

## **What you and your clients need to know about captive insurance**

In recent months, captives have come to the forefront of the insurance industry.

As a result, there has been increased interest in what they are, the benefits that they provide, and if they are viable option for companies.

### **WHAT IS A CAPTIVE?**

A captive is a privately held insurance company, and it can be a subsidiary of the insured business. It issues policies, collects premiums, pays claims, just like a commercial insurer; however, it does not offer insurance to the public.

While a captive can be a great financial tool, it will not work for every business. In order to create and operate a successful captive insurance program, the operating company must generally have a substantial amount of risk. That risk can be insured commercially, or it can be self-insured by the business. If a particular area of risk is already insured, then the business may elect to cancel its current commercial policies and insure those risks with a captive. If the risk is already being self-insured, there may be certain benefits to financing that risk via a captive.

Other qualifying characteristics include:

- Profitable operations, with taxable income ranging from \$1.5 to \$100 million;
- \$250,000 or more of self-insured or uninsured business risk;
- 100 or more employees; and,
- \$500,000 or more of commercial insurance expense.

The Internal Revenue Code, related Internal Revenue Service rulings, and case law all support the use of captive insurance companies to manage risk. When properly employed, the use of a captive insurance strategy can help a business owner to better manage their insurance costs, control claims, accumulate surpluses in anticipation of unforeseen risk, and allow for the accumulation of wealth on a tax-deductible basis.

And while a company may exhibit that above-stated characteristics, how does a business owner know if their business truly qualifies for a captive?

### **QUALIFYING FOR A CAPTIVE**

For large builders, manufacturers, distributors and trucking companies, captives are becoming more and more widespread thanks to increased industry awareness.

For the business owner, regardless of industry, the first step is to take a closer look at the overall risk that the business faces. They should examine risks that are typically insured by commercial property and casualty insurance, and consider risks that are already self-insured. A good place to start is by carefully reading the business' property and casualty insurance policies. This will allow them to see what is covered, and what is not. In fact, most policies exclude the most severe types of risk those that are potentially catastrophic, such as a product recall or construction defect.

Once they have taken inventory of the various risks, they must assess each risk and determine a strategy to address that risk. For example, there are certain risks that cannot be insured in the commercial marketplace and others that must be insured, such as workers' compensation insurance, which is a requirement in many states.

In determining a strategy to address each risk, a cost benefit analysis must be undertaken. Can insurance be purchased? Is it economic to purchase insurance? Is that risk better financed with a captive? These are just a few of the questions that need to be answered in order to gain a complete understanding of whether or not a captive is beneficial for the company.

If the risk is already being self-insured by the business, then structuring a captive enables that business to transfer that risk off its balance sheet in a tax-favorable manner. For example, a manufacturer that does not have coverage for a product recall can now transfer that risk to a captive via an insurance premium. Thanks to unique insurance company taxation rules, captives

rarely pay tax on income in the year in which it is received. What this means for the manufacturer is that a product recall can now be financed on a pre-tax basis.

Once they have completed a self-analysis, it's critical to engage a qualified captive management company to conduct a feasibility study. But how do they determine if the management company they have selected is qualified for the job?

## **FINDING A PROVIDER**

Some captive management companies have little experience; others have a great deal. Some have little understanding of taxation; others are experts. It can be confusing and even overwhelming when choosing a firm with which to work. Also, ill-advised captive transactions can expose owners to significant tax liabilities, penalties and interest.

Moreover, guidance by qualified experts can be costly. A business considering a captive should expect to invest time, resources and money when evaluating the feasibility of such a program.

When determining if a captive is appropriate, it is important to qualify service providers by examining the following aspects:

- **Client references.** Checking clients references is key to learning, direct from a provider's clients, their level of satisfaction.
- **Experience and track record.** Successful captive management taker a combination of accounting and insurance skills. A captive manager's staff should include people who are qualified in both areas. In addition, one should learn about the manager's history. How long has the captive manager been in business? How many clients have been audited, and what were the results?

- **Multiple domiciles.** Is the management team experienced with multiple domiciles? A captive manager who has dealt with them will be able to provide flexibility and understanding of the benefits of other domiciles.
- **Actuarial services.** An in-house actuary may face too many potential conflicts of interest. In addition, certification by an independent actuary often has more credibility with insurance and tax regulators.
- **Cost.** Fees should reflect the value of the service provided. If you want a basic bookkeeping service, the price should be low. Fuller services will cost more.

Developing and initiating a captive program may not be suitable for all companies, but by employing the tactics outlined in this article, they can make the decision that best suits their needs.