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CAPTIVE INSURANCE COMPANY REPORTS

Tax Reform and Captives

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Editor's Note: Much has been and is being written about the effect of the new tax act on captives. It is time to "look at the numbers" with two well-informed actuaries. While we are aware of the mantra, "Don't form a captive for tax reasons," we realize that tax reasons play a big part in captives. And, we have previously offered some legal, regulatory, and tax angles. Now we learn how the numbers actually work in this excellent explanation from **Joel Chansky** and **Mike Meehan** of Milliman, Inc.

Well, it's been over 30 years since the Tax Reform Act of 1986. While one of us is old enough to remember how insurers and captive insurers were impacted, we're not here to rehash the good old days. Let's look ahead to the newly minted tax legislation and see how it might impact captives. We'll be focusing on US federal taxes and any corresponding economic benefits associated with single-parent captive insurance companies taxed as property and casualty insurers. We'll split our US taxpayer captive universe into two broad categories: large captives and small captives.

Large Captives ($10 Million or More in Premium)

Just a bit of background to set the stage. The US federal tax benefits afforded to larger captives are created by accelerating tax deductions for reserves carried by the captives. Companies that simply self-insure can only deduct expenses related to property, workers compensation, and liability claims when the expenses are actually paid. Any self-insured reserves established to pay for the estimated costs to settle claims that have already occurred can't be deducted.

We have a timing difference here—the total deductions will eventually be the same under a captive or noncaptive scenario, but the captive scenario will accelerate the deductions. This changes the way US federal taxes are paid. The captive owner will pay lower upfront taxes and then eventually "catch up" to the self-insurer.

CICR comment: While the owner hopes for some changes in his favor.

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While the captive owner is holding those saved funds, they can be invested and earn a return not available to the self-insurer. It's a little like having an interest-free loan whose balance declines over the lifetime of the underlying claims.

So, what's new? Well, there are two main items that impact larger captive insurers. The first, and the biggest, is the new marginal tax rate of 21 percent, a sizeable decrease from the current top rate of 35 percent. The second, and less impactful, is the change in the benchmark interest rates to be used for discounting loss reserves. Essentially, higher interest rates will be required relative to the current values. There are other changes in the new tax legislation that impact insurance companies, but they are less likely to have much of an impact on captives.

When marginal tax rates drop, the economic benefit of the accelerated deductions drops proportionally, ignoring the annual cost to own and operate a captive. Going from 35 to 21 percent results in a 40 percent decrease in the US federal tax benefit afforded to large captive owners. Increasing interest rates used for discounting loss reserves will reduce the deductions for reserves, which, all else equal, will serve to shrink the timing difference of deductions between a captive and a self-insurer. The change in the benchmark interest rate will impact each captive differently, depending on the mix of insurance coverages in the captive, as well as how long the captive has been in business.

The new interest rates haven't been published as yet, so we haven't attempted to quantify their impact. But to keep things simple, let's use 10 percent as the average expected decrease of the tax-timing benefit described above. Combining this with the 40 percent haircut due to lower marginal rates, the tax-timing benefit is roughly cut in half!

So, strictly from a US federal tax perspective and all else equal, large captives will provide less bang for the buck for their owners under the new tax legislation. How much less depends on the captive's risk and reserve profile. What we end up with is an example of a piece of a probusiness tax law change that isn't very helpful to captive insurers. It's a small piece of the puzzle but one that risk managers should take a hard look at.

Small Captives (under $10 million in Premium)

Okay, we've got our arms around how the new tax legislation affects larger captives. But what about smaller captives?

Let's break the universe of small single-parent captives into two broad groups: captives with premiums above $2.2 million and captives with premiums at $2.2 million or less. For the over $2.2 million group, these captives are impacted exactly like the larger captives described above. Prior analyses that we have performed show that captives below $5 million in annual premium are likely spending more on the cost to own and operate a captive than they are receiving in timing-related federal tax benefits. Lowering the marginal tax rates and the level of discounted reserves that can be deducted increases this breakeven threshold and simply reduces the likelihood that there is any economic benefit attributable to the timing of deductions that aren't available to self-insurers for this group—even in the $5 million–$10 million band.

Let's look at the small so-called micro-captives. These are captives that elect to be taxed as small insurers pursuant to Section 831(b) of the Internal Revenue Service (IRS) code. This election means that for any tax years with premiums of $2.2 million or less ($2.3 million in 2018 and indexed to inflation in subsequent years), the insurer is not subject to federal income taxes on underwriting gains. Only investment income is taxable and at the new corporate rate of 21 percent. Prior to

2016, the premium limit was $1.2 million. Since many companies were originally established with this in mind, and since the IRS has been investigating some of the companies making this election, it is likely that the $1.2 million premium levels will persist for a while. More on this to follow.

Under the old tax law, given low losses, making an 831(b) election was a way for smaller profitable business owners to reduce their tax burden. In short, paying a premium to the captive for insurance coverages with low likelihoods of having losses allowed the captive owners to convert a 39.6 percent marginal tax rate to a 23.8 percent tax rate. And the cost to do this was the cost of owning and operating a captive.

Where do we get the top marginal rate of 39.6 percent? Most smaller businesses have been set up so that income "passes through" the books of the business to the owners at the owners' personal tax rates. Under the expiring tax law, this was 39.6 percent. The structures in use are S corporations, partnerships, or sole proprietorships.

So why would a business owner want to do this when the top marginal tax rate in a regular company (C corporation) was only 35 percent? Because of double taxation. The C corporation pays 35 percent of taxable income to the IRS, and then, if the owner wants to take money out, there is a tax on dividends of up to 23.8 percent (20 percent for dividends and a 3.8 percent surcharge on investment income tied to the Affordable Care Act for higher income taxpayers). On a notional $1 million of taxable income, $350,000 goes out in taxes on the company's tax return, and then the $650,000, when released to the owner in the form of a dividend, gets hit with another 23.8 percent tax of $154,700, leaving $495,300 to the owner after tax. Better to use the pass-through rate of 39.6 percent and keep $604,000 after tax. See Table 1 below.

Now we know where all of these tax rates come from—35, 39.6, and 23.8 percent, respectively, for C corporations, individual (both non-pass-through and pass-through), and individual dividend—under the expiring tax law. What are those rates now? They are 21, 37,

Table 1
No Captive Insurance Company

	Pretax Reform		**Posttax Reform**	
	C-Corp	Pass-Through	C-Corp	Pass-Through
Pretax Income	1,000,000	1,000,000	1,000,000	1,000,000
Tax Rate	35.0%	39.6%	21.0%	37.0%
After-Tax Income	650,000		790,000	
Dividend Tax Rate	23.8%		23.8%	
Owner's After-Tax Income	495,300	604,000	601,980	630,000
Resulting Marginal Tax Rate	50.5%	39.6%	39.8%	37.0%

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and 23.8 percent. We've covered the 21 percent corporate rate, and the dividend rate of 23.8 percent hasn't changed. But the individual rates have changed; the top marginal rate has dropped from 39.6 to 37 percent. There is another provision for business owners that allows for a 20 percent deduction on the first $315,000 of taxable income, but the deduction phases out once taxable income reaches $415,000. We are assuming that most micro-captive owners are dealing with taxable income over $415,000, so we've ignored the 20 percent deduction provision for now.

What's a small business owner to do? First, going on a very short tangent away from our topic of captives, should they simply avoid the pass-through structures and just file as a C corporation? Probably not. Sure, the 21 percent rate looks better than the 37 percent rate. However, once you factor in the double taxation of 23.8 percent on the remaining 79 percent available for dividends, the result is a total tax rate of about 40 percent. Better to pay 37 percent than almost 40 percent. See Table 1 on the previous page.

What about a micro-captive? Is that still a good idea? Let's take a look.

Let's assume our captive owner has been paying $1.2 million in premiums with no insured losses and $100,000 in captive-related expenses. We surveyed several captive managers who indicated a fee range of $70,000–$100,000 (including any fees associated with participation in a risk pool of other 831(b) captives). The prior tax law produced a "savings" of $113,400. We get that by comparing the after-tax income with no captive to that with a captive.

With no captive, we pay 39.6 percent of the $1.2 million, or $475,200, and we're left with $724,800. With the captive, expenses of $100,000 mean that we can only dividend $1.1 million back. At the 23.8 percent marginal dividend tax rate, this means federal taxes are $261,800, and after-tax income is $838,200. Compared to no captive and $724,800 of after-tax income, the captive owner is ahead by $113,400. A pretty good deal. Should that program be renewed in 2018?

Table 2
Comparison of No Captive versus Utilizing Captive Insurance Company—Making 831(b) Election

	Pretax Reform		**Posttax Reform**	
	Pass-Through	Captive	Pass-Through	Captive
Premium		1,200,000		1,200,000
Captive Operating Expenses		100,000		100,000
Captive Claim Costs		0		0
Pretax Income	1,200,000	1,100,00	1,200,000	1,100,000
Tax Rate	39.6%	23.8%	37.0%	23.8%
Owner's After-Tax Income	724,800	838,200	756,000	838,200

Let's start with the "no captive" scenario. Our business owner simply keeps the $1.2 million and pays a pass-through tax on this at a 37 percent rate. The resulting tax is $444,000, for an after-tax income of $756,000.

What about the captive scenario? Since the 23.8 percent marginal rate hasn't changed, we get the same after-tax amount of $838,200 that was calculated above. The owner is still ahead of the game, but now by $82,200 relative to not having a captive. The "gain" drops from $113,400 to $82,200, or 27.5 percent. A pretty sizeable haircut! See Table 2 on previous page.

The examples above all assume zero insurable losses in the captive. But what if there are losses in the captive? These are not tax deductible since underwriting income is not taxed. This isn't anything new, but since we're looking at the benefits of owning and operating a micro-captive, it bears repeating that *losses in the captive are not tax deductible. The more losses, the less the "tax savings" from the captive.*

With our notional $1.2 million of income, the "breakeven point" would be an insurable loss of $623,000. Here, in the captive scenario, after paying losses and expenses of $723,000, the balance of $477,000 could be dividended back and after paying the 23.8 percent tax, that leaves $363,500. This equals the "no captive" scenario, where the original $1.2 million is reduced for a tax-deductible loss of $623,000. The result is $577,000, and, after taxing this at 37 percent, we're left with $363,500. If insurable losses are below $623,000 in our example, the captive scenario wins. See Table 3 below.

Another risk is if the captive is part of a pool and the captive owner has to pay losses of other captive owners, which could easily wipe out the very benefit being pursued. Let's look under the hood of the risk of being in a pool. We'll assume that the captive is in a pool of other captives, all writing $1.2 million in premium. Further, we'll assume that all $1.2 million of the premium is pooled and, therefore, each participant cedes $1.2 million to the pool and then assumes $1.2 million back, with a

Table 3
Comparison of No Captive versus Utilizing Captive Insurance Company—
Making 831(b) Election

	Without Risk Pool		**With Risk Pool**	
	Pass-Through	Captive	Pass-Through	Captive
Income/Premium	1,200,000	1,200,000		1,200,000
Captive Operating Expenses		100,000		100,000
Insurable Loss/Captive Claim Costs	623,000	623,000		108,000
Pretax Income	577,000	477,000	1,200,000	992,000
Tax Rate	37.0%	23.8%	37.0%	23.8%
Owner's After-Tax Income	363,510	636,474	756,000	755,904

spread of risk among the captive owners. Finally, we'll assume that our notional captive owner cedes no losses to the pool. If the pool loss ratio is 9 percent or more, the $82,200 gain noted above is wiped out.

To do the math, 9 percent of $1.2 million is $108,000 (this would be our captive's share of assumed losses from other parties), and that is no longer available to be dividended. Coupled with the $100,000 of expenses, the dividend is reduced to $992,000. Applying the dividend tax rate of 23.8 percent results in a tax of $236,000, leaving $756,000—exactly the same outcome as not having the captive (and no insurable losses for the captive owner). See Table 3 on page 5.

When we stretch the premium out to $2.2 million, the scales tip in favor of the small captive. With no captive, the $2.2 million gets taxed at 37 percent, leaving $1,386,000 for the owner. With a captive, even at $100,000 of expenses, the remaining $2.1 million, net of dividend taxes of 23.8 percent leaves the owner with $1,600,200 of after-tax income, or a gain of over $200,000. The risk of losses is still present using the logic outlined above.

As noted above, small captives have caught the attention of the IRS. The IRS is looking to make sure that the premiums charged to the captives are proportional with the risk being undertaken and are not simply being arbitrarily set at some level, like close to the $1.2 million or $2.2 million thresholds for making the Section 831(b) election. A number of micro-captives were set up with premiums close to $1.2 million (the $2.2 million limit was new in 2017 and was not part of the recent tax law change). Given the IRS scrutiny, many have chosen to stay the course and leave premiums at the current levels.

Conclusion—
Where Do We Go from Here?

You might ask, "What happens if we wait a few years to declare the dividend and let the gains in the captive accumulate tax-free?" Let's save that for our next analysis. For now, let's just say that the new tax legislation has cut back on the economic benefits related to US federal taxes previously enjoyed by some captive owners.

In summary, captives are great risk management tools and often result in terrific economic and noneconomic benefits. But if it's tax benefits that are driving the decision, take a hard look at the numbers! ■

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