Captive formation and tax pitfalls

Common pitfalls to avoid when forming a captive insurance company

Over the past couple of decades, the captive insurance industry has undergone tremendous growth worldwide and specifically within the United States. For many US companies looking to insert a captive insurance company into their structure, the process of quickly building one has revealed certain areas that need to be addressed early on when forming a captive insurance company. As these challenges may not be apparent, this piece focuses on the pitfalls potential captive insurance company owners need to avoid when forming their own captive insurance companies and selecting the appropriate domicile.

Pitfall 1: assuming it's acceptable to form a captive insurance company primarily for tax reasons

It's been said before, but it bears repeating: don't let the tail wag the dog. While certain federal and state/local tax benefits may be one of the outcomes from forming a captive, they cannot and should not be the primary reason to do so. Forming a captive insurance company must be done primarily for valid business, capital and risk management purposes.

A more complex scenario would be to form a US entity that is not being treated as an insurance company for US federal income tax purposes and have the US entity reinsure the risk to a foreign insurance company. The US entity would not be seen as reinsuring this risk for US federal income tax purposes; instead, the insured would be seen as paying the premium to the foreign insurance company. Using a US entity that is not treated as an insurance company for US federal income tax purposes may eliminate application of state self-procurement tax in certain cases.

In either of these scenarios, a taxpayer may not be subject to the US federal insurance excise tax if the taxpayer paying the premium is domiciled in a country that has a tax treaty with the United States containing an exemption for the US federal insurance excise tax.

Pitfall 2: assuming the Internal Revenue Service (IRS) considers your captive an insurance company

This is one of the biggest and most understandable pitfalls a prospective captive insurance company owner can encounter. From the owner perspective, the captive operates as an insurance company. It is registered and approved by a state or foreign insurance department, files financial statements with the domicile of record, follows insurance accounting rules (assuming risk transfer is met) and writes insurance contracts. Taking all of the above into account, why wouldn't such a company qualify as insurance company for tax purposes? The devil is in the details.

From the IRS perspective, the above facts do not necessarily determine whether a captive is an insurance company for federal tax purposes. Rather, the IRS looks at this from a much different lens than a state or foreign insurance department does. It requires deeper analysis and a more independent view of the transactions being made within and outside the captive insurance company. Since the Internal Revenue Code (IRC) does not define insurance for federal income tax purposes, the industry has looked largely to the courts for guidance. Through a series of court decisions, we now have the four pillars required to achieve insurance treatment for federal income tax purposes: risk distribution, risk shifting, commonly accepted notions of insurance and the presence of insurance risk.

When forming a captive insurance company, it is paramount to be aware of these rules and seek professional advice so that the entity will meet all these definitions (this, of course, assumes the goal is to have a captive that meets the definition of "insurance company" for federal income tax purposes). Failure to satisfy these requirements can create significant legal, tax and public perception problems for an organization. For these reasons, owners should consult with tax and other professionals to be certain these requirements are met.

Pitfall 3: not seeking professional help when forming your captive insurance company and structuring your new insurance program

Given the complexity of the rules governing the formation of captive insurance companies, even the most intelligent, creative and business-savvy business owners may unintentionally run afoul of certain ambiguous or overly complex areas of regulatory and tax laws that govern the insurance business. Prospective owners would be well advised to consult experienced professionals in accounting, actuarial, investment, legal, risk management and tax, among others. While enlisting outside assistance comes at a financial cost, it protects the overall health and longevity of the captive by making certain it is structured properly with insurable risks and has sound premium pricing, a tax opinion and a sound investment strategy.

Those reluctant to enlist outside assistance should consider the outcomes in such Tax Court decisions as *Avrahami*, *Reserve Mechanical* and *Syzygy*. In all three of those decisions, the court held that the companies did not qualify as insurance companies for federal income tax purposes. In support of that holding, the court cited a wide variety of poor taxpayer facts, including flawed premium pricing models and improper insurable risks. None of the companies had a tax opinion supporting its position as an insurance company for federal tax purposes. Better tax advice during formation would have likely helped these companies avoid legal trouble. Similarly, listening to the advice given is imperative. If it sounds too good to be true, or the sales pitch starts with tax, beware.

Pitfall 4: not understanding how states will tax your captive

State taxation of captive insurance companies is a very complex area and encompasses much more than income tax. In fact, a majority of states assess premium tax in lieu of income tax. To comply with state law, captives must know which states assess income tax on insurance income. Depending on the ownership structure of the captive and state law, the captive could be required to file income tax returns on a separate company, combined or unitary method. Inclusion in a return may not mean additional tax, but a company needs to make sure its position in this area is understood and documented. Proper state tax planning can help avoid pitfalls.

Beyond income and premium tax considerations, captive insurance companies must consider direct placement (i.e., self-procurement) taxes. States can assess direct placement taxes when insurance coverage is purchased from an insurer not licensed to do business in that state. For example, a company headquartered in state A purchases insurance from its wholly owned captive domiciled in state B, which is not authorized to do business in state A. In this situation, it is possible for state A to assess direct placement taxes to the insured. States generally will have exceptions to these rules, but understanding when direct placement taxes may apply can help with selecting a domicile, as the captive insurance company will be licensed to do business in that state. If your operations are headquartered in, or the premium purchased would be allocated to, the state in which the captive is domiciled, then direct placement taxes may no longer apply, subject to individual facts and circumstances.

Pitfall 5: assuming income generated by your offshore captive will be tax-deferred or that deferral is your only international income tax consideration

Before the enactment of the Tax Cuts and Jobs Act (TCJA), tax on the income of a US-owned offshore captive could be deferred if certain requirements were satisfied. With the TCJA's enactment, however, the tax implications with respect to offshore captive's income have become more complex.

The TCJA revised or added IRC provisions, such as related party insurance income (RPII), Subpart F, passive foreign investment company (PFIC) and global intangible low-taxed income (GILTI), significantly impacting the timing of tax consequences related to the earnings of a US-owned offshore captive. Most insurance income of a captive will now be considered Subpart F income, although there are exceptions. The new GILTI regime is designed to capture income of a controlled foreign corporation (CFC) that is not considered Subpart F income.

Structuring an offshore captive as a non-controlled foreign corporation (NCFC) may produce a positive effect on the timing of tax, but other structural areas need to be considered. This is challenging to do in a captive structure, because often the risk being insured is related-party coverage, which means the RPII provisions are likely to kick in, or there is 25% US shareholder ownership, either of which will likely make the captive insurance company a CFC and subject to the anti-deferral provisions of Subpart F. Even if NCFC status is achieved, one must consider the PFIC provisions, which prevent investment companies masquerading as insurance companies from deferring earnings.

Aside from these rules, there are other offshore considerations that are worth mentioning: federal excise tax, IRC Section 953(d) election to be taxed as a US corporation, dual-consolidated losses, US trade or business, branch profits tax and other potential tax compliance complexities with owning an offshore entity. While domiciling a captive offshore may be a powerful and prudent planning tool for an organization for a number of business reasons, the tax issues involved are highly complex and the advice of a CPA or tax attorney versed in the taxation of offshore insurance income is recommended if you are considering any domicile outside of the US.

Conclusion

Captive insurance companies are viable, powerful and efficient structures designed to better manage risk and capital, but the challenges of forming a captive need to be recognized. Failure to avoid the pitfalls previously outlined can negatively affect a business's overall risk management strategy or worse, the reputation of the business itself.

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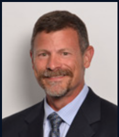

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