Have You Heard of Captive Insurance?

Would you like to insure your own risk while keeping the profits that would go to a commercial insurance company? Would you like to receive significant tax benefits by insuring your own risk? Do you want to smooth out cash flows should you experience an insurable claim that you are currently self-insuring? This is possible through the use of captive insurance companies. We see captive insurance companies as not only a way to insure risk that may be otherwise uninsurable or unaffordable, but also as a tool in which you can reduce your tax burden, protect wealth, and plan for future generations.

What is a captive insurance company? A captive insurance company, commonly known as a captive, is a small insurance company, formed to insure the risk of a related, parent company. Captives come in many forms and can be complicated. To simplify it using an example, a business could form a captive to insure some of its risks. Each year, the business would pay the premium, deductible to the company, to its own captive insurance company. The premium that the business pays would be determined by a captive manager, which employs accountants and actuaries who analyze the company's unique characteristics as they relate to insurable risk. The captive can hold reserves, which are then invested. When a claim is filed by the practice, the captive would pay the claim out of its reserves. So utilizing a captive is similar to obtaining commercial insurance and filing claims, except you own the insurance company and like the profitable commercial insurance company, you are able to keep the money that is in excess of claims paid.

Captive Insurance allows you to insure your own risk

A captive can be formed as a domestic company, or it can be formed off-shore in certain jurisdictions. Both domestic and off-shore captives have their own unique benefits specific to that domicile. Domiciles are generally selected because of the regulations governing them and the management and formation costs of that particular jurisdiction.

831(b) or Small Captives must keep annual premiums under $1.2 million in order to qualify for significant tax benefits. By exceeding $1.2 million in annual premium,

Captives have significant tax and other financial benefits

the tax benefits of an 831(b) captive are lost. When we evaluate whether a captive is right for our clients, we would want to see someone whose company has significant self-insured risks that would generate premiums of at least $600,000. We recommend against insuring potentially catastrophic risks that are insurable in the commercial insurance market, and instead insure risks with low frequency and moderate liability for which commercial insurance is currently unavailable.

Forming a captive benefits a company's owner from a tax standpoint because the insurance premium is a business deduction in the year that the premium is paid, not when a claim occurs, as would be the case with self-insuring the risk. Therefore, by utilizing a captive, a business can amortize the risk of loss over time and smooth the volatility associated with insurable events. As long as annual premiums remain below $1.2 million, the insurance company will pay no tax on that premium. Once money is inside of a captive, only the realized gains are taxed. The money inside of a captive should be managed in a diversified way to reduce risk. Investment options are relatively unrestricted, and a portion could even include writing mortgages, investment in real estate, private equity, and venture capital.

When well managed, insurance companies can be very profitable

Captive insurance companies also offer another level of creditor protection. The money that is paid into the captive is protected from creditors or potential creditors of both the owner and the business due to the fact that it is its own viable business entity formed for the purpose of insuring certain related-party risk. Courts have been very reluctant to allow creditors of the parent company or its owners to attach to the assets of a captive insurance company.

Captive Insurance Companies

From a long-term tax benefit standpoint, 831(b) captives receive very favorable tax treatment. Captives can convert ordinary income minus any claims into long term capital gains and qualified dividends. This is because no tax is paid by the captive on

Small captives may write up to $1.2 million in annual risk premiums

premiums. At some point, once its reserves are high enough, the captive can declare a dividend or when there is no longer a need for the captive or an owner is retiring, it may be liquidated at long term capital gains rates. These very powerful tax attributes have led to significant abuse by certain promoters and owners of captives. The IRS has placed heavy scrutiny on captives due to the abuse, as a result, it is important that owners of captives recognize that the tax benefits are ancillary to the risk components and that if the company is properly insuring risk, the tax benefits can follow. It is imperative to utilize a reputable captive manager with actuaries and CPAs that maintain strict guidelines and understand the insurance industry along with the IRS's stance on captives. A reputable captive manager will evaluate your business by speaking with the owners and key employees to identify any areas of insurable risk and then determine the premiums required to insure that risk. The manager will then form the captive in the selected jurisdiction and manage the processing of claims and annual actuarial studies and audits.

If you have any questions or you would like more information on captive insurance companies, please don't hesitate to ask. We would be more than happy to help you in whatever ways we can.

John Schaffer joined Abundance in 2013 and oversees the firm's compliance program and advises clients on matters of personal wealth. His prior experience ranges from real estate and construction to criminal and civil law. John attended The Pennsylvania State University, where he majored in Marketing, and later returned to complete a joint degree in Law and a Masters of Business Administration. His graduate education focused on business, tax, and estate law. John is an active member of the Pennsylvania Bar.

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