

## **831 B Captive Tax and Financial Planning Primer**

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Tens of thousands of small to medium sized businesses (SMBs), the backbone of job growth and innovation in the US economy, could benefit by using 831(b) captives if they understood the incentives and advantages of formalizing their enterprise, uninsured and under-insured risk management programs. Just as individual financial and tax planning advisers need expertise in retirement planning, all business financial and tax planning advisers need expertise in 831 B captives as they truly can help protect and strengthen SMBs and the families that own them.

A privately held 831 B captive saves up to \$450,000 annually in income taxes and allows that extra cash to be retained within a business family to protect and strengthen the family business group. Properly designed and managed, these protective loss reserves can accumulate outside of the business owner's estate, protecting assets and enabling small business to survive unexpected disruptions and more easily accumulate business succession reserves. Since small to medium sized businesses are the backbone of the US economy, job growth and innovation, the underlying tax policy objectives of IRC section 831(b) are clearly in the nation's best long-term interest. Advisers need to increase expertise in 831(b) captives and better educate small to medium sized businesses on these valuable and greatly under-utilized advanced business risk planning vehicles.

These tax advantaged small captive insurance companies accelerate reserve asset accumulation by closely held businesses. Provided you design your 831 B Captive correctly to meet business purpose and economic substance tests, this special IRC code section 831(b) election allows an operating company to deduct premiums paid while allowing the related party captive insurance company to exclude the premium income from federal income tax (forever not just deferred). Most domiciles that license and regulate captives also allow the ownership to be structured so the captive's asset reserves accumulated are not in the estate of the owners of the insured related operating companies.

### Why This is So Important

Consider by contrast why so many successful business owners invest in retirement plans. The US government enacted income tax deferral provisions specifically aimed to encourage retirement savings. The US government went even farther with properly designed and operated 831B captives. This makes perfect sense verses thinking it is some tax loophole. Small to medium sized businesses (SMBs) account for the majority of job growth and innovation in the US. It is clearly in the USA's strategic interest to encourage these SMBs to create protective reserves. Doing so not only makes them more competitive, but designed correctly increases business succession financing options.

If the 831b captive builds sufficient reserves, it can expand its insurance program to greatly reduce expense of commercial market policies as well as expand employee coverage offerings (like medical stop loss) at more affordable rates.

### Various Uses of 831 B Captive Asset Reserves

These tax leveraged asset reserves accumulating in your 831b captive (assuming of course policy losses are low due to effective risk safety and management practices) can be used for a variety of purposes unless you select an overly restrictive regulatory domicile for formation:

- loaned to the insured operating companies who paid the premiums (or other family businesses);

- invest in related family businesses;
- invest in real estate (unlike retirement plan assets which have restrictions against related party loans or investments);
- distributed as dividends which are historically taxed at more favorable rates;
- on wind-up capital distributions are also historically taxed at lower rates than the value of the deduction when premiums were paid; and
- for the most sophisticated entrepreneurial families, the life cycle of an 831b captive can involve it exiting the insurance business, retaining its accumulated reserves, and evolving into a family fortress entity of one type or another (unregulated or regulated depending upon the family's sophistication and advisory team vision).

Most of the restrictions that apply to retirement plan assets do not apply to excess reserves in your 831b captive. They simply are a superior business and risk management engineering tool to retirement plans for high net worth owners of successful businesses. But for the costs of creating and managing an 831 B Captive, certainly many more businesses would utilize them.

In the future Congress may amend IRC 831(b) to limit the amount of premium an insured can pay for low frequency enterprise risk coverages to some percentage of insured's gross revenues, to prevent captive underwriting abuses. The IRS probably should issue some guidelines in this regard as protecting 831(b) and encouraging its broader use is important. Limiting premiums to a percentage of insured gross revenues would not make sense as applied to lines of coverages such as employee benefits or legitimate increased self-insured retentions and deductibles on commercial market policies. Also any such limits should probably not apply in years 1 and 2 as captives need to build reserves, but should apply to later years where the captive loss experience has been good.

### **Tax Summary**

Internal Revenue Code section 831(b) exempts, not merely defers, all operating income from qualifying captive insurance companies from federal income tax. This special tax benefit encourages small and mid-market sized companies to create protective risk reserve assets. As mentioned earlier, structured correctly, important asset protection and estate planning objectives are also easily achieved adding another layer of protection and expanded business succession capacity.

The 831(b) election allows a small insurance company to receive up to \$1.2 million per year in premiums, without paying any income taxes on those premiums (while the related party operating company insured deducts the premiums against ordinary income). The 831(b) election is not available to larger captives. They do however still benefit from general insurance accounting and tax advantages enabling deduction of reserves against uncertain future losses, a special accrual accounting benefit available only to licensed insurance companies.

The significant advantage of the 831(b) election is that the company is able to accumulate surplus from underwriting profits free from tax without need of use of the restrictive and complex typical insurance company reserve accounting. This 831(b) tax advantage greatly leverages a small businesses capacity to built risk reserve assets which they retain investment control over verses losing control forever of premiums paid to unrelated traditional insurers or continuing to self-insure with after-tax dollars significant enterprise risks. When integrated with estate plans, the wealth protection and accumulation benefits can be substantial.

While IRC Section 831(b) provides special income tax exemption benefits to underwriting premium revenue of \$1,200,000 or less each year from federal income tax, investment income is still taxed. This special tax benefit helps place small privately held captives insuring risks of affiliated businesses on a level playing field with much larger commercial insurers who have long benefited by special accounting and tax law provisions.

If the 831(b) election is abused, the IRS could not only deny the deduction to the operating company who paid the premiums, but also tax the captive on its premium income. Substantial penalties and interest could also apply if the IRS deems the structure abusive. So care must be exercised to not be creating an 831 B Captive merely for tax savings; real business and non-tax economic purpose must be objectives of the design and operating decisions.

### **Current Uses of 831 B Captives**

Surveys of these small to mid-market sized companies confirm nearly all are increasingly concerned about enterprise and catastrophic risks, generally uninsured prior to formation of a captive, ranging from technology risks, regulatory risks, key employee risks, key customer risks, key supplier risks, and other catastrophe risks. Once these smaller companies become familiar with captive insurance, they often expand the captive program scope to make them more competitive, improve safety programs and initiatives, and better weather hardening insurance markets.

Captive formation in the US is a relatively new legal phenomenon. That is why few people know what they are. Vermont was the first state to dedicate insurance department staff to encourage captive formations in the early 90s. Now 20 years later, over 30 US states authorize captive formations. While nearly all Fortune 500 companies today have formed a captive, the special 831(b) tax election available only to small captives has created the needed incentive for smaller closely held businesses to take advantage of them to become stronger and more competitive.

### **Future of 831 B Captives**

Internal Revenue Code section 831(b) captive insurance companies accounted for most new US taxpayer owned captive formations in 2010 and 2011. Nearly all were formed by small to mid-market closely held family businesses and some successful professionals, especially medical and high-tech professionals.

Among elite business financial advisory firms, captives are becoming increasingly popular as these advisers understand how a captive fits with many of their successful business clients, usually high net worth families.

### **More Observations of Interest on 831 B Captives**

While many states approved new 831(b) captive applications in 2010 and 2011, Delaware and Utah experienced the highest percentage growth rates among US domiciles due to low fees and high quality service. A few offshore domiciles, with low initial capital requirements and efficient regulatory systems, continue attracting 831(b) captive insurance company business from US owners due to Internal Revenue Code section 953 elections which allow these foreign domiciled companies to be taxed as a US taxpayers, thus qualifying these foreign domiciled captives for the 831(b) election. This also allows a foreign domiciled captive to avoid the US foreign excise tax on non-admitted premiums.

US based Cell and Series LLC programs allow the greatest flexibility, easiest application process, and enable initial capital lower than foreign domiciles in some cases. As familiarity with the handful of well run Series LLC and cell programs rises, we expect wider use by smaller privately held companies across all industries to form 831b captives. The most sophisticated will pursue 3rd party risk underwriting they understand and have an existing business connection to (such as Best Buy and Verizon's captives writing product replacement and warranty coverage of their customers) in order to increase underwriting profits of the captive and turn it into a true profit center.

#### Costs to Form and Operate Small 831 B Captives

Total formation and annual operating costs can be kept as low as \$25,000 including domicile expenses although well established and properly staffed firms cannot maintain high service levels and trained back-up staff without charging more than this. Going with the lowest cost service providers is not well advised in this industry as quality varies greatly.

Risk pool fees may also apply in order for the 831 B captive to meet risk distribution requirements of the IRS in order for the captive to be considered an insurance company for tax purposes. Well run risk pools are careful not to accept risks with high likelihood of loss. Many companies interested in forming a captive are determined unqualified due to their risk management characteristics not meeting pool underwriting requirements. See our taxation discussion for more information on risk distribution and other tax requirement issues.

The minimum required start-up capital of your captive varies greatly. Joining an existing program cell or series program requires far less start-up capital and reduced operating costs than stand alone pure captives. Most new 831(b) captive owners join existing cell or Series LLC programs due to the lower cost of entry and operation. Most US domiciles require \$250,000 minimum initial capital and surplus to form your own captive, which is an arbitrary number states seem to have adopted when copying each other's captive statutes. Some very experienced domiciles allow captive formation with as little as \$25,000 in initial start-up capital and surplus. We predict at some future point, some US domiciles will follow with risk based minimums versus the current \$250,000 arbitrary minimum of most of not all US domiciles.