

Choosing the high-deductible captive approach

Martin Eveleigh of Atlas Insurance Management outlines the advantages and benefits for companies to explore the high-deductible insurance programme

THERE ARE a number of alternative ways for a company to assume more risk and thereby reduce its reliance on the conventional insurance market. The use of a captive insurance company has many advantages but is not always possible due to the reluctance that some traditional insurers have when dealing with a captive. The 'high-deductible' approach is a useful way of circumventing this problem as it allows companies readily to assume more risk within the structure of the existing insurance relationship.

A high-deductible insurance programme written into a captive insurance company

can also be seen as an alternative to a captive seeking reinsurance, or it can be an end in itself.

Many captives, particularly single-parent mono-line captives in the middle market, can have difficulty finding reinsurance because their premium volumes are too low to interest conventional reinsurance markets.

In these cases, it makes sense to consider buying a high-deductible policy, probably from the existing commercial insurer, and using the premium saving to buy a deductible reimbursement policy from the captive.

Compare the following two diagrams,

“The high-deductible insurance programme allows companies to assume more risk within the structure of the existing insurance relationship”

which achieve essentially the same risk financing objective through different structures:

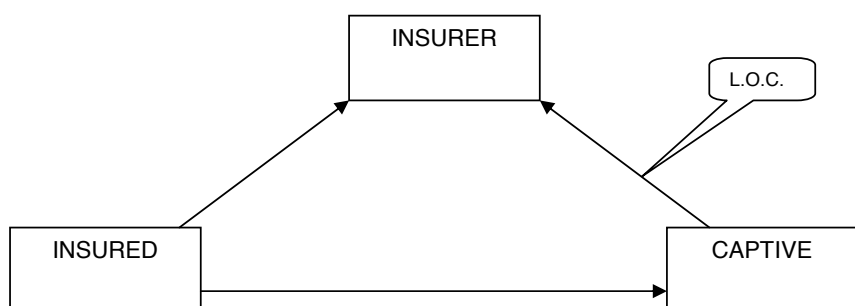
In both cases, the insured has retained US\$250k of risk in a captive. The solution in diagram 1 may have several advantages:

1. Staying with the insured's existing insurer/agent with whom a long relationship has been developed and who insures other parts of the insured's programme;
2. The policy is issued by an admitted insurer, so avoiding the need for fronting where it would otherwise be needed.

On the other hand, where fronting is not an issue, the need to post a LoC may be seen as a slight disadvantage – although the captive should have sufficient assets to do so.

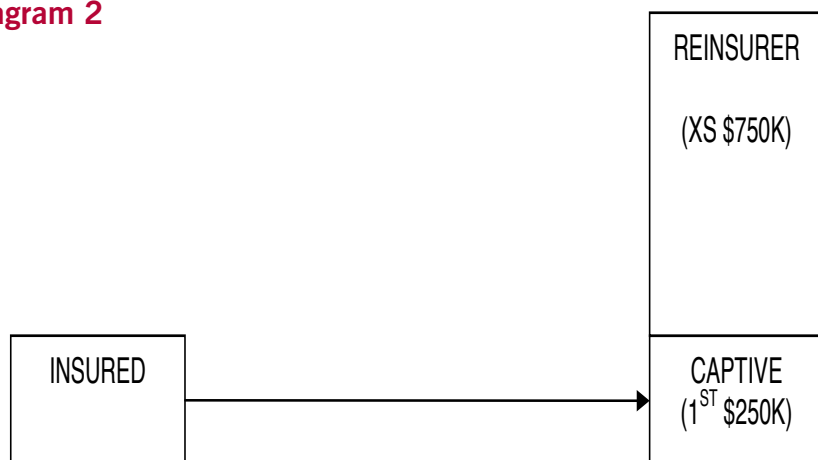
The high-deductible programme becomes an end in itself where the insurance policy has to be issued by an admitted carrier. This is particularly true of statutorily mandated insurance such as workers' compensation, where high-deductible programmes are commonly used.

Diagram 1



1. Policy issued by onshore admitted insurer subject to high deductible – US\$250k, for example.
2. Insured buys second “Deductible Reimbursement” policy from captive to cover US\$250k deductible.
3. Captive provides Letter of Credit (LoC) (if required) to onshore insurer.

Diagram 2



1. Policy issued by captive
2. Captive purchases excess of loss or stop-loss insurance in reinsurance market – Reinsurer pays balance of claims above US\$250k, for example.

Many insureds seek to lower their workers' compensation premiums through a high-deductible programme but such a programme on its own – without the captive component – has its own disadvantages, not least the need to provide LoCs to the insurer.

The high-deductible programme also allows the captive to write the premium that it retains rather than showing a written premium that is much larger than its retained premium.

Thus the high-deductible programme may help the captive keep its written premium below the US\$1.2m limit for qualification as partially tax-exempt under IRC Section 831(b).

The solution in diagram 1 works well in these cases and the deductible may be substantially more than US\$250k, for example US\$1m.

Workers' compensation captives

Because workers' compensation is a statutorily mandated coverage, policies must either be issued by an admitted insurer or the insured must qualify as self-insured in the states in which it has employees.

While self-insurance has its attractions, the regulatory approval process can be extremely onerous. Opting for a high deductible achieves virtually self-insured status for the retained part of the programme and the high-deductible policy has many advantages.

First, the licensed insurer that issues the policy will satisfy regulatory requirements in all relevant states without any action needed on the part of the insured. Secondly, the high-deductible policy will include most services on a bundled basis although it may be open to the insured to source these services from alternative providers. Finally, the premium discounts available can be very significant.

“The high-deductible programme also allows the captive to write the premium that it retains”

The most obvious disadvantage of such a programme is the need to collateralise the deductible (at least to the extent of the loss pick plus a percentage), usually by means of a LoC.

By financing the deductible risk in a captive through the purchase of a deductible reimbursement policy, the insured obtains a number of benefits. Perhaps the most striking of these is that, assuming the premium paid to the captive to be tax-deductible, the LoC can be funded out of pre-tax rather than post-tax dollars because the captive will provide the collateral funds.

LoCs

Where a high-deductible programme is in place, the traditional insurance company generally requires a LoC to support the exposure under the deductible.

This is particularly true for programmes with a long exposure 'tail' such as general liability or workers' compensation. When a captive is not in place the LoCs are secured on the client's assets. If a captive is used, then the security can be the captive's own assets.

The disadvantage with high-deductible programmes is that the LoCs can start to stack or accumulate as the programmes develop and there are more 'open' years with unsettled claims. Trust accounts or funds withheld are often used an alternative to LoCs.

Tax issues

There are two fundamental tax issues to consider when establishing a high-deductible captive programme:

1. Tax-deductibility of the premium;
2. Tax status of the captive and profits returned to the insured;

For insurance premiums to be tax-deductible, the arrangement needs to involve 'risk shifting' and 'risk distribution'. In essence this means transferring risk to another party and the sharing of risks within the (captive) insurance company.

This required element of sharing risk presents both opportunities and hurdles. Sharing risk with others who have a similar loss experience to one's own and similarly good risk management practices should be considered a good thing as it helps spread risk among a group and smooth underwriting results over a period of time. However, the company seeking to 'self-insure' by establishing a captive may at first be nervous at the idea that self-insuring must include sharing risk, if the tax benefits of the arrangement are to be realised. In the end, most companies will accept the risks involved if it is demonstrated that those risks are properly managed and that the tax advantages outweigh them.

The tax status of the captive and profits returned to the insured is a very large subject. Those entering a captive programme have a choice between domestic captives, controlled foreign corporations, non-controlled foreign corporations and foreign corporations that elect to be taxed as US-domestic insurers. For those whose premium income falls below US\$1.2m – and there will be many of them when the programme uses a high deductible – there is the opportunity for the captive to take advantage of the partially tax-exempt status afforded by IRC S.831(b). Where premium volumes are higher, use of a non-controlled foreign corporation may be advantageous.

The optimal tax solution will always vary from one insured to the next depending on size, the risks to be insured and the corporate structure of the insured amongst other factors. Professional advice in this area is very strongly recommended.



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