

IF IT QUACKS LIKE A DUCK ... SERIES LLCs AND SECTION 831(B) CAPTIVES

POSTED BY [JAMES LANDIS](#) ON JULY 26, 2011



Ever since the Department of Treasury issued Proposed Regulations in September 2010, there has been increased awareness and “hype” surrounding the use of Series LLCs and their accompanying Special Business Units (“SBUs”) for the formation of captive insurance companies. It seems that many captive providers think this new structure is “better than sliced bread.” In our view, it is just bread.

A Series LLC is a Special Purpose Captive allowed under the captive insurance statutes of a few states, most notably Delaware. The Special Purpose Captive acts as a “core” company under which are created SBUs, with each SBU insuring a different company (or each insuring different risks of one company). Although each SBU is managed by the core company, for tax and legal purposes, each SBU is “owned” by the persons who bear the “economic benefits and burdens of ownership” in the SBU.

The Proposed IRS Regulations, for the first time, contemplates recognizing cells and SBUs as “stand alone” corporate entities for tax purposes, allowing each of them to make elections such as those available under section 831(b) of the Code. (Although the Service has not yet issued Final Regulations, every indication is that they will do so soon with few changes, if any from the Proposed Regs). This has created some of the hype about SBUs.

Section 831(b) of the Code allows an insurance company with no more than \$1,200,000 in annual premiums to exclude those premiums (and thus the net underwriting profits) from taxation. An insurance company choosing to take advantage of this section must attach a written election to its first tax return (an1120-PC). Section 831(b)(2)(B) of the Code sets

forth complex "attribution rules" that must be carefully followed so that two or more captives (or SBUs) are not deemed to be owned together, thus adding their gross premiums together and perhaps violating the annual \$1,200,000 limit for electing insurance companies.

So, do SBUs work for section 831(b) captives? The answer is "yes," but using the Series LLC structure does not offer as many advantages as some providers would like you to believe.

First, since each SBU is treated as an independent entity, the attribution rules of section 831(b) still apply. Some providers believe that just because each SBU is separate, a company can have several of them, each making the 831(b) election. This is not true unless each SBU is deemed to be owned by separate adults (or some combination of adults) that satisfy the attribution rules. These rules have not been suspended just because one uses a Series LLC.

Second, although set-up costs for each SBU will be less than for a stand-alone captive insurance company, the savings will not be enormous. Delaware is proposing that each new SBU pay a set-up fee of \$2,400 (although this remains under discussion) as compared to \$3,200 for a stand-alone captive. But each new SBU will still need an actuarial opinion, business plan and biographical affidavits. And clients will likely incur higher legal fees as their counsel must review the SBU and LLC agreements. The only other savings will be the lack of a filing for a new corporate charter, but that fee is minimal.

Does an SBU need its own capital? Some providers advertise that this type of captive needs no capital (unlike a stand-alone captive that must have a minimum of \$250,000 in capital by statute). It is true that current statutes do not require capital other than at the core company. (Delaware, however, has circulated a proposed administrative order requiring that each SBU have capital, but the amount is nominal.)

The IRS has, however, always viewed inadequate capital as one element in finding that an entity is not an insurance company for tax purposes (thus denying the deduction for premium paid to that entity). Since each SBU will be treated as a single entity for tax purposes, it is logical to assume that the IRS will not be pleased if an SBU has zero or inadequate capital relative to premiums received.

Annual costs for an SBU will be approximately 10-15% less than for a stand-alone. This reduction is based on the annual premium tax being allocated among all of the SBUs under a single core and because annual accounting and actuarial costs will be somewhat lower than that for a stand-alone company.

The Series LLC structure therefore does hold some advantages over a stand-alone captive. But all of the basic rules still apply. First and foremost, each SBU must be an insurance company with qualified, diversified and properly priced risks. Second, the Series LLC does add some complication to the entire concept of creating one's own insurance company. We

have seen some presentations by captive providers that are a maze of boxes and arrows. Is this complication for complication's sake? We believe so.

Entrepreneurs interested in owning a private insurance company are often quite cautious (as they should be) about new ventures, particularly ones with significant tax benefits. For many it remains difficult to comprehend how one "owns" a captive in the legal sense while technically the SBU is part of a Series LLC owned by others.

Perhaps the (few) benefits of a Series LLC outweigh these complications. However everyone should beware of captive insurance providers that exaggerate these benefits and those that ignore the important basic details that make the difference between a true insurance company and a sloppy structure that may be viewed as a sham by the IRS. After all, if it quacks like a duck...it probably is.

Authors

James Landis collaborated with Rick Eldridge in writing this article. Rick Eldridge is the President & CEO of Intuitive Insurance Corporation and the Managing Partner of Intuitive Captive Solutions, LLC.

View the original article at:

http://www.linkedin.com/news?viewArticle=&articleID=659911673&gid=1527087&type=member&item=63524265&articleURL=http%3A%2F%2Fwww%2Einsurancethoughtleadership%2Ecom%2Findex%2Ephp%2Fsite%2Fcapture-insurance%2Fif-it-quacks-like-a-duck-%2E%2E%2E-series-llcs-and-section-831b-captives%2F&urlhash=xCVW&trk=group_most_popular-0-b-shrttl