

Captive Insurance Companies

A Common Sense Approach to Improved Risk Management

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Although many believe that captive insurance companies are a relatively new phenomenon, the captive insurance industry can be traced back to the 19th century. Today, nearly all *Fortune* 500 companies and thousands of midsized companies maintain captive insurance companies, and this author believes the captive insurance industry will continue to evolve as companies continue to face multiple threats to their survival on multiple fronts. Commercial insurance companies are struggling to create the risk management products many businesses need. This article provides an explanation of captive insurance companies, how they are regulated, and how they can help companies manage the myriad risks of doing business.

WHAT IS CAPTIVE INSURANCE?

A captive insurance company is a subsidiary formed by a private company to finance its retained losses in a formal structure under the guidance of an appropriate state insurance department. Captive insurance companies are normally formed to supplement commercial insurance, allowing companies to retain the money that would otherwise be spent on insurance premiums.

The first active captive insurance company in the United States was started in Ohio by Fred Reiss, who in 1953 founded Steel Insurance Company of America for Youngstown Sheet & Tube Company in Ohio. Reiss drew the term “captive” from the steel company’s captive mines, which were sending ore back to the company’s mills. In a short time, U.S. businesses began to realize that they could create a profit center out of an ordinary business expense: the cost of insurance.

By 1960, there were more than 100 captive insurance companies in the United States, providing insurance that was commercially unattainable or purchasing supplemental insurance to round out an existing commercial insurance coverage portfolio. This was a paradigm shift from simply buying insurance, as businesses realized the value of the tax advantages, asset protection, improved cash flow, and the ability to create significant equity created by moving to captive insurance.

Businesses continued to see the benefits of captives; in 1980, the number of captives established both onshore and offshore had reached 1,250. Many state governments were beginning to recognize both the economic and social benefits that captives could provide to their individual states. Captive ownership had proven to be tremendously positive for mid-sized businesses, as it permitted businesses to manage risk more effectively, thereby improving their survivability. By 1981, the number of captive insurance companies had reached 1,400, and it grew to 1,600 by 1983. Within another three years, the number of captives exceeded 2,200, and the annual premiums rose above \$7 billion.

In 1986, a pivotal year for the captive insurance industry, the definition of controlled foreign corporations changed. Owners of group captives were obligated to declare their share of captive income, and loss reserves had to be discounted. In addition, Congress enacted section 831(b) of the Internal Revenue Code, which allowed insurance premiums paid by a business to be 100% deductible to the sponsoring business while not being considered income to the captive when the premiums are received. This permitted captives receiving premiums of \$1.2 million or less in annual premiums to exempt the premium received from their underwriting income when calculating income for taxation. Thus, premiums received, less claims paid and expenses incurred, resulted in an underwriting profit that would be taxed at 0%.

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Congress's rationale was that it should encourage smaller companies to create the necessary insurance coverage to protect their enterprises. While commercial insurance is a prudent component of sound business development, it represents a cost that frequently limits the growth of smaller businesses. IRC section 831(b) allowed midsized businesses to grow their balance sheets more quickly to support the risk of their owners and resulted in a rapid growth of captive insurance companies among mid-sized businesses.

At the same time, 33% of all Fortune 500 companies now owned larger IRC section 831(a) captive insurance companies. The growth of all captives continued, and by 1992, the number of reported captives had reached 3,150, with annual premiums paid exceeding \$11 billion. By 1998, 80% of

Fortune 500 companies owned captives; by 2010, Swiss Re reported that captive insurance company premiums worldwide had reached \$60 billion annually.

The captive insurance industry and the stability that it creates for various businesses represent an important source of jobs and income for many state governments. By the end of 2013, Vermont alone had established more than 1,000 captive insurance companies; in addition to the numerous white-collar jobs developed to service these emerging captives, the associated businesses hired additional employees to staff the captives themselves. The latest annual survey of Tennessee captive insurance professionals showed that the state's captive insurance sector generated an economic impact of over \$692 million during 2016, according to state insurance commissioner Julie Mix McPeak.

Government statistics (<http://ready.gov>) report that 70% of all jobs in America come from businesses with 500 employees or less. The growth of the captive insurance industry—particularly among small and midsized businesses—therefore benefits both business growth and the states sponsoring these captives.

THE PRINCIPLES OF CAPTIVE INSURANCE AND THE CONTROVERSY

The IRS defines a captive insurance company as a “wholly owned insurance subsidiary.” Insurance can be defined by three basic tenets initially derived from *Harper Group v. Comm’r* [96 T.C. 45, 47 (1991)], which states that all captives must comply with the following three factors: 1) the arrangement involves the existence of an insurance risk, 2) there is both risk shifting and risk distribution, and 3) the arrangement is for insurance in its common accepted sense. United States Tax Court decisions have, over time, brought clarity to captives established in a compliant manner.

Because of the prevailing state insurance regulations in the 1950s, Reiss’s initial captive insurance company was established in Bermuda. Thus, the initial growth of the captive insurance industry was offshore, and many still believe that captives are a strictly offshore business phenomenon. The IRS initially questioned the concept of deductible “self-insurance” and, in 1977, issued Revenue Ruling 77-316, which denied the deductibility of captive insurance premiums based on what was referred to as the “economic family” doctrine. This doctrine, which called into question the basic tenets of risk shifting and distribution established in 1941, was fought in the courts and ultimately repudiated.

In 1978, Revenue Ruling 78-338 defined the number of participants in a “group” captive that were needed to create deductible insurance premiums: “A ‘group’ Captive is an insurance company formed by multiple corporations seeking to insure similar risk, i.e. ... workers compensation, health

insurance, employee benefits, etc.” This decision would later help clarify the risk distribution components of stand-alone captives (Revenue Ruling 2002-90).

The federal government had defined the necessary components of insurance in *Helvering v. Le Gierse* [312 U.S. 531 (1941)], which established the principle that both risk shifting and risk distributions are required for a contract to be treated as insurance. Many court cases followed this initial decision, but clarity is still being sought, particularly as it relates to captive insurance. This is important because, as discussed below, almost every state government sponsors the development of captive insurance companies.

The court battle over captive insurance continued for over 20 years after Revenue Ruling 77-316. In Revenue Ruling 2001-31, the IRS finally acknowledged that it would no longer evoke the economic family doctrine to challenge the deductibility of captive insurance premiums. Instead, it began to fight selective battles, believing that the basic premise of insurance as defined and understood by the courts needed further clarification.

In 2014, the IRS suffered another major defeat in *Rent-A-Center, Inc. & Affiliated Subsidiaries v. Comm’r* [142 T.C. 1 (2014)], and *Securitas Holding, Inc. & Subsidiaries v. Comm’r* [T.C. Memo 2014-225 (2014)]. Following these setbacks, the IRS responded by placing captive insurance companies on its “Dirty Dozen” list of possible tax scams. By 2016, the IRS required captives under IRC section 831(b) to be treated as “transactions of interest,” requiring disclosure by owners, managers, and material advisors as to their role in all captive transactions. IRS Notice 2016-66 required IRC section 831(b) captive owners to file a Form 8886, “Reportable Transaction Disclosure Statement,” and their material advisors to file Form 8918, “Material Adviser Disclosure Statement.”

After reexamining the risk requirements and the needs of businesses affected by IRC section 831(b), and in spite of the IRS including captives on its “Dirty Dozen” list, Congress increased the section 831(b) annual deductible insurance premium limits from \$1.2 million to \$2.2 million and further indexed this amount for inflation under the 2015 Protecting Americans from Tax Hikes (PATH) Act. In addition to the premium increases, the PATH Act also provided specific language preventing IRC section 831(b) captives from being used as estate tax planning vehicles. Although only a small number of captives was being used in this manner, Congress essentially decided that the ownership of each captive should mirror the ownership of the sponsoring businesses.

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On August 21, 2017, the Tax Court rendered a decision in *Benjamin and Orna Avrahami v. Comm’r* [149 T.C. No. 7 (2017)] that expanded the points made in its initial decision rendered in *Harper*. In *Avrahami*, the court denied deductions for premiums paid to an offshore insurance company and determined, among other things, that elections made under IRC section 831(b) were invalid and premiums paid did not qualify as insurance premiums for federal income tax purposes.

While the fact pattern in *Avrahami* is not indicative of how compliant captive insurance companies should be structured or managed, the case does bring more clarity to the use of IRC section 831(b) arrangements. This decision followed years of consistent precedent by stating the following:

- Risk distribution is vitally important. Pools that do not constitute insurance in the commonly accepted sense will not be able to provide risk distribution. Drafting coverage in a manner that precludes or eliminates meaningful actual claims is not insurance in the commonly accepted sense.
- A captive with no claims experience is a problem. From 2007 through 2013, there were no direct claims filed with the *Avrahami* captive insurance company. In addition, no claims were filed with the risk pool either, in spite of the fact that 50–75 clients participated in the arrangement.
- Claims review and payment methodology was not done in an organized manner. The essence of an insurance company is to handle claims when they come due; ad hoc claims treatment and inconsistent review and approval procedures are problematic.
- The court will criticize a lack of actuarial experience and inappropriate or inexplicable pricing or methodology. The Tax Court determined that “actuarial pricing of the policies issued by the Avrahami captive were utterly unreasonable.”
- Captive arrangements can increase the probability of success by incorporating the use of independent advisors, including tax advisors, legal counsel, actuaries, risk managers, and captive managers.
- Arm’s-length, bona fide arrangements and transactions must be utilized.
- Adherence to capitalization requirements as instructed by domicile regulators is essential.
- Investments and loans will be reviewed in an overall context of reserves and surplus; loans should not be encouraged. The Tax Court found that in *Avrahami*, “the insurance company had invested more than two-thirds of its assets in long-term, illiquid, and partially unsecured loans to related parties and failed to obtain advance approval from its regulators for such loans.”

This decision, together with the many years of history outlined above, provides a clear picture of what not to do when structuring and managing an IRC section 831(b) arrangement. But it also reaffirms years of best practices that have helped many businesses achieve a greater level of risk protection than previously envisioned.

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Captives must carefully abide by all risk shifting, risk distribution, insurance pricing, claims adjudication, and state and federal compliance outlined over the past decades. Only then can

commercial insurance be integrated with private coverage to create the optimum risk management solution.

PRACTICAL USAGE

Several conditions can drive the formation of captive insurance companies. Many times, companies are unable to obtain necessary insurance coverage; other times, there is a hardening of premiums, and companies look to obtain less expensive coverage. In addition, most companies seek to have more control over their current insurance programs.

Regardless of the reason for forming a captive insurance company, the goal is the production of a compliant entity that recognizes and abides by the years of court decisions that have formed the modern captive insurance industry.

Currently, commercial insurance companies are not capable of reacting to the rapid changes of the modern marketplace, nor have they ever been capable of insuring the many hidden risks most businesses face. Proper risk management requires an integrated approach of both commercial and private insurance, as the following examples illustrate.

In 2003, a substantial medical practice developed a captive insurance company. This captive was initially created to address what the medical practice considered the excessive cost of its medical malpractice insurance premiums; it was designed to develop a “war chest” to fund the deductible costs related to their medical malpractice insurance policy. The design of this captive was compliant and contained 34 additional lines of insurance coverage.

The captive ultimately resulted in a substantial reduction in claims against the practice’s commercial insurance company. This occurred because of the accumulated assets that were available to control claims and because of a change in behavior by the practice’s members, who soon realized that their money was funding the deductibles. As the assets in the captive increased, the practice decided it would increase the amount of the deductibles on the commercial medical malpractice policy; this lowered the commercial insurance premiums as the captive took on more of the deductible risk. Currently, the practice’s commercial medical malpractice policy is half the cost for equivalent medical groups in the area.

Since the initial inception of the captive in 2003, the patients serviced by the medical practice changed. The demographics of the local community changed, and the passage of the Patient Protection and Affordable Care Act changed the medical marketplace. As a result, the practice began to see more patients relying on Medicaid; in 2017, Medicaid decided to audit the practice. The time,

legal cost, and the use of staff in reconstructing notes, resulted in a significant cost to the practice. Fortunately, the captive contained two policies designed to assist in this type of disruption—one providing legal protection and the other covering audit expenses. Both policies were part of a much larger pool of policies, so the costs to the practice were manageable. Neither line of coverage would have been available in the commercial marketplace. Because of the captive strategy, the medical practice was able to choose the attorneys that represented it in the Medicaid audit. One of the doctors is considering retiring from the practice, and his buyout will be partially funded from the assets within the captive.

This captive insurance company is an example of how a well-constructed captive can change a business and at the same time serve the community more effectively. The number of overall employees at the practice has increased over time because of the financial stability created by the captive, and the staff and professionals have gained a greater sense of control and peace of mind. Issues that would be threats to the practice's solvency have been solved by the use of the captive.

Successful, compliant captives serve a wide range of businesses, ranging from large professional practices to manufacturing businesses to distribution businesses. For example, recently a nursing home in Brooklyn, N.Y., experienced a fire caused by a patient lighting a cigarette in his room. The sprinkler system flooded the building, and the nursing home's commercial insurance carrier covered everything except the front lobby due to an exclusion in the commercial coverage. The nursing home's captive insurance company, however, covered this loss.

Products are sometimes denied entrance into a state because the state has passed a law against certain products. California's Proposition 65, which banned entry of products containing chemicals "known to the state of California to cause cancer and birth defects or other reproductive harm," is one such example. Certain businesses were able to deal with these regulatory changes because of their captive insurance companies.

During Hurricane Sandy, flooding damaged electrical equipment located in the basement of a commercial office building, causing a legal firm in the building to relocate uptown. While the firm's commercial insurance policy refused to insure it for flood damage, its captive insurance company covered this event.

The U.S. National Cyber Security Alliance found that 60% of small companies are unable to sustain their business over six months after a cyber-attack. According to the Ponemon Institute, the average price for a small business to clean up after being hacked stands at \$690,000; for middle-market companies, the cost can be over \$1 million. Small and midsized businesses are hit by 62% of all cyberattacks—approximately 4,000 per day—according to IBM. Cybercriminals target small

businesses because they are easy targets to penetrate. Retail giant Target, not to mention multiple middle-market companies, has dealt with the damages from cyberattacks through the integration of captive insurance with existing commercial coverage.

Finally, consider the reputational damage that can be created because of false reports on social media. For example, a manufacturer familiar to the author recently fired an unproductive and disgruntled employee. Shortly thereafter, disturbing claims began to appear on social media disparaging the owner and the quality of his product. Damage control was expensive and difficult, and it ultimately took more than 18 months for the manufacturer to recover from this event. An integrated approach of commercial and captive insurance can properly indemnify a business for these kinds of losses.

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COVERING THE GAPS

From its modest beginnings, the captive insurance industry has developed into a strong nationwide alternative for many businesses. These results were based on the pragmatic needs of businesses in cooperation with a Congressional belief that insurance, proper capitalization, and proper management are essential ingredients for the growth of all businesses. If an IRC section 831(b) captive is not structured correctly and lacks the attributes of genuine insurance as developed through numerous years of case law, it will be scrutinized by the IRS for possible abuses. Done correctly, however, an IRC section 831(b) captive compliant under current law can now play a larger role in supporting participating businesses.

Insurance premium payments from a business to a captive insurance company are deductible for income tax purposes under a properly structured program. Most astute business owners understand the risks they face. While smaller companies do not have the team of in-house advisors that larger companies have, captive insurance companies are nevertheless a viable option for saving costs while still shielding the company from risk.

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