

Myth Busting: Let's Talk 831b Micro Captives



If you're new to the world of captives and decide to do a quick Google search to learn more about them, a deluge of information will flood your screen and will likely leave you with more questions than answers. In the course of your research, you'll probably encounter information stating that captives are once again on the IRS "Dirty Dozen" list.

Every year, the IRS publishes a list of the twelve worst tax scams and calls it the "Dirty Dozen." Unfortunately, micro-captives have made an appearance on the list almost every year since 2015, only being left off of it in 2020. In the latest edition of the "Dirty Dozen," the IRS "warns people to be on the lookout for promoters who peddle false hopes of large tax deductions from abusive arrangements."

While it's clear that organizations considering forming a micro captive should heed this warning, the IRS' aggressive stance against micro captives disincentivizes entities to form one, even when they stand to benefit from this type of arrangement for legitimate reasons. There are many misconceptions surrounding micro captives as a result of the "Dirty Dozen" designation, which is why it's important to understand the reasons micro captives made the list. Doing so empowers companies to reap the rewards of micro captives, without touting IRS regulations.



COMMON MYTHS SURROUNDING MICRO CAPTIVES

MYTH #1

THE MAIN GOAL OF A MICRO CAPTIVE IS TO LOWER TAXES

Though tax incentives tend to dominate popular discourse about micro captives, the reality is that this legal aspect is just one small part of the whole picture. There are many reasons why business owners decide to form a micro captive, and the tax advantage is just one of them.

Micro captives became popular because if it is taxed under 831b of the Tax Code, it does not pay tax on its underwriting income. It pays income tax only on its investment income, provided gross annual premiums are \$2.2 million or less. However, there are additional incentives for forming a micro captive, such as improved risk management, control of cash flow, improved control over claims, access to reinsurance markets, and pricing stability. And this list is not exhaustive.

Furthermore, the IRS has acknowledged that micro captives are a legitimate tax structure. Businesses seek to reap many benefits from forming a micro captive beyond tax incentives. A prudently structured and maintained micro captive that's set up for insurance purposes is acceptable in the eyes of the IRS.

MYTH #2

HAVING A MICRO CAPTIVE IS AN INVITATION FOR A TAX AUDIT

Forming a micro captive does not mean that you are guaranteed an audit by the IRS. In reality, the IRS targets entities that abuse the legitimate structure of captives by promoting the tax benefits while ignoring the risk management and distribution functions for which they're meant. It is crucial to work with the right team and captive manager who can ensure that a micro captive is properly formed, structured, and managed. Micro captives set up to act like a true insurance company for a risk management objective and that meet regulatory parameters are significantly less likely to get audited. Taking these necessary steps helps organizations make their case should the IRS audit them.

MYTH #3

INCREASED SCRUTINY MEANS MICRO CAPTIVES AREN'T WORTH THE TROUBLE

Though the bad press around micro captives might make you think this, the reality is that there are still many benefits to be gained from forming a micro captive if you go about it the right way. This is why many companies are currently considering captives for their risks in the face of a hardened insurance market, which is when carriers increase premiums and underwriting scrutiny while reducing coverage limits or even pulling out of certain markets altogether. Though successfully standing up a micro captive might require a lot of time and resources, they are a great alternative to third-party insurers for long-term risk management.

Because the IRS has shown a distaste for captives, anyone considering forming any type of captive needs to take many factors into consideration. Though captives can be extremely useful, they're not the right fit for every situation. Captives are complex entities and businesses should partner with an experienced team capable of carefully planning and operating a successful captive insurance company.

[Connect with our Captives Professionals](#) to learn more about whether a captive is right for your business



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