Compliance **Bulletin**

Important Legislative Changes to IRC 831(b)

effective January 1st 2017

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Quick Facts

- New rules restrict ability of a business owner's spouse or lineal descendant's from holding interest in the captive.
- Targets perceived estate planning abuse.
- 831(b) annual premium limit will be increased from $1.2M to $2.2M. An inflation provision will be applied each year thereafter.
- Effective January 1st 2017.

If a Spouse or Lineal Descendant ("Specified Holder") owns or has interest in the Captive they must own or have equal interest in the Insured Company ("Specified Assets") subject to a 2% di minimus exception.

On Friday December 18th Congress passed the 'Tax Extenders Bill', otherwise known as the Protecting Americans from Tax Hikes (PATH) Act of 2015. The PATH Act made more than 20 tax breaks permanent in addition to retroactively extending a number of others for two or more years. Page One Hundred and Seventy Six (p. 176) included new rules affecting small captive insurance companies. The purpose of this bulletin is to provide captive owners and their advisors with:

- An overview of the legislative changes;
- Background information on its origins and;
- Action steps for those affected by the new rules.

BACKGROUND

In February of 2015 the Joint Committee on Tax and Senate Finance Committee (SFC) put forth proposed legislation in the form of a mark-up document. The document called for modifications to the alternative tax treatment for small insurance companies making the 831(b) election.

If passed, the proposal would have modified the election in two ways. First, the annual limit would have been increased from the $1,200,000 amount to $2,200,000 with annual indexes for inflation. Second, and most importantly, the proposal imposed additional restrictions intended to narrow the application of section 831(b). Specifically, for a property and casualty insurance company to be eligible to make the section 831(b) election, *no more than twenty (20%) percent of its written premiums for a taxable year can be attributable to any one policyholder*. In addition, the proposal required the company assume or otherwise take on *no risks through reinsurance*.

Implementation of these tightening provisions would have invalidated the election for numerous existing captives. The requirement for eighty (80%) percent third party risk coupled with the prohibition on reinsurance would make qualification difficult for many pure captives.

Source of Discontent

Motivation for the proposed restrictions stemmed from congress's perception that a significant number of captives were being formed primarily for estate planning purposes. The model congress objects too is

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straightforward. A parent company forms a captive making the children or trust for the benefit of the children shareholders. Since the premium represents payment for product or service (ie – the insurance policy) there is no gift tax. If the children own the captive outright, the premium payment effectively transfers the money outside of the parent's gross estate.

The above referenced proposal would certainly have mitigated abuses associated with estate planning and the 831(b) election. However, many industry observers felt the proposal was too far reaching.

While certain abusive structures would be eliminated, many legitimate programs would have also been caught in its wake. Fortunately, stakeholders from the regulatory, association, service provider and captive owner fronts were able to intervene on behalf of the industry and urge congress to reconsider the scope of the tightening legislation.

While the industry was able to help modify the impact of the regulations and preserve use of the election, the new law still clearly takes aim at captives established with an estate planning component.

THE NEW RULES

The statute introduces two new terms into the captive insurance lexicon; **"Specified Assets"** and **"Specified Holder"**.

Specified Assets are defined as or mean "with respect to any insurance company the trades or businesses, rights, or assets with respect to which the net written premiums (or direct written premiums) of such insurance company are paid."

More simply put, Specified Assets are the items being insured. If ABC Co. forms a captive, ABC Co.'s assets being insured are Specified Assets.

Specified Holder is defined as or means "with respect to any insurance company any individual who holds (directly or indirectly) an interest in such insurance company and who is a spouse or lineal descendant of an individual who holds interest (directly or indirectly) in the specified assets with respect to such insurance company."

More concisely, a Specified Holder is a spouse of lineal descendant of a person who owns the company being insured by the captive.

New Terms:

Specified Assets: The Parent Company's assets that are being insured by the captive.

Specified Holder: Spouse of lineal descendant of a person who owns the company being insured by the captive.

Now that we have defined these new terms we can evaluate them in the context of the statute which says all captives making the 831(b) election must comply with one of the following requirements:

"(I) no more than 20 percent of the net written premiums (or, if greater, direct written premiums) of such company for the taxable year is attributable to any one policyholder, **or**

(II) such insurance company does not meet the requirement of sub-clause (I) and no person who holds (directly or indirectly) an interest in such insurance company is a specified holder who holds (directly or indirectly) aggregate interests in such insurance company which constitute a percentage of the entire interests in such insurance company which is more than a de minimis percentage higher than the percentage of interests in the specified assets with respect to such insurance company held (directly or indirectly) by such specified holder."

For a typical single parent captive established primarily to insure the risks of its parent company, compliance with Section I will be

difficult. If compliance with Section I isn't feasible then the captive must ensure that it complies with Section II in order to preserve the validity of it's 831(b) election.

The language in Section II is convoluted. However, it can be accurately summarized as follows:

If a Spouse or Lineal Descendant ("Specified Holder") owns or has interest in the captive they must own or have equal interest in the Insured Company ("Specified Assets") subject to a 2% di minimus exception.

It is worth noting that failure to comply with Section I or II of the new legislation does not affect whether or not the captive transactions qualify as insurance. Compliance status only determines whether or not the captive is eligible for the 831(b) election. Qualification as a bona fide insurance company (ie – risk shifting, risk distribution) is not addressed in the legislation.

CONCLUSION

For captives making the 831(b) election with ownership structures that match that of the insured company(s) it is largely business as usual. On the other hand, captives owned by spouses or lineal descendants of the owner of the insured company should contact their advisors as soon as possible to determine the effect of the new law on their captive. Some of these captives will have to dramatically alter their ownership structure or forgo use of the election.

Naturally, the increase in the 831(b) premium limit presents a new option for captives writing between $1,200,000 and $2,200,000. Likewise, these captives should contact their advisors to determine if the election is a viable alternative and in their best interest.