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Captive Insurance? The Answer Is Education

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As an accountant, I have a question for you. How many of your clients own their own captive insurance company?

I can guess that the answer will be less than two, maybe one, probably zero. In reality, many financial advisors and accountants are not familiar with captive insurance. A captive is a form of self-insurance through which a parent company establishes its own insurance company that is licensed by a state insurance department.

Why would a business need or want its own insurance company? There are many reasons, but the most obvious is to turn a profit. Captives are not a new phenomenon. They got their start in the United States in the 1960s but have been a financial strategy in various forms in other parts of the world for a few hundred years.

In the past year *The Wall Street Journal, The New York Times* and *Forbes* have published articles on captive insurance companies. In addition, captives have made news in relation to the Affordable Care Act. Health insurance provided to employees through self-funded programs including captives is exempt from the Affordable Care Act. With the press focusing on captives, it may appear they are becoming mainstream. But are they really? As of the end of 2012, estimates are that there were only approximately 6,000 captives worldwide.

According to AM Best Captive Center, there were 1,000 captives in 1981, indicating tremendous growth in recent years. It is estimated that 98 percent of S&P 500 companies have their own captives and in many cases they have multiple captives.

Today almost 100 percent of Dow Jones Industrial Average companies have a captive. The largest and many of the most profitable companies are actively using captives. Companies such as Microsoft, Google, Apple, Dow Chemical, Coca Cola, Sears and Disney have their own captives. Even some of the nation's best-known universities and nonprofits have implemented captives.

According to figures from the latest United States Census, there are approximately 30 million businesses in the U.S. Yet there are only about 6,000 captives worldwide. If captives are such a great tool or option, then why aren't more companies taking advantage of them? The answer is very simple: lack of education.

The majority of accountants today do not have clients who own their own captives, so they are not familiar with them as business and financial planning tools. In the past most small or midsize companies never could consider establishing a captive due to the costs associated with starting a captive.

A company would be required to allocate large sums of money for statutory capital, and it would also need to hire an accountant, an actuary and an attorney to manage the captive. Due to these constraints, only the largest and most profitable companies took advantage of captives. The smaller companies were priced out of the captive space. Most accountants have had little need to be versed in captives because it was a tool their clients did not use.

Now, due to changes in legislation and economies of scale, captives are available to a much broader marketplace. In the U.S., 40 states plus the District of Columbia, Puerto Rico and the U.S. Virgin Islands all have captive legislation. Vermont is the third-largest captive domicile in the world, and Delaware the fastest-growing domicile.

In the last two years New Jersey, Connecticut and Oklahoma have added captive legislation, and Florida and Maine have improved their legislation. The U.S. government has also enacted legislation to give incentives in the form of tax savings to captives.

With so many states competing in the captive marketplace, we have witnessed a shift from offshore to onshore captives. For years U.S.–based companies would go offshore to domiciles like Bermuda, where it was less costly and easier to set up a captive. According to Marsh & Co., from 1991 to 2000, 65 percent of the captives formed were domiciled offshore. That trend reversed during the last decade: 52 percent of the captives formed from 2001 to 2012 were established onshore.

So why aren't more companies using captives? Once again it comes down to education. The majority of accountants in the nation are not working with a Fortune 1,000 client base. They are working with small to midsize companies. Since captives were primarily a tool for the largest companies, most accountants were not familiar with the way captives work and how the options they offer could benefit their clients.

There are many reasons why a company would consider establishing its own captive. The following are several of the most important:

Save on current and future commercial insurance premiums: Many of the largest insurance brokers in the world offer captives. However, they are not always recommended because it is not in the broker's best interest. One of the most common uses of a captive is to use it to insure the deductibles of an existing commercial policy.

For example, let's say a midsize Wall Street brokerage firm had very few claims on its errors and omissions insurance, but was still paying very large commercial premiums for its coverage. Solution: Raise the deductibles on the E&O policy to the maximum allowed and reinsure those deductibles in the captive. By raising the deductibles, the commercial premiums were lowered thus saving the firm money. If the company had chosen to follow the same strategy without the captive, by setting aside reserves for future claims, those reserves would not be tax deductible. With a captive, the premiums paid to cover the deductible would be tax deductible.

Employee benefits and the Affordable Care Act: Why isn't every company that is eligible to use a captive using one? The firm just doesn't know about them is probably the best answer. We have listed above just a few of the reasons for owning a captive. In fact, there are many more. One other relevant reason for establishing a captive today is the effect that the captive has on provisions of the Affordable Care Act that go into effect in 2015. Self-insured plans are exempt from the act. Therefore, those companies that use their captive to self-insure parts of their company's medical plan can also be exempt.

Provide for supplemental insurance coverage or coverage for excluded items: If commercial insurance were free, it would be used to cover every risk that could possibly be covered. This is not the reality. There are two negative insurance scenarios that business owners should never have to face: rejected claims or uncovered claims.

For example, this past fall when Hurricane Sandy devastated the East Coast, many business owners had to deal with claims that were flat out rejected because of exclusions listed in their policies. Other businesses came to realize that there were instances in which they could have had coverage, but unfortunately they did not. Solution: As part of any proper captive implementation, a feasibility study and risk analysis should be performed.

In this risk analysis it is crucial to find all of the exemptions and exclusions listed in their policies. The captive can then be used to issue a Differences in Conditions policy to cover those exemptions. Unlike commercial insurance, the owners of the captive have control over what they choose to cover, and they also have control over what claims can be made on those policies.

Business litigation and reputational risk protection: Every business owner is concerned about being sued and having the assets of the business jeopardized. It is a fact that we live in a litigious society. For example, let's say a company executive serves on the board of a nonprofit. The charity gets sued by a third party and as part of the lawsuit she and the rest of the board of directors are also sued. In most cases the nonprofit will have a Directors' and Officers' Policy in place. However, how much is the deductible for that policy? Who will represent the board members in the lawsuit? Solution: If the executive in question owned her own captive, then the captive could issue an Outside Directorship Policy. The policy would protect the executive and make sure she was represented by the legal counsel of her choosing while also ensuring that she would not personally be responsible for any of the deductibles.

Asset protection and estate tax planning: Captives provide both large and small companies significant income tax benefits that I won't cover in this article. However, another benefit that a captive can deliver is in the area of estate planning.

Example: a father and son jointly own a business that they have started together. The father is concerned about the estate tax implications his share of the business will have on his son at the time of his own death.

Solution: The father and son establish a captive for their business. Instead of owning it individually, the captive is set up so that the son or a trust for the benefit of the son will own the captive. Now, every year the company pays premiums to the captive (up to $1.2 million per year), and the company will get a tax deduction for the premiums paid. Whatever is left at the end of each year in the captive, after expenses and claims have been paid, will now go to the reserves of the captive. These assets are now completely exempt from the father's estate.

The facts and examples I have presented should spark a professional's interest in captives. Captives offer a number of options which professionals must understand and be prepared to utilize as they become more commonly used in small and midsize businesses.

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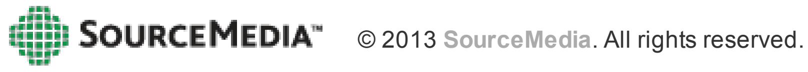
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