Captive Insurance Companies

A Mainstream Risk Management Tool

By Mark Koogler

No longer in the shadows of Cayman Island palm trees, captive insurance companies constitute a mainstream alternative risk mechanism for U.S. businesses. A business prepared to finance self-insured risks may wish to consider a captive as opposed to paying for losses as incurred. A captive insurance company is a licensed insurance company, authorized to operate under special captive legislation, which, in general, insures the risks of its parent and affiliates and in some cases, third party risks.

The Use of Captives

The use of a captive insurer as part of a risk management program is dependent upon an analysis of how much risk is to be retained and how that retained risk will be financed. A captive has some advantages over pure self-insurance. Potential losses may be pre-funded based on actuarially derived projected losses; the premium paid for insurance coverage may be deducted as a business expense; and the captive may have an accelerated tax deduction depending on when the reserve is established versus when it is paid. In addition, a captive insurer may improve the monitoring of results by

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reporting as a separate entity, and the use of insurance professionals may reduce costs and lower premiums based on better average loss histories. The insurance offered by a captive insurer can serve as formal evidence of coverage to meet the contractual requirements of third parties.

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A captive has the ability to buy-down qualified self-insurance retentions or issue buy-down high deductibles and self-insured retentions. As an example, a business that bought a high-deductible workers' compensation policy may form a captive insurer to insure the retention level. A business may also consider forming a captive to insure a self-insured retention level where the severity of risk is high but the frequency of claims is low.

A captive can also reinsure the risks of its parents or affiliates. In the situation where a captive may reinsure its parent's group benefit plans, the transaction may be a "prohibited transaction" under ERISA in that plan assets are being transferred to, or used by, the captive insurer which would be a party in interest. The Department of Labor has an expedited process to grant exemptions to this prohibited transaction arrangement if certain conditions are satisfied. Among these conditions are that the captive be U.S. domiciled and financially sound; the captive be authorized to reinsure benefits and the reinsurance arrangement with the fronting carrier must be indemnity reinsurance; the fronting carrier have a Best's "Excellent" rating; participants be notified of the arrangement and be provided with immediate and objectively determinable benefit enhancements; premiums be reasonable; and an independent fiduciary review and approve the transaction.

Types of Captives

Pure, protected cell, group and association captives are among the types of captives generally authorized under special captive legislation. The majority of captives are pure captives, which are authorized to insure or reinsure the risks of its parent and affiliates, and in some cases controlled unaffiliated risks. Some domiciles permit association or group captives,

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these permit businesses—which on their own would not qualify for risk distribution—to participate in a qualified captive arrangement. Protected cell captives are among the more popular types of captive insurers in recent years. A protected cell captive consists of separate cells, each cell owning particular liabilities and assets. The assets of another cell and the protected cell captive's general assets cannot be used to satisfy the debts, liabilities, obligations or expenses of another cell.

Protected cell captives, which are a hybrid of a pure and group captive, are experiencing particularly strong growth in domiciles that permit the formation of series limited liability companies. These limited liability companies are authorized under the state's limited liability company law to establish series or classes of series with separate and distinct books and records separate from the protected cell captive insurer and the other series or classes. Delaware and Tennessee in particular have been the beneficiaries of the popularity of protected cell captives.

The other growth engine for captives has been the ability of certain captive insurance companies to elect to be treated as an "831(b)" captive. An 831(b) captive is a captive insurance company that meets all of the requirements of a captive insurance company, but because it has annual premiums not in excess of $1.2 million, elects to be taxed under Section 831(b) of the Internal Revenue Code. Under that election, the captive is not taxed on its underwriting profit but is taxed only on its investment income. Federal legislation is under consideration that would raise the maximum annual premium level for 831(b) captives to $2.2 million, subject to adjustment.

Criticism of Captives

Captives are not without their critics. Micro or small captives are listed on the IRS' "Dirty Dozen" List of Tax Scams for 2015. These small captives, also known as 831(b) captives, face scrutiny because of the difficulty a small captive has in meeting the definition of "insurance" for federal tax purposes. In a captive arrangement, there may be an insurance risk, risk transfer and risk distribution. Unscrupulous promoters of captives ignore these considerations and advise captive prospects to insure business or investment risks, ignore risk transfer by not assuring the liability transfers to another entity, and fail to appropriately distribute the risks among a sufficient number of insureds. On the other hand, captive owners have recently had success in the U.S. Tax Court, as the tax court has looked through the corporate structure of the insureds to the number of underlying risks to determine that risk distribution exists. These victories, however, were limited in scope because the captives in question were large captives, not 831(b) captives.

831(b) captives are also being scrutinized by the Treasury and Congress because of abuses in estate planning tax arbitrage. The use of an irrevocable trust as the owner of the captive and the purchase of life insurance by the captive on the owner are two examples of IRS-asserted abuses of captives that may be become the subject of legislative restrictions on captives for estate planning purposes. Alternatives to a pure captive, which may not meet the requirements of the IRS safe harbor revenue rulings for risk distribution, include an association, group or protected cell captive. An association captive may have limited applicability due to the necessity of a business being a member of the association. Similarly, unless a business can align with other businesses with similar insurance risks, a group captive may not be available. However, protected cell captives offer an opportunity for unrelated businesses to become insureds under a captive arrangement.

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Captive legislation, and in some cases, the state's limited liability company law, act in concert to facilitate risk transfer and risk distribution for businesses, which on their own could not.

These abuses have often overshadowed the professionalism demonstrated by captive managers and other service providers to assure that 831(b) captives follow the precedent-setting case law and IRS safe harbor revenue rulings that have established a road map for risk transfer and risk distribution. The Captive Association Leadership Council is considering ways to counter unscrupulous promoters of small captives and the taint that such promoters have on the entire small captive industry. Insurance needs and a business purpose must be emphasized over tax benefits in marketing materials. Care must be given to assure that adequate capitalization, sufficient risk distribution and a realistic probability of applicable coverage exist in any captive arrangement.

Future of Captives

Thirty-six states have captive insurance legislation, and the competition for being viewed as a preferred captive domicile is heating up. Re-domestications, small captives and the formation of cells or series, have resulted in strong captive growth, and continue to result in further revisions to captive legislation among the states. Onshore domiciles that have experienced the greatest growth have generally revised their legislation, both captive and limited liability company laws, to promote the formation of captives in their jurisdictions.

Some states, including states that have recently adopted captive legislation, prefer not to be a dominant player in the captive industry, but view themselves primarily as a captive domicile for businesses located in their states. The competitive nature of captive domiciles — particularly those that distinguish captives from commercial insurers and create more flexibility in the type of captive, type of legal entity and ability to write insurance coverages — will cause those states that do not keep up to simply fall behind. Captive owners are prepared to accept risk, and they want the legislative flexibility to design an insurance program that meets their particular circumstances.

As feasibility studies examine the best domicile for a prospective captive owner, the preferred onshore domiciles will embrace legislation that makes formation and customization of an insurance program more convenient; regulatory support; and resources that are responsive to captive insurers and support the captive industry as an economic tool of their state through a re-examination of legislation to assure competitiveness.

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