Forming a Captive Insurance Company

A Tax Perspective

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Part of a CPA's job is to evaluate the potential tax benefits of various business and estate planning strategies.

One planning strategy that is gaining more and more acceptance is the formation of a captive insurance company, which has important tax considerations. The three primary tax aspects to evaluate in the captive structure are deductibility of the premium from the parent to the captive, tax treatment of the premium once it received by the captive, and taxation of the money if it is distributed from the captive.

What is a Captive?
A captive is an insurance company established primarily to insure the risk of its parent company and affiliated organizations or groups. Comparisons are often ma to self-insurance. While the retention of risk is the obvious similarity, a captive generally provides greater tax benefits. A company that self-insures incurs a tax deduction only when a claim is paid, whereas a captive allows the parent to claim a deduction for premium contributions to the insurance company.

Just because a captive is considered an insurance company does not mean the premiums are automatically deductible to the parent. The IRS states that for a transaction to be considered insurance, both "risk shifting" and "risk distribution" must be present.

Risk shifting occurs when a person or entity facing economic loss transfers some or all of the potential loss to an insurer. Under FAS 113, for a transfer to be considered insurance, the must be at least a 10 percent chance of a 10 percent loss. Simply stated, there must be some chance for underwriting losses between premiums paid and the limits of the policy.

Risk distribution involves the law of large numbers where enough relatively small, independent risks are involved to reduce the possibility that one large claim will exceed the premium received and threaten existing reserves. The IRS has set forth several revenue rulings outlining methods by which captive owners can achieve sufficient risk distribution.

Safe Harbor Rulings
Rev Rul 2002-90 - This ruling states that risk distribution is present if the captive insures 12 or more operating subsidiary companies where none of the subsidiaries have coverage for less than 5 percent or more than 15 percent of the total risk insured by the captive.

Rev Rul 2002-89 - If the parent does not have 11 or more qualifying subsidiaries, then the captive can accept third party risk from a risk pool. This happens when the captive reinsures portion of its risk to a pool and receives an equal portion of third-party risk back from the same pool.

Rev Rul 2005-40 - Clarifies guidance on the two rulings listed above and provides case studies.

Taxation of the Captive
There are two primary tax treatments for single-parent captives. The first is an 831(b) small insurance company and the second is a regular property and casualty company.

831(b) Small Insurance Company - Internal Revenue Code Section 831(b) allows a captive to be taxed only on its investment income. Section 831(b) states that if an insurer writes $1. million or less of premium on an annual basis, the premiums received are tax-free. 831(b) is an annual election and the captive insurance company files a separate return from the par on Form 1120-PC.

Regular P&C Company - These captives are taxed on premium income received, as well as investment income, but receive a deduction for claims, reserves and operating expenses. F more discussion on the taxation of insurance companies, see IRC 831(a), 831(c)-831(d) and 832. IRC 832(b)(5) contains a discussion of reserves.

Captive Distributions
Should a captive owner wish to close down a captive, it would be the dissolution of a C Corp, which is generally treated as a capital gain under IRC 336.

While the tax benefits can be substantial and are important, there should be one or more non-tax motivations for forming a captive. These include the opportunity to retain and invest underwriting profits, customize coverage, reduce insurance expenses, and gain control over a risk management program. As evidenced by the Tax Code, Congress realized the importance of offering protection against adverse insurance cycles and the effect on business owners.

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