CPA
Practice Advisor

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insure risks of its owners, and those insured benefit from the captive insurer's ...

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Captive insurance is generally defined as an insurance arrangement that is wholly owned and controlled by those insured. The primary purpose of the said captive is to insure risks of its owners, and those insured benefit from the captive insurer's underwriting profit.

The facts of a captive, do not clearly distinguish the captive insurer from a mutual insurance company. The definition of a mutual insurance company is that it is technically owned and controlled by the policyholders.

But no one who is merely a mutual insurance company's policyholder exercises control of the company. The policyholder may be asked to vote on matters requiring policyholder action. But this usually means that the policyholder will be presented with a proxy and advised by the board that runs the company as to how to exercise its vote. As soon as the insurance ceases, so does the policyholder's ownership status. The policyholder has not invested any assets in the insurance company and does not actively participate in running it.

Captive insurance is utilized by insureds that choose to

- put their own capital at risk by creating their own insurance company,
- working outside of the commercial insurance marketplace,
- to achieve their risk financing objectives.

Tax law generally allows businesses to create captive insurance companies to protect against certain risks. Traditional captive insurance typically allows a taxpayer to reduce insurance costs. The insured business claims deductions for premiums paid for insurance policies. Those amounts are paid, either as insurance premiums or reinsurance premiums, to a captive insurance company owned by the insured or

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risks, fail to match genuine business needs or duplicate the taxpayer's commercial coverages. Premium amounts may be unsupported by underwriting or actuarial analysis, may be geared to a desired deduction amount or may be significantly higher than premiums for comparable commercial coverage.

Policies may contain vague, ambiguous or deceptive terms and otherwise fail to meet industry or regulatory standards. Claims administration processes may be insufficient or altogether absent. Insureds may fail to file claims that are seemingly covered by the captive insurance.

It is important to point out that for the last three years micro-captives have been on the IRS's Dirty Dozen Tax Scams. They are viewed as abusive tax shelters by the Service, and if not set up properly can cause unwanted scrutiny from the service.

A captive can only be capitalized by $1.2 million. If the captive is set up correctly, the taxes paid by the captive will be only on net investments of the capitalization made in in investments. The companies that captives are tailored for are doctors looking to supplement malpractice insurance, professionals, and others that may have a large judgement entered against them.

However, where captives are beginning to take root is in the cannabis industry. The reason for this, is that cannabis owners have a hard time finding insurance for their crops or dispensaries. Unscrupulous promoters of these captives use the promises of large tax deductions to sell to cannabis clients, as well as the fact that they will have insurance. The problem is that the amounts paid to the captives are not deductible by cannabis clients. Further, the maximum amount of capitalization, $1.2 million, doesn't cover most damages incurred if there was a fire or some other act of God. Not to mention cannabis is already scrutinized by the IRS. Participation in a captive would cause additional scrutiny.

Captives have their place, but for most businesses you have to weigh the positives

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