Changes to 831(b) – What Now?

In late December 2015, the United States Congress changed the provisions of section 831(b), generally beginning in 2017. The changes are principally: (1) increase the maximum amount of premiums to $2,200,000 (and index it for inflation) that an electing captive insurance company can have; (2) provide that a captive with no more than 20% of premiums from a single policyholder; and (3) provide that if a captive does not meet clause (2), that no spouse or lineal descendant can own more of the captive than he or she owns in the operating company. Details of these changes will be discussed below.

What hasn't changed?

The changes have nothing to do with whether the captive is a bona fide insurance company. The same tests of insurance apply to large and small captive insurance companies. The IRS believes that there must be a non-tax business purpose for the captive insurance company.

In addition, the Tax Court requires that the risk insured must be an insurance risk (not a business risk or investment risk), must include risk shifting and risk distributions and the arrangement must be insurance in its commonly accepted sense. If a captive meets these tests, then it is an insurance company, even if it does not meet the new section 831(b). If it doesn't meet the new rules, then it is taxed under section 831(a) just as larger companies are.

As noted above, the law generally does not go into effect until 2017. As people review specific fact situations over the next year, questions will likely be raised as to the application of the new law. The industry will identify and address them, and the IRS may issue guidance.

Increase in limit

The increase in the maximum premiums to $2,200,000 is indexed for inflation in $50,000 increments. The cost of living base year is 2013. The premiums against which the $2,200,000 is measured are the greater of the direct written premiums or net written premiums.

Diversity requirement

As referenced above, the new law imposes a "diversification" requirement that may be met either of two ways: (1) 20% cap on any single policyholders; or (2) no wealth transfer.

20% limit on premiums from one policyholder

The first test is that no single policyholder pays more than 20% premiums. For this purpose, the premiums of related entities are treated as coming from one policyholder. The attribution rules are very broad and can encompass a wide variety of relationships. The relevant premiums are the greater of direct written premiums and net written premiums.

Example 1: Assume that A owns A Co. (an operating company); B owns B Co.; C owns C Co. etc. through L owns L. Co. These twelve companies (A Co. through L. Co.) each pay an equal amount of premium to a group captive owned equally by A through L. This arrangement would meet the diversity requirement because no single policyholder paid more than 20% of the premium (each paid 8-1/3%).

Example 2: Assume the same situation as Example 1, except that A owns not only A Co. but also K Co and L Co. B still owns B. Co, C owns C Co., etc. This arrangement would not satisfy the 20% diversity requirement because A Co., K. Co and L. Co are owned by the same person, their premiums must be aggregated and they exceed 20% (they total 25%).

Wealth transfer prohibition

If a captive does not meet the 20% test, it can achieve diversity (and thus qualify for section 831(b)) if it has qualifying ownership. The intent of the new law appears to prohibit captives with a wealth transfer aspect from electing section 831(b). The new law provides that if the captive is owned by the spouse or lineal descendant of one who owns the operating company, section 831(b) cannot be elected if any of the spouse or lineal descendant owns more in the captive than the operating company (subject to 2% de minimus differential than the IRS can change).

The premise seems to be that if the captive operates profitably, that the net income will be transferred to the owner(s) of the captive. Congress determined that it did not want to permit captives to elect 831(b) treatment if there was a wealth transfer.

Example 3: Father owns 70% of the operating company and Son owns 30% of the operating company. Son owns 100% of the captive. The captive would fail the ownership diversification test because the Son's ownership in the captive (100%) exceeded by more than a de minimus percentage Son's ownership in the operating company (30%).

Example 4: Father owns 70% of the operating company and Son owns 30% of the operating company. Father owns 70% of the captive and Son owns 30% of the captive. The captive would meet the ownership diversification test because the Son's ownership in the captive (30%) did not exceed by more than a de minimus percentage Son's ownership in the operating company (30%).

Example 5: Father owns 70% of the operating company and Son owns 30% of the operating company. Father owns 80% of the captive and son owns 20% of the captive. The captive would meet the ownership diversification test because the Son's ownership in the captive (20%) did not exceed by more than a de minimus percentage Son's ownership in the operating company (30%). Here the "wealth transfer" is to the father.

Additional reporting

The new act provides that the IRS can request information from taxpayers concerning the diversification tests.

Next steps

The law does not go into effect until 2017. As companies review their particular fact situations, questions will arise concerning the treatment of various scenarios.

For instance, how does the law affect pooling? Are there any policy considerations that must be taken into account in interpreting the words of the amendments? Who is treated as the owner of the captive, if the captive is owned by a corporation, partnership or trust? How does one compute taxable income in 2017 if a captive is taxed under section 831(b) in 2016, but under section 831(a) in 2017?

While it would be optimal if all questions could be answered immediately, there will likely be many questions that can't be answered with complete certainty for some time.

After a large tax act, Congress' Joint Committee on Taxation often publishes a formal explanation referred to as the "Blue Book", so there may be additional Congressional explanation. The IRS may also issue one or more sets of guidance. The industry will try to determine the contours of the diversity requirements. Given Congress' clear decision to limit wealth transfer, if any estate planning "loopholes" are discovered, I would discourage the industry from exploiting them, lest Congress amend the statute once again to limit or eliminate section 831(b).

The IRS is extraordinarily active auditing captives that have elected to be taxed under section 831(b). In 2015, the IRS linked these captives with tax shelters for the first time. This is the so-called "Dirty Dozen".

While the IRS is presumably supportive of the restrictions on wealth transfer in the new act, the IRS listed many additional concerns in tis "Dirty Dozen" notice. Accordingly, there is no assurance that the IRS will reduce its audits just because of this legislation. I assume most prospective captive owners would be more concerned with IRS audit activity than the new legislation.

Because I believe that the vast majority of captives are formed as insurance vehicles, and not wealth transfer, I don't think that the new legislation will substantially affect new formations of captive insurance companies.

I think that existing captives who would not qualify under the new legislation will fall into the following categories: (a) no change in ownership with the effect that the captive is taxed under section 831(a); (b) ownership is changed so that the operating company and captive have mirror ownerships; or (c) some captives may have served their usefulness and are dissolved. I think most will fall into categories (a) and (b).