Captive Insurance Arrangements For Small Companies

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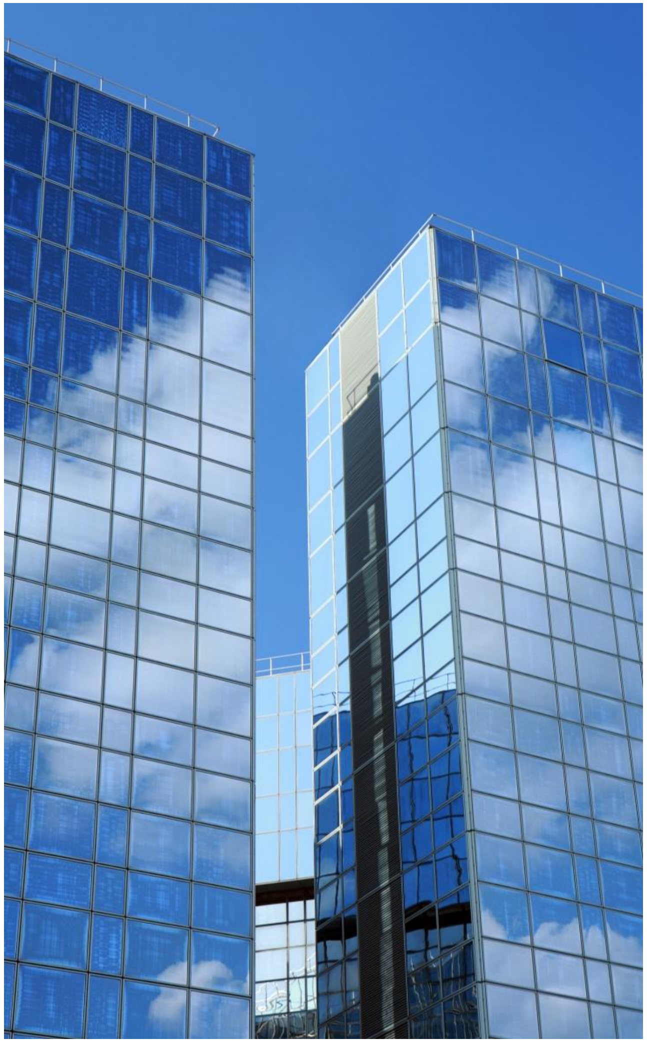
What is a Captive Insurance Company?

- A Captive insurance company is an insurance company formed primarily or exclusively to insure the risks of one or more affiliated businesses.
  - There are many types of captives. However, the materials contained herein focus on captive insurance companies that insure property and casualty risks of affiliated closely-held businesses (i.e., business risk insurance) through the issuance of insurance policies in return for premium payments; and
  - The Captive insurance company is owned by one or more of the owners of the affiliated closely held business (and/or the heirs of the owners).



Traditional Insurable Risks

Some traditional risks

- General liability (includes property)
- Vehicle liability and property
- Errors and omissions
- Directors and officers
- Employment practices
- Employee fidelity
- Construction defects
- Subcontractor default
- Workers compensation

Some Non-Traditional Risks

- Deductibles
- Administrative actions
- Data breach/cyber risk
- Loss of key customer
- Loss of key supplier
- Loss of key employee
- Litigation expenses
- Business interruption
- Tax audit
- Policy exclusions

- Terrorism
- Kidnap, ransom
- Product recalls
- Loss of franchise agreement
- Subcontractor default
- Earthquake
- Mold
- Accounts Receivable
- Intellectual property

Using Captive Insurance Arrangements to Maximize Value

For decades, captive insurance has been used by large companies to reduce the premiums paid for the company's property and casualty insurance and reduce the amounts needed to fund self-insured risks associated with the company's tangible and intangible assets. The group captive structure and its segregated cell variation can bring these cost savings to small and medium sized business at a far lower cost than establishing the single parent captive commonly used by large companies.

The group captive and captive cell structures provide an opportunity for you to introduce cost saving opportunities to your business clients that can be further enhanced by the income tax and succession planning techniques commonly used by estate planning professionals.

I. Cost Saving

A captive insurance structure can accomplish several cost saving objectives.

Reduce premium costs. Rather than using a commercial property and casualty (P&C) insurance company, a business should consider the cost savings associated with the use one of the many forms for a captive insurance company. The use of a single parent captive insurance company, a captive cell, a fronting company, a risk retention group or becoming a member of a captive group can reduce premium costs from 15% to as much as 35%.

Insure self-insured risks. A captive structure can provide casualty insurance for risks a business is exposed to but that are not presently insured, thus reducing the amounts needed to fund the payment of future losses.

Low cost captive alternatives. Until recently, captives were not financially viable for small and mid-sized companies. Captives in the single parent form were primarily used by large companies because of the high expenses incurred in formation and the ongoing costs of administration. The use of cell captives and group captives have significantly lowered these costs.

II. What is a captive insurance company?

A captive is a bona fide insurance company. Its business is primarily supplied by and controlled by its owners, which are normally the principals insured.

"An insurer established to write coverage for the company, companies or people who founded it."

Captive insurance company is a broad term used to describe the many different ways in which a captive can be structured and utilized.

III. Objectives of a captive?

- **Reduce cost of insurance coverage.**
  - Reduce premiums for existing P&C coverage.
  - Reduce amount needed to fund self-insured risks.
  - Retain a portion of risk internally.

- **Determine and insure gaps in existing coverage**
  - Deductibles
  - Available but too expensive
  - Insure excluded risks where no commercial coverage is available, such as toxic mold

- **Financial windfall if no claims.**
- **Reduce non-insurance costs.**
- **Control investment of reserves.**
- **Control claim process and negotiation leverage.**
- **Eliminate having to subsidize others with higher risk potential.**

IV. Forms of captive structures: In general.

- Single parent.
- Segregated cell or the incorporated cell. A cell captive is less expensive to form and operate.
- Group captive. The lowest cost alternative. When using the group captive, the insured is not the owner of the insurance company.
- Risk retention group.
- Fronting company (provides access to reinsurance).
- Special purpose captive.

V. Requirements for a tax deduction.

Risk distribution and risk sharing.

Risk Distribution is required when the necessary 50% portion of the premiums are paid into a group pool where all risks are shared proportionately. The following is an example of a compliant pool:

Pool member	Premium paid	% of group claims shared
X	$20	20%
Y	$30	30%
Z	$50	50%

Reserves in the pool start at $100.

Example 2. X is paid $40 on a claim. Each member of the pool shares in all claims proportionately. Reserves are reduced to $60 as a result of the $40 claim paid out of the pool's reserves and are shared as follows:

X	Y	Z	
$20	$30	$50	Premium paid
-8	-12	-20	Share of group's loss
$12	$18	$30	Remaining share of group's reserves

V. Requirements for a tax deduction (continued)

Example 2. Z is paid $60 on its submitted claims

X	Y	Z	Total	
$20	$30	$50	$100	Premiums paid
-12	-18	-30	-60	Share of group's loss
$ 8	$12	$20	$ 40	Remaining share of group reserves

If X cancelled its coverage, X would only be entitled to an $8 refund. There is real risk distribution as X's share of the pool's reserves bear a portion of another pool member's claims.

- **Group captives significantly reduce the costs of satisfying the risk distribution requirement.**
- **The cell of a group captive still needs to satisfy risk sharing and risk distribution. The IRS guideline is that only 50% of the risk can be retained. The incorporated cell can provide access to low cost reinsurance.**

VI. Choosing a domicile.

- **Regulatory environment.** Some jurisdictions are friendlier than others, or their statutes may permit different used and forms of captives.
- **Minimum capitalization requirements** – varies between jurisdictions from $150,000 to $750,000. Separate series of a group captive requires risk-based amount of capital, typically
- **Start-up costs and annual maintenance** – typical start-up costs range from $50,000 to $80,000 for pure captive (plus required capital) and from $20,000 to $25,000 for cell (or series) of group captive.
- **Underwriting risk classification**
- Traditional coverage or non-traditional coverage, such as loss of license.
- **Tax implications.**
  - Small insurance company with premiums less than $1,200,000. See Section 831(b) of the Internal Revenue Code. Applies to US tax-law compliant companies.
  - Excise taxes on premiums paid for non-US captives.

VI. Choosing a domicile (continued).

- **Foreign or domestic?**
- **Restrictions the jurisdiction imposes on investment of reserves. For example: Bermuda and Cayman Islands require that all reserves be kept in country of registration.**
- **Can the Captive lend its reserves back to the insured? The Utah captive statute permits such loans.**
- **Favorable US jurisdictions include: Vermont (greatest no. and most sophisticated regulation of captives), Utah (no premium taxes and no income taxes), Delaware, Nevada, Hawaii, etc. It is advantageous if your company already has ties to a captive jurisdiction.**
- **These foregoing considerations are for pure captives. Our sponsored captive is domiciled in Delaware.**

VII. Does your business need a captive?

- **Phase 1.** Actuarial and engineering study to evaluate the risks a business has and the financial exposure of each risk.
- **Phase 2.** Feasibility study and determining the cost of reinsurance to satisfy risk distribution requirement.

An experienced team of underwriters, accountants, insurance managers and lawyers perform phases 1 & 2

- **Phase 3.** Implementation.
- **Phase 4.** Administration and operations.
  - Ongoing legal and accounting requirements.
  - Annual reports.
  - Claims administration.

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