TAX

Voices Demystifying alternative risk transfer programs and their tax consequences

By F. Hale Stewart December 26, 2023, 11:58 a.m. EST 7 Min Read

The current insurance market has become difficult for everyone involved.

Insurers are withdrawing from entire markets. Fewer insurers are offering quotes on applications while underwriters are asking for additional information as part of the application process. Reinsurers are tightening underwriting standards, further constricting coverage.

In short, experts have claimed the insurance market hasn't been this challenging since the 1980s, an era dubbed the Commercial Insurance Liability Crisis.

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Myriad issues are contributing to this difficult environment. To name a few, large jury verdicts are more frequent, global warming is causing an increase in natural disasters, and inflation is adding more

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As a result, larger companies, typically those that spend at least $1 million on insurance annually, and their advisors, are increasingly looking toward alternative risk transfer programs to finance risk. ART programs provide a number of benefits, including more control over premiums, more flexibility in design and a more stable renewal process.

However, they can often be difficult to navigate and, while they should not be the driving rationale for such a program, the associated tax consequences involved require a thorough vetting.

To start, an alternative risk transfer program is best understood in comparison to the more commonly used guaranteed cost program where, for a premium, a company pays an insurer to assume the financial consequences of loss.

For example, a manufacturing company pays an insurer a $100,000 premium to assume $1 million dollars of liability risk. This provides the insured with a known cost (the premium) for a specific amount of risk transfer (here, $0 to $1 million of losses). The company has contracted with the insurer to not only pay the claim but process it, potentially hire contractors to perform related work and provide legal representation. The premium provides a bundle of services for a flat fee.

With an ART program, the insured and the insurer share the burden of risk. This is traditionally accomplished with a deductible, where the insured assumes the first layer of claims. It can be small ($500) or very large ($100,000 or more). Once the insured has paid the entire deductible, the insurer assumes financial responsibility.

Determining the feasibility of an ART program requires thorough analysis.

In essence, a company will self-underwrite to determine whether an ART program is the right fit. In doing so, the company needs to deeply analyze its operations to identify and value potential risks. Outside professionals such as insurance specialty firms, law or accounting firms perform this work.

employment agreements). Once insurable risks are identified, accounting records are analyzed to determine what a company may be able to afford on this program. Interviews with insiders provide additional, nuanced information.

The analysis should first document the insured's "origin story," which usually includes:

1. A three to five-year history of the company's insurance program;
2. A complete analysis of the insured's premiums over that time period, including whether they have increased sharply while claims have remained steady or even declined;
3. A review of policy terms and conditions that answer whether exclusions have increased;
4. A claims history that answers whether the insurer has become more aggressive in claims processing;
5. Deductibles indicating whether the insurers forced the insured to assume more risk; and
6. Insurance company relationships detailing whether the insurers left the market or indicated they wouldn't renew an insured.

The next step is to analyze the requested documents to uncover any fortuitous event that might hurt the company financially.
Questions asked include, but are not limited to: Has the company assumed the risk in a contract? Does the company need to indemnify an executive in the event of a lawsuit? Does the company have a large number of assets that would be costly to replace? Are there key relationships (such as key suppliers, customers or personnel) that, if lost, would harm the company?

Next, a cost must be associated with identified insurable risks. This process can be as simple as arriving at an appraised value for real estate, determining the cost of losing a key employee or supplier, or creating a histogram of losses to determine an appropriate self-funding level. Here, the core concept is calculating a rough cost estimate for each specific event to enable the company to determine if it wants to fund a loss and, if so, how to pay for it.

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After review, companies may decide to pay to self-insure through ART certain risks, which provides a financial incentive to become more proactive with risk management.

There are two payment methods. The first is to fund costs directly from cash, which is reserved for losses below a low threshold (for example, 1,000). The second is to form a captive insurance subsidiary, which involves several associated tax consequences. (This discussion focuses exclusively on the basic mechanics of key insurance company taxation issues. There are additional case law issues that are beyond the scope of this article. This article assumes the insured will not make the 831(b) election, instead opting for standard 831(a) tax treatment.)

To start, the payment of a premium for insurance to a third party may be an "ordinary and necessary" business deduction under Section 162 of the Internal Revenue Code.

An insurance company treats this payment as gross income for tax purposes. An insurer can also deduct claims payments as expenses. Suppose an insured pays $100,000 in premium to its captive, which then pays $75,000 in claims. The $100,000 in premium is income to the captive, which can then deduct the $75,000 in claims payments, leaving it with net income of $25,000 for tax purposes.

The second tax issue is that of insurance company reserving, where the insurance company accounts for the potential of paying a claim.

Here, assume that a captive is underwriting workers compensation insurance. The insured files an initial claim for a back injury that is priced at $2,500. The captive accounts for this with a $2,500 reserve for a potential claim. The captive may be able to deduct this amount. After an initial consultation, it's determined that the injury is more complex, now totaling $10,000. This may allow increases in the reserve deduction by $7,500. Then, after additional tests in the following months, it's determined that the final cost will be $8,000. Assuming the insured has deducted the full $10,000, it must now add back $2,000. As shown in this example, reserving can become a complex endeavor requiring third-party assistance.

When the captive receives a premium payment, it is placed in an interest-bearing account, providing additional income to the captive. In larger captive arrangements, the insurer will have an asset/liability mix where it will align investments with potential claims. The combined return on the investment portfolio is additional income to the captive.

When an insured uses a guaranteed cost insurance program, it gives the time value of money and reserving benefit to the third party insurer. Worse, it does so without earning any interest on the transaction. It only receives some of its money back in the form of claims payments or in certain cases policy rebates. This is why the insurance industry sometimes refers to premium for claims cycle as "swapping dollars." It also explains why the insurance industry sometimes describes premium payments in loan or financing terminology instead of payment for services.

So, taking into account the above concerning ART programs such as captive insurance, what are the reasonable benefits an insured might expect if they utilize a captive?

The first is the combination of transparency and predictability in pricing. In self-funding, the insured obtains regular information on the cost of its losses, giving it a complete and up-to-date picture of the cost of its risk, enabling the company to better predict its future costs and design the program to meet its actual tailored risks. The insured should also gain some leverage in negotiation with insurers since it now has the ability to self-fund some losses. Finally, the insured should now be incentivized to control losses since it now has a partner that will share underwriting gains that occur when claims are diminished.

As the previous discussion indicates, the determination to self-fund some losses is a complex decision requiring a great deal of analysis and time. Outside parties should be consulted to help with the analysis and the company should engage in a large amount of internal debate to determine if the decision is appropriate.

However, despite the thorough analyses involved, the benefits can be extensive, but only if the insured is willing to follow through on its decision by taking a long-term view of its risk management

F. Hale Stewart Attorney, Zerbe, Miller, Fingeret, Frank And Jadav LLP

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