Captive Insurance May Help In A Pandemic, But Caution Is Key

By **Patrick McCann** (July 2, 2020)

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As a result of the national pandemic created by COVID-19, small business owners across the country are learning the painful lesson that their traditional property and casualty insurance policies may be inadequate to fully address the risks faced by their businesses.

Across the country, businesses have filed a growing number of lawsuits in state and federal courts challenging the denial of claims related to damages caused by mandatory government shutdowns and other related business interruptions.

Traditional commercial insurance carriers have denied coverage based on exclusions contained in the policies that prevent coverage for viruses and by pointing to language in the policies that require physical damage to a business location before any coverage is applicable.

Based on these developments, there has been a renewed focus on using captive insurance companies as part of an alternative risk management strategy for small businesses. Captive insurance companies can be an important component in a company's overall risk management program designed to complement the existing commercial insurance coverages and address any gaps in those coverages.

A captive insurance company is able to provide coverage for areas that are otherwise unavailable in the commercial insurance market — like a business interruption caused by a virus. However, given the Internal Revenue Service's ongoing coordinated campaign targeting small captive insurance companies and the businesses that rely on them, business owners need to conduct significant due diligence to ensure that their planned insurance company can withstand any future government scrutiny.

The IRS has listed small captive insurance companies among its annual dirty dozen list since 2015 and, in 2016, Notice 2016-66 designated transactions with small captive insurance companies as transactions of interest that must be disclosed to the government. On Jan. 31, the IRS announced the formation of 12 new examination teams to investigate small captive insurance companies and the businesses that purchase property and casualty insurance policies from them.

Recently, the IRS has made clear that these investigations will proceed despite the impact of COVID-19. The IRS' hostility toward captive insurance despite Congress' encouragement of it as an alternative risk management strategy highlights the need to ensure that a planned captive insurance program is as strong as it can possibly be.

Using the limited guidance provided by the IRS and analyzing the only three Tax Court cases that have examined captive insurance[1] can provide a helpful road map for business owners interested in forming a captive insurance company to protect their businesses. By making a significant upfront investment in the formation of the proposed captive insurance company, business owners can ensure their captive insurance arrangement is in the best position to defend any future challenges to its validity.

Significant Upfront Investigation and Due Diligence

The decision to form a captive insurance company should only be made after a significant investigation and due diligence process. Business owners should work with their professional advisers to identify a captive insurance management company to help them through that process.

Working with the captive insurance management company, business owners need to closely evaluate their existing business operations to get a clear picture of the risks that business faces, and determine any gaps in their existing commercial insurance coverages that can be addressed through the use of a captive insurance company.

Owners should work with the captive insurance management company to identify policies that address the risks their company faces and make sure that they are planning to only purchase policies that are tailored to their specific industry and business operations.

A small captive insurance company can provide a business with coverage that is not otherwise available, or is prohibitively expensive, in the traditional commercial insurance coverages. Such policies complement the existing commercial insurance policies and should be drafted based on the coverages and exclusions provided by those existing commercial insurance coverages.

Owners may also consider purchasing deductible reimbursement policies, which will allow them to increase the deductibles on their commercial insurance policies and reduce the premiums on those policies. It is important to eliminate the possibility of any overlap in coverages provided by the captive insurance policies with the policies purchased from a business' traditional property and casualty insurance provider.

Once policies have been identified, business owners should work with a licensed actuary to make sure the premiums are reasonably priced in light of the coverage provided. All pricing needs to be done in accordance with the accepted standards of actuarial practice developed by the Actuarial Standards Board. The actuary should document his or her methodology as part of a premium pricing report that clearly identifies the basis for the premium prices.

One of the challenges faced in the captive insurance industry is that many of these coverages do not have comparable commercial insurance counterparts, which can make pricing difficult based on the inability to rely on commercial insurance benchmarks. The actuary must be able to support any assumptions or personal judgments that are part of his or her pricing methodology.

Strong Risk Distribution

One of the most important aspects of any proposed captive insurance program is the strength of the company's risk distribution. The courts have identified risk distribution as one of the essential elements of insurance for federal income tax purposes. In each of the three Tax Court cases that address small captive insurance companies, the Tax Court has found that the companies failed to adequately distribute their risk, which was enough to invalidate those companies as insurance companies for federal income tax purposes.

Those cases provide important insight into the types of issues the IRS and the courts will examine when evaluating risk distribution of a small captive insurance company. Additionally, the IRS has previously provided two safe harbors for ensuring that a captive insurance company achieve adequate risk distribution in Revenue Rulings 2002-89 and 2002-90. The easiest way to achieve adequate risk distribution is by meeting one of the two safe harbors.

Revenue Ruling 2002-89

Revenue Ruling 2002-89 addresses the ability to achieve adequate risk distribution through issuing insurance and/or reinsurance contracts to unrelated third parties in addition to the related operating company.

Here, the IRS provided a safe harbor for insurance companies that insured both related and unrelated companies. In order to meet that safe harbor an insurance company must receive less than 50% of its total actuarially determined premiums from a related company and the remaining premiums — which were also "established according to customary industry rating formulas" must be received from unrelated companies.

Under this rule, an insurance company that participates in a risk pool in which it receives 51% or more of its total premiums from unrelated companies should satisfy the risk distribution component. However, the captive insurance owner and manager should thoroughly investigate the mechanics of any proposed insurance pool.

In each of the three Tax Court cases, the court criticized the operations of the insurance pool and disqualified the pool as insurance for federal income tax purposes. Based on the disqualification of the insurance pools, the Tax Court concluded that the companies failed to adequately distribute risk and were, therefore, not insurance companies for federal income tax purposes.

Insurance company owners and managers should evaluate the strength of any proposed insurance pool in light of the criteria outlined by the Tax Court in the three prior captive insurance cases.

Revenue Ruling 2002-90

Revenue Ruling 2002-90 provides guidance for captive insurance companies trying to achieve adequate risk distribution through insuring solely the risks of related operating entities owned by a common parent.

This rule provides a safe harbor for a captive insurance company that provides insurance to 12 domestic operating companies that operate on a decentralized basis. None of the operating subsidiaries' premiums account for more than 15% or less than 5% of the total premiums paid to the related captive insurance company.

The safe harbor requires that "the premium of the operating subsidiaries, determined at arm's length, are pooled such that a loss by one operating [company] is borne, in substantial part, by the premiums paid by the others."

Additionally, the 12 operating entities and the captive insurance company must "conduct themselves in all respects as would unrelated parties to a traditional insurance relationship" and the insurance company must be "regulated as an insurance company in each state where it does business."

It is important that there be a legitimate business purpose for the existence of the 12 operating entities outside of the desire to achieve the safe harbor provisions of Revenue Ruling 2002-90.

Conservative Investment Strategy

The primary goal for investing captive insurance premium receipts should be to maximize the funds available for the payment of any claims. Before making any investments, captive insurance company owners and their managers should review the National Association of Insurance Commissioners' guidance on investments and ensure that they are not planning on making any prohibited investments under that guidance.

Companies should avoid any investments that threaten the liquidity of the insurance company or that could jeopardize its ability to pay for covered losses under the policies it sells. Additionally, captive insurance owners should avoid any related-party investments, such as loans to owners of officers of the insurance company.

Historically, the government has looked favorably on insurance companies that have invested their premium receipts in marketable securities. However, given the market volatility related to COVID-19 and the uncertainty surrounding the larger economy, captive insurance owners and managers may want to consider an even more conservative investment strategy in the near future.

Conclusion

The COVID-19 pandemic has highlighted the significant gaps in protection offered by traditional commercial property and casualty insurance companies and demonstrated why Congress has continued to encourage the use of small captive insurance companies as an alternative risk management strategy through the enactment (and expansion) of Section 831(b).

However, business owners that are considering the formation of a small captive insurance company must be aware of the risks involved given the IRS' ongoing hostility toward them. They should be prepared to work closely with their professional advisers and a captive insurance management company to ensure that they are creating the strongest captive insurance program possible.

First and foremost, a small captive insurance company must be formed and operated as an insurance company, which requires significant investigation and due diligence. Business owners should only move forward with the formation of a small captive insurance company after confirming that such a company will be an appropriate tool for their company's risk management needs.

By completing a thorough examination of their company's proposed insurance operations, including policy selection, premium pricing, day-to-day operations, risk distribution and investment strategies, business owners put themselves in the best possible position to demonstrate the validity of their captive insurance program and its important role in their company's risk management program.

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[1] The Tax Court has released three captive insurance related opinions that were all victories for the Internal Revenue Service: Avrahami v. Commissioner of Internal Revenue, 149 T.C. 144 (August 17, 2017); Reserve Mechanical Corp. v. Commissioner of Internal Revenue T.C. Memo. 2018-86 (June 18, 2018); and Syzygy Insurance Co. v. Commissioner of Internal Revenue, T.C. Memo. 2019-34 (April 10, 2019). Reserve Mechanical has been appealed to the United States Court of Appeals for the 10th Circuit.