



831(b) Captives

One of the fastest growing sectors of the captive insurance industry in the past few years has been among 831(b) captives or “micro” captives. What exactly is an 831(b) captive and why have they become so

popular? In this newsletter we take a look at this sector and highlight some of the pros, cons and pitfalls around these captives. This article includes information presented in our September 2011 webinar by Patrick Theriault of Strategic Risk Solutions and Dan Kusaila of Saslow, Lufkin & Buggy, LLP.

Definitions

Technically there is no such thing as an 831(b) captive. It is not a type of captive, but rather purely a tax election available to certain insurers (just like a LLC could elect to be taxed as a corporation or as a partnership). An 831(b) election could be made by most types of captive: single parent, groups, RRGs, etc. Indeed the election is not specific to captives, but to all types of property & casualty insurers, commercial insurers and captives alike. Other descriptions used to describe captives which make an 831(b) election include small captives, micro captives and mini captives.

The core of the election is that an insurance company with annual written premiums of \$1.2 million or less can elect to be taxed on its taxable investment income only.

Captives making this election would have the ability to accumulate underwriting surplus tax-free. Exhibit 1 shows an example of the tax benefit of the election. The options in the example are maintaining a deductible program with no captive, and alternatively having a captive write a deductible reimbursement policy with and without making the 831(b) election. The impact is measured in terms of the overall tax cost to the group (parent and captive). Key assumptions are:

- \$5 million taxable group income prior to deductible expense
- \$533,700 in losses each year, all paid within the year.

Exhibit 1: Tax Benefit of Captive and 831(b) Election

Tax Cost	Year 1	Year 2	Year 3	Year 4	Year 5
No Captive	1,778,520	1,778,520	1,478,520	1,778,520	1,778,520
Captive	1,720,946	1,723,145	1,461,960	1,725,565	1,727,333
Captive 831(b)	1,523,709	1,525,908	1,527,223	1,528,328	1,530,096
Benefit					
Captive	55,574	55,375	16,560	52,955	51,187
831(b)	197,237	197,237	(65,263)	197,237	197,237

- A large loss of \$750,000 in year 3.
- \$1.2 million in premiums paid to the captive, deductible to the parent.
- 40% combined effective tax rate (Federal and State).

On its own, the captive has a minimal benefit over the current deductible program. But once it makes the 831(b) election the benefit is quite significant, lowering the tax cost to the group by over 11% compared to the current program. This is a simplified comparison of the tax impact only. Frictional costs and the cost of capital would need to be factored in, as well as tax deferral on long-tail lines of business to assess the feasibility of a captive.

Qualifications

While the tax benefits of the 831(b) election are attractive, it is not available to everyone. It is designed for small property & casualty insurance companies and insurers must fall within that category to qualify.

- **Insurance Company for Tax Purposes:** the election is only available to insurance companies. If a captive does not meet the requirement to be treated as an insurance company for tax purposes, the election cannot be made or worse would be reversed after being made with resulting negative implications. These could include fines and interest on top of the tax owed.

Being treated as an insurance company for tax purposes is a critical issue for captives for other reasons, including the ability for the insureds of the captive to deduct the premiums paid as a taxable expense, and for the captive to make deductions for loss reserves. The inability for the insureds to deduct the premiums paid to the captive could result in additional annual taxes of up to \$480,000, assuming a combined Federal and State income tax rate of 40%, \$1.2 million in premium and no losses. Any losses during the year would be deductible and reduce the additional tax cost.

There are two main routes to achieving insurance company status:

1. Brother-sister structure, where the captive is positioned as a “sister company to the insureds creating risk transfer and where there are sufficient insured “brother” companies to achieve risk distribution.
2. Third-party business: this can be achieved through re-

lated party business, such as customer or partner programs or employee benefits. There has also been a growth in pooling arrangements where the captive reinsures some risk from a pool of unrelated business (see Risk pooling article in this newsletter).

- **\$1.2M Premium Limitation:** the election is only for small insurance companies. This is defined as companies with no more than \$1.2 million in net written premiums or direct written premiums, whichever is the greater. Net written premiums includes all policies issued directly by the insurer plus assumed reinsurance, less ceded reinsurance. However, direct written premiums applies to all policies issued directly by the insurer regardless of reinsurance. For a captive underwriting directly and then ceding risk to a reinsurer, this may limit its ability to seek an 831(b) election.
- **Controlled Group:** if there is more than one insurance company that is part of a consolidated return or controlled group, the premiums of all insurance companies must be aggregated in order to determine if the \$1.2 million threshold has been exceeded.
- **Property & Casualty Insurers:** the election applies to property and casualty insurance companies only. Employee benefits coverages are considered third party business and can improve a captive's ability to be treated as an insurance company for tax purposes. However, employee benefits are sometimes considered life insurance and could jeopardize the captive's tax status as a property & casualty insurer.

The captive should be formed for insurance purposes first with the 831(b) election a secondary consideration if the captive qualifies.

Drawbacks

There are drawbacks to the 831(b) election, the most significant of which is the inability to carry forward net operating losses (NOL). This limitation is broadly applied in any year in which the company is taxed under section 831(b).

- Can not be carried forward from a year in which the company was taxed under Section 831(b)
- Can not be carried forward to a year in which the company is taxed under Section 831(b).
- Can not be carried forward across a year in which the company is taxed under Section 831(b). You lose any existing NOL carry forward benefit once we make the election.

Other significant drawbacks are the inability to deduct incurred losses and the limitation on the deduction of operating expenses to investment expenses.

While the election works to your benefit when you make an underwriting profit, it can work against you when you have losses.

Insurance Considerations

Even if the captive qualifies for the election, it may not be beneficial to make it. There are types of risks which are more suitable for an 831(b) election than others. Issues to consider include:

- **Frequency and severity of losses:** lower frequency, higher severity risks are more suitable as the election allows for a more tax efficient build-up of surplus to pay for the losses in the years in which they occur. High frequency, low severity risks have less volatility and are easier to predict and accurately fund for. Underwriting income for these risks should not fluctuate greatly from year to year, and many captives aim to underwrite at a break-even position passing on savings through premium reductions instead.
- **Long-tail versus short-tail:** insurance companies are able to expense discounted loss reserves. For long-tail lines of coverage (such as workers compensation and liability), this means that underwriting results and taxable income can be deferred for many years until claims mature. The benefit of the tax exemption under the 831(b) election will be reduced for those lines of coverage. Conversely for short-tail lines of coverage (such as property), there is limited ability to hold IBNR reserves. In years where losses are low, the 831(b) election will have a greater impact, allowing the underwriting surplus to be grow tax free.
- **What works:** risks that are commonly seen in 831(b) captives are low frequency, high severity coverage types, that may not be available in the commercial market or are very expensive. Examples include property and related coverages (e.g. mold), weather risks, cyber risk, pollution liability and clean-up, and difference in conditions/difference in limits.

Exit

While an 831(b) captive pays no tax on its underwriting income, the owners of the captive will be taxed on the dividends distributed by the captive. The same is true for a captive not making an 831(b) election. The election eliminates the double taxation of the captive paying tax on its underwriting income and then also having its dividends subject to income tax. Consideration should be given to the exit strategy for the captive in its initial structure as a single parent captive may have the ability to repatriate the funds into the parent pre-tax. Other structures may also allow the funds to be taxed as long-term capital gains rather than income.

Keys to Success

There is a lot of interest and activity around 831(b) captives, driven in large part by the potential tax benefit. However to successfully utilize it, the captive should exist and be viable independent of the election. It should exist first and foremost for insurance reasons, not tax reasons. If the captive is structured in this manner and meets the qualifications to make an 831(b) election it should withstand any scrutiny from the IRS

The discussion presented in this article should not be viewed as tax advice. The taxation of any captive is dependent on individual circumstances. Consult your tax professional for the applicability of an 831(b) election for your captive.

Risk Pooling

The previous article highlighted the importance of having a captive treated as an insurance company for tax purposes. Among other requirements, this requires there to be risk distribution in the programs insured. For smaller organizations, which are typically involved in smaller captives looking at an 831(b) election, it is often difficult to achieve risk distribution within its own insurance program. It does not have sufficient operating companies of comparable size to be able to create a brother-sister relationship with the captive that will achieve the required level of risk distribution. (see Revenue Ruling 2002-90). Instead the captives turn to third party risk to achieve risk distribution and most often to risk pools or risk mixers.

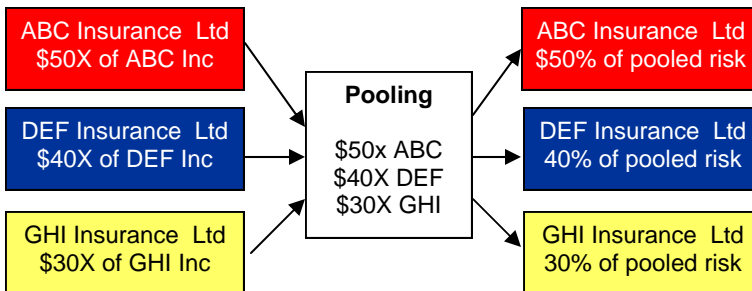
Risk Distribution Through Third-Party Risk

Having decided to use third-party risk to achieve risk distribution, how much does a captive have to write? Revenue ruling 2002-90 sets a safe harbor of 50% conceding that is sufficient to constitute insurance. It also ruled that 10% is not enough. Earlier case law has supported 30% unrelated risk to achieve insurance (Harper vs Commissioner, 1996). Most risk pools use 50% under Revenue Ruling 2002-90.

How It Works

Participants in the risk pool cede a quota share of their risk equal to 50% or more of the total premium underwritten by the captive to the risk pool. In return, the captive assumes reinsurance from the pool equivalent to the amount of risk ceded into the pool, measured by premium. In Exhibit 2 below, ABC Insurance Ltd ceded \$50X of premium to the pool and assumes the same amount in reinsurance of the pool. This allows different sized programs to be in the pool. The third party business is achieved through a single reinsurance contract. The IRS will look through the reinsurance contract to the number of insureds within the book of business being reinsured to assess risk distribution.

Exhibit 2: Illustrative Pooling Arrangement



Structural Requirements

The use of these risk pools is relatively new, but there are some recent tax rulings which recognize the pools as legitimate insurance companies and define some structural requirements:

- **Separate operation:** the pool must be run separately to any member with separate books and records. No single member

can have control over the pool. Notwithstanding this requirement many pools allow the members to maintain control over the investment of funds “paid” into the pool.

- **Risk transfer:** the captive’s risk must be assumed by the pool and vice versa. The concern with insuring unrelated risk is that the captive does not understand the risk it is underwriting or have any control over the risk. Many pools try to mitigate this by either creating a pool of low perceived risk or capping the aggregate amount of a member’s losses in the pool. However, there must be sufficient risk transferred between the pool and its members to meet the risk transfer requirement.
- **Adequate capitalization:** the pool must be adequately capitalized to meet the risks it is assuming.
- **Risk distribution:** the pool itself must meet the requirements for risk distribution with sufficient numbers of members and an even spread of risk among the members. In our simplified diagram additional members of the pool would be required.

Insurance Considerations

Risk pools may allow a captive to achieve insurance company status, but underwriting third party risk has its dangers. Many captives have gotten into considerable trouble by taking on risk they did not understand and couldn’t control. It is important that a captive is comfortable with the structure of the risk pool and the risk it is assuming. Not all risk pools are the same.

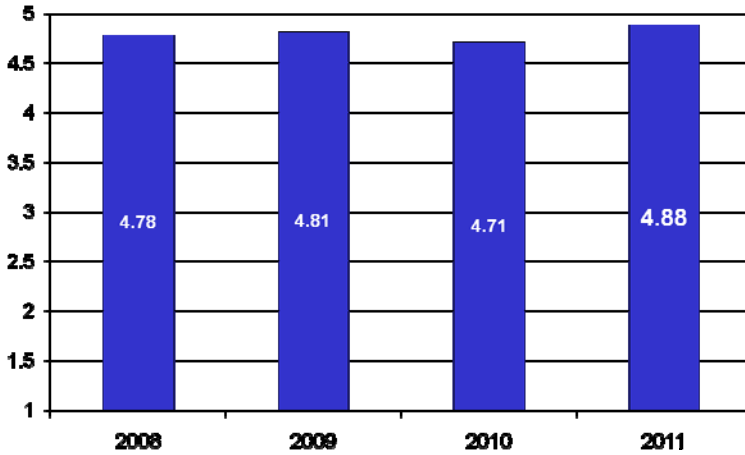
- **Type of risk:** many pools are homogeneous. The type of risk ceded into the pool is similar in nature to that assumed from the pool. However, there are different schools of thought around low risk. Some pools use low frequency risks, such as terrorism to create the pool. Others use high frequency risks such as workers compensation, as these are more predictable and have less volatility. The captive owner needs to be comfortable with the risk being ceded both from an insurance perspective, but also from a tax perspective. If there is no risk of loss in the pool the IRS may find it is not an insurance company removing the tax benefits to the members.
- **Layer of risk:** Many pools have a layered structure and either the primary or the excess layer may be pooled. Pooling in the excess layer creates a lower likelihood of loss but also has more volatility. The primary layer is more predictable, but will attract losses and the pool’s loss experience may be significantly different than the members. There is also the potential for an accumulation of losses by member or across the pool, unless there are aggregate limits applied.

There are also potential insurance benefits to pooling, as the captive achieves a greater spread of risk. By the law of large numbers, this should produce more predictability and less volatility in the book of business underwritten.

In conclusion, like any other aspects of captive feasibility, the structure and operation of the pool needs to be vetted to ensure the captive owners are comfortable with the risks being assumed, their obligations in the pool and the exit provisions.

Strategic Risk Solutions Achieves Higher Customer Satisfaction Ratings

On December 19, SRS announced the results of its annual customer survey. Despite previously high ratings, overall customer satisfaction improved over 2010. All respondents to the survey said they were satisfied or highly satisfied with SRS services. The survey had a larger number of respondents than any of SRS's prior annual customer surveys.



(1 = very dissatisfied; 2= dissatisfied; 3 = neutral; 4 = satisfied; 5 = very satisfied)

“Providing high quality captive management and consulting services is the foundation of our business. This result is validation of the approach we have taken and an endorsement of our staff”, said Brady Young, President of SRS. “This is a continual process and we have implemented several measures during the year to maintain and improve the quality of our services. These include SAS 70 reviews and the creation of our Professional Standards Committee. While the survey ratings are high, there are areas for improvement and we will be working hard to ensure that we receive highly satisfied ratings from all our clients in the future,” added Young

Copies of the survey results are available on our web-site at www.strategicrisks.com.

Staff News

Sarah Nestor joined our Cayman office in November as an Insurance Accountant. Sarah has four years insurance accounting

experience and joins SRS from PricewaterhouseCoopers, Dublin where she was an Assistant Manager in the Insurance Division. Sarah is a member of the Institute of Chartered Accountants in Ireland.

Saldea Arboladura re-joined the firm in December as an Account Manager in our Bermuda office. Saldea has nine years accounting and auditing experience, including four years experience with captives and commercial insurers and reinsurers in Bermuda. She is returning to Bermuda after two years in her native Philippines. Saldea was previously with SRS Bermuda from 2007-2009.

Industry Events

SRS will be participating in the following upcoming industry events. Please contact us at info@strategicrisks.com to arrange meetings with our team at any of these industry events.

January 30—February 1, 2012, 21st World Captive Forum: SRS is pleased to be sponsoring this event to be held at the Doral Resort and Spa, Miami, FL. Brady Young and Patrick Theriault will be speaking at the conference.

March 11-13, CICA 2012 International Conference: Melissa Hancock and Derick White will be speaking at the conference to be held at the Westin Kierland Resort, Scottsdale, AZ.

SRS Webinar Series

SRS hosts monthly webinars on topical issues affecting the captive insurance industry.

Our January 2012 webinar will feature a review of captive activity during 2011 and a look forward to 2012.

- **January 26, 1pm:** Captive Insurance—the State of the Market

Recordings - Recordings of prior webinars may be viewed at any time. A full listing of webinars is on our web-site at www.strategicrisks.com/webinars. Recordings of webinars conducted during Q4 2011 include:

- 2011 Captive Taxation Update
- Evaluating Captives - a Guide to the Feasibility Process
- 831(b) Captives - Pros, Cons and Pitfalls

Strategic Risk Solutions (SRS) is an independently owned captive management and consulting firm. The company is an approved manager of captive insurance companies in most leading onshore and offshore domiciles. SRS is committed to being the premier provider of captive management and advisory services in the territories in which we operate.

For more information on SRS, visit us at www.strategicrisks.com.

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