

A man in a pinstriped suit is climbing a large, dark rock. He is leaning against the rock with one hand and has a pained or strained expression on his face. The background is a clear blue sky.

The trials and tribulations of 831(b)s

Against a backdrop of legal battles and regulatory changes, small captives have been through a lot. But how much has the landscape changed, and are 831(b)s still an attractive option for the middle market? *US Captive* investigates.

Captives that make the 831(b) election—also known as microcaptives or enterprise risk captives (ERCs)—have long been a cost-effective method for smaller and medium-sized companies to get involved in alternative risk financing.

The sector has gone through a series of changes over the last few years, for example the Protecting Americans from Tax Hikes Act of 2015 (PATH Act) increased the maximum annual premium limitation for 831(b)s from \$1.2 million to \$2.2 million (effective January 1, 2017) with a provision for inflation adjustments in future years (\$2.2 million to \$2.3 million for the 2018 tax year).

Further amendments have been made to this act in 2018 with the Consolidated Appropriations Act.

Although the 831(b) election for insurance companies has existed since 1986, microcaptives have come under increased scrutiny

from the Internal Revenue Service (IRS) after they were labelled as “transactions of interest” in Notice 2016-66 in November 2016.

The IRS has audited more of these captive structures in the belief that small businesses are using them to insure against improbable risks that they never pay claims on, and the premiums then return to the business owners with little to no tax.

“The past few years have been a bumpy ride for the captive insurance industry which, as any, wants regulatory certainty,” says Ryan Work, vice president of government relations at the Self-Insurance Institute of America (SIIA).

“The increased premium deductibility threshold amount, now tied to inflation, certainly makes ERC captives more attractive. Similarly, the PATH Act provisions put in place to temper abusive behaviour are a positive step for the industry overall.

“At the same time, the burdensome requirements imposed by Notice 2016-66, along with recent court decisions such as *Avrahami* and *Reserve Mechanical*, have tempered the attractiveness of captives for some owners.”

Despite the regulatory pressure, Work says, the small captives sector has been and will continue to be an attractive risk vehicle for business owners seeking to mitigate appropriate alternative risks in the right way.

He continues: “Like many policy and regulatory activities in this past, this too shall pass. In the meantime, it is essential that the industry take proactive steps forward, while at the same time continuing to educate policymakers and regulators at the state and federal levels on captive insurance in general.”

Changes to the PATH Act

On March 23, President Donald Trump signed into law HR 1625, the Consolidated Appropriations Act 2018.

The act contains technical corrections that amend IRS Code Section 831(b) by adding clarifications to the diversification requirements imposed by PATH Act of 2015.

“The Consolidated Appropriations Act 2018 clarified some points that were ambiguous under the PATH Act of 2015. The US Congress’ Joint Committee on Taxation’s explanation is very helpful, as the industry reviews the language in the new law,” says Charles Lavelle, senior partner at Bingham Greenebaum Doll.

Under the PATH Act, 831(b) captives are required either to have

no more than 20 percent of premiums from one policyholder or to meet certain ownership tests intended to remove any estate tax planning capability in the captive’s ownership.

Amy Lewis, vice president of Captive Resources, says that the language of this act had left many with questions on the actual application of the rules.

One of the ways the act amended the language of the PATH Act was to define a policyholder as “each policyholder of the underlying direct written insurance with respect to such reinsurance or arrangement”.

Lewis explains that this language allows a captive that is a member of a risk management pool to ‘look through’ the reinsurance to consider each insured in the pool as a policyholder for the purposes of this test, alleviating a concern that the pool could be considered a single policyholder for the test.

The act also modified the ownership test language, eliminating spouses (unless they are not a US citizen) from the definition of a specified holder and providing an aggregation rule for certain spousal interests, and expanding the definition to include stepchildren and other descendants which, Lewis says, clarifies some of the ownership questions arising from the act.

It also adds a concept of “relevant specified assets” to aggregate the holdings of the assets for the purposes of comparing a specified holder’s ownership in the captive to the ownership of insured assets.

“The insured assets are not considered separately under the modified language, which restricts the ownership of specified holders in applying the de minimus test. While this is a clarification of the prior language, it still does not fully address how to determine the amount of interest held by a specified holder,” says Lewis.

She concludes: “I believe that it is a good first step to helping interpret the PATH Act legislation, and helpful, but more guidance and clarity would be welcomed by taxpayers and practitioners.”

The SIIA engaged with Congress several years ago to help shape the PATH Act, and has continued to work with policymakers to seek needed clarification to some of the ambiguous language in the original legislation.

Work adds: “The PATH Act clarifications passed as part of this year’s omnibus appropriations bill did indeed help clarify issues surrounding spousal ownership, along with the definition and calculation of specified assets within the original law.

“In addition, the clarifications offer a much-needed look-through provision that was unintentionally left out of the original PATH Act. Together, these changes hopefully provide some needed guidance for the entire industry.”

Court battles

In August 2017, *Avrahami v Commissioner* was the first high-profile US Tax Court case against microcaptives, with Judge Mark Holmes concluding that the arrangements made by Benjamin and Orna Avrahami through their captive, Feedback Insurance Company, were not insurance for federal tax purposes.

There are concerns that the outcome of this case has hurt the reputation of captives that make the 831(b) election, and that this decision would embolden the IRS to audit more structures.

Reserve Mechanical v Commissioner is the IRS's latest win against small captives, as the court determined that captive insurer Reserve Mechanical's risk pool entity, PoolRe Insurance, operated by Capstone Associated Services, was not a “*bona fide* insurance company” because it did not distribute risk.

There is debate over whether PoolRe—when it was used as a stop loss insurance company from 2008 through 2010—constituted insurance transactions.

Capstone had disputed the tax court's comparison to *Avrahami*, arguing that PoolRe's payment of substantial claims and inclusion of unaffiliated third-part reinsurance to its legitimate insuring of a mining business were valid reasons as to why the insurance transactions were legitimate and different from the comparisons made.

The industry is still awaiting the opinions on several cases currently pending before the US Tax Court, which involve insurance companies that have made the section 831(b) election. At the time of writing they include *Caylor v Commissioner*, *Wilson v Commissioner* and *Szygy Insurance Co v Commissioner*.

Lewis says that this continued IRS scrutiny is definitely a concern to existing and potential 831(b) captive owners.

“The IRS has clearly stated that it recognises there are legitimate captives and is searching out the abuses, but the process of identifying what is a legitimate captive continues to need guidance, in addition to what was provided by the Appropriations Act,” she says.

“More and more companies are considering how to integrate small captives into their overall risk profile and continued guidance to provide clarity will help these companies to set up captives in accordance with both the letter and the intent of the law.”

US tax reform

The US Tax Cuts and Jobs Act 2017 represents the first major overhaul to federal taxes since 1986, and there are provisions that US and international captives should be wary of.

Large captives benefit in two ways: their tax on underwriting profits is reduced from 35 percent down to 21 percent, and their tax on investment income is reduced to 21 percent.

831(b) captives would still be taxed 0 percent on their underwriting profits, but they now have the added benefit of having their



““The clarifications offer a much-needed look-through provision that was unintentionally left out of the original PATH Act.”

Ryan Work, Self-Insurance Institute of America

investment income taxed at the lower 21 percent corporate rate—compared with up to 35 percent previously.

“I don't think that the US tax reform legislation at the end of 2017 has had a material effect on insurance companies that have elected to be taxed under section 831(b). These insurance companies are used for risk management purposes, and tax reform has not materially changed the financial consequences of insuring with an affiliated small insurance company,” says Lavelle.

Karl Huish, executive vice president, North America, Artex Risk Solutions, adds that tax considerations are just one of many factors that influence the decision that a company evaluates when deciding to start a captive insurance programme.

“Although companies are generally paying less federal income tax post-tax reform, it isn't the huge reduction that some companies expected a year ago, especially for pass-through entities such as partnerships and S corporations,” says Huish.

“There are many reasons that companies form captives that are not dependent upon tax. Those reasons have not changed post-tax reform.” ■