CHAPTER 89

Captive Insurance Companies

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The captive insurance company strategy is used by privately held businesses desiring to reduce property and casualty insurance costs, control premiums, receive an annual income tax deduction of up to $1,200,000, and have at least $250,000 in excess free cash flow.

A captive insurance company insures all or part of the risks of its parent or the subsidiaries of a parent. This unique company is created when a business, or a group of businesses, form a corporation to insure or reinsure their own risk. These self-insurance vehicles can allow businesses to pay lower premiums, tailor coverage to their specific needs, accumulate investment income to help reduce net losses, access reinsurance markets to transfer risk, and gain greater control over claims as well as their broad risk management operations.

A "pure" captive is owned and controlled by one entity and insures that entity and/or its subsidiaries. A group captive is an insurance company owned and controlled by two or more unaffiliated organizations, which is formed to provide insurance to its group or association of owners. The owners are usually companies from a related business field.

You may form a captive insurance company as a subsidiary or affiliate of a business entity or entities to insure or reinsure the risks of those entities. The premiums paid by the business entities to the captive to insure the risks of the entities are tax deductible. Captive insurance companies are given tax incentives due to provisions in the U.S. Tax Code which allow a captive to accrue reserves against future claims. This tax incentive is only available to insurance companies.

A captive insurance company is an insurance company with claims, policies, policyholders, reserves, and surplus. A captive must be formed as a C corporation in the United States or foreign jurisdiction for the purpose of writing property and casualty insurance to a small and usually related affiliated group of insureds. The main purpose of a captive is to insure the risks of the companies that are also owned by the captive's owner, or parent.

The captive insurance company and the entities it insures should have an arm's-length relationship and should act independently of each other, except for payment of premiums for the risk coverage. In the beginning, a captive is set up to reduce the costs of insurance coverage for the business entities. As the captive grows, it can become a profitable business which enhances the owner's wealth. The captive assumes the risk that is currently self-insured.

With a captive, you can insure deductibles and/or exclusions on existing policies, or you can take on a portion or all of the traditional insurance risk. The profitability of traditional insurance companies, like banks, is tied to its investment income. In strong markets, insurance premiums may be artificially depressed in an effort to raise more dollars. In a weak market, insurance companies will raise premiums to offset its losses. The captive, unlike a traditional insurance company, can charge premiums based on claims history and actuarial predictions rather than on profits and losses.

You can also reserve premium payments when commercial insurance is inexpensive and access those reserves when commercial insurance is expensive. At that time, the captive owner can raise deductibles on existing policies and have the captive insure the deductibles. Alternatively, the owner can refund the premiums which can be used to pay the increased premiums, or explore reinsurance.

The captive can earn investment income on the premiums paid. This investment will allow more funds to be available to pay claims and/or increase profits. The captive will reduce the administrative costs such as agent commissions, compliance with federal and state regulations, office overhead, and salaries inherent in commercial insurance premiums.

With commercial insurance companies, premiums are determined based on the claims experience of other similar businesses. This technique benefits business entities with poor claims experience, but hurts entities with good claims experience. With captive insurance companies, the insured will benefit from good claims experience and the surplus in the captive will be available to the shareholders. The captive determines the terms of coverage, which provides flexibility to tailor the policy to accommodate the specific needs of the entities.

The first step in creating a captive insurance company is a feasibility study to determine whether a captive insurance company is right for a client. This step includes a review of the client's existing liability insurance policies, including workers compensation, general liability, and errors and omissions policies. The captive does not generally replace the existing commercial policies, but is used to provide coverage for policy exclusions and deductibles. The captive has direct access to the reinsurance markets, which allows it to obtain wholesale premium quotes. The captive can also provide coverage for risks for which no insurance is otherwise available, known as naked risk.

Captive insurance companies may be set up in the United States or offshore. Several states have captive insurance statutes, including Arizona, Delaware, Washington, D.C., Hawaii, Kentucky, Montana, Nevada, Utah, and Vermont. Vermont is the largest captive domicile in the United States. Vermont will accept a letter of credit to satisfy the capital requirements. The number of states permitting captive insurance companies is increasing in response to recent IRS "safe harbor" rulings. The most popular offshore domiciles include the British Virgin Island, Bermuda, and the Cayman Islands. Traditionally, offshore domiciles have had lower initial capitalization requirements and set-up costs.

Captives are generally formed by a "turn key" approach. The set-up involves actuaries, attorneys, underwriting, issuance of policies, and a regulatory licensing process. The client will generally work with a team of tax and legal professionals for advice about ownership of the captive for income, estate, and gift tax planning. Formation costs are in the $50,000 to $100,000 range for most simple captives, but more for more complex ones. Turn key administration will cost at least $40,000 per year.

The Regulations provide: "The term 'insurance company' means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring or risk underwritten by insurance companies." There is no definition for "insurance" or "insurance contracts" in the Internal Revenue Code (IRC) or in the Regulations. However, the Courts have generally held that an insurance contract involves risk shifting and risk distributions.

In 2002, the IRS issued three Revenue Rulings providing "safe harbors" for captives: Revenue Ruling 2002-89 (Third Party Risk), Revenue Ruling 2002-90 (12 Entity), and Revenue Ruling 2002-91, which deals with a group captive arrangement.

The IRC allows property and casualty insurance companies certain deductions against taxable income not allowed for ordinary businesses. This results in minimum or no taxable income on the premiums received. Moreover, Section 831(b) of the IRC sets forth a tremendous tax advantage to captive insurance companies. If the captive's total premiums are less than $1.2 million per year, it may elect to be taxed only on its investment income, and premiums are not taxable income.

You can gain significant income and estate tax advantages if you implement a captive strategy for your privately held business. When the operating business pays premiums to the captive, wealth is transferred from one entity to another tax free. The premiums paid are deductible by the entity paying the premium and receipt of the premium by the captive is generally tax free. The monies in the captive will also be protected from the operating business's creditors. If the captive is owned by children or grandchildren, outright or in trust, there will be a transfer without gift, estate, or generation-skipping transfer tax. This type of planning opens up tremendous opportunities for multi-generational planning, including using life insurance to leverage the wealth transferred.

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