TAX BENEFITS FOR SMALL CAPTIVES

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Risk management without passion, innovation and accountability is just buying insurance
Tax Benefits for Small Captives

Companies are created with a common purpose of generating profits, with a focus on maximizing earnings in order to return value to shareholders or the owners of the company. Controlling costs and limiting business risks help to increase shareholder value. One of the largest expenses a business may incur is the cost of insurance to protect the company from various internal and external risks. Whether it is workers’ compensation, employee benefits, general liability or property coverage, many companies are paying more and more each year for insurance protection. Today, a growing number of businesses are forming captive insurance companies as a way to reduce their overall costs of insurance and better control their risks.

A captive insurance company, commonly referred to simply as a “captive”, is a real insurance company with policyholders, premiums, claims and regulatory oversight. Captives primarily insure the risks of the parent company or other entities that are related through common ownership. For example, the owner of a group of businesses can form a captive insurance company for the purpose of insuring some or all of its related companies. The insured business(es) pay premiums to the captive in exchange for insurance coverage. In addition, captives can insure the risks of controlled, unaffiliated businesses resulting in opportunities to both capture underwriting profit it wouldn’t otherwise be able to and to strengthen business relationships along a business’ supply chain. A captive can be owned by the business owner, a spouse, relatives, a trust, or any of the companies under common ownership.

First and foremost, captives are and should be formed as a risk management tool. The most compelling reason to form a captive is to reduce the overall insurance costs to its related affiliates. Through lower administrative costs and access to the reinsurance markets, a captive insurance program can provide insurance at a substantial savings compared to the commercial marketplace. In addition to these savings, by understanding the company’s own loss experience, a captive provides a way to recapture underwriting profits which would otherwise be realized by a traditional insurance carrier. Although the monetary benefits are the most recognized, a captive adds much more value to the organization. Such additional benefits include the ability to customize its insurance program, increase claims control, provide coverage not available in the traditional market and provide a formalized mechanism to monitor the company’s risk.

Due to the increase in the awareness of the captive industry as a whole and the benefits a captive can provide, we are seeing tremendous growth within the captive insurance industry. Gone are the days in which only the Fortune 500 companies were aware of the benefits a captive program provides and had the resources available to form a captive. The industry is seeing further expansion into the middle market sectors. With smaller companies now taking advantage of the benefits that captives provide, the premium levels are often much less than those of the larger fortune 500 companies.

A special tax election is available to “small property and casualty insurance companies” which can substantially reduce the company’s federal income tax liability. Captives whose premiums do not exceed $1.2 million can elect, pursuant to IRC § 831(b), to be taxed solely on taxable investment income. Thus, all underwriting profits earned by
the captive are essentially earned tax-free. This represents a significant advantage, especially when considering the operating entity being insured will receive a tax deduction for the full amount of premiums paid to the captive. This could potentially result in permanent federal income tax savings of up to $420,000 ($1.2 million * 35%) to the operating entity. These small captives electing to be taxed on their taxable investment income are often referred to as “831(b) captives”, referencing the Internal Revenue Code section to which the election pertains to.

**Example:** XYZ Company formed ABC Captive Insurance Company to insure the general liability coverage for XYZ’s 50 subsidiaries, all sister corporations to ABC Captive. The total premium paid by all sister companies is $1 million. The captive will not pay a loss until year 3 of the program, which is actuarially determined to be $500,000. All companies file a consolidated federal income tax return with XYZ Company.

Based on the facts above and ABC Captive Insurance Company has made an election pursuant to IRC § 831(b). The subsidiaries would receive a deduction for the $1 million of premium paid to ABC. In turn the captive insurer would not be subject to federal taxation on the premium received, representing a $350,000 savings ($1 million* 35% tax rate) to the overall consolidated tax return.

The ownership of the captive plays an important role in determining how the built-up profits will be taxed upon distribution to its owners. For those captives owned by corporations, dividends paid to the parent company would qualify for a 100% dividends received exclusion from taxable income. Dividends paid by small and middle market captive insurance companies owned by individuals, or flow-through entities owned by individuals, have a different tax regime to consider. Owners would be subject to tax on dividends received at the individual federal dividend rates (currently between 15%-23.8%) plus any additional state tax. As one can see choosing an appropriate ownership structure from the inception of the captive is a consideration which should not be taken lightly.

**Example 2:** Based on the facts in Example 1 and ABC Captive Insurance Company has paid a dividend of $100,000 to XYZ Company, its wholly owned parent company. XYZ Company would record $100,000 of income within its financial statements. However, for federal income tax purposes the company would receive a $100,000 dividends received deduction, thereby reducing its taxable income to zero. Assuming this was the only transaction XYZ Company recorded for the year, the company would have no tax liability.

**Example 3:** Based on the facts in Example 2 except that ABC Captive Insurance Company is wholly owned by Jack Frost, an individual in the highest tax bracket. Jack Frost would report the $100,000 dividend income on his personal tax return, Form 1040. Due to his high tax bracket Jack would be subject to a federal dividends tax rate of 23.8%, resulting in a tax liability of $23,800. While this seems like all tax benefits have been squandered, we must remember Jack’s business received a $35,000 tax benefit for the $100,000 of premium paid to the captive. This results in a net permanent federal tax savings of $11,200 in addition to receiving the benefit from the time value of money.
Up to this point the focus has been on current tax benefits and how they relate to the overall corporate structure. As mentioned above, the ownership of the captive can play just as important a role in tax planning as the actual captive itself. For example, if a captive is owned by a trust whose beneficiaries are the children, over the age of 21, of the owners of the operating business, an opportunity exists to pass wealth outside the parent’s estate. By paying premiums to the captive, wealth is essentially transferred out of the operating business to the captive. Premiums paid to the captive will reduce the federal tax liability of the operating business. Because insurance companies enjoy unique tax advantages, it is easier to mitigate the tax exposure to the captive. For example, as discussed above in greater detail, insurance companies can reduce their tax liability by making an § 831(b) election which could essentially negate taxes on all underwriting income. By utilizing a trust, it is possible that every premium dollar paid would pass outside the parent’s estate and to the children without creating any federal gift or estate taxes.

While the tax benefits are the most recognized and sought after, tax cannot be the motivation for forming a captive insurance company. Both the IRS and the Courts have consistently ruled that in order to sustain insurance treatment for federal income tax purpose, there must be a legitimate non-tax business purpose (or purposes) for the captive insurance arrangement. Although accelerating a deduction for premiums paid to an insurance company is also one of the benefits of setting up a captive, it cannot be a leading consideration. The Courts have ruled those arrangements established solely for tax purposes to be “shams” and have disallowed the deductions for premiums paid to the captive. Remember first and foremost, captives are and should be formed as a risk management tool.

Business purpose is only the beginning in establishing a captive insurance company built to withstand IRS scrutiny. If the premiums are paid to a captive, there are various tests that must be satisfied to determine whether the payment will in fact be treated as a deductible insurance premium. A captive must be treated and must operate as an insurance company for income tax purposes for premiums to be deductible by an insured party. In making this determination, the test factors involve: identifying the presence of an insurance risk, risk shifting, risk distribution, capitalization, indemnifications and guarantees and whether the contracts are commonly accepted as insurance. In addition, the captive’s primary and predominate business activity must be the issuance or reinsurance of insurance contracts. Each of these test factors has evolved through modern case law and must be present in order to not only withstand a challenge from the IRS but to ensure successful in court as well.

In summary, captive insurance companies have a proven track record of being a valuable risk management tool. However, many small and middle market clients are attracted to captives with the sole purpose of the IRC § 831(b) advantages in mind. Given the proper management team, many of these small and middle market clients can be enlightened to the numerous other benefits captives have to offer while being structured in such a manner to preserve its IRC § 831(b) status under IRS scrutiny.
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