

LEGISLATIVE CHANGES REQUIRE

CAPTIVE INSURANCE COMPANIES

TO IMMEDIATELY ASSESS THEIR OPERATIONS

On December 18, 2015, President Obama signed into law The Protecting Americans from Tax Hikes Act of 2015 ("the PATH Act"). The PATH Act accomplished major legislative agenda items by extending certain business and individual income tax provisions that had expired at the beginning of 2015. The PATH Act also contained important changes to the law that will affect many Captive Insurance Companies ("CIC").

A Brief background on The Alternative Tax for Small Insurance Companies

Insurance companies other than life insurance companies with net written premiums, or direct written premiums if greater, less than \$1.2 million in the tax year, may elect to be taxed only on taxable investment income and avoid income taxation on its underwriting income. Net written premiums generally means gross premiums, written or received on insurance contracts during the tax year, less return premiums and premiums for reinsurance. Generally, direct written premiums are the gross amount of premiums received by a nonlife insurance company for directly issued (not reinsurance) insurance policies.

PATH Act Modifications to Code section 831(b)

Effective for tax years beginning after December 31, 2016 (i.e. 2017 for calendar year taxpayers), the Act increases the maximum amount of annual premiums that small property and casualty insurance companies can receive and still elect to be exempt from tax on their underwriting income **from \$1.2 million to \$2.2 million**. This \$2.2 million amount will also be adjusted for inflation in future years.

In addition to increasing the above referenced threshold amounts, the PATH Act added a new eligibility requirement to qualify for this tax break. Beginning in 2017, a CIC must meet on the following test:

- (i) A Premium concentration test; or,
- (ii) a No Excess ownership test.

Under the Premium concentration test, no more than 20% of net written premiums (or if greater, direct written premiums) for a tax year be attributable to any one policyholder. All related or controlled taxpayers will be aggregated for purposes of this testing compliance with the 20% provision.

Under the No Excess ownership test, a CIC is eligible for the 831(b) election if each owner of the insured business or assets has no greater an interest in the insurer than he has in the business or assets that are paying the premiums to the CIC, and each owner holds no smaller an interest in the business than his interest in the CIC. This percentage interest test only applies to spouses and lineal descendants and there is a de minus rules for variances of 2% or less to accommodate minor ownership variances.

Our Preliminary Thoughts

There are several important matters that Congress left in the hands of the IRS to issue further guidance upon with respect to the PATH Act changes to Code section 831(b). However, what we do know at this time is that:

1.) The PATH Act's increase in the amount of net written premium **from \$1.2 million to \$2.2 million, along with its future inflation adjustment,** is a welcomed legislative change and will result in significant increased underwriting ability for a single captive insurance company; and,

2.) The changes brought about through the PATH Act's eligibility tests will require a close look at the existing business structure for taxpayers with a CIC in place and require sophisticated U.S. tax counsel familiar with the controlled group testing rules, which are among the most complex rules in the Internal Revenue Code, to ensure the eligibility tests are satisfied.

DUGGAN BERTSCH has successfully assisted individuals and companies in their U.S. taxation, corporate, and regulatory matters, including captive insurance companies, and the application of the controlled group rules. There are many structural options to comply with the new eligibility tests and which option to choose will require a customize analysis of your particular facts and circumstance. **Immediate attention** should be provided to these changes since we are beginning 2016 and any structural changes to either a CIC or the business structure of an insured CIC policyholder requires significant time to plan and implement and there are **no grandfathering rules** in place which normally protect existing legal structures from legislative changes that have a retroactive effect. Please feel free to contact our office if you would like assistance in any of your captive insurance company needs.

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