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A Closer Look at Captive Insurance

JUNE 2008 - Captive structures have long been marketed by insurance brokers as a way to control and stabilize the cost of insurance, but these brokers often fail to maximize the benefits of a captive. Captive insurance companies are often overlooked and misunderstood because their costs and benefits are not simple to explain. By understanding the nuances of captive transactions, insurance, economics, and taxation, CPAs can improve the financial advice they offer.

In its simplest form, a captive is a privately held insurance company that insures a business. It issues policies, collects premiums, and pays claims, just like a commercial insurer, but does not offer insurance to the public. Historically, captive insurance companies were only for large corporations: 80% of the S&P 500 use captive-insurance programs. With the enactment of favorable tax regulations and other legislation, however, captives are no longer just for large corporations. Middle-market and family businesses can take advantage of the same benefits.

The concept of enterprise risk management has brought captives to the forefront of risk management practices. As a business owner, the first step is to take a look at the overall risk the business faces and examine risks that are typically insured by commercial property and casualty insurance. One should also consider risks that are already self-insured. A good place to start is by reading property and casualty insurance policies. In fact, most policies exclude the most severe types of risk—those that are potentially catastrophic. Once a business owner has taken inventory of the various risks, he must assess each risk and determine a strategy to address it. When facing a risk, the business can transfer the risk to a commercial insurance company; it can avoid the risk by cancelling the operations giving rise to the risk; or, it can look to alternative risk transfer methods, such as a captive insurance company.

Requirements

While captive insurance companies can be a great financial tool, they are not right for every business. In order to create and operate a successful captive insurance program, the operating company must generally have two or more of the following characteristics:

Profitable operations, with taxable income ranging from $1.5 to $100 million; $250,000 or more self-insured or uninsured business risk; 100 or more employees; and $500,000 or more in commercial insurance expenses.

How a Captive Works

Insurance agents have historically marketed captive insurance to businesses as a way of replacing conventional insurance. But captives can offer even more. Instead of looking at the usual business risks, savvy financial experts consider risks not covered by conventional insurance policies. This raises the question of why a business would want to insure additional risks that it wouldn't otherwise have to. Consider, however, that those additional risks were always there; they were simply risks that were self-insured. In reality, most businesses knowingly—or unknowingly—self-insure an alarming amount of risk, including the following kinds of items:

- Policy exclusions, such as mold and pollution
- High deductibles and self-insured retentions
- Operating risks, such as product recalls
- Credit default
- Loss of key customers and suppliers
- Disability
- Types of insurance unavailable in commercial markets
- Natural disaster
- Construction defects
- Administrative actions

The cost of this "self-insurance" outside of a valid and qualifying captive structure is not tax-deductible. A properly formed and operated captive may, however, deduct insurance premiums that are paid into a privately owned insurance company. Claims are paid with pre-tax dollars. If no claims are made, the captive retains the premiums for future business risks or distribution.

FIN 48

FASB Interpretation (FIN) 48, Accounting for Uncertain Tax Positions, has made it imperative for CPAs to determine if a transaction requires disclosure in a company's financial statements. Guidance provided by qualified experts is the best way to avoid unwanted disclosures that could serve as red flags for IRS auditors. In the absence of private letter rulings or legal opinions from tax professionals, captive owners must carefully analyze a proposed program and view the deductibility of premiums to be paid objectively. Ill-advised captive transactions can expose owners to significant tax liabilities, penalties, and interest.

Expert guidance is costly. A business considering a captive can expect to invest time, resources, and money when evaluating the feasibility of such a program. The formation and start-up costs of a captive insurance program mean that a business must be large enough to have the required risk for the business plan to work, as quantified above.

Favorable Tax Provisions

The cornerstone of favorable captive tax provisions is IRC section 831(b). This provision, designed to encourage the formation of new insurance companies, provides for their alternative taxation (excluding life insurance companies) if a company's direct written (or net written, if greater) premiums do not exceed $1.2 million. A qualifying captive making a valid IRC section 831(b) election can deduct premiums paid to its captive insurance company and pay income tax only on the captive's investment income.

Until 2001, the IRS, looking at parent-captive structures, consistently held that if the insured risk were not transferred out of the "economic family," no risk shifting took place. Without risk shifting, the insurance premiums were not deductible by the parent company. This economic family position would disqualify an otherwise well-managed captive insurance program. After consistently losing this position in the courts, however, the IRS issued pronouncements that restated the service's position regarding captives and provided a favorable basis for captive formation, operation, and management.

Revenue Ruling 2002-89 provided one safe harbor in a captive insurance environment. The IRS reiterated that if a parent's premiums paid to the captive insurer are 90% of the total premiums earned by the captive, and the parent's risks are 90% of the captive's risks, then there is insufficient risk shifting. This would mean that none of the premiums paid by the company to the captive are deductible. The IRS went further and stated that if the risks of the parent were less than 50% of the captive's total premiums and risks, there would be sufficient risk shifting, and premiums would be deductible.

Revenue Ruling 2002-90 created an additional safe harbor. The ruling involved a domestic holding company with 12 operating subsidiaries, each with a significant volume of independent, homogeneous risks. The IRS stated that when each subsidiary has liability coverage for less than 5% and no more than 15% of the total homogeneous risk insured by the captive, the premiums would be deductible.

These IRS rulings, along with others, provide welcome guidance on risk-shifting issues for captive insurers. The rulings constitute a trend, an indication that the IRS recognizes that captive programs can be properly structured for valid business reasons, and premium payments to them can be deductible. The "safe harbors," including those described above, have eliminated many of the gray areas.

Case Study

Several years ago, a national battery manufacturer recalled more than 10,000 of its boat, golf cart, and recreational vehicle batteries because they were found to be potentially dangerous. Product recall is rarely covered under a general liability insurance policy; in fact, it is often explicitly excluded, as had happened in this case. The manufacturer paid for the recall out of its retained earnings.

Since that time, the battery manufacturer has structured a captive to insure product recall, product liability, and other related risks. In order to comply with Revenue Ruling 2002-89, the manufacturer's captive is required to have greater than 50% of its risk from independent third parties. The captive does this by participating in a risk pool for a proportion of the risk it accepts from the operating company. A risk pool helps its captive clients achieve requisite compliance and risk distribution.

Additional Ideas to Consider

In addition to giving a business better control over its insurance costs, a captive program can provide the following benefits:

- The deduction of insurance premiums that flow tax-free to the captive, where they accumulate on a pre-tax basis in anticipation of future claims;
- The ability to distribute underwriting profits to shareholders as dividends or upon liquidation;
- Ownership by a family trust, LLP, FLP, or other entity for the benefit of future generations; and
- The ability to give key employees restricted ownership in the captive, in order to provide an increased incentive to manage risk effectively and reward loyalty.

Furthermore, captive insurance companies can be a powerful year-end planning tool because insurance premiums are deductible and insurance companies receive favorable tax treatment.

Risks and Rewards

The Internal Revenue Code, related IRS rulings, and case law all support the use of captive insurance companies to manage risk. When properly employed, the use of a captive insurance strategy can help businesses better manage insurance costs, control claims, accumulate surplus in anticipation of unforeseen risk, and allow for the accumulation of wealth on a tax-deductible basis.

Companies and their advisors must be thorough when exploring a captive program. Programs vary greatly, are complex to understand, and can result in significant tax and economic detriment. Any company considering a captive should carefully analyze the risks and rewards with its advisors.