Captives: benefits for entrepreneurs

Stewart A. Feldman of **Capstone Associated Services** discusses the significant insurance and tax benefits of captives for owners of middle-market businesses

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For most business owners, the risks inherent in running a business and the cost of insurance to comprehensively protect from those risks can be significant. Unfortunately conventional insurance policies are written to exclude the most likely claims that a business faces. Business owners looking for alternative methods of covering their business' risks will find that owning their own captive insurance company makes great economic sense.

For decades the US Congress has encouraged businesses to insure their exposures, which in turn increases the likelihood of a business's long-term success. To this end, Congress has enacted several provisions of the Internal Revenue Code that encourage the formation of small insurance companies that can bear the risks of affiliated business operations. These provisions are no different than other tax provisions which encourage home ownership, medical insurance or setting aside monies in tax deferred retirement plans.

The benefits of funding a captive insurer stands in sharp contrast to buying otherwise overpriced conventional insurance. In the case of the captive, excess premiums are not lost to a third-party insurer, but rather can be distributed to the captive's owner at favourable tax rates.

In short, alternative risk planning provides greater risk protection, greater insurance flexibility and, where appropriate, a captive can also tie into business succession and estate planning for the closely held business owner.

> "A CAPTIVE ALLOWS A BUSINESS TO CUSTOMISE ITS INSURANCE PROGRAMME IN ORDER TO MATCH ITS SPECIFIC REQUIREMENTS AND OBJECTIVES"
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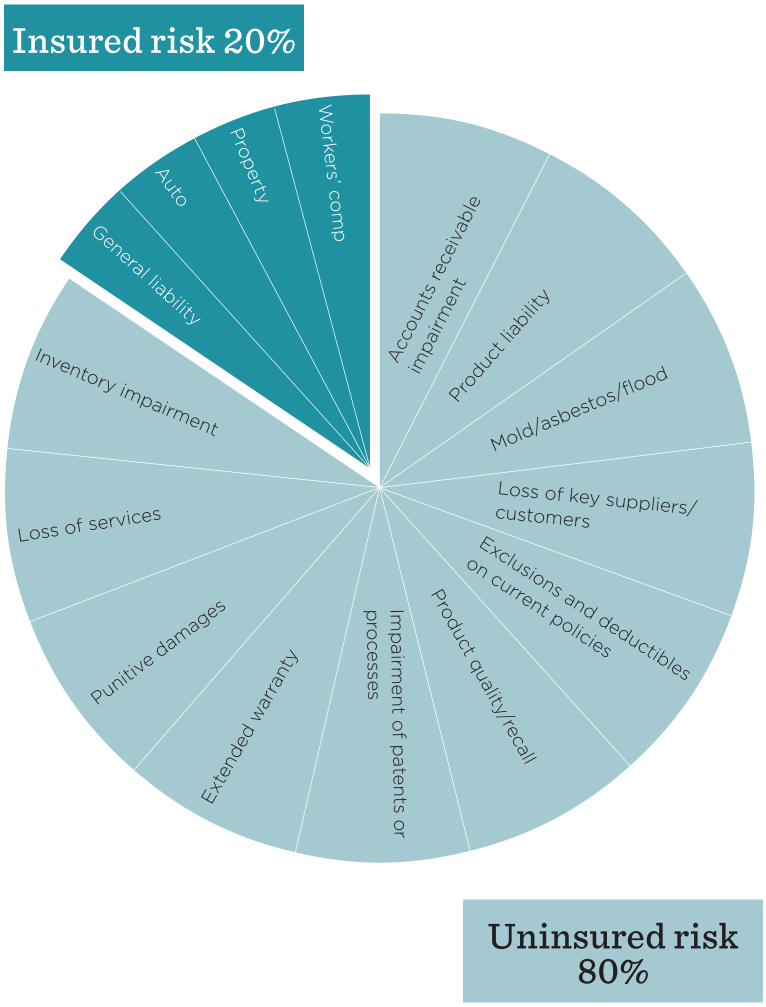
Captives allow an operating company to take on current risks – whether already self-insured or covered through a third-party policy. Knowingly or unknowingly, many businesses are susceptible to un-insured or underinsured risks. Rather than self-insure for those risks with after-tax dollars, a captive enables a business owner to obtain insurance that is otherwise too costly or not readily available in the commercial markets. For example, some businesses find commercial coverage overpriced either because its particular industry has high losses or because the conventional insurance market is not competitive. Similarly, a business owner may conclude that the conventional coverage exclusions effectively negate the coverage desired. A captive allows a business to customise its insurance programme in order to match its specific requirements and objectives. The captive can offer customised policies that are based on the specific needs of the business such as increasing deductibles, expanding the scope of coverage, and controlling conventional premiums. This flexibility enhances rather than displaces the conventional carriers.

Captives are ubiquitous among publically-held companies; more than 80% of Fortune 500 companies take advantage of some sort of captive arrangement. Over the past decade, many substantial closely held companies have also entered the captive market. Captives may be formed in the US or a foreign jurisdiction and are licensed to write property and casualty insurance to a small group of affiliated insureds. Rather than replacing conventional coverages in total, captives more often are used to supplement or augment current conventional coverages. More central to a captive are risks that are currently not covered by conventional, commercial carriers or where the pricing of the commercial policies is out of line. Risks such as business interruption, natural disaster, high deductibles, credit default, construction defects, disability, loss of key customers and suppliers, supply chain interruption, policy exclusions, extended warranties and other types of insurance unavailable in commercial markets are often self-insured by businesses.

Alternative risk planning

The mechanics of alternative risk planning are straightforward with property and casualty insurance premiums paid to a captive being 100% deductible to the insured as its ordinary and necessary business expenses. On the receiving captive side, assuming the captive is an insurance company for federal income tax purposes—which is far beyond the scope of this article—the premiums may be tax exempt in the captive (which must be a calendar year, US C corporation) and the investment income may be similarly tax free. Payments for losses paid by the captive are fully taxable, but offset against the loss being reported. Of course, premiums must be for bona fide insurance policies and must be properly priced in the marketplace.

If the captive is properly set up and operated as a bona fide insurance company, with the premiums determined at arm's length, and with the policies falling within the parameters of commercial reasonableness, the business can deduct the premiums paid to the captive. Under Section 831(b) of the Internal Revenue Code where annual premiums are less than $1.2m, the underwriting profits of the captive are federal income tax exempt. Over the years, IRS tax guidance and numerous court rulings have established the parameters for tax-compliant captives. And of course a captive insurer must conduct itself in as good a form as a conventional insurance company. The captive insurer certainly cannot be operated as an extension of the owner's personal chequebook. Statutory authority plus various IRS pronouncement and interpretive court decisions make this an ideal time for closely held businesses to consider a captive.



> **“CAPTIVE INSURANCE COMPANIES ARE REGULATED AT THE STATE LEVEL AND REQUIRE EXPERIENCED AND SOPHISTICATED ADVISORS TO KEEP THE COMPANIES COMPLIANT”**
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Ownership and regulation

As with other types of corporate structuring, the ownership of a captive can lend itself to additional planning, whether of an asset protection nature, pre- or post-nuptial marital planning, or estate planning. Where a captive is established by a junior generation, the residual value of the captive after paying claims can be transferred to descendants without gift, estate or generation-skipping transfer tax consequences.

Captive insurance companies are regulated at the state level and require experienced and sophisticated advisors to keep the companies compliant with both the domicile's and home state's insurance regulators as well as the IRS. It is crucial that they are managed properly in both the short and long term. That is why having the appropriate professionals involved when considering a captive is paramount. The tax attorney, regulatory attorney, financing lawyer, CPA, actuary, captive management company and insurance professionals should be experts in the captive area. In addition to providing guidance though the complexity of managing a compliant captive insurance company, your professional team will help choose the best domestic or foreign jurisdiction for the captive, help evaluate the appropriate property and casualty insurance for your business, assist with the reporting and tax filing requirements, assist with legal requirements to ensure maximum asset protection, provide options for investment vehicles and provide options for transferring wealth through estate planning.

Captives provide middle market companies many advantages, including lowering insurance costs, enhancing control over cash flows and investments, improving risk management and loss control, and providing a tax-efficient mechanism for funding future losses.