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How, Why, and When to Create a Captive Insurance Company

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The potential risk management, cash flow, and tax benefits of captive insurance companies have proven attractive to a number of automobile dealers and dealership groups over the years. Many others, however, have been discouraged by the complexities involved in establishing and managing a captive.

Recent tax law changes have altered the picture somewhat and could make forming a captive insurance company a more viable strategy for some dealers who had previously ruled it out. In view of these changes, dealers would be wise to review the basics of captive insurance companies and reconsider both the potential benefits and potential risks.

Forming a captive insurance company is a complex undertaking with many possible unforeseen consequences. The decision to form a captive will have a significant effect on an auto dealer group's cash flow strategies, as well as on its broader enterprisewide risk strategy. In addition, dealers should expect that a captive also will attract close scrutiny from the IRS. Although forming a captive can be a daunting endeavor, many dealers opt to work with a third party that has a deep understanding of captives and their unique circumstances to help mitigate any concerns.

In many instances, dealers initially are attracted by the potential tax benefits a captive might offer but eventually come to appreciate the risk management and cost-control benefits of a captive even more. In order to assess the potential benefits and risks accurately, it's useful to begin with a clear understanding of the fundamental characteristics of captive insurance companies and the reasons why many dealership groups have chosen to form them.

What and Why – the Fundamentals of Captive Insurance

A captive insurance company is a legally licensed, limited-purpose property and casualty insurance company. Its main business purpose is to insure certain risks of its owners or companies affiliated with its owners.

In the case of auto dealerships, these affiliated companies typically include multiple dealership points, as well as real estate companies that own and lease the dealerships' facilities, management companies, and other types of businesses that are formed to provide related business services to the dealership or dealer group.

Forming a captive insurance company is a complex undertaking with many possible unforeseen consequences.

It's important to remember that a captive must be a legally licensed insurance company and is bound by the laws governing all insurers. Although a captive serves a limited number of customers, its purpose is not to provide bargain coverage by operating at a loss or charging its customers unrealistically low rates. Rather, it must be able to demonstrate it is a viable, solvent business, charging arm's-length premiums as established by customary insurance industry rating formulas.

Technically, a captive insurance company can provide coverage against virtually any type of risk as long as the laws of the state in which the captive is domiciled allow the line of business to be underwritten. The types of insurance a captive can provide include – but are not limited to – the following:

- Property or inventory damage
- Garage liability
- Automobile
- Extended warranty
- Business interruption
- Cyberrisk
- Workers' compensation
- Director and officer liability
- Fiduciary liability
- Crime
- Finance and insurance practices
- Pollution liability
- Workplace violence
- General and umbrella liability
- Employment practices liability
- Reputational risk

Note that a captive generally is not used to replace existing commercial insurance coverage against these risks. Instead, it usually overlays such policies, enhancing or augmenting the owner's coverage in one of three ways:

1. Covering gaps or specialized risks that are not addressed by commercial providers
2. Providing "first-dollar" coverage, which allows the owners to purchase lower cost, high-deductible policies from their commercial providers
3. Providing excess coverage for losses that exceed the policy limits of their commercial policies, again allowing owners to purchase lower-cost policies with lower coverage limits

As a practical matter, smaller captives generally are most useful for providing coverage that could be characterized as low frequency but high severity – in other words, insurance against losses that occur somewhat rarely, but are quite costly when they do occur. In this way, a captive can help reduce the net cost of risk as part of the dealership group's broader safety and loss prevention strategy.

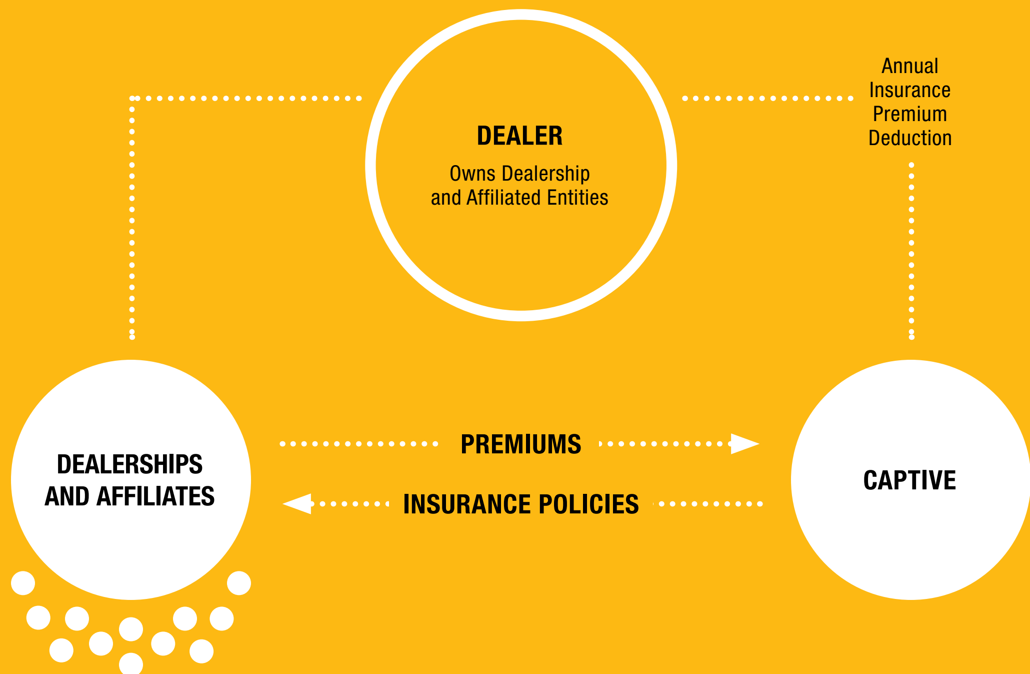
Benefits of captive insurance

Proper Structure Is Critical

In addition to its risk management features and potential cost-control benefits, a captive insurance company also can give its owners access to some advantageous tax treatments. To achieve these benefits, however, it is essential to structure the captive properly.

The traditional relationship between a captive insurance company and its affiliated companies is illustrated in Exhibit 1.

Exhibit 1: Traditional Dealership/Captive Structure



Source: Crowe analysis

The traditional dealership/captive structure consists of dealership points, real estate companies, and management companies as well as a captive insurance company, which all are owned by the dealer.

The fundamental tax advantage of a captive is that the various insured entities can deduct the premiums they pay to the insurer, but under the right conditions the captive will not have to pay income tax on those premiums. The captive does pay tax on its earnings from investing those premiums.

In order to qualify for such safe harbor treatment, the captive must meet the definition of a small insurance company as defined by Internal Revenue Code (IRC) Section 831(b). That means its annual gross premium income must not exceed $1.2 million – but that number is about to change, which is one of the reasons captives are getting more attention these days. (The upcoming changes for captives are discussed later.)

In addition to having premium income that is below the Section 831(b) threshold, the captive also must meet certain very specific structural requirements, as detailed in several IRS revenue rulings. Foremost, the IRS looks heavily at the nontax reasons for establishing a captive. The specific structure that is best for a particular dealership group depends on a variety of factors, which makes it important to work with an adviser that understands both the automotive retail business, as well as insurance and insurance taxation.

Changing Tax Laws, Potential New Opportunities

The premium income limit for qualifying as a small insurance company under IRC Section 831(b) has remained steady for many years. That changed, however, with the passage of the *Protecting Americans From Tax Hikes Act of 2015* (PATH Act) in December 2015.

The PATH Act sometimes is referred to as the 2015 Tax Extenders Act – a reference to a series of temporary tax provisions that has been routinely reinstated every year. In addition to extending a number of tax provisions that were due to expire, the 2015 PATH Act raised by $1 million the revenue limit for an insurer to qualify as a small insurance company – from $1.2 million in gross premium income to $2.2 million – beginning in 2017. It also ties this number to the inflation rate in future years. This boost in the revenue limit means many more captives could qualify for the enhanced tax benefits offered to small insurers.

Making the Call – A Complex Decision

While the potential tax benefits of a captive insurance company often are the initial attraction for many dealers, tax considerations are not the only factor – or even the primary factor – that should drive the decision to form a captive. Ultimately, many dealers find even greater value in a captive's ability to accelerate claims management, which, in turn, enables the dealer to more effectively manage its enterprisewide risk management strategies.

When deciding whether – or how – to form a captive, dealers should consider a variety of additional factors such as choosing where the captive will be domiciled, which type of structure will be best suited for their particular group, the initial capitalization and solvency requirements they will need to meet, and various other regulatory and operational issues. In many instances, the advantages can outweigh the risks and complications, but qualified professional guidance is essential to determine if a favorable business case can be made.

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