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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

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**TOPIC: Planning with Small Captives – Significant Changes on the Horizon?**

**MARKET TREND:** The use of small captive insurance companies primarily for estate planning purposes is coming under increasing regulatory and legislative scrutiny.

**SYNOPSIS:** Captive insurance companies can provide businesses with an important risk management tool that allows them to obtain protection against a wide variety of losses. To promote the creation of insurance reserves which protect businesses against potential losses (and thus support business longevity), captives are taxed under many of the same rules applicable to traditional insurance carriers. With the enactment of Internal Revenue Code ("Code") § 831(b), small and mid-sized business were provided with access to this important market. However, perceived abuses with the use of smaller, "micro-captives" in transactions primarily motivated by estate planning are prompting the IRS and Congress to more closely review the use of these smaller captive arrangements, as evidenced by the addition of "abusive" micro-captives arrangements to the IRS list of "Dirty Dozen Tax Scams." More restrictive captive insurance legislation may be forthcoming, although it appears unlikely in 2015.

**TAKE AWAYS:** The addition of micro-captive arrangements to the IRS Dirty Dozen list is a definitive "heads-up" that the use of captives primarily for estate planning purposes is under careful scrutiny. Thus, any possible estate planning benefits attributable to a captive arrangement created in reliance on current laws cannot be guaranteed, since there is no certainty that any new captive legislation will provide "grandfathering" protection. While legislation is likely, it does not appear imminent for 2015. Thus, AALU will continue to monitor this situation and advise of important developments.

***MAJOR REFERENCES:*** *Code § 831(b).*

Captive insurance arrangements have received more attention in recent years from owners of closely-held businesses who are seeking to reduce the costs of their property and casualty insurance ("**P&C**") and utilize certain tax rules applicable to small captive insurance companies. IRS and legislative scrutiny of certain captive arrangements, however, has also increased, particularly with respect to arrangements that provide more than ancillary estate planning benefits to the captive owners, as discussed below.

### *WHAT IS CAPTIVE INSURANCE*

Essentially, captive insurance is a type of self-insurance implemented through an entity owned and controlled by the insured business (or the owners of that business).[1] The captive insurance company (the "**captive**") is a licensed insurance company that generally provides P&C insurance only to companies controlled by the insured business or the business owners. A captive can insure various P&C risks, including those for general comprehensive liability, umbrella liability, construction defects, employment practices, directors and officers' liability, breach of contract liability, etc. Like a traditional insurance company, the captive issues policies, collects premiums, and pays claims. It also must set aside reserves to meet its legal obligations and its operating expenses, based on applicable state insurance requirements.

### *WHAT ARE "831(b)" OR "SMALL" CAPTIVES?*

Under Code § 831(b), a captive whose premium income does not exceed $1.2 million during a tax year (the "**831(b) premium limit**") is taxed only on its investment income, not premium income, if it makes the required Code § 831(b) tax election (an "**831(b) captive**" or a "**small captive**").[2] Code § 831(b) was enacted by Congress as a way to provide small insurance companies with the same tax treatment as afforded to mutual insurance companies (i.e., simplified rules for calculating income).

### *WHY USE AN 831(b) CAPTIVE*

For closely-held companies involved in various types of businesses, such as distribution, shipping, trucking, real estate development, construction, certain agricultural activities, etc., a properly structured and operated captive can provide several practical benefits, as well as receive tax treatment based on specific tax rules applicable to traditional insurance companies:

**Risk Management & Insurance Coverage Benefits**. An 831(b) captive can provide small and mid-size businesses with an important risk management tool that allows them to obtain protection against a wide variety of losses. For example:

- *Coverage of Insurance Gaps*. The captive can assume self-insured risks such as deductibles or risks that are commercially uninsurable due to high costs or lack of available coverage (e.g., cyber risk, loss of key customers, business interruption, or other enterprise risks, etc.).

- *Reduced Insurance Costs.* The captive can:

  - Reduce premiums for existing P&C coverage by eliminating premium costs charged by traditional carriers to support profit margins and overhead or to subsidize coverage for other, higher-risk insureds in the same risk pool as the insured business.
  - Reduce the amount of capital needed to fund self-insured risks by customizing policy deductibles, coverage scope, risk levels, and premiums to the insured business' needs.
  - Adjust the amount of risk the captive retains internally or reinsures, depending on whether the economics of obtaining reinsurance make sense under available market rates.

- *Benefits from Unused Reserves.* Unlike with a commercial carrier, when the insured's actual claims are less than actuarially predicted, a captive's unused reserves can be (1) refunded to the insured, (2) applied to reduce future premiums, or (3) paid to the owners of the captive as a dividend.

- *Control Over Investment of Reserves.* Control of the captive also means that the owners can direct the investment of the captive reserves, unlike with a commercial carrier.[3]

**Tax Treatment.** In addition to the imposition of income tax only on the investment income (and not premium income) of the 831(b) captive, as noted above, the insured business can deduct premiums paid to the 831(b) just as if they had been paid to a traditional carrier.

### *831(b) CAPTIVES & ESTATE PLANNING*

The implementation of an 831(b) captive should be driven by business purposes, such as the provision of better insurance risk management and cost savings for a company. Assuming there is a business need for the captive, however, there is currently no prohibition on structuring the ownership of that captive effectively for estate planning purposes. For example, a business owner may create a long-term, irrevocable trust for the benefit of family members and fund it with assets sufficient for the trust to form and capitalize the captive. The trust would then solely own the captive.

For estate planning purposes, the business owner's initial transfer to fund the trust likely would be taxable as a gift, subject to the application of any lifetime gift tax exemption or available annual exclusions. If the business owner also allocated generation-skipping transfer ("**GST**") tax exemption to this initial gift to the trust, estate and GST taxes would not apply to the trust in future generations. If the insured's actual claims are less than actuarially predicted, the captive's reserves will grow. The captive may distribute the accumulated, unused reserves to the trust (as the captive shareholder) either as dividends or as a capital gain distribution upon complete liquidation of the captive (both of which may be taxed at long-term capital gains rates). Thus, the receipt of these captive proceeds by the trust could result in wealth transfers to younger generations of a business owner's family.

### *831(b) CAPTIVES AND LIFE INSURANCE*

Generally, obtaining life insurance should not be a main purpose or goal of creating an 831(b) captive. Captives are designed to provide P&C coverage, the premiums for which are generally tax-deductible. In contrast, premiums paid for life insurance usually are **not** deductible, and using or relying on informational materials indicating otherwise likely is not wise.

Only in **very limited situations** should a captive consider the purchase of life insurance, such as for reinsurance for the risks it insures. For example, if the captive provides long-term business interruption insurance to an operating business, including coverage for loss of a key employee (such as a highly productive salesperson), the captive may want to acquire life insurance on that key employee to reinsure part of its business interruption risk. However, the loss of that key employee must be shown to adversely affect business, and the amount of life insurance coverage held must be directly related to the potential loss exposure (e.g., the captive should not acquire $10 million in life insurance coverage if the expected loss from the death of the key salesperson is only $5 million).

### *IRS CONCERNS*

For several years, the IRS has audited 831(b) captives with a focus on whether: (1) real risks are being insured; (2) there is sufficient risk-shifting and risk-distribution to qualify for classification as an insurance company under the Code; (3) the insurance premiums charged are artificially inflated to maximize a company's tax deductions; (4) life insurance is being inappropriately purchased on a tax-deductible basis; and/or (5) the captive is being inappropriately used for estate planning purposes. The IRS has become concerned over the perceived use or promotion of certain 831(b) captive arrangements (so-called "micro-captives") primarily for the individual tax and estate planning purposes of the business owner, rather than for the business's P&C insurance needs.

In February 2015, the IRS formalized its concerns by including these micro-captive arrangements on its list of "Dirty Dozen Tax Scams." According to the IRS list, "abusive" micro-captive arrangements will likely involve one or more of the following:

- Poorly drafted insurance documents that charge high premiums to cover either ordinary risks that could be more economically insured by a traditional carrier or esoteric, implausible risks that are extremely unlikely to occur (presumably, in both cases the higher premiums are desirable to generate larger deductions).

- Total annual premiums that equal the amount of deductions a business entity needs to reduce income for the year, or, for a wealthy entity, total premiums equal to $1.2 million annually to take full advantage of Code §831(b) (essentially, in both cases the premiums are tailored to the client's tax deduction needs as opposed to reflecting the actual costs for insuring the assumed risks).

- Missing or insufficient underwriting and actuarial substantiation for the insurance premiums paid (underscoring the importance of having an experienced, professional actuary perform a complete and accurate risk assessment to establish captive premium amounts).

- Hefty fees paid to promoters to manage the micro-captive, which assists taxpayers unsophisticated in insurance to undertake and continue the "charade" (this phrasing may indicate that the IRS is targeting promoted arrangements).

***LEGISLATIVE ACTIVITY & OUTLOOK***

**Summary of Recent Legislative Activity**. Even with IRS concerns, as there are many small and mid-sized businesses for which a captive arrangement would make economic business sense, some members of Congress want to expand the benefits of Code § 831(b) by increasing the 831(b) premium limit from $1.2 million to $2.2 million. With this in mind, the following is a summary of the legislative activity this year on this issue to date:

- In early February 2015, the Senate Finance Committee marked-up a proposal to increase the 831(b) premium limit to $2.2 million, but which included additional restrictions that would have significantly narrowed the application of § 831(b), effectively putting captives out of reach for many small companies (particularly family-owned businesses).[4] Shortly thereafter, however, the Senate Finance Committee modified the proposal to remove the additional restrictions.

- In April 2015, Senator Orrin Hatch, Chairman of the Senate Finance Committee, introduced Senate bill S. 905, which would increase the 831(b) premium limit to $2.2 million (to be adjusted for inflation) without imposing any new restrictions under that Code section. However, S. 905 includes a provision mandating that the IRS study and submit a report to the Senate Finance Committee (by February 11, 2016) that reviews the use of captives for estate planning purposes and includes legislative recommendations for addressing any potential abuses. The Senate Finance Committee reported S. 905 for consideration by the Senate by voice vote.

  - The IRS had advised the committee that it is closely reviewing perceived estate planning abuses using small captives, and it appears the committee was receptive to these concerns.

- A House companion bill to S. 905 (H.R. 1788), also introduced in April 2015, similarly increases the 831(b) premium limits, but it does not include the provision for an IRS study.

**Outlook**. Some industry organizations have suggested that targeted legislative "tighteners" should be enacted for 831(b) captives that would limit the ability to use small captives primarily for estate planning purposes while simultaneously allowing small captives to be broadly used for legitimate business purposes. While some type of legislation on this issue is likely, it does not appear that any changes will occur in 2015.

***TAKE AWAYS***

The addition of micro-captive arrangements to the IRS Dirty Dozen list is a definitive "heads-up" that the use of small captives primarily for estate planning purposes is under careful scrutiny. Thus, any possible estate planning benefits attributable to an 831(b) captive arrangement created in reliance on current laws cannot be guaranteed, since there is no certainty that any new captive legislation will provide "grandfathering" protection for existing captive arrangements. While legislation is likely, it does not appear imminent for 2015. Thus, AALU will continue to monitor this situation and advise of important developments.

***NOTE***

[1] Traditionally, many captives were established in foreign jurisdictions. Many states, however, have implemented captive legislation with fee and tax structures competitive with foreign jurisdictions. Thus, most captives are now formed as U.S. companies.

[2] This conclusion assumes that the small captive is respected as an insurance company for federal tax purposes. Although a full discussion of the tax and regulatory requirements for forming a captive are beyond the scope of this report, there is a long line of federal court cases that uphold the use of captive insurance companies when the requirements set out by the courts are met. The basic guidelines which must be followed include: (1) a shift of risk from the insured companies to the captive; (2) a distribution of the risk by the captive among multiple insureds; and (3) conduct of business by the captive in a manner similar to traditional insurance companies. The IRS has provided some clarification as to how a captive can meet these basic requirements. Under Rev. Rul. 2002-90, the IRS has ruled that a captive that issued policies to 12 controlled subsidiary companies was properly classified as an insurance company, and that the premiums paid by the affiliates to the captive were deductible for federal income tax purposes. Yet, a captive that does not issue policies to 12 or more affiliates may still qualify as an insurance company for tax purposes under several federal court decisions. *See Harper Group v. Commissioner* 979 F.2d 1341 (9th Cir. 1992) (holding that where the captive issued approximately 30% of its policies to unrelated third parties, then the captive could qualify as an insurance company even though its other policies were issued to less than 12 subsidiary companies); *see also Malone & Hyde, Inc. v. Comm.* 62 F.3d 835 (6th Cir. 1995) (8 insureds). In Rev. Rul. 2002-89, even though a captive issued policies to just one affiliate, its parent company, the IRS approved the captive because it issued more than 50% of its policies to unrelated third parties. Thus, in certain situations, “pooling arrangements” can be used by captives to meet the risk diversification requirement. It should be noted, however, that the IRS is currently looking at such "risk pools" to make sure they comply with all requirements and are not shams. *See* CCA 201350008.

[3] The captive’s reserve investments, however, must comply with applicable state insurance laws and regulations, which typically limit investments to a broad range of publicly-traded investment options designed to preserve capital and generate moderate growth and income.

[4] Specifically, for a P&C insurance company to have been eligible to make the § 831(b) election under this proposal, no more than 20% of the company's net written premiums for a taxable year could be attributed to any one policy holder (for this purpose, all policyholders that were related or were members of the same control group were treated as one policy holder). In addition, the proposal would have required that small insurance companies assume or otherwise take on no risks through reinsurance.




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