PART XIX: CAPTIVE INSURANCE

8010. What is captive insurance?

In its simplest form, captive insurance is insurance that is provided within a corporate group, through a subsidiary that is controlled by a parent company. Instead of purchasing insurance from an external commercial insurance company, the parent company manages the risks of the corporate group through the subsidiary. The captive then either reinsures these risks or retains the risks itself. As with a traditional insurance policy, the parent company (or group of companies) pays premiums to the subsidiary providing coverage. See Q 8011 for variations on this basic form of captive insurance.

Captive insurance may be used for a variety of reasons. Many times it can be used when a company has risks that are difficult or impossible to cover with traditional insurance. The parent company is often able to save substantially on premium costs by using captive insurance because traditional insurance companies charge higher premiums to cover their own costs and turn a profit. Using captive insurance allows the insured entities to pay only for coverage, retaining any profits within the corporate group. Further, the corporate group controlling the captive is able to retain control over how any insurance profits are invested and managed. While the tax benefits of captive insurance are often not the primary motivator for using a captive insurance structure, they can provide motivation for forming a captive, instead of using commercial insurance. See Q 8012, Q 8013 and Q 8020 for the tax considerations applicable to captive insurance companies.

While captives are typically used to insure against general liability or workers' compensation risks, they can also be used to cover more obscure risks (such as terrorism-related risks) that are much more difficult to insure through traditional commercial insurance. Larger corporations may form multiple captives to insure against different risks, rather than pooling all risks together within a single captive.

A captive insurance company can be organized domestically, in any jurisdiction that has a captive statute permitting organization, or in a variety of offshore locations. See Q 8018 and Q 8019 for a discussion of the tax treatment of foreign-domiciled captives. See Q 8020 for an overview of the state taxes that may apply to a domestically-organized captive.

8011. What are the different types of captives?

Captives may take on a variety of different forms to provide the type of coverage desired by a particular business group.

A single parent captive, also referred to as a "pure" captive, is a captive company with a single owner. The captive provides insurance coverage only to this parent company (or related business group). Because pure captives provide insurance coverage only within the single business group, this structure provides the greatest degree of flexibility. Pure captives are exempt from many of the regulatory requirements, such as consumer protection regulations, that are applicable to other forms of captive entities.

The term "group captive," on the other hand, refers to a category of captives where insurance coverage is provided outside of a single business group. This category of captives includes association captives, industrial insured captives, and risk retention groups. An association captive insures the risks of companies that are members of a single organization or industry. The risk and costs associated with providing this insurance are spread among the group, and the captive is either jointly owned by the association members, or is owned by the association as a whole.

Industrial insurance captives, as the name suggests, insure the risk of an industrial insurance group. Companies included within the group must meet certain size and operational requirements.

Risk retention groups are a form of captives created by the Product Liability and Risk Retention Act of 1986. Originally, these types of captives were formed to insure against risk of product liability litigation that was otherwise difficult to insure. Today, risk retention groups are more likely to be used among doctors, lawyers, hospitals, and other groups facing similar risk exposure. Risk retention groups allow members of an industry who face similar risk exposure to come together and form their own insurance company, which is preempted from certain state insurance regulation.

Single parent captives and group captives are funded by an entity that is insured by the captive. Agency captives, rent-a-captives, sponsored captives, and protected cell captives, on the other hand, are all types of captives that are funded by an unrelated entity, or "sponsor." The sponsor then "rents" the services of the captive to various insured entities.

Planning Point: These types of captives, while easy to form because they require no initial outlay of capital by the insured, offer the insured less control over the captive's cost and operational structure.

8012. What tax benefits that can be realized by a captive?

Typically, the parent entity that owns a captive insurance company can deduct the premiums it pays to the captive as ordinary and necessary business expenses under IRC Section 162. The captive is then permitted to deduct the allowable amount of reserves that it invests to cover its exposure.

Often, the captive is able to substantially accelerate loss deductions available for the corporate group. Captives that qualify as insurance companies (see Q 8014), like traditional insurance companies, are permitted to take a loss deduction for losses that have been reported, or for losses that have been incurred but not yet reported, even if the claim has not yet been paid. Generally, a company would be required to wait to take the deduction until the claim has been paid.

However, smaller captives may be able to avoid all income taxation. Under IRC Section 501(c)(15), a very small insurance company can avoid paying income taxes on income from premiums and investments if it receives $600,000 or less each year and more than 50 percent of that income was premium income. IRC Section 831(b) increases the amount of non-taxable premium income permitted to $1,200,000, but requires that the captive pay income taxes on any investment income it receives (see Q 8013).

While tax preferential treatment can provide a strong motivation for companies in establishing a captive company, in order to realize these benefits the company must have a legitimate insurance purpose for forming the captive (see Q 8014).

8013. What is an IRC Section 831(b) captive? When are the insurance profits earned by an IRC Section 831(b) captive taxed?

In order to qualify as an IRC Section 831(b) insurance company, the captive must have net written premiums of less than $1,200,000 per year.[1] Under Section 831(b), an insurance company meeting the premium requirement is not required to pay any income taxes on its insurance profits. Federal tax therefore applies only to investment income realized by the captive.

Further, the premium payments made by the parent entity to the captive may be deductible under IRC Section 162 if the captive meets the risk shifting and risk distribution requirements outlined in Q 8016.

The captive must elect tax treatment under Section 831(b) and, once the election is made, it can be revoked only with the consent of the Secretary of the Treasury.[2]

8014. What are the risk shifting and distribution requirements that allow a captive insurance contract to qualify for favorable tax treatment?

The concepts of risk shifting and risk distribution are two issues that are especially important for the pure captive insurance company (See Q 8011). In order to be treated as an insurance contract, both risk shifting and risk distribution must be present.[3] If the captive transaction is not treated as an insurance contract, the tax deduction for insurance premiums may be unavailable.[4]

Risk shifting is traditionally found to be present in an insurance contract because the insured party shifts the risk of loss to the insurance company. Risk distribution occurs when the insurance company that assumes the risk of loss distributes this risk among a pool of insured entities.[5]

The problem captive insurance companies often face in meeting these requirements is that both the insured and the insurer are usually owned within the same corporate group, so the risk never leaves that group. The IRS initially found that the insurance premiums paid by the parent company to its subsidiary captive entity were not deductible.[6] In Revenue Ruling 77-316, the IRS introduced the concept of the "economic family" and found that because the parent entity and wholly-owned captive insurance company were a part of the same economic family, no risk shifting was present because the risk remained within the corporate "family."[7] Further, risk distribution was not present because the captive did not distribute its risk among a group of insured entities, since it insured only entities within its own economic family.[8]

1. IRC Sec. 831(b)(2)(i).
2. IRC Sec. 831(b)(2)(ii).
3. *Helvering v. LeGierse*, 312 U.S. 531, 539 (1941).
4. Treas. Reg. §1.162-1(a).
5. See, for example, *Comm. v. Treganowan*, 183 F.2d 288 (2nd Cir. 1950); *Beech Aircraft Corp. v. United States*, 797 F.2d 920 (10th Cir. 1986).
6. Rev. Rul. 77-316, 1977-2 CB 53.
7. *Id.*
8. *Id.*

Though the IRS abandoned this rigid approach to captive insurance transactions in Revenue Ruling 2001-31, where it announced that it would examine these transactions on a case-by-case basis, the basic analysis is still important because risk shifting and risk distribution remain required elements of the insurance contract.[1]

Risk shifting and risk distribution have been found to exist in several captive insurance arrangements. In Revenue Ruling 78-338, the IRS found risk shifting and risk distribution existed where the captive was owned by 31 unrelated shareholders, none of whom owned a controlling stake in the captive.[2] In Revenue Ruling 2002-91, the taxpayer-company and a small group of companies in the same industry formed a group captive (see Q 8011) where an insurance contract was found to exist.[3] The captive provided insurance only to the group of owners, none of whom controlled more than a 15 percent interest in the captive. The IRS allowed the deduction, finding that an insurance contract existed because:

1. an insurance risk was present;
2. the risk was shifted and distributed; and
3. the transaction was of a type that is insurance in the commonly accepted sense.[4]

The IRS noted that there was a very real possibility that any member of the group could sustain losses in excess of the premiums that it paid to the captive. By paying premiums to the captive, risk was shifted to, and distributed among, the unrelated group.

The IRS has privately ruled that an insurance contract existed in a "brother-sister" captive arrangement where the parent entity formed a captive subsidiary to provide insurance to its "sibling" subsidiaries.[5] The IRS found that an insurance relationship was present and listed several factors that were important in its determination:

1. Neither the parent entity nor any related entities guaranteed the subsidiary's performance;
2. The captive subsidiary was adequately capitalized;
3. There was a legitimate insurance-related reason for forming the captive (in this case, recent disruptions in the market for workers' compensation insurance);
4. The captive was fully regulated for most of the year as a U.S. insurance company;
5. The captive assumed the workers' compensation risks of several of its sibling subsidiaries, distributing the risk of loss among this pool of insureds.

1. 2001-26 IRB 1348.
2. 1978-2 CB 107.
3. 2002-52 IRB 991.
4. Citing *Ocean Drilling & Exploration Co. v. United States*, 988 F.2d 1135 (Fed. Cir. 1993); *AMERCO, Inc. v. Comm.*, 979 F.2d 162 (9th Cir.l 1992).
5. Let. Rul. 200149003.

Planning Point: These factors, among others, are those typically relied upon by the IRS in the facts-and-circumstances inquiry employed to determine whether a valid insurance contract exists.[1]

8015. Are there any safe harbors that can be used in a captive to ensure that an insurance arrangement will be found to exist?

Yes. Because of the uncertainty of the IRS' facts and circumstances inquiry, the IRS released Revenue Rulings 2002-89 and 2002-90, which provides safe harbor methods for determining whether a captive arrangement will constitute insurance.

In Revenue Ruling 2002-89, the IRS found that, in a parent-subsidiary relationship, a captive will qualify as insurance if at least 50 percent of the premiums received by that captive insure unrelated third party risk. In Revenue Ruling 2002-90, which involved a brother-sister captive arrangement, the IRS found that if the captive insured the risk of at least twelve entities, insurance would be present for income tax purposes.

These revenue rulings provide a degree of certainty for companies that wish to form captive insurance subsidiaries that will insure only the risk within the corporate group.

8016. How does the tax-exempt status of the captive's owner affect the captive?

While Q 8014 and Q 8015 focus on for-profit companies that want to structure their related captive so that it can be classified as an insurance company for tax purposes, tax-exempt entities typically aim to avoid insurance company classification.

IRC Section 501 permits many organizations to operate on a tax-exempt basis, but it also contains a specific provision limiting the ability of these organizations to engage in commercial insurance activities.[2] An organization will not qualify for tax-exempt status if any substantial portion of its business involves providing commercial-type insurance.[3]

The IRC excludes the following insurance-related activities from the definition of "commercial insurance":

1. Insurance provided at a substantially reduced cost to charitable recipients;
2. Incidental health insurance provided through a health maintenance organization of a kind customarily provided by such organizations;
3. Property or casualty insurance provided by a church organization for the benefit of that church organization;

1. PLR 200149003. See also Rev. Rul. 2002-90, 2002-52 IRB 985 (deduction allowed where the risk was shifted to a sibling captive and distributed among a pool of 12 brother-sister entities and a legitimate insurance-related purpose for forming the captive was present); Rev. Rul. 2008-8, 2008-5 IRB 340 (denying the deduction for a parent-subsidiary relationship and permitting it where all premiums paid by subsidiaries were pooled to shift the risk of loss to the captive sibling entity and the risk was found to be distributed among 12 brother-sister entities), FSA 200202002.
2. IRC Sec. 501(m).
3. IRC Sec. 501(m)(1).

4. Retirement or welfare benefits provided by a church organization for its employees or beneficiaries of its employees;

5. The use of charitable gift annuities.[1]

If the insurance activity of the tax-exempt organization does not fall within one of these exclusions, the insurance profits of the captive will be taxed to the organization as unrelated business taxable income (UBTI).[2]

Further, because of the state taxes that may apply to the premiums paid to a captive insurance company, the tax benefits of qualifying as an insurance company may not be sufficient to offset the additional taxes applied in the case of an entity that is operating on a tax-exempt basis. See Q 8020 and Q 8012.

Planning Point: While captive arrangements may be especially attractive to tax-exempt organizations because of the types of risk they may encounter, proper structuring is important to ensure that the tax liabilities do not exceed the benefits of the captive arrangement. Hospitals and school districts, for example, may find captive arrangements useful in insuring against malpractice and workers' compensation risks. If properly structured, the use of captive structures can greatly reduce the cost of insurance for these organizations.

8017. How can captive insurance be used as an estate planning tool in closely held businesses?

In the closely held business context, captives can play a valuable role in estate and business succession planning. If the captive is owned directly by (or for the benefit of) a business owner's chosen beneficiaries, the business owner may transfer wealth without gift, estate, or generation-skipping transfer (GST) taxes.

To avoid gift, estate, and GST taxation, the transfer of funds to the captive must be made in the ordinary course of business (meaning that the funds received by the captive are also deductible under IRC Section 162). When the transaction occurs in the ordinary course of business, it will be considered to have been made for adequate and full consideration.[3]

If the captive qualifies as an insurance company, the premiums paid by the insured entity or entities will be considered insurance premiums, which are ordinary and necessary business expenses under IRC Section 162 (See Q 8012). If this is the case, gift, estate, and GST taxes will not apply to the transfer.

Planning Point: In the context of a closely held business, the use of captives can be part of an effective estate planning strategy. The business owners can form a captive entity to provide insurance for their business group and name children and grandchildren as the owners of that captive. Because all funds transferred to the captive will escape gift, estate, and GST taxes, the net underwriting profits of the captive will essentially have been transferred to the owners' children and grandchildren transfer tax-free. The structure of the transaction is important in estate

1. IRC Sec. 501(m)(3).
2. IRC Secs. 501(m)(2)(A), 513.
3. Treas. Reg. §25.2512-8.

planning, so the business owner should seek professional advice from legal and tax advisors in forming the captive entity and transferring the premiums to that entity. To avoid transfer taxes, it is important that the owner have no retained interests in or control over the captive.

8018. What taxes apply to a foreign captive that do not apply to a captive formed domestically?

While captives that are formed in foreign jurisdictions can often take advantage of tax benefits that are not available within the U.S., these captives may become subject to U.S. excise taxes that erase the benefits of a foreign domicile.

A U.S. excise tax of 1 percent is applied to gross reinsurance and life insurance premiums and a 4 percent excise tax is applied to direct property and casualty premiums paid to a foreign insurer.[1]

Further, U.S. shareholders of a controlled foreign corporation (CFC) must include their pro rata share of the CFC's insurance income in their gross income if their stock ownership exceeds certain threshold amounts.[2] A foreign captive will be considered a CFC if U.S. shareholders (as defined below) own more than 50 percent of either (a) the combined voting power of the corporation or (b) the total value of the corporation.[3]

A "U.S. shareholder" is defined, for these purposes, as a person who owns at least 10 percent of the total combined voting power for all classes of stock in the foreign corporation.[4]

While the captive itself is not taxed under the CFC provisions, the U.S. shareholders are treated as though they have received a distribution of the insurance income and are taxed on this income. For example, if a corporation organized in the U.S. forms a captive in Bermuda and distributes ownership of the captive among its U.S. subsidiaries, those U.S. subsidiaries will be taxed based on their proportionate ownership shares in the captive.

8019. Can a foreign captive avoid excise taxes and elect to be taxed as a domestic insurance company?

A foreign captive can avoid the excise taxes imposed on foreign insurance premiums, as well as certain reporting requirements, if it elects to be taxed as a U.S. insurance company.[5] This is known as a Section 953(d) election. Upon making this election, the foreign captive is treated as though it has transferred all of its assets to a domestic captive in connection with an exchange to which IRC Section 354 applies.[6]

Once the Section 953(d) election has been made, it can be revoked only with IRS consent.[7]

1. IRC Sec. 4371.
2. IRC Sec. 951(a)(1).
3. IRC Sec. 957(a).
4. IRC Sec. 951(b).
5. IRC Sec. 953(d).
6. IRC Sec. 953(d)(4).
7. IRC Sec. 953(d)(2)(A).

8020. What are the state-level taxes that may apply to a captive entity? What are the corresponding state tax benefits that a captive may realize?

A captive is generally subject to taxation in the state where it is formed. State taxes can take the form of franchise, premium, or self-procurement taxes, depending on the state law.

The captive will be regulated as an insurance company in the state in which it is formed, just as any other insurance company. Most states impose a premium tax on the value of the premiums collected by the captive.

Despite this, the premium taxes imposed by many states are highly favorable to captives. For example, Vermont, which is one of the largest U.S. markets for captive insurance companies, collects a premium tax of 0.38 percent on the first $20 million of insurance premiums collected by the captive in the state. The second $20 million of insurance premiums is taxed at 0.285 percent, the third $20 million is taxed at 0.19 percent and anything above $60 million in premiums is taxed at 0.072 percent.[1] The total amount of premium taxes that must be paid by a captive in Vermont is capped at $200,000 annually.[2] Vermont also imposes a minimum premium tax of $7,500.[3]

Some states also impose a self-procurement tax on the insured entity that procures insurance directly from non-admitted insurance companies. These taxes also vary from state to state. In Florida, for example, an insured entity that independently procures its insurance is subject to a self-procurement tax of 5 percent of the gross premiums paid.[4] Florida also charges a 0.3 percent service fee, increasing this tax to 5.3 percent.[5]

However, assuming that the captive is formed to serve a legitimate insurance-related purpose, many state-level tax benefits can be realized. Generally, the captive will not be subject to state-level income tax in the state in which it is domiciled. Though many of these states will continue to apply a premium tax to the premiums collected by the captive within the state, these tax rates are typically much lower than a state's income tax rates.

Further, even if the captive is subject to state income tax requirements, the deduction for premium expenses outlined in Q 8012 is usually available at the state tax level, as well, assuming the arrangement qualifies as an insurance transaction. (See Q 8014).

1. 8 V.S.A. 6014(a).
2. 8 V.S.A. 6014(c)(1).
3. 8 V.S.A. 6014(c)(1).
4. Fla. Stat. § 626.938(3).
5. *Id*.