CAPTIVE
INSURANCE GROUP

Summary of Changes to IRC 831 (b) From 2015 Appropriations Bill

The following summarizes the changes coming from the legislation that was passed by Congress at the end of 2015. This summary was published by Forbes and is a good outline of the changes to captive insurance companies qualifying under IRC 831 (b).

Though encompassing several pages of new legislation, the 831(b) changes actually accomplish very little; in fact, just two things really. By the way, all these changes take effect beginning in 2017.

First, the current $1.2 million limit on premiums will increase to $2.2 million (and be indexed against inflation). This is great news, and is the result of the Hon. Senator Charles Grassley's long-time quest to increase the limit to benefit so-called farm mutual insurance companies that are widely used throughout the Midwest.

That is the good news. But to get us the good news, Grassley had to find a revenue offset to make up for this increase, and he did so by attempting to close a perceived abuse of 831(b) captives which are misused as a wealth-transfer tool. This brings us to the bad news (sort of).

Second, an insurance company that seeks to make the 831(b) election must comply with a new diversification requirement, which means that the captive must comply with at least one of two new tests.

Diversification Test #1 is that no more than 20% of premiums can come from any one policyholder. For this purpose "one policyholder" is broadly defined to include businesses paying premiums to the captive and which are owned by the heirs of the business owner, the business owner's spouse, and members of the same "control group" of companies.

The apparent (we really don't know) goal of this test is to allow Senator Grassley's farm mutual and similar group captives to comply with the diversification requirement, yet weed out abusive captives that use so-called "risk pool" arrangements so as to meet one of the tax tests for risk distribution (which is different than diversification).

This test would effectively require a single-owner 831(b) captive to participate in at least four risk pools to meet risk diversification, and even these risk pools could not have the same owner.

But if an 831(b) captive cannot meet Diversification Test #1, then it can instead attempt to meet Diversification Test #2, which, as drafted, is so complicated as to almost be indecipherable by experienced captive attorneys.

Diversification Test #2 is met if the heirs or spouse of the business owner do not, directly or indirectly through a trust or business entity, own more than 2% than the interest they own in the businesses being insured.

This is better explained by way of example than trying to parse the statutory language. Let's say that a manufacturing business which needs products liability insurance is owned 50% by Dad and 50% by Son. In that case, to qualify for the 831(b) election, the captive could be owned by Son only up to 50% (the same as the manufacturing business) plus 2% — or 52%.

Or, let's say that Dad owns 100% of the manufacturing business; Son could only own 2% of the captive.

This second test is aimed at folks who attempt to abuse 831(b) captives by using them as a wealth-transfer vehicle, by allowing Dad to move tax-deductible premiums to Son, outside of Dad's taxable estate.

New definitions provided in the statute make clear that this test will apply whether the ownership of the captive is held by Son, a trust for Son, or another company or partnership in which Son is a member.

Quite bizarrely, the two new diversification tests also apply to spouses of the business owner, i.e., it would apply to Dad's spouse as well as Son. This has the potential to cause a lot of problems in community property states, and it is difficult to discern any greater policy reason for including a spouse in this calculation other than some Congressional staffer was dozing on mescaline while drafting. This is so bad that a technical amendment will probably be required to correct it.

Indirectly, the new diversification requirement not only significantly limits an 831(b) company's usefulness for estate planning, but it probably also knocks out a related use for 831(b) companies, which is to act as a vehicle to purchase life insurance with pre-tax dollars. The requirement does so by effectively trapping the proceeds of a life insurance policy within Dad's taxable estate, at least in substantial part, which of course from an estate and gift tax perspective is highly undesirable.

Folks who have used their captive to purchase life insurance will now need to figure out how to get it out of the captive, pronto. Thanks for playing.

Similarly, captives that are owned in trusts and other estate planning vehicles, such as family limited partnerships and family LLCs, will need to evaluate whether they are in compliance with the new 831(b) diversification requirements. Doubtless, there will be a number of these arrangements for which remedial action will be required in 2016 before these changes go into effect.

Also on the subject of the new diversification requirement, Congress has authorized the IRS to seek information (read: require the filing of a form) to ensure that the diversification requirements are being met.

Well, that's it for the changes, which really are not great. The vast majority of real 831(b) captives that actually provide real insurance to businesses will be unaffected, other than they will have to meet the IRS reporting requirements when and if the IRS comes out with a new form. These changes do not affect or supplant the existing tax rules for risk shifting and risk distribution.

For example, let's say that Dad owns the businesses being insured, and Dad also owns the captive. Before these changes, the captive arrangement was fully in compliance with all risk shifting and risk distribution requirements. In this scenario, Dad, the businesses and the captive will all be able to carry on as before, apparently unaffected by these changes other than somebody might have to file an IRS form on diversification someday, and in 2017 the premiums can go up to $2.2 million if actuarially justified.

Otherwise, the 831(b) captives that do not comply with the new diversification requirements now have until December 31, 2016, to either come into compliance, wind-up, or prepare to comply with the ordinary insurance company tax rules outside the 831(b) election.