SECTION 831(B) CAPTIVES AND THE IRS: UNDERWRITING AND AUDIT ROULETTE
BY JAMES LANDIS, DECEMBER 12, 2011*

Much has been written about the financial and tax power of forming and operating a captive insurance company that qualifies for the tax benefits of section 831(b) of the Internal Revenue Code. But all too often, promoters of this concept forget that each captive must be first and foremost a risk management tool with legitimate risks and properly priced premiums.

An "831(b)" captive is an insurance company whose premiums do not exceed $1,200,000 per year and which elects to have those premiums exempted from taxation. If the captive has proper "risk distribution" (a topic for another article), then the insured company can deduct the premium being paid to the captive, while the captive pays no income taxes on that premium. After the payment of losses and expenses, any profits in that captive can be distributed at a favorable dividend rate or can be distributed in a full liquidation of the captive, and the shareholders will receive those accumulated profits at capital gains rates. And if the captive is owned by trusts or adult children, the entrepreneur can also enhance the benefits in his or her estate plan by side stepping the estate tax.

But these benefits are only possible if you first get the underwriting right. Over the years we have conducted audits on existing 831(b) captives formed by some of our competitors. After reviewing the underwriting done for these captives, we have been amazed by what people are charging for risks, many of which can be insured in the traditional insurance market at much lower rates. We call it "underwriting by the blind." The IRS is well aware of the pricing abuses in our industry. As we understand it, the majority of negative audits recently have not been because of faulty "risk distribution" mechanisms, but due to badly over-priced premiums being paid to the captive.

For example, we found a $10,000,000 (revenues) manufacturer who had purchased a $1,000,000 general liability policy, including products liability, in the insurance market for an estimated $25,000 annual premium. The new captive issued a "differences in condition" policy with a $1,000,000 limit and charged the insured over $200,000 in annual premium. This type of policy covers things like exclusions in the underlying policy. It does not take an insurance expert to realize that such a premium is unreasonable and bears no relation to either market rates or the real risk that is being assumed (particularly since the insured was manufacturing a non-hazardous consumer product).

Another example of egregious pricing is in the area of terrorism risk. One provider is promoting captives with over $600,000 in premium for $10 million in limits for this type of risk despite the fact that the client could purchase that same coverage in the standard insurance market for less than $5,000. How can such a payment be "ordinary and necessary" and therefore be deductible?

Knowing that these captives were approved by a regulator, we keep asking ourselves "where are the actuaries and the regulators and why do they not concern themselves with the relationship between the risk assumed and the premiums charged?"

The simple fact is that the requirements of the captive insurance laws fall far short of the requirements of the IRS. The laws of each captive insurance jurisdiction in the United States require an actuarial opinion accompany each application for an insurance license. But that opinion is limited to determining "the amount and liquidity of its [the captive's] assets relative to the risks to be assumed [meaning the policy limits]." Thus a regulator's primary concern is to ensure the solvency of the captive. Typically, this is achieved through pro-formas showing 3-5 year expected and adverse loss scenarios. Note that there is no requirement to examine or opine on individual rates used to price specific exposures being assumed by the captive.

This "gap" between the captive insurance law and the realities of the tax authorities can be immense. One of the first questions asked by the IRS in the audit of a captive is "How were the premiums (pricing) determined for each risk assumed?" Without an opinion of an actuary regarding these rates, it then comes down to the knowledge of the underwriter used by the captive management company. It is apparent that many captive managers do not have sufficient depth in this area or do not care to go beyond the specific requirements of the captive licensing requirements (we, however, require that our actuaries examine every rate that we use in our Feasibility Studies).

Looking over 27 years of forming captives and pricing risk, we can say that a rule of thumb is that a properly priced portfolio of risk for a captive should equate to total premiums equal to 1-2% of the insured's revenues. The reason revenues are a good guide is because the majority of risks being transferred to section 831(b) captives are casualty risks. And the exposure base for casualty risks is generally revenues. The underwriter cannot change the exposure base, but he can raise the rate that is multiplied times the exposure base to get to a higher premium as desired by the client. But the captive will not survive an audit if rates are raised too high.

1-2% of revenues is only a guideline: there are exceptions. But if you see a captive manager suggest that the premiums payable to an 831(b) captive can be 6-10% (or more) of revenues, run! That manager is ignoring the important risk management requirements of this captive concept to the detriment of its clients. And the clients are playing audit roulette, hoping their "number" does not come up.

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