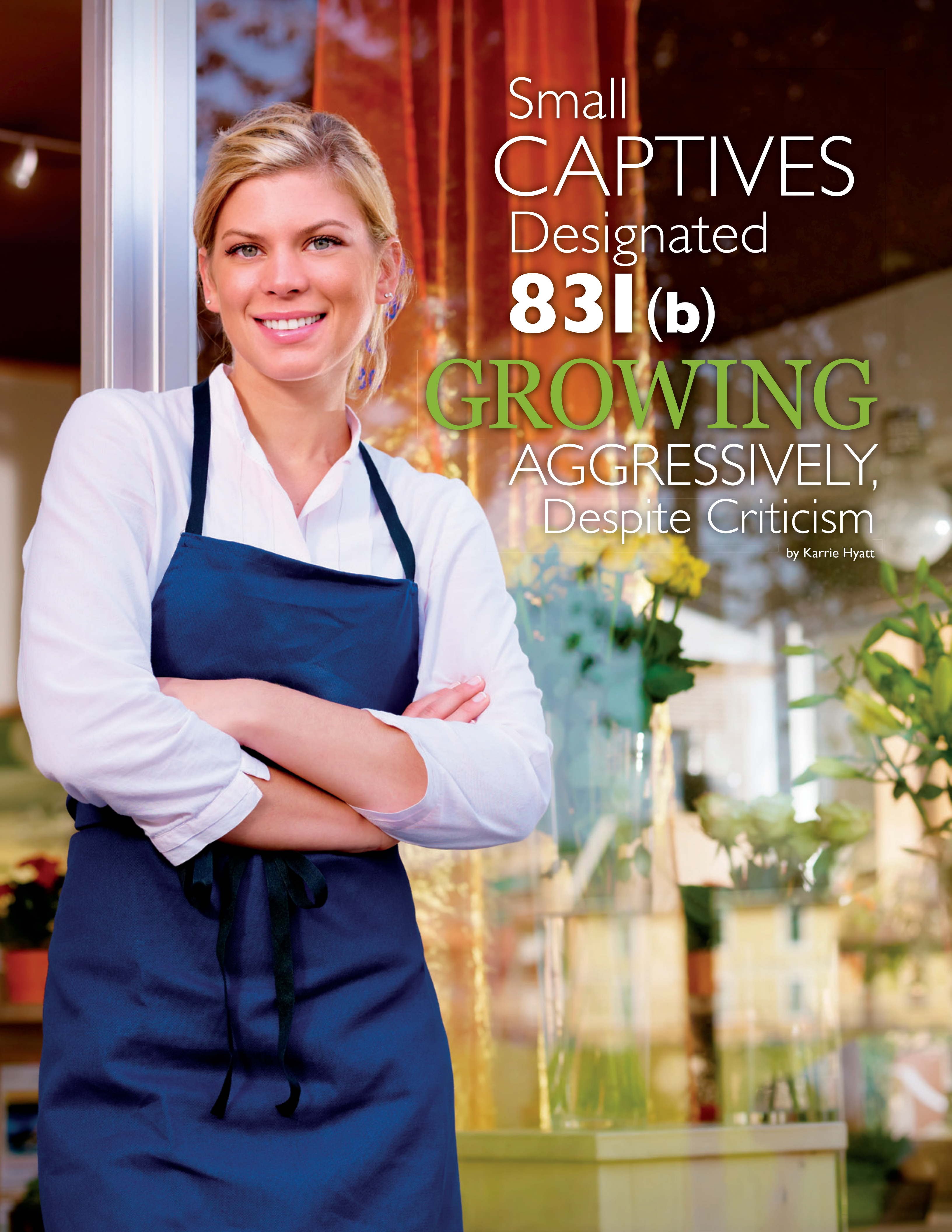

Small CAPTIVES Designated 831(b) GROWING AGGRESSIVELY, Despite Criticism

by Karrie Hyatt

Small captives that opt for the 831(b) tax designation have been growing exponentially over the last five years. However, with their tremendous growth, opponents to the captive structure have also grown. The IRS has begun looking into captives using this tax designation. Yet, when properly set up and managed, these captives can provide a great deal of benefits to small companies.

The entities known as 831(b) captives are captives created by small or 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. These small captives can also be part of a cell captive or series LLC structure and, depending on the domicile, be taxed separately from their parent captive. However, 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.

Last month, the Self-Insurance Institute of America, Inc. (SIIA) suggested that captives operating as 831(b) captives should be referred to as Enterprise Risk Captives (ERCs). In a release, SIIA said that the "terminology was approved by the association's Alternative Risk Transfer Committee in response to increased industry concern that the 831(b) label promotes a negative perception of these types of captive programs."

The use of this new terminology is seen by the organization as a step to improve the status of small captives so that they are not seen just as a tax designation. Part of creating this new term is to define what they are, something that has not been done in a systematic manner. SIIA has defined the parameters of ERCs as: they manage risks not generally addressed by commercial insurance programs; their risks are low in frequency and high in severity; their policies are first party, they have elected for the 831(b) designation; and they have the option to facilitate wealth transfer/estate planning. For the purposes of this article, the terms 831(b) captives and Enterprise Risk Captive (ERC) will be used interchangeably.

Many Factors Drive Exponential Growth

Since 2009, the huge growth experienced in the 831(b) arena has been fueled by several factors. As many larger companies have established captives, the market began to look to small to mid-sized companies interested in forming captives. An increase in the number of domiciles and the development of a wider variety of captive structures have made it more affordable for smaller companies to form their own captive. While, more widespread and better understanding of the tax code and the benefits that captives can provide have also played a role in the emerging popularity of ERCs.

According to Jeffrey Simpson, an attorney with Gordon, Fournaris & Mammarella, PA, ERCs are "typically are used by small, privately-held companies to address first-party, high severity, low frequency risks that are generally uncovered by traditional commercial insurance or unavailable in the commercial market. Frequently, the captive is structured with the intent of facilitating certain additional financial benefits such as wealth transfer and estate planning."

Since 2010, formations of ERCs have been on the rise – especially in domiciles like Delaware, Utah, and Vermont. Captives taking the 831(b) election are thought to make up as much as 30% of the market in the U.S., said Les Boughner, executive vice president with Willis North American Captive & Consulting Practice. He maintains that the net growth of ERCs in the U.S. market is above 75%.

Many of these smaller organizations have realized that they have a number of risks that they have been retaining themselves (knowingly or sometimes unknowingly) for which commercial coverage is not available or expensive," said Patrick Theriault, managing director, Strategic Risk Solutions. "A captive can be a great way to better finance these risks.

Criticism Stems from Three Issues

Yet even with their rapid expansion, Enterprise Risk Captives have their critics. The criticism stems from three issues: these small captives might be used as tax shelters, not to transfer risk; there have been a number of "promoters" engaging in setting up captives who may not have a background in insurance; and these captives have been used solely as a wealth transfer mechanism.

Small captives opting for the 831(b) designation can gain a hefty tax advantage which can incline critics to believe that they are not proper insurance companies. "Many [small captives] engage in pooling arrangements, which we view as creation of risk to gain a tax advantage," said to Sandra A. Bigglestone, director of captive insurance, Vermont Department of Financial Regulation. "Vermont has a different philosophy for captive insurance. Aggressive tax strategies don't fit here. We struggle with reconciling the idea of an insurance company that doesn't anticipate losses."

The IRS also seems to have a problem with captive insurance companies, particularly ERCs, and has been scrutinizing more heavily companies using the 831(b) tax designation. The extra scrutiny has been caused by the increase of captives filing under 831(b) and the fear that some of these companies may not be insuring genuine risk. In the last two years, audits of small captives have increased in frequency, according to industry insiders.

Theriault believes that not many ERCs are being used as tax shelters, but the problem is one more related to perception. "Many folks, when they think small captives, focus on a small part of the overall captive structure – the potential tax benefits. Because the potential tax benefits for a small organization can be material, I think some folks jump to the conclusion that these captives must be formed purely for tax reasons and not for risk management reasons."

Another issue affecting ERCs is that they are being promoted and formed by non-insurance professionals. With favorable captive laws that have eased the fiscal requirements and simplified the registration process, it has become easier for those without a background in insurance to organize a captive.

"While historically the captive discussion was mostly centered around insurance brokers/consultants, captive managers and a few attorneys, we are now seeing CPAs, bankers and investment managers, financial planners, life insurance agents, etc… being interested in captives," said Theriault. "Some of the more traditional captive service providers are questioning this and whether some of the new entrants to the market have the appropriate experience to put good programs together."

However, while there have been a number of non-insurance professionals putting together small captives, according to Simpson, it does not necessarily mean that the captives they form are less likely to be a proper captive. "The owners of these captives often first hear about the idea from a financial planner or investment advisor. Many of the opponents of Enterprise Risk Captives are people from traditional insurance backgrounds who are uncomfortable with… the means by which the captive owner gets educated."

A third issue, which follows hard on the heels of non-insurance professionals promoting small captives, is that captives can be used as a mechanism for wealth transfer. A company can use a captive to shift finances between family members or other individuals, avoiding the steep inheritance taxes. It is not prohibited for captives to structure in financial transfer elements, but their primary focus needs to be insuring risk.

Bigglestone said that in Vermont, "A few Vermont captives have estate planning elements, but the essential parent/captive/risk management chain still exists, and the captive has a business insurance reason for operating."

"Captives are a tool for insurance risk management and risk financing," she continued. "In the context of many 831(b) captives, where there's minimal chance of experiencing a loss, you have to question the insurance purpose. For that reason, Vermont discourages the use of captives as tax and estate planning vehicles, and really wants to see a necessary insurance purpose, regardless of the premium volume."

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."

Your risk is a unique combination of factors. Shouldn't your solution be too?

Your risk is as unique as your business. After all, medical risk is constantly in flux. Markets change and so do opportunities.

Over the past twenty years, we have grown and evolved across multiple lines of business and geographies. This means that while we possess the expertise, scope and scale to protect against a wide array of risks, we continue to focus on only one. Yours.

To see how our experience and insight can work for you, visit:
www.partnerre.com/risk-solutions/health

PartnerRe

Underwritten by PartnerRe America Insurance Company
Executive Office: 199 Fremont St., San Francisco, CA 94105
Form H0214 03/2014

AIG Benefit Solutions

Bring on experience

The benefits landscape is constantly changing. For generations, AIG Benefit Solutions has offered innovative solutions to help our clients meet their challenges and prepare for tomorrow.

We offer a diverse portfolio of insurance products designed to help businesses offer competitive benefits that protect their employees and families.

- **Supplemental Medical Solutions** for more complete health coverage
- **Protection Solutions** including life, accident and disability plans
- **Employer Risk Solutions** including stop-loss and captive arrangements
- **Multi-Product Solutions** like ProtectPak^{SM} to simplify benefit offerings

Watch our "About Us" video at www.aigbenefits-solutions.com.

Visit aig.com/benefits to learn more about what AIG Benefit Solutions can do for your business.

AIG Benefit Solutions® is the marketing name for the domestic benefits division of American International Group, Inc.

The underwriting risks, financial and contractual obligations, and support functions associated with products issued by American General Life Insurance Company, The United States Life Insurance Company in the City of New York, and National Union Fire Insurance Company of Pittsburgh, Pa., are the issuing insurer's responsibility. The United States Life Insurance Company in the City of New York is authorized to conduct insurance business in New York. National Union Fire Insurance Company of Pittsburgh, Pa., maintains its principal place of business in New York, NY, and is authorized to conduct insurance business in all states and the District of Columbia. NAIC No. 19445. Not all policies are available in all states.

AIG Bring on tomorrow

The Issues at Stake with ERCs is True of All Captives

While these problems have been plaguing the small captive sector, many of the issues surrounding ERCs can also be applied to captives of any size.

"Every so often we encounter some captive programs that might make you scratch your head as to what problem they are really addressing," said Patrick Theriault. "This is true for both large and small captives and the principles used to evaluate captives are the same no matter the size of the captive."

Jeff Simpson agrees, "While there are certainly some participants in the Enterprise Risk Captive arena who are bad actors and should be policed, the same is true of every other type of captive insurance program. The fact is that ERCs are perfectly legitimate and the vast majority of them are executed carefully and with good risk management as the underpinning."

The Future of ERCs

What does the future hold for Enterprise Risk Captives? With outstanding growth in recent years, yet surrounded by controversy, what will the future likely hold for 831(b) designated captives?

"Everyone is trying to read tea leaves on this question," said Simpson. "The industry is organizing itself to set some appropriate standards for these types of captives and to ensure those standards are met. At the same time, the IRS appears to be doing essentially the same thing. So, I would not be surprised if the next few years lead to some regulatory and tax guidance that helps practitioners build better Enterprise Risk Captives. But I do see them continuing to be used and do not expect them to go away."

This seems to be the consensus. These small captives have carved a niche out for themselves that is serving an important role in the self-insurance sector. While the IRS may change its rules for the 831(b) designation, Enterprise Risk Captives will still play an important part in the industry. According to Les Boughner, what happens to the tax structure, "Is up to the IRS and Congress, but existing 831(b) s, properly structured in accordance with IRS guidelines, will not go away should the election be discontinued. They serve as a valued structure for the self-insurance needs of medium sized companies."

As with many new concepts in the financial sector, Enterprise Risk Captives are being subjected to criticism and extra scrutiny. And this is a good thing. As these captives continue to fill in coverage gaps and become more prominent, education and proper guidance will be key. "We need to educate potential captive owners to make sure they can make informed decisions," said Theriault. "Since the majority of the captives being formed right now are small captives I think it is worthwhile looking into this sector of the market to make sure that the growth is being driven for the right reasons, the risk management benefits." ■