"NUTSHELL ON TAX CONSIDERATIONS IMPACTING THE DECISION TO CAPTIVE OR NOT," by Tom Cifelli, CaptiveExperts.com Managing Editor, © October 2011.

Excerpt:

Here is a quick summary of the types of taxes that impact the business decision of whether or not to create a captive insurance company to formalize and expand the sophistication of self-insurance and risk management programs.

Discussion:

Three (3) primary types of taxes are applicable to insurance products and programs that a business should strive to minimize – premium taxes, income taxes and excise taxes. Most businesses experience deferred and reduced federal and state income taxes from its core business operating units by forming a captive insurance program. Properly structured, a captive insurance program can also minimize or avoid otherwise applicable insurance premium and excise taxes.

Here is a summary of applicable tax types properly structured captive programs can minimize.

Premium Taxes

- Premium taxes are often due from captives and other insurance companies on direct written premium revenue ranging from 2/10ths of 1% to ½ of 1% (depending on the state). Most states have a cap on the maximum premium tax due ranging from $50,000 to $200,000. Some states like Arizona and Utah have no premium tax on captives domiciled in their state to attract large captives to domicile in their states)
- Premium taxes may also be due from insureds in many states on "self-procured" or nonadmitted insurance. These taxes are generally much higher than direct premium taxes often being as high as 4% or more. These nonadmitted premium taxes apply to the purchase of insurance by an insured from insurance companies (including captives) domiciled in another state or offshore.
- Newly enacted provisions of the Dodd-Frank Act's NRRA subtitle took effect in July 2011 that may cause new interest by US based companies to form a captive (or re-domicile an existing captive) in an insured's "home state" to reduce exposure to nonadmitted insurance premium taxes that generally range from 2% to 6% depending upon the applicable state.

Income Taxes

- Federal and state Income taxes generally apply to the net income of captives. It should be noted that there are substantial tax advantages of being an insurance company such as being able to take current deductions for uncertain future claims and claim processing related expenses that would be non-allowable accrued expenses for any other type of business. These special expenses for claims reserves give insurance companies significant income tax advantages that help reduce the cost and encourage "reserving" capital for future losses.
- A special exemption from federal income tax for "small insurance companies" is available for qualifying captives that make a 831(b) election. This election is for small US based captives that have $1.2 million or less in total annual premium revenues. The election allows the avoidance of

all federal income tax on operating net income (exclusive of income from investments). The increased awareness of this special 831(b) election for small qualifying captives has fueled most of the growth in new US domiciled captives in recent years.

Excise Taxes

- There are applicable US federal excise taxes (from 1% to 4% depending on type of insurance) on premiums paid by insureds to non-US taxpayer insurance companies. It is important to note that some treaties with foreign countries exempt this excise tax and give a slight advantage to these foreign jurisdictions over other non-treaty jurisdiction insurance companies. Some tax advisers believe US excise taxes can be avoided by forming US domiciled captives with US sourced insurance fronting arrangements.