Planning with Micro-Captive Insurance Companies After the PATH Act

CLAUDIO A. DE VELLIS

Although the PATH Act's expansion of the Section 831(b) exclusion was helpful, it also added diversification requirements under Section 831(b) that made micro-captive planning more challenging.

Recent changes made by the PATH Act[1] will force closely-held business owners who have integrated captive insurance companies into their risk management profile to revisit the economics, risk management, and estate planning goals of their designs. A new risk diversification requirement added by the PATH Act will force business owners to either increase their captives' participation in risk pools, or restructure existing estate planning designs. This article explores the history of closely-held captive insurance companies (referred to herein as "micro-captives"), discusses the income tax requirements of insurance arrangements, including the recently promulgated diversification requirements under the PATH Act, and suggests ways to deal with the new law.

BRIEF HISTORY OF CAPTIVES

Historically, captive insurance companies (including micro-captive insurance companies) have been used by business owners for many reasons. First, captives help business owners cover exposure from self-retained risks. These are risks that business owners have determined not to cover though traditional commercial carriers for a number of reasons, including the cost may be too high relative to the potential exposure, or they were simply willing to take the risk. From an actuarial perspective, these self-insured risks do not require the same level of reserves as commercial policies that cover catastrophic losses related to property damage, general liability, automobile, and umbrella coverage. A typical risk managed through a self-insured retention program is one that, although is likely to occur, has less potential exposure. Typically, a self-insured risk retention program is imple-

mented with a strong loss control program to mitigate the self-insured exposure. Depending on the type of coverage, some of these risks may still be covered through a commercial insurer, in conjunction with a high deductible plan, with the deducible portion representing the self-insured risk.

Second, a captive can help business owners reduce overall insurance costs. By taking on greater self-insured risks, business owners who also enhance their loss control programs may reduce commercial insurance premiums and losses associated with self-retained risks. This allows the insured to capture a portion of the underwriting profit in a commercial insurance policy by better managing its own risks. In addition, a larger self-insured retention program may incentivize a commercial carrier to offer better pricing as a way to retain some of the lost premiums. Finally, a cost savings can be achieved by a business enterprise that is a good actor with a good loss experience rating in an industry experiencing significant current losses and increasing premiums. The captive permits the business enterprise to use its own experience rating rather than that of its industry.

Third, a captive can permit a business owner to obtain coverage that may not otherwise be available in the commercial market. This can be achieved by having the captive underwrite policies that cover gaps and exclusions in the business owner's commercial policies. It may also permit a business owner to underwrite directly from a reinsurer, typically available only to a licensed insurance company. Buying insurance coverage through a reinsurer has the advantage of eliminating the middleman and gets the business owner the wholesale price of coverage.[2]

Fourth, a captive can help a business owner control the timing of premium payments and smooth out cash flow to better coincide with its business cycles. The timing and amount of premium payments made to a commercial carrier is not flexible beyond the typical monthly, quarterly, semi-annual, or annual payment cycle.

Fifth, a captive gives the insured business greater control over the claims process, including, timing and administrative issues related to claims, selection of lawyers to handle a lawsuit related to a claim, and a greater say in whether or not a claim is even covered by the policy.

INSURANCE FOR INCOME TAX PURPOSES

The Code defines the term "insurance company," in relevant part, as "any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts."[3] While the Code sets forth this general definition of an insurance company, the definition of what constitutes insurance has been a matter left to the courts. In fact, the Supreme Court in *Helvering v. LeGierse*, 312 U.S. 531, 25 AFTR 1181 (1941), articulated in a single sentence what has become the primary definition of insurance for income tax purposes. In *LeGierse*, the Court declared that "[h]istorically and commonly insurance involves risk shifting and risk distribution." Each of these elements must be present for the insurance relationship to be respected for income tax purposes. If either risk shifting or risk distribution is not present, the insurance arrangement will not be respected and the insured's premium payment will be characterized as a nondeductible reserve. Each of these two requirements is considered in turn.

Risk shifting involves shifting the economic risk of loss from one party (the insured) to another party (the insurance company). In several Revenue Rulings, the IRS has stated that "risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer, such that a loss by the insured does not affect the insured because the loss is offset by the insurance payment."[4]

Courts have considered different factors to determine whether an economic risk of loss has been shifted. Adequacy of the capitalization of the insurance company is the most important factor in this determination.[5] For example, depending on the risks insured and the potential loss, if an insurance company cannot sustain the loss, the economic burden may rest with the insured. In addition, if the insurance company's risk of loss is contractually capped or indemnified by a party related to the insured (e.g., the parent of the insured), risk shifting has also not been achieved.[6] Assuming that risk shifting has been met, the insurance company must still meet the risk distribution requirement.

The focus of risk distribution is determining whether the insurance company has spread its risk of loss among a sufficient number of insureds. This means that a micro-captive must insure third-party risks, that is, risks of companies other than its parent and related brother-sister companies (with certain exceptions for brother-sister

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1 Protecting Americans from Tax Hikes Act of 2015, P L. 12/18/15.

2 It should be noted that reinsurance companies typically underwrite risks that involve significant premiums. So it will not be practical for a micro-captive to access the reinsurance market until it achieves a greater level of reserves that permit it to underwrite greater coverage.

3 Section 816(a).

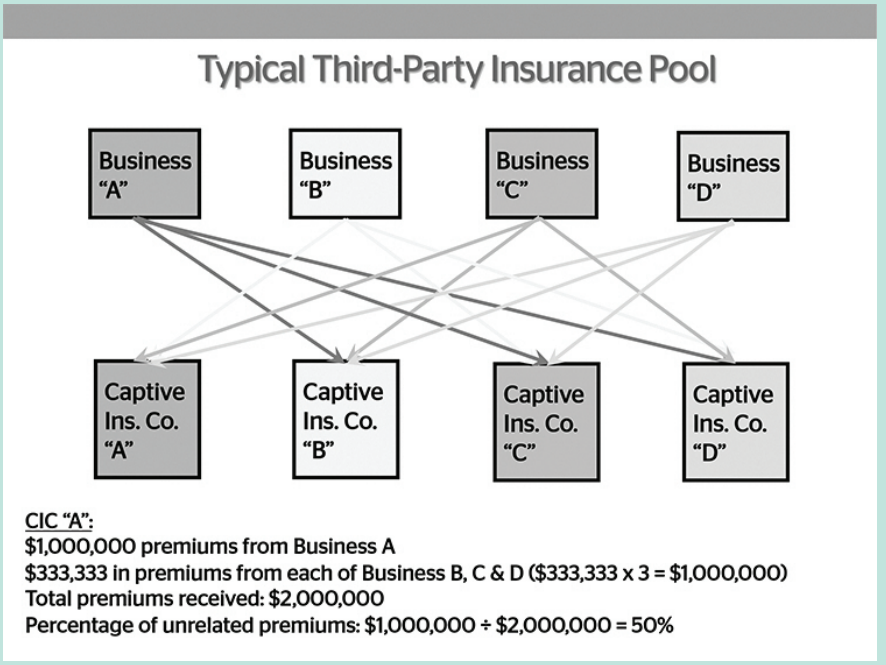
4 Rev. Rul. 2002-89, 2002-2 CB 984, Rev. Rul. 2002-60, 2002-2 CB 985, and Rev. Rul. 2002-91, 2002-2 CB 991. (The IRS found risk shifting to exist where a wholly owned subsidiary captive insurance company received less than 50% of its total premiums from its parent, the parent did not guaranty performance of the captive subsidiary, and the captive did not make any loans to the parent).

5 *Beech Aircraft Corp.*, 797 F.2d 920, 58 AFTR2d 88-5548 (CA-10, 1986) (This case involved a wholly owned insurance company that was thinly capitalized with $150,000 to cover potential excess losses of several million dollars. In addition, the total exposure for the insurance company was capped at the total amount of premiums received plus investment earnings on the premiums. Only the insured parent would have borne a loss.).

6 *Stearns-Roger Corp.*, 774 F.2d 414, 56 AFTR2d 85-6099 (CA-10, 1985) (involving an indemnification agreement running from the parent to its captive insurance company subsidiary); *Malone & Hyde, Inc.*, 62 F.3d 835, 76 AFTR2d 95-5952 (CA-6, 1995) (involving an undercapitalized captive insurance company subsidiary in which parent retained risk of loss under an agreement to hold subsidiary harmless from losses); *Carnation Co.*, 71 TC 400 (1978) (involving a fronting arrangement in which commercial insurance carrier ceded 90% of the risk of the insured to the wholly-owned insurance subsidiary of the insured), *aff'd* 640 F.2d 1010, 47 AFTR2d 81-997 (CA-9, 1978).

EXHIBIT 1

Typical Third-Party Insurance Pool



companies noted below). Through a series of Revenue Rulings, the IRS has delineated the concept of risk distribution as follows:

1. Risk distribution incorporates the statistical phenomenon known as the law of large numbers
2. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim.
3. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer may smooth out losses to match more closely its receipt of premiums.
4. Risk distribution entails a pooling of premiums so that a potential insured is not in significant part paying for its own risks.[7]

So how much third-party risk is necessary to achieve risk distribution? Case law had set different percentages based on the specific facts of several cases, with the lowest amount of third-party risk reported at approximately 30%.[8] This means that 70% of the total risk insured by a captive insurance company could be that of a related party, with the remaining 30% from unrelated parties. Notwithstanding that 30% of unrelated third-party risk was generally accepted as industry norm to achieve risk distribution, the IRS has established a safe-harbor of 50% for third-party risk.[9]

Assuming that a captive insurance company can achieve an acceptable level of third-party risk, there are two ways to insure third-party risk. One way is for the captive insurance company to participate in a risk reinsurance pool. Under this arrangement, a captive enters into a reinsurance, or risk-sharing agreement with other captives through a captive insurance company manager. Under the arrangement, each captive in the risk reinsurance pool agrees to insure the risk of the affiliated owners of the other captives in the pool. By way of example, assume a micro-captive earns $2 million of premiums and needs to achieve a 50% level of third-party risk. It would issue policies having aggregate premiums of $1 million to the companies owned by its affiliated closely-held business owner. These are "direct policies" because they are issued by the micro-captive directly to its affiliated insured businesses (not third-party risk). It would also enter a risk reinsurance pool through which it insures the risks of hundreds of other companies. These "indirect policies" (or "pooled policies") would generate aggregate premiums to the micro-captive of $1 million. Through the risk pool, the micro-captive insures a portion of each policy issued to a company in the pool. By insuring hundreds of companies, no one claim will wipe out the reserves of the micro-captive because the risk

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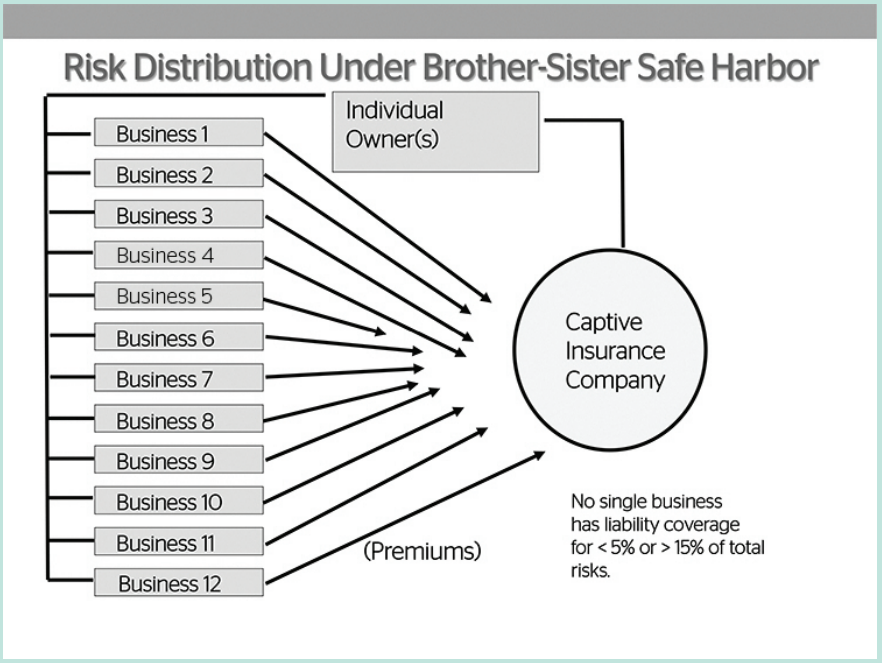
EXHIBIT 2

Risk Distribution Under Brother-Sister Safe Harbor



is dispersed among many insurance companies. This is the third-party risk that achieves risk distribution. (Exhibit 1 illustrates a typical risk pool arrangement, in which each micro-captive insures the risks of several insured businesses.)

An alternative to risk pooling is the "brother-sister" arrangement whereby a micro-captive insures only the risks of its sister companies, that is, companies owned by the common parent of the captive. There is no third-party risk in the brother-sister arrangement because the micro-captive and the insured businesses are owned by a common parent. Notwithstanding the lack of third-party risk, risk shifting and risk distribution will be achieved under this paradigm if there are a sufficient number of insureds and the risks are reasonably distributed among all of the insureds.[10] Initially, the IRS had successfully argued that there could be no risk shifting and risk distribution when the economic risk of loss remains on the balance sheet of entities within the same affiliated group. This economic family doctrine was first espoused by the IRS in Rev. Rul. 77-316, 1977-2 CB 53.[11] The economic family doctrine made good sense when the captive insurance company was a subsidiary of the insured because the economic risk of loss was never removed from the parent's balance sheet. However, when a captive insurance company and the insured are owned by a common parent, the risk of loss may be shifted as between the subsidiary insurance company and the insured, even though the common parent remains economically neutral. After several taxpayer victories in the brother-sister captive insurance company arrangement,[12] the IRS abandoned the economic family doctrine[13] and published

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7 Rev. Rul. 2002-89, 2002-2 CB 984 and Rev. Rul. 2002-90, 2002-2 CB 985 (both citing *Clougherty Packing Co.*, 811 F.2d 1297, 59 AFTR2d 87-668 (CA-9, 1987) and *Humana Inc.*, 881 F.2d 247, 64 AFTR2d 89-5142 (CA-6, 1989)).

8 The Ninth Circuit approved 29% in *Harper Group*, 979 F.2d 1341, 70 AFTR2d 92-6053 (CA-9 1992), *aff'g* 96 TC 45 (1991). *Amerco Inc.*, 979 F.2d 162, 70 AFTR2d 92-6048 (CA-9, 1992) (approving third-party coverage ranging between 52%-74%). See also *Ocean Drilling & Exploration Co.*, 988 F.2d 1135, 71 AFTR2d 93-1184 (CA-F.C., 1993) (approving third-party coverage ranging between 44%-66%). In practice, it is not absolutely clear whether the percentages refer to total premiums received or total losses covered. These figures tend to be proportional in any event, and it is common to measure the risk distribution percentages in terms of total premium dollars.

9 Rev. Rul. 2002-89, 2002-2 CB 984 (The IRS found risk distribution present where a wholly-owned-subsidiary captive insurance company received less than 50% of its total premiums from its parent and more than 50% of total premiums from unrelated insureds.).

10 *Hosp. Corp. of Am.*, TCM 1997-482 (This case involved the common parent of an affiliated group of companies that owned and operated hospitals and formed a wholly owned captive insurance company. The premiums paid by the insured subsidiaries to their sister insurance company met the test for risk distribution because a loss by the insurance company would not affect the balance sheet of the separate insured.); *Kidde Industries Inc.*, 81 AFTR2d 98-326 (Fed. Cl. Ct., 1997) (involving the same reasoning for a broad based conglomerate with 100 subsidiaries that required products liability coverage during a products liability insurance crisis in the 1970s).

11 Rev. Rul. 77-316 was declared obsolete by Rev. Rul. 2001-31, 2001-1 C.B. 1348.

12 *Humana Inc. supra* note 7; *Kidde*, *supra* note 10; *Hosp. Corp. of Am.*, *supra* note 10. The courts finally accepted taxpayers' argument articulated in *Moline Properties Inc.*, 319 U.S. 436, 30 AFTR 1291 (1943) that a corporation will be considered a taxable entity separate from its owner so long as it has a valid business purpose.

13 Rev. Rul. 2001-31, 2001-1 CB 1348.

a safe-harbor test for the brother-sister arrangement.[14] Under the safe-harbor, risk shifting and risk distribution are present when the micro-captive insures at least 12 other sister subsidiaries with no one insured representing less than 5% or more than 15% of the total insured risk.[15] (See Exhibit 2 for an illustration of the brother-sister arrangement.)

Even if risk shifting and risk distribution are met, courts have added a third element requiring that an insurance arrangement must have "commonly accepted notions of insurance." In addressing this last requirement, courts have examined whether the insurance company was properly organized, whether it respected corporate formalities, whether it was adequately capitalized, whether it was regulated by state law, and whether policies and premiums are market comparable.[16]

Taxation of Insurance Companies.

Every non-life insurance company is subject to federal income taxation under Subchapter L of the Code (Part II, Sections 831 through 835), and will be treated as a corporation for entity classification purposes, regardless of the actual type of entity it is.[17] Insurance companies are subject to income tax like every other corporation, but with certain statutory modifications. The taxable income of an insurance company is its gross income (defined under Section 832(b)(1)) less deductions (defined under Section 832(c)). The most significant modification is the permissible deduction for losses "incurred but not reported," often referred to as IBNR. This is an actuarial calculation that permits an insurance company to deduct the present value of its estimated reserves, or future amounts set aside to pay claims.

Micro-captives, on the other hand, are not taxed based on the general rules applicable to insurance companies; instead, they are taxed under the alternative treatment afforded to small insurance companies under Section 831(b). Under this section, an insurance company that receives less than $2.2 million[18] a year in net premiums can elect to be taxed on its net investment income only, with a complete exclusion for the premiums received.[19] This incentive was put in place by Congress in 1986 to encourage the creation of new insurance companies at a time when insurance markets were extremely tight. It is important to note that the micro-captive is still a C corporation and therefore, will be taxed on its investment income.[20] In addition, distributions from the micro-captive are treated either as qualifying dividends or liquidating distributions, both taxable to the owner (currently at preferential income tax rates). Most significant is that the election under Section 831(b) does not affect the current deductibility of the premiums paid by the related insured business. Assuming that a micro-captive is profitable, there can be tremendous tax savings by deferring the premium income, as well as the tax arbitrage between the premium deduction at ordinary income tax rates and the captive dividend at preferential income tax rates.

For the closely-held business owner who has multiple lines of businesses with a sufficient amount of insurable risk and insurance premiums possibly in excess of the Section 831(b) limit, use of multiple micro-captives may provide a solution. It is possible for a closely-held business owner to create two or more captives to cover the risks of its affiliated businesses. In such cases, careful attention should be given to the controlled group rules under Section 1563(a), which are made applicable to micro-captives by Section 831(b)(2)(B). These rules are designed to prevent closely-held business owners from gaming the system and claiming multiple exclusions under Section 831(b)(2).[21] To foreclose this abuse, the Code applies various attribution rules to limit closely-held business owners to one exclusion under Section 831(b). Notwithstanding these limitations, it is still possible to create multiple micro-captives if there are a sufficient

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14 Rev. Rul. 2002-90, 2002-2 CB 985 (The IRS determined risk distribution was present where an insurance company was formed to insure the professional liability risks of 12 sister companies owned by its common parent, such that no one subsidiary was bearing its own loss.).

15 For purposes of the 12-entity rule, single-member LLCs are disregarded. See Rev. Rul. 2005-40, 2005-2 CB 4.

16 *Ocean Drilling & Exploration Co.*, *supra* note 8; *Amerco Inc. supra* note 8.

17 Section 7701(a)(3). The entity classification of an insurance company is not binding for federal income tax purposes. See Reg. 301.7701-1(a)(1). Even a non-incorporated entity will be classified as a corporation if its predominant business activity is issuing insurance contracts. Rev. Rul. 83-132, 1983-2 CB 270.

18 The limitation under Section 831(b) had previously been $1.2 million from 1986 through the end of 2015. It was increased to $2.2 million by the PATH Act.

19 Section 831(b)(1).

20 In managing the investments of a micro-captive, thought should be given to investments that produce dividends to take advantage of the dividends received deductions applicable to C corporations. It is also important to remember that C corporations do not enjoy the benefit of preferential rates on long-term capital gains. The good news is that the exempt premium income is not an add-back for the alternative minimum income tax.

21 Under the attribution rules, a micro-captive is treated as receiving premiums from all companies that are part of the same control group. Therefore, if multiple micro-captives are created by the same persons and each micro-captive receives $2.2 million of premiums, the micro-captives would be deemed to receive total dividends in excess of the Section 831(b) limitation.

number of different owners of the micro-captive.[22]

Although the taxation of insurance companies, and specifically micro-captives, is clear from a statutory perspective, the implementation of micro-captives has come under greater scrutiny from the IRS in recent years. In fact, micro-captives made news when they were identified by the IRS on its Dirty Dozen tax scam list for 2015.[23] By adding micro-captives to the list of tax scams it is targeting, the IRS has sent a message that it will seek to invalidate bogus micro-captives and the promoters that push them as a tax dodge. This does not mean that every micro-captive will be invalidated or that there is no room for legitimate micro-captives established for valid business reasons. Rather, the IRS is targeting micro-captives that have been used to push tax deductible premium dollars into a tax deferred vehicle with very little economic substance and a small likelihood of ever paying out a claim. The abusive cases identified by the IRS include micro-captives that overcharge premiums for policies, or insure risks for which there will never be a claim. In addition, the IRS is concerned about insufficient underwriting and actuarial substantiation, as well as captive managers that seem to match premium pricing with the desired level of tax deduction sought by the operating business. The Dirty Dozen list should not preclude business owners from considering a micro-captive as part of a legitimate risk management structure. However, it is a reminder that a micro-captive, like every business venture, must be engaged in for a true business purpose.

PATH ACT CHANGES

The PATH Act had a significant impact on the creation and use of micro-captive insurance companies. On one hand, it expanded some of the benefits afforded to micro-captive insurance companies. On the other hand, additional qualification requirements made the use of existing and newer structures more difficult to manage.

The expanded benefits increased the Section 831(b) limit from $1.2 million to $2.2 million for net written premiums received in tax years beginning after 12/31/16. This means that a micro-captive making a Section 831(b) election can receive almost twice as much insurance premiums as it did in the past and still maintain its qualification to be taxed only on its net investment income. This change was long overdue. The original Section 831(b) limitation had not been increased since it was first enacted in 1986, despite many attempts to increase the limit by various members of Congress over the last ten years. The increased threshold is also indexed for inflation starting in 2016.[24]

Other changes made by the PATH Act affect the qualification requirement for Section 831(b) and were promulgated primarily to address perceived abuses by some taxpayers. A new "diversification" requirement qualitatively affects the ownership and risk distribution decisions of every micro-captive owner. The diversification requirement can be satisfied through either a "risk diversification test" or a "relatedness test,"[25] each of which requires careful analysis and planning.

The risk diversification test is met if no more than 20% of net written premiums to the micro-captive are attributable to any one policyholder.[26] In essence, this increases the risk distribution requirement (discussed above) from 50% to 80%. This new requirement will force micro-captives to take on additional third-party risk, presumably through a risk reinsurance pool. It is not clear whether the Service will look through a risk reinsurance pool to the underlying insureds to determine who is a policyholder for purposes of the risk diversification test. The Service has looked though risk reinsurance pool arrangements in the past to analyze whether risk distribution existed.[27] If the IRS were to look through a risk reinsurance pool, no insured in the pool could pay premiums in excess of 20% of the total premiums. In addition, for purposes of determining the identity of the payors of premiums, the new law attributes premiums to all policy holders who are related or are members of the same controlled group.[28] To the extent a concern exists that one or more insureds may pay greater than 20% of the total premiums of the risk pool, the micro-captive may have to participate in multiple risk reinsurance pools, each with different participating insured businesses. Alternatively, the risk pool could limit premium payments by all

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22 This may be less of a planning concern given the increase in the Section 831(b) exclusion. Practically speaking, if a business can write insurance premiums of $2.2 million, it must have significant risks and most likely will have a substantial business enterprise. In the author's personal experience with businesses writing premiums in excess of the historical Section 831(b) limit, the operating businesses have been in industries with significant justifiable risks (e.g., manufacturing, construction, and transportation) and had significant operations generating gross revenues in the multiple hundreds of millions of dollars.

23 IR-2015-19, 2/3/15.

24 The Section 831(b) limit increases in increments of $50,000 with a base year of 2013 for calculating inflation adjustments.

25 The names of these tests are not identified as such in the statute. These are the monikers identifying them in the Technical Explanation of the PATH Act published by the Joint Committee of Taxation.

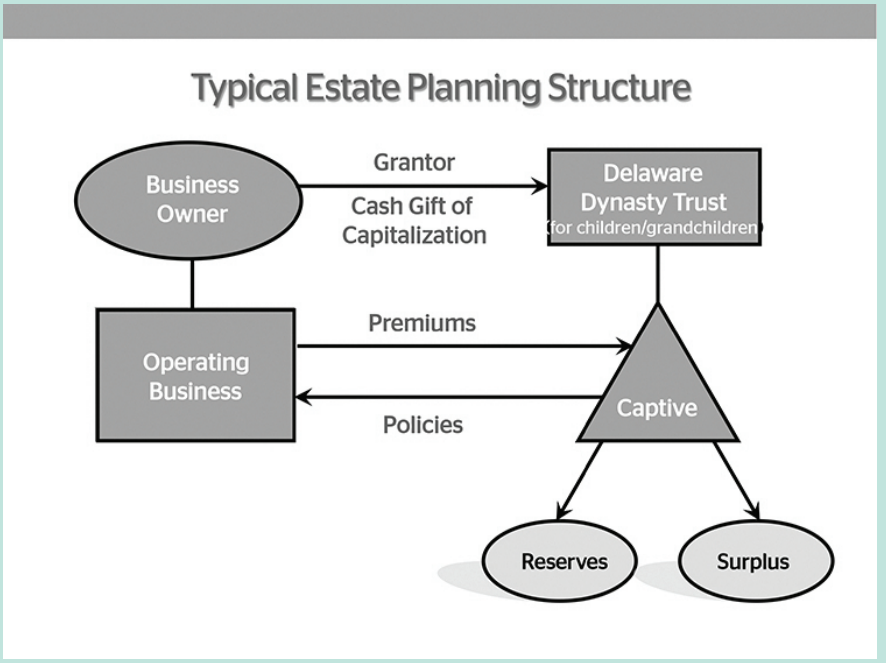
26 Section 831(b)(2)(B)(i)(I).

27 Rev. Rul. 2009-26, 2009-38 IRB 366.

28 Section 831(b)(2)(C)(i)(II). (For this purpose, "related" is defined by reference to Sections 267(b), 707(b), and 1563).

EXHIBIT 3

Typical Estate Planning Structure



participants to 20% of total premiums. It will be incumbent on the closely-held business owner to discuss the risk reinsurance pool arrangement with the captive insurance company manager that runs the risk pool to assess the impact upon the risk diversification test. More significant is that a micro-captive that previously achieved risk distribution without use of a risk reinsurance pool, that is, through a brother-sister arrangement, cannot meet the risk diversification test because there is no third-party risk in that structure. These owners will be forced to satisfy the relatedness test.

The relatedness test requires the ownership of the micro-captive to mirror the ownership of the insured business, except for a de minimis difference of no more than 2%.[29] The test must be satisfied whenever the owners of the micro-captive are the spouse or lineal descendants of the owners of the insured business. This test was designed to prevent a perceived estate planning abuse whereby a taxpayer would make a relatively small up-front gift to form the micro-captive that was owned by the next generation and then transfer millions of dollars of income tax deductible premiums into the micro-captive. (See Exhibit 3 for typical estate placing structure.) Thus, if the micro-captive is owned 100% by junior generation family members, these family members must also own at least 98% of the insured business. If the micro-captive is owned 100% by senior generation family members, the ownership of the insured business is irrelevant for purposes of the relatedness test because the statute requires matching ownership whenever the junior generation owns the micro-captive. In addition, if the micro-captive is owned by collateral relatives of the owner of the insured business (e.g., siblings, nephews), the relatedness test will not have to be met. The relatedness test may be preferable for a business owner who does not want additional third-party exposure presented by the risk diversification test.

The statute has left some unresolved issues with the relatedness test. For instance, the statute requires ownership of the micro-captive to mirror the ownership of the "specified assets" of the insured.[30] These are defined as the assets of the insured business from which premiums are paid. It is not clear, however, how the ownership percentages of the insured business are to be calculated. By way of example, if a child owns 25% of a micro-captive that is receiving premiums from three different insured businesses, does the child also have to own 25% of each insured business? Is it sufficient for the child to own 25% of the aggregate assets of all three insured businesses? For instance, if the child owns 90% of business 1 and 25% of businesses 2 and 3, but the value of the assets of business 1 represents 25% or more of the value of the assets of all three businesses. It is not clear that this ownership would satisfy the test.

In addition, the statute determines ownership of the micro-captive and the insured business both directly and

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29 Section 831(b)(2)(B)(i)(I).

30 See *supra* note 21.

indirectly through attribution applied to trusts, estates, partnerships, and corporations. However, there is no guidance on how to apply the attribution rules to determine indirect ownership. For instance, are grantor trusts disregarded for this purpose so that the grantor is the deemed owner? That makes sense because this is an income tax statute, but the result would nullify the relatedness test. Are partners of partnerships counted by capital or profits interests? For clarification, the IRS could issue regulations incorporating the attribution rules of Section 1563 (the controlled group rules) because these rules are currently used to determine both ownership under the risk diversification test and the total amount of premiums received by a micro-captive for purposes of the Section 831(b) limit. Taxpayers will have to await further guidance for answers to these questions.

The PATH Act does not change the common law elements of risk shifting and risk distribution necessary for a valid insurance arrangement. However, its new requirements create a second layer of qualification under Section 831(b) for micro-captives.

IMPACT ON EXISTING ARRANGEMENTS

The PATH Act does not change the common law elements of risk shifting and risk distribution necessary for a valid insurance arrangement. However, its new requirements create a second layer of qualification under Section 831(b) for micro-captives. While the new requirements certainly affect the planning of any new micro-captive, they have a greater impact on existing micro-captives that were formed and operated prior to the new law.

Unfortunately, the PATH Act does not grandfather existing micro-captive ownership structures for purposes of the relatedness test. So a micro-captive that has been operating for several years and which was incorporated into a business owner's estate planning could be in violation of the relatedness test as of 2017. For example, if a business owner used a trust to own 100% of the micro-captive, but retained ownership of the insured business, the business owner would fail the relatedness test. Because the PATH Act did not exempt preexisting ownership structures from the relatedness test, the business owner may have to modify or unwind some or all of the previous estate planning. The reallocation of ownership interests requires careful consideration of the tax consequences, valuation issues, and also limitations imposed by existing legal structures.

Consider the following consequences for a business owner whose micro-captive is owned 100% by a trust for the benefit of the business owner's spouse and descendants. The trustee can make distributions of the micro-captive shares only to a beneficiary of the trust. Since the business owner's spouse is a beneficiary of the trust, the trustee could distribute the micro-captive's shares to the spouse-beneficiary, who could in turn make a gift-tax-free transfer to the business owner. Although this series of transfers is without gift tax consequences, it does add a significant asset to the business owner's estate.[31] If the business owner's spouse were not a beneficiary of the trust and a similar strategy were used with a descendant-beneficiary of the business owner, the ultimate transfer to the business owner would be a taxable gift. Gift tax will be payable if the value of the shares exceeds the beneficiary's available gift tax exemption. It may be possible to have a descendant-beneficiary appoint the micro-captive shares to the business owner (or to the business owner's spouse) through the exercise of a broad limited power of appointment. Such exercise is generally not a taxable gift, provided the beneficiary does not have a fixed income interest in the trust and the trustee has full discretion over the trust income and principal rather than discretion based on an ascertainable standard.[32]

Both of the described distributions reallocate micro-captive shares to the business owner to solve the relatedness test, but at a significant estate tax cost. The shares of the micro-captive are also likely to be worth a lot more than when the micro-captive was first established and should continue to increase in value over time. The trust, however, would be left with very little value after the transfer. The estate tax cost could be mitigated in part by having the business owner purchase the micro-captive shares from the trust at fair market value. Although the trust and the business owner will exchange equivalent value, an estate planning opportunity will still be lost if the growth in the assets of the trust underperforms the growth on the shares of the micro-captive in the business owner's estate. For income tax purposes, if the trust is a grantor trust, this transfer would be income tax free.[33] If the trust is not a grantor trust, the transfer would result in an

NOTES

31 Query: Would the trustee be in breach of his or her fiduciary duty to the beneficiaries of the trust if the trustee knowingly participates in a plan to move ownership of the micro-captive shares to the grantor?

32 If the trust does not grant a beneficiary a broad limited power of appointment, it may be possible to decant the trust (distributing assets from an old trust to a new trust with more favorable terms) to grant such a power.

33 If the grantor trust has a grantor trust substitution power under Section 675(4)(C), a swap of assets is the likely scenario.

immediate gain on sale to the trust because the current value of the micro-captive shares is likely to be significantly greater than its cost basis. An alternative strategy may be to liquidate the micro-captive and form a new micro-captive with permissible ownership under the new legislation. This may be more costly from an income tax perspective than the sale by a non-grantor trust because of the double-tier tax system for C corporations. Obviously one has to consider the built in gains on assets as well as state level tax consequences of each of these options.

Whatever strategy is used to transfer the micro-captive shares to the business owner, a fair market value appraisal of the micro-captive is required. Once operational, the micro-captive will have millions of dollars in surplus and reserves, not to mention enterprise value for the profits as an ongoing business. A business owner would be well served by hiring a competent appraiser to determine the value of the micro-captive shares so as to avoid additional gift tax concerns if the transaction is later determined by the IRS to have been for less than fair market value.

Of course, if a business owner does not want to unwind the existing ownership structure of the micro-captive, but still wants to satisfy the relatedness test, he or she could make a gift of his or her interest in the insured business to the trust or other owners of the micro-captive. Apart from the obvious gift tax cost, if the business owner has previously given away 100% of the micro-captive, he or she may not be willing to also part with 100% of the business. It may be possible for the business owner to part with the business without making a gift and with the ability to direct the ultimate disposition of the business if he or she gifts the business interest to a trust in a transfer that is an incomplete gift for federal gift tax purposes. The business owner would retain lifetime and testamentary powers of appointment over the trust to make the transfer incomplete for gift tax purposes. The beneficiaries of the trust would be the same individuals who own the micro-captive. For income tax purposes, the trust could be designed to be a non-grantor trust. Assuming application of the same attribution rules used to determine controlled group status (see footnote 21), the assets of the trust would be attributed to the beneficiaries of the trust and relatedness test could be satisfied. Unfortunately, the IRS has not issued regulations that address how attribution will be applied through trusts.

If the foregoing restructurings are not feasible or otherwise acceptable to the business owner, he or she could forego the relatedness test in favor of the risk diversification test. As discussed earlier, this test basically increases the risk distribution requirement of the micro-captive from 50% to 80%. Thus, instead of unwinding the existing ownership of the micro-captive, the micro-captive has to assume additional third-party risk. This means increasing the micro-captive's participation in a risk reinsurance pool and putting more of its assets at risk. This is an economic and risk management decision that will be informed in part by the historical claims made in the risk reinsurance pool used by the micro-captive. If the risk reinsurance pool has low recurring losses (as a percentage of premiums received), the anticipated economic losses sustained may be less than the estate tax imposed by undoing the prior ownership structure. Based on a current estate tax rate of 40% (federal only), a typical risk reinsurance pool should be a safer bet. As discussed above, this also assumes that no one insured in the risk pool has written more than 20% of the total premiums; otherwise, the micro-captive may have to participate in multiple risk pools.

Notwithstanding the foregoing, a business owner who has implemented a brother-sister arrangement to satisfy risk distribution may find it more difficult to satisfy the new risk diversification test if he or she has also done significant estate planning. Although technically no third-party risk is required to achieve common law risk distribution in the brother-sister arrangement, such arrangement fails the risk diversification test under the PATH Act. A business owner who has used a brother-sister arrangement to achieve risk distribution must either satisfy the relatedness test by possibly unwinding existing estate planning arrangements, or forego the brother-sister arrangement and convert to a risk reinsurance pool to satisfy risk distribution as well as the risk diversification test.

CONCLUSION

Similar to many federal tax statutes aimed at curbing perceived abuses, the government giveth and the government taketh away. The increased Section 831(b) exclusion was a welcome and much-needed change, but the additional diversification requirements have made planning with micro-captives more difficult to navigate. Owners of new micro-captives will have to deal with more stringent requirement for qualification under Section 831(b), but they will still have an easier path than the owners of existing micro-captives. The lack of grandfathering for existing ownership and risk reinsurance pool structures will require a lot of work by most micro-captive owners and their captive insurance advisers. Unless further guidance is issued soon, owners of existing micro-captives will have to make difficult decisions to restructure their arrangements.

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