One giant leap for small corporations

The 831(b) election offers a host of benefits that captives are watching closely. CIT takes a look

JENNA JONES REPORTS

A micro captive is typically defined as an insurance company that qualifies under section 831(b) of the US Internal Revenue Code. Under the section, which was written in 1986, insurance companies that write $1.2 million or less in premium per year only pay tax on investment income.

According to David McManus, president of Artex Risk Solutions, he himself coined 'micro captives' to describe the insurance companies taking up the 831(b) election. "We originally coined the term (I credit myself with inventing it!) to embrace Artex's strategies designed to bringing what larger companies are doing in the risk financing arena down to a smaller company audience."

McManus adds that—despite coming up with the term—as more small and medium-sized enterprises (SMEs) took advantage of the 831(b) election, it became synonymous with the code.

Douglas O'Brien, national casualty and alternative risk practice leader at Wells Fargo Insurance Services, explains that there are secondary benefits that apply to micro captives "including the potential to deduct up to $1.2 million in premium payments as business expenses and retain 100 percent of the underwriting profit if no claims are paid".

"If done properly, the business owner could ultimately save a significant amount in taxable net income which can be used to fund future risk exposures or taken as profit distributions in the form of dividends or capital gains."

Karl Huish, president of the Artex Risk Solutions captive division, explains the history behind the emergence of micro captives. He states that while there were always some small captives based in the US, the revision of section 831(b) in 1986 opened the door to micro captives. A handful of captive managers began using 831(b) in the late 1990s, and micro captives have grown significantly over the last 10 years.

O'Brien feels that the influx of micro captives in the past decade is primarily due to increased education, favourable revenue filings and promotion of alternative risk transfer vehicles.

Huish adds that from a domicile standpoint, micro captives are established just like any other captive. "The only difference is making the 831(b) election. Because this is a US tax code election, micro captives are applicable to captives that will be owned by US persons. The risks can be US or non-US based."

"Both foreign captives and domestic captives can make the 831(b) election. Foreign captives would first need to make the 953(d) election to be taxed as a US captive."

With the exemption of the obligatory premium rule, micro captives are, as Huish states, just like any other captive. Though O'Brien explains that a micro captive can also provide myriad tax benefits to companies that fit the bill.

He says: "Most companies that have established or are considering these types of captives are privately held companies with sufficient exposures to uninsured or retained loss but also with positive net income, a high effective tax rate and, for companies that do not meet the criteria on their own, a willingness to take on true third-party risk in some form."

"There is no restriction for publically traded firms in terms of creating these types of captives, however, we often see closely held publically traded firms having more interest in these vehicles."

This is because the $1.2 million premium is relatively low for most publicly traded firms and the benefits derived are not as material, says O'Brien. Shareholders and analysts may prefer to see these premiums and any resulting surplus utilised for other business purposes.

While coverage lines for micro captives can include any exposure to loss that an insured has, most micro captives include low frequency/moderate severity exposures to loss, which are typically self-insured, says O'Brien. Lines of business can include loss of key customer, loss of key supplier, brand reputation, environmental liabilities, impact of regulatory changes and more.

"The key issue is that these coverages must be

real and tangible to each insured. Moreover, the insurance premiums allocated to each coverage line must be established at an arm's length distance and have some objective basis in determination. This is why it's important to utilise an insurance broker, insurance actuaries and other risk management professionals in the process."

As a niche in an ever-expanding market, micro captives are seen as an economically feasible structure for SMEs that do not require a traditional captive.

Huish explains the lucrative reasoning behind the formation of a micro captive. "If the micro captive is considered to be an insurance company by the IRS, and has made the 831(b) election, then the micro captive does not pay any federal or state tax on any underwriting profit for the captive. The micro captive will pay tax on any realised investment income, but such income is likely to be modest."

It is the exemption of tax on underwriting profit that makes SMEs, that would normally shy away from captives for cost reasons, reconsider their options, adds Huish.

"Most (more than 80 percent) Fortune 500 companies have a captive, and it provides good risk management for such companies. Giving the financial incentives of a micro captive to smaller companies encourages them to better their risk management as well," he says.

The benefits of forming a micro captive—including tax, wealth transfer and deferred compensation—are obviously appealing to companies that suit the requirements, but O'Brien warns against establishing a micro captive for the wrong reasons, and points out the dangers of doing so, which could include attracting the attention of regulatory authorities.

Dangers include the improper allocation of premium to coverage lines, inability of the insurance transaction to meet the minimum risk distribution and even the inclusion of unrealistic coverage lines that do not remotely pertain to an insured's actual exposure to loss.

He says: "The key is that first and foremost, this is a risk management vehicle and it must meet the requirements of an insurance transaction to meet minimum risk distribution or risk shifting requirements. An insured needs to have a legitimate business purpose in the form of uninsured or underinsured exposure to loss prior to setting [a micro captive] up."

O'Brien also states that most small-to-middle market insureds fail to meet the IRS criteria for risk shifting and risk distribution on their own. In the absence of meeting the criteria, the insured must take on third-party risk.

"Most insureds meet the criteria by joining a risk pooling consortium or taking on the acts of independent contractors. Trying to set up a micro captive without paying attention [to requirements] will likely result in some significant scrutiny."

Most foreign regulators view micro captives as a regular captive vehicle but smaller, so they are regulated the same way, says Huish.

"Larger businesses have traditionally used captives for typical insurance risks, such as workers' compensation, auto and property. Micro captives can insure both traditional risks and also 'business enterprise' risks. [Certain] regulators understand these risks and make it easier to get the captive approved in their domicile. Some regulators actively seek out micro captive business, and other regulators are neutral about it."

Companies must also recognise that sufficient premiums and surplus need to reside in the micro captive for a number of years before dividends are taken back and/or loans of any size are permitted.

O'Brien says: "The vehicle must function as any prudent and well run insurer would and taking too much capital out of these captives or taking the capital out too soon could also result in unnecessary scrutiny."

The benefits of micro captives are evident, but Huish highlights another potential downside to the structure.

He explains that once the 831(b) election is made, it is irrevocable, meaning that if the captive receives more than $1.2 million in premium, then losses cannot be carried forward from year to year.

While McManus concurs that premium limitation is a clear disadvantage to forming a micro captive, he feels that the biggest potential downside occurs if companies establish captives that rely solely on a tax provision to justify their existences.

"Tax codes change, and although there's nothing on the horizon to suggest that the 831(b) tax provision will change, Artex never let that be the only reason why a captive is justified. We have a strong belief that even if the tax code altered a lot of the businesses that we have brought into the captive world would want to stay there." CIT