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IRS Scrutiny of 831(b) Tax Treatment for Microcaptives a VCIA 'Hot Topic'

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BURLINGTON, Vt.—Among the “hot topics” discussed at the Vermont Captive Insurance Association's annual conference in Burlington was the Internal Revenue Service's scrutiny of so-called “microcaptives” opting for Internal Revenue Code Section 831(b) tax treatment and the potential impact of that scrutiny on the broader captive industry.

Under Section 831(b), insurance companies earning no more than $1.2 million in annual written premiums can opt not to pay taxes on those premiums, being taxed only on their investment income.

Those microcaptives have been one of the fastest growing areas of captive insurance.

“There's been enormous growth in small captives,” said Robert H. Myers Jr., partner at Morris, Manning & Martin L.L.P. in Washington, who participated on Thursday's hot topics panel. “It's very attractive from a tax perspective. The problem is it's too attractive.”

“In many cases, they have been oversold by wealth managers, estate planners, financial planners and so on. The result is the IRS has gotten wind of this,” Mr. Myers said. The IRS has been “pretty efficient” in its approach to looking into microcaptives, he said, focusing on the pools some microcaptive arrangements use in an effort to demonstrate the risk distribution needed to qualify for insurance treatment by the IRS. If the IRS determines the pools aren't valid, it will then treat the pool participants as tax shelters rather than insurance vehicles, Mr. Myers said.

David F. Provost, deputy commissioner in the Captive Insurance Division of the Vermont Department of Financial Regulation, said the state doesn't like such pool arrangements. “We're not comfortable with pools,” he said.

While some microcaptives may be being formed for noninsurance purposes, there are many small captives doing legitimate insurance business, Mr. Provost said,

“Our position is the same: We license insurance companies, and your taxes are your business,” Mr. Provost said. “There are plenty of good, well-planned small captives that take advantage of this election.”

Deborah Lambert, partner at Johnson Lambert L.L.P. in Raleigh, North Carolina, who moderated the hot topics session, said she's concerned that the IRS scrutiny of captives making an 831(b) election might have a negative impact on captives overall.

“One of the things that concerns me is a reputation risk for the whole captive insurance industry,” she said.

Mr. Myers agreed that possibility exists. “You might see something in the Wall Street Journal or the New York Times, and that's not good for captives as a whole,” he said.