MICRO-CAPTIVES: BUILDING A STRONG FOUNDATION FOR SUCCESS

Amy Lewis, of Captive Resources, LLC, discusses, in spite of continued close scrutiny from the IRS, the continued viability of legitimate micro-captives, and the considerations to ensure the structure succeeds

Ongoing scrutiny by the Internal Revenue Service (IRS) around 831(b) micro-captive insurance companies and the potential misuse of these captives has caused some companies to step back for an analysis over whether a micro-captive insurance company is the right fit for their risk management needs. Given the recent activity around the potential abuse of these captives, now is a good time to review how to develop a strong foundation for success when forming or managing a micro-captive. A micro-captive that has been structured correctly can be an effective tool for successfully managing a company's risk profile and supporting a business's risk management needs.

While there has been significant negative publicity around micro-captives highlighting the potential abuses related to these captives, the IRS included the following statement in Notice 2016-66:

"The Treasury Department and the IRS believe this transaction ('micro-captive transaction') has a potential for tax avoidance or evasion. See IR–2016–25 (discussing characteristics of an abusive micro-captive insurance structure). However, the Treasury Department and the IRS lack sufficient information to identify which § 831(b) arrangements should be identified specifically as a tax avoidance transaction and may lack sufficient information to define the characteristics that distinguish the tax avoidance transactions from other § 831(b) related-party transactions."

Amy Lewis

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Additionally, in the publication of the IRS Dirty Dozen list, wherein the IRS has included micro-captives under tax shelters as a potential abuse, the IRS led with the following statement:

"Another abuse involving a legitimate tax structure involves certain small or 'micro' captive insurance companies."

While the IRS is actively scrutinizing micro-captives, this language clearly indicates it believes legitimate micro-captives exist, and the intent is to weed out the bad apples, not cut down the apple tree. For companies that have legitimate insurance needs, especially related to unique or specialized coverages that may be unavailable or cost prohibitive in the traditional insurance market, a micro-captive can be a cost effective solution. Forming a micro-captive can improve a business's risk management program and also allow for better cash forecasting, as payments for actuarially determined premiums can be included in the budgeting process. It is an opportunity to step into the world of alternative risk management while providing the business with an individualized risk management plan.

In order to build a solid foundation for a micro-captive, in addition to a legitimate insurance need, a company must have the willingness to commit and ability to operate an insurance company. Consideration of the formation of an insurance company should include, but not be limited to, consultation with all the business's risk management and financial personnel or consultants regarding how the business is impacted by a captive formation. Although the limitation on annual premium was increased from $1.2m to $2.2m (adjusted for inflation) for years after 31 December 2016 as a result of the PATH Act (which allows a micro-captive that elects 831(b) to receive premiums up to $2.2m per year while only paying tax on its investment income), further analysis is needed around which risks to insure. A micro-captive is limited by the

capital invested and premiums paid, and therefore, there are also limits as to how much risk can be assumed by the captive in its initial years. The team should assess those limits, as well as how they may be adjusted in the future. This will likely limit the captive to select commercial coverages the business currently has in place, or coverage that it has been unable to secure in the marketplace. A well-informed team will look to recommend coverages for the micro-captive that supplement and support the current risk management program.

Additionally, in looking to form a micro-captive, considerable information is needed by the captive manager assisting in the captive formation in order to gain an understanding of the business's insurance needs including a detailed description of the business's operations and structure, business financials, types of employees and employee count, current insurance coverages and loss history, risk concerns of the business, and other additional items. A diligent captive manager or consultant will spend a significant amount of time reviewing this information and discussing the results of the review with the business to ensure that the appropriate lines of coverage are priced and that the types of coverage that are difficult to cover in the commercial market, whether because they are unavailable or simply too expensive to insure, are included for pricing. Insufficient time invested in this step may be an indication to the business owner that a resulting micro-captive would not have a solid foundation upon review. Additionally, this initial discovery phase lays the groundwork for additional discussions in future years. As the captive matures, covering additional or more expensive exposures may become possible

Once the potential lines of coverage have been identified and agreed upon by all parties, one of the most important building blocks in creating a strong foundation for the captive is pricing by an independent third-party actuary. The actuary should have experience pricing various coverages in multiple industries across multiple locations. No matter how much experience an individual or captive manager has in the insurance industry, a qualified actuary is better equipped to calculate the premiums at an arms-length standard using appropriate, established actuarial standards of practice.

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Another important consideration when establishing a micro-captive is the choice of an appropriate domicile for the captive. This presents yet another opportunity to ensure that the micro-captive supports the business. There are multiple considerations when choosing a domicile for a captive, including the reputation of the domicile, the captive legislation and geographic accessibility. Another important factor to consider is whether to domicile the captive onshore or offshore. The perceived benefits of domiciling a micro-captive offshore may be offset by the added complexity of having an offshore entity. The perception that an offshore entity is a potential suspect for tax avoidance is mitigated by the fact that any micro-captive must make an election to be taxed as a US entity under IRC Section 953(d) in order to elect IRC Section 831(b). However, the regulation of captives by the states is generally more rigorous than the regulation by foreign jurisdictions and the additional capital required by the states is more in line with the IRS's opinion that there should be adequate capital, regardless of the jurisdictional requirements. An acceptable ratio is generally considered to be in the range of 3:1 to 5:1 of premium to capital.

Finally, once the captive is formed, hiring qualified parties in addition to the captive manager and captive consultant is critical to the success of the captive. Continuing to use a qualified third-party actuary to review and reprice policy premiums is a critical factor in the continued success of the captive. Utilizing qualified accountants and tax preparers to provide audited financials and tax returns for the captive will help to cement the micro-captive's foundation.

In conclusion, when considering forming a micro-captive to support a business's insurance needs, carefully building a strong foundation will ensure that it continues to be an effective tool to help manage the business's risk profile for years to come.