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INSURANCE COMPANY TAXATION

By William York, VP of Marketing

There are very good business reasons to establish a captive property and casualty insurance company. This is important to understand because while captive insurance companies have certain tax advantages, the business reasons for establishing a captive insurance company are greater than the tax advantages alone

In this case the tax tail should not wag the dog. Tax benefits are as important as other reasons that make it prudent to create a captive property and casualty insurance company. The captive tax advantages serve broader social purposes providing incentives for businesses to better manage risk and achieve greater economic stability, thus reducing overall insurance claims as well as saving jobs. Good risk management is an important social goal. This is why the Federal Government provides tax incentives for insurance companies.

A captive property and casualty insurance company is a standalone company that must elect to be taxed as a "C" corporation under current legislation. As a property and casualty insurance company, it must file an annual tax return, Form 1120-PC U.S. Property and Casualty Insurance Company Tax Return.

Insurance companies are taxed under a special sub-chapter of the Internal Revenue Code: Subchapter L.

This is where the special tax benefits are found.

Large insurance companies take in millions (some take in billions) of dollars each year in premium. These premiums can be thought of as the annual sales revenue of the company.

Normally, a company deducts current ordinary and necessary expenses from their gross revenue. In this case, premiums are a large part of an insurance company's gross revenues plus they also report large amounts of investment income to determine their taxable income!

Each premium collected by a captive property and casualty insurance company has a portion allotted to settle a possible future claim that might need to be paid. Therefore, not all current premium income is considered taxable income even though there is a difference between when the premium is received and when a legitimate claim is submitted for payment. A portion of the current premium is "unearned" as it will be paid as a claim of an "unknown" amount at some "unknown" time in the future. Legitimate claims that have been incurred but not yet presented are also "unknown" (Incurred-but-not-reported losses) or IBNR.

This is where the captive property and casualty insurance company, as well as other insurance companies receive a **tax benefit unique to the insurance industry.** Insurance companies are allowed to place some portion of the current premium income as a "reserve" against future claims that have yet to be reported. The "reserve" builds up over the years. The ability of an insurance company to make a deduction from current premiums and to make an addition to its reserves will only defer income taxation from that premium as the income is not free.

This is similar to your 401(k) retirement account. Income taxation is only deferred until you make a withdrawal from your account years later. However, the tax deferral has real value since the contribution and earnings in the account grow tax deferred. Therefore, insurance companies benefit from its deferral on current premiums.

Annual additions to the reserve from current premiums are made not knowing the amount in claims that will ever be paid. If it turns out that additions to the reserve are larger than necessary, adjustments are made. The reserve is reduced, and the amount of the reductions is taken into taxable income. Again, additions to reserve are not entirely tax free since a company making larger than needed additions to the reserve will eventually be taxed on the excess.

By choosing to own your own insurance company, a business owner is able to simultaneously lower commercial insurance costs while partially deferring the taxation of income collected as premium.

There is no question that the special tax treatment of insurance companies and the deferrals of income tax on a large portion of their premium income have tremendous value. Why do you think Warren Buffet loves the insurance business? He loves the "float." He loves the use of the tax deferred reserves for many years before a claim is paid.

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