



## Congress Expands and Tightens Section 831(b) Small Insurance Company Election

By: Christopher M. Flanagan

On December 18, 2015, Congress enacted the Protecting Americans from Tax Hikes Act of 2015, making, among other items, several significant changes to the provisions of Internal Revenue Code Section 831(b), which provides generally favorable tax treatment for electing small insurance companies. Certain of these changes had long been sought by taxpayer advocates, while other changes are aimed at perceived abuses of the system, and will likely significantly curtail the availability of these provisions to many companies. The Act's amendments are effective for the first taxable year beginning after December 31, 2016.

By way of background, Section 831(b) of the Code provides an alternative taxation regime, pursuant to which eligible insurance companies can elect to exclude their underwriting income from taxable income and be taxed solely on their investment income. Prior to this change in law, this election was available only to eligible insurance companies with annual premiums not in excess of \$1,200,000. This \$1,200,000 limitation has been in place since the law's enactment in 1986, and taxpayers have long been advocating for an increase in this amount to better reflect the current environment.

The new law increases this annual limitation to \$2,200,000, and indexes this ceiling amount for inflation beginning in 2016, both very favorable changes for taxpayers, and likely expanding the group of taxpayers eligible to make the election. As an offset to the resulting potential revenue loss, however, the new law adds two limitations to the ability to utilize this alternative taxation regime, targeted in large part at preventing the perceived use of these provisions to reduce the estate and gift tax base. The new provisions require that an insurance company otherwise eligible under and electing to apply the revised Section 831(b) also satisfy either a diversification test (generally showing that no single policyholder (or related group of policyholders) pays more than 20% of the applicable premium base) or an ownership test (generally demonstrating that certain persons related to owners of the insured business do not have an ownership interest in the insurer that exceeds by more than a de minimis amount their ownership interest in the insured business). The Act also authorizes the Internal Revenue Service to require information reporting designed to demonstrate compliance with these new limitations.

As mentioned above, the new changes go into effect for taxable years beginning after December 31, 2016. It is important to note, however, that there is no grandfathering rule in the Act, so that the provisions of the new legislation apply to existing as well as newly-formed companies. As a result, existing 831(b) companies will need to review their structure in light of these new requirements, and may need to make changes in order to continue to qualify for Section 831(b) treatment.

There are certain open issues regarding the applicability of these new rules, and we have almost a year until they become effective. It is likely therefore that there will be further developments on this front over the coming months, which we will monitor.

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