Published on *The National Law Review* https://natlawreview.com

Managing Risk—Captive Insurance Companies

Article By:

Kristen E. Hazel

In every **mergers and acquisitions (M&A)** transaction, a series of risk management choices must be made. These choices range from "bet the company" decisions to ordinary course insurance procurement decisions. Following an acquisition or a divestiture, risk management decisions must be made with regard to the newly constructed business enterprise. As an example, consider a global acquisition that results in a decentralized management structure. Over time, the businesses will begin to align from both an operational and a management perspective. The risk management team will look for opportunities to reduce insurance costs and to minimize loss exposures as operational and management decisions are made. A captive insurance arrangement can be an important tool for reducing those costs and minimizing those exposures. Captive insurance companies can offer a wide variety of coverage, ranging from standard risks—general and auto liability, property, certain types of employee benefits and workers compensation—to more exotic lines of coverage, such as terrorism and cyber risks. There are several forms of captive insurance arrangements each uniquely suited to particular fact patterns. The common denominator among the various forms of captive insurance is enhanced risk management, reduction of the cost of risk and, in the for-profit arena, potential tax benefits.

What is a captive insurance company?

First and foremost, a captive insurance company is an insurance company. The business of the company must be, predominantly, the underwriting of risks, management of claims and related activities, including investment activities. In conducting this business, the insurance company accepts risk of loss associated with a specific contingency. Second, the insurance company is "captive" in that it may be wholly owned within a related group of companies and insure only risks of that related group (of course, the captive may also insure unrelated parties).

A captive insurance company can be organized as a domestic corporation or as a foreign corporation. In either case, the company is licensed and regulated by the applicable jurisdiction's insurance regulator. Typically, a captive insurance company is run by a professional insurance manager. Of course, the owner/policyholder's risk management professionals will be involved on a daily basis, and these in-house professionals, not the management company, will make the captive's business and strategic decisions.

What constitutes the business of insurance?

As a general principle, insurance is a contract that operates to protect the insured against an economic loss arising out of a particular contingency in exchange for a premium payment. The risk must arise as a result of an uncertain or fortuitous event and must relate to an economic loss. A good example of the type of risk often covered by captive insurers is workers' compensation risk. In contrast, business risks, such as risks associated with defective products that must be replaced, do not typically have the requisite element of uncertainty or fortuity to be considered insurable risks.

How does the captive insurance company operate?

The insurance risk must be transferred to the captive insurance company, which must then have a sufficient pool of risks, such that the insured is not funding its own risk. In other words, once the risk is transferred to the insurance company and an actuarially determined premium is paid by the insured(s), the insurer has a sufficiently diversified risk pool, such that the premium payment cannot be more properly viewed as a deposit.

In a simple example, assume Company A procures general liability insurance for Company A and its affiliates from a commercial insurer. The policy provides for a deductible or self-retention and covers claims up to a specified policy limit. Company A wants to procure a supplemental policy to cover the deductible, but it finds commercial insurance to be too costly. To solve this problem, Company A could organize a captive insurance company to fund for this risk. Each affiliate would be an insured under the captive insurance policy, and the captive insurer would accept each affiliate's risk in exchange for an actuarially determined insurance premium. Following the insurance transaction, the captive insurer bears the risks funded by the pooled premiums of the insureds, and, with respect to the insured risk, the insureds are financially protected.

Of course, there are a number of steps that Company A would need to take to implement this strategy: hire a management company;, prepare a feasibility study, engage legal counsel, form an entity, apply for an insurance license, engage an actuary to determine a premium and allocation among the participating members of the Company A affiliates and to determine the captive insurer's loss reserve (an estimate of the value of claims not paid), and establish internal policies and guidelines for implementation and maintenance of the captive insurance company. The captive insurance industry offers numerous resources to accomplish these tasks.

Once funded and operational, the captive insurance company will permit the owner(s) to centralize certain risk management decisions and, over time, the overall loss experience may improve. Moreover, by centralizing and managing risk, the combined businesses or, in the case of a divestiture, the newly rationalized business can devote more resources to the business itself.

What are the tax benefits of a captive insurance company?

The business driver for a captive insurance company is, at its core, risk management—loss mitigation and improved claims handling. An additional potential benefit of a captive insurance company lies in the U.S. federal income tax treatment of such a company. From a tax perspective, the captive insurance company must: (i) take on insurance risk; (ii) exhibit risk shifting and risk distribution; and (iii) constitute insurance in the commonly accepted sense. Where all three factors are present, the captive is treated as an insurance company for U.S. federal income tax purposes. Within a U.S. group of companies, the insureds' premium payments would be deductible by the insureds and includible in income by the insurer. Thus, the deduction and inclusion should net to zero. The tax benefit arises from an additional deduction available only to insurers. Under the insurance rules applicable to captive insurers, the captive insurer is able to deduct an actuarially determined, discounted insurance loss reserve currently. This deduction provides a timing benefit to the group; rather than defer the deduction until the claim is paid, the captive insurance company is able to take the deduction currently. If the captive insurance company is organized outside the United States, the loss reserve becomes available through application of anti-deferral rules. Deemed income under the anti-deferral rules is reduced by the deductible loss reserve.

Of course, maintaining insurance company tax status is important. If the captive fails to qualify as an insurance company for U.S. federal income tax purposes, the foregoing tax treatment would be lost—the premiums no longer would be deductible by the insureds, and the loss reserve may be recaptured. In addition, special challenges are present in the M&A context. Specifically, a post-acquisition structure may contain multiple captive insurance companies if both the acquirer and target had captive arrangements in place prior to the transaction. Merging captives can be difficult, and the combination transaction must be carefully structured to avoid unintended tax consequences. An alternative to combining the captives, putting one or more of the captives into run-off, presents equally challenging tax issues. There, generally, are ways to structure around the tax issues, but careful coordination between the risk management and tax teams is advisable.

Are there tax detriments?

Many states impose a premium tax and/or a direct-placement or self-procurement tax. The premium tax is generally levied on gross premiums received by the insurer. The direct-placement tax is imposed on the insured. The direct-placement tax is levied when an insured procures insurance from a non-admitted carrier. For example, if an Ohio insured procures insurance from a Vermont captive insurer, the insured would be liable for the Ohio self-procurement tax because the Vermont captive insurer would be treated as a non-admitted carrier.

An additional tax in the form of a federal excise tax arises when insurance or reinsurance is procured from a non-U.S. insurer without tax treaty protection (*e.g.*, an insurance or reinsurance company organized under the laws of Bermuda). The excise tax rate on insurance transactions is 4 percent of premiums paid and 1 percent of premiums paid on reinsurance transactions.

Operating the Captive Insurance Company

Captive insurance companies have been around for decades, and they have withstood countless challenges by the Internal Revenue Service (IRS). Nonetheless, continued challenges can be expected. Best practices for maintaining the insurance company include:

- Contemporaneous documentation of the business purposes and business strategy for the captive insurance company;

- Adequate capitalization to ensure that the captive insurance company can withstand losses by using actuarial analyses and maintaining adequate corporate capital;

- Respect the corporate formalities of the captive insurance company; hold regular board meetings to address substantive issues, maintain books and records, and maintain independence in making risk management decisions; and

- Undertake periodic internal audits with corporate, legal and tax counsel

If contacted by the IRS, don't go it alone. The industry is rich with resources to help.

National Law Review, Volume IV, Number 51