arbitrary and capricious because they require captives to maintain loss ratios that are unreasonable in light of the low-frequency, high-severity risks that captives underwrite. Moreover, the IRS failed to articulate a satisfactory explanation for why it selected those unreasonable loss ratios.

94. Under the Final Rule and accompanying regulations, a captive that meets the 20 Percent Relationship Test and the Financing Factor is classified as a listed transaction if its loss ratio over the past ten tax years is below thirty percent. 26 C.F.R. §1.6011-10(c). A captive that meets the 20 Percent Relationship Test is classified as a transaction of interest if its loss ratio the past ten tax years is below sixty percent, regardless of whether the captive meets the Financing Factor. 26 C.F.R. §1.6011-11(c).

95. These loss ratios are arbitrary and capricious. Captive insurance companies frequently experience low loss ratios for extended periods of time because, in most years, the types of risk they underwrite do not materialize, as the IRS acknowledged in the Final Rule. *See* 90 Fed. Reg. at 3,541.

96. Indeed, the Tax Court held that a company provided valid insurance for federal tax purposes even though the company's loss ratio for the ten-year period from 2000 to 2009 was only twenty-eight percent. *See R.V.I. Guar. Co., Ltd. & Subsidiaries v. Commissioner*, 145 T.C. 209, 216 (2015).

In some years, the company's loss ratio was as low as 0.2 or 0.3 percent. *Id.* But under the Final Rule and accompanying regulations, captives that experience the same ten-year loss ratio as the company in *R.V.I.* are now classified as tax avoidance transactions, and captives with significantly *higher* loss ratios are classified as potential tax avoidance transactions.

97. In the rulemaking, the IRS attempted to explain away the *R.V.I.* decision with an accounting trick. It noted that the insurance company's average loss ratio for five overlapping ten-year periods was thirty-two percent. 90 Fed. Reg. at 3,541. The IRS then "rounded down" that figure "to 30 percent in the final regulations." *Id.* That justification fails for at least two reasons.

98. First, the IRS's rationale relies on a method of calculating a captive's loss ratio that is different from the method used by the regulations. The regulations require small captives to calculate their loss ratio based on the "most recent ten taxable years." 26 C.F.R. §1.6011-10(b)(2)(ii). Under that formula, the company in *R.V.I.* would have failed to provide insurance for federal tax purposes between 2000 and 2009. The IRS cannot change that formula to distinguish a case that shows why the loss ratio set by the Final Rule and accompanying regulations is irrational.

99. Second, the IRS kept the Loss Ratio Factor at sixty percent for captives that it designates as transactions of interest, which likewise triggers onerous and costly reporting requirements. The IRS determined the sixty-percent figure by drawing a comparison to the loss ratios of commercial insurance companies, as reported by the National Association of Insurance Commissioners. *See* 90 Fed. Reg. at 3,542. That comparison is inapt, however, because the NIAC dataset does not include the loss ratios of small captives, so it is not representative of the insurance companies that the Final Rule and accompanying regulations cover. *Id.*; *see also Rent-A-Center*, 142 T.C. at 12 (commercial insurance companies have different loss ratios than captives because "they face competition and, as a result, typically price their premiums to have significant underwriting losses. They compensate for underwriting losses by retaining sufficient assets … to earn ample amounts of investment income").

100. Although commenters pointed out this flaw, the IRS dismissed the problem by stating that it was not "aware of" any "alternative data set" that would be representative of the loss ratios experienced by small captives. *Id.* Although agencies can sometimes rely on "[im]perfect empirical or statistical data" for rulemaking, inferences drawn from the data must be "reasonable." *See FCC v. Prometheus Radio Project*, 592 U.S. 414, 428 (2021). Here, it was not reasonable for the IRS to draw an apples-to-oranges comparison between loss ratios of small captives and loss ratios of the fundamentally different insurance companies represented in the NIAC dataset.

101. Further, the IRS's professed lack of relevant data beggars belief. Through its unlawful promulgation of Notice 2016-66 and the accompanying reporting requirement, the IRS received and reviewed what must be thousands of reports from thousands of captive owners covering over a decade of tax years. It has hundreds of active Tax Court cases against captives and an untold number of open audits. Perhaps the IRS has not reviewed and processed the data it already has, or it has chosen not to use it. Either is a violation of the APA.

102. Accordingly, the Final Rule and accompanying regulations are arbitrary and capricious. The Court should hold them unlawful and set them aside. 5 U.S.C. §706(2).

PRAYER FOR RELIEF

Plaintiff respectfully requests that this Court enter judgment in its favor and against Defendants and provide the following relief:

A. a declaratory judgment that:

i. Defendants violated the APA by promulgating the Final Rule and accompanying regulations in excess of statutory authority;

ii. Defendants violated the APA by promulgating the Final Rule and accompanying regulations contrary to law;

iii. Defendants violated the APA by promulgating the Final Rule and accompanying regulations with arbitrary or capricious reasoning;

B. an order holding unlawful and setting aside the Final Rule and accompanying regulations;

C. a permanent injunction forbidding Defendants from enforcing the Final Rule and accompanying regulations against Plaintiff, its clients, and its affiliates;

D. reasonable costs and expenses of this action, including attorneys' fees; and

E. all other relief that Plaintiff is entitled to, as the Court deems just and proper.

Dated: April 9, 2025

Respectfully submitted,

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**pro hac vice application forthcoming*