

Captive Insurance Companies

An Opportunity for Closely Held Businesses

By Robert E. Bertucelli

The economic crisis of the past few years has caused many closely held businesses to reexamine both their costs and their opportunities to build on their financial success of the past. One such opportunity that has already been seized upon by larger companies—the captive insurance company—is now available to many family-owned enterprises. Although this concept is not new, recent legislative changes have made it more broadly appealing. At a time when expenses are coming under greater scrutiny, the creation of a captive insurance company provides an opportunity not only for current tax planning but also for liquidity and estate planning that will benefit successful business owners and their families.

One of the necessary costs of operating a business is insurance to cover the risks associated with that enterprise. The risks may be varied, such as product liability coverage, fire, theft, professional liability, and business interruption. No matter the risk, there is usually an insurance company that will be willing to underwrite that coverage if the premium is adequate. If an insurance company is not comfortable in assuming the entire risk, it can acquire reinsurance coverage, where the underlying risk is partially transferred to another insurance company. Inherent in the insurance process is the transfer of risk to the insurance company in exchange for the premium payment. Adequate reserves are maintained by the insurance company to allow for payment of the specified policy coverage should the risk mature.

A business owner—or his financial advisor—might realize that the profit the insurance companies are making comprises a



large part of the insurance premiums. For an entrepreneur whose claim history on various insurance policies has been so modest as to cause him to view his insurance program as a necessary evil, now there is a technique that may provide economic benefits far surpassing the risk transfer that insurance was designed to provide.

Definition of a Captive Insurance Company

A captive insurance company is an entity created by a closely held business or its owners to provide insurance coverage for its operations. The insurance that the captive underwrites can include risks that are presently being covered by an independent insurer.

ance company or that are presently self-insured by the operating companies. The insurance premiums that are paid to independent insurance companies are generally deductible under Treasury Regulations section 1.162-1, while self-insured risks do not result in any tax deductions until they are paid to a third party (Revenue Ruling 79-338, 1979-2 CB 212). The captive that is formed is usually a corporation, although other business entities, such as LLCs, may be used. For tax purposes, the insurance entity needs to be taxed as a C corporation, but an LLC or another form of partnership can qualify if an election is made under Treasury Regulations section 301.7701-3(a).

There are a number of different types of captives, including the following:

- Single-owner captive, also referred to as a “pure captive,” which insures only the risks of the owner or the owner’s subsidiary operations (definition from www.vermontcaptive.com);
- Group captive;
- Association captive;
- A risk retention group (RRG);
- Reciprocal;
- Sponsored captive; and
- Branch captive.

Because the vast majority of captives in the United States are of the single-owner variety and because this type can potentially provide economic benefits, this article will focus on that category.

Benefits of Establishing a Captive

The benefits from such an arrangement can be significant, not only from the perspective of the business enterprise itself but also at the shareholder level.

Minimization of insurance cost to the business. The use of a captive insurance company allows the business to pay the calculated insurance premiums to the captive based on the company’s risk needs, as opposed to the insurance company’s profile. The profits inherent in the insurance premiums will now remain with the captive and accrue over time, allowing for the investment of those profits at favorable tax rates. Likewise, the premiums will be stabilized and not be subject to market fluctuations so often seen in commercial premiums. The flexibility remains with the business to transfer only those risks that can be borne with economic prudence.

The business can control its risk more efficiently. The business controls the claim process through its captive, thus eliminating delays, costly denials, and any outside influence on its risk management process. The company can structure its insurance program to provide only the coverage it needs in the amounts it desires without restrictions dictated by the marketing needs of the insurance companies. The captive can then avail itself of lower cost reinsurance if the risk in a particular area exceeds its risk tolerance.

The business can improve its cash flow. The premium payments made to the captive could be less than comparable insurance premiums to an outside insurance company. In addition, under the provisions of IRC section 832(b), the captive will generally pay no federal income tax on premium income up to \$1.2 million per year, thus allowing for the rapid accumulation of profits and investment income. The investments made by the captive may provide some liquidity and financing for the parent entities in future years. If prudent, the captive could pay dividends to its shareholders, which in today’s tax environment would receive favorable tax treatment by virtue of a 15% tax rate.

The captive can provide for family wealth accumulation. The ownership of the captive insurance company can be held by the family members of the shareholders of the business, allowing for wealth transfer without resulting gift or estate tax liability. The valid use of a separate taxable entity, such as the captive, also protects the assets of that entity from the reach of the creditors of the business.

The parent corporation may be able to obtain an indirect tax deduction for otherwise nondeductible, nonqualified deferred compensation. It can do this by having key employees of the parent share in the stock ownership of the captive. Upon the retirement of these key employees, their stock in the captive could be redeemed, perhaps using an installment note. That would allow the captive to make a stream of payments to the redeeming shareholders and have their gain taxed at capital gains rates.

The process of establishing and running a successful captive insurance arrangement is not simple and requires the services of a number of experienced professionals, such as actuaries, attorneys, accountants, and managers. Thus, there will be operating expenses both at the inception of the captive as well as on an annual basis to make sure that the captive is operating as a valid insurance entity. These costs will usually limit the availability of these arrangements to the more successful, established enterprises with a solid track record of profitability and cash flow and where the risks to be transferred are more easily defined. See *Exhibit 1* for a list of the types of risks that can be insured by a captive insurance company.

Tax Aspects

In order to produce the benefits described above, the captive insurance company must qualify for favorable treatment as a small insurance company under the provisions of IRC section 831(b). This elective section provides that there will be no tax on the premium income of a small insurance company for any year in which its premium income does not exceed \$1.2 million. Any

EXHIBIT 1 What Coverage Could Be Provided by a Captive?		
Financial	Traditional	Nontraditional
Equity risks	Property risks	Price volatility
Currency risks	Liability risks	Inventory risks
Interest rate risks	Casualty risks	Warranty risks
Commodity risks	Employee benefits	Environmental risks
Credit risks	Business interruption	Catastrophic risks
Investment risks	Workers’ compensation	Employment practices

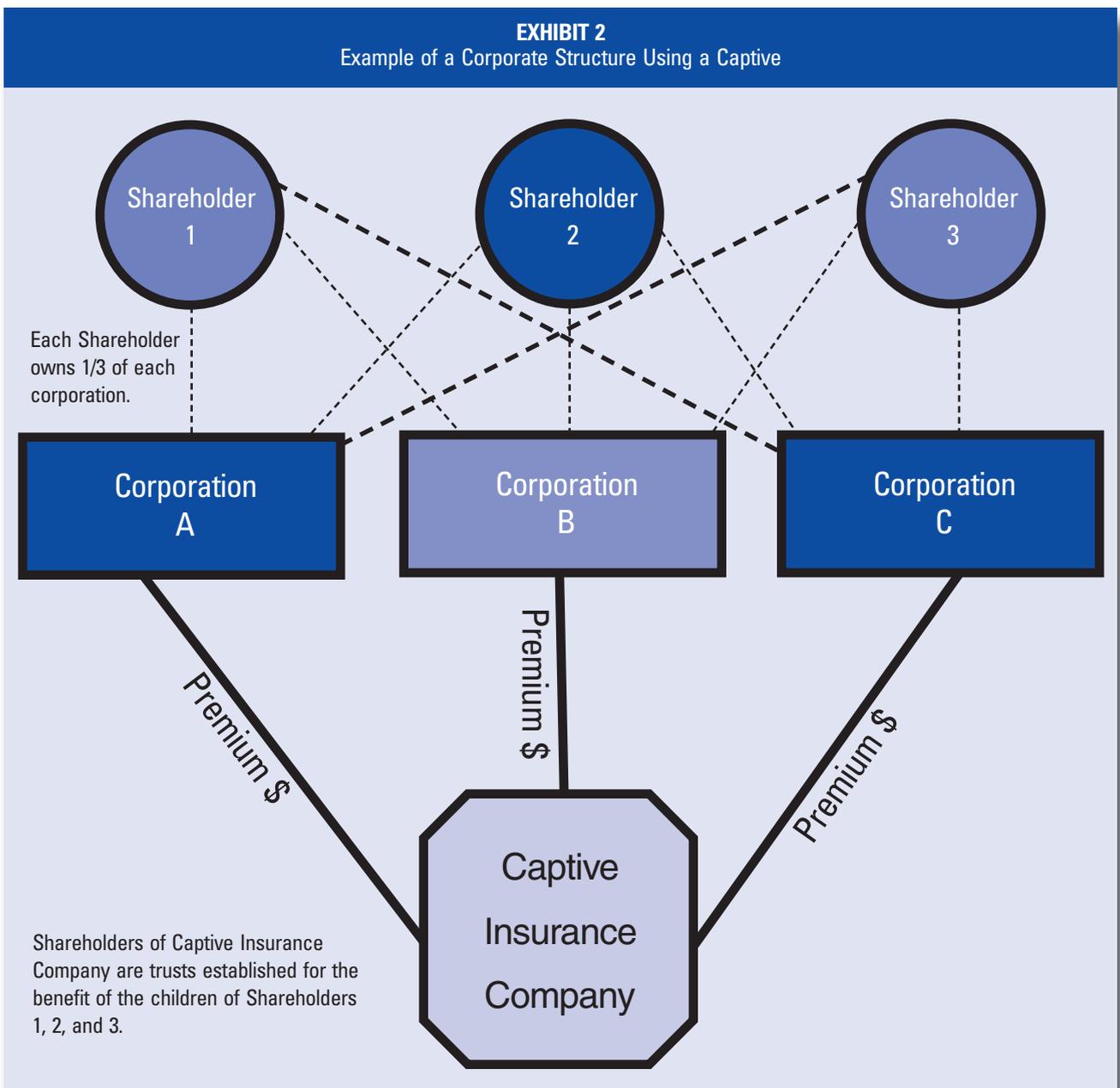
investment income of the captive will be subject to tax at the regular corporate tax rates. Because an insurance company is defined under IRC section 816 (a) as a company where more than 50% of its business activities must be composed of issuing insurance or annuity contracts or reinsuring risks underwritten by insurance, it is critical to monitor the level of a captive's investment activities, lest it lose its status as an insurance company.

The effective use of a captive insurance company is based in large part on the valid-

ity of the insurance arrangement between the business entity and the captive. Interesting, however, is the fact that neither the IRC nor the regulations define "insurance" or "insurance contract." The U.S. Supreme Court, however, has explained that in order for an arrangement to constitute insurance for federal income tax purposes, both risk shifting and risk distribution must be present (*Helvering v. LeGierse*, 312 U.S. 531 [1941]; Revenue Ruling 2002-90, 2002-52 I.R.B. 985 [12/30/2002]). Likewise, the relationship

between the parent company and related entities and the captive insurance company must be recognized as a true insurance relationship. This is the area that was addressed in *Humana Inc. v. Comm'r.* (881 F 2d 247 [6th Circuit, 1989]), a case that is often cited as the advent of the captive insurance company trend that we now enjoy. Thus, it is necessary that the relationship result in true risk transfer and risk distribution among the entities involved. Recent revenue rulings have elaborated on this requirement as follows:

EXHIBIT 2
Example of a Corporate Structure Using a Captive



■ Revenue Ruling 2002-90 discusses the payment of insurance premiums by 12 operating subsidiaries to a sister captive insurance company. In the opinion of the IRS, the providing of insurance by the captive to 12 different entities resulted in adequate risk transfer and risk distribution so as to constitute a valid insurance arrangement.

■ Revenue Ruling 2002-89 addresses the need for risk distribution in order to validate the insurance arrangement. The ruling indicates that the insurance premiums earned by the captive must be primarily from nonparent sources in order to establish a sufficient risk distribution. Although the two situations discussed in this ruling—90% from the parent being too high and less than 50% being okay—indicate different results, the question remains as to whether or not some middle ground—say, 67%—would be adequate as well. For safety's sake, since the ruling does confirm the acceptability of less than 50%, that would be a conservative planning guideline.

■ Revenue Ruling 2005-40 elaborates on the requirement that a valid insurance arrangement requires a distribution of risk. This ruling includes several examples that help to demonstrate a few of the insurance requirements mentioned above. It states that if the parent entity represents the source of a majority of the premiums earned by the captive, the distribution of risk has not occurred. This is true even if, nominally, the insurance is written between the captive and single-member LLCs established for valid nontax purposes by the parent. The use of disregarded entities will cause the apparent distribution of risk to be disregarded as well, because the risk would be deemed to be that of the parent company alone and not that of the separate LLCs. If those single-member LLCs were to elect—under Treasury Regulations section 301.7701-3(a)—to be taxed as corporations, the payment of premiums to the captive would result in sufficient distribution of risk and the desired result could be achieved.

■ Revenue Ruling 2007-47 describes a company that operates in a manner that is harmful to people and property. Government regulations require that upon cessation of business, the company must restore its business property to its original healthy state, requiring it to spend signifi-

cant sums of money. The liability to pay the associated costs involved was uncertain only as to its amount and timing. The company attempted to insure against such future liability by paying premiums to a captive insurance company. The IRS held, however, that any risk that is virtually certain to occur cannot be the essence of a valid insurance policy as used in a captive structure, because the insurance risk or fortuity is missing.

At some point, the captive's managers may want to distribute some of the accumulated investment income to the shareholders of the captive. These distributions will constitute qualified dividends eligible

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for the current 15% federal tax rate on dividend income if paid from current or accumulated earnings and profits as described in IRC section 301. Likewise, if the stock of the captive were to be sold or liquidated, the proceeds of the distribution to the shareholders would qualify for capital gain treatment under sections 331 or 1221.

The state taxation of captives is dependent on the state or states in which the captive is doing business. Some states, such as New York, assess a tax on the premiums paid by their taxpayers to an unauthorized insurer if the insured risks are wholly or partially located within their state

(NYS Tax Law section 1551). In New York, this tax is paid on Form CT-33-D at a rate of 3.6% of the premiums allocated to risks within New York State. Although the tax represents an additional cost of implementing the captive strategy, it certainly does not outweigh all of the other potential benefits.

The tax aspects of using a captive insurance company are complex and are still evolving through rulings and case law. Therefore, the use of an experienced insurance advisory firm, both at inception and throughout the operation of the captive, is highly encouraged.

Implementation

If a company's owners decide that a captive may make sense for their enterprise, the course of action they should pursue is as follows:

■ Discuss with a reputable insurance consulting firm which state would be the most appropriate in which to form a captive insurance company. Some states are more receptive to captives than others, and the state regulation of captives may cause significant operating cost differences based on that selection.

■ Once the state has been selected, a law firm as well as an accounting firm with experience in the application and qualification of captives in that state should be selected and retained. The accounting firm selected should be approved by the insurance department of the selected state.

■ In coordination with the insurance consulting firm, law firm, and actuary, a feasibility analysis and business plan should be prepared, most of which will be incorporated into the insurance company application to the selected state.

■ Once approved, the law firm, actuary, and accountant will need to be retained to provide necessary professional services on an annual basis. In most states, the financial statements of the insurance company will need to be audited by the accounting firm. In addition, the captive should have professional investment advisors to assist with the investment of the insurance reserves as well as the profits of the captive company.

Example

To obtain a greater appreciation of the power of this planning tool, consider an

example of how this arrangement would work. In *Exhibit 2*, a simple corporate structure is described wherein three shareholders have ownership of three related entities. For purposes of this example, assume that one of the entities is an operating company, another entity leases equipment both to the operating company as well as to its customers, and the third entity holds the title to real estate that may or may not be used in the operations of the other two entities. This example uses corporations as the type of entities involved; however, there is no restriction on the use of any business entity, with the exception of the captive insurance company, which must be taxed as a C corporation, even if it is not formally a corporation by structure.

The equity ownership of the captive provides a fertile planning opportunity for the three shareholders mentioned above. One of the more effective structures will have the equity of the captive held by trusts established for the benefit of the children of the shareholders. In this way, the earnings of the captive will accumulate for the benefit of these beneficiaries, with no transfer tax costs such as federal or state gift or estate taxes.

As can be seen in *Exhibit 3*, the premium and investment income of the captive generally far exceeds the costs incurred on an annual basis and thus provides ample

investment funds to accumulate year to year. Note also the small amount of tax shown in this exhibit. As already mentioned, if eligible and elected, the captive will pay tax on its investment income but there will be no federal tax on its premium income.

One may ask how this amount of profit could possibly be realized on a year-to-year basis and still be allowed for tax purposes. In this regard, in exchange for the premium income it receives, the captive has assumed the risks outlined by the insurance contract for the year. Once the year has expired and the risk has not matured, the premiums paid become part of the earnings of the captive. In the early years of a captive's existence, if the assumed risks are in excess of the captive's asset base, the insurance managers may recommend the use of reinsurance policies whereby the excess risks are transferred to another insurance company. This process highlights the need for a knowledgeable and efficient insurance manager.

The prudent investment of these premium funds, coupled with efficient management of the insurance operations, should result in a significant growth potential for the captive. If the net income of the captive remained constant, as depicted in *Exhibit 3*, the investment fund after five years of operation would have grown to

in excess of \$4.5 million. This money, as it's accumulating, could be used to make appropriate investments, which might, in turn, enhance the operations and value of the operating companies.

Results

Captive insurance companies, long favored by *Fortune* 100 companies, are now viable planning opportunities for smaller, closely held but successful business entities. The proper use of a captive insurance company arrangement should result in the following:

- Tax deductions being generated for the successful operating and related companies;
- Regular cash inflows into a captive, with most of its revenue sheltered from taxation by the provisions of a favorable federal tax law;
- The accumulation of liquid resources by the captive, allowing for the creation of a significant investment program;
- The ability to transfer family wealth to family beneficiaries without the imposition of any federal or state transfer taxes;
- The ability of the operating entities to stabilize and even reduce the costs associated with their insurance coverage needs;
- With proper structure, the captive could produce a source of deferred compensation to the shareholders and their families, without the need to include any other employees or groups;
- The captive could also provide a source of interim or long-term financing for the related entities, if the requirements of a properly managed investment program are adhered to;
- The ownership structure flexibility of a captive provides for a means of asset protection in the case of litigation.

The benefits of such a planning tool could significantly outweigh any costs or administrative burdens associated with its creation and operation. Thus, it should be considered and reviewed for those entities that can benefit from it. □

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EXHIBIT 3 Income from a Captive

Revenue:	
Premium income	\$1,000,000
Investment income	15,000
Total revenue:	\$1,015,000
Expenses:	
Claims processed and paid	50,000
Professional fees	50,000
Administrative expenses	25,000
Miscellaneous expenses	10,000
Total expenses:	135,000
Income before tax	880,000
Income tax:	1,000
Net income:	\$879,000