Forming a Captive:

A Strategic Solution for Closely Held Companies

Risk Management Answers

Risk Solutions to Reduce Cost and Increase Profit

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The property and casualty insurance market is headed into another cycle of increasing rates that is predicted to mirror similar the markets of the mid 1980s and early 2000s, during which insurance premiums soared by up to 300 percent. Past hard markets led many companies to migrate from traditional insurance to alternative risk transfer (ART) programs that include large deductible programs and the formation of captive insurance companies. In recent years the costs of forming a captive have been greatly reduced, making it an excellent option for middle market. The combination of rising insurance rates, lower costs for formation and the ability to take greater control of your insurance program makes now an excellent time to learn how an 831(b) Captive can reduce costs and ultimately protect the profitability of your business.

Risk management experts predict that ART vehicles, specifically captives, are going to become an increasingly popular business tool. "The biggest trend in risk management is the continued movement by organizations into the Alternative Risk Transfer Market through the use of captives, self-insurance, risk retention groups and large deductibles," says Dr. Robert Hartwig, an economist and President of the Insurance Information Institute. "The trend also points toward a diminishing role for traditional insurance. Business owners need to be aware of those changes and to the extent possible plan ahead for them," he advises.

The 831(b) Captive

There are many different types of captives and ways they can be structured to meet the needs of a parent operating company. The fastest growing type of captive and among the ones most frequently selected by mid-market companies (with revenues excess of $25M) is a

"Rather than using captives as a money-saving vehicle when traditional insurance costs rise, owners are viewing their captives as an efficient and effective long-term risk management and risk financing tool."

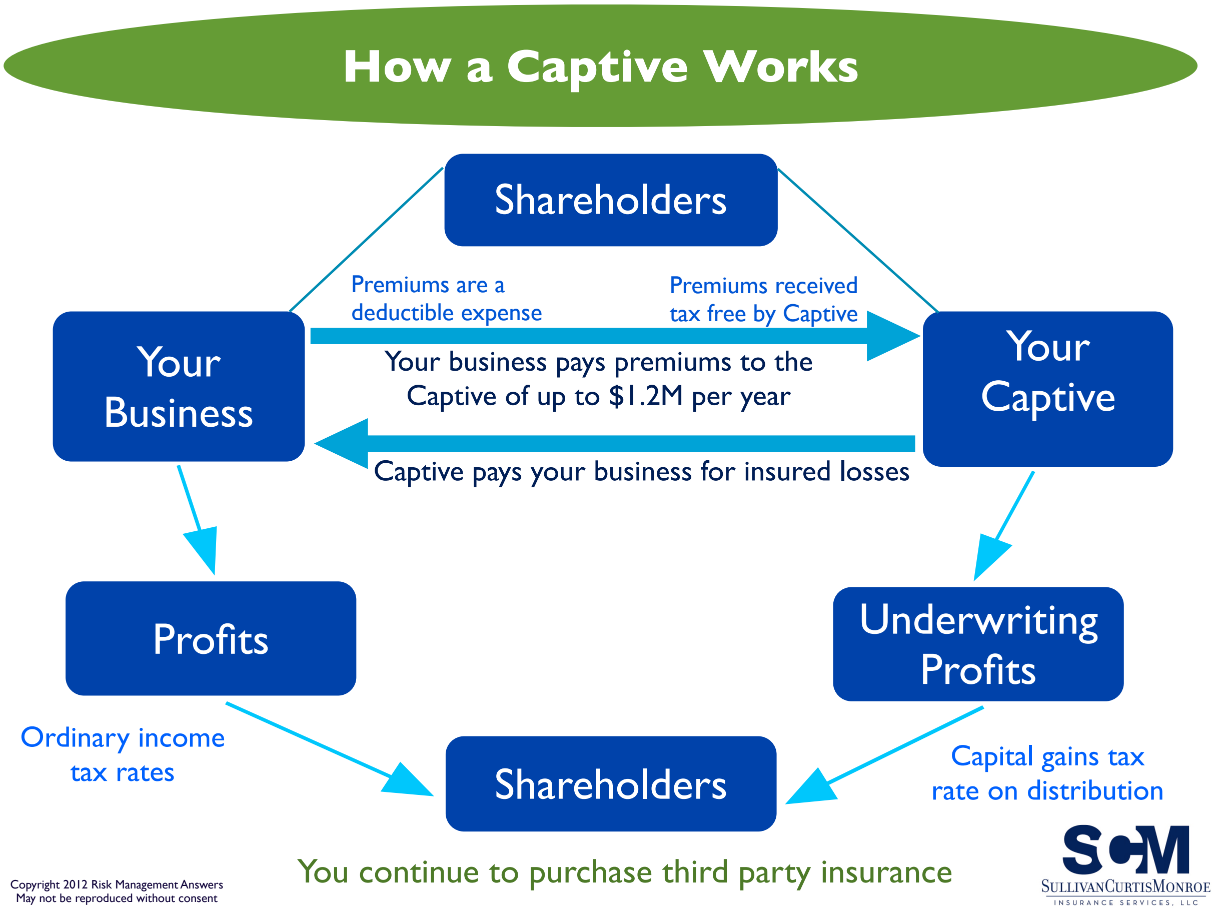
Morgan O'Rourke
Risk Management Magazine

micro captive, referred to as an 831(b) Captive for the Internal Revenue Code section that allows insurance companies to be formed with less than $1.2 million in annual premiums. Based on the most recent *Business Insurance* magazine survey 54% of the captives formed in 2011 by the three leading independent captive managers were 831(b) Captives. Through an 831(b) Captive, a business can:

- Create a pre-tax reserve against potential future losses
- Reduce third-party insurance expenses
- Reduce current taxable income, defer tax events
- Convert ordinary income to capital gains, and
- Potentially provide for the efficient transfer of wealth to the next generation

The 831(b) Captive is best structured as an overlay to a company's current insurance program. It does not necessarily replace traditional coverage, and is most often used to insure policy exclusions and previously uninsured risks. A company may have forgone insuring detrimental risks because of premium cost or the inability to find a carrier willing to underwrite the specific risk. Finding underwriters will increasingly be a problem as rates rise and insurers refuse to insure more hazardous risks. The captive structure increases protection for risks of loss previously unfunded on the balance sheet. These can include:

- Administrative Action
- Contingent Business Interruption
- Credit Risk
- Cyber Liability
- Directors & Officers
- Errors & Omissions
- Excess Workers Compensation
- Intellectual Property
- Political Risk
- Pollution
- Product Recall
- Supply Chain Interruption
- Warranty



831(b) Captive Benefits

A disadvantage for businesses insuring in the traditional insurance market is that premiums are set based on the pooled losses of many companies in your class. If your loss ratio is lower than industry standards, you are realizing reduced premiums as a reward for managing your own long-term loss experience. In contrast, rates established by a captive are based solely on your business' own experience, thereby decreasing the cost of coverage. Further, premiums paid to the captive do not include the amount of overhead and profit that is a part of a traditional insurance company's pricing.

The 831(b) election allows a small insurance company to receive up to $1.2 million per year in premiums without paying any income taxes on the those premiums. The insured operating company deducts the premiums against ordinary income. As an example, a California Subchapter S Corporation receives a tax deduction of approximately $500,000 on the formation of a $1.2 million 831(b) Captive. Distributions from the captive are paid as dividends, and therefore are taxed at the more favorable capital gains rate.

Other benefits of forming an 831 (b) Captive include:

- The ability to customize coverage and the types of risk that is insured.
- The investment income realized on premiums paid into the captive is retained.
- The return of underwriting profit is realized by the captive owners.
- Increased insurance capacity as a successful captive accumulates surplus over time.
- Long-term stabilization of insurance costs because of ability to control rates and manage losses.
- The parent company becomes an owner rather than a buyer of insurance.

The significant advantage of the 831(b) Captive is that a business is able to accumulate surplus funds from underwriting profit free from tax. This tax advantage greatly leverages a businesses' capacity to build risk reserves over which they retain investment control versus not being able to control premiums paid to traditional insurers. When integrated with estate plans, the wealth protection and accumulation can be substantial. The 831(b) Captive can be a valuable wealth management tool, although that cannot be the primary purpose for formation. *Business Insurance* magazine notes that state insurance regulators are looking closely at micro captives to ensure formations are for non-tax reasons and to primarily transfer and fund insurance risk.

Essential Expertise

The 831(b) Captive is first and foremost an insurance and risk management tool. Therefore, it is imperative that an insurance broker knowledgable in captive formations conducts the assessment, analysis and evaluation of potential risks for inclusion in the captive along with an experienced 831(b) Captive manager. Often when other trusted advisors who have little or no insurance and risk management experience oversees this analysis, problems develop because there is a high probability that the coverages selected and priced do not comply with the IRS 2002-89 Safe Harbor ruling on risk selection and distribution. The IRS standard for compliance requires that risks placed in the captive must be ordinary and necessary to the operating company. As an example, if a manufacturer includes ocean cargo coverage in the captive when there is no such risk, it would be a deemed unnecessary and not in compliance. Likewise, the amount charged for premiums for included risks must be reasonable. Premium costs must be benchmarked against current market rates. For instance, charging a $200,000 premium for terrorism risk when the market rate is $928 is not reasonable.

Operating a Captive

The operation of a captive is similar to a traditional insurance company, although on a much smaller scale and at lower expense. A captive manager performs day-to-day operations, pays claims, oversees the accounting, annual tax audit, and serves as liaison with the board of directors and regulators.

The Origin of Captives

A captive is a private insurance company formed to insure the risks of its parent/operating company. Its business is primarily supplied by and controlled by its owners, which are normally the principal insureds. These owner / insureds participate in controlling the underwriting, claims and investment decisions of the captive. Captives account for half of the $150 billion ART market, and continue to be the fastest growing segment of the ART market with more than 5,500 captives in existence today, up from just over 1,000 in 1982.

Despite misconceptions, captives are not a present day innovation. Formation of captives can be traced back to the mid 1800s when a group of New England textile manufacturers formed a group captive (a mutual) in response to the high fire insurance rates of the period. In the 1930s the U.S. manufacturer of LifeSavers determined that a wholly owned offshore risk-funding company could provide significant benefits to its parent company and formed a captive domiciled in Bermuda. Interestingly, Allstate began as the captive for Sears, which later opted to expand its coverage to its customers.

The country or state a captive is formed in is referred to as a domicile. Today a captive can be domiciled in more than 35 countries and in 24 of the United States, resulting in many choices of where you can choose to form your company's captive.

The foundation for all insurance is risk distribution. In traditional insurance, risk is distributed through insurance pooling arrangements or reinsurance agreements. In the case of a captive, the risk coverage is specific the the parent company and the captive owner has direct control and access to the captive's assets.

A wealth money manager with expertise in captive governance can advise how the assets of a captive can be placed in a wide range of investments, including real estate. A captive must be formed for risk management purposes. The tax benefits a captive provides are important but secondary. Additionally there may be additional wealth management opportunities for some businesses.

The First Step: A Feasibility Study

To determine if a captive is an option for your company, a feasibility study is conducted. This study includes a thorough quantitative and qualitative assessment of the operating company, an analysis of the proposed risks to be transferred into the captive, and the calculated premium for each. The rule of thumb is that a properly priced portfolio of risk for a captive should equate to total premiums equal to one to three percent of the insured's revenues. If revenues are large enough, multiple 831(b) Captives can be formed. This comprehensive study includes the actuarial report listing the captive's risks and premiums, pro forma spreadsheets, and information about the captive domicile and related expenses. An insurance broker and a captive manager experienced in captive formations should work together as the primary team to conduct the feasibility study. The cost of conducting the study depends on the size of the parent company and the types of proposed risks to be covered by the captive. The cost of a feasibility study ranges from $7,500 - $15,000.

Having been an insurance broker during the hard market cycles of the 1980s and early 2000s, I know the affects that rate increases will have on midsize companies and the underwriters currently in the market. As insurance rates rise, and costs soar, you may find the answer to these increases is forming a captive. Start by answering these important questions:

- Is there a more efficient way to finance claims and losses to achieve improved outcomes?
- Will a Strategic Risk Management approach using a captive achieve consistent long-term benefits to the organization?
- How can you minimize risk of loss, therefore preserving the assets of a captive?

Privately held, middle-market companies that take the time now to determine if ART, specifically the 831(b) Captive, is the best way to improve the structure of their current insurance program can benefit from this strategic solution by reducing cost and assuring future profit.

Business Insurance Expert Cites Captive Growth

"This growth (in captives) is due in part to middle market companies' greater knowledge and acceptance of captive programs, something that once was thought to be only a way for large corporations to cover property and liability exposures," states Mike Tsikoudakis, Associate Editor, *Business Insurance*. "Experts say middle-market and small companies' better understanding of risk and how to transfer that risk has driven much of the growth of (micro) captives during the past year," according to Tsikoudakis in a recent article.

About the Author

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