Forming a Captive Insurance Company? Understand the Business and Tax Implications

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Many U.S. companies have formed captive insurance companies to achieve significant benefits, but the decision whether to form a captive is often clouded by misconceptions and a failure to recognize both the business and tax implications involved. This article reviews the most common business reasons for forming a captive and examines the various types of captives that can be formed. It also discusses the critical business and tax questions that must be weighed to determine the proper ownership, domicile, and corporate structure of a captive insurance company, particularly as they relate to third-party risk, captive tax implications, and insurance regulatory issues.

Captive Insurance Company Basics — A Changing Picture

For many executives, the term "captive insurance company" still has some negative connotations. In the past, captives often were regarded primarily as tools for providing problem coverage or coverage not readily available in the commercial market. Today, captives offer other advantages, particularly after several revenue rulings by the Internal Revenue Service in 2002 provided guidance on the tax treatment of captives.

A captive insurance company is a legally licensed limited-purpose property and casualty insurance company. A captive's main business purpose is to insure the risks of its owners or the companies affiliated with its owners. Captives can be formed by any type of business — financial institutions, manufacturers, construction companies, and automobile dealerships, to name only a few of the most common ones.

A captive can provide virtually any type of insurance, as long as the laws of the state or country in which it is domiciled (*i.e.*, incorporated, licensed, managed, and operated) allow the line of business to be underwritten. Some of the most common types of insurance captives offer are:

- Builders' risk
- Contractors' professional liability
- Pollution
- Directors' and officers' liability
- Cyber security
- Professional liability/error and omissions
- Fiduciary liability
- Crime
- Property damage/business interruption
- Automobile liability
- General and umbrella liability
- Workers' compensation (reimbursement)
- Employment practices liability

The types of coverage captives offer continue to evolve. For example, faced with rising employee health care costs, some companies have recently begun incorporating employee benefits programs into captive insurance companies.

Business Reasons for Forming a Captive

A common misconception about captive insurance companies is that they are formed primarily to secure certain tax benefits, particularly the ability to accelerate the deduction for losses. This advantage over self-insurance or a simple rainy-day fund is significant because the premiums paid to the captive insurance company generally are a deductible business expense to the company that formed it and thus accelerates the deduction of future losses.

Tax considerations alone, however, should not be the primary reason for forming a captive. Instead, relevant business considerations should drive the decision. Although the relative importance of these considerations varies with each situation, there are some significant factors that can influence the decision to form a captive.

1. Improved Risk Management and Risk Financing

A captive insurance company can be a highly effective tool for gaining better control of an organization's risk-management and risk-financing functions. A captive can enhance the overall organizational view of risk management and provide valuable ways to identify and quantify risks, both insured and uninsured. Forming a captive also can help management demonstrate to the board of directors, audit committee, and relevant regulators that the company is pursuing a prudent and transparent approach to risk management at various levels of the organization.

2. Lower First-Dollar Insurance Costs

Another common misconception about captives is the belief that their primary use is to replace existing commercial coverage. This is true in some situations, but more commonly, the captive is used to augment existing commercial insurance, especially by providing first-dollar coverage for losses. When a captive is available, most companies use it to provide coverage for selected commercial policy deductibles.

For many companies, a captive also offers the opportunity to reduce the cost of commercial policies by increasing deductibles to reduce premiums. Since the captive has the flexibility to insure any risk it chooses and to customize the terms and conditions of its policies, many companies are able to use a captive to take better advantage of their positive loss history or their relatively high tolerance for certain categories of risk.

3. Plugging Gaps in Commercial Insurance Coverage

Every company has gaps in its insurance coverage. Historically, many companies simply self-insured any risks that were excluded from commercial polices. Today, forming a captive allows businesses to plug gaps in their commercial policies by writing coverage the conventional market is unable to offer at an affordable rate or unwilling to offer at all.

Exhibit 1: Internal Risk without a Captive

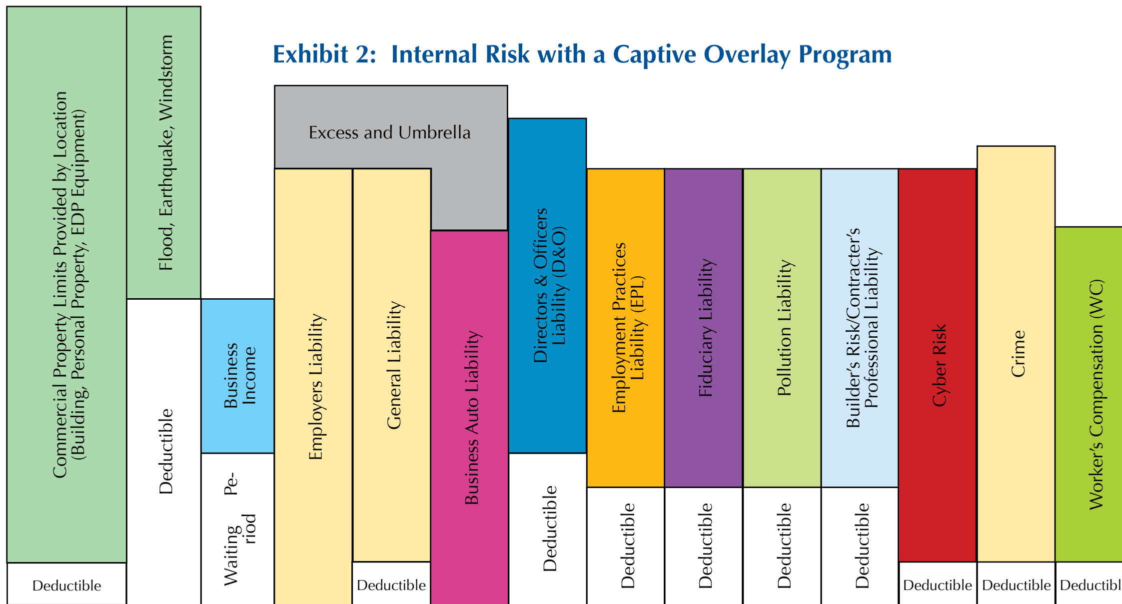

Exhibit 2: Internal Risk with a Captive Overlay Program

For example, business interruption from commercial carriers often is offered only with numerous exemptions. A captive policy can be written to overlap the commercial policy and fill in those gaps. Captive policies also commonly insure against cyber risk, workplace violence, fraud and other crimes, directors' and officers' liabilities, and employment office liability.

In addition to plugging gaps in existing policies, captives often are used to cover deductibles or to add coverage above the limits on an existing commercial policy, as illustrated by the nearby exhibits.

The first exhibit illustrates the gaps in a hypothetical company's existing insurance program. The second demonstrates how a captive insurance company can be used to manage risk, adding protection where commercial coverage either is unavailable or would be prohibitively expensive without limits.

In the example presented in the exhibits, the captive is used to provide first-dollar coverage for deductibles and waiting periods imposed by commercial policies and to add excess coverage above commercial policies' limits. It is also used to provide supplemental coverage for risks, such as pollution liability coverage, that are not covered by the company's commercial policies.

In contrast, the captive does not provide coverage in areas where existing coverage is considered adequate or where the owning company is able to tolerate greater risk exposure, such as crime losses or workers' compensation coverage.

4. Improved Cost Control and Internal Cost Tracking

If operated efficiently, a captive insurance company can reduce costs by absorbing the markup inherent in most commercial insurance coverage. In addition to controlling commissions, administration, and other overhead costs, a captive can establish claims-handling policies and procedures that are specifically tuned to match the

operating company's requirements. Tracking and documentation are thereby enhanced, which increases the company's control over claims processing. A captive can also improve internal cost tracking, allowing premiums and costs to be allocated across various subsidiaries and operating divisions.

From a broader perspective, a captive also is useful for promoting greater awareness of specific risk factors that commonly lead to losses. This awareness is a necessary first step toward developing appropriate safety policies and procedures, and it can pave the way for developing safety incentives that can further reduce losses.

5. Creating a Profit Center

A captive can offer a company the opportunity to generate additional profits by diversifying into the open market to offer insurance coverage to unrelated customers. For example, a tool manufacturer formed its own captive to insure the inventory maintained in the trucks of its independent distributors. Because they understood the risks better than other insurance carriers and could control them more effectively, the manufacturer and the captive insurance company were able to offer lower-cost coverage and eventually create a significant new profit center for the manufacturer.

6. Gaining Access to the Reinsurance Market

Because a captive is a fully licensed insurance carrier, it generally is able to gain direct access to reinsurance providers that underwrite the captive's risk. This access spares the company commissions and profit margins that are built into the process when reinsurance is attained through a commercial carrier.

The savings associated with eliminating these costs typically outweigh the incorporation fees, legal expenses, and other start-up costs involved in establishing a captive. This direct access to the reinsurance market is often the principal factor that induces companies to form a captive.

7. Added Estate Planning Flexibility

Another often-unrecognized benefit of a captive is the opportunity to transfer capital and value to a new generation of owners. This transfer is possible because the ownership of the captive does not have to match exactly the ownership of the operating company. In fact, depending on the needs of the estate, a captive can be held by a completely different ownership structure.

For example, a captive can be wholly owned by the second generation, so when premium income flows to the captive it in effect transfers wealth to the next generation while also building a large capital reserve. Alternatively, a captive can be owned directly by a trust, or parents and children can share ownership of the captive by forming a corporation or partnership.

Ownership Structure and Risk Management Issues

A commercial insurer spreads its risk over a diverse group of customers or by insuring against a variety of categories of unrelated risk so that a catastrophic event in one area does not threaten the solvency of the insurer. For many captives, however, the methods available for mitigating risk might be limited.

For a captive to qualify for tax treatment as an insurance provider, the IRS requires it to pass specific risk-shifting and risk-distribution tests, as defined in a series of 2002 revenue rulings. In addition to requiring that at least 50 percent of the captive's income be derived from insurance, these revenue rulings spell out several types of ownership scenarios for a captive insurance company:

Pure, Single-Parent Captive

When a captive insurance company is owned by a single parent company, one of two types of safe harbor ownership structures can be used to spread the captive's risk exposure:

1. Unrelated Business

This safe harbor structure is defined in Rev. Rul. 2002-89, 2002-2 C.B. 984. Although the parent company or primary shareholders own 100 percent of the captive, they do not account for all of the captive's risk exposure. Instead, more than 50 percent of the company's homogeneous risk exposure must be derived from insuring third parties.

A common example is the extended warranty business of an automobile dealer or manufacturer in which individual warranty holders account for more than 50 percent of the captive's risk exposure. In such cases, only certain types of extended warranty programs may qualify as acceptable third-party risk for tax purposes. For example, the warranties sold must be optional, not required by law, and warranties that cover either scheduled or routine maintenance may not be considered. Warranty contract language should be reviewed carefully to verify that the extended warranties being offered meet these requirements.

These types of captives also are common in the construction industry, where general contractors may meet the third-party risk exposure requirement by collecting certain insurance premiums.

Other sources of risk can be used to meet the 50-percent third-party risk exposure requirement. These include independent contractors, employee benefits programs, and other businesses with which the owning company does business.

The 50-percent threshold is a bright-line IRS test. There have been some court cases, however, that resulted in companies' being permitted to operate captives with third-party risk that was less than 50 percent.

Rev. Rul. 2002-89 specifies that the captive must charge its owners arm's-length premiums, which are established by customary rating formulas. It also implies that no parental or related-party guarantees should be made in favor of the captive and that no loans should be made from the captive to the parent or any insured subsidiaries.

2. Brother-Sister/12-Entity

This safe harbor structure is detailed in Rev. Rul. 2002-90, 2002-2 C.B. 985. In this ruling, a captive insurance company is completely owned by a holding company. This holding company also owns 100 percent of at least 12 affiliated C corporations, which are the captive's customers.

Although the original revenue ruling specifies that the captive's customers must be C corporations, subsequent IRS guidance opened the door to allow additional types of businesses to participate as captive customers under the 12-entity scenario. What is essential is that each of the businesses must not be a disregarded entity for tax purposes. The revenue ruling specifies that the liability coverage for each of the subsidiaries must account for at least 5 percent, but no more than 15 percent, of the total risk insured by the captive.

This type of structure often is used by small or family-held businesses, or by closely related groups such as a corporation with at least 12

subsidiaries. As with the 50-percent threshold, there have been court cases allowing captives to insure fewer than 12 affiliated subsidiaries.

As with the unrelated business scenario, the captive must charge all the related subsidiaries arm's-length premiums established by customary rating formulas. Rev. Rul. 2002-90 also implies that no parental or related-party guarantees should be made in favor of the captive, and that no loans should be made from the captive to the parent or any insured subsidiaries.

Group or Pool Captive

Companies unable to meet either the unrelated business requirements of Rev. Rul. 2002-89 or the 12-entity test of Rev. Rul. 2002-90 may choose instead to take advantage of the group captive structure defined in Rev. Rul. 2002-91, 2002-2 C.B. 991.

In this type of structure, a group of unrelated and independent entities each form their own wholly owned captive insurance company, and each captive directly insures the risks of its affiliated owner. In order to provide adequate risk shifting and distribution, the unrelated captives then purchase reinsurance policies from the other captives in the pooled structure.

This form of captive ownership is popular with a broad range of industries such as restaurant chains, manufacturing, financial services, and virtually any type of business that has fewer than 12 independent subsidiaries.

Other Captive Structures

Other types of captive ownership structures are also possible. These include association captives formed and owned by members of an industry or trade association to share the risks of the group and segregated cell captives and risk-retention groups, which allow members that engage in similar or related businesses to pool only their liability insurance.

Captive Tax Implications

Once a captive meets the income, risk-shifting, and risk-distribution tests set forth in the relevant IRS revenue rulings, it can qualify as an insurance company, which allows the owning affiliate to accelerate its deduction from the time loss occurs to the time of the premium is paid.

For the captive insurance company itself, there are additional federal income tax questions to be addressed, depending on the amount of premium income the company receives. Based primarily on income, two general types of single-parent captive insurance companies exist: traditional and section 831(b).

1. Traditional Captive Insurance Company

If gross premiums exceed $1.2 million, the parent may establish a traditional captive insurance company. In such a situation, the premiums paid by the parent are tax deductible. The captive is taxed on its premium income, but it gets a deduction for the actuarially determined reserve requirement it must meet, which means the captive pays tax on a smaller portion of the premium income.

This arrangement provides consistent coverage, stabilizes earnings, and allows the captive to earn investment income and realize underwriting income while qualifying for a tax deduction for discounted losses and loss-adjustment expenses.

2. Section 831(b) Election

When the gross premiums paid to the captive do not exceed $1.2 million annually, the captive may make an election under section 831(b) of the Internal Revenue Code. Under this election, the captive's premium income is exempt from federal income tax, and it is taxed solely on its investment income. This option can result in a potential annual tax reduction approximating $400,000.

This $1.2 million threshold refers to all property and casualty premiums within a controlled group. Only one section 831(b) election is permitted in a controlled group, so a captive cannot be split into two companies in order to stay below the $1.2 million premium level. Once property and casualty premiums for the group exceed $1.2 million, the entire section 831(b) election is lost, and all income is taxed under traditional captive insurance company provisions.

Recent Tax Legislation

Recent legislation has also affected captive insurance companies. For example, one of the provisions of the *Health Care and Education Reconciliation Act of 2010* was the codification of the "economic substance" doctrine in section 77019(o) of the Code. Under this new provision, a transaction — such as the formation of a captive — is deemed to have economic substance only if 11) it changes the taxpayer's economic position in a meaningful way other than its federal income tax consequences, and (2) the taxpayer has a substantial business purpose, beyond any potential federal income tax savings, for entering into the transaction.

Several provisions of the *Foreign Account Tax Compliance Act of 2010* also might affect foreign-based captives. One of these provisions is a potential 30-percent withholding tax on payments to nonfinancial foreign entities with substantial U.S. ownership. FATCA should be reviewed carefully if a company plans to establish a captive insurance company that will be domiciled in a foreign jurisdiction.

In September 2010, the U.S. Department of the Treasury proposed new regulations regarding the classification and tax treatment of domestic series limited-liability companies, domestic cell companies, and foreign series or cell companies that conduct business as insurance companies. Currently, many foreign-based cell captives are not deemed to be controlled foreign corporations (CFCs) because the owner of the cell does not own a sufficient amount of stock in the overall corporation to trigger the deemed Subpart F income provisions that apply to a CFC. In addition, many cell captives are currently structured so that they meet the risk distribution rules only at the corporation level and not at the cell level.

If these regulations are finalized as currently proposed, the risk distribution and ownership tests will be applied at the cell level. This could result in a captive's being deemed a CFC and the captive's losing its status as an insurance company for federal income tax purposes. As a practical matter, however, these proposed regulations could be changed before being finalized. For the time being, companies should simply be aware of the possible future changes and understand how they might comply with the proposed regulations if they take effect.

Taxation of Captive Dividends

For captives that are domiciled in the United States, the taxation of dividends paid to the parent company or companies is the same it will generally be for any other corporation. If the captive is included

in a consolidated return, there is effectively no tax on the dividend because dividends paid by a captive to its parent should qualify for the dividend-received deduction (DRD) for a U.S. corporation. Dividends from foreign captives are subject to different rules, which could make these issues more complex for foreign captives.

Domicile-Related Tax Questions

Deciding where a captive will be incorporated and based can raise some significant tax questions, particularly if the captive is domiciled outside the United States. A foreign captive is subject to direct U.S. taxation if it is doing business through a permanent establishment in the United States. An agent in the United States is considered a permanent establishment for this purpose, unless the agent is both economically and legally independent from the captive. In general, such a captive is subject to U.S. corporate income and branch profits tax.

Under section 953(d) of the Code, a foreign-based insurer may elect to be taxed as a U.S. domestic corporation, thus avoiding branch profits tax concerns and federal excise tax as well as some operating restrictions. When capital requirements and expenses are lower than those for domestically based captives, this option provides more favorable tax treatment for the foreign-based insurer.

If a foreign-domiciled captive does not make the section 953(d) election, its premiums are subject to federal excise tax, which applies to any premiums paid to non-U.S. insurers by U.S. persons for risks wholly or partly in the United States. The excise tax requirement does not apply to premiums paid to foreign-based captives that have elected section 953(d). The federal excise tax rate is four percent of gross premium for direct insurers and one percent of gross premiums collected for life insurance or reinsurance policies.

Other Domicile Questions

Beyond tax questions, the domicile of the captive can be affected by multiple regulatory and operational issues. Even for U.S. captives, these factors enter into the domicile decision:

- **Regulatory environment.** Some states are more responsive than others to the concerns of companies seeking to establish a captive insurance company.
- **Operating costs.** These include annual fees, upfront costs, and taxes on premiums, which vary considerably from one jurisdiction to another.
- **Meeting requirements.** It is common for a jurisdiction to require the captive to conduct an annual meeting where the entity is domiciled.
- **Geographic convenience.** It makes sense to establish a captive in a location that is easy to reach by plane and has similar business hours.
- **Investment requirements.** Some domiciles have less restrictive requirements while others require that policyholder surplus be held in cash or U.S. government or exchange obligations.
- **Capitalization requirements.** Most U.S. domiciles require an initial capitalization of at least $200,000 to $250,000 for pure captives. Minimum solvency requirements typically call for a premium-to-surplus ratio of between 3-to-1 and 5-to-1, on both a gross and net basis.
- **Other operational issues.** Companies must consider issues such as the availability of high-quality professional services and a well-developed legal environment, along with a strong local infrastructure to assist in the day-to-day operations. When considering a foreign domicile, consideration should also be given to practical questions such as compatibility of language, currency, laws, and customs as well as the general economic, political, and social stability of the country.

For both foreign and domestic domiciles, one useful indicator is the relative number of licensed captives already domiciled in the jurisdiction. A relatively large number of licensed captives indicates the jurisdiction is committed to providing appropriate infrastructure, responsiveness, and a captive-friendly regulatory environment.

Operating the Captive

It is important that the captive be managed, operated, and regulated as a legitimate insurance company in order to avoid triggering potentially adverse tax and financial reporting issues. In other words, the captive must be established to meet a valid business purpose — not merely for a tax advantage.

In addition to meeting the capitalization requirements of its domicile, a captive insurance company must receive its premiums on a current basis. It must issue actual policies and pay losses and claims according to those policies. Simply put, the captive must pass the "look, act, and feel" test of an insurance company.

Operating a captive insurance company also can raise certain regulatory and financial issues, which can vary from one industry to the next. For example, although captives are common in the construction industry, they can have an unintended effect on a contractor's bonding capacity because the capital needed by the captive is removed from the contractor's balance sheet, causing the contractor to appear weaker to the surety. Industry-specific considerations such as these should be taken into account when forming and operating a captive.

Weighing the Pros and Cons

Forming a captive insurance company has a major influence on the parent company's risk-management strategy as well as a potential impact on its cost and internal control structures. Revenues and succession planning can also be affected.

When considering whether to form a captive, answers to critical business and tax questions must be weighed carefully to determine if a business case can be made and, if so, what the best ownership structure, domicile, and corporate structure would be.

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