WHITE PAPER

GLOBAL CAPTIVE SOLUTIONS

Micro Captives Under a Microscope: Converting Your 831(b) to an 831(a)

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CAPTIVE RISK

The Benefits of Small Captives as Alternative Risk Financing Solutions

WHAT IS AN 831(B) ELECTION?:
AN 831(B) IS A TAX ELECTION MADE BY THE OWNER OF A CAPTIVE, TRADITIONALLY A CELL OR PURE CAPTIVE. THIS CLASSIFICATION DETERMINES THAT A CAPTIVE QUALIFYING TO BE TAXED AS A U.S. INSURANCE COMPANY MAY PAY TAX ON INVESTMENT INCOME ONLY IN ANY YEAR THAT ITS WRITTEN PREMIUM IS AT OR BELOW THE THRESHOLD ESTABLISHED BY THE IRS FOR THE APPLICABLE TAX YEAR.

Since the 1950s, captives have served as legitimate strategic solutions for businesses. However, 831(b) captives, otherwise referred to as micro or small captives, have been under increased scrutiny by the Internal Revenue Service (IRS) over the last few years. With soft-warning letters coming from the IRS, coupled with a pending Supreme Court case and recent Tax Court losses related to 831(b) captives, many organizations are considering shutting down their captives to avoid tax penalties.

The decision to exit a captive should not be taken lightly. Most certainly, the choice to enter the captive was based upon a desire for a long-term strategy to solve for business risks, and that desire is likely still there. Micro/small captives electing 831(b), when formed for legitimate insurance purposes, still serve as valuable risk management tools for many.

Instead of exiting a micro/small captive, organizations should consider moving to an 831(a) election.

831(b) Election Under Increased Scrutiny from IRS

831(b) tax election captives have existed for more than 30 years. However, the past decade has seen the IRS closely examining the operations of these captives. Listed as part of the "Dirty Dozen" tax scams – a list of common scams taxpayers may encounter – consistently from 2014-2019, micro captives have been put under a microscope due to the "potential for tax avoidance or evasion," according to the IRS.

Though micro captives were removed from the Dirty Dozen list in 2020, the IRS has continued to scrutinize them. Soft-warning letters have been issued to thousands of taxpayers involved in captives making the 831(b) election, informing them of increased examination and the potential resulting penalties. And while certain groups under audit were offered settlements in 2019, scrutiny continued into 2021, when the IRS established a new office dedicated to addressing the abusive micro/small captives.

Many captives that make the 831(b) election are still legitimate business structures, yet organizations are looking for a less volatile solution. Instead of exiting the captive, converting the election from an 831(b) to an 831(a) is a simple solution that still yields the benefits of a captive.

Convert Your Captive to Keep Your Benefits

Traditionally, micro/small captives come in one of two structures: a cell captive or a pure captive. Though these structures vary in capitalization requirements, the overall tax benefits remain the same:

- Tax deduction for the parent company for the insurance premium paid to the captive, based upon facts and circumstances as determined by the tax advisor.
- Various other tax savings opportunities, including income tax savings for both the captive and the parent.
- Opportunity to accumulate underwriting profits in tax-favored vehicle.
- Distributions to captive owners at favorable tax income rates.

- Asset protection from the claims of business and personal creditors.
- Potential reduction in the amount of insurance premiums presently paid by the operating company.
- Access to the lower-cost reinsurance market.
- Insuring risks that would otherwise by uninsurable.

With the threshold continuing to increase from the legislation under the PATH Act of 2015, middle-market corporations tend to steer toward micro/small captives making the 831(b) election and larger corporations form captives and utilize the 831(a), it is the annual premium that determines the tax code classification once a captive has elected to operate as an 831(b) at its infancy.

ENGAGE YOUR RISK MANAGER TO LOOK AT WAYS TO EXPAND A CAPTIVE AND IDENTIFY AREAS OF OPPORTUNITY FOR INCLUSION.

How to Convert to 831(a)

Instead of abandoning a working risk management strategy, organizations can shift to 831(a) election, which offers the same tax benefits with less scrutiny than continuing with an 831(b) election. It all comes down to growing the business's combined total of net written plus received premium. Once the income statement contains enough premium to breach the limit of the current IRS threshold, the captive will automatically convert to an 831(a). Organizations should follow a process to ensure the captive continues to work as a viable strategy.

1. Engage Your Risk Manager

Not every organization has a risk manager, but most have a broker, and those with a captive likely have a captive advisor. Engaging the risk manager, captive advisor, or broker is the crucial first step.

Risk managers will look at ways to expand the captive, identifying areas of opportunity for inclusion. This may include employee benefits, a portion (or all) property coverage, other coverage types and even the addition of third-party risk.

WHAT IS THE DIFFERENCE BETWEEN AN 831(B) AND 831(A) ELECTION?

While both offer the same benefits, there are some important differences between the two classifications. Under an 831(b) election, there is no federal income tax on the captive's underwriting profits, while the profits of an 831(a) election are subject to income tax.

Employee Benefits: The COVID-19 pandemic saw the expansion of captive use for employee benefits, according to Business Insurance. Employers have adjusted their approach to employee health to stay competitive in the job market, expanding beyond traditional health and retirement plans to include digital well-being, mental health and employee assistance programs (EAPs).

Adding more robust employee benefits offerings to a captive can expand the balance sheet while allowing businesses to attract top talent.

Property Coverage: Captives have historically served to protect companies from risks which are prohibitively expensive to ensure traditionally. The right advisor will look at what is currently included in the captive and other areas of opportunity based on an organization's strategic goals and provide recommendations on moving either a primary of quota share tower or property coverage to the captive.

Third-Party Risk: Though captives have traditionally covered the risk of the forming company, advances in technology have opened up the way for adding third-party risk to a captive strategy, including that of customers and vendors. Common third-party risks include:

- Extended warranties
- Auto liability
- Travel accident
- Employee voluntary benefits
- Identity theft

A risk manager will look at the opportunities available to expand the balance sheet through adding third-party risk to a micro/small captive.

2. Price Out New Lines of Businesses

New coverages added to a captive need to be appropriately priced. A third-party actuary was likely brought in for the initial captive formation process - all domiciles require an annual actuarial report - so businesses likely have existing relationships with an actuary. If not, however, captive advisors do have these necessary relationships.

An actuary will price out any new lines of business added to the captive to appropriately reflect the risks being insured. Because captives sometimes write insurance for unique coverages unavailable or priced at high rates in a traditional market, commercial ratings won't reflect pricings accurately. An actuary will conduct analyses to determine the right premium to charge for coverage limits and deductibles, quantifying the risks covered, the nature of exposures and the changes in the risk profile due to new additions.

3. Submit Change of Business Plan

The original captive formation process included business plan creation, which will need to be updated to reflect the new lines of coverage. The business plan describes the how and why of the captive being formed.

These plans are submitted to regulators before licensure can be issued and outline the business operations of the parent companies and how they are currently insured, the type of captive being established and the reasoning behind the selection, the lines of business or coverage being insured, capitalization, and expected premium, operating ratios and underwriting ratios.

The captive advisor will make these required business plan changes on behalf of the parent companies and submit the documents to the regulatory board for approval.

Cost Considerations

Because captives electing to be taxed under section 831(b) are taxed only on investment income, including dividends, interest, rents, royalties, capital gains and losses, and non-insurance business income, and 831(a) captives are taxed on insurance income as well, there will be an increase in taxes.

Capital requirements of the captive may or may not change, depending on the captive structure. Micro/small captives traditionally

WHY ARE CAPTIVES FORMED?

- Increase control over insurance purchase
- Finance retained risk on a pre-tax basis
- Flexibility of coverage options
- Premium stability
- Entrepreneurial opportunity
- Increased control over claim process
- Improve consolidated tax position
- Access to lower-cost reinsurance market

come in two forms: cell and pure captives. Depending on the structure of the captive, there are different cost considerations when converting from electing 831(b) to 831(a).

Cell Captive: Due to a cell captive's structure, in which the core handles capitalization, there is usually no change for the cell owner.

Pure Captive: Though pure captives tend to have minimal capital requirements, there could be an increase due to the additional lines of coverage or increased limits placed within the captive structure.

Convert Your Micro/Small Captive

Hylant's captive experts are available to help convert your existing captive from the 831(b) election to a captive utilizing 831(a). Copntact an expert today to get started.

SOURCES

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