The middle market gusher

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Captives are a compelling proposition for middle market companies in the US. Stewart Feldman spells out the benefits of taking charge of your own risk management.

Businesses with significant uninsured risks are in a position to use the powerful tools associated with alternative risk and captive insurance planning that traditionally have been seen only in the realm of large businesses. Captives have become the premier method for covering non-standard risks and providing for enhanced control over cash flow and investments.
From business interruption to supply chain disruption, companies are opting to cover their risks through a captive, supplementing their conventional insurance programmes with tailored insurance coverages. A captive boom has unfolded with more states passing captive insurance legislation. In turn, more of the middle market is beginning to realise the benefits of owning a captive.

Lower insurance costs, improved risk management and loss control, and a tax-efficient mechanism for funding future losses are just some of the benefits that business owners realise from alternative risk planning. Consequently, captives can become an integral part of the financial structure of the operating company.

Capstone Associated Services provides captive administration and, through our affiliated law firm, turnkey captive insurance management, for more than 100 captive insurance companies. Our focus is on insurers with less than $1.2 million per year in annual property and casualty premiums. Having formed more than 130 captive insurance companies in multiple domiciles over the last 15 years, we understand the unique needs and challenges affecting closely-held businesses, especially those with unique operational risks and limited management layers.

Capstone and its affiliates provide legal support for regulatory, financial, insurance and tax matters, along with our actuaries, risk managers, underwriters, CPAs, accountants and administrators, rounding out the turnkey management services. Even in the case of an IRS audit, our federal income tax litigators take responsibility for ensuring the success of the planning. Owners of closely-held businesses prefer the one-stop shopping and the extensive in-house capability that Capstone and its affiliated law firm offer.

Compliance with Internal Revenue Code Section 831b and the many court cases and tax regulations defining what constitutes an insurance company, dictate that a skilled team of professionals—

ranging from actuaries to lawyers and CPAs and insurance underwriters—oversees the planning. Because a captive is a regulated insurance company, most business owners need to have a third party professional administer the many moving parts of alternative risk planning on a turnkey basis. Capstone has performed this function since 1998 and has developed extensive expertise with the issues, laws, regulations and guidelines needed to ensure success. For the same reason, regulators demand ongoing professional management.

Many captive managers are able to perform the clerical aspects of the captive's formation, but the ability to support the client usually stops there. Legal and professional tax and accounting responsibilities are usually disclaimed in the fine print, leaving clients to their own devices. We regularly tell business owners to do their research before turning to someone who lists a UPS post office box as their office, or someone who is a 'CPA' with no experience in domicile regulation, feasibility assessment, or in providing legal support in the case of an audit.

Many of our referrals have come from clients who have hired banks to perform 'captive insurance management' only to realise that the banks have disclaimed all services other than those that are clerical in nature.

The practicality of captives

Most *Fortune 500* companies already have captives. With Capstone's entry into the market in 1998, many middle market companies were able to take charge of their risk management. These substantial closely-held companies have formed captives in the US or foreign jurisdictions and are licensed to write property and casualty insurance to a small group of affiliated insureds.
While companies sometimes replace conventional coverages, companies have usually chosen to augment existing coverages plagued with exclusions that leave their operating businesses vulnerable to common risks.

Risks such as business interruption, supply chain disruption, loss of services, credit default, construction defects, disability, loss of key customers and suppliers, the costs of extended warranties and other types of insurance which are either unavailable or of limited availability in the conventional markets are often covered by captives.

A case in point we recently worked with was a supplier and distributor in the oil and gas industry that worked directly with overseas growers and suppliers of guar—a common raw material used in in the fracking sector. Guar is in high demand. However, the company's existing insurance policy was insufficient in light of the nature of its business, with gaping holes in coverage given the international sourcing.

The feasibility study concluded that the client was a prime candidate for a captive. The company's existing coverage did not address foreign political or economic risk associated with guar's limited supply. What was needed was an 'all risks' policy associated with the client's supply of guar.

The practicality of captives is echoed in the types of coverages that operating business owners can opt for. As in the case of our client, Capstone concentrates on providing coverage for the many risks which generally are not covered by a conventional insurance programme. Through Capstone and its affiliated team of lawyers, clients can enjoy a custom-designed captive insurance programme.

Legal expense reimbursement, tax liability, equipment breakdown, cyber risk, workers' compensation, medical deductible buyback, pollution, and the loss of major customers or vendors are just some of the coverages utilised by clients in various industries, ranging from manufacturing, construction, transportation, wholesale and retail, to medical and engineering. This flexibility usually enhances rather than displaces the existing conventional insurance programme.

Rather than self-insure for those risks with after-tax dollars, a captive enables a business owner to obtain insurance that is otherwise too costly or not readily available in the commercial markets. Businesses find conventional, commercial coverages that are meant to cover these specific risks overpriced or not readily available.

Coming out on top

Captives must be operated in compliance with (i) the Internal Revenue Code and its regulations; (ii) the statutes and regulators of the domicile where the insurance company has been established; and (iii) the home state of the insureds. The formation and ongoing management of a captive must be overseen by experienced professionals who understand the insurance, tax and legal aspects of the company. Operating a captive requires special skills that go far beyond the capabilities of small administrative service providers.

Working with a true turnkey service provider—who provides legal, tax, regulatory, insurance, actuarial, risk management and financial services—enables a business owner to offload the many moving parts of captive insurance planning to others. Success demands that the client be informed about what is needed to form and maintain a compliant captive. The client must identify and retain a provider who takes responsibility in writing for all federal, state and domicile regulatory issues.

The typical red flag is the client's lack of a contractual agreement with the professional team that will be called on to deliver all the alleged services to be provided. Also, they typically do not have access to experienced legal support in order to handle the complex legal matters associated with captive insurance planning or the possibility of an audit by the insurance or tax regulators. A true interdisciplinary skillset is needed to carry out the formation and effective support of the captive. It is a business owner's obligation to separate the amateurs from the professionals and rise above the fray.

The right domicile is also a contributing factor. Captives must operate in a regulatory environment that is both efficient and effective. Attributes of a compliant domicile include responsiveness, cost-efficiency, and expertise with the middle market. Some US-based domiciles work mainly with larger enterprises and aim to drive tax revenues to the state and boost tourism dollars from directors' meetings, bank accounts, auditors or other services that must be bought locally. Middle market business owners often find these domiciles inhospitable given their desire for cost-effective, efficiently provided services.

The true benefits of captive insurance

The popularity of captive insurance planning as an alternative risk management tool is due in part to the ancillary benefits it provides. Property and casualty insurance premiums that are paid to a captive are fully deductible to the insured as its ordinary and necessary business expenses. If the captive is properly set up with appropriate premiums throughout, is fully compliant, and includes policies that fall within the parameters of commercial reasonableness, the captive's premiums are taxed at attractive rates—as low as zero percent.

Operating businesses are allowed to deduct losses only as they occur. In contrast, insurance companies are unique in that they are able to deduct loss reserves based on a past claims experience. However, for US C-corporations under Section 831b of the Internal Revenue Code where annual premiums are less than $1.2 million, premium revenue may be tax-exempt. With a captive insurance arrangement, those premiums are available to fund losses during the coverage period, or in the event that losses are lower than expected, the profits can be distributed to the captive's owners at advantageous tax rates.

Another significant advantage of the captive arrangement is the avoidance of the inevitable claim denial. Conventional insurers may legitimately deny a claim due to exclusions or on an arbitrary basis. Often legitimate claims are denied, necessitating an insured's suing the insurer to recover on the insurance coverage obtained, even in the case of a *bona fide* claim. Businesses are then compelled to sue their insurance companies to recover unpaid claims. In contrast, claims administration via a captive can be much more timely and legitimate, with wrongful claim denials a thing of the past. The benefits associated with captive insurance—including estate planning, asset protection, tax efficiencies, and custom-made coverages—are now an option for mid-market companies. Wise business owners will take advantage of the resulting opportunity.

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