

Business Insurance

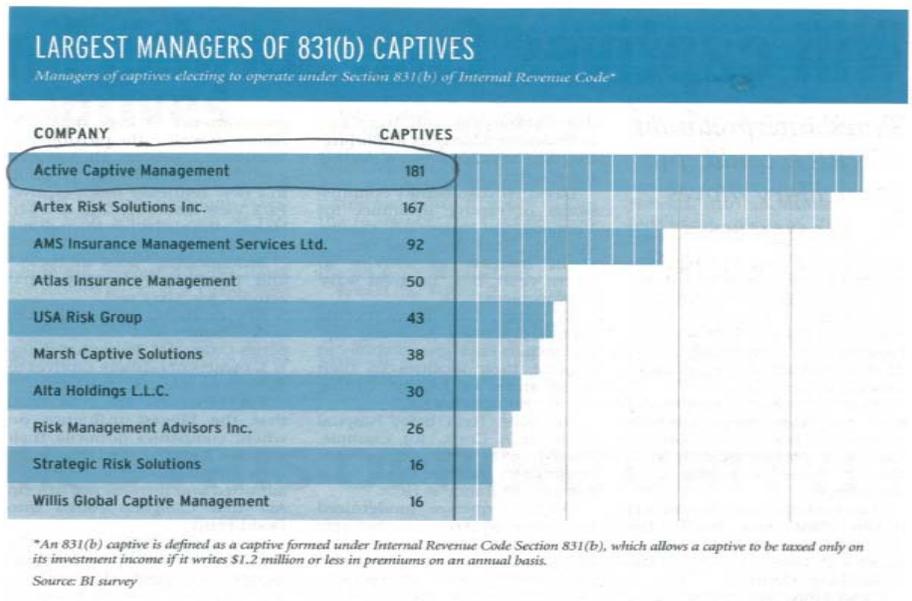
Forming 831(b) microcaptives more popular with smaller firms

Potential misuse of tax incentive raises regulatory concerns

March 4, 2012 - 6:00am

More midsize and small companies are tapping alternative risk transfer mechanisms and creating 831(b) captive formations.

Also known as microcaptives, the formal name refers to Internal Revenue Code Section 831(b), which allows insurance companies with less than \$1.2 million in annual premiums to elect to have their federal taxes based only on their investment income.



Experts say middle-market and small companies' better understanding of risk and how to transfer that risk has driven much of the growth of microcaptives during the past year.

"A lot (of smaller companies) are recognizing what were previously unknown risks or unappreciated risks. People are recognizing that those things that 'will never happen' sometimes do happen," said Charles J. Lavelle, partner and chair of the federal tax team and its insurance industry team for law firm Bingham Greenebaum Doll L.L.P. in Louisville, Ky.

Alternative risk transfer also is becoming much more mainstream, he said, noting that middle-market companies are attuned to states that are introducing attractive captive legislation and have greater awareness of captive structures through captive service providers.

As more captives have formed in general, "the exposure to the captive structures has gone down into the middle-market companies," said Ross Elliot, captive insurance director at the Utah Department of Insurance in Salt Lake City. "They're now beginning to see the advantages to them of formalizing their risk management and putting it into in a captive facility."

Of the 69 captives Utah licensed in 2011, Mr. Elliot said 75% were microcaptives based on their premium volume.

Another factor driving microcaptive growth is more knowledgeable captive service providers, experts say.

Property/casualty agents and brokers have become knowledgeable and can recommend captive solutions for hard-to-place risks for middle-market companies, said Karl Huish, senior vp at Artex Risk Solutions Inc. in Mesa, Ariz.

“We also see referrals and introductions made by other trusted advisers,” such as certified public accountants, attorneys and other financial advisers, he said. “These other professional advisers are becoming more knowledgeable about captives; and as they become more knowledgeable, they're bringing that up to their clients.”

Rob Walling, principal and consulting actuary at Pinnacle Actuarial Resources Inc. in Bloomington, Ill., said captive managers, agents and brokers have done a good job of bringing captives to the forefront for smaller companies that are savvy enough to go into a microcaptive but might not be in a position to go in to a single-parent captive program.

Pinnacle works with microcaptives by looking at exposures and determining loss probability and capital levels needed for the captive.

“As the market is more educated, the insured becomes more educated,” Mr. Walling said. “Those middle-market insureds are really feeling a lot of economic strain right now, so anything they could do to control their insurance costs better is better for the business' overall survival.”

Taking advantage?

While microcaptive growth may reflect sound risk management, some in the industry fear that some companies are taking advantage of the favorable tax treatment rather than insuring viable risk, which could lead to regulatory scrutiny.

The tax incentive is not necessarily driving the formation, but it does help make a small insurance captive program work, said Kirk D. Mooneyham, managing director of captive management services at Wilmington Trust Co. in Greenwood Village, Colo.

When prospective microcaptive owners talk about setting up their programs, tax incentives are not the first thing mentioned, Mr. Mooneyham said.

“It's about how does the captive work. That's not saying that there aren't people out there that are setting them up to take that advantage, either,” he noted.

But if a microcaptive is used solely for tax purposes that have little to do with transferring risk, Pinnacle's Mr. Walling said microcaptives may face regulatory scrutiny in the future.

“831(b) is very intentionally and specifically intended for insurance purposes,” Mr. Walling said. “I think the worst of what we're seeing right now is 831(b)s that are...surely wealth-management mechanisms that have very little true insurance risk to them, and there is a very real risk presented by those types of programs” in terms of regulatory scrutiny, he said.

State insurance regulators are looking closely at microcaptives to make sure companies set up their programs for nontax business reasons to transfer risks and fund insurance risk, experts say.

Montana, which licensed 24 captives in 2011, views microcaptives as insurance companies.

“We look at them as insurance vehicles and we want them to have an insurance purpose,” said Steve Matthews, captive insurance coordinator for the state of Montana in Helena. “If they get a tax advantage out of them, that’s an extra that goes with it.”

Montana licensed about 15 microcaptives in 2011, and approximately 35 to 40 microcaptives operate in the state, Mr. Matthews said.

“Favorable tax treatment—we do not like to see that in mind initially,” Utah’s Mr. Elliot said.

Even so, the tax advantages are a key piece in forming the program and must be considered, he said. “It’s just too large of an elephant in the room to ignore.”