



Enterprise Risk Captives

Just as with the mass of an iceberg, many of the inherent risks of operating a business are not readily apparent. These risks are below the surface or hidden in the depths of the balance sheet. An Enterprise Risk Captive (ERC) brings these risks to the surface by establishing a bonafide insurance company. Enacted as part of the Tax Reform Act of 1986 and amended by the Protecting America from Tax Hikes of 2015 (PATH), Section 831(b) of the Internal Revenue Code allows insurance companies to elect to be taxed only on their investment income if the company receives less than \$2.3 million in annual premium. The operating company receives a current expense deduction for insurance premiums paid, while the insurance company, choosing the 831(b) election, pays no taxes on its underwriting profit.

To be considered an insurance company, an ERC must be established with economic substance, the policies must cover insurable risks not business risks, it must be managed to ensure sufficient risk transfer and risk distribution, and operated in accordance with commonly accepted standards of insurance.

The target profile of an ERC candidate generally meets most of the following criteria:

1. *Privately held*
2. *Gross revenue of at least \$20 million*
3. *Stable cash flow*
4. *Substantial self-insured/uninsured balance sheet risk*
5. *Consistent pretax profit of at least \$1 million*

While ownership of an ERC may be flexible, the PATH legislation encourages that the ownership of the captive virtually mirrors the ownership of the operating company.

An ERC acts as an overlay to a traditional risk management program, such as workers' compensation, general liability, property and auto. Most middle-market business owners, by choice or unknowingly, self-insure a significant amount of risk. Previously self-insured enterprise risks are identified, actuarially priced and transferred to the ERC insurance company. When appropriately structured, the premiums are tax deductible to the operating company, yet not subject to current taxation on underwriting profit within the captive. The potential underwriting profit in the captive, upon distribution, will be taxed at the then current dividend or capital gain rates.

Risks that could be transferred to an ERC include:

Administrative Actions	Pollution	Litigation Defense
Directors & Officers	Coastal Wind & Flood	Cyber Liability
Supply Chain Interruption	Difference in Conditions	Loss of Key Contract
Product Recall	Product/Service Rework	Reputational Risk
Loss of Key Employee	Regulatory Changes	Loss of Key Supplier
Deductible Reimbursement	Subcontractor Default	Imbedded Warranty

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