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TOPIC: Has the PATH Act Muddied the Way for Planning with Small Captives?

MARKET TREND: The use of small captive insurance companies primarily for estate planning purposes may be a thing of the past.

SYNOPSIS: Captive insurance companies can allow businesses to obtain insurance protection against a wide variety of property and casualty ("P&C") losses more affordably and are taxed under many of the same rules applicable to traditional insurance companies. Internal Revenue Code ("Code") § 831(b) provides small and mid-sized businesses with access to this important insurance market, encouraging these businesses to build up reserves that could protect against losses and thus support overall business longevity. However, the IRS had become concerned that the special tax rules under Code §831(b) were being used in "micro-captive" arrangements primarily to accumulate wealth in these smaller captives for wealth transfer and estate planning purposes, not for insurance protection. The PATH Act attempts to both enhance the business benefits of small captives and address the perceived estate planning abuse by making two major changes to Code §831(b): (1) increasing the amount of premium income a captive can receive while still qualifying for Code §831(b) treatment, and (2) imposing two new tests, a risk diversification test and an ownership

diversification test, one of which a captive must meet to qualify under Code § 831(b). These changes are effective for all existing and new small captives beginning in 2017 and after.

TAKE AWAYS: While the new diversification tests potentially limit the possible estate planning benefits attributable to small captive arrangements, 831(b) captives created primarily to provide P&C insurance coverage to businesses should not be greatly impacted. However, as there are no "grandfathering" provisions in the new legislation, non-compliant existing small captives must be restructured before 2017 to meet one of the required tests. Owners of these existing captives should contact their insurance and legal advisors now to review their current ownership structures for compliance.

PRIOR REPORTS: 15-28.

MAJOR REFERENCES: Code § 831(b), as modified by §333 of the Protecting Americans from Tax Hikes Act of 2015; Joint Committee on Taxation Technical Explanation of the PATH Act (JCX-144-15, Dec. 17, 2015).

Owners of closely-held businesses have shown increasing interest in captive insurance arrangements and a way to reduce the costs of their P&C insurance and take advantage of certain tax rules applicable to small captive insurance companies. While the recent legislation has increased certain benefits with regard to small captives, it also may limit the ability of captive owners to use the captives for ancillary estate planning benefits.

IN BRIEF: CAPTIVE INSURANCE & SMALL CAPTIVES[1]

Captives Generally. Essentially, captive insurance is a type of self-insurance through an entity owned and controlled by the insured business (or the owners of that business). A captive insurance company (a "**captive**") generally provides P&C insurance[2] only to companies controlled by the business or the business owners.[3] Like a traditional insurance company, the captive issues policies, collects premiums, pays claims, and must set aside reserves to meet its legal obligations and operating expenses, based on applicable state insurance requirements.

"Small" Captives. A captive whose premium income does not exceed $1.2 million (increasing to $2.2 million in 2017, as discussed below) during a tax year ("**831(b) premium limit**") is ***taxed only on its investment income***, not premium income, as an "**831(b) captive**" or "**small captive**," if it makes a Code §831(b) tax election ("**831(b) election**").[4] Also, an insured business can deduct premiums paid to a small captive just as if paid to a traditional insurer. The intent was for captive arrangements to encourage

smaller companies to build up reserves that could protect against losses and thus support overall business longevity. Without this tax treatment, captives could be cost-prohibitive for most small and mid-sized businesses.

<u>Practical Uses</u>. In addition to the tax treatment noted above, a small captive can provide significant risk management and P&C insurance coverage benefits for closely-held companies involved in various lines of businesses, such as distribution, shipping, trucking, real estate development, construction, certain agricultural activities, etc. These benefits include:

- Covering risks that are commercially uninsurable due to high costs or lack of available coverage (e.g., cyber risk, business interruption, etc.),
- Reducing premiums by eliminating carrier charges that support profit margins and overhead,
- Providing control over investment of reserves,[5] and
- Allowing unused reserves to be (1) refunded to the insured, (2) applied to reduce future premiums, or (3) paid to captive owners as dividends.

Given the above, there are many small and mid-sized businesses for which small captives could make economic and business sense. Accordingly, some members of Congress wanted to expand small captive benefits by increasing the 831(b) premium limit from $1.2 million to $2.2 million.

CONCERNS WITH 831(b) CAPTIVES & ESTATE PLANNING

Although business needs should drive the use of 831(b) captives, before the PATH Act, there were no limitations on structuring the ownership of a small captive in an efficient manner for estate planning purposes, as illustrated below:

> ***Example:*** John, a business owner, creates a long-term, irrevocable trust for family members and funds it with assets sufficient for the trust to form and capitalize X Captive as sole owner. John's initial transfer to fund the trust likely is taxable as a gift, subject to the application of any lifetime gift tax exemption or available annual exclusions. If John 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 businesses' actual claims are less than actuarially predicted, X Captive's reserves will grow. X Captive could distribute any accumulated, unused reserves to the trust (as sole captive shareholder) either as dividends or

as a capital gain distribution upon X Captive's complete liquidation (both potentially taxed at long-term capital gains rates).

In addition to the business advantages provided by a captive, the above structure also could provide ancillary estate planning benefits to younger generations of a business owner's family.

For the past several years, however, the IRS has expressed concern over the perceived use or promotion of certain 831(b) captive arrangements (so-called "micro-captives") primarily for a business owner's individual tax and estate planning purposes, rather than for the business' 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."

PATH ACT RESPONSE - BALANCING COMPETING INTERESTS[6]

The PATH Act seeks to address both Congressional goals to enhance the business benefits of small captives and IRS concerns over potential abuses by making ***two major changes to Code §831(b): (1) increasing the 831(b) premium limit and (2) adding a new diversification requirement for a captive to make an 831(b) election***.

Increased 831(b) Premium Limit. The PATH Act increases the 831(b) premium limit from ***$1.2 million to $2.2 million***, with indexing for inflation.

> ***PRACTICAL IMPACT***. This increase, combined with inflation-indexing, will significantly benefit more small and mid-sized businesses by allowing them to better manage their P&C coverage and risk profiles.

New Diversification Requirement For 831(b) Captives. After the PATH Act, a captive can make an 831(b) election ***only if it annually satisfies one of the following tests***:

1. ***Risk Diversification Test.*** ***No more than 20% of the insurer's written premiums can come from a single policyholder***. For this purpose, the determination of "policyholder" applies various attribution rules under the Code,[7] so related policyholders (e.g., a business owner's spouse and descendants, members of the same "control group" of companies, etc.) generally will be treated as a single policyholder. Accordingly, if a business owner owns 100% of a captive and also owns 100% of each affiliated company insured by the captive, the captive will not meet this test but would seek to qualify under the ownership diversification test discussed below.

Note, however, that the legislation raises some questions regarding application of this test to captive "reinsurance pools." To qualify as an insurance company for tax purposes, a captive must evidence sufficient risk distribution. Some small captives have used reinsurance pools to meet this requirement, whereby a captive effectively exchanges its insurance risk with other captives, such that it receives the necessary percentage of premiums from unrelated entities to achieve the needed risk distribution. Additional guidance will likely be needed regarding if and how certain "look-through" principles[8] may apply to these reinsurance pools in determining whether a captive meets the risk diversification test.

PRACTICAL IMPACT. Many family-owned small captives may not meet this risk diversification test and thus will be required to satisfy the "mirror ownership" test described below to make an 831(b) election, presumably making it more difficult to structure a small captive primarily to achieve estate planning objectives.

2. ***Ownership Diversification Test.*** Assuming a captive does not meet the risk diversification test above, this alternative test requires that ***no spouse or descendant of a business owner, either directly or indirectly (i.e., through a trust or business entity), own a percentage interest in the captive that exceeds by more than 2% their ownership interest in the underlying insured businesses or business assets***. To illustrate this so-called "mirror ownership test:"

   Example 1 – Single Business – Single Owner: Mom owns 100% of X Co. and 100% of a captive that provides X Co.'s P&C insurance. The captive will qualify for an 831(b) election because no spouse or descendant of Mom owns an interest in the captive.

   Example 2 – Single Business – Multiple Owners: Mom and Daughter own 60% and 40%, respectively, in X Co. and 50% each in a captive that provides X Co.'s P&C insurance. The captive will not qualify for an 831(b) election because Daughter can own no more than 42% of the captive (equal to her 40% in X Co. plus 2%). Alternatively, if Mom owned 100% of X Co., Daughter could only own up to 2% in the captive (Daughter's 0% in X Co. plus 2%).

   Example 3 – Multiple Businesses – Single & Multiple Owners: Mom and Daughter own 60% and 40% of X Co. and 50% each in the captive. Daughter owns 100% of Y Co. and Z Co., which the captive also insures. The captive will not qualify for an 831(b) election because Daughter owns more than 42% of the captive (40% in X Co. plus 2%).

Example 4 – Spousal Ownership: Wife owns 100% of X Co., which is separate property she inherited from her parents. The captive was created after Wife inherited X Co. and is owned 50% each by Wife and Husband (assume due to an ownership agreement or applicable community property laws). The captive **will not** qualify for an 831(b) election because Husband, as a spouse, owns more than 2% of the captive (0% in X Co. plus 2%).

Example 5 – De Minimis Ownership: Mom owns 100% of X Co. and 80% of the captive. The remaining 20% of the captive is held equally among 10 trusts, one each for the individual benefit of her three children and seven grandchildren. The trusts hold no interests in X Co. Although the captive **will qualify** for an 831(b) election because each trust owns only 2% in the captive (0% in X Co. plus 2%), this is likely not a practical planning solution for most captive owners.

PRACTICAL IMPACT. This ownership test directly targets small captives used primarily as estate planning vehicles. This will make it more difficult to transfer substantial ownership interests in a captive to spouses or descendants without corresponding transfers of interests in the insured businesses or assets.

It is unclear, however, exactly how the IRS will analyze indirect ownership by trusts or other entities for purposes of the ownership test, including whether a captive owned by a fully discretionary trust will be treated as having one owner or as being owned by the trust beneficiaries and whether a grantor trust will be disregarded so that the grantor is deemed the sole captive owner. In addition, spousal ownership issues could be significant for small captive owners in community property states, if a spouse is deemed a 50% owner of the captive but not of the insured businesses.

New Reporting Requirements. The PATH Act also provides that any insurance company for which an 831(b) election is in effect for a taxable year must annually report information required by the IRS relating to these new diversification requirements. The specific content of the reporting requirements will need to be addressed in future IRS guidance.

PRACTICAL IMPACT. This reporting will enforce the requirement that a small captive continue to meet one of the diversification tests for each year it makes an 831(b) election, imposing addition administrative and compliance costs for small captive owners.

Effective Date - No Grandfathering Protection. These changes are effective for tax years ***after December 31, 2016 and apply to all 831(b) captives created before or after that date***.

> ***PRACTICAL IMPACT***. There is ***no grandfathering protection for existing small captives***. If not in compliance, existing small captives ***must be restructured before 2017*** to meet either the risk diversification or mirror ownership test. Accordingly, owners of these existing captives and/or small captive-insured businesses and assets, particularly those held through trusts or other family entities intended as estate planning vehicles, should ***contact their insurance and legal advisors now*** to review their current ownership structures for compliance.

TAKE AWAYS

While the new diversification tests potentially limit the possible estate planning benefits attributable to small captive arrangements, 831(b) captives created primarily to provide P&C insurance coverage to businesses should not be greatly impacted. However, as there are no "grandfathering" provisions in the new legislation, non-compliant existing small captives must be restructured before 2017 to meet one of the required tests. Owners of these existing captives should contact their insurance and legal advisors now to review their current ownership structures for compliance.

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NOTES

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[1] See *WRMarketplace #15-28* for a more in-depth discussion of captive insurance and the use and tax treatment of small captive insurance arrangements under Code § 831(b).

[2] As more fully discussed in *WRMarketplace #15-28* with regard to captives and life insurance, 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. Thus, only in very limited situations should a captive consider the purchase of life insurance, such as for reinsurance for the risks it insures.

[3] While captives used to be established primarily in foreign jurisdictions to save costs, a number of states have implemented captive legislation with competitive fee and tax structures, which now allows most captives to be formed as U.S. companies.

[4] Assumes 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. See Note 2 in *WRMarketplace #15-28* for a more detailed discussion of these issues, including a summary of the basic guidelines that must be followed.

[5] 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.

[6] *See* §333 of the PATH Act. See also Chris Riser, "New Rules for 831(b) Captive Insurance Companies," Dec. 23, 2015; Jay Adkisson, "Congress Makes 831(b) Captives Much Better and Deals with (Some) Abuses in 2015 Appropriations Bill," *Forbes Magazine* (www.forbes.com), Dec. 19, 2015; and Jim Sabella, "I.R.C. §831(b) Changes Effective 1/1/2017," *DHG Views,* January 2016 for a greater discussion of these tests and applicable examples.

[7] Specifically, the attribution rules under Code §§ 267(b) and 707(b), and a somewhat modified version of the controlled group rules of §1563(a).

[8] *See, e.g.,* Rev. Rul. 2009-26.