

Business Strategy: Capturing Insurance Costs

By Alan J. Fine, CPA, JD

Executives have used captive insurance companies for a variety of corporate risk management and financial planning purposes for more than 100 years. In the right circumstances, captives provide both better risk management and significant cost savings on their insurance expense. Great concept, but, as the saying goes, the devil is in the details.



Alan is a member in Brown Smith Wallace's Insurance and Reinsurance Group, where he specializes in the taxation of insurance companies. Alan has 12 years of tax experience,

working closely with insurance companies for 10 years.

Captives might provide coverage for workers' compensation risk, professional malpractice risk, product liability and general liability. Some companies use captives to insure risks for which they cannot obtain affordable insurance in the commercial markets. With Missouri's recent legislation permitting the formation of captives (Senate Bill 215), executives should be evaluating the benefits (including cost) of forming a captive.

Taming the Devil

In Germanic folk tales, such as those of the Grimm brothers, the devil was depicted as evil, but often friendly, and fell asleep with his grandmother combing his hair.

If you can soothe the devilish details of forming a captive correctly, you can achieve:

- Enhanced management and control of risk;
- Reduced pricing volatility;
- Improved access to reinsurance markets;
- Coverage for risks that either may not be available or are unavailable at a reasonable price in commercial markets;
- Accelerated deductibility of risks that had been self-insured

To realize and maximize these benefits, management must ensure that the captive is properly structured. Many mistakenly believe that because the captive is regulated as insurance, it grants insurance company status for federal income tax purposes.

But for a captive (or any other insurance company) to be recognized as an insurance company, the underlying contracts must qualify as insurance for federal income tax purposes. Insurance contracts generally must have: (1) risk shifting; (2) risk distribution; (3) insurance risk; and (4) generally accepted notions of insurance. These details must be carefully considered because the Internal Revenue Service has been challenging captive insurance companies for more than 30 years.

Meeting the Requirements

Risk shifting looks to who bears the ultimate economic risk of loss for claims under the contract.

The IRS has consistently ruled that the risks of a parent company insured by a subsidiary captive does not shift the risk, since any potential detriment to the subsidiary ultimately reduces the parent's investment in that subsidiary

This may be mitigated by the captive insuring outside risks. Then, the IRS would look at the proportion of outside risk to parent

risk to determine if the risk ultimately is shifted. Risk distribution incorporates the principle of large numbers in order to reduce the probability that the insurance company will suffer a large claim or claims will exceed the insurer's assets. It also includes the pooling of premiums so that no single insured is paying for a significant portion of its own risk.

Generally accepted notions of insurance looks to whether the insuring organization appears and acts like a true insurance company, including whether the organization is organized and regulated as an insurance company, adequately capitalized, charges arm's length premiums and issues valid, legally binding policies.

Clearly, forming a captive requires careful planning and analysis of the details to achieve the desired business objectives and tax benefits.

**For more information,
please contact:**

Alan J. Fine, CPA, JD
314.983.1292
afine@bswllc.com

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