Small Captive Insurance Legislation Passes House

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The long-awaited tax extenders bill that the House passed December 17 would bring significant changes to the taxation of small insurance companies, whose high audit rates demonstrate the attention the IRS is paying to what it views as potential abuses by unscrupulous tax advisers.

The Protecting Americans from Tax Hikes (PATH) Act of 2015 proposes to rework section 831(b), which now provides an election for property and casualty insurance companies that receive less than $1.2 million in premiums to recognize only investment income, in lieu of the broader income definition under section 832.

The new legislation, which if enacted will be effective starting in 2017, would do three things, said Charles J. Lavelle of Bingham Greenebaum Doll LLP: raise the 831(b) premiums limit, address mutual or group captives' ability to qualify for section 831(b), and address Congress's concern with estate planning.

The PATH Act passed the House as an amendment to H.R. 2029. The omnibus appropriations legislation, also an amendment to H.R. 2029, is scheduled for a vote on December 18. Senate passage and President Obama's signature of both are likely to follow.

In a win for the small insurance industry, the premiums allowed under section 831(b) would increase from $1.2 million to $2.2 million and would be subject to inflation for the first time since 1986.

There would also be a new diversification requirement. Under current law, an insurance company must only have premiums below the threshold and make a timely election to qualify for section 831(b) treatment.

An insurance company must pass one of two tests to satisfy the legislation's diversification requirement. The first is that no more than 20 percent of net written premiums may be attributable to any one policyholder. The second test, which applies if the insurance company fails the first, is that no family member -- either "spouse or lineal descendant (including by adoption)" -- of the policyholder's owner may own assets in the captive insurance company in a percentage higher than the family member's ownership in the policyholder. There is an exception to the second test for de minimis (2 percent) amounts of ownership percentage difference.

"This legislation helps to ensure that small mutual insurance companies will continue to be able to serve rural residents who have unique circumstances, such as living far from a fire station, and so are often unable to obtain private property insurance through traditional insurance companies," Senate Finance Committee member Chuck Grassley, R-Iowa, said December 16 in a press release.

Former acting IRS Commissioner Steven T. Miller, who is now National Director of Tax at alliantgroup, said the bill's effect on the industry would be minimal. *"My first read is that provided that the structure of the captive doesn't have estate planning aspects to it, I don't think it will have a large impact,"* he said. The largest impact, he said, is that premiums will be increasing, which is a positive.

"I think the legislation seems practical; while it still narrows the eligibility provisions, it provides an alternative test," Susan E. Seabrook of Buchanan Ingersoll & Rooney PC said. *"These changes, coupled with raising the premium cap, seem like a good compromise,"* Seabrook said. When legislation to curb small insurance abuses (H.R. 625, the Infrastructure 2.0 Act) was first introduced in February, a compromise seemed difficult to accomplish, she said.

IRS Concerns Addressed?

While the statute is aimed at estate planning abuses, practitioners wonder whether the insurance measures in general will satisfy the IRS's increased scrutiny in the area. In February the IRS added the use of section 831(b) captive insurance companies to its "Dirty Dozen" list. In its release at the time, the IRS called small captive insurance companies a "legitimate tax structure." The concern is when *"unscrupulous promoters persuade closely held entities to participate in this scheme by assisting entities to create captive insurance companies onshore or offshore,"* the IRS said.

The question remains whether this statute does anything to ease the Service's concerns about captive insurance companies, Miller said, adding, *"I don't begin to think for a minute that it will."*

Although Congress addressed estate planning issues for small captives with "laser vision," Miller said, estate planning is not the primary driver of small captive examinations. The primary drivers are whether the premiums are reasonable, the coverage is realistic, and the money is being used in a way congruent with a legitimate insurance company, he said.

"I think it will be interesting to see if the IRS audits with the same intensity after this legislation," Lavelle said. He said the next year will provide practitioners an opportunity to learn more about Congress's thought process and how the IRS is planning on implementing the law.

Some of the issues that may be hashed out are how the legislation will affect brother-sister and pooling captive arrangements. Also, there is a question whether indirect ownership for the second diversification test covers contingent beneficiaries in a grantor trust.

Seabrook wondered if the diversification test could be circumvented -- for example, a promoter could still create multiple small insurance companies and restrict interests in the captive to below the 20 percent bar, similar to a "rent-a-captive" scenario. This suggests that the use of captive insurance companies for estate planning purposes is the intended target of the diversification tests, she said.

New Reporting Regime

The legislation would require the IRS to collect information on the diversification test, which would presumably require the agency to create a separate form for insurance companies using the section 831(b) election. Currently, taxpayers use Form 1120-PC, "U.S. Property and Casualty Insurance Company Income Tax Return," to indicate their election under the code section.

"I think the reporting requirements will provide the IRS with a much more efficient process to determine if the arrangement is problematic and if it is insuring real insurance risks," Seabrook said. She said that through the many promoter and captive audits, the IRS has collected information that has helped shape its understanding as to what it views as a potentially abusive strategy.

Miller, however, said that any positive outcome for taxpayers would be tempered until it is seen what the IRS does with the new information reporting, because it may not address what worries the Service -- such as the types of risks insured and whether the premiums are reasonable.

Although the changes to section 831(b) wouldn't become effective until 2017, the IRS has its work cut out for it, Miller said. Not only must it create new forms but it also must modify its software to take the data from the forms, which can become expensive, he said.

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