

# Captive Insurance – A Tool for PEOs

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PEOs that purchase high deductible workers' compensation insurance are, in a very real sense, insurance companies. They are not licensed or regulated as insurance companies, but they bear long tail risk traditionally born by insurance companies. Significant reserves must be established against these risks.

Unlike a licensed insurance company, PEOs are unable to take a tax deduction for those reserves. Assuming a PEO's taxable income is passed through an S corporation or a limited liability company to an individual owner in the highest tax bracket (35%), the PEO must earn \$1,538,500 and pay \$538,500 in federal income tax for every \$1 million in collateral/reserves it needs to establish. This is a serious capital constraint on the PEO's business.

Captive insurance can provide a cost effective way for a PEO to reduce its current tax exposure. Admittedly, this may be no more than a timing difference as to when a deduction or income is recognized. If the reserves are used to pay claims, the deduction is available in the year of payment. If the reserves are later released, income will be recognized in the year of release.

However, the timing difference is important. First, the time value of money on the earlier deduction or delayed tax can

be significant where reserves are easily in six figures. Second, the tax may be delayed to a future date when cash is available to pay it, i.e., when reserves are released.

For a captive solution to work:

1. The captive and its policy must satisfy all federal tax requirements; and
2. The captive structure must satisfy the requirements of the PEO's primary insurance carrier.

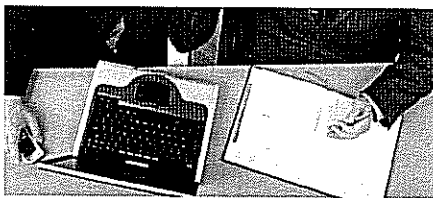
There are three basic requirements for the policy premium to be deductible:

1. The policy and the premium must be structured so that the risk is shifted from the PEO to the insurance company. There must be a significant probability of a significant loss to the captive.
2. The insurance company must issue policies to a sufficient number of separate insureds so that the policies and the risks are subject to the law of large numbers. In IRS jargon, the risk must be "redistributed." The IRS in Revenue Rulings has established safe harbor guidelines. Risk redistribution will have occurred if no single insured is responsible for 50 percent or more of the captive's premium (Rev Rule 2002-89, 2002-52 I.R.B. 984 (12/30/2002)), and there are at least 12 insureds (Rev Rule 2002-90, 2002-52 I.R.B. 985 (12/30/2002)).
3. The captive must be a real insurance company and not a sham. The Sixth Federal District Court of Appeal has established seven factors that can be looked at in applying an all facts and circumstances test. *Malone & Hyde, Inc. v. Commissioner* 62 F.3d 835 (6th Cir. 1995):

1. Whether the insurance company has its own capital or whether the insured or related parties have provided guarantees to the insurance company, i.e., the insurance company isn't really taking the risk;
2. Whether the captive is thinly capitalized;
3. Whether or not captive is loosely regulated under the laws of its jurisdiction;
4. Whether or not the insureds face real hazards;
5. Whether or not policy premium is based on market rates;
6. Whether or not claims are verified before they are paid; and
7. Whether or not the captive's business operations and assets are kept separate from the insured or parties related to the insured.

Finally, the relationship between the captive and the primary carrier must be structured in such a way that the captive's reserves can be used to satisfy the primary carrier's need for collateral. Each carrier has its own preferences regarding structure, but practically speaking, the primary carrier will need to control the reserves of the captive. In this way the primary carrier will be able to credit the captive's reserves against its own actuarially determined reserve requirements.

While these requirements are technical, there are a number of seasoned professionals and programs available to assist PEOs with having the benefit of captive structures.



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Relief from the enormous homeowner's insurance rate hikes of 2006 were debated in a special session in January, with a major property insurance bill passed and signed by the governor. This legislation will be in effect at the beginning of the 2007 session, and it appears the issue will be discussed again. No specific ideas have been brought up, but it is too early to tell.

The only legislation that must be passed is the budget. For the past couple of years, the state has been flush with a large surplus. The building boom, which we experienced due to the hurricanes of 2004 and 2005, generated this surplus. Last year the Legislature used about \$500 million to bail out Citizens, the state's property insurance company. Fortunately, Florida did not have any storms in 2006, which allowed the state to rebuild its treasury, but it did not generate a great deal of revenue. This year the state's budget, according to the governor, Senate president and speaker of the House, is going to be smaller than last year's. A great deal of time will be spent deciding how services will be cut from the budget. Florida must pass a balanced budget, so you can imagine there will be a lot of debate by all government entities trying to keep their programs alive.