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FREE TRIAL

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In general, insurance companies are insurers of risk for individuals, businesses, and any other entity whose existence or operations carries associated and inherent risk. Accordingly, in the event a policy holder suffers a loss relating to an insured risk, insurance companies compensate policy holders for such loss. But what happens when a business exists or operates with certain risks that are not covered under

traditional insurance policies offered by large insurance companies such as Allstate, Liberty Mutual, Hartford Mutual, etc.? For example, assume Company X is a federal government contractor whose business operations, revenue stream, and existence are almost entirely reliant upon the federal government. As such, government shutdowns, budget cuts, contract non-renewals, and even terrorist events are all risks Company X carries and could severely affect and diminish Company X's bottom line should any of them occur. In addition, as it happens, insurance coverage for these risks may be unavailable under a traditional insurance policy. While Company X's options are limited, they are not completely lacking. Indeed, Company X may inquire about forming a captive insurance company as a means of hedging the monetary loss associated with any realized loss on these risks.

All insurance companies are formed pursuant to state law, with captive insurance companies insuring the risk of the company that owns it. Instead of a company buying an insurance policy, they establish an insurance company—the captive—and then insure the risk associated with the company. In its purest form, the captive will be a subsidiary of the parent that it insures. However, the insurance model, as highlighted with Company X, is only one form of a captive. Indeed, there are other types of captives as well as other legitimate purposes for establishment. A captive can also be structured as a subsidiary company that re-insures a risk that is covered by regular insurance through a third party.[1] In addition, a captive can be a subsidiary that insures a parent's risk and then transfers that risk over to a third company.[2] In sum, captives are generally used by companies that either have high insurance premiums with a traditional plan, cannot find traditional coverage at all, engage in high risk activities, or where premiums are mispriced compared to the market risk.

Captives can also be used as a means to access the reinsurance market, an opportunity not presented to traditional insurance purchasers. Indeed, reinsurance often comes at a steep discount to retail insurance policies, and may be as much as 40 percent less than a commercial policy. Captives as insurance options not only present excellent opportunity for many businesses that could not otherwise find insurance, but also potentially provides access to newly emerging markets or a retreat from pricey or mispriced markets. Indeed, as entrepreneurs continue to dream up and implement new ideas, insurance companies try and keep pace with respect to insurance coverage for risks associated with those ideas. But without captives, a company owner would be forced to remain uninsured, or go to an insurance market such as Lloyds, who would then create a policy for the new idea, which could be cost

prohibitive. Accordingly, whatever the type of captive, or whatever the purpose for setting one up, they can have wide and varying positive uses for companies that utilize them. However, captives are not without controversy.

IRS Scrutiny

Like many business formations and transactions, forming and owning a captive insurance company has associated state and federal tax benefits. It is because of the exploitation and abuse of these tax benefits that the IRS has historically scrutinized the legitimacy of captives and challenged abusive arrangements.

Specifically, pursuant to §831(b) of the Internal Revenue Code, a captive insurance company may elect to be taxed on its net investment income as opposed to the normal tax rates computed by §11.[3] In other words, in the event a captive's payouts for claims during a given year do not exceed the amount of premiums collected during that respective year, the captive may thereafter use those premiums for investment purposes. Under §831(b), if a captive's gross annual premiums do not exceed $1.2 million, the captive can elect to be taxed only on its net investment income.[4] Thus, captives collecting premiums less than $1.2 million may opt to operate untaxed on its premium income.

Accordingly, the IRS focuses on red flags to detect abuse and weed out captives with a focus on sheltering income as opposed to insuring risk. Marketing information promoting captive insurance as tax mitigation, not as an insurance tool, is frequently identified as a red flag. In addition, the IRS will analyze whether the insured risk's likelihood of being realized is low. The IRS will also investigate the captive's history of claims made versus claims paid, as well as instances when the premiums are always $1.2 million. Other red flags include the flow of premiums back to the hands of the captive's parent company (and owner of the captive), a lack of risk distribution, poorly supported or unsupported actuarial findings, little or no analysis of the non-captive market for the same rates, marketing materials promoting estate planning benefits of creating a captive as well as excessive guarantees, and little or no claims history within the risk pool.

However, despite such tax abuse and increased IRS scrutiny, captives remain popular as ever as more and more states are throwing their hats into the captive ring. Indeed, there are currently 35 jurisdictions supporting captive regimes in the U.S. (not to mention the numerous foreign countries that have active and thriving captive regimes).

In general, each jurisdiction that maintains a captive regime treats and taxes the captive entity in a unique way. As such, companies can afford to be choosy regarding when and where they decide to set up a captive, effectively creating a captive marketplace and allowing companies to jurisdiction shop for the most favorable captive regime to fit their circumstances. Recently, as more states have recognized the revenue potential of a captive regime and with more businesses realizing the usefulness and benefits of utilizing a captive, the marketplace is expanding and thriving.

Accordingly, as more states have either entered the captive marketplace, or they have revised existing captive regimes to attract and entice businesses into setting up shop within their borders, states are engaged in an unintentional race to the bottom whereby states adopt less cumbersome administrative procedures and more favorable fee structures. For instance, North Carolina offers an online application process, while Oregon has moved to tax alternatives, such as annual fees, in an effort to draw more attention. However, when deciding where to set up a captive, businesses take many factors into consideration. Of chief concern for most businesses is the stability with the state's captive regime. Vermont, being one of the more prolific captive insurers with more than 1,000 captives domiciled in the state, enjoys a successful captive regime thanks in large part to its longstanding captive laws that were established two decades ago.

In addition, the size of the business' operations and whether it would be economically or administratively practical to set up a captive outside its home state should be taken into consideration. Other concerns include capitalization requirements, a standard which may be subject to change in certain jurisdictions; premium taxes; whether the state even permits the captive to write the respective insurance policy; reporting and maintenance requirements; changing definitions and standards of insurable risks; restrictions on investing net premiums; sustainability of the local and national economy; and even political unrest. At stake is the revenue used to set up and maintain a captive, which is usually quite substantial and which, in most circumstances, involves diverting potentially taxable revenue, and effectively creating an expense in the first state.

Considerations for a Captive

For example, let's say our aforementioned Company X was incorporated, maintained a principal place of business, and operated exclusively in North Carolina. Let's also say

that Company X had a phenomenal year, significantly expanding its business operations into new and unchartered areas and, in the process, tripling its gross revenue to $10 million. In addition, Company X has identified new risks associated with such expansion, and it has determined that a captive insurance company would be the most effective way to protect itself. Accordingly, Company X enters the captive marketplace and begins to jurisdiction shop. During its search, Company X determines that North Carolina's captive regime is not as compatible with its needs as Delaware's, and, thus, decides to form in Delaware. To form its captive, Company X's capitalization and maintenance costs, premiums, and other associated fees are drawn from Company X's newly tripled revenues. Thus, the revenue used to set up and maintain Company X's captive was originally revenue earned while conducting business in North Carolina—revenue which was potentially taxable in North Carolina. However, that revenue is now diverted to Delaware, where the captive will be subject to Delaware tax law and other annual fees and costs. In addition to the transfer of revenue, any premiums paid into the captive also creates a tax deduction as an ordinary business expense, thereby offsetting North Carolina taxable income in the process.

While Company X's circumstance is not much different than another business sinking an expense into a purchase or investment in another state, a captive's initial capitalization and annual maintenance and administrative costs can be quite substantial. However, the largest transfer of potential taxable revenue comes with the annual premiums being paid to the captive. Since the IRS allows up to $1.2 million of premiums to be paid into a captive without being subject to federal income tax, it's not unrealistic or inconceivable to posit that most captives are structured so that a parent company's premiums total an amount close to that figure. In addition, captives receiving premiums in excess of $1.2 million may be subject to income taxes on underwriting income, which may not accrue for years or even decades, depending on the policies written. Thus, let's say that the premiums that Company X pays to its captive totals $1.1 million per year. Well, that is $1.1 million per year that would have likely been subject to corporate income tax in North Carolina (or it could have been reinvested into Company X's infrastructure in North Carolina), but is now diverted to Delaware. As North Carolina is undoubtedly aware, Company X's annual premiums of $1.1 million will add up pretty quickly when considered with other North Carolina businesses that either have or will form a captive outside the state. While the $1.1 million or a portion of it may one day make its way back to North Carolina (whether as

a claim payout or, if no claims in that respective tax year, by virtue of investment), the likelihood of that money ever being subject to North Carolina tax is remote.

Some states (such as Texas and Illinois), recognizing the need to recoup or recompense lost tax revenue, have adopted self-procurement taxes whereby a home state will impose a tax on the amount of premiums paid to a captive in another jurisdiction by certain businesses located in the home state. While most self-procurement tax rates are nowhere near a state's corporate income tax rate, the concept at least serves both as a (sort of) deterrence for home state businesses and as a means of recovering what may be lost tax revenue. Others would argue that self-procurement taxes are an attempt by conventional insurance companies to limit choice in the captive marketplace and drive businesses to conventional insurers.

Conclusion

In sum, captives can be an incredibly useful tool for companies that are either unable to find insurance coverage, find coverage mispriced, want easier access to the reinsurance market, or desire to supplement their commercial insurance. The tax benefits associated with captives may also attract businesses with illegitimate intentions. As such, they can be misused and abused as tax shelter tools. Furthermore, as states continue seeking an advantage in an effort to attract business and tax dollars, the captive's popularity will continue to grow, causing the IRS to try and rein in the inherent abuses associated with them. The pertinent business owner should ensure that their captive is in good order, insuring actual and realistic risks, and that it can sustain scrutiny when red flags are raised by federal and state tax authorities. In addition, an independent analysis of the associated risks must be complete in order to appropriately price the premiums going to the captive. However, at some point, businesses may decide that the scrutiny associated with setting up and maintaining a domestic captive is no longer worthwhile or that the “juice ain't worth the squeeze,” and will accordingly begin looking at the offshore captive marketplace.

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[1] See Rev. Rul. 77-316, 1977-2 C.B. 53 (declared obsolete in Rev. Rul. 2001-31) (Rev. Rul. 77-316 presents three (3) situations in which a taxpayer sought insurance coverage for itself and its subsidiaries via a captive insurance company).

[2] Id.

[3] I.R.C. § 831(a); See I.R.C. § 11(b).

[4] I.R.C. § 831(b)(2)(A). Beginning January 1, 2017, the $1.2 million limit will be raised to $2.2 million and a new diversification requirement for captive insurance companies will be implemented.

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