MORETON & COMPANY

Property & Casualty Newsletter

October 2018: Captives

Captives Underwriting Controlled Unrelated Business

In order for premium paid to a captive insurer by its owner to be a customary tax-deductible business expense (just like any premium paid to a commercial insurer), the IRS requires a wholly-owned captive meet one of two risk distribution thresholds. These are either:

- At least 50% of the captive's annual premium must come from Controlled Unrelated Business originating outside of the organization's own risk profile, or
- There must be sufficient numbers of separate, affiliated entities insured (like wholly-owned subsidiaries). This is a moving target due to recent tax court cases, but the IRS mandates at least 12 entities with no one sub contributing more than 15% of the captive's annual premium income.

The second item is more involved, so we'll focus on the first one.

Controlled Unrelated Business (CUB) is insurance "sold" to an outside party where the captive owner maintains a close relationship with that buyer. While insurance regulators won't want captives to get in the business of selling insurance direct to disparate parties – after all, that's what commercial insurers do – they have allowed certain types of CUB products underwritten by captives.

Reasons a captive owner may want to consider a CUB program:

- **Tax Advantage:** The IRS has held that not meeting the "risk distribution" guidelines fails to make a captive "insurance," therefore disallowing premium paid by the owner to be a tax deductible business expense. Without that deductibility, it often negates the attractiveness of a captive. But if the owner can arrange their captive into one of the following two "profit center" scenarios, they can then get the tax deduction of "own" premium payments, plus hopefully start a profitable business line related to their commercial enterprise, or reduce costs in other areas that consistently increase year-after-year.

a. The most common method is to insure behind-the-scenes a contractual warranty given to a customer, or provide an Extended Warranty policy. Most states hold that a typical Manufacturer's Warranty of fitness and durability is not insurance and therefore cannot be directly underwritten by a captive, although the owner can captive-insure its own obligation. States also normally hold that Extended Warranty and Affinity programs (such as maintenance or scratch and dent repair plans on new cars) are insurance and therefore fair game for a captive, most often sold at the point of original sale of the product, or even as an after-market sale for that matter. There are some roadblocks: while a captive is always an admitted and licensed insurer in its domiciliary state, that will not be the case in other states. The captive may need to involve a licensed "fronting" insurer to issue policies in non-domicile states, then reinsure that business to the captive. These are common set-ups, but the "fronters" usually want to see a high premium threshold to use their policy "paper". Manufacturers, equipment dealers, contractors, specialty engineering firms, or high-end consumer goods retailers can take advantage of this.

b. One method gaining ground the last few years is employers providing benefit plans outside of ERISA to their employees through a captive CUB program. Vision, dental, STD/LTD, long-term care, and legal services can all be considered acceptable CUB because the insured is not the captive owner, rather the insureds are employees voluntarily purchasing these coverages. Since these plans tend to be profitable with claims costs manageable, they make good considerations for CUB.

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- **Cost Containment:** Along with the idea of voluntary employee benefit plans as CUB, ERISA allows employers to enter into self-funded major medical programs for their employees. These have gained much ground the last couple decades due to the extreme rising costs of healthcare services and are akin to high-deductible plans in other commercial lines of insurance. While the federal ERISA law governs how health insurance is to be managed for employees, it doesn't direct how money should be set aside to pay for the self-funded portion. A captive can be used to "insure" this obligation, it is considered CUB, and thereby may meet the IRS's risk distribution guidelines. Captive owners then can utilize cost containment tools that aren't always offered by full-program health insurers, such as nurse case management, utilization bill reviews, 2nd opinion referrals, etc.

CUB programs can be complex, involving opinions from tax and operations attorneys, as well as needing captive professionals to guide you through every step of the way, from initial feasibility investigation to ultimate implementation. Moreton & Company is always ready to discuss your ideas and to help you determine if this type of sophisticated risk handling tool is right for you.

Please contact your Moreton & Company consultant with any questions.

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