



TAX / MANAGEMENT ACCOUNTING

# Captive insurance for the middle market

Recent IRS guidance and court cases, plus PATH Act changes, make captives more attractive to medium-size companies.

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**B**usiness, by nature, is risky. Even with proper research and planning, business owners know to expect the unexpected. Nonetheless, part of proper planning may include business owners managing their own risks—such as certain casualty, property, and enterprise risks—by forming captive insurance companies to gain greater flexibility and potential cost savings.

This article will help CPAs better understand the purpose and benefits of captives—as well as the options available, particularly for a middle-market business owner. Additionally, it explains how provisions of the Protecting Americans From Tax Hikes (PATH) Act of 2015 (Division Q of the Consolidated Appropriations Act, 2016, P.L. 114-113) offer new, favorable tax opportunities to owners of captive insurance companies.

A captive insurance company is an insurance company formed by a business or a business owner to insure the risks of the business and related or affiliated businesses. A captive also may be formed by multiple businesses or business owners from different companies, which is generally referred to as a group captive. The benefits of owning a captive include flexibility in insurance coverage arrangements and the potential to retain underwriting profits. Captives may issue property and/or casualty insurance coverage against a wide variety of possible liabilities and may be used to insure life and health risks as well. In addition, captives provide an opportunity to insure against liabilities that may be generally uninsurable or that are difficult to insure because coverage is unavailable in the commercial market or is excessively priced.

When a company purchases commercial insurance, it pays a third-party company to take on a certain amount of its risks. The insurance company calculates the costs that the risks might present and charges a premium accordingly. If the risks/losses ultimately are less than the premiums charged, the insurance company makes an underwriting profit. The same concept applies to a captive. A captive evaluates the risks it undertakes and charges premiums sufficient to cover them. If the costs associated with those risks are less than the premiums charged, the captive makes an underwriting profit. The premiums received by the captive are invested, just as a commercial insurance company invests its premiums and earns an investment return. The key difference between using a captive and purchasing commercial insurance is that the owner of the captive has the role of both the insured and the insurer.

The key benefits of operating a captive include:

If a legitimate business purpose is the primary focus of a strategy, including regulatory-driven requirements, it will be classified as acceptable.

(1) The premium payments are tax-deductible as a business expense under Regs. Sec. 1.162-1(a), and (2) the premium income to the captive either is reduced by loss reserves or may be nontaxable under Sec. 831(b), depending on the amount of premium income. If the captive is operated successfully, it will generate profit that belongs to the captive owner, not a commercial insurance company, while also providing significant tax benefits.

For income tax purposes, captives are often referred to as large or small. A large captive does not have a stated limitation on premiums received; however, a small captive taking advantage of a Sec. 831(b) election must limit premiums received to \$1.2 million or less. Starting in 2017, the premium limitations will increase to \$2.2 million per year under the PATH Act. Both types of captives must be taxed as C corporations (see Sec. 1361).

The distinction between the two is important in operating a profitable insurance company. A large captive can shield premium income only through loss reserves, which must be determined by actuarial analysis based on past loss experience, just as any other insurance company operates. A small captive makes an election to be treated as such under Sec. 831(b). The primary advantage of making the Sec. 831(b) election is that the small captive is then exempt from income tax on up to \$1.2 million (\$2.2 million in 2017) of premiums received without having to actuarially establish reserves to offset premium income.

Companies with uninsured or underinsured risks are prime candidates for captives, as they can provide otherwise unavailable or difficult-to-procure insurance. Also, companies with a history of low losses may consider using a captive to insure matters that are covered in their commercial insurance programs, given the profit opportunity, tax benefits, and investment opportunities. Captives also provide benefits such as claims management flexibility and the opportunity for improved risk management procedures. Captives are generally designed to complement, not replace, a company's commercial ▶

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insurance program by addressing certain types of risk more efficiently and by filling holes and gaps in a company's risk management program.

Middle-market companies usually do not have sufficient loss experience for a stand-alone large captive to be cost-effective, given the costs to set up and operate one. Small captives or group captives (described below) are the best captive opportunities for middle-market companies.

### GROUP CAPTIVES

A group captive is a large captive involving a number of participants. Some specialize in specific industries and are referred to as homogeneous group captives. Others, including companies from a variety of industries, are referred to as heterogeneous group captives. Selecting a type of group captive should take into account the particular benefits each affords, including loss control services and the opportunity to learn lessons from the other participants. A group captive is designed to replace primary layer casualty insurance, including general liability, automobile liability, and workers' compensation. A number of insured companies are involved, and significant premiums are paid into the captive; thus, a group captive is typically a large captive.

The group captive, depending on its design, may cover up to the first \$1 million in exposure for each of the above areas through a combination of primary and excess coverage for each of its insureds, plus reinsurance or "stop-loss" coverage. The primary layer is insured by several mechanisms. An example is a group captive with an A layer and a B layer. The A layer is directly funded and paid by the individual insured, with necessary funding determined by

past loss experience. Once the A layer is exhausted, losses are paid by the B layer. The B layer is funded and paid by the entire group of companies that are members or insureds. All the losses incurred in the B layer are shared by all the participants in the group captive. Normally, there is also a reinsurance layer above the B layer that essentially operates as a stop-loss mechanism if the shared-risk layer incurs significant or excessive losses.

In a group captive, the participants are paying not only for their losses but also for other participants' losses. The funding for the excess layer is equivalent to the premiums and costs needed to buy commercial reinsurance. Participants either are owners of the group captive or are insureds that do not have an ownership interest in the group captive. This is an important distinction because significant liabilities may be associated with ownership that do not exist for a participant that is only an insured. The risks to a participant must be carefully examined, including past loss experience of the B-layer risks, as well as the move away from traditional or "guaranteed cost" insurance. A move from traditional insurance to a group captive and back from a group captive to traditional insurance is not easy due to the collateral requirements of each type of program and therefore must be undertaken with care and study.

Many group captives are operated in offshore domiciles for ease of administration and to reduce operating costs. Some group captives operate wholly offshore as non-U.S. entities and do not subject themselves to U.S. tax treatment. Others that operate offshore elect to be subject to U.S. tax treatment under Sec. 953(d). There are inherent risks in operating offshore, particularly if a group ▶

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### IN BRIEF

■ A captive insurance company formed by a business or business owner can provide flexibility in covering property, casualty, and liability risks and the potential to retain underwriting profits. Premiums paid to a captive may be tax-deductible as a business expense, and premium income to the captive may be reduced by loss reserves or, for certain small captives, nontaxable up to a limit

under Sec. 831(b).

■ Under recent amendments to Sec. 831(b), the small-insurer exemption limit increases in 2017 from \$1.2 million in premiums received to \$2.2 million. The new law also introduces diversification requirements intended to deter use of the exemption as an estate planning strategy.

■ Group captives may cover a variety of pooled risks, often in primary and secondary layers of coverage. Many are

domiciled in foreign countries as non-U.S. entities but may elect to be subject to U.S. tax treatment.

■ The IRS has often challenged, including in recent court cases, captive arrangements on the basis of risk distribution, whether they insure traditional risks and not just business or investment risks, and whether risks are shifted or distributed sufficiently among unrelated businesses.

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## A captive program and commercial insurance program should be designed to complement and optimize the cost/benefit of all coverages.

captive chooses not to be subject to U.S. tax yet conducts significant business in the United States. This issue should be examined carefully by a company considering participation in a group captive.

Group captives are a valuable tool for the middle-market business under the right circumstances, but they are not without inherent risks, and they must be evaluated carefully with the assistance of experts before participation.

### SMALL CAPTIVES

A small captive is defined by the amount of premiums that the captive writes annually. To receive the special tax treatment afforded by Sec. 831(b), a company must elect to receive this tax treatment, and the net premiums written by the captive may not exceed \$1.2 million per year (\$2.2 million per year in 2017 and after). The captive must also be operated as a separate and regulated insurance company to obtain the special tax treatment afforded by Sec. 831(b) (premium income in a small captive is not taxable income to the captive). An analysis of the company risks and exposures is conducted, the insurable risks identified, loss history for those risks reviewed, and premiums determined by a licensed actuary, taking into account commercial insurance rating factors and the risks presented by the particular company.

The small captive is licensed and operates as an insurance company subject to compliance with applicable domicile laws and regulations. Assuming the risks underwritten do not result in excessive losses, an underwriting profit will be generated, resulting in a new profit center for the owner of the captive. Small captives are used to insure the difficult-to-insure risks of a company that generally do not generate a significant number of claims, i.e., “low frequency,” and deductibles associated with commercial insurance. This allows the captive to accumulate underwriting profits over time as a “rainy day” fund for losses. Due to the benefits afforded by Sec. 831(b), the funds accrue on a tax-advantaged basis.

Small captives are powerful risk management tools, if operated correctly. To qualify for the

valuable tax benefits associated with a Sec. 831(b) election, the captive must be set up as and meet the requisite formalities of an insurance company from a regulatory standpoint, as well as meet the definition of a valid insurance company operation from the IRS and/or Tax Court perspective.

### IRS HISTORICAL CHALLENGES AND GUIDANCE

The IRS’s view of captives has evolved, and the Service has challenged certain aspects of captive insurance companies over the years. First, the IRS made significant attempts to disallow the special tax treatment for a number of captives, primarily large captives. The primary arguments for those challenges were (1) that the captive was not writing “insurance” in the required sense due to a lack of risk shifting and risk distribution (and particularly the IRS’s definition of such), and (2) that excessive premiums were being paid for the risks underwritten. After years of litigation regarding captives, beginning in 2002 the IRS issued a series of revenue rulings providing safe harbors for the concepts of risk distribution and risk shifting that provide some guidance in structuring a captive from the IRS’s perspective. Without exception, each revenue ruling provided a significantly more conservative requirement than the case law on each point.

### Risk distribution

Risk distribution generally refers to the sharing of insurance risks and is a required element of insurance. Rev. Rul. 2002-91 provides that the distribution of risk allows the insurer to reduce the possibility that a single claim will exceed premiums received. The ruling indicates that a pooling of premiums is necessary to reduce the potential that the insured is, in essence, paying for its own risks while obtaining a tax deduction. Accordingly, the elements of risk distribution are driven by the number of “exposure units” and the pooling of premiums from which to pay losses. The combination of a sufficient number of exposure units and pooling of premiums makes losses more predictable so that they more closely match premiums received.

### Fortuity

In addition to risk shifting and risk distribution, according to the IRS, the insurance policy issued by the captive must be insurance in a typical sense. Thus, there must be fortuity or uncertainty as to the risk underwritten. A common objection by the IRS is that the insured risk is a mere business or investment risk rather than a traditional insurance ►

Starting in 2017, the Sec. 831(b) premium limitation for a small captive will increase to \$2.2 million per year, up from \$1.2 million.

risk. For instance, the IRS found premiums paid to create reserves for inevitable nuclear decommissioning costs did not constitute the purchase of insurance since there was no uncertainty as to whether the costs would occur (see Chief Counsel Advice 200703007). It also found that premiums paid to create reserves for product warranty claims did not constitute the purchase of insurance when the company manufactures or sells the products that the warranty agrees to replace (see Technical Advice Memorandum 200827006).

#### Unrelated business

Under Rev. Rul. 2002-89, if more than 50% of premiums earned by a subsidiary captive are premiums from unrelated entities, this is sufficient for risk shifting and risk distribution. The IRS also stated that where 10% of the total premiums earned come from unrelated businesses, that is not enough for risk shifting or distribution.

#### Internal risk distribution

In Rev. Rul. 2002-90, the IRS ruled that where 12 subsidiaries paid premiums to an affiliate captive, with each subsidiary having no more than 15% and no less than 5% of the total risk insured, there was enough risk distribution and risk shifting.

#### CAPTIVE RECENT DEVELOPMENTS

Unfortunately, a number of companies have been marketing captive management services to middle-market companies for small captives that have little or no insurance industry experience, and these advisers have set up many small captives for tax savings instead of risk management and insurance purposes. This practice has attracted the negative attention of the IRS and has shifted the focus of tax litigation issues to small captives as well as large captives. The IRS recently included in its 2016 annual “dirty dozen” list a discussion of small captives under “abusive tax structures.” This year is the second that improperly formed and operated captive insurance companies have appeared on the list. (It is worth noting that trusts, limited liability companies (LLCs), and limited liability partnerships are also listed as tools used in abusive tax structures.)

States, through their departments of insurance, regulate the types of policies and their premium pricing. Careful review by onshore regulators will generally prevent the problems that draw IRS scrutiny to the entire industry. As the small captive business evolves, more often, small captives are set up and operated by insurance experts and then regulated by sophisticated onshore state departments of insurance, reducing the number of captives set up for tax, not insurance, purposes. A captive program and commercial insurance program should be designed to complement and optimize the cost/benefit of all coverages for a company, some of which are more appropriate for a commercial insurance policy and some more appropriate for a captive to insure.

#### RECENT TAX COURT DECISIONS

##### Rent-A-Center

*Rent-A-Center*, 142 T.C. 1 (2014), involved a Bermuda captive, Legacy, that elected to be taxed

## AICPA RESOURCES

### Articles

“Tax Clinic: Evolving Trends in Captive Insurance,” *The Tax Adviser*, June 2015, [tinyurl.com/jmy5bwh](http://tinyurl.com/jmy5bwh)

“Tax Clinic: Captive Insurance Solutions for Rising Insurance Premiums,” *The Tax Adviser*, Oct. 2014, [tinyurl.com/zb2e93z](http://tinyurl.com/zb2e93z)

“The Benefits of Captive Insurance Companies,” *JofA*, March 2013, [tinyurl.com/jjk8co5](http://tinyurl.com/jjk8co5)

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as a U.S. taxpayer and insured the business risks of Rent-A-Center. The IRS disallowed Rent-A-Center's deductions for premium payments to Legacy, claiming Legacy was a sham entity created for tax purposes. Among other things, the IRS challenged a financial guarantee by Rent-A-Center to Legacy for its losses. The IRS viewed this as a circular transaction, which was evidence that Legacy was a sham. The Tax Court found that the parental guarantee, under the facts and circumstances of the case, was acceptable. This case illustrates that the Tax Court will assess the business purpose behind an arrangement that may at first glance appear to be a circular transaction or a tax-driven strategy. If a legitimate business purpose is the primary focus of a strategy, including regulatory-driven requirements, then the arrangement will be classified as acceptable.

#### **Securitas Holdings**

In *Securitas Holdings*, T.C. Memo. 2014-225, the Tax Court held that payments made by subsidiaries of a parent corporation to another subsidiary of the parent, which was a captive insurance company in a brother-sister arrangement, were properly deductible. The court found that based on the arrangement's economic consequences, the requisite risk shifting was present for the arrangement to be insurance. With respect to risk distribution, the Tax Court focused on the number of underlying risks rather than the number of insureds in reaching its decision and ignored the IRS revenue rulings requiring a certain number of insured entities. The opinion confirms in this case that risk shifting and risk distribution can be achieved even with a small number of insureds, as long as the risks insured are numerous enough for the law of large numbers to apply.

#### **RECENT LEGISLATIVE CHANGES**

The PATH Act was part of a large budget and tax deal. Altogether, the Joint Committee on Taxation estimated that the bill included \$622 billion in tax breaks.

Section 333 of the PATH Act modifies several provisions of the Internal Revenue Code related to Sec. 831(b) captives. The most significant changes, which go into effect in 2017, are the increase mentioned above in the limitation on premiums from \$1.2 million to \$2.2 million per year (with the new limit indexed to increase with inflation) and new diversification requirements targeted at the use of captives as estate planning tools. Under the diversification requirements, ownership in the insured

operating businesses must be aligned with ownership of the captive if a spouse or lineal descendant (child or grandchild) of an individual who owns an interest in the operating company/insured has ownership in the captive. This ownership may be either directly or through a trust, estate, partnership, or corporation. The company may qualify under either of two ownership diversification tests: (1) The ownership by the spouse or lineal descendant must be the same as his or her ownership of the operating company (with some *de minimis* exceptions), or (2) no more than 20% of the net written premium of the captive can be attributable to any one policyholder. For purposes of this rule, all policyholders that are related (within the meaning of Sec. 267(b) or 707(b)) or are members of the same controlled group are treated as one policyholder.

The increase in the premium limit to \$2.2 million annually creates an opportunity for current captive owners to evaluate their programs to see whether additional risks can be insured. The increase will also make captives more appealing to larger companies that might not have found enough economic benefit with the \$1.2 million premium limit.

The changes regarding ownership will require many of the captives that include estate planning to modify either their ownership structure or their insurance and reinsurance programs to fit within the new requirements.

#### **THE PATH TO A SUCCESSFUL CAPTIVE**

Congress has reaffirmed the validity and usefulness of small captives and their role in protecting companies by including favorable provisions in the new PATH Act.

Nevertheless, the IRS will continue to examine and challenge captives by pulling apart and examining each element of a large or small captive to determine whether it is formed onshore or offshore; it is capitalized adequately; there is risk shifting and risk distribution under the IRS criteria; premiums are reasonable, given the risks covered; and the company is operated in an arm's-length manner, i.e., there are no loan-backs and no guarantees by the parent company or business owner. These challenges can be addressed and minimized by working with an experienced captive manager with insurance and risk management skills (not just tax skills). The path to a successful captive operation includes the proper business motivation; insurance skills; and knowledge, appropriate structure, underwriting, and management. ■

