WEALTH MATTERS

An Insurer of One's Own? It's Possible, With Caveats

Chang W. Lee/The New York Times

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EVERY so often I come across a financial strategy that sounds too good to be true. That was how I felt when I heard about the increased use of captive insurance companies by entrepreneurs and small-business owners.

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A captive insurance company is essentially a private insurer that is a wholly owned subsidiary of another company. These captives, as they are called, accept the premiums that the company would have paid to a regular insurer and then cover any claims against the parent company. If the claims are less than the premium, the captive has made a profit, just as a regular insurance company would. The difference is that the company that set it up benefits, not the insurer.

Fortune 500 companies and large nonprofit organizations, like hospitals and medical schools, have used captives for decades to self-insure against predictable risks, like workers' compensation or malpractice claims. (The New York Times Company has a captive insurance company called Midtown Insurance Company.)

But in 2002, the Internal Revenue Service issued guidance on how to set up captives to comply with the tax code, and that gave way to a rush to form them, said Jay Adkisson, chairman of the American Bar Association's committee on captive insurance companies and a former owner of such a company in the British Virgin Islands.

“Today it’s hard to find a major company or university that doesn’t have one,” he said.

Now financial advisers are increasingly pitching captives to smaller businesses, including physicians’ groups, restaurant owners and companies that want to cut the costs of health insurance for their employees. They are being portrayed as a way not only to save money on insurance premiums but also to reduce income taxes and transfer money to heirs free of estate tax.

But the rush to set up captives could lead to problems for the business owners and for people filing claims against them.

INSURANCE PURPOSE From the point of view of the companies that set up these entities, captive insurance companies make perfect sense.

If a business paid a premium of $1 million to a regular insurer and had only $600,000 in claims, it would lose $400,000. If, however, it put the same amount of money into a captive, it would keep the extra $400,000 in the captive. This amount would then increase over the years.

Of course, that company could end up having $2 million in claims the first year. It would have to have a reinsurance policy to cover the claims, or pay them out of its reserves.

Mr. Adkisson said a captive could be seen like any other subsidiary. “A guy who owns a car lot can buy a carwash and wash his own cars,” he said.

So when should a small-business owner think about setting up a captive?

“You need to have enough risk to justify the captive,” he said. “If you take a doctor group and they cut people open for a living, they’re going to have more risk than an accounting firm.”

Jeff Kurz, president of Red Hook Risk Services, a consultancy to hospitals, nursing homes and groups of doctors looking to set up captives, said such an arrangement could generally be worth considering for businesses with more than $750,000 in taxable income and more than $1 million in insurance premiums.

But he said it was important to pay attention to risk. “A huge misnomer is I’m going to start a captive and save a lot of money next year,” he said. “You might not set aside enough money to pay for the claims down the road.”

Ken Sturm, who owns several restaurants and nightclubs, including P. J. Clarke’s and Iridium Jazz Club in New York, said he became interested in having a captive insurance company when his traditional insurance policy did not cover a claim. Several years ago, one of his restaurants in Times Square was closed for three days because of work in the neighborhood, but his policy had a waiting period of 96 hours before the insurance covered any losses.

The captive he set up covers such losses. “I can write specific policies that go above and beyond my typical commercial liability coverage,” Mr. Sturm said. “Business interruption coverage. Data breach. Legal fees. You can do deductibles.”

TAX SAVINGS The administrators of captive insurance companies are quick to play down any tax savings, which is an issue that regulators are watching.

"The easiest 'no' is when a company comes in and talks about taxes, taxes, taxes and doesn't mention insurance for half-hour into it," said Dave Provost, deputy commissioner for captive insurance at Vermont's Department of Finance.

But saving on income taxes is a big draw. While a company would get the same tax deduction for paying premiums to a captive as to a regular insurer, the real advantages come to people whose company profits flow through to their personal income tax.

A person setting up a captive under section 831(b) of the Internal Revenue Code can put up to $1.2 million a year into a captive, tax-free. If the captive pays out less than that in claims, it can eventually start returning the surplus to the business owner in the form of dividends, which are taxed at a lower rate than income.

ABUSES The big red flags are companies that are insuring for risks that they do not have simply to take advantage of the tax savings. Common examples are terrorism risk for a small, domestic company, or a business owner in Nebraska insuring against hurricane risk.

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