Could captive insurance reduce your business taxes?

If your business offers health insurance benefits to employees, there's a good chance you've seen a climb in premium costs in recent years — perhaps a dramatic one. To meet the challenge of rising costs, some employers are opting for a creative alternative to traditional health insurance known as "captive insurance." A captive insurance company generally is wholly owned and controlled by the employer. So it's essentially like forming your own insurance company. And it provides tax advantages, too.

Benefits abound

Potential benefits of forming a captive insurance company include:

- Stabilized or lower premiums,
- More control over claims,
- Lower administrative costs, and
- Access to certain types of coverage that are unavailable or too expensive on the commercial health insurance market.

You can customize your coverage package and charge premiums that more accurately reflect your business's true loss exposure.

Another big benefit is that you can participate in the captive's underwriting profits and investment income. When you pay commercial health insurance premiums, a big chunk of your payment goes toward the insurer's underwriting profit. But when you form a captive, you retain this profit through the captive.

Also, your business can enjoy investment and cash flow benefits by investing premiums yourself instead of paying them to a commercial insurer.

Tax impact

A captive insurance company may also save you tax dollars. For example, premiums paid to a captive are tax-deductible and the captive can deduct most of its loss reserves. To qualify for federal income tax purposes, a captive must meet several criteria. These include properly priced premiums based on actuarial and underwriting considerations and a sufficient level of risk distribution as determined by the IRS.

Recent U.S. Tax Court rulings have determined that risk distribution exists if there's a large enough pool of unrelated risks — or, in other words, if risk is spread over a sufficient number of employees. This is true regardless of how many entities are involved.

Additional tax benefits may be available if your captive qualifies as a "microcaptive" (a captive with $2.2 million or less in premiums that meets certain additional tests): You may elect to exclude premiums from income and pay taxes only on net investment income. Be aware, however, that you'll lose certain deductions with this election.

Please contact Ceschini, CPAs at (631) 474-9400 for more information about this topic and other tax and business developments – such as new IRS regulations and court decisions.