Captive Insurance in the Age of COVID-19

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Agenda

- Captive Insurance Overview
  - Captive Insurance 101
  - Potential Advantages of Captive Insurance
  - Evaluating Whether a Captive Is Right for Your Company
- Tax implications
  - Special Tax Rules for Insurance Companies
  - “Micro Captive” Insurance Companies
  - Tax-Exempt Captive Insurance Companies
  - Tax Considerations for Nonprofit Insureds

Captive Insurance 101

What is a captive?

- A captive is a licensed insurer regulated under state law.
- Many state laws/regulations have been amended to foster the use of captives (e.g., Vermont, Utah, South Carolina, DC, etc.).
- A captive has all of the obligations and responsibilities of a commercial insurer.
- However, it is generally owned or controlled by those whose risks it insures.
  - For example, a captive could be formed by a retailer to provide insurance for the retailer's operations.
- In some cases, captives are also used to insure the risks of third parties, similar to commercial insurers.
  - For example, a trade association could assist in forming a captive to cover members of the organization and similarly situated businesses.

Captive Insurance 101

How does a captive work?

- The captive assumes the risks insured and is responsible to the insured(s) for those amounts. Captive policies generally are similar to—but often simpler than—commercial insurance.
  - They contain coverage grants, exclusions, and other terms.
  - They have limits and deductibles or SIRs.
  - Coverage disputes are generally rare but not impossible.
- Captives can transfer some or all of their obligations by buying reinsurance (essentially insurance for an insurer—here the captive).
- Captives can also utilize a "fronting company"—a licensed insurer that issues the insurance policy on behalf of the captive, and which is 100% reinsured by the captive reinsurer. In that instance, the fronting company intends to have no risk of loss.
  - This can be useful if the captive is not licensed to issue the insurance in question. Fronting arrangements also assist with compliance with financial responsibility laws imposed by many states.
  - However, the fronting company (insurer) assumes a credit risk, since it would be required to honor the obligations imposed by the policy if the captive reinsurer fails to indemnify it.

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Captive insurance 101: Types of Coverage Available

Captives can be used to provide the following types of coverage (among others):

- Employee healthcare insurance
- Workers' compensation
- Product liability
- Professional liability
- Extended warranty and service contracts
- Cyber security and terrorism
- Other company-specific risks
- Increasingly, property insurance

Risks can be tailored to specific industries or circumstances and may provide coverage not commercially available (e.g., for COVID-19 or defense by firms not typically approved as panel counsel by insurers).

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Captive Insurance 101: Types of Captives Available

Single Parent

- Wholly owned subsidiary of parent company.
- Structured to meet individual company risk profile.
- Can be structured to insure third-party risks, if desired.

Multi-Parent

- Jointly owned by a group of companies in the same industry.

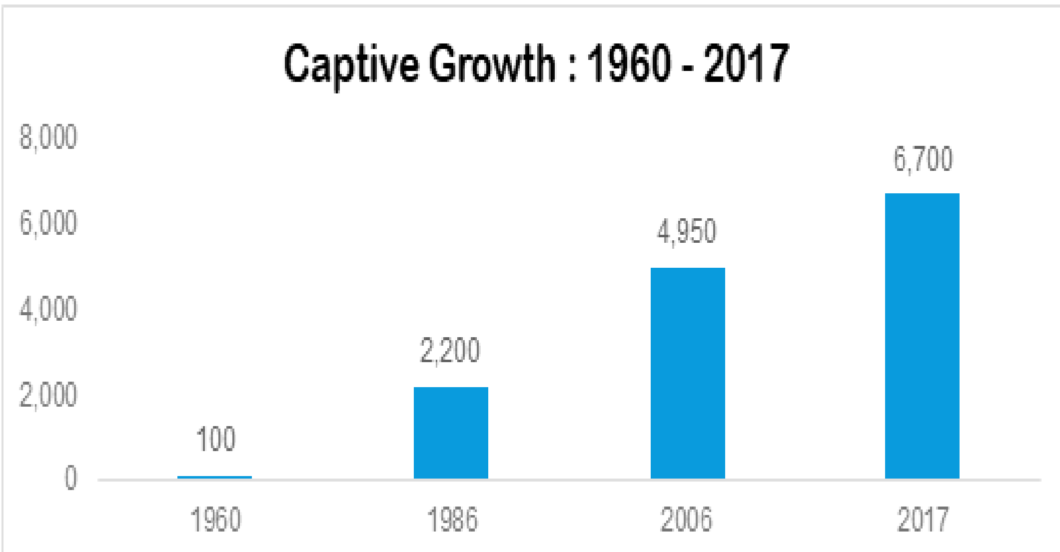
Heterogeneous

- Jointly owned by a group of companies of similar size but in different industries.
- Pooling of resources to better manage and diversify the insured risks.

Rental Captive/Cell

- Usually owned by a broker or third-party claims manager.
- Participant pays a fee to the captive owner to utilize a preexisting captive (or “cell” of a captive).
- May be appropriate where forming and managing a captive is not feasible.
- “Cells” are intended to be separate from each other, but the concept is newer than, and not as well settled as, corporate separation.

History and Growth of Captive Insurance



History lesson:

The term “captive” dates to the early 1950s, when Fred Reiss created the Steel Insurance Company of America for the Youngstown Sheet and Tube Company. Youngstown owned its own mines, which it called “captive mines,” because they were used to mine ore for the company’s mills. Reiss created the Steel Insurance Company of America to write insurance solely for those mines, and therefore called it a “captive insurance company.”

Captive Insurance 101—Committee Structure

Captives, like all insurers, must address underwriting, claims, investment of premiums and other funds, and audit responsibilities.

Underwriting Committee

- If the captive is to entertain risks other than that of the owners, then an Underwriting Committee should be established, along with underwriting standards, lines of authority, and procedures.

Claims Committee

- The Claims Committee is established to regularly review claims reports to determine trends, underwriting violations, and reserving practices. It may be involved in selection of adjusters, attorneys where appropriate, and reserve management.
- Third-party administrators can also handle claims in exchange for payment of a fee. Third-party administrators take no risk, however, and spend the captive's money.

Investment Committee

- Funds will be received upon creation and should be responsibly invested so that they are available to pay claims. Investments are usually limited by state law.
- Earnings from these investments can, over time, be considerable. If funds are improperly managed, they can cost the owner substantial sums and even imperil the continuation of the captive.

Potential Advantages of Captive Insurance

- **Coverage tailored to meet the parent's specific needs and risk profile**.
  - A captive can underwrite any risk it chooses and customize the terms of its policies.
  - It can also retain the premiums normally taken as profit by commercial insurers.
- **Greater control over claims**
  - A captive can specify claims handling and procedures and control the defense.
- **Ability to access reinsurance markets directly,** including workers' compensation, general liability, auto liability, professional liability, and credit risk.
  - Because reinsurers deal primarily with insurance companies, a captive allows the parent to go directly to the reinsurer and potentially save money.
- **Insure risks and obtain policy limits not traditionally available in the commercial insurance market**, such as credit risk and COVID-19.
- **However, the captive is on the hook for claims, so reinsurance should be strongly considered if claims can be variable or catastrophic.**

Potential Advantages of Captive Insurance

- **Reduced operating costs**
  - Insurance coverage purchased in the traditional market generally includes a payment for the insurer's acquisition costs, administration, and overhead, as well as profit to the insurer.
  - A captive can reduce these costs (with the size of any reduction dependent on the captive's loss experience and claims-handling costs).

- **Accumulation of investment income to fund losses**
  - With premiums paid upfront and losses funded over time, investment income can accumulate in a tax-free domicile, providing additional funds to pay for losses and a corresponding reduction for further captive funding.

- **Improve Risk Management**
  - A captive can operate and manage a central risk pool, implement an appropriate stop-loss reinsurance program to manage risks, and reduce the overall cost of risk.

Evaluating Whether a Captive Is Right for Your Company

Characteristics of a good candidate for captive insurance:

- A company paying high insurance premiums with low and consistent claim numbers
- A company with steady cash flow
- A company with a manageable and predictable risk portfolio and good risk management practices and procedures

Characteristics of a weaker candidate for captive insurance:

- Poor risk management practices and procedures
- High loss ratios
- Short-term outlook or price driven
- Financially less strong
- Highly volatile or catastrophic exposures without the support of stable lines
- Are too small to accept the risk of loss

Special Tax Rules for Insurance Companies

- A captive insurance arrangement allows the parent to self-insure, deduct insurance premiums paid to the captive, control the investment of the premiums (consistent with regulatory requirements), and then receive tax-free treatment when the captive is liquidated.
- IRC 832(b)(5) and IRC 846 allow insurance companies to deduct a portion of their reserves for unpaid claims.
- IRC 832(b)(4)(B) generally allows insurance companies to reduce the recognition of collected but unearned premium income to 20% (i.e., 80% deferral on unearned premium reserves).
- Under a self-insured arrangement, the insured would recognize a tax deduction as losses are paid out over time but would generally not be able to deduct a reserve for losses.

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Special Tax Rules for Insurance Companies

- Insurance companies may be eligible for special tax elections.
  - Insurance companies with less than $2.4 million in annual premium income ("micro captive" insurance companies) can make an election under IRC 831(b) to be taxed solely on investment income.
  - Insurance companies with no more than $600,000 in gross receipts may qualify for tax-exempt status under IRC 501(c)(15).
  - A captive insurance company formed in a foreign jurisdiction can make an election under IRC 953(d) to be taxed as a U.S. corporation.
    - Electing taxation as a U.S. corporation avoids the federal excise taxes on insurance premiums paid to a foreign insurance corporation and may eliminate withholding tax burdens.

Special Tax Rules for Insurance Companies

- The Internal Revenue Code does not define the term "insurance." Courts have focused on four factors: (1) risk shifting; (2) risk distribution; (3) insurance risk; and (4) insurance in the commonly held sense.
  - *Risk shifting* is the transfer of the impact of the potential loss from the insured to the insurer.
  - *Risk distribution* is the dispersal of risk to a larger population to reduce the changes that a single loss event will affect all insured parties in the same manner.
  - *Insurance risk* is generally implied within the first two factors. The insured must face some hazard, or insurance cannot be present.
  - *Insurance in the commonly held sense* is focused on whether the insurance arrangement itself is legitimate. The captive should be organized and operated as an insurance company and licensed as an insurance company, and its primary business should be insurance.

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Special Tax Rules for Insurance Companies

- Captive insurance companies may be subject to state and/or federal excise taxes.
  - *Premium taxes* owed by the captive insurance company or a licensed "fronting" company.
  - *Self-procurement taxes* for insurance companies that independently procure insurance.
  - *Federal excise taxes* if the insurance company is formed in a foreign jurisdiction.

“Micro Captive” Insurance Companies

- A “micro captive” insurance company makes an election to be taxed only on its investment income. Up to $2.4 million in net premium income can be excluded from taxable income.

- The IRS has scrutinized micro captive insurance companies heavily in recent years, due to the potential for abuse. IRS Notice 2016-66 requires micro captive insurance companies and their owners to file IRS Form 8886, Reportable Transaction Disclosure Statement, unless the company complies with both of the following safe harbors.

  - The liabilities the micro captive incurs for payment of insurance claims and claim administration expenses are at least 70% of the premiums earned by the micro captive, less policyholder dividends paid.

  - The micro captive does not provide financing to the insured or a related party.

- In addition, the ownership of the captive insurance company and the insured entities must generally be aligned.

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“Micro Captive” Insurance Companies

- The IRS has prevailed in recent cases challenging micro captive insurance arrangements.
- In March and July of 2020, the IRS issued thousands of “soft” letters to taxpayers that filed Form 8886 to disclose involvement with a micro captive insurance company.
- The IRS has formed 12 micro captive examination teams to handle audits of micro captive insurance arrangements.
- In December 2020, the Supreme Court heard oral arguments in *CIC Services v. IRS*, a case challenging the reportable transaction disclosure requirements in Notice 2016-66.

Tax-Exempt Captive Insurance Companies

- Insurance companies that receive no more than $600,000 in gross receipts are exempt from federal income tax if insurance premiums make up at least 50% of those gross receipts.
- 501(c)(15) tax-exempt insurance companies are rare, due to the low $600,000 threshold.
- The threshold cannot be avoided by forming multiple related insurance companies, since the $600,000 limit applies on an aggregate basis.

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