



# 180°

A guide to what's hot in the world of captives and ART



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## Small Insurance Company Tax Regulations

The Internal Revenue Code has historically provided two very powerful tax advantages to small insurance companies, including captive insurers, in order to provide them additional financial resources to pay claims. These regulations, which are contained in sections 501(c)(15) and 831(b) of the Code, were amended in April of this year with the passing of the Pension Funding Act of 2004. This article examines the provisions of these two regulations, the effect of the recent changes and the potential use of these regulations for captive insurance companies going forward.

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### Internal Revenue Code §501(c)(15)

Under this section of the Code, a property and casualty insurance company can elect to be exempt from U.S. taxes. This means that:

- All underwriting income earned by the company is not subject to tax
- Investment income received is not taxed
- Long-term capital gains are not taxed, i.e. a contributed asset to a 501(c)(15) company could be sold and those assets re-invested with no tax effect
- Short-term capital gains and dividends are not taxed.

Obviously this provision presents some powerful tax advantages to an insurer, and eligibility for this election is limited to small insurance companies. The origins of the provision lie with small agricultural insurers that were granted preferential tax status to encourage their creation and fill a gap in the commercial market. To qualify insurers must be writing business below a certain revenue threshold. They must also be predominantly engaged in the business of insurance and be deemed insurance companies for tax purposes.

Prior to the recent changes the revenue threshold to qualify under 501(c)(15) was \$350,000 in direct or net written premium, whichever was the greater. This definition had inadvertently opened up the 501(c)(15) regulation to abuse by insurance companies with questionable insurance risk and overcapitalization. The most recognized of these cases was an individual who formed a 501(c)(15) to write less than \$5,000 in premiums and avoided federal taxes on \$173 million in income by contributing appreciated assets into the insurance company and liquidating those assets.

**April 2004 Changes** - To clamp down on the potential abuse of IRC §501(c)(15), a significant change was made to the revenue threshold for eligibility. The \$350,000 premium threshold was replaced by a threshold of \$600,000, but applying to gross receipts. Premiums

received must account for at least 50% of gross receipts. For the purposes of eligibility, the gross receipts of all members of a related group are aggregated. This would include parent and brother, sister companies of the insurance company, whether or not they are insurance companies themselves.

**Applicability to Captives** - These changes effectively remove the 501(c)(15) election as an option for captives. To qualify the total revenue of the captive and its parent combined would have to be less than \$600,000 (and premium income would have to be more than 50% of the combined revenue). Virtually all 501(c)15 captives formed in recent years no longer meet the requirements under this definition and starting with fiscal year 2004 will no longer be tax exempt.

### Internal Revenue Code 831(b)

IRC §831(b) allows for a property and casualty insurance company to elect to be taxed only on its investment income. Under this structure the significant advantage is that the company is able to accumulate surplus from underwriting profits free from tax. This election is only open to insurance companies of a certain size.

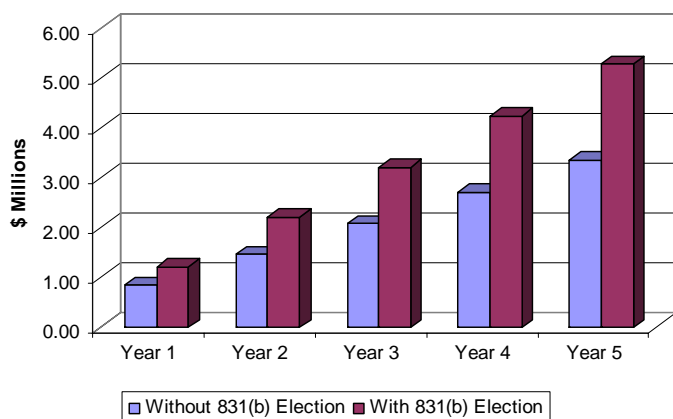
**April 2004 Changes** - The Pension Funding Act of 2004 removed the minimum size criteria to be eligible for the election. This had previously been set at direct premium (or written if greater) of \$350,001 to dovetail with the IRC §501(c)(15) election. The maximum size criteria was left unchanged at \$1.2 million in direct premium (or written if greater). No gross receipts measure is applied to 831(b) companies.

The \$1.2 limitation includes all premiums written by companies within the same consolidated group. Companies must also be deemed insurance companies for tax purposes to be eligible for the election.

**Applicability to Captives** - The changes leave IRC §831(b) as a viable and powerful option for captive insurance companies. Many captives previously formed under Section 501(c)15 would meet the requirements of Section 831(b) and could now make this election. As well as onshore captives, the IRC §831(b) election is available to offshore captives that choose to be taxed as a U.S. company by making a 953(d) election.

The ability to accumulate underwriting surplus tax free has significant advantages for the funding of shorter-tail more volatile lines of coverage such as property. Lacking the ability to create IBNR reserves under annual insurance contracts, captives have not been an attractive option to fund medium frequency (1-in-5 to 1-in-10 year) events as income tax is payable in the years with good loss experience. This "tax drain" can considerably limit the accumulation of surplus in the captive and increase the cost of funding medium frequency events. The exhibit below shows the build up of capital under a captive program with an annual premium of \$1 million, paid-in capital of \$250,000 and no losses. At the end of Year 5, the 831(b) captive has 57% more capital than the captive not making this election.

**Year End Capitalization**



**Withdrawing Funds** - It is important to note that while a 831(b) pays no taxes on underwriting profit, its owners are taxed on dividends and other compensation received from the 831(b). Further when the 831(b) is sold or liquidated, its owners will pay tax on any gains on the value of their stock at long-term capital gains rates. For distributed surplus, this structure may allow for tax deferral and change the rate of taxation from ordinary income rates to long-term capital rates. No income tax will be paid on funds distributed as losses, making the funding of medium frequency, medium severity losses in this structure particularly attractive.

*The above discussion of taxation of captive insurance companies is highly dependent on individual circumstances. It should not be viewed as tax advice. Consult your tax professional for an opinion of the applicability of these sections to your situation.*

## Domicile Update: Bermuda

In the last issue we focused on Arizona, one of the newest captive domiciles. This month we highlight Bermuda, the country where captives were invented.

The world's first captive was set up in Bermuda in 1962. Today the Bermuda insurance market is the second-largest in the world. In 2003 annual premiums written were over US\$ 62.7 bn and estimated statutory capital and surplus exceeded US\$ 75.5 bn, a third of that premium was written in captives.

**Regulatory Environment.** In 2002 the Supervisor of Insurance's department left the Ministry of Finance and became a function of the Bermuda Monetary Authority. This restructuring ensures that Bermuda's insurance regulations are managed by an independent and non-political body. The admissions committee of the Insurance Advisory Committee (IAC), meets weekly to consider applications for new registrations. Membership of the IAC includes representatives from regulatory, business and professional agencies and the Bermuda insurance industry is largely self regulating.

Companies are classified into different categories, allowing for different levels of regulatory oversight. For captives, the relevant categories are:

- Class 1: Single parent captives
- Class 2: Multi-owner captives
- Class 3: Single parent, group, association or agency captives with more than 20% of net premiums derived from unrelated business.

A unique aspect of the Bermuda regulations is the formulaic approach to the minimum amount of capital and surplus that is required by a company. These minimums are detailed in the fact sheet below.

**Why Bermuda?** As the largest and oldest captive domicile, Bermuda offers several advantages to captive owners:

- **Experience and reputation:** Bermuda has more captives and has been regulating captives longer than any other domicile. Its regulatory environment is well developed and enjoys a sterling reputation with International regulatory authorities.
- **Infrastructure:** Bermuda has built an exceptionally strong infrastructure of captive managers and service providers. It boasts some of the leading insurance professionals in the world and has consistently been at the forefront of innovation in the insurance industry.
- **Reinsurance market:** Unlike other captive domiciles, Bermuda is supported by a reinsurance market offering significant capacity in support of captive programs. Meetings with underwriters can be scheduled to coincide with captive meetings.

- **Premium Tax:** Bermuda charges fees based on capitalization rather than premium taxes. This structure can be attractive for larger captives.
- **Multinational domicile:** Bermuda is a recognized captive domicile for organizations from all over the world. The acceptability of Bermuda's insurance regulations help in structuring captive participation in global programs.

**Recent Developments** - There has been considerable activity in Bermuda around Segregated Account Companies (SACs). Bermuda companies have for some time been able to segregate assets and liabilities within the corporate structure by means of a private act. Legislation to allow SACs was passed in 2000. A 2003 survey by Bermuda's captive management industry identified 83 SAC's with 6,246 cells and confirmed an increasing demand for this structure. We expect this trend to continue.

### Bermuda Captive Fact Sheet

**Applicable Legislation.** The Insurance Act of 1978, along with supporting amendments and regulations.

**Number of Captives.** 1600 international insurers are registered in Bermuda, over 1150 of those are captives.

#### Capitalization & Solvency Requirements

The greater of the minimum capital & surplus, the premium test or the loss test

	Class 1	Class 2	Class 3
Min Capital & Surplus	\$120,000	\$250,000	\$1,000,000
<b>Premium test</b>			
NWP < \$6M	20%	20%	20%
NWP > \$6M	10%	10%	15%
<b>Loss Test</b>			
Loss and Loss Expense	10%	10%	15%

#### Premium Taxes

No premium taxes apply. Fees assessable on capital apply and range from \$3,635 to \$27,825

#### Regulatory Fees

Class 1 – General Business	\$880
Class 2 – General Business	\$1,500
Class 3 – General Business	\$5,000
Class 1, 2, 3 – Long-term Business	\$5,000

## SRS News

**Client News** – SRS is pleased to announce and welcome the following new client captive programs:

- **RoofConnect**, a national network of roofing contractors, established a group captive program within the **Northgroup Sponsored Captive**, a company managed by SRS.
- **Atria Senior Living Group**, a leading senior care and assisted living organization, has selected SRS to manage its newly created South Carolina single parent captive.

**Our People** – SRS is pleased to announce the addition of **David Holmes** in our Bermuda office. David joins us as a broker within SRS Access, a Bermuda brokerage subsidiary of SRS. He has over 25 years brokerage experience in the Bermuda market and was mostly recently a senior broker at Willis, Bermuda.

SRS congratulates the following staff members on promotions effective July 1, 2004.

- Michael O'Malley, Managing Director;
- Charlie Tagman, President, SRS Underwriters;
- Keith Tagman, Director;
- Trung Khuu, Senior Analyst;
- David Littlehale, Senior Account Manager; and
- Merissa Bushey, Account Manager.

**Events** – SRS will be exhibiting at the **Vermont Captive Insurance Association** conference in Burlington, Vermont from August 10<sup>th</sup> to August 12<sup>th</sup>. We will be at booth 9 in the exhibit hall. Stop by the booth or schedule a meeting with a member of our team to discuss how SRS can address your captive needs.

**Comments** – If you have comments or questions about 180°, we would love to hear them. In particular we are interested in requests for technical topics to be covered in the newsletter. Please e-mail us at [inf@strategicrisks.com](mailto:inf@strategicrisks.com) with comments.

SRS provides underwriting, management and wholesale brokerage services in the alternative insurance market. We design, implement, manage and grow captive and ART programs on behalf of corporations, groups and insurance companies. SRS is an approved manager of captive insurance companies in Arizona, Bermuda, Cayman Islands, South Carolina & Vermont. Through a wholly owned subsidiary SRS is also licensed as an insurance broker in Bermuda.

For more information on SRS, visit us at [www.strategicrisks.com](http://www.strategicrisks.com).

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