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About the Author

Peter S. Rauner
FCAS, MAAA

Mr. Rauner is a Senior Consultant with Pinnacle Actuarial Resources, Inc. and manager of its Chicago, Illinois office. He is a Fellow of the Casualty Actuarial Society (CAS) and member of the American Academy of Actuaries (AAA). He is a member of the AAA's subcommittee on Medical Professional Liability and former member of the CAS' Committee on Health Care Issues. He holds a M.S. degree in Actuarial Science from Ball State University and a B.S. degree from Earlham College.

Mr. Rauner has provided formal Statements of Actuarial Opinion in the United States as well as several offshore domiciles. His clients come from a broad range of industries including healthcare, education, technology, construction and retail, among others. To this end, he has gained valuable insights and developed strong relationships with captive owners and managers, brokers, regulators and auditors.

During his career, Mr. Rauner has presented on a variety of topics including alternative risk financing, medical professional liability and workers compensation.

Mr. Rauner may be contacted at
630 · 457 · 1296
prauner@pinnacleactuaries.com

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Does your 831(b) captive quack?

By Peter S. Rauner, FCAS, MAAA

We have all heard the adage, "If it looks like a duck and quacks like a duck, it's probably a duck." Although this approach may work for the average observer, under closer scrutiny the trained eye can easily distinguish between a Mallard duck and a Muscovy duck.

Such is the case with captive insurance companies and well-disguised trust accounts. Both can be established in exotic vacation destinations for the primary benefit of their owners. Both can be used as a means of inter-generational wealth transfer. In fact, a Regulation 114 Trust account can even be used within the context of a captive insurance company to manage its assets. The primary difference between the two is that, when "certain criteria are met," captive insurance company policyholders can deduct their contributions (a.k.a. premium payments) as operating expenses against otherwise taxable income. Contributions to trust accounts are not deductible.

What are these "certain criteria"? We will get back to that in a moment. First, consider an individual of high net worth seeking to retain as much hard earned income as possible. Assume a business generates $20 million in annual revenue and passes along $5 million in annual profits to its owner in the form of a Schedule K-1 distribution. At the end of the tax year, the owner's accountant advises that the maximum allowable pre-tax deductions have already been taken and the business owner is now faced with paying Uncle Sam taxes on the entire Schedule K-1 income.

In an attempt to maximize the client's after-tax income, the owner's financial planning consultant may recommend an 831(b) captive insurance company. By setting up an 831(b) captive insurance company and issuing insurance policies naming the business and/or the business owner as the named insured, the owner can deduct up to $1.2 million in premium payments as business expenses and retain 100% of the underwriting profit if no claims are paid. At the end of the day, the business owner will have saved as much as $420,000 in taxes per year which can be used to fund future risk exposures or taken as profit distributions in the form of capital gains. Further, the captive insurance company structure affords the additional benefits of protecting assets from creditors and efficiently transferring wealth to future generations.

Although the results of the financial planner's research is all factual, there's another saying that goes, "If it sounds too good to be true, it probably is." In fact, the business of insurance is a highly regulated industry under the watchful eyes of interested parties including the National Association of Insurance Commissioners, the Federal Trade Commission, the Securities and Exchange Commission, and the Internal Revenue Service (IRS) as well as several industry trade and consumer protection groups. Specifically, the IRS is very interested in transactions just like the one described

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above for obvious reasons. Despite working with the labyrinth of tax laws that make up the Code, few financial advisors are well-versed on the business of insurance and its unique set of laws and regulations. Furthermore, there are many insurance advisors that would be hard pressed to define the fundamental principles of an insurance transaction from the IRS' perspective.

For starters, the term "831(b) captive insurance company" refers to a closely held, special purpose company in the business of insurance that qualifies and has elected to be taxed as a U.S. corporation under Section 831(b) of the Internal Revenue Code. This section of the code provides that certain "small" insurance companies writing between $350,000 and $1,200,000 in annual premium can elect to be taxed solely on the basis of the investment income earned during the tax year. To illustrate the impact of this election, consider a company that writes $1,200,000 in annual premium, has $200,000 in expenses, $100,000 in investment income, no claims, and generates $1,000,000 in underwriting profit. Assuming a 35% tax rate, the company (and its owners) can save $350,000 in federal income taxes annually by making the Section 831(b) election. That is, the company will be taxed only on the $100,000 investment income as opposed to the sum of its underwriting profit and investment income earned during the tax year.

The remainder of this article is dedicated to developing a basic framework in order to distinguish between a qualified captive insurance company in the eyes of the IRS and a well-disguised trust account. As was introduced earlier, the IRS has developed certain criteria for applying taxation rules to companies engaged in the business of insurance. Generally speaking, the IRS has characterized an "insurance company" as a company whose primary business activity during the taxable year is the issuing of insurance contracts or the reinsuring of risks underwritten by insurance companies. The IRS further states that, though the company's name, charter powers, and subjection to state insurance laws are significant in determining the business that a company is authorized and intends to carry on, it is the character of the business actually performed that determines whether the company is taxable as an insurance company under the code.

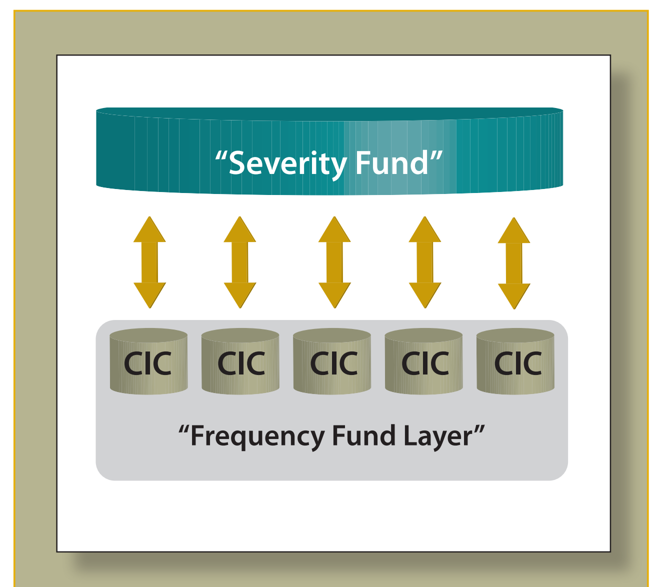
Interestingly, neither the code nor tax regulations define the terms "insurance" or "insurance contract." The accepted definition of the term "insurance" for federal income tax purposes states that the business of insurance involves risk shifting and risk distribution. Subsequent case law has refined this definition to involve a contract, whereby, for an adequate consideration (i.e., policy premium) one party agrees to indemnify another against loss arising from certain specified contingencies or perils. The courts have also established that the risk transferred must be the risk of an economic loss.

Through several court battles and private letter rulings, the IRS has provided guidance in determining "safe harbor" thresholds for demonstrating risk shifting and risk distribution. According to the IRS, risk shifting occurs when a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer. From a practical standpoint, risk transfer is evidenced by the uncertainty with respect to the amount and timing of the cash flow resulting from an insurance transaction – that is, the premium income and expected claim and expense payments. One widely used rule of thumb in the world of reinsurance, called the "10-10 Rule", suggests that risk transfer exists when the issuer of an insurance contract has at least a 10% chance of incurring at least a 10% economic loss. Another measure that is gaining acceptance is the Expected Reinsurer Deficit (ERD). ERD can be viewed as the probability of an underwriting loss multiplied by the net present value of the average severity of the underwriting loss. ERD overcomes some shortcomings of the 10-10 Rule, particularly when evaluating coverage with relatively low likelihoods of large losses, such as property catastrophe or high layers of excess liability coverage.

Despite the fact that case law has not produced consistent results to date, IRS scrutiny regarding minimum thresholds for risk distribution have focused on one of two criteria: (1) the number of "brother-sister" or unrelated third-party policyholders, or (2) the percentage of "brother-sister" or unrelated third-party premium written by the company. According to IRS Rev. Rul. 2002-90, the safe harbor threshold for the minimum number of unrelated parties was set at 12 policyholders. However, smaller groups do exist and have not been successfully challenged as long as a "substantial" proportion of unrelated annual premium is written by the captive. The prevailing thought on a safe harbor minimum threshold is that 30% of the captive's annual premium from unrelated third-party policyholders represents an accepted standard.

Thus, over the years, case law has found that the two primary elements that define an insurance transaction are the existence of risk transfer and risk distribution. However, there is a third element identified by the IRS as being relevant in applying taxation to the business of insurance.

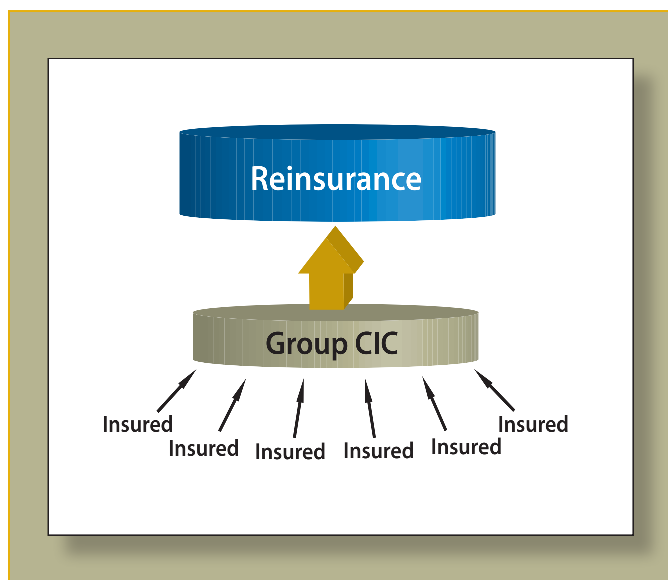
Figure 1 - Frequency/Severity Fund Model



Even though somewhat less obvious than the other two, the IRS has become more diligent in peeling back the onion to get at the true nature of the relationship between insurer and insured. To this point, the IRS has analyzed the characteristics of the business transacted to ensure that it is in a manner consistent with the standards applicable to an insurance arrangement between unrelated parties. In addition to risk transfer and risk distribution, some of the notable facts upon which the IRS has based its decisions include:

- whether premiums are established at arm's length, based on the insured's risk profile and consistent with standard industry pricing practices
- whether the captive insurance company is formed for a legitimate business purpose
- whether the company issuing the contract is properly organized and operated
- whether the captive insurance company is adequately capitalized

Figure 2 - Group Captive Model



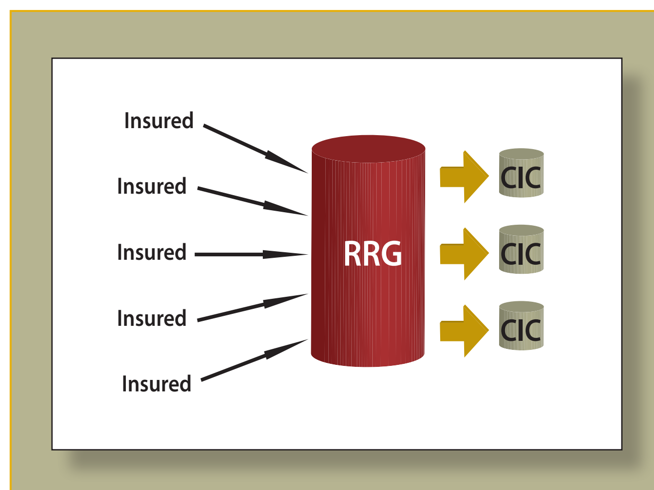
Of these characteristics, probably the easiest point of contention from the IRS' perspective lies in the basis on which policy premiums are determined. Standard industry practices develop insurance base rates from historical claim and exposure experience aggregated into homogeneous categories such as line of business, type of coverage, risk class, and location. Insurance policy premiums are then developed by multiplying a given risk's exposures by the corresponding base rate and applying any number of rating factors intended to tailor the "average" base rate to reflect an individual insured's risk profile. Given that underwriting profits are disregarded for companies making the Section 831(b) tax election, the manner by which policy premiums are developed is of obvious concern to the IRS.

Although there are many ways to utilize an 831(b) captive, one of the more common structures involves a single-parent captive and several brother-sister or unrelated party captives. Under this structure, each captive issues policies to cover the business risks of their owner and assumes a portion of the risks covered under policies issued by the other captives. This model is sometimes referred to as a "Frequency Fund/Severity Fund" structure where the frequency fund layer represents risk retained within the individual captives, and the severity fund layer represents risk exposures pooled among all participating captives **(see Figure 1)**. In this manner, the individual captive retains the stable, low risk exposures and pools the more volatile risks within the severity fund which is shared proportionately among the other participating captives. One disadvantage of this model is that it can be difficult to find enough participants willing to assume unrelated party risks to meet the IRS' risk distribution threshold. Another disadvantage is that a single parent structure often does not have a sufficient number of separate entities with an adequate amount of risk.

Another common structure involves the use of a group captive. Under this structure, the captive issues policies to several unrelated parties (some or all may be captive owners) and in turn purchases reinsurance for portions of the risk exposures assumed **(see Figure 2)**. Advantages of this model include a clear demonstration of risk distribution, access to reinsurance, and sharing of captive operating expenses. One disadvantage is that there may be a need for a fronting carrier which would increase the overall operating costs.

A third common structure utilizing an 831(b) captive includes the combination of a risk retention group (RRG). In this model, the RRG issues the insurance policy directly to the captive owner and cedes a portion of the risk exposure to an 831(b) captive **(see Figure 3)**. Advantages of this structure include the absence of fronting costs and the ability to add coverages issued directly by the captive. Disadvantages include the addition of state premium taxes and the restriction that RRGs cannot insure property or workers compensation exposures.

Figure 3 - RRG/831(b) Model



While these structures can and are being set up for legitimate purposes, one must be careful that the administrators of these structures are meeting all of the safe-harbor thresholds imposed by the IRS including adherence to the substance-over-form-doctrine. For example, insurance contracts can be drafted to provide coverage for legitimate business risks where covered events, the benefits provided and the premium charged for such policies are not consistent. To ensure compliance, the incidents that trigger or give rise to a covered event must be clearly defined so as to avoid ambiguity in the claim verification process. Similarly, the benefit provided under the contract must be clearly defined and consistent with the economic loss resulting from the covered event. Finally, the premium charged for a given insurance contract must be related to both the insured's exposure to risk and the benefits provided under the contract. Verification of these elements is a non-trivial exercise that is best left to qualified insurance professionals.

Conclusion

As captive insurance companies gain in popularity with non-insurance advisors, one should anticipate that the IRS' scrutiny of such vehicles will also become more frequent and comprehensive. So, while a properly constructed captive insurance company can afford its owner with a valuable tool for optimizing risk management strategies and operating efficiencies, "the devil is in the details."
Essentially, one must be prepared to:

1. demonstrate that the captive is formed for a legitimate business purpose other than optimizing tax efficiencies
2. justify that the insurance contract(s) issued transfer a real risk of economic loss and that premiums are commensurate with the risk transferred and the benefits provided
3. clearly establish compliance with the IRS' standards for risk distribution

In short, if you want your captive insurance company to quack, be sure that you "get your ducks in a row."

For more information contact Peter Rauner at 630 • 457 • 1296 or prauner@pinnacleactuaries.com

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