The Wealth Counselor

A monthly newsletter for wealth planning professionals

Captive Insurance Companies - Creating Current & Recurring Revenue

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My practice is people oriented and exclusively devoted to estate planning, estate and trust administration, estate and trust litigation, asset protection and business planning. My newsletter highlights wealth planning issues designed as helpful insights to your practice

This issue of The Wealth Counselor examines Captive Insurance Companies, a topic that should be of interest to all business owners with annual net profits of $500,000 or more, as well as all planners who serve them. Perhaps over-hyped at times, Captive Insurance Companies (Captives) are a legitimate planning tool that offers significant benefits to clients, while also generating significant current and recurring revenue to the planning professionals who understand, implement and maintain them. An understanding of Captives allows the wealth planning team to distinguish and/or solidify itself as its clients' trusted advisors while providing unique and valuable client services.

What is a Captive Insurance Company?
A Captive Insurance Company is a subsidiary or an affiliate of a company or group of companies that serves to insure or reinsure some or all of the risks of that company or group of companies. A company that pays reasonable premiums to a properly formed Captive may deduct them just like any other insurance premiums paid.

The benefits of Captives include that they can:

- Provide coverage for uninsurable risks
- Allow flexibility over claims management
- Create wealth in underwriting profit (potential estate planning opportunity)
- Protect assets and reserves
- Provide incentive for establishing "best practice" risk management procedures

A Captive has to be a real insurance company and that means being a true riskspreading vehicle. This can be accomplished through risk pooling and other means. A Captive cannot just insure the risks of its owner.

Planning Tip: Captives can also provide income tax deferral and/or savings, estate tax savings, wealth transfer, and asset protection.

The History of Captives

Some may believe that the benefits of Captives are simply too good to be true. To the contrary, the IRS has issued several Revenue Rulings since 2001 that provide specific guidance for Captives, including Safe Harbor guidelines in Revenue Ruling 2005-40. (See also Rev. Rul. 2001-31, 2002-89, 2002-90, 2002-91, and 2008-8.) These rulings have in fact created the opportunity for Captives owned by mid-size, privately owned companies, as well as their use for estate and business planning purposes.

Planning Tip: Properly implemented and maintained, Captives are legitimate and can provide significant client benefits.

What Risks Can a Captive Insure?

Companies form Captives to insure against both risks for which insurance coverage is available and those for which it is not. Some examples of otherwise uninsurable risks are:

- Earthquakes
- Loss of Key Customers
- Some Director & Officer Liabilities
- Punitive Damages
- Excess Errors & Omissions
- Deductibles
- Mold
- Construction Defects
- Exclusions
- Contract Claims
- Intentional Acts

Companies form Captives if they believe that they can self-insure in a cost-effective way. Otherwise insurable risks against which companies self-insure include:

- Worker's Compensation
- General Liability
- Health
- Auto
- Collision
- Professional Liability
- Errors & Omissions
- Director & Officer Liability
- Builder's Risk

Tax Treatment of Captives
Under Internal Revenue Code Sec. 831(b), if a Captive receives premium payments of less than $1.2 million per year, there is no tax on the premium income. However, Captives are C corporations and therefore pay tax on investment income at corporate rates.

Planning Tip: Business owners can use Captive profits to fund life insurance more tax efficiently, either as a direct investment of the Captive or by using Captive dividends to pay insurance premiums. However, clients should understand that the death benefit will be subject to tax, at a minimum, at long-term capital gain rates upon dissolution of the Captive. Life insurance death benefits are also a preference item for corporate Alternative Minimum Tax, so owners of large Captives should be mindful of that issue as well.

Estate Planning Opportunities with Captives
Captives provide numerous estate planning opportunities. In addition to owning a Captive outright or through an entity, business owners can capitalize Captives owned by children (or better yet, inside a trust for children's benefit), or they can later gift or sell the Captive to children or a trust for children's benefit. To the extent a business owner can deduct premium payments to a Captive, those premium payments are not gifts and therefore are not subject to gift or generation-skipping transfer (GST) tax. If claims against the Captive's reserves are less than the premium payments, the Captive will leverage the transfer to children or a trust for children's benefit, while removing the Captive's assets from the taxable estate of the business owner.

Planning Tip: To the extent business owners can deduct premium payments to a Captive, those payments are not gifts and therefore are not subject to gift or GST tax, even if someone other than the business owner owns the Captive. However, premiums that are not deductible will be subject to estate and possibly GST tax. The initial capitalization of a Captive may also be subject to gift and GST tax, depending upon ownership.

Business owners can also use equity buildup with a Captive to provide seed money to a grantor trust for that trust's future purchase of estate assets.

Business Planning with Captives
Captives are also a useful tool for business planning. If key executives own a percentage of a Captive, the Captive can create very powerful management incentives. For example, a Captive can incentivize key executives to improve risk management practices; the better key employees manage risk, the more Captive profits remain after payment of claims. Because Captives are C corporations, owners can grant key executives ownership interests in a Captive with preference rights that become more valuable as the executive hits certain revenue targets or cost reduction targets. Such preference rights are not possible with an S corporation election, which many closely held businesses have made, because there can only be one class of S corporation stock.

AAdditionally, Captives can be a part of a golden handcuffs plan. The business owner could also implement a deferred vesting schedule for Captive stock to make it increasingly expensive for the executive to seek employment elsewhere.

Planning Tip: Captives offer significant business planning benefits, particularly as an incentive and retention tool for key employees.

Formation and Administration

First year costs for Captives are generally $75,000 or more. Ongoing annual costs are $36,000 or more for management fees, plus $20,000 or more for audit, tax, licensing fees, and actuarial fees. Where there are less than 12 insureds, third party risk costs are typically 2.5% - 4% for risk pool insurance purchases plus loss of use of funds while held by the risk pool.

Planning Tip: Ideal clients are those with $500,000 or more in taxable profits at the company level, and the business must face substantial risks that are not entirely within its control.

Conclusion

Captive Insurance Companies can offer significant benefits to businesses that face substantial risks not within their control. By working together, the planning team can identify those businesses that might benefit from a Captive and explore with the client the benefits of Captives generally and whether a Captive meets that client's unique planning goals and objectives. Captives provide significant benefits to business owners and the planning professionals who understand them.

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