

BUSINESS INSURANCE[®]

WORLD

CAPTIVE FORUM

Small Captives: The Innovations
and Dislocations

#WorldCaptiveForum

JANUARY 30 – FEBRUARY 1, 2019

Our Panel

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William White, Assistant Commissioner, New Jersey Department of Banking and Insurance

Today's Topics

- Anything the audience wants to discuss
- Section 831(b) changes
- Small captive insurance company court cases
- “Campaigns” and Global Settlement Initiative?
- Issues – what should we think about

Section 831(b) Changes

- Cap on premiums
 - 2016 - \$1,200,000
 - 2017 - \$2,200,000
 - 2018 - \$2,300,000
 - 2019 - \$2,300,000
 - 2020 - indexed in \$50,000 increments
- Budget act clarifications of diversification rules –
 - 20% cap on single policyholder premiums is measured by the ultimate policyholder in a reinsured situation
 - Diversification test further clarified in March 2018
 - Clarification of ownership, including spouses that are U.S. citizens and step children
 - Treasury can provide guidance on measuring risk

Small captive insurance company court cases

- [Avrahami](#) (Judge Holmes) – this case was not appealed
 - Taxpayer lost: No risk distribution and no insurance as commonly accepted
 - No penalty: Lawyer advice and first section 831(b)/162/953(d) case
- [Reserve Mechanical](#) – case is on appeal
 - Taxpayer lost: No risk distribution and no insurance as commonly accepted
 - No penalties had been proposed
- [Caylor](#) (Judge Holmes) – no opinion yet
 - Brother-Sister Arrangement – No pool
- [Wilson](#) (Judge Holmes) – Last brief due Nov. 8, 2019
 - Same pool as Avrahami, but different experts and witness
- [Syzygy](#) – no opinion yet
 - Domestic captive- IRS seeks to tax both insured and captive

“Campaigns” and Global Settlement Initiative?

- The IRS’ Large Business & International Division has redirected its audit philosophy
 - Focus resources on specific issues (“campaigns”), rather than comprehensive general audits
- On 1/31/17, LB&I announced its first 13 “campaigns”
 - “Micro-captive” was one of the first 13 campaigns
- Global Settlement Initiative?

Overarching Questions

- What were the primary concerns the IRS and Congress had when the PATH Act was passed that added a new diversification test? Did this change address all the “problems” with section 831(b) election?
- Are the tax benefits of a section 831(b) election worth it?
- How necessary is getting a second opinion about the captive from someone who is independent from the captive promoter?
- How small can an insurance program be in order to benefit from a section 831(b) election?

Issues – what should we think about:

- Which has a better chance to pass an IRS audit, a wonderfully designed captive where the owner makes few claims and has high tax motivation, or a poorly designed captive where the owner makes lots of claims and has high non-tax motivations?
- Must an insured make a major change in its commercial insurance program when the captive begins?
- If one has a sufficient number of statistically independent risk exposures, does the number of insureds matter? Can a single insured ever be the only insured of a captive?
- Can the insured have a target amount or budget for premiums?

Issues – what should we think about:

- Must an insured have prior losses in an area before buying a captive policy to cover that exposure?
- What criteria can a potential captive owner use to evaluate a good risk pool?
- Is judgmental rate setting (no actuary) ever acceptable? Terrorism?
- If an insurance arrangement is invalid, can the IRS both disallow the deduction and impose income on the captive?
- How much can a captive loan to an insured or affiliate and be safe?

Issues – what should we think about:

- Is non-tax business purpose required to have a valid insurance program?
- How much due diligence must a pool participant do? Mutual insured?
- What is circular flow of funds? Does lack of claims prove lack of risk?
- Does the captive owner(s) have to understand insurance? The program?

Issues – what should we think about:

- Is the IRS' distinction between insurance risks v. business risks valid?
- If a risk has been sold in the commercial market for years, is it automatically an insurance risk for Federal income tax purposes?
- Must an insured file every claim with its captive?
- If a fronting company is not a valid insurance company for Federal income tax purposes, does that preclude the reinsurer from being a valid insurance company for Federal income tax purposes?

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