Do Not Overlook The Power of Captive Insurance Companies to Mitigate Risk and Build Wealth:

Why Business Owners Need to Act Now to Form Their Own

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An Educational White Paper for the Owners of Small and Midsize Companies
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If you were a business owner on the East Coast during the winter of 2015, you lost money. Economic damage and losses from U.S. winter storms in January alone rose to an estimated $500 million, according to Impact Forecasting, a unit of Aon.

As of late February, the "Siberian Express" accelerated this figure to $2 billion in damages, leaving thousands of businesses out in the cold. Roofs toppled, warehouses flattened, factories shuddered, and businesses locked their doors against seven-foot walls of snow. Owners took it in the teeth—car dealerships, retail giants, clothing boutiques, grocery chains and all manner of small to midsize businesses with property and casualty insurers not covering full losses. And, it's the second year in a row.

In 2014, the "Polar Vortex" cost the US. Economy $15 billion, according to Planalytics, a weather research firm for businesses. So how do businesses recover without the right insurance coverage? The fact is, many don't.

One solution for the future. The formation of a captive insurance company (CIC). Many small and mid-size private and closely held companies can benefit mightily with a captive on their side. But they don't know it's possible.

The Fortune 1000 has valued CICs since the 1950s. In fact, more than 90 percent hold one or more CICs; more than half of all property and casualty premiums written are written through CICs.[1] The January 2012 newsletter by *The Center for Insurance Policy and Research* cites nearly 3,000 CICs domiciled in the Caribbean; 1,200 in Europe and Asia; and more than 1,000 captives in the United States.[2]

In this educational white paper, we intend to level the risk management playing field for small, mid-size private and closely held businesses, and suggest the potential for attractive wealth accumulation for the business owner. You can take full advantage of the same strategies as large corporations use to gain business and tax benefits, if you set up your own captive insurance company. We will show you how form a CIC, offer ways to better manage enterprise risk and cultivate the wealth potential of CICs for investment opportunities.

CICs Defined

Business owners establish Captive Insurance Companies as private insurers and separately owned entities—that they, key employees, family members or an estate planning trust may own—to accept premiums for the purpose of insuring and mitigating common and unusual risks that originate with the owner's company. This arrangement addresses enterprise risk versus catastrophic risk.

Corporations, associations, trusts, limited partnerships, limited liability companies and individuals may own or control captives in more than 50 domestic and international jurisdictions—more on domiciles ahead.

The core differentiators between CICs and commercial insurance carriers - captives cannot sell insurance to the general public, and regulations are less stringent.

Let's take a moment to review some of the major risks covered by CICs, despite the reality that many owners often ignore or short change enterprise risk management.

Risks Covered by Captives

PROFIT
RISK
LOSS

Commercial pollution, commercial property, cybercrime, general crime

Employee dishonesty, employment practices, errors and omissions

Legal defense costs, kidnap/ransom, inventory obsolescence

Loss of franchise, loss of key customers/suppliers, loss of key management

Professional liability, loss due to regulatory changes, director/officer liability

- Tax liability, business interruption, inability to collect receivables, market fluctuation
- Terrorism, transportation damage, warranty costs or shortfalls

The more glamorous side of captives comes from entertainers or professional athletes, as cited in this case study.

The Case of Court Superstar, Adrian B.*

A pro basketball play, Adrian B, makes more than $8 million annually in salary and endorsements. He faces a high risk of a career-ending injury, as do all professional athletes, and wants to do something smart about it. His teammates simply go to a specialty lines carrier, like Lloyd's of London. Instead, he listens to his advisor and opts to create a CIC that will write policies for loss of income from all types of injuries including knees, ankles, wrists, and hands.

A reasonable premium for Adrian is $1 million a year given his pre-existing conditions and age. He's allowed to deduct the full $1 million in premium payments to his CIC. In turn, he reinsures the worst possible injuries, like his teammates, through Lloyd's for a premium of $500,000. He self-insures for minor injuries. Now, he's totally protected, and has mitigated all risks. Best of all, his premiums are treated in a tax-favored way and asset-protected from his creditors.

Let's look at another case study in the medical field.

The Case of Two Doctors on Two Paths*

Longtime friends, Drs. Johnson and Brennen owned medical surgery centers with similar revenues. Both were unhappy with the exorbitant cost of their group's medical malpractice and commercial liability policies. Our partner, JadeRisk, created a CIC to cover the least significant, most common medical malpractice claims ($100,000 per occurrence). This cut Johnson's existing premiums because the deductibles were much higher for the third-party policies. But the real benefit arose when, after five years, Johnson still had $1 million in CIC reserves, even after paid claims, which he chose to invest in a trust for his family, building wealth out of his taxable estate.

Brennen wanted to insure against Medicare fraud, HIPAA litigation expense, and create malpractice defense policies to pay for litigation. Brennen did not have to pay out claims and his robust reserves remain available to cover any losses. Since Brennen wants to bring in younger partners, he plans to use his CIC as part of an exit strategy from his surgery center, with each young partner paying some of his buyout from both the business and the CIC.

And let's look at one final case study.

Private Equity Firm*

A successful private equity firm with six senior partners wanted to develop a wealth accumulation strategy to reduce current income taxes and put money away for later years. They met with several firms and discussed various strategies such as nonqualified deferred compensation plan, qualified defined benefit pension, and nothing seemed to fit: The firm employed 80 people that needed to be included or its Limited Liability Corporation (LLC) tax structure wouldn't work for the deferral of income.

After bonuses to all employees, the private equity firm had $3 million of taxable income (taxed at 50 percent), including federal and state income taxes. The partners wanted to minimize the income tax liability associated with their firm and accumulate funds on a more tax-advantaged basis, beyond the reach of their personal and corporate creditors.

The shares of the captive would be owned by the six partners, some naming their children as owners. That later move avoids gift and generation-skipping transfer (GST) taxes. The partners would be trustees of their childrens' trust.

The captive manager performed a feasibility study analyzing the firm's current coverage to determine risks that are either self-insured or underinsured. That feasibility study identified 10 risks and designed separate coverage for each of those risks. The annual premiums of $1.2 million are fully tax deductible by the firm and not taxable to the CIC. Only the investment gains are taxed.

The captive's surplus, after approval of the state insurance department, is permitted to be reinvested back into investments the private equity firm has selected at a lower tax rate that the firm's own tax bracket.

Each of the partners controlled a portion of the investment fund through LLC investments inside the CIC. This strategy was ideally suited to help the firm manage enterprise risk while, at the same time, accumulate wealth for each of the partners.

*Note: Case studies are hypothetical and for illustrative purposes only. Individual results may vary.

On the opposite end of the spectrum, imagine the mind-boggling situations today that could take out a business. Consider the war on ISIS, and the impact of one terrorist act. One need only cite Copenhagen, London, Madrid, New York and Paris. What about an employee's dishonesty with financials and the cost in revenue and reputation to a small financial institution. These scenarios are a fact of life, but they do not have to devastate companies.

Savvy Safety Net

Companies who fall to these crises self-insure for uninsured risks when traditional insurance is unavailable or simply too costly. Even when commercial insurance is available, CICs can fill the gaps in existing policies where exclusions, high deductibles, or policy coverage limits leave the business owner and his/her company vulnerable.

“Indeed, captive insurance must rank as one of the best asset protection strategies ever created.”

“Indeed, captive insurance must rank as one of the best asset protection strategies ever created,” says Jay Adkisson in a 2013 Forbes article[3] and author of the book *Adkisson’s Captive Insurance Companies.* Earlier in the text, he affirms, *“The primary purpose of a captive is to save money on insurance, and in this captives have no equal.”*

Understandably, the middle market is now embracing the use of captives, once considered the domain of major corporations. Artex Risk Solutions, Inc. has seen a 100 percent increase in new businesses joining existing captives in the last year.

A Look Back

Wrapped in a fascinating history, CICs date back to the 1500s when ship owners gathered in the London coffeehouses, sharing and transferring the cost of risk for their ships amongst themselves.[4] Instances of this also occurred in the 1700s and 1800s, when businessmen in a given industry created mutual insurance companies to provide risk coverage.

The term “captive” took root in the 1950s with Frederic M. Reiss, a property engineer/insurance broker from Youngstown, Ohio, also regarded as the father of captive insurance. Because regulators made it too expensive to set up CICs in America, Reiss went offshore in 1962 to Bermuda. A watershed moment for captives came in the

1980s when liability coverage couldn't be found on the commercial market or many buyers found it completely unaffordable in what was a harsh climate at the time.

In the next page, we'd like to run down an important list of all the advantages to be derived from forming a CIC.

Tangible Benefits of CICs

The advantages of CICs are so numerous that it is difficult to cover fully in this paper, so we are limited to a bulleted list and stand by to offer greater detail as needed. Look at all you can do and all you can benefit from by forming a captive:

Expand Coverage and Risk Mitigation

- Realize control over your risk management program and litigation defense
- Fill in coverage gaps caused by deductibles, excess losses, exclusions, copayments
- Consolidate deductibles to enhance coverage
- Create a creditor-protected pool of reserves for the unexpected
- Insure the uninsurable or the unavailable
- Better manage underwriting to your specific situation, not broad, historical claims
- Shift and distribute risk across a wider number of companies
- Establish more efficient claims processing

Reduce Cost of Insurance and Risk Management

- Reduce business overhead costs with optimal blend of commercial and self-insurance
- Minimize reliance on commercial carriers and costly premiums
- Motivate commercial brokers to compete for best prices
- Gain direct access to reinsurance markets for cost savings
- Negotiate discounted fees for franchises, subsidiaries or association members
- Protect against unanticipated rate hikes
- Stabilize premium pricing

Reduce Tax Liabilities

- Leverage tax-advantaged deductibility of premiums
- Tap into potential for tax-favored accumulation of underwriting/investment income
- Reduce state tax on premiums

Realize Added Profitability

- Improve cash flow benefits
- Improve consolidated income statements
- Accelerate growth of corporate assets for bonding/banking purposes
- Gain ability to directly control choice in premium investments
- Participate in profit from “no loss” year
- Create a Profit Center
- Build handsome reserves for later investment and retirement strategies

Enhance Estate Planning

- Create avenue for key employees and heirs to earn money to buy the business
- Accelerate wealth accumulation through investment income
- Use a multitude of CIC-directed strategies to advance estate planning

Enjoy Added Flexibility

- Use CIC reserves and surpluses in emergencies to “save” your business
- Enjoy freedom to insure any risk you select; customize policy terms and conditions
- Improve loss control efficiency

In short, CICs save time, money and aggravation, as well as position you to reap the reward of premium investments once claims are paid.

The Best Candidates for CICs

In considering whether to form a captive, you are advised to follow these basic criterion. First, your company must be profitable and benefit from annual, adjustable tax deductions. Second, your business structure must show multiple entities or be in a position to create multiple operating subsidiaries or affiliates or reinsure a portion of your risk in a pool with other entities. Third, your business must show $500,000 or more in sustainable operating profits.

Next, the risks you intend to insure must be real and true to your business, and are currently uninsured or underinsured. Finally, it is important that you are interested in and need asset protection, long-term wealth accumulation or strategies for family wealth transfer.[5]

Insurance Requirements

If you go to the expense and effort to form a CIC, then you need your premium payments to stand the test of deductibility. [Note that self-insurance payments are not generally deductible.] To do so, you need to **prove your CIC is a valid insurance company;** obtain an insurance license from your jurisdiction; and provide insurance to the operating company or its affiliates. The insurance needs to include risk shifting and risk distribution; that is, shift the risk(s) to the CIC and distribute it across a larger pool or group of affiliates. In this way, the CIC accepts risk from multiple separate entities, thus satisfying the insurance requirement.

The IRS qualifies a corporation as an "insurance company", if more than half of the corporation's business during a given year comprises activities that constitute "insurance", as determined for federal tax purposes.

In order for an arrangement to constitute insurance, two requirements must be met—there must be (1) risk shifting and (2) risk distribution.

Risk Shifting

> "Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences to another, so that a loss does not affect the insured because the loss is offset by the insurance payment.

Risk Distribution

> "Risk distribution occurs when the party assuming the risk distributes its potential liability among many insureds. Risk distribution incorporates the statistical phenomenon known as the law of large numbers and allows the insurer to reduce the chance that a single claim will exceed the amount of premiums taken in.

Risk shifting is generally the easier of the two requirements to meet. Risk distribution is typically the more difficult requirement to satisfy, especially if a single parent captive is involved. The IRS has issued several ‘safe harbor’ rulings that help define what constitutes sufficient risk distribution.

In Revenue Ruling 2002-89 the IRS indicated that risk distribution is present if at least 50% of the premium received by the captive relates to unrelated third-party risk (i.e., less than 50% of the premium comes from the parent company and the liability coverage provided to the parent company accounts for less than 50% of the total risks insured by the captive). Although the IRS safe harbor percentage is 50%, it should be noted that a Tax Court case has indicated that 30% unrelated third-party risk may be sufficient (see *Harper Group v. Commissioner* (1992)).

In Revenue Ruling 2002-90 the IRS indicated that sufficient risk distribution was present where the captive insured only the risks of twelve related parties. Subsequently, in Revenue Ruling 2005-40 the IRS clarified that a disregarded entity, such as a single member LLC, would not count as an entity for purposes of the twelve entities required. Although the IRS safe harbor number is twelve related parties, one court case has indicated that insuring the risks of seven related parties may be sufficient risk distribution (see *Humana, Inc. v. Commissioner* (6th Cir. 1989)). It should be noted that each related party should generally comprise no less than 5% and no more than 15% of the overall risks insured by the captive.

Risk Pools

In situations where potential captive owners cannot meet either of the above criteria for risk distribution, some captive programs offer them the ability to participate in risk pools. This involves each of the member captives in the pool

> insuring the other captive owners against certain types of risks, thus potentially enabling them to meet the requirement that they insure sufficient third-party risk."
>
> *Source:* **Pacific Life**, *"Captive Insurance Companies and the Role of Life Insurance."*

Types of Captives

Large captives do not work well as a risk management strategy for small and midsize companies. Requirements are complex; operating costs are high. In 1986, Congress adopted § 831(b) of the Internal Revenue Code to stimulate the formation of small captives by giving owners the benefit of a federal income tax exemption for underwriting premium revenue up to $1.2 million. If fully qualified, these premiums are a deductible operating expense, reducing its income tax by that full amount. Those premiums are not taxable to the CIC, only the earnings on those dollars.

Even for a small captive, do not underestimate restrictions and the government's watchful eye. In our opinion, however, these restrictions pale by comparison to potential tax incentives, which make small captives a powerful risk management, wealth management, asset protection and estate planning tool.

As Business Evolves

Over the years, captives have taken on many shades of grey as business owners create new ways to use captives and alternative ways to transfer risk. Here is a sample of five types of captive arrangements, as cited in the CIPR Newsletter:

Single-Parent Captive. Underwrites only the risks of its parent or affiliates, also known as pure captives.

Group Captive. Underwrites only the risks of an established group of companies with similar businesses or exposures.

Association Captive. Underwrites risks only for trade, industry or service group, like a doctors' medical group; not unlike a group captive but sponsored and owned by a group of firms within an organization with common needs.

Rent-a-Captive. Owned by an outside group and open to participants for a fee. Members rent licenses and capital and prefer for reasons a size or inclination, not to form their own arrangement.

Risk Retention Group. An association or group captive formed for the main purpose of assuming and spreading risk from commercial liability exposure.

In addition to this short list, we encourage you to learn about agency, branch, diversified, protected cell captives, as well as producer-owned reinsurance companies (PORCS).

Forming a Successful CIC

Formation of a CIC can be time-consuming due to a mound of paperwork. But the heaviest burden on you is the advance analysis needed before even deciding on your structure and launching the application process.

First, determine your capital availability, decide which specialty lines to underwrite, and set forth how much investment flexibility that you require. Often, clarity with these decisions will lead you automatically to your choice of domicile.

We emphasize that you seek out the counsel of professionals, that along with your financial advisor, will help you do the important analyses and, above all, the pivotal feasibility study. This is complex, a bit like trying to complete those cardboard table puzzles with a thousand pieces. One piece ends up between the cushions of the sofa and you may be stuck for weeks.

The feasibility study sets forth your optimal ownership structure; it establishes the entities to comprise the CIC; it identifies your goals for asset protection and estate planning; it covers procedures for following best practices; it reviews how your design meets published IRS requirements in your chosen jurisdiction. And so much more. The following is a general tutorial on steps to form a CIC, although we do recommend that you work with a professional firm with expertise in the area.

With your license application to the Insurance Commission in your domicile, be prepared to provide the following information:

1. Completed biographical profiles on each officer and/or director of the company
2. Written plan of operation, accompanied by an actuarial report or feasibility study, prepared by qualified independent actuary
3. Pro forma financials for the next five years
4. Proposed charter and by-laws
5. Actuarial analysis
6. Loan agreements
7. An independent valuation of subsidiaries may be required

INSURANCE POLICY
INSURANCE
Business Insurance Planning
Business interruption insurance
Legal expenses insurance
Errors and omissions insurance
Purchase insurance
Interest rate insurance
Trade credit insurance
Gap insurance
General liability insurance
Product liability insurance
Health insurance
Life insurance
Mortgage insurance

Moreover, you are going to need extensive ancillary documentation. For example, owner/director affidavits, background checks, disclosures, policies and agreements, code of ethics, conflict of interest clarification, corporate formation papers, business plan, organizational minutes, investment policy statements, and more.

Cost and time to form your CIC depends on your service provider and the domicile jurisdiction you have chosen. Estimates vary widely. Start-up capital for a simple CIC can be as low as $10,000 (offshore Nevis) or jump to $250,000, a minimum for domestic U.S. domiciles.[6]

Set-up and fees to maintain the CIC may approach $75,000. However, these fees may be fully tax deductible as a reasonable business expense. Each case is different. That's why it is essential to work with your third-party advisors on negotiating fees.

Domicile Requirements

A domicile is the jurisdiction where the captive insurer is incorporated and regulated; it can be onshore or offshore. Originally, captives were set up in Bermuda, the Cayman Islands, or the British Virgin Islands because people held the perception that there were local tax benefits to be had. In fact, the U.S. did not have captive legislation yet and treated captives the same as commercial carriers.

As of February 2014, 37 states in America have passed "enabling legislation" and not only "recognized the fundamental legitimacy of a properly structured and operated captive insurance arrangement, but also created 'safe-harbors' in the confused area of risk distribution," cites the American Bar Association in its *Business Law Today* newsletter.

In this same article, the authors conclude that the best domicile to form your captive may well be the one you are in—this is because you can learn anecdotally how the Insurance Commissioner's office behaves toward captives. You can learn what you need to know from other captives in the jurisdiction to streamline your set-up or avoid any land mines going forward.

Tax Considerations

Without a doubt, there are tax advantages associated with formation of a captive: 1) tax-favored accumulation of underwriting and investment income; 2) deductibility of premiums paid for by the insured; 3) if the captive qualifies as a true insurance company for tax purposes, then it can deduct a 'reasonable and fair' loss reserve for unpaid actual losses incurred.[7]

As mentioned earlier, Congress added a provision to IRC § 831(b) in 1986 that created a new world for small insurance companies: "If a property and casualty insurance company with gross premium income of $1.2 million or less (known as a mini-captive) makes an election under that section, it avoids tax and its premium income and owes tax only on its investment," according to the *Journal of Accountancy.*

Deciphering tax code is a challenge for the best tax accountants. Let's try to simplify as best we can. An insurance company must be taxed as a C-corporation and file its return on a calendar-year basis, unless in a consolidated tax return. In an LLC or partnership, the company must elect to be taxed as a corporation under the regulations of § 7701. The captive can issue stock, and pay out dividends. Also know that multiple captives can be established, an advantage to shareholders with differing investment philosophies or retirement goals. The critical decision here is to work closely with an expert tax accountant.[8]

Ask us about the power of forming series LLCs or cell companies, which is beyond the scope of this paper, except to say—these structures give you the ability to operate a captive insurance entity at lower costs and use much smaller levels of risk and premiums, thus opening up availability to a wide range of smaller companies.

A brief word about the regulatory climate**.**

Regulatory Concerns

We welcome regulation in the insurance industry because it protects policyholders, investors and other constituents. In the case of captives, governance comes from the state in which they are domiciled. And unlike commercial insurance companies, captives do not serve the public, only their parent company.

An annual audit is required by an independent certified public accounting firm with “industry-specific” experience in the insurance sector. Regulators will also conduct a formal actuarial review of pricing policies and methodology for loss reserves.

Thus far, we have extolled the virtues of captives because we believe in them for particular companies under particular circumstances. At this point, we want to shift gears slightly and review some of the disadvantages, which we also believe are surmountable.

Manageable Disadvantages

To offer a balanced perspective on CICs, it is only fair we point out some potential disadvantages of owning a CIC. Critics of CICs may mention high start-up costs and capitalization requirements; heavy organizational and administrative burdens; need for experts in key insurance disciplines; turbulence in the reinsurance market, and consequences of a change in business structure. Let’s explore these points one at a time.

High start-up costs and capitalization requirements. Captives can be expensive when you factor in implementation costs, management fees, legal and auditing fees, local taxes, and regulatory/licensing fees. The amount of expenses and fees vary depending on the domicile chosen for the captive.

While difficult to pin down, estimates on CIC start-up costs may approach up to $75,000. This investment is subject to negotiation with service providers and merits a competitive search for a firm specializing in captive development and with a proven track record.

As mentioned earlier, the initial capital requirement for captives in the United States is $250,000. Since a captive candidate must show $500,000 in profitability, management allocates the capital requirement from profits and looks to future investment performance of the captive to offset.

Organizational and administrative burdens. Yes, the business owner of the captive will be responsible for underwriting, claims processing, and loss control, adding to time, personnel overhead. But the good news is you can outsource these functions to a captive management company.

Need for experts in key disciplines. To be effective and stay in compliance, the captive needs a cadre of experts in all related insurance disciplines as advisors on issues affecting risk management, shifting and distribution. The recommendation is to retain a risk manager or outsource to a competent captive management firm.

Volatility of reinsurance market. In the face of adversity, the reinsurance market reacts far more quickly than the traditional insurance market. Why does this matter? Experience rating charges. Because reinsurance ties premiums closely to the loss history of the insured, premiums increases may occur more quickly. Plan ahead.

Change in business structure. Finally, in terms of disadvantages, it is important to recognize that forming a CIC is the same as forming a new business; only now the corporate owner is in the insurance business—a risky business. And, in effect, pays claims out of his/her own pockets.

The decision to form a captive immediately refocuses the company on risk management and demands whole new set of skills, specialized knowledge and oversight for which the owner may have little or no background. But sharper focus on risk management is a good thing since many owners treat risk as an unwanted stepchild. This strange new captive frontier can be confidently traversed with the assistance of third-party consultants adept at the structure and management of CICs.

Wealth-Building Machine

With all the positive reasons for forming a CIC, I've saved the best for last.

With your payment of $1.2 million in premiums to the CIC annually, you enjoy full deductibility, and once all claims are covered, you can invest and manage the excess income in an asset allocation model in a portfolio of financial instruments of your choice. And, like a qualified retirement plan, you don't have to withdraw any monies until age 70.5 years. One captive business owner says it best:

"If a business paid a premium of $1 million to a regular insurer and had only $600,000 in claims, it would lose the $400,000. If, however, it put the same amount of money into a captive, it would keep the extra $400,000 in the captive. This amount would then increase over the years," says Ken Sturm, who owns several restaurants and nightclub in New York, and set up a captive when his traditional insurer did not pay a claim.[9]

After a period of time, you may no longer need the protection of the captive and choose to terminate or liquidate the CIC, now potentially brimming with reserve income. In a worst case scenario, you will be subject to taxes on the capital gains. In a best case scenario, you can access that money tax free with a number of fresh strategies we've developed. *Let us show you how.*

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For more information on how you can form and manage a captive insurance company for wealth accumulation, please contact one of our advisors:

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