



R&Q Quest Management Services Limited (Bermuda) Changes in the pipeline with the spotlight on 831(b) elections.

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Preamble.

In recent years there has been a significant proliferation in the use of US Internal Revenue Code provision 831(b) in the creation of small insurance companies - often referred to as 'micro captives'. Whilst in principle these are a legitimate, bona-fide structure with the potential for very real benefits, they are coming under increasing scrutiny from the IRS. With the 2014 tax filing season well underway, Washington has stepped up efforts to clamp down on potential abuses which could result in lost tax dollars for the US Treasury¹. At the same time, proposals are being put forward by the Joint Committee on Taxation to alter the criteria which would need to be satisfied to qualify for the 831(b) election². This paper gives a broad overview of what an 831(b) is, and move on to discuss some of the key costs and benefits, before interpreting the proposed changes.

831(b) – The fundamentals.

While captives could have once been considered the domain of only the largest corporations, an 831(b) election has been widely seen as a way for smaller and medium-sized entities to move in to self-insurance. When used correctly, there are a number of potential benefits which will be explored below. This election is available not only in the US, but also for captives with US parent companies domiciled offshore in locations such as Bermuda.

A key clarification is that an election is required to use the 831(b) provisions and this election must be approved by the IRS – an '831(b) captive' is not simply a something that can be created. At the time of writing, 831(b) election is available to a (captive) insurer with up to **\$1.2 million annual written premiums** (the greater of net and direct written premiums). All insurance companies, other than those writing life, are eligible to apply provided the other requirements are satisfied. In terms of applicability, the Code mandates *"The election under clause (ii) shall apply to the taxable year for which made and for all subsequent taxable years for which the requirements of clause (i) are met. Such an election, once made, may be revoked only with the consent of the Secretary³."*

831(b) benefits and considerations.

The key benefit of an 831(b) election is that electing companies will be taxed on their investment income, and not on premiums. The tax exemption on the operating income for the captive is just that: an exemption and not a deferral. The parent company also benefits by obtaining a tax deduction in the current year for the premiums paid to the captive. A further advantage is that the creation of a new program will potentially help the business owner better manage exposures. For example, by obtaining coverage for risks that were previously uninsured or underinsured. Further, it will likely shift attention in favor of risk management within these entities, which brings a raft of potential upsides that are associated with a robust risk management program.

While these benefits can be significant with a well-structured program, there are some important considerations. Firstly, there are restrictions on the use of underwriting losses in an 831(b) arrangement; prohibiting loss carry-forward while the legislation gives no relief for tax due on investment income. Secondly there is the consideration of risk and risk distribution required to be treated as an insurer for the 831(b) election. This is to comply with the IRS Safe Harbor provisions which, amongst other things, include a requirement for more than 50% of the premiums to be derived from third parties (unrelated). Also fundamental in qualifying as an insurer is the requirement for the existence of risk transfer (i.e. possibility of loss), which is important when a particularly potent point in considering the structure of a pooling arrangement.

What is the stance of the IRS?

The IRS appears to be looking closely at potential abuses by insurance companies with an 831(b) election. However, it is worth reinforcing that the IRS does refer to these small captives as “a legitimate tax structure¹”. One of their key arguments is that “insured claims deductions under the tax code for premiums paid for the insurance policies while the premiums end up with the captive insurance company owned by same owners of the insured or family members¹” Some of the underlying issues question whether any real transfer of risk takes place in these arrangements and promoters of micro captives are starting to be looked at by the IRS in more detail.

Proposed new legislation: opportunities and threats.

In a proposal dated 9 February 2015 by the Joint Committee on Taxation, there is mention of an increase in the premium threshold from \$1.2M to \$2.2M. The proposal then goes on to outline restrictions which would narrow the 831(b) application. However, paper JCX-44-15 dated 11 February 2015 goes on to amend the proposal by removing the proposal for increased restrictions.

Should the proposed increase in limits from \$1.2 to \$2.2M proceed, there will be opportunities for more significant savings by way of greater tax deductions for premiums paid. It will also expand the scope and perhaps open the market to those entities for which \$1.2M in premiums written was not sufficient for their requirements. Expanding the size of these smaller captives will provide further tools to more entities wanting to foster a strong risk management and financing strategy. With more comprehensive insurance structures, there is more scope to mitigate the lack of insurance or under-insurance, which is good for the captive owner, the economy and society as a whole.

The initial proposal to restrict the application of 831(b), although subsequently removed, does point to a potential narrowing in the scope of 831(b) applicability in the future. This is something which should be closely monitored to ensure nothing is overlooked.

Looking ahead

Naturally, the increased attention being placed on these micro captives by the IRS may serve to suppress the appetite of those considering setting up new captives with an 831(b) election, and potentially for captives in general. However, there is also an opportunity to promote the legitimacy and success of well-structured captives which comfortably satisfy the 831(b) criteria, extolling the associated potential benefits of risk management and asset protection. Should the premium limit increase to \$2.2m, this could serve to boost the scope of entities which could benefit from the election.

As with any new vehicle, it is imperative to ascertain what the entity is aiming to achieve when considering an 831(b) election (or indeed any alternative risk transfer arrangement). A thorough case-by-case analysis is vital to maximize the potential benefits and smooth the process of creating and running a micro captive which adheres to all legislative requirements. The metrics will be different for every client.

With the increased focus by the IRS, it is now more essential than ever to have a robust technical and holistic feasibility analysis performed when considering setting up such a vehicle. It is in this way that all parties to the transaction have a more complete grasp of the issues when developing an optimal structure, which is sound from a regulatory perspective.

R&Q Quest Bermuda's Approach

R&Q Quest Bermuda take a very hands-on approach, taking the time to explain exactly what alternatives are available to assist in the selection of the vehicle most appropriate to the needs of the parent company.

We will continue to monitor the situation closely to ensure that we are the forefront of developments in 831(b) legislation, striving to ensure that we continue providing first-class, independent service, fully compliant with the latest regulatory requirements.

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The material presented in this report is not offered as legal or tax advice. Neither the author nor R&Q Quest Management Services Limited is engaged in legal or tax advisory service. For advice or assistance in specific cases, the services of an attorney or other professional advisor should be obtained.

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References:

¹ <http://www.irs.gov/uac/Newsroom/Abusive-Tax-Shelters-Again-on-the-IRS-Dirty-Dozen-List-of-Tax-Scams-for-the-2015-Filing-Season>

² <https://www.jct.gov/publications.html?func=select&id=74>

Paper JCX-21-15: (February 09, 2015):

Description Of The Chairman's Mark Relating To Modifications To Alternative Tax For Certain Small Insurance Companies

Paper JCX-44-15: (February 12, 2015)

Description Of The Chairman's Modifications To The Chairman's Mark Proposal Relating To Modifications To Alternative Tax For Certain Small Insurance Companies

³ <http://www.law.cornell.edu/uscode/text/26/831>

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