

SURETY BONDING & CONSTRUCTION RISK MANAGEMENT 2020 CONFERENCE

January 27-29, 2020 | Bonita Springs, FL



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AGC's Surety Bonding & Construction Risk Management 2020 Conference

Jan. 27-29, 2020

Captive Insurance: 2020 & Beyond

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Captive insurance overview



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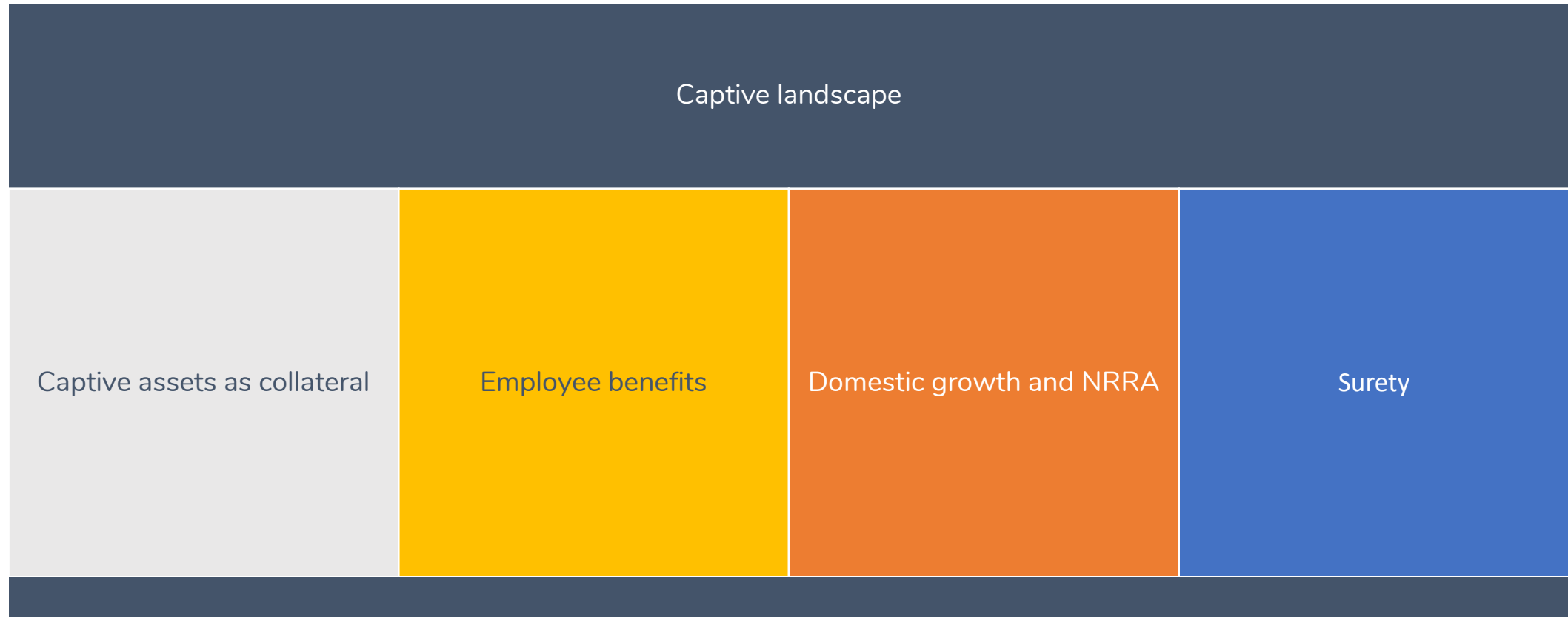
- A captive is a insurance company principally owned by the insured.
- Captives have a limited license in the jurisdiction (domicile) where they are licensed. Currently 38 states have captive legislation.
- Most captives insure primary deductibles or self-insured retentions.
- For most contractors this takes the form of CCIP retentions, subcontractor default and traditional program retentions on workers' compensation, general liability, auto liability, professional liability, subcontractor default, etc.

Emerging areas in the captive industry



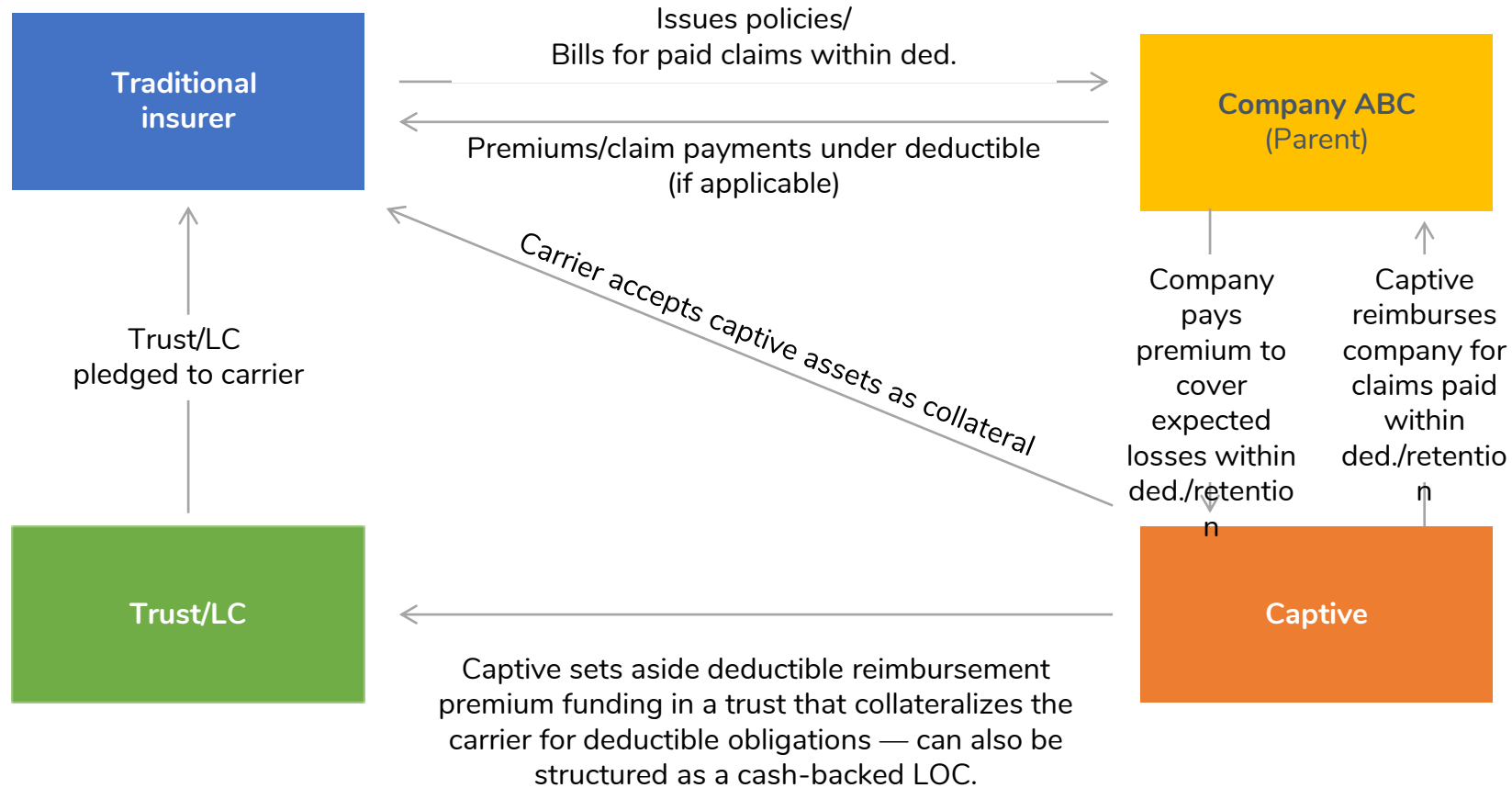
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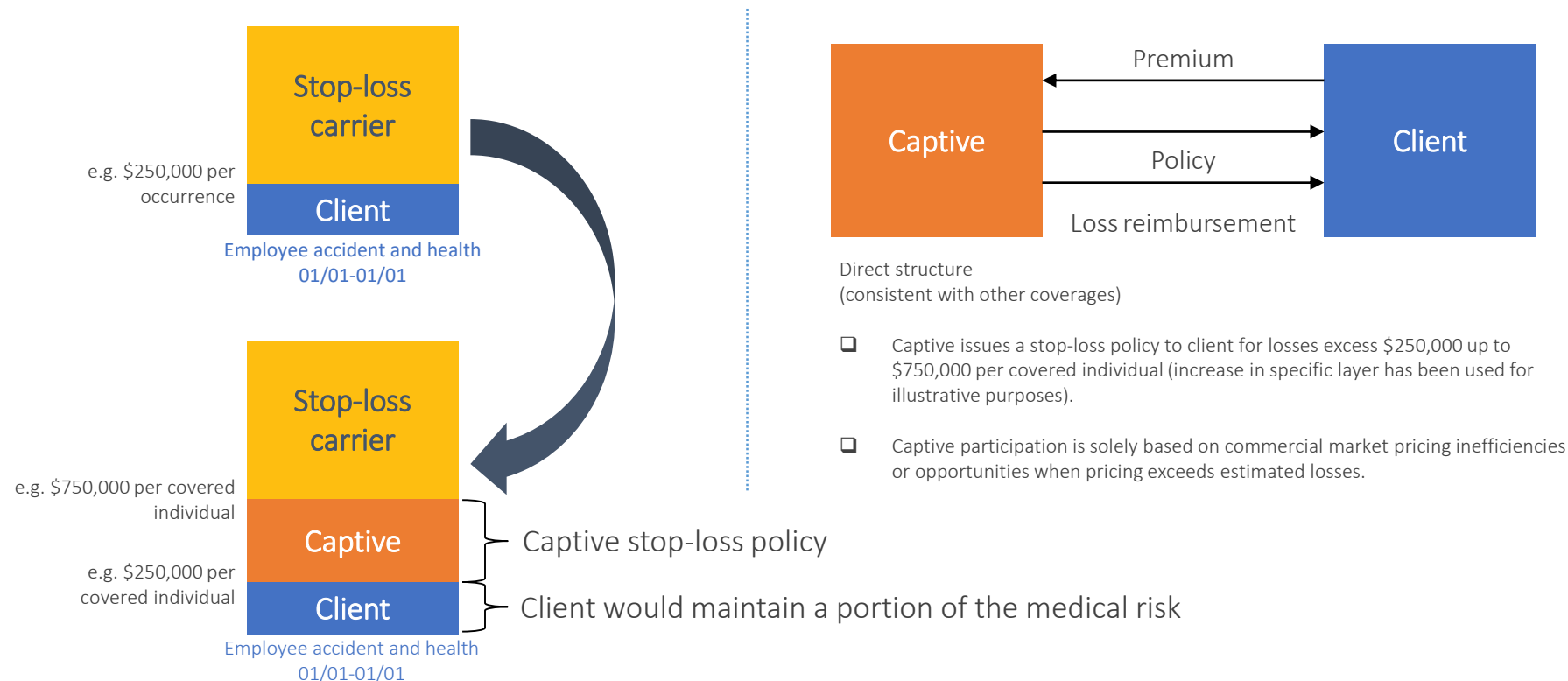


Captive and collateral strategies

Using a captive as collateral vehicle



Using the captive to finance medical stop loss

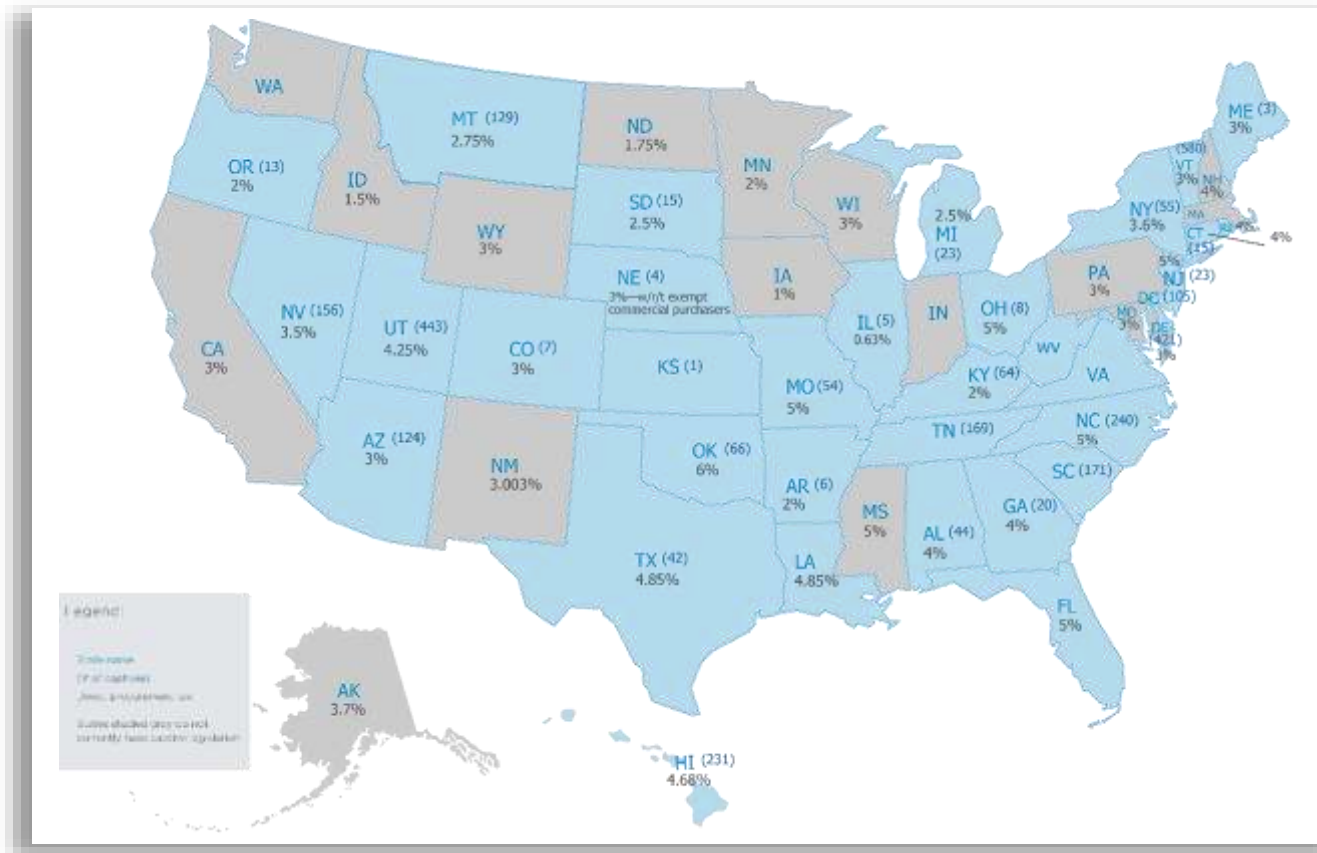


- The captive insures client directly (not the plan). Contractual indemnification for stop-loss programs structured as shown do not require DOL Prohibited Transaction Exemption.

Domiciling closer to home

Nonadmitted Reinsurance Reform Act

- 35 states now have captive legislation — highly competitive.
- Dodd Frank/Nonadmitted Reinsurance Reform Act (NRRA).
 - Enacted July 21, 2011.
 - Intended to alter way in which surplus lines taxes were collected.
 - Issue of self-procurement taxes elevated.
 - “Home state” collects 100% of tax.
 - Incentive to domicile captive in “home state.”
 - Johnson & Johnson court case upheld — in favor of New Jersey.



Captive utilization on surety programs factors to consider



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- Annual surety premiums - > \$500,000.
- Captive capitalization.
- Is the captive outside the indemnity agreement with the surety?
- Limited number of sureties willing to reinsure to a captive.
- Current cost of program.

Why large captive owners should know about small captive developments



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- The IRS began challenging large captives in 1977 and litigated numerous cases.
- In 2001, the IRS finally conceded that captives can be used if they are done right, and in 2002 the IRS issued parameters; since then, the IRS has been narrowing the strike zone.
- The IRS lost two large captive cases in 2015.
- The IRS has more recently been intensely focused on small captives, and the courts have made some disturbing statements.
- If the IRS establishes bad law, it will impose that on large captives.

§ 831(b) Election — Small Insurance Companies



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- Tax Election that allows “Small Insurance Companies” to have underwriting income be exempt from tax.
 - Investment income is subject to tax.
 - NOLs cannot be carried forward or backward out of an 831(b) year.
 - §1563 controlled group rules determine aggregation for purposes of annual premium limitation.
- § 831(b) largely unchanged from 1986 TRA to 12/31/16.
- Many changes since; topics today include:
 - PATH ACT.
 - Notice 2016-66.
 - Risk pool scrutiny and IRS audits
 - Avrahami, Reserve Mechanical, Syzygy

Example:

- A father and son each own 50% of a business. The son cannot own more than 52% of the captive.

PATH Act, effective 01/01/17

- Increased §831(b) threshold from \$1,200,000 to \$2,200,000 and indexed to CPI thereafter. (The 2019 threshold is \$2,300,000.)
- Removes most estate planning components from §831(b) ownership.

Notice 2016-66



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- Issued in November 2016 — requirement that now impacts the disclosure requirements for virtually all 831(b) captives.
- Describes at length captive reinsurance pool structures and concerns the IRS has identified.
- IRS acknowledges there are 831(b)s used for valid risk management; however, on audit it has challenged most every one.
- All captives with EITHER of the following must disclose the captive as a Transaction of Interest and file Form 8886 with the Office of Tax Shelter Administration:
 - Cumulative five-year loss ratio of 70% or less.
 - Captive loan backs to related parties.

Notice 2016-66 — disclosure requirements



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- For which reason the captive is reporting.
- Where the captive is domiciled.
- A description of all of the types of coverage provided by the captive.
- A description of how the premiums were derived. Include the name and contact information of any actuary or underwriter who assisted in these determinations.
- A description of the claims paid by the captive.
- A description of the assets held by the captive.

Notice 2016-66 — takeaways



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- Lockton assisted with over 30 of these filings for our 831(b) clients.
- Lockton must file as a material advisor for these transactions as well.
- 831(b)s can still be good vehicles for retaining risk.

Nontax business purpose and proper structuring are critical.

- Actuarial support for premiums for valid insurance risks.
- Proper capitalization, investments and operation.
- Claims activity.

Audits and court cases



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- The IRS has audited extensively and has won three small captive cases.
- Syzygy both disallowed deductions for the premium payments and taxed the captive on those same premiums.
- The cases have held that if the pooling mechanism is not an insurance company for tax purposes, then the risks assumed from the pool do not count in determining if there is risk distribution.
- The courts were skeptical when the premiums put into a pooling mechanism equal those returned by the pool (less ceding %).
- The IRS recently announced a settlement program.

Tax cut and jobs act



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Largest change in tax law in 30+ years.

- 1986 TRA is most recent comparable tax legislation.
- House and Senate approved Dec. 20, 2017.
- President Trump signed Dec. 22, 2017.
- Cost projected to be \$1.46 trillion:
 - Will be offset by \$455B additional revenue. \$66B in increased federal interest, net cost \$1.1 trillion.
 - All from Joint Committee on Taxation (JCT) staff.

Impact to businesses



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- Drops corporate tax rate from 35% to 21%.
- 20% deduction of domestic qualified business income (QBI) from partnerships, S-corporations and sole proprietorships (subject to certain limitations).

Impact to businesses

For business tax, you essentially have a choice of these options:

- Corporation — Subject to tax, two layers of tax after dividend.
- Partnership — One layer of tax, K-1 to 1040.
- S-corporation — One layer of tax, K-1 to 1040.
- Sole proprietorship — 1040 Schedule C.

Individual rates are lowered too:

- New law has seven rate structures. Top rate goes from 39.6% to 37%. (39.8% top rate was actually 40.8% once you took into account the 1.2% phase out for itemized deduction limitation. [Pease limitation.])

Reductions quantified



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Corporation

\$100 net income

\$35.00 income tax
(35% rate on Form 1120)

\$15.47 dividend tax (23.8% of \$65)

\$50.47 total tax/TR 50.47%

New law $21\% + (\$79 * 23.8\%) =$
39.8%

Partnership/S-Corp/Sole P

\$100 net income

40.8% income tax
(39.6+ 1.2% phase out of itemized deductions)

No dividend tax

\$40.8 total tax /TR 40.8%

New law $37\% * 80\%$ (some
businesses) = **29.6%**

Tax reform: Impact on captive insurance



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Larger traditional captives:

- Tax acceleration benefit is going to decrease 40% + in most instances (large captives).

Owners of pass-through entities:

- Federal income tax rate differential between dividend tax rates and ordinary income rates will go from $\approx 15\%$ to 5% for qualifying businesses.

