

# PEO Insider

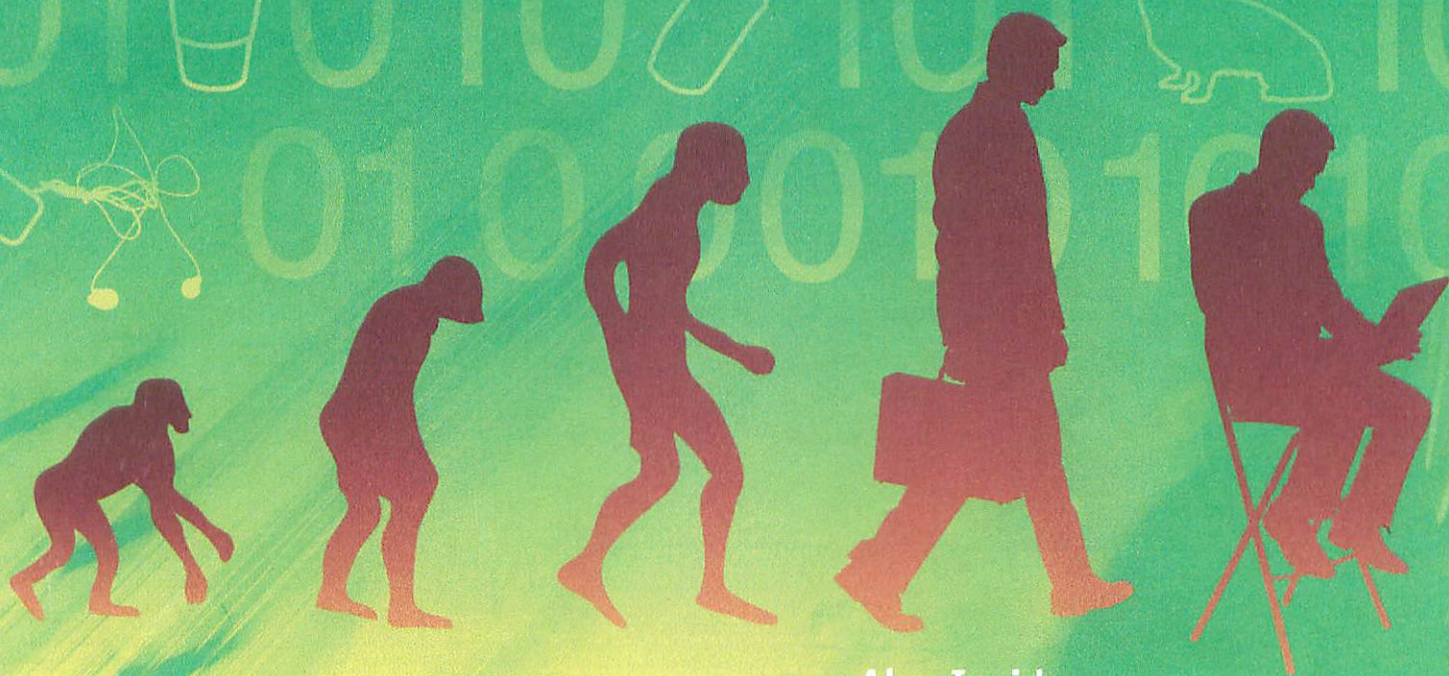
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## PEOs and the New Workplace

*Changing with the Times*

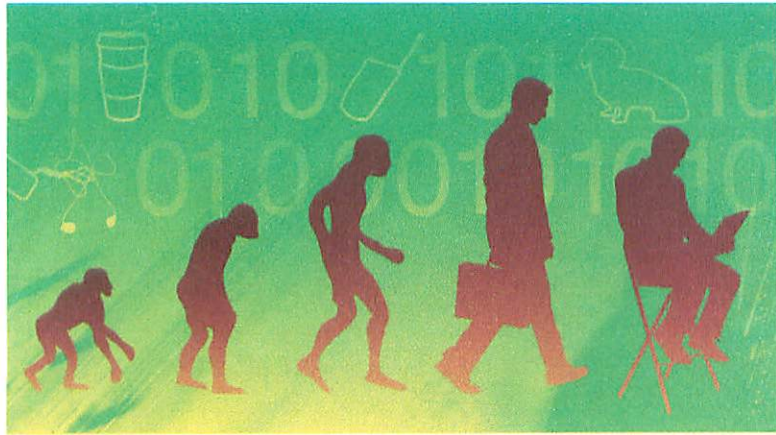


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# Captive Insurance for PEOs

G. Kristin Delano, Esq.



PEOs with high deductible workers' compensation insurance, while not licensed or regulated as insurance companies, bear significant risk traditionally born by insurance companies. Substantial reserves must be established against these risks—reserves that are generally held by the PEO's primary workers' comp carrier as collateral.

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

Captive insurance can provide a cost effective way for a PEO to reduce the capital drain attributable to current tax exposure. The tax reduction is a result of the following factors:

- The PEO can take a deduction for premium paid to the captive insurance company;
- The captive can set aside the premium as tax deductible reserves;<sup>1</sup> and
- The captive's reserves can be used to satisfy the primary carrier's requirements for collateral.

Admittedly, the result may be no more than a deferral of the income tax. If the PEO's collateral is used to pay claims, the deduction is available in the year of payment. On the other hand, while an immediate deduction may be available for premium paid to a properly structured captive, if at some future date a portion of

the captive's reserves are released as being redundant, income will be recognized at that time.<sup>2</sup>

However, the timing difference is important. First, the tax may be delayed to a future date when cash is available to pay it, i.e., when reserves, which are highly liquid, are released. Second, reserves can easily be in seven figures, and the time value of money enjoyed by putting off tax impact can be significant.

## Putting the Captive Solution to Work

Unlike traditional insurance, a captive usually is not a means for the PEO to shift risk to unrelated third parties. The captive

will establish its reserves, pay the claims, and pay its share of captive administrative expenses with a combination of the premium paid by the PEO, capital that will be supplied to the captive by the individuals or entities that own the PEO, and income earned by the captive on its reserves.

Usually, there will continue to be a requirement for the primary workers' comp carrier to hold the reserves as collateral. As the captive is unlikely to be licensed or admitted in the primary carrier's state of domicile, the captive arrangement will not enable the primary carrier to receive credit against its reserving requirements unless it holds the captive's reserves as collateral.<sup>3</sup>

- 1 The PEO cannot take such a deduction, but the captive can because the captive will be taxed as an insurance company.
- 2 Frequently reference is made to the "release of reserves." In this context "reserves" and "collateral" are close to being interchangeable terms. Sometimes PEOs set aside and hold their own reserves against future workers' comp losses. More often, the reserves are delivered to the primary workers' comp insurance carrier to be held as collateral. The release of the collateral on the part of the primary carrier is usually going to result in a corresponding release of reserves on the books of either the PEO or the captive insurance company, as applicable. If

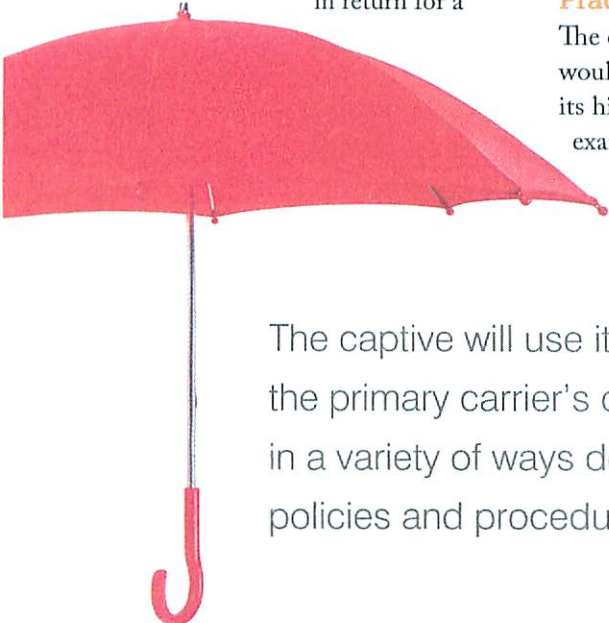
- the reserves were deductible by the captive insurance company, then the release of those reserves will result in taxable income.
- 3 The deductible arrangement is strictly between the PEO and its high deductible carrier. If the PEO fails to pay the amounts within its deductible, under the laws of most (if not all) states, the primary insurance carrier is responsible for the entire amount of the claims from injured employees. Therefore, the primary carrier must set aside reserves on its books to satisfy its responsibility. If it holds a letter of credit, cash, or securities (subject to state statutes), the amount of its own assets that must be used to establish reserves is reduced.

## in a nutshell

- Unlike a licensed insurance company, PEOs are unable to take a tax deduction for their reserves. Captive insurance can provide a cost effective way for a PEO to reduce the capital drain attributable to current tax exposure.
- For the insurance premium to be deductible to the PEO, the captive and its policy must satisfy basic federal income tax requirements.
- The captive arrangement does not change the basic economic arrangement between the PEO, its ownership group, and the high deductible carrier.

The captive will use its reserves to satisfy the primary carrier's collateral requirements in a variety of ways depending upon the policies and procedures of the primary carrier. The methods of posting reserves can include:

- Putting cash<sup>4</sup> or securities into the possession of the primary carrier in return for a



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contractual obligation on the part of the primary carrier to use the reserves for agreed-upon purposes;

- Placing the reserves into the kind of trust account used under various state statutes designed to permit domestic carriers to receive credit for reinsurance from non-admitted reinsurance carriers; or
- Delivering the reserves to a third-party financial institution as collateral to support letters of credit in favor of the primary carrier. The benefit of this particular approach is that, subject to the liquidity requirements of the LOC issuer, the captive and its ownership group may have more discretion with the investment of the reserves.

### Federal Tax Requirements

For the insurance premium to be deductible to the PEO, the captive and its policy must satisfy the three basic federal income tax requirements:

- The insured risk (workers' comp expo-

sure) must be shifted from the PEO to the captive;

- There must be a distribution of risk within the captive, i.e., the captive must insure several parties;<sup>5</sup> and
- The captive must be a real insurance company and not a sham.<sup>6</sup>

### Practical Considerations

The easiest way to explain how the captive would work together with the PEO and its high deductible carrier is to use this example: PEO X is eligible for a manual

premium (ignoring its mod factor) of \$5 million of which 30 percent (\$1.5 million) is paid to its high deductible carrier. That leaves 70 percent of manual (\$3.5 million) available to pay premium to the captive.

Whether risk has been shifted under a policy is a matter to be determined by an actuary in each case. For purposes of this example, it is going to be assumed, if the premium paid is \$3.5 million, a policy with an aggregate exposure of \$4.2 million based on the loss history of the PEO is going to be adequate to find risk has been shifted. Let's also assume PEO X's fair share of the captive's administrative expenses is \$75,000. The difference between \$4,275,000 (policy exposure plus administrative expenses) and \$3.5 million (the PEO's premium) is \$775,000. This difference must be supplied, in some form, by the parties that own the PEO and not by the PEO itself.

Assume the primary workers' comp carrier may require collateral of up to \$4.2 million; the captive will be in a position to supply it. The capital supplied by the

PEO owner(s) as well as the premium may be used for this purpose.

### Conclusion

Captives are not for all PEOs. Most PEOs with a guaranteed cost policy would not need a captive. Further, even if a PEO has a high deductible primary workers' comp policy, unless the amount of collateral it is required to place with its primary carrier on an annual basis is expected to be \$500,000 or more, a captive arrangement probably isn't going to be a cost-effective solution.

Finally, the captive arrangement does not change the basic economic arrangement between the PEO, its ownership group, and the high deductible carrier. The PEO and its owners, together, will be responsible for the entire insurance exposure attributable to the deductible. However, the captive can be an effective tool to shift the timing of a tax impact from the time when reserves have to be posted (and funds may not be available for payment) to a time when reserves are released as unnecessarily large (and cash is available for payment).●

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4 This can include savings accounts, certificates of deposits, repurchase agreements, or similar near-cash instruments.

5 For more on risk shifting and risk distribution, please see *Clougherty Packing Co. v. Commissioner*, 811 F.2d 1297, 1300 (9th Cir. 1987), *Humana Inc. v. Commissioner*, 881 F.2d 247, 257 (6th Cir. 1989), Rev Rule 2002-90, 2002-52 I.R.B. 985 (12/30/2002).

6 *Malone & Hyde, Inc. v. Commissioner* 62 F.3d 835 (6th Cir. 1995).

### further reading

Related and similar articles are available to NAPEO members on the NAPEO Web site and in the *PEO Insider* article library:

- Large deductible policies and other WC issues: [www.napeo.org/members/insider/mar05/feature.cfm](http://www.napeo.org/members/insider/mar05/feature.cfm)
- Collateral: [www.napeo.org/members/insider/may05/riskmgmt.cfm](http://www.napeo.org/members/insider/may05/riskmgmt.cfm)
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