I n the shifting landscape of healthcare in the U.S., physicians are feeling a good bit of uncertainty about how best to manage their medical professional liability (MPL). One of the more common risk management tools, the captive insurance company, is used more frequently now, by hospitals and physicians groups. In particular, the use of 831(b) captives, or “small company captives,” has increased the most, due to the advantageous tax treatment. Small company captives are created via an election afforded in section 831(b) of the Internal Revenue Service Code that lets captive insurance companies with premiums less than $1.2 million exempt their underwriting income (earned premiums less claim expenses) from federal income tax. This election is a significant benefit for small company captives, especially those that have a low frequency of claims. However, the small company captive must meet the IRS’s definition of an insurance company, as established for tax purposes. This very definition has been the focus of IRS examinations in recent years, to ensure that captive insurance companies do in fact meet the requirements to qualify as an insurance company for tax purposes. In summary, a small company captive must demonstrate these characteristics to be considered an insurance company by the IRS for tax purposes. As you’ll see with any legitimate tax planning strategy, there are some people and organizations that try to take advantage of this election without fully meeting the requirements for it. Recently, in response to the new popularity of the small company captive, the IRS has increased its scrutiny of them, to ensure that they are in fact following what is set down in the IRS Code for companies looking to properly qualify as an insurance company for calculating its tax purposes.

On May 28, 2014, Sheryl Flum, Branch Chief, IRS Office of Chief Counsel provided some

**A Small Company Captive**

1. **It must act like an insurance company.**
   The small company captive must establish insurance policies, set and collect premiums, pay claims, record insurance reserves, and follow the regulatory and financial requirements established by its place of domicile. Furthermore, the premiums that are established should be developed via actuarial or market-based studies, and not arbitrarily determined.

2. **It must transfer risk.**
   The small company captive must assume the reasonable possibility of a significant loss with the insured. If there are terms in the insurance policy between the small company captive and the insured that limit the captive’s loss, then it is possible that the policy issued does not qualify as an insurance policy.

3. **There must be risk distribution.**
   This requirement follows the concept of “pooling of risks” as used in the insurance industry. There must be enough risk distributed among the various entities of the insured, or the small company captive must have the majority of its risk insured with third parties, in order to meet this requirement.
basic guidelines, in a webinar hosted by the American Bar Association Section of Taxation, on what the IRS is doing to address some of the abusive small-company tax strategies.  

- There are no bright-line rules.  
Through IRS tax court cases, a series of bright-line tests, or “safe harbors,” have been interpreted within the captive industry, assuming that if these are followed, the small company captive will automatically qualify as an insurance company for tax purposes. For example, it is common in the captive industry to assume that, in order to meet the risk distribution criterion, at least 51% of the captive’s business should be with a third party (IRS Revenue Ruling 2002-89, 2002-2 CB 984, 2002-90, 2002-2 CB 985). Similarly, if the captive does not want to include third party risk, the captive has to insure at least 12 entities, with no single entity representing more than 15% of the overall risk (IRS Letter Ruling 201219009, 201219010, 201219011). Note that these rulings cannot in fact be interpreted for structuring a captive program, as both facts and circumstances will likely be different.  

- There is no definition of “insurance” in the tax code.  
Flum said, “Not any one thing will make a captive bad. But, if you have a captive where the types of policies that are being written do not truly reflect the risks of the business, or where the risk is so ephemeral that it’s really not something for which insurance would be appropriate, or the pricing of the policy is so exaggerated that in the private market no one would pay that amount, then those are the kinds of things that would cause IRS examiners to scratch their heads.”  

- Premium pricing must be consistent with the type and level of risk assumed.  
Flum stated that she wasn’t sure whether the IRS would consider premium pricing developed by actuaries to be more supportable than pricing provided by an insurance underwriter. She said, “If the cost of your insurance is similar to what it would have been if you’d gone to a private insurance company, that would go to establishing you had the right price.” Further, she stated, it would seem that, “If you have somebody who knows about pricing insurance policies, that’s a fact that’s better than having nobody who knows about insurance pricing.” Based on Flum’s comments, then, the sponsor of a small company captive has the burden of demonstrating how the specific facts and circumstances of its captive structure comply with the spirit of the IRS Code; they cannot rely on any bright-line tests.  

- Procedures must be directly related to the type of risk and probability of that risk occurring.  
Ensure that the premiums are supported by sound actuarial studies or third-party market studies. Arbitrarily developed premiums, along with unusual types of risk, are scrutinized more thoroughly by the IRS; they could accuse the captive managers of attempting to arbitrarily maximize the $1.2 million premium Federal tax exemption. For example, a $500,000 premium for hurricane catastrophe insurance coverage for a plant located in Iowa, is not likely to be considered a realistic premium, given the remote probability of such an event.  

- Ensure that there is proper risk distribution, through the use of third parties or by having a sufficient number of entities.
ties insured by the captive. Although the tax rulings stated previously are not true “safe harbors” from the IRS’s perspective, they are nonetheless legitimate guides that can be used during the structuring phase of the captive, to help ensure that the risk distribution criteria have been met. Retain all of the documentation that demonstrates how the captive structure meets the risk-distribution and transfer-of-risk criteria.

- Keep the insurance policies between the captive and the insured simple.
  The insurance policies between the captive and the insured should mirror a standard insurance policy. There should be a premium charged in exchange for covering a loss event(s), up to the limits stated in the policy. When numerous terms and conditions are added to the policy that change the nature of the coverages, limits, premiums, and reimbursement from claims, these features will get more scrutiny from the IRS as potential risk-limiting features, and thus the policy may not qualify as a true insurance contract.

- Have claims.
  The captive is supposed to be an insurance company, and insurance companies have claims. If the captive does not have any claims, this becomes a red flag for the IRS, suggesting that the coverages that are insured by the captive may not be valid, or that the premiums for those coverages have not been calculated in relation to the actual probability that those losses will occur. Note that a low number of claims could be reasonable for a catastrophe-type coverage characterized by high severity and low frequency, such as hurricane coverage. As long as the premium is priced according to the actual risk of loss, these types of coverages are appropriate.

- Proper funding of capital.
  The captive needs to be properly capitalized, so that there are sufficient funds to manage the insurance business it is writing. In addition, funds for capital need to be physically transferred to the captive insurance company, and retained by it.

Overall, small company captives are a viable alternative-risk tool that healthcare organizations can use to manage their MPL risk effectively. However, as with any strategy, there are rules and regulations that need to be followed, to achieve the benefits that are expected from setting up a successful captive.

Reference