Affecting the Future of Captives

Minor changes in 2017 could have lasting affect on the captive industry

Written By Karrie Hyatt

While 2017 was not a year of upheaval in the captive industry, there were many issues—small or tangential—that will have an enduring effect on captives. The PATH Act, major cyber security incidents, a decision in the Avhrami case, and last, but not least, the end-of-the-year tax reform all touched the captive marketplace and could impact the future of captives.

State of the Marketplace

Captive numbers continued to grow in the U.S. in 2017 and are forecasted to increase further in 2018, despite the lingering soft-market. While most captive domiciles are reporting gains in captive numbers, captives formed at a slower rate than in 2015 and 2016. With numbers reported by the beginning of last month, North Carolina led formations with 124. Utah, Delaware, and Montana also had a strong showing with 63, 53 and 42 captives formed, respectively. These numbers were driven by large numbers of cell captive formations, an area in which these domiciles lead. Vermont is still the largest captive domicile in the U.S. with 566 active captives, despite having slightly fewer captives at the end of 2017.

Last year, eight domiciles updated their captive law—Arkansas, Delaware, Georgia, Illinois, Montana, Tennessee, Texas, and Vermont. For the first time in several years, no new state entered the captive domicile arena. In 2018, so far four domiciles are looking to or have already updated their captive law—Georgia, Kansas, South Carolina, and Vermont—with several more likely to follow. Vermont tweaks its captive law nearly every year, part of the reason that it still leads the captive industry.

PATH Act and Notice 2016-66

The large numbers of cell captives formed last year could have been influenced by the change to the limit of net written premiums for companies using the 831(b) tax option. On January 1, 2017, the *Protecting Americans from Tax Hikes Act of 2015* (PATH Act) went into effect. The law created tax relief benefits for businesses and families, but it also made changes to the tax code regarding the 831(b) option. The PATH Act increased the premium limit to $2.2 million, from $1.2 million, and requires captives electing the tax option to meet a "Diversification Requirement" in the ownership structure.

Ostensibly, the PATH Act should help to stem many of abuses the Internal Revenue Service has accused 831(b) captives of committing, while also allowing small captives to grow. However, even as the PATH Act went into effect, the IRS was still bearing down on 831(b) captives in the form of Notice 2016-66—in which the IRS labeled them as "transactions of interest" and sought to require additional financial disclosures—and by again naming the subsector to its annual "Dirty Dozen" list.

The PATH Act made provisions for inflationary increases and as of January 1, 2018 the IRS, as part of its annual adjustments for inflation, increased the premium limit for Section 831(b) by $100,000 to $2.3 million. As of March, there has been no follow-up to Notice 2016-66, as the IRS is likely still processing the data it received from 831(b) captives last spring. When the IRS does follow-up, it could prove disruptive to the subsector. Notice 2016-66 stated that the IRS in conjunction with the Treasury Department will decide one of three things after reviewing the requested data: that 831(b) transactions will be removed from "the transactions of interest category in published guidance," will be designated a "listed transaction"—a tax avoidance scam, or it will be listed as a "new category of reportable transaction." If either of the second two decisions comes down, it could mean a huge change in management and regulation of 831(b) captives.

Cyber Threats

2017 brought cyber attacks to the forefront of the world's attention, as well as the need for cyber security programs and cyber liability insurance. A large-scale ransomware attack on May 17 affected computer systems worldwide. When the threat was dealt with, many businesses found themselves woefully underinsured against that attack or any kind of cyber attack.

In the 2017 North America Cyber Risk Transfer Comparison Report released last year, sponsored by Aon Risk Solutions and independently conducted by Ponemon Institute LLC, most companies fear a cyber attack yet the uptake of cyber-related insurance is still well below property, plant and equipment (PP&E) coverage. The findings indicate that companies believe information assets to be slightly higher in value than PP&E, but information assets are underinsured by comparison. More than half the respondents surveyed believed that security threats will increase in the coming years, yet companies are still slow to get adequate coverage. Reasons for not purchasing liability coverage is cost, availability, and too many restrictions/exclusions. All reasons that make captives look like the perfect alternative to traditional insurance for insuring cyber liability.

On the other side of the coin, early in 2017, the New York Department of Financial Security (NYDFS) began requiring all NYDFS-regulated entities—including banks, insurance companies, and other financial institutions—to file a Certification of Compliance with NYDFS' Cybersecurity Regulations office on an annual basis starting February 2018. Companies that are exempted have fewer than ten employees, have less than $5 million in gross revenue, or have less than $10 million in year-end total assets. Most small captives will not be affected by this requirement.

Using the NYDFS's requirements as a model, the NAIC Cybersecurity (EX) Working Group made adjustments to the draft of their own model law that had been in development since 2016. The Data Security Model law is intended to help state insurance departments regulate cyber security. On the whole, it won't affect very many captives, but it does require risk retention groups to be subject to the regulation. The Cybersecurity Working Group approved the sixth version of the model law last summer and has forwarded it up the committee chain for further approval. It will be several years before the model law is approved and adopted by NAIC member states.

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Avhrami Decision

Last August, the United States Tax Court released its decision in the case of *Avrahami v. Commissioner,* a highly anticipated decision regarding captive insurance companies electing to use Section 831(b) of the U.S. Tax Code. The captive industry had long-awaited this decision to set case law for the regulation and management of 831(b) captives.

The Avrahami case revolved around Arizona small business owners Benyamin and Orna Avrahami and their St. Kitts-domiciled captive, Feedback. The Internal Revenue Service considered Feedback's tax filings as a "micro captive" as invalid and issued a notice of deficiency for nearly $2.5 million in taxes and penalties for taxes filed in 2009 and 2010. The judge in the case found that Feedback did not qualify as an insurance company and was not eligible for the 831(b) election.

Because the decision focused narrowly on Feedback's unique situation, it has not caused any sweeping changes to case law regarding these types of captives. On the whole, the industry was pleased with the decision, but many were concerned that it could strengthen the IRS's position that captives opting for the 831(b) designation are using it as a tax dodge.

Advocates for the captive industry were quick to advise small captives to revisit their pooling arrangements to be sure that their risk distribution is being used correctly. Since the decision, some small captives have closed shop. However, small captives, primarily cell captives, are still being formed in large numbers. Over the next year, there will likely be more small captives closing down or restructuring as a result of the decision.

Tax Law

The much-anticipated *Tax Cuts and Jobs Act of 2017* was signed into law by President Trump in December. The new law will benefit captives as to their investment income but might make forming a captive less appealing.

While the primary focus of a captive is about self-insuring risk, no one can deny the added benefit of reduced taxes, especially for small and medium-sized captives. Industry insiders are not expecting to see any established and well-functioning captive retire, but there might be a downturn in the number of captives forming.

In a "Captive Thought Leader Video" made for Captive.com, Bruce Wright, partner with Eversheds Sutherland (US), said that the increased reserve discount and decreased tax rate could reduce the benefit of having a captive. The reduced tax benefits will be something that shows up in the cost-benefit feasibility study that is performed prior to establishing a captive. In some cases, companies may decide that captive insurance is not for them, but industry experts believe that there won't be a large downturn in captive formations as none of the other benefits of owning a captive will be diminished.

Looking Forward

Captives electing the 831(b) tax option were, again, the most controversial sector of the industry in 2017 and, until some guidance is released by the IRS, will continue to be in the line of fire. This, and the reduced tax benefits that come as a result of the Tax Cuts and Jobs Act, might have the effect of reducing small captive formations this year. Nevertheless, the non-tax-related benefits of captives continues to expand. ■

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.