# Captive Insurance Companies

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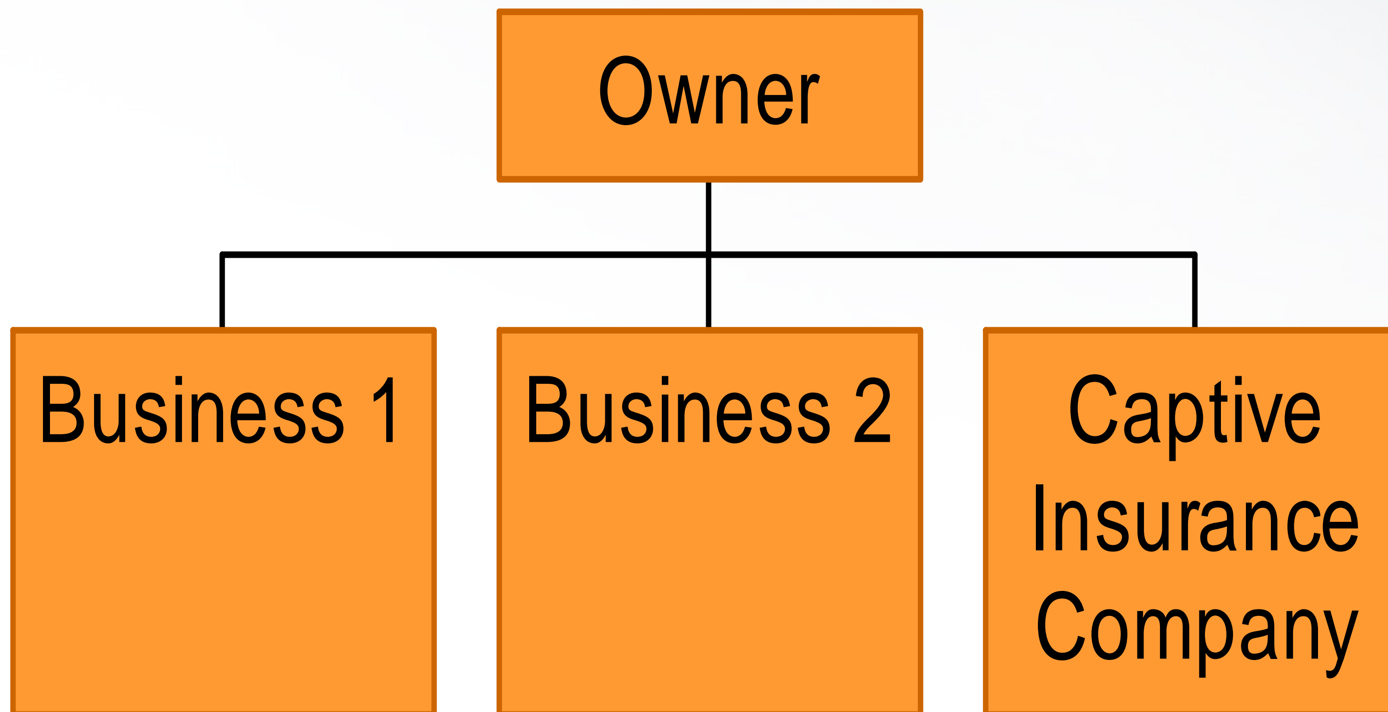
# What is a Captive?

- “An insurance company owned and controlled by its policyholders.”
- A Captive is an unlicensed insurer, except in its own domicile.
- A Captive is one of many principal arrangements by which an organization can finance deliberate retained risk.

# Typical Captive Structure



# Why are Captives Formed?

- Primary insurance companies typically wish to only retain the predictable levels of risk and “cede” or transfer unpredictable levels of risk to others (reinsurers).
- A CAPTIVE allows an insured to assume the benefits normally enjoyed by a primary insurer.

**Insurance is the Biggest Concern of Small Business Owners**

- Over the past few years, business owners have experienced skyrocketing insurance costs.

# Worries of the small employer

Labor Qlty. 8%
Labor Costs 5%
Inflation 1%
Credit/Int. Rates 1%
Insurance 28%
Taxes 17%
Poor Sales 16%
Regulations 11%
Competition 9%

Source: National Federation of Independent Business (November 2003); Insurance Information Institute

# What are the benefits of a CIC

- Puts the Control of your insurance program in your hands
- Reduce Taxes
- Build wealth
- Estate planning
- Reduced operating cost
- Improved cash flow
- Cost-effective mechanism for risk retention
- Availability of special coverage
- Enhanced risk management perspective
- Direct access to the reinsurance market
- Writing unrelated risks for profit
- Stable marketplace
- Improved services
- Continuity of risk management operations

# Who helps create captives?

- Actuary
- Attorney
- CPA/accountant
- Investment manager
- Left off this list is an insurance agent (which seems strange since we are talking about an insurance company).

# Purpose of a Captive

- To begin, let us be clear that captives are all about money.
- Clients want one to make money.
- It will cost money to have one and clients who have one will pay their own losses, when and if losses materialize.
- Captives are another method by which risk of loss is financed.

# Captives versus Traditional Insurance

- With traditional insurance, clients write checks to insurance companies and have X amount of insurance coverage.
- The insurance is priced to make a profit for the insurance company.
- With a CIC, the shareholders are taking some amount of risk in-house.
- This is done in hopes of good claims so in the long-run premiums can be decreased and wealth can be increased.
- Traditional carriers often work with captives because the captive can be used to absorb lower dollar figure claims.

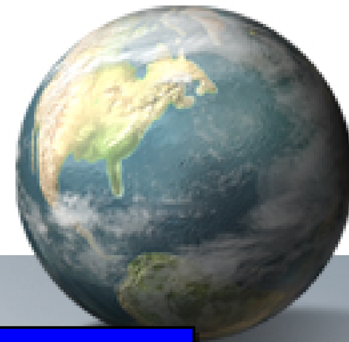
# Captive vs. Self Insurance

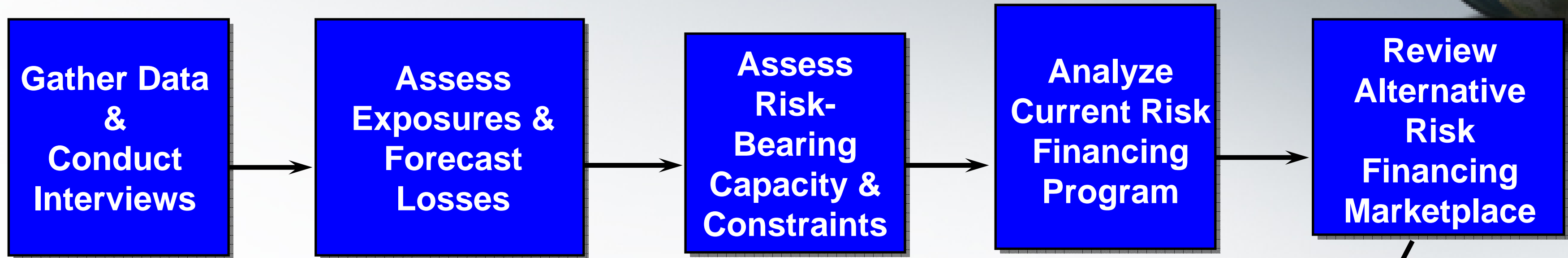
- Why a captive instead of deductibles/retentions or self-insurance?
- That is the magic of insurance.
- Current accounting and tax rules do not permit deductions for reserves held for the payment of losses in the future.
- But, if those funds are bundled, and collectively called an "insurance premium," they are deductible

# Structuring a Captive

- First of all, the premiums paid must be sufficiently large to gain economic advantage. $250,000 for a **501(c)(15)** and $400,000 annually for an 831(b).
- Second, clients must be able to pay the claims, and secure the future losses.
- Third, clients must recognize that a captive is a business separate and apart from their other business, no matter what structure is ultimately selected. (Which means a client must pay attention to running the captive or like any business it will not perform well).

# Determining the Feasibility and Goals of a Captive






Financial Insurance

Reinsurance

Actuarial Accruals

Rent-a-Captive

**Compare Alternatives To Captive (3 Minimum)**

Hedging

Multi-Year Spread-Loss Plan

Internal Allocation System

Other Financial Products

Multi-Line Aggregate Stop-Loss

***Decision Criteria:***

Acceptable level of risk

Minimizes long-term cost*

Time between Occurrence & Settlement

Reduces administrative time and expense

Risk Retention Capacity:

- Liquidity
- Financial Strength
- Pre-Tax Earnings

***Prepare, Present, and Implement***

* *Minimum cost criteria include:*

- Minimized outgoing cash flow
- Earliest tax deductibility
- Lowest frictional cost

# Costs

- The costs to establish a group captive are typically higher than a single parent captive. Range of fees could be from $50,000 to $250,000, depending on what the client is planning to do.
- The average price for a small singe parent captive should be less than $50,000; the bulk going toward actuarial, consulting, regulatory and legal.

# Domicile Selection

- After a feasibility study meets the goals of the client, the domicile for the captive must be selected.
- Basically these are onshore, with one of the 24 States permitting captive formation; or offshore, outside the United States (i.e. Bermuda, Cayman Islands, British Virgin Islands leading the way).
- A principal difference between onshore and offshore is potential ease of regulation.
- **U.S. domiciled companies should NOT use an offshore captive to write insurance in the U.S. and think they will avoid U.S. income taxes**.

# Captive Structures

- Single parent
- Group/association/RRG
- Rental captives, Segregated protected cell
- Common Characteristics.
  - One of these is the participation of a risk sharing partner, or traditional insurer.
  - Risk sharing partners provide such necessary and desirable services as certification of coverage and limits; reinsurance; loss control and mitigation; claims reserving, adjustment, and oversight; risk management; underwriting and regulatory response and assistance.

# Single Parent Captive

- The single parent captive is still the most prevalent structure in use today.
- This is an insurance company owned by one company, usually the insured.
- This form has been in use for over 50 years, and has stood the test of time and challenge.
- A single parent captive is most often used to provide coverage either directly, where permitted, or as reinsurance of a traditional primary insurer.
- It is frequently used for reinsurance on workers compensation programs as well as for property insurance, directors and officer's liability, terrorism, and toxic mold.

# Group or Association Captive

- The group or association captive is a structure in which multiple businesses join together either through a formal association or an informal relationship to use a captive to obtain coverage or limits otherwise unavailable. (Trade associations),
- The Risk Retention Group is a group captive formed under the LRRA of 1986 which is a federal law. The main advantage is that a RRG can write liability exposures on a direct basis and is regulated by its state of incorporation. Therefore, no fronting carrier is needed.

# Rental Captive

- Rental captives gained popularity over 20 years ago as a reaction to the costs of forming and operating a captive.
- The use of someone else's captive necessarily means that you will be paying increased fractional costs.
- These may be offset by not having the costs of establishing and operating your own facility
- In recent years, the IRS has had success in challenging the deductibility of premiums paid to some rental facilities based on an apparent lack of real risk transfer.

# Segregated Protected Cell Captive

- Because of IRS challenges and reserve inadequacies, several domiciles introduced the Segregated Protected Cell structure.
- A segregated cell is a structure in which an existing insurer or "captive," owned by an insurance company or service provider, assists in the creation of cells within itself.
- These cells must follow similar procedures for establishing a single parent captive, but stop short of ultimate regulatory approval as the regulators look to the sponsor for compliance with their regulations.

# Establishing Premiums

- In the purchase of traditional insurance, the actuary works with the underwriter and others to provide a premium.
- In a captive situation, the actuary often works largely unaided to calculate a premium that will cover the claims, and provide an underwriting profit.
- The goal is typically not to reduce premiums and to do so can be dangerous when not actuarially sound.

# Income Tax Reduction

- The IRC provides certain tax advantages to insurance companies depending on the amount of premium income received.
- **Large Insurance Companies** - Insurance companies with annual premium income of more than $1.2 million are allowed to deduct reserves for losses even though payments of claims might be five to ten years in the future.
- **The insurance company pays tax on its net (premium and investment) income at ordinary C-corporation rates**.

# Tax reduction continued

- **Small Insurance Companies** - Insurance companies with annual premium income of less than $1.2 million can elect to be taxed only on investment income.
- Premium income is tax free. However, investment income earned on the funds held inside the insurance company is taxable at ordinary C corporation rates. **(Internal Revenue Code section 831(b))**

# **Example of an** 831(b)

- Sam (a real estate investor and business owner) sets up a CIC.
- Sam raises the deductible on his current insurance policies and insures the new higher deductible with his CIC.  His traditional premiums are lowered by $50,000.
- With the CIC in place, Sam's companies buy new insurance coverages including business interruption, terrorism, employment practices and fire damage to his tracts of timber.

# Continued

- Sam's new premium to the CIC is $450,000 (which his businesses can write off).
- The CIC does not pay income tax on the premium received.
- If Sam is in the 40% tax bracket, he just saved $180,000 in taxes, and
- Sam paid the $450,000 into his personally owned CIC.
- The income in an 831 captive is income taxed at the corporate rate.

# Tax reduction continued

- **Very Small Insurance Companies** - Insurance companies with gross receipts of less than $600,000 and premium income representing more than 50% of the gross receipts - premium income **and** passive investment income are free of federal income tax. **(Internal Revenue Code section 501(c)(15))**
- In calculating the gross receipts limitation, clients must include the gross receipts of other businesses that are within a controlled group

# Law Changes

- The Pension Funding Act of 2004 was passed and it had a negative affect on Sections 501(c)(15) or 831(b) captives.
- Under prior tax law, a property and casualty insurance company was <u>exempt</u> from federal income tax if the greater of net or direct written premiums was $350,000 or less.

# Continued

- Section 501(c)(15) has been amended to indicate that a stock property casualty insurance company or reciprocal is tax-exempt if:
  - 1) its gross receipts for the tax year do not exceed $600,000, and the premiums received for the tax year are greater than 50% of its gross receipts.
  - Therefore, these small captives, if funded heavily for a period of time, will ultimately have their income exceed 50% of the premiums paid and will then lose their tax exempt status (if not converted to a 831 captive).
  - This is a major change and will significantly limit the use of 501(c) captives.

# Estate Planning

- In our Sam example, if Sam's daughter owned the CIC, Sam would have shifted significant wealth to the daughter gift and estate tax free.
- In this example, the total potential tax savings for paying $450,000 into a captive insurance company could be as much as $400,500. The breakdown is as follows:

| | |
|---|---|
| Income tax savings | $180,000.00 |
| Estate tax savings | 220,500.00 |
| Total | $400,500.00 |

# Example 2

| Year | Allowable Related Party Insurance Premiums | Federal Tax Deduction @ 35% | State Tax Deduction @ 7% | Potential Estate Tax Savings @ 49% | Annual Potential Tax Savings | Cumulative Tax Savings |
|---|---|---|---|---|---|---|
| 2005 | $840,000 | $294,000 | $58,800 | $411,600 | $764,400 | $764,400 |
| 2006 | 840,000 | 294,000 | 58,800 | 411,600 | 764,400 | 1,528,800 |
| 2007 | 840,000 | 294,000 | 58,800 | 411,600 | 764,400 | 2,293,200 |
| 2008 | 840,000 | 294,000 | 58,800 | 411,600 | 764,400 | 3,057,600 |
| 2009 | 840,000 | 294,000 | 58,800 | 411,600 | 764,400 | 3,822,000 |
| | Five Year Total | 1,470,000 | 294,000 | 2,058,000 | 3,822,000 | |

# Asset Protection

- Captives are NOT asset protection tools
- Having said that, assets in a Captive are asset protected from creditors of the owners of the captive.
- Many are offshore which provides additional asset protection.
- Domestically, insurance company laws are in place to protect policy holders which helps protect reserves in a captive.

# For estate planning

Company

Tax-Deductible
Premiums

Irrevocable Trust

CIC

Client

Gifts Seed Money

- The client gifts “Seed” money to the IT.
- IT forms Captive.
- Captive Sells insurance to client’s company.
- Company makes tax-deductible premium payments.
- CIC is owned by IT therefore the tax-deductible premiums are not out of the client’s estate and the business now has additional insurance coverage.

# Life insurance

Company

Tax-Deductible
Premiums

Irrevocable Trust

CIC

Client

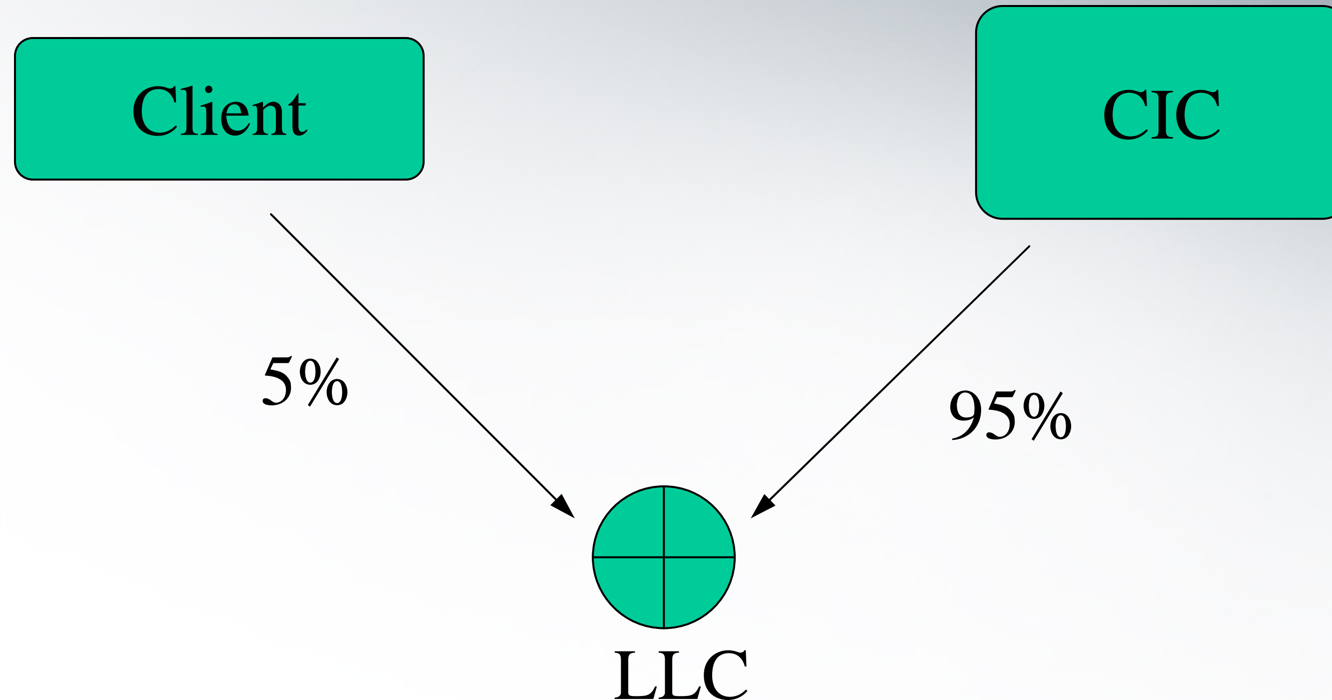
Gifts Seed Money

CIC buys high cash value
life insurance policy

Life insurance
policy

- The CIC manager has a duty to invest the money in a prudent manner.
- A High Cash Value policy is a terrific idea because it 1) mitigates investment risk (downside protection), 2) would provide a financial windfall that would really fund the CIC upon a death, 3) allows money to grow in an 831(b) captive tax free.

# Exit strategy: Client accessing cash tax free

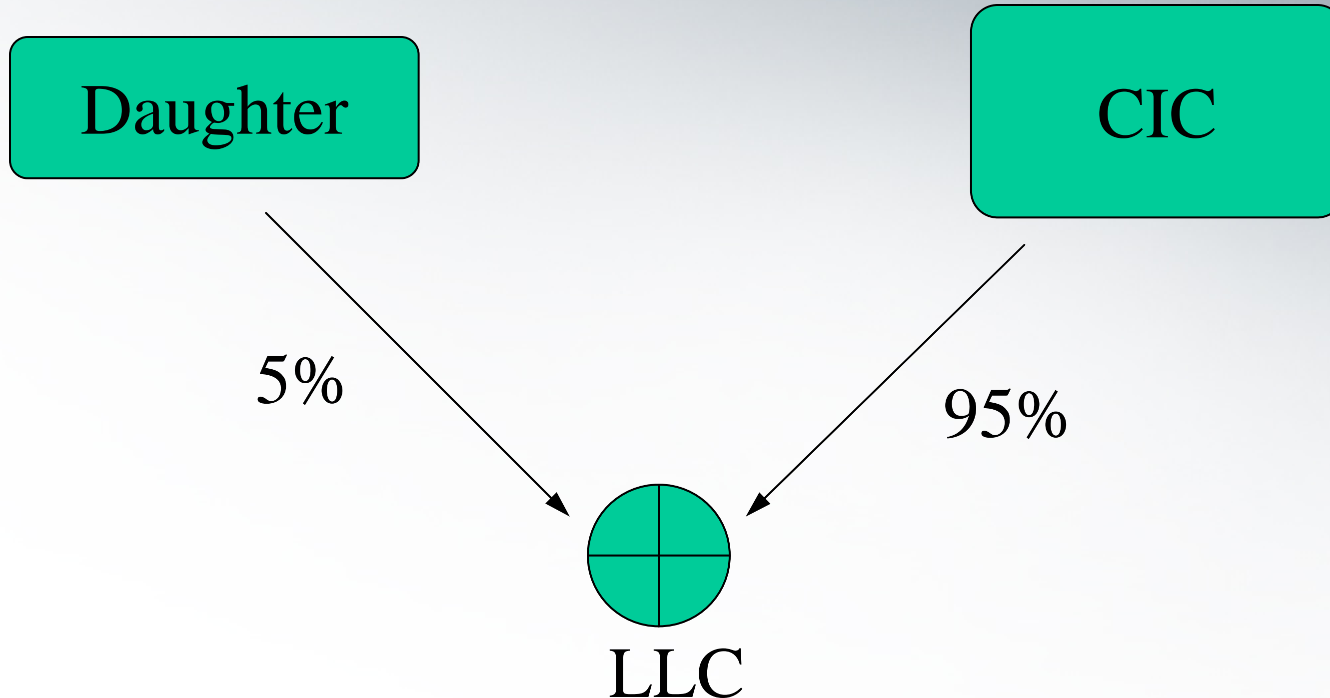



- CIC invests $1,000,000 into an LLC and becomes preferred non-managing member.
- Client invests $50,000 and becomes non-preferred managing member.
- LLC buys 2 life policies (one cash building and one to pay back the CIC its investment plus rate of return.
- Daughter through special allocations from the LLC will have access to tax free loans from the life policy

# Continued

- Think about the finances
- Company deducts $500,000 for premiums.
- Normally the client would pay $200,000 in income taxes and would take money home after tax which would be in the estate.
- With a CIC and the LLC transaction, $500,000 would go into the CIC where 85% of that money would be poured into a cash value life policy in the LLC structure where the client would have access to tax-free loans from the policy.

# Exit strategy: Daughter accessing cash tax free




- CIC invests $1,000,000 into an LLC and becomes preferred non-managing member.
- Daughter invests $50,000 and becomes non-preferred managing member.
- LLC buys 2 life policies (one cash building and one to pay back the CIC its investment plus rate of return.
- Daughter through special allocations from the LLC will have access to tax free loans from the life policy

# Summary

- While captives are not an everyday topic for most of an advisor's business clients, it is one that can be very beneficial when used for the right client.
- The CWPP™ program revolves around educating its advisors on matters that can benefit the high income/net worth client and in order to be a full service advisor to business clients, it is essential to have a working knowledge of captives.