SIIA PUSHES BACK ON IRS REGULATION OF SMALL CAPTIVES

Written By Caroline McDonald

In April of this year, the Internal Revenue Service (IRS) and the U.S. Department of the Treasury announced proposed new regulations to more closely govern captives that elect under Internal Revenue Code § 831(b) – and which would severely limit access to captive insurance programs for small- and medium-sized businesses in the United States.

The proposed new regulations would make certain small captives under IRC § 831(b) a "listed transaction" – requiring separate reporting to the IRS – or as "transactions of interest," which trigger further IRS scrutiny.

IRS Proposed Rule 109309–22 seeks to overregulate certain § 831(b)-electing captives by creating untenable loss ratio requirements (65 percent), loan back limitations, and 10-year retroactive provisions, while imposing arbitrary and capricious standards.

These actions not only propose to legislate through regulatory action, contrary to congressional intent, but would prevent middle market American companies from mitigating against critical and evolving legitimate business risk.

It is especially onerous that the IRS is seeking to create a 10-year retroactive period in changes to law and regulatory authority, which is unprecedented in scope and creates a capricious burden on U.S. business.

None of the four criteria identified by the IRS in the proposed regulation, either separately or in their own right, are abusive. As such, they should not be used under the proposed criteria to label a transaction as a listed transaction or transaction of interest unless they are always tax avoidance.

Interested parties were given a 60-day period to comment, ending June 12 with 174 comments published, including those from the Self Insurance Institute of America (SIIA), and a number of captive owners, managers, state captive associations and other organizations. The IRS also held a hearing July 19 in Washington, D.C. to listen to additional oral testimony on the proposed regulations.

SIIA stated that it strongly believes the IRS should create criteria that track existing law and authority, not circumvent that law, or ignore congressional intent in an arbitrary and capricious retroactive manner. Importantly, § 831(b) has and continues to be a valid tax election available to insurance companies that qualify and make the election.

Beginning in 2014, SIIA has maintained ongoing advocacy for a balanced approach with the IRS that enforces against abusive behavior, while also allowing appropriate access to captive insurance as the statute provides. Since that time, Congress has clarified § 831(b) access twice, while the IRS has failed to issue needed guidance.

According to Ryan Work, senior vice president of government affairs, SIIA continues to assert that the IRS should create appropriate criteria – based on the thousands of captives that have complied with data requests – that also tracks existing law and authority. He stated, "Treating § 831(b)-electing captives differently than other larger captives or commercial insurance companies is harmful and overbearing."

SIIA also stated: The IRS proposed rule 109309-22 seeks to over-regulate certain § 831(b)-electing captives by creating untenable loss ratio requirements (65 percent), loan-back limitations, and 10-year retroactive provisions. For these reasons, SIIA continues to recommend that the IRS engage with the captive insurance industry and business owners to more appropriately craft regulations that curb abuse, while further understanding the intent, need, and appropriateness of risk mitigation.

Chaz Lavelle, partner at Dentons Bingham Greenebaum LLP, in Louisville, Kentucky, said of the proposed regs: "If you have a company that makes the § 831(b) election, and if at least one 20 percent owner of the captive is either an owner, the insured or a relative, and if the captive had a loan-back of $1 of premium within the last five years, or more than five years but you haven't paid it off, you are a listed transaction."

He added, "You can also be in this category if you have a less than 65 percent loss ratio. That applies if you have been in existence for 10 years. If less than 10 years, you are a transaction of interest." The purpose of this, he said, is to determine if the captive is truly engaged in insurance.

THE BEGINNING OF § 831(B) CAPTIVES

A "micro-captive" is one that seeks the § 831(b) tax election, meaning that the captive is only taxed on investment income, and not on underwriting profit.

These small captive structures were created by Congress in 1986, when it passed regulations designed to help small companies remain competitive. This allowed small and medium sized American companies to set aside reserves, much like their larger

counterparts, to mitigate against future risks.

Since enactment, § 831(b) has served a critical policy purpose to help small- and medium-sized businesses mitigate risks not available, or too expensive, in the commercial insurance market.

Since that time, Congress has clearly intended for § 831(b) to streamline and assist businesses in mitigating against risk that includes farmers, auto dealers, community banks, manufacturers, trucking, construction, professional services firms, and many others.

THE IRS ISSUE WITH SMALL CAPTIVE PROGRAMS

David Guerino, senior vice president, managing director of captive insurance at KeyState Captive Management LLC in Burlington, Vermont, explained that in 2015, Congress passed the PATH Act, increasing the annual limit of premiums for § 831(b) captives to $2.2 million from $1.2 million, and increasing the threshold according to inflation.

To qualify as a small captive under § 831(b) captives must write premium at a current maximum threshold of $2.65 million in annual premium, which SIIA successfully advocated to increase as part of the 2015 PATH Act which was passed by Congress and benchmarked to inflation.

"This was a clear indication of Congress' intent to allow small and mid-size businesses to avail themselves of the § 831(b) captive structure as a risk management tool, while curbing certain abusive practices in the industry, particularly surrounding estate planning" Guerino said.

Under the newly proposed regulations, a small captive which, during its past five taxable years, returned premiums to the insured, or an affiliate in a non-taxable transaction, would be considered a "listed transaction" – a transaction that the IRS has determined to be for tax avoidance.

An § 831(b) captive recording a loss ratio less than 65 percent during the past 10 taxable years would also be considered a "listed transaction."

Brian Johnson, managing director, risk at International Actuarial Consulting in Charleston, South Carolina, concluded, "Currently we're in a waiting game, but I feel confident that if this goes through as proposed, the IRS will end up having a court decision that doesn't go their way, because somebody will be willing to spend the money."

Learn More
888-248-8952
selffunding@benefitmall.com

BenefitMall
SELF FUNDED DIVISION

©2023 BenefitMall. All Rights Reserved.

WHO IS AUTHORIZED TO GOVERN § 831(B)S?

At the heart of the issue is whether IRS authority preempts state authority to govern captive insurers of any size. The McCarran-Ferguson Act, enacted in 1945, established state regulation of insurance companies.

According to GovInfo:

- The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.
- No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance.

A submission to the IRS by Glen Mulready, Oklahoma's insurance commissioner, proposed that any decisions made be based on this principle. He suggested forming a task force including regulators, the IRS, and the industry to work out a solution.

In his comments, Mulready said, "It is a sincere invitation. Instead of litigation, let's have conversations and identify each other's issues and work things out."

Steve Kinion, captive insurance director with the Oklahoma Department of Insurance, noted, "The Oklahoma Department of Insurance and Commissioner Mulraney feel strongly about the infringement on the state's authority to regulate insurance. We did not recognize anywhere in the proposed regulation that any kind of congressional authority had been given to the IRS to promulgate the proposed regulation."

The proposal, he said, "establishes standards that for some kinds of insurance will be impossible to meet." As an example, he cited the April 19, 1995, Oklahoma City bombing, "The largest and most significant event of domestic terrorism in the United States to date."

The issue, Kinion said, is that if a business decided to form a captive to insure it from terrorism risks, "and over a period, say nine years, never had a claim; under the IRS proposed regulation, that captive insurer would be a 'transaction of interest.'" The possibility of preparing for a terrorism event, he believes, is something that was not considered.

"We've had a lot of litigation, that is not the best path to regulation," Kinion said. "Conversation, discussion, and negotiation leads to better long-term public policies. Otherwise, it can get expensive, and the wheels of justice move slowly."■