


# IRS 831(b) Captives

Still Critical of but

## NEW Legislation May Change That



For the last two tax seasons the IRS has named captives operating under the 831(b) tax designation to their "Dirty Dozen" list – a list the department releases each year warning tax payers of potential tax dodges and scams. However, last December the PATH Act was signed into law which, when it goes into effect, should help to shore up some of the legislative loopholes that have been misused and help to expand the "micro" segment of the captive industry.

Written by Karrie Hyatt

## 831(b) Tax Designation

Small to medium-sized captives are referred to by several different names – micro captives and enterprise risk captives are two – but not all small captives take the 831(b) tax designation. 831(b) captives are small to medium-sized companies that elect to take advantage of the Internal Revenue Service 831(b) tax code that allows insurance companies with premium of \$1,200,000 or less to pay taxes only on its investment income, not on its premium. Just like any other alternative risk transfer vehicle, these small captives must qualify as actual insurance companies – they must insure risk and be structured so as to act in risk shifting and risk distribution. Captives opting for the 831(b) designation can gain a hefty tax advantage which arouses suspicion in critics that they are not proper insurance companies.

Smaller captives electing the 831(b) designation are the fastest growing segment of the captive industry with many domiciles specializing in their formation. According to Les Boughner, chairman of Advantage Insurance Management, “By my analysis, using published numbers, in 2015, there was a global net growth of 103 captives. In U.S. domiciles and domiciles that cater to USA tax payers there was a net growth of 128. In domiciles that cater to small to mid-sized captives there was a net growth of 140. Now you can debate the precise number but not the order of magnitude.” Boughner’s analysis does not take into account protected cells or segregated cell companies, but if there were accounted for then the growth rate of captives would be considerably higher.

With their rapid expansion in the last decade, these smaller captives have garnered a great deal of criticism which stems from three main issues: they might be used as tax

shelters; there have been a number of “promoters” engaging in setting up captives who may not have a background in insurance; and they have been used solely as a wealth transfer mechanism.

According to Boughner, “[831(b) captives] are being tainted by wealth management firms that know little about captives who are promoting the tax advantages without any regard to the need for a proper structure in accordance with accepted IRS guidelines. Properly structured they perform a valuable function for self-insured reserves and accruals.”

## The “Dirty Dozen”

In 2015 and 2016, the Internal Revenue Service placed captives using the 831(b) tax designation on its “Dirty Dozen” list. This list, released annually in January and February, highlights tax schemes that target consumers. Called “micro captives” in the IRS press releases, it says that some captives using the 831(b) designation are using it for wealth transfer rather than insuring genuine risk. Falling under the umbrella term of Abusive Tax Structures, which also includes Misuse of Trusts, the IRS warns consumers to be wary of “unscrupulous promoters, accountants, or wealth planners persuade the owners of closely held entities to participate in these schemes.”

Among the other eleven tax schemes highlighted were phone scams and email phishing schemes, which topped this year’s list. The other eight were return preparer fraud, offshore tax avoidance, inflated refund claims, fake charities, false padding of deductions on returns, excessive business credit claims, falsifying income and frivolous tax arguments.

Being called out on the “Dirty Dozen” list for the second year in a

row shows that the IRS will continue to target 831(b) captives as potential scams and will continue to scrutinize the structures. While being placed on the list does not mean that captives electing the 831(b) designation cannot form or operate, it does add a black mark the captive industry.

Industry opinion is mixed. Many feel that the IRS is unduly calling out enterprise risk captives and imparting a taint to the captive industry as a whole. There are those that welcome the scrutiny in order to weed out the promoters using the designation as a tax dodge. “It’s one of those classic examples of a few bad apples spoil the whole bunch,” said Boughner. “There are people who are promoting these things as pure wealth transfer vehicles and they’re going to have to stop. For those of us who have been working to broaden the segment for small to medium-sized companies, there really is no impact.”

Jeffrey K. Simpson, director at Gordon, Fournaris & Mammarella, P.A. believes that, “Tax evasion not nearly as prevalent as the IRS thinks. This is merely a new use of a captive insurance to address risks that were historically never addressed. Business sees a new efficiency where the IRS sees something amiss.”

While there are no numbers as to how pervasive scheme is Boughner said, “I know most of our major competitors and they, like ourselves, are forming sustainable captives for risk management purposes, not tax purposes.”

## PATH Act of 2015

Amidst the criticism and scrutiny of captives filing under the 831(b) election, new legislation was passed in 2015, that could help propel growth in that sector as well as weed out captives that are acting as wealth transfer mechanisms.



The Protecting Americans from Tax Hikes Act of 2015 (PATH Act), a bipartisan bill signed into law on December 18, 2015, by President Obama, will make permanent many expired and currently available tax relief benefits for business and families, as well as making changes to tax compliance issues. For the captive insurance industry, PATH Act will increase the limit of net annual written premiums to 2.2 million dollars for those captives electing the exemption.

In addition, the Act also changes the qualifications regarding ownership diversity for those captives. Previous iterations of the code had diversification requirements, but the new law strengthens them. It will require any captive electing for the 831(b) designation to meet a "Diversification Requirement" by one of two ways – the risk diversification test or the relatedness test. In the risk test, "An



insurance company meets the diversification requirement if no more than 20% of the net written premiums (or, if greater, direct written premiums) of the company for the taxable year is attributable to any one policyholder." "Policyholder" in this instance is defined by IRS attribution rules that state policyholders who are related or have a partnership (trust, estate, or corporation) are considered one policyholder for this test.

Concerned about members in a reference based pricing plan? **No need.**

**FAIRChex**  
THE CHOICE IS CLEAR

- ✓ Support members shopping for care with transparent cost/quality data
- ✓ Pre-negotiate rates with providers to avoid any balance billing
- ✓ Achieve cost control and improved member experience

Get started for as little as \$1 PEPM | [solutions@fairchex.com](mailto:solutions@fairchex.com) | 844-640-0754 | [fairchex.com](http://fairchex.com)

**IHC**  
Risk Solutions

**Our**  
world-class  
capabilities

**A powerful**  
combination

 **Swiss Re**  
Corporate Solutions

Sometimes more really is more. Swiss Re Corporate Solutions has joined forces with IHC Risk Solutions. By integrating IHC's business we are complementing this highly-regarded firm's wealth of expertise with our own financial strength and global capacity. It's a powerful combination of expertise and capabilities, and we believe it offers enhanced value to any employer seeking to self-fund their healthcare benefit plan. But there's another belief that we share with IHC, and that's in the paramount importance of understanding and supporting the needs of our customers and building strong, enduring partnerships. We wouldn't have it any other way. **We're smarter together.**

[swissre.com/esl](http://swissre.com/esl)

Insurance products underwritten by Westport Insurance Corporation and North American Specialty Insurance Company.





You need  
a stop loss provider with a  
**long-term  
commitment**

in  
sync

and over 150 years of  
financial  
**strength and  
stability**

## Guardian Stop Loss Insurance

Mitigate the risk of your self-funded medical plan with Guardian. Employers have counted on us to protect their employees with products like Life and Disability insurance for over 50 years — now we can help protect their companies too.

With a strong mutual foundation and exemplary financial ratings, Guardian has been there for our customers — and we plan to always be there — especially when they need us most.

### What we offer:

- A comprehensive stop loss contract with no new lasering
- Immediate reimbursement on specific stop loss claims
- No minimum thresholds for monthly aggregate accommodation

Visit [www.guardiananytime.com/gafd/wps/portal/contact-us](http://www.guardiananytime.com/gafd/wps/portal/contact-us)

Guardian Stop Loss Insurance is underwritten by The Guardian Life Insurance Company of America, New York, NY. Policy limitations and exclusions apply. Optional riders and/or features may incur additional costs. Financial information concerning The Guardian Life Insurance Company of America as of December 31, 2014 on a statutory basis: Admitted Assets = \$45.3 Billion; Liabilities = \$39.6 Billion (including \$34.9 Billion of Reserves); and Surplus = \$5.7 Billion. Ratings as of 08/15 and are subject to change. Policy Form # GP-1-SL-13.

File #2015-9276 Exp. 8/17



**GUARDIAN**<sup>®</sup>

LIFE

DENTAL

VISION

DISABILITY

ABSENCE

SUPPLEMENTAL HEALTH

**STOP LOSS**

ASO

GuardianAnytime.com

The Guardian Life Insurance Company of America<sup>®</sup>, (Guardian) 7 Hanover Square, New York, NY 10004. GUARDIAN<sup>®</sup> and the GUARDIAN G<sup>®</sup> logo are registered service marks of The Guardian Life Insurance Company of America and are used with express permission.

If companies do not pass the risk diversification test, they must pass the relatedness test which, summarized, means that the ownership of the insured business and the ownership of the captive are largely mirrored with a 2% margin of difference. For example: A parent owning the insured business while their child is the primary owner of the captive will not pass the relatedness test.

The law goes into effect after December 31, 2016, and will affect captives from fiscal year 2017 and beyond.

According to Simpson, *“The PATH Act changes will help because, by addressing estate planning, they eliminate a motive for abuse. But the changes will not solve everything because they do not address everything the IRS views as motivation for abuse and they do not address the IRS’ fundamental distrust of captive insurance arrangements.”*

Proponents for 831(b) captives are pleased to see the million dollar increase as the \$1.2 million limit has been in place for thirty years. As this segment of captives has grown, the lower limit on premium has been restrictive to growing small businesses. Some outlets have reported that the increase in the limit on premium will see a burst of new captive formation. However, Les Boughner believes that this will benefit established captives, not engender a surge of new formations. “Some people seem to think this means there will be more and more captives, I’m not so sure. I think there’s a small segment that will capitalize on it but I don’t think it will suddenly open up the segments dramatically.”

How much the PATH Act will affect captives electing the 831(b) exemption remains to be seen, as the full affects will not be known until several years down the road. In the meantime, the IRS will continue to keep close watch on captives misusing the 831(b) designation as a wealth transfer loophole.

“The PATH Act changes will help because, by addressing estate planning, they eliminate a motive for abuse. But the changes will not solve everything because they do not address everything the IRS views as motivation for abuse and they do not address the IRS’ fundamental distrust of captive insurance arrangements.” ■

*Karrie Hyatt is a freelance writer who has been involved in the captive industry for more than ten years. More information about her work can be found at [www.karriehyatt.com](http://www.karriehyatt.com).*



**SIPC**  
Self-Insurers’ Publishing Corp.

## Do you aspire to be a published author?

Do you have any stories or opinions on the self-insurance and alternative risk transfer industry that you would like to share with your peers?

We would like to invite you to share your insight and submit an article to *The Self-Insurer!* SIIA’s official magazine is distributed in a digital and print format to reach over 10,000 readers around the world. *The Self-Insurer* has been delivering information to the self-insurance/alternative risk transfer community since 1984 to self-funded employers, TPAs, MGUs, reinsurers, stop-loss carriers, PBMs and other service providers.

**Articles or guideline inquiries can be submitted to Editor Gretchen Grote at [ggrote@sipconline.net](mailto:ggrote@sipconline.net)**

***The Self-Insurer* also has advertising opportunities available.** Please contact Shane Byars at [sbyars@sipconline.net](mailto:sbyars@sipconline.net) for advertising information.