OCTOBER 2016
www.bdo.com

AN ALERT FROM THE BDO INSURANCE INDUSTRY PRACTICE

BDO KNOWS: INSURANCE

2017 TAX CHANGES COULD LEAD TO OPPORTUNITIES FOR SMALL PROPERTY/ CASUALTY INSURANCE COMPANIES

As part of the 2015 Protecting Americans from Tax Hikes ("PATH") Act, a significant change was made to the Internal Revenue Code ("IRC") provision IRC Section 831(b), which provides for an alternative tax for small property/casualty insurance companies, under which such companies are taxed solely on their investment income. This change may open more opportunities for companies to form captive insurance companies that qualify for the alternative tax regime set forth in IRC Section 831(b).

BACKGROUND

Property and casualty insurance companies are generally taxed as regular "C" corporations for U.S. federal income tax purposes, with various adjustments for items specific to insurance companies. However, a special rule in IRC Section 831(b) provides an alternative tax regime for certain small property/casualty insurance companies. Under the special rule contained in IRC Section 831(b)(1), a company eligible for this alternative tax can elect to be taxed only on its "taxable investment income" under the normal corporate tax rates (typically 35 percent under current law).

Under the pre-2017 version of this code section, this alternative tax election could be made by a property/casualty insurance company if its net written premiums (or, if greater, direct written premiums) for the taxable year did not exceed $1.2 million. Such an election, once made, may be revoked only with the consent of the Secretary.

To prevent abuse, IRC Section 831(b)(2)(B) provides certain "controlled group rules" providing that, in determining whether a property/casualty insurance company meets the "premium" threshold described above (i.e., premiums that do not exceed $1.2 million), premiums from all insurance companies that are part of the same "controlled group" are taken into account.

PATH ACT CHANGES

As a result of changes made to IRC Section 831(b) as part of the PATH Act, the alternative tax for small property and casualty companies will apply to those companies whose net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed $2.2 million (increased from $1.2 million) in taxable years beginning after December 31, 2016. This test continues to be done on a "controlled group" basis, as described above. Thus, because of

HOW DO I GET MORE INFORMATION?

For more information, please contact:

MARC S. ROCKOWER
Tax Managing Director, Core Tax Services
212-404-5587
mrockower@bdo.com

RANDY SCHWARTZMAN
Northeast Tax Regional Managing Partner
631-927-1159
rschwartzman@bdo.com

Read more ▶

the increased limit on the premium that the insurance company can write while remaining eligible for the election, the favorable rules of Section 831(b) will apply to more property and casualty companies beginning in 2017.

However, in connection with the increase in the premium limitation amount, the PATH Act also added a couple of additional requirements that were designed to address certain practices that Congress and the Treasury Department were concerned with. The first requirement (IRC Section 831(b)(2)(A)(ii)) is that the insurance company must meet certain "diversification requirements" as set forth in IRC Section 831(b)(2)(B). In order to meet the diversification requirements, an insurance company must meet one of the following two tests:

(I) No more than 20 percent of the net written premiums (or, if greater, direct written premiums) of such company for the taxable year is attributable to any one policyholder; or

(II) Such insurance company does not meet the requirement of subclause (I) and no person who holds (directly or indirectly) an interest in such insurance company is a specified holder who holds (directly or indirectly) aggregate interests in such insurance company that constitute a percentage of the entire interests in such insurance company that is more than a de minimis percentage (defined as not more than 2 percentage points) higher than the percentage of interests in the specified assets, with respect to such insurance company held (directly or indirectly) by such specified holder.

For purposes of the first diversification requirement described above, the test is done on a "controlled group" basis. Accordingly, the requirement that no more than 20 percent of the net written premium be attributable to any one policyholder can only be met if no more than 20 percent of the premium is coming from a controlled group of entities of which the policyholder is a member.

These diversification requirements were added to the IRC in an attempt to address a subset of small insurance companies viewed as problematic by the IRS and Treasury. In certain cases, for example, captives have insured highly improbable risks and are designed merely to generate a tax deduction for the business owner, while passing wealth on to the business owner's heirs. However, many captive insurance companies that are not formed as mere estate planning entities can still benefit from the elective rule at the higher premium cap.

Any company contemplating forming a captive insurance company should consider whether such a company could benefit from the election to be taxed solely on investment income and whether the company would meet the new diversification requirements.

People who know Insurance, know BDO.

ABOUT BDO USA

BDO is the brand name for BDO USA, LLP, a U.S. professional services firm providing assurance, tax, advisory and consulting services to a wide range of publicly traded and privately held companies. For more than 100 years, BDO has provided quality service through the active involvement of experienced and committed professionals. The firm serves clients through more than 60 offices and over 500 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multi-national clients through a global network of 1,408 offices in 154 countries.

BDO USA, LLP, a Delaware limited liability partnership, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO is the brand name for the BDO network and for each of the BDO Member Firms. For more information please visit: www.bdo.com.