Too much candy for a nickel?

Bill HR 3301 proposes raising the annual premium limitation for §831(b)-electing insurance companies, but is this favourable tax provision for captives and small insurers robust enough to be relied on?

by ***Phillip England***

Occasionally tax advisors get questions about whether a §831(b) captive's $1.2m annual limitation on net written premiums will become inflation-indexed.

Most recently, on 22 July 2009, a bill (HR 3301) was introduced in the US House of Representatives that proposes raising the annual premium limitation to $2,025,000 for a §831(b)-electing insurance company and inflation-indexing such limitation in future years.

The proposal is similar to previous bills in previous Congresses going back to 2003. The National Association of Mutual Insurance Companies says it has led efforts to amend the tax legislation. The Property Casualty Insurance Association of America and the Allstate Insurance Company have also reportedly lobbied for such legislation. Advocates of the proposal bemoan that the $1.2m limitation, which was established by the 1986 Tax Reform Act, has not been updated since then.

Will the proposed legislation be enacted to make the §831(b)-based planning opportunity more generous? If recent history is our guide, one observation might be that this proposal has not made it to the top of the list of issues of national importance. But perhaps therein lies the point worth noting: §831(b) made it into the insurance tax statutes 24 years ago in the name of simplification and apparently Congress is not looking to do away with it.

Getting greedy

Over the past couple of years, captive promoters have speculated that §831(b) might be a tax break that will not be available much longer.

Some captive managers have expressed the concern that if too many captives are formed that qualify for §831(b), the greedy could spoil the tax benefit for all the others. One commentator has, with good insight, compared the proliferation of §831(b) captives to trying to get too much candy for a nickel.

Indeed for Fortune 500 companies' captives, whose annual premiums may total tens or hundreds of millions of dollars, §831(b) (which does not even apply to them) would seem to be a nickel and dime opportunity.

Meanwhile new captive domiciles are catering to §831(b) captives for (mostly) closely-held business owners, and new reinsurance products are being marketed to enable §831(b) to buy the requisite quantum of risk distribution in the effort to qualify a captive as an insurance company for federal tax purposes.

Speculation about the potential demise of §831(b) due to overzealous formation of captives brings to mind Mark Twain's remark that "the rumours of my death have been greatly exaggerated". Tax legislative history reveals how Congress has struggled to define the abusive aspect of the proliferation of small, tax-advantaged insurance companies:

1) As explained in a February 2004 report by the Joint Committee on Taxation, a then-proposed bill would have restricted §501(c)(15) to small mutual insurance companies, not stock insurance companies. The rationale was to revive the original purpose of §501(c)(15) as an administrative convenience for small local mutual farm insurers. Advocates of this restriction argued that sheltering investment income through §501(c)(15) was an abuse perpetrated primarily by stock insurance companies. However, the proposal to restrict §501(c)(15) to mutual insurance companies was ultimately replaced by the $600,000 gross receipts limitation.
2) As ultimately enacted, the $600,000 gross receipts limitation responded to a simpler identification of tax abuse: namely, sheltering investment income through a small insurance

company, regardless of stock or mutual company status and regardless of whether it is licensed in one state, multiple states, or offshore (in the case of a §953(d) electing insurer). This fix accommodated insurance tax policy that has attempted to treat mutual and stock companies equally since 1984.

3) In the General Explanation of the Pension Funding Equity Act of 2004, the Joint Committee on Taxation also said: "Because the [§831(b)] election results in the taxation of investment income, the Congress does not believe that it is abused to avoid tax on investment income."

It is noteworthy that as recently as 2004 Congress concluded that §831(b) is not tax abusive.

Taxpayers' victory

In Notice 2002-70, the Internal Revenue Service (IRS) put §831(b) and §501(c)(15) companies on its tax shelter blacklist in response to the emergence of literally thousands of vehicle extended service contract reinsurers belonging to car dealers. Around that time, the prevailing view in the field examination wing of the IRS was that many such affiliated reinsurance companies must betray some sort of sham.

However, the taxpayer victory in United Parcel Service v. Comm., 254 F.3d 1014 (11th Cir., June 20, 2001) made it difficult for the IRS to allege 'sham' against a validly licensed reinsurance company that insures unrelated party risk. So the IRS field examiners attacked vehicle service contract reinsurers another way: by disputing risk distribution.

But as witnessed by Technical Advice Memoranda 200453012 and 200453013, the IRS conceded that vehicle service contract reinsurers passed muster as insurance companies. Two weeks later, the IRS reversed Notice 2002-70 by issuing Notice 2004-65, thereby removing that tax shelter taint from §831(b) and §501(c)(15) companies. Since then, the IRS has continued to scrutinise §501(c)(15).

Some commentators have indicated that §501(c)(15) is effectively dead as a tax planning tool in light of the $600,000 gross receipts limitation. Presumably what is meant is that the $600,000 gross receipts limitation applies on a controlled group basis and any corporation that would want to insure its risks with a captive insurance affiliate recognises more than $600,000 of gross receipts annually.

However, it is important to note that the controlled group aggregation rule for measuring gross receipts applies only among C corporations (including captives) within a controlled group, not S corporations or partnerships or sole proprietorships (or limited liability companies (LLCs) treated as such).

As legal advisors, our role includes advising caution about captive insurance tax strategies that may be potentially more complicated than has been

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explained by a promoter. Ironically, with respect to §831(b) and §501(c)(15), sometimes we find ourselves explaining why these favourable tax provisions may in fact be more robust than some advisors have been suggesting.

Risky business

If there should be a concern about going too far with §831(b) planning, perhaps the concern would involve demonstrating the business purpose and economic substance of arrangements that sew multiple §831(b) insurers from one cloth.

One example is a parent-child pair of captives where, for example, a closely held business pays $2m of captive insurance premiums: $1m to a captive owned by the father and $1m to a captive owned by his son, who is over 21. Both captives could be eligible for §831(b) because the constructive ownership attribution rules are sufficiently permissive, but deeper justification may be needed for configuring ownership this way.

In a group captive context, another planning approach stems from the observation that the members of a risk pool effectively insure one another. Therefore, if all the members are captives, the risk pool could let each member be a captive reinsurer of other members' risks, which might be advantageous if each member's premiums do not exceed $1.2m. The cost of implementing multiple §831(b) captives has become more affordable in jurisdictions such as Delaware, which recently licensed a series LLC captive.

At bottom, §831(b) was enacted to simplify and unify the tax treatment of small stock and mutual non-life insurance companies that do not otherwise qualify for tax exemption under §501(c)(15). Because §831(b) exempts net underwriting income from corporate taxable income, naturally the temptation is to inflate underwriting income. That temptation could lead to a transfer pricing question, not necessarily a question about applying §831(b).

As captives becomes more commonplace, the IRS's challenges to captives, including §831(b) captives, are likely to become more sophisticated. Sophisticated analysis of §831(b) captives should be able to confirm or deny their legitimacy for tax purposes. It is not §831(b) that should be the cause for caution. Rather, vigilance, both by taxpayers and IRS examiners, is necessary in assessing the relative newness and conceptual complexity of tax analysis for captives. As always, careful analysis and planning is key to all aspects of captive endeavours – including the use of §831(b). CR