BUSINESS INSURANCE

Changes to microcaptives may heighten appeal

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Changes designed to curb abuses of so-called microcaptives could actually lead more small and midsize firms to use them.

Under a measure that President Barack Obama signed into law last year, microcaptives electing Section 831(b) of the U.S. Tax Code can avoid taxation on up to $2.2 million in premium income per year, indexed for inflation, effective in 2017.That compares with the current $1.2 million limit on premium income. Captives electing Section 831(b) are taxed only on their investment income, not their underwriting income.Sources said diversification requirements also included in the new law are intended to address abuses of microcaptives, which appeared alongside identity theft and phishing on the IRS' 2015 list of Dirty Dozen Tax Scams.To qualify for that tax break under the new law, captive sponsors have to meet a diversification requirement that no more than 20% of net written premiums come from any one policyholder. However, such captives still can qualify for the tax break if the ownership of the parent company or companies is within 2% of mirroring the ownership of the insurer.The 831(b) election has been abused by financial professionals who marketed it as a wealth-transfer vehicle rather than a risk management tool, said Doug O'Brien, national casualty and alternative risk practice leader at Wells Fargo Insurance Services USA Inc. in New York. In some cases, when premiums were converted to surplus, owners would "take back that surplus or give it to grandkids, children or spouses," he said."You're kind of taking out the bad actors" with the revised requirements, Mr. O'Brien said. The primary focus will be "building up surplus for that day that will come when you might have that high-severity loss and you don't want it to impact your balance sheet."Plenty of interested companies have decided against an 831(b) election to avoid attracting an IRS audit or because they did not feel there was IRS support of the structure, said Leslie C. Boughner, chairman of the business insurance division at Advantage Insurance Management L.L.C. in Naples, Florida. By increasing the threshold and directly addressing estate planning and wealth-transfer abuses, the IRS effectively "endorsed" 831(b), he said.While the $2.2 million ceiling will allow more companies to take advantage of the election, Mr. O'Brien said "this will still be the domain" of privately held “middle-market companies, with revenue from $25 million up to probably $500 million.”The total number of captives worldwide was 6,876 in 2014, a 7.1% increase over the previous year, according to the latest Business Insurance survey.Charles J. Lavelle, senior partner at Bingham Greenebaum Doll L.L.P. in Louisville, Kentucky, said traditional captive users with premiums up to $2.2 million will “seriously consider making the election,” but he also said there are downsides to weigh.“If your claims fluctuate substantially, then you’ll have years where you have an underwriting loss, and that’s where the election is unfavorable … and the election is irrevocable,” Mr. Lavelle said.Many companies likely will take a wait-and-see approach, but captives electing Section 831(b) will become more prominent over time, Mr. O’Brien said.Christopher L. Kramer, senior vice president of business development at Caitlin Morgan Insurance Services in Cleveland, said inquiries have increased since the Section 831(b) changes were passed.The changes have “elevated the recognition that captives are a useful tool,” Mr. Kramer said.The election is, perhaps, most useful to recapture profits that commercial insurers would otherwise take, said Sean B. Rider, managing director of consulting and development at Willis Towers Watson P.L.C.’s global captive practice in New York.So even though workers compensation is a main reason companies move to a traditional captive arrangement, sources said the generally high-frequency and low-severity line is less desirable for microcaptives that want to maximize underwriting income.However, Jason Flaxbeard, senior managing director at Beecher Carlson Holdings Inc. in Denver, said many clients who have made the election do write workers comp. “It provides them with a lower underwriting profit in some instances, but that’s because the captive is set up to respond to a specific risk management need,” Mr. Flaxbeard said.Because of the opportunity to retain underwriting profits, sources said many companies write risks such as business interruption, cyber, terrorism and natural catastrophes.Nontraditional lines such as audit liability, intellectual property and copyright infringement might be included, either because they can’t be obtained in the traditional market or a company has an unusual risk, Mr. Kramer said.Beecher Carlson’s Mr. Flaxbeard said the changes to Section 831(b) are great for anyone “in this space appropriately and for the right reasons.” Advantage Insurance’s Mr. Boughner called the amendments “a very positive development for the captive industry.”“There are going to be captive managers out there that are now going to have to restructure their entire portfolio,” Mr. Boughner said. “And there are going to be others that did it for the right reasons in the right way that are going to look at (the changes) and say, ‘This really has no impact on us. We’re just going to continue to grow the business.’”
