HOUSTON BUSINESS JOURNAL

Friday, February 1, 2008

Captive insurance programs: Boon for middle-market companies

HOUSTON BUSINESS JOURNAL - A business that doesn't have a captive insurance program in place may soon be in the minority: Insurance industry trends indicate that most businesses will implement a captive insurance program by 2010.

Already, more than 10,000 businesses - representing industries ranging from finance to construction - have begun to accumulate vast amounts of pre-tax wealth through captive insurance programs, which use insurance subsidiaries formed to insure or reinsure the risks of its parent company. An estimated 900 captives will be incorporated during 2008, and more than half of those will be formed by middle-market businesses.

Historically, captives have been used by Fortune 500 risk managers as a way to capture commercial insurance premiums. Large multinational companies self-insure several lines of coverage via a captive - general liability, workers' compensation, employee benefits and property insurance. With favorable claims experience, self-insurance became another profit center for the parent company.

Today, because of recent changes to Internal Revenue Service policies, middle-market businesses are also utilizing captives as another profit center.

How does a captive work?

A captive writes policies for the parent company at the owner's discretion. The parent company can determine the policy terms, whether or not to write new or renewable policies and the types of insurance coverage to write, which can vary from year to year.

The only business that can file a claim is the parent company. If the owner has years of good claims experiences, the premiums that have been successfully deducted can later be taken as dividends or as liquidated capital at the capital gains tax rate.

For example, consider, Company ABC, a California-based commercial construction business with taxable income of $10 million. It will pay 45 percent in federal and state income taxes, leaving it with 55 percent, or $5.5 million for claims or for distribution to shareholders. Instead, Company ABC funds $4 million in premiums to its wholly owned captive insurance company. It now has an additional $1.5 million available for expenses, claims or additional distributions to shareholders.

Captive insurance enables business owners to better manage insurance needs including cost, coverage, service and capacity. Additional benefits include:

- *Pre-tax wealth accumulation.* Insurance premiums are an expense to the parent company and flow tax-free to the insurance company, where they collect on a pre-tax basis in anticipation of future claims.
- *Favorable distribution rules*. In the event that claims do not materialize, underwriting profits can be distributed to shareholders as dividends.
- *Asset protection.* Because the captive is an independent corporate entity, creditors of the parent company may find it difficult to seize the captive's assets.
- *Estate planning.* A family trust or other entity can own the captive.
- *Retention of key employees*. Giving key employees restricted ownership in the captive can provide a foundation for retention.

Additionally, the captive transaction is a powerful year-end planning tool because insurance premiums are deductible to the parent and flow tax-free to a captive qualifying under §831(b)of the Internal Revenue Code. At year end, a captive can provide nearly twice as much capital to the business as would have otherwise been paid in taxes. This makes the formation of a captive an attractive and viable option for middle-market companies.

Captives candidates

Captives will not work for every business. However, good candidates generally meet two or more criteria:

- Profitable operations, with taxable income ranging from $1.5 million to $100 million.
- $250,000 self-insured/uninsured business risk.
- 100 or more employees.
- $500,000 or more traditional third-party insurance expense.

The reason for these stringent qualifications is that a captive can be expensive to form and manage. In order for it to be a cost-effective option, actuaries and underwriters must be able to quantify $500,000 or more in risk premiums from the parent company's business operations. Hence, the parent company must be large enough and in a risky enough industry – such as construction, manufacturing, distribution or others – to qualify.

The owners, shareholders and executives must diligently study a captive's potential benefits and burdens. Such an analysis should extend considerably beyond the cost of existing insurance, and focus on net dollars to shareholders.

Truth be told, traditional insurance has become extremely expensive for some types of coverage and has taken on the form of "Swiss cheese." As a result, many middle-market companies have chosen to actively manage their insurance portfolios by taking on large deductibles and/or self-insuring areas where they are exposed.

Types of risks

A common thread among business executives is concern about taking on additional risk. However, if that risk consists solely of items they were otherwise self-insuring, have they really taken on more risk?

In reality, most businesses unknowingly self-insure an alarming amount of risk. The problem is that self-insurance without a captive is not tax-deductible for federal or state income tax purposes. Nor are loss reserves set aside to finance future lawsuits and other risk exposure. As a result, these risks can cost twice as much because they must be paid from profits on which the business has already paid tax.

On the other hand, businesses that have structured a captive insurance company can finance that risk using pre-tax dollars. With a captive, self-insured risk can be converted into tax-deductible premiums that are paid into a privately held insurance company. Risks can now be addressed with this pre-tax nest egg.

In the event that claims do not materialize, the captive will capture a substantial pre-tax sum to be used for the future business risks, or for distributions to owners, family members and/or key executives, all favorable tax rates.

Self-insured risk

A middle-market business typically structures a captive to fill in gaps where conventional insurance markets do not provide coverage, or where the cost is deemed economically prohibitive. Common areas of risk are found in commercial insurance policy deductibles and exclusions. Here, the business has not assumed additional risk, as it is already exposed to such risks before establishing a captive.

Some industries and the self-insured risk they face include:

- *Construction* – construction-effect liability excluded by a general liability policy.
- *Manufacturing* – product liability excluded by a general liability policy.
- *Distribution* – distributor liability excluded by a general liability policy.
- *Professional* Services – administrative actions excluded by an errors and omissions policy.

Ultimately, actuaries and underwriters quantify the self-insured risk. That risk is converted into insurance premiums, which are deducted from the taxable income of the parent company. There, the funds are invested and can be used to pay claims and be distributed to shareholders as dividends.

Looking forward

Until 2001, IRS regulations prevented the middle market from utilizing captives. Unlike large corporations, the average business could not afford to defend captive insurance transactions in tax and appellate court, even though the courts vigorously disagreed with the IRS regulations and frequently sided with the taxpayers.

However, after losing a number of significant cases in 2002 and 2005, the IRS issued new guidelines that clearly articulated the IRS's position regarding captives. They defined what the IRS would examine when analyzing the deductibility of premiums in a captive transaction. The resulting "safe harbors" have eliminated the gray areas. Where conflicting case law and ambiguous areas in the IRS rulings once created confusion, clear rules have opened the door to captive transactions for the middle market.

The IRS may change its stance on captive insurance companies. It has in the past. Fortunately, the trend has been positive for captives, and the IRS has demonstrated the willingness to work with taxpayers by clarifying rules rather than by reversing them.