

SURVIVAL IN THE CAPTIVE INSURANCE INDUSTRY

David Liptz, of Liptz & Associates, reflects on how to survive in an ever more competitive industry

Own and operating a captive insurance company has similarities to those individuals competing on the TV show *Survivor*; competing in an environment of complex trails and maps (regulatory, tax and business laws), successfully navigating a new environment (the insurance business), and achieving rewards by winning “competitions” (proper documentation of your insurance business).

There is not enough room on these few pages to comment on ALL best practices, but this article will touch upon a variety of the “best practices” that are required to set yourself up for the best chance of being the “survivor” in the captive insurance industry and your insurance business. The basic theme for success is application of the most relevant and specific information and the proper documentation of same.

As a CPA that has been involved in the captive insurance industry for 20 years, I’ve seen the industry continue to evolve. Formerly, it was mainly “big business” such as Fortune 500 companies that had access to insurance vehicles such as captive insurance companies. As much as technology has made advances and become more accessible, affordable and accepted if not required to survive in business and life, so too have legislative and legal interpretations in the area of taxation, and these changes have brought vehicles such as captive insurance to the middle markets. Now, (relatively) small business can choose

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to avail themselves of these same legislative and legal opportunities formerly “reserved for companies with extensive in-house counsel or budgets sufficient to enlist the expertise of multiples of affiliated firms.” Business today has become far more technological, and also developed as a legal-legislative “race” to amass information. Over time, the possession of information and big data collection has been what has built societies to grand heights, and a lack of information has levelled the once powerful and flourishing to rubble.

Information and the application of that information as knowledge, and the wisdom on how to best use that knowledge, is what gives societies, and now businesses, advantages over others. Similar to how society has seen the internet emerge from novelty

to necessity, the transition from the written letter, to telegraph, to email and now video conferencing and beyond, information powers successful societies, businesses and individuals. The application, the ACTION of progressing from the mere possession of information to the wise and efficient application of that knowledge is key to not only survival in today’s global economic condition, but in the race to tomorrow’s success and security.

Your choice to implement, OWN and MANAGE a self-insurance business is likely akin to why you decided to start your business in the first place; you believe you can do something better or a little different than others. In understanding the framework of a captive, you discover that you may be able to manage your insurance risks differently, more efficiently and in fact better than the commercial insurance carriers.

In *Survivor*, the participant must, out of a necessity borne of their intolerable circumstances, progressively venture further away from their “base” to collect articles and advantages to improve their opportunity to “win.” The genesis of your choosing, or being prompted to explore and then implement modes of alternative risk management are also borne out of necessity; seeing your commercial insurance policy premiums rising, the amount of coverage decreasing and the claims reimbursement process being slow and fraught with frustrations. The call to action is thus and with the information acquired, you



must now take action and implement. To do so can be daunting, yet these powerfully challenging times of growth and exploration for your business enable it to not only “survive” but thrive.

The journey begins with a feasibility study and a business plan. Think of this as a GPS as to the why, how and the trails for your insurance business. This study and planning will ask certain questions to gather the information necessary to assess the cost/benefit. Does it make sound economic sense to self-insure? What risks and how much to self-insure – what are the costs and benefits of the business? The study is a written document that is akin and partner to your business plan that was submitted to your banker upon receiving your working capital loans. It provides a picture of the journey you plan to take to reach your goals. In order for you to stay on your trail, you want these documents to contain sufficient details and documentation that supports your intentions toward embarking on a profitable journey. Although a picture or a photo is nice and tells a thousand words, a movie tells

a hundred VOLUMES. You don't need a static image of the past, which is what a photo is; you need a movie that you can edit, add to and expand as the story of your success unfolds and powers your vision from now and into the future. You can take a photo all by yourself; a movie, however, will require a crew to help you meet your aims. Members of your crew or teammates include an insurance manager, lawyer, investment advisor and CPA.

At the trailhead, you obtain your articles of incorporation, insurance license and permission to conduct business from one of the “park rangers” – in this case, the governmental insurance regulator; other “park rangers” will include taxing authorities, reinsurance members and rating authorities. The regulator will give you their rules and check in points that must be adhered to in order to navigate away from the swamps, insect infested brush and even a license suspension. The timing of filing your annual financial audit prepared by an approved CPA, the premium tax returns, obtaining pre-approval for business plan changes, obtaining pre-ap-

proval for changes to your risk profile, obtaining pre-approval for changes to your investment plans, staying within the solvency requirements; these are all ways that may cause you to step into the “license suspension” hole. Your production crew will begin to provide you with other items of interest and importance.

Your trail must contain informational waypoints so others that come behind you can find their way. You have done this by writing down and documenting your business processes; your hiring practices, how to operate machinery and keep it clean, how vendor invoices are approved and paid, how to initiate and get purchases approved, and so on. Your insurance business must document its processes and systems: determining which risks to insure, how premiums are developed and calculated, how a claim is submitted, administered and paid out, how the insurance reserves are determined and calculated, and more.

Your CPA's role is vital to providing lead scouting on your documentation. The annual audit process requires the CPA to

request, obtain and review the paper work that makes up your business. The rules required to be followed are determined by the Generally Accepted Auditing Standards, along with numerous standards promulgated by “governing organizations” and the CPA licensing board’s extensive documentation requirements.

As the writer, producer and director of your movie, your journey likely will contain various side trails and scenes that will branch off from the main trail and movie, but always converge back and tie to your goals, making confusing individual scenes merge into a seamless story anyone can view and understand. These transactions are often outside the lines of a perfect box and require detailed agreements, documentation and continued updating. Examples include:

- Related party transactions
- Enterprise risk underwriting and business risk analysis
- Concise actuarial studies
- Sophisticated investment transactions that comply with solvency requirements
- Consolidations of related investment entities

As you move down your trail and through production, you will encounter signs and possible interactions with a “park ranger” and/or your co-producer(s). Understanding the signs (rules and regulations) and conversing intelligently with these park rangers is a critical, essential and absolutely necessary part in ensuring you are able to navigate down your path of production and reach your goals.

Over the last couple of years, several new rules and regulations have been imposed onto the captive insurance industry by the Internal Revenue Service (IRS) and US Treasury Department. In December 2015, the PATH tax act was passed and signed into law. The PATH act contained two new provisions that directly impacted an insurance company whose business plans include making an election pursuant to IRC 831(b).

The PATH act passed new legislation that increased the premium limit to \$2.2m from \$1.2m but also imposed two diversification requirements in order to qualify under IRC 831(b):

- Diversification test; or
- Ownership test

The captive must meet only one of the above tests. On the surface, these diver-

sification requirements seem clear and straightforward but the IRS has provided no guidance on how to comply with the statute. The diversification test is such that no more than 20% of the insurance company’s premiums are from any one policyholder. The ownership test is such that the insurance company’s ownership must mirror the ownership of the insured(s) within a margin of 2% or less.

As mentioned earlier in this article, those choosing to self-insure normally have business structures that have several layers and entities. Our experience shows that because of this reality, the amount of planning necessary to comply with the new PATH act tests is involved. The communications from the meetings held with the various professionals in the owners circle of key advisors should be

“The journey begins with a feasibility study and a business plan”

documented as well as the many exhibits and pro-formas developed to assist in the analysis.

Some details that should be discussed will be the definition of a policyholder in the context of reinsurance pools, the ownership attribution rules pursuant to IRC 267(b) and 707(b) when exploring the definition of a single policyholder. How the same attribution rules will apply to the direct and indirect ownership of the captive; indirect ownership includes through a trust, grantor trust, estate, partnership or corporation.

Most owners of a captive insurance company that made an election pursuant to IRC 831(b) are fully aware of the IRS Notice 2016-66 that was issued on 1 November 2016 that designated certain small captives as “transactions of interest” and the involved compliance requirements. The filing of the IRS Form 8886 was not a simple process for those tasked with the job of preparing the form. Liptz & Associates as an office spent hundreds of hours consulting with leading tax attorneys, captive insurance professionals, internal discussions and CPAs to help us develop our “best practices” of completing the form.

The preparation of the Form 8886 required the review of detailed records. Some of the information necessary to be reported may date back over 10 years ago; explanations of how the captive owner first learned and why they formed their captive insurance company. It was vital that these records were clear and detailed so were consistent with all prior and current filings. To help in the survival of this filing, the owner and the captive’s team of professionals had to communicate, share information and maintain a consistent approach.

In addition to the PATH act tests and the Notice 2016-66 compliance requirements, the “Taxing park ranger” normally will take a position that your captive insurance company functions in a similar way to commercial carrier operations. The insurance company must still meet the risk shifting and risk distribution requirements noted in Revenue Rulings 2002-89, 2002-90 and 2002-91, as well as the numerous other detailed revenue rulings and tax court decisions. Each of these “road maps” or “scenes” as rulings and court decisions require your team or crew to document how the business is complying and should be recognized as an insurance company for US income tax purposes.

Although the insurance regulator “park ranger” will not offer you an opinion on the tax status of your captive, the rules and procedures that they instill and require will promote the good health of the captive to operate as an insurance company in the commonly known sense.

To set up the survival of owning and operating your captive insurance company for success requires constant attention and documentation. Your insurance regulator is required by statute to conduct an examination every three to five years, and the IRS may choose to audit your company or other legal issues may arise, so therefore, detailed records are a must in order to set yourself up for success.

In summary, your survival requires the owner and his crew to operate their insurance company in a profit-motive. The production and retention of detailed records on the how and why you chose to take your specific trail. Your main keys are communication and documentation, and they will set you up to survive and succeed. 