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Captive Insurance -- Basics

A captive insurance company **(CIC)** is an insurance company that insures the risks of operating business entities within the same "economic family".

1. A CIC benefits its owner(s) generally through a combination of factors.

1.1 As with any conventional insurance premium, premiums paid from a business to the CIC are tax deductible expenses under IRC § 162(a).

1.2 A CIC that elects treatment under IRC § 831(b) is exempt from income taxation of premiums received up to $2.2 million annually. There is a public policy rationale for this favorable tax treatment. By including this provision in the tax code in 1986, the US Congress intended to increase competition among insurers and increase the range of choice for insurance consumers.

1.3 An 831(b) CIC is taxed only on its investment income. The "dividends received deduction" under IRC § 243 provides additional tax efficiency for dividends received from its corporate stock investments.

1.4 Policy premiums paid to the CIC stay in the economic family. Roughly 35–50% of premiums paid for conventional "retail" insurance go to overhead, administration and profit. A CIC reduces those costs. Further, since a CIC invests its reserves and surplus in its own investment accounts, investment gains benefit the CIC's owner(s) (not an outside insurer).

1.5 A CIC customizes insurance policies directly to the needs and preferences of a business to improve insurance coverage and/or decrease premium costs.

1.6 A CIC customizes policies to insure risks that are otherwise uninsurable or too expensive to insure using conventional insurance. Thus, a CIC is a tax-efficient substitute for "self-insurance" (i.e., no insurance). Instead of using post-tax dollars to make a "rainy-day" fund, up to $2.2 million no-tax dollars can be shifted as insurance premiums to the 831(b) CIC annually.

1.7 A CIC is particularly well-suited for insuring "business loss" risks; for example, loss of business revenue resulting from loss of key employee or customer, change in government regulations, loss of operating license, etc. (see Section 6 below).

1.8 A CIC has access to reinsurers. For a high-premium policy (e.g., $1 million), a CIC can negotiate directly with a reinsurer for favorable "wholesale" insurance rates.

1.9 A CIC established in an offshore jurisdiction incurs no state income tax liabilities.

1.10 Although a non-831(b) CIC must recognize premiums as income, deductions under IRC § 832(b)(5) for IBNR (incurred but not reported) loss reserves provide arbitrage opportunities to the CIC. The "dividends received deduction" under IRC § 243 also applies.

1.11 A CIC offers flexible financing of annual premiums (and capitalization requirements), accommodating a business's cash flow problems. For example, a significant portion of annual premiums may be paid at the end of the premium year.

1.12 CIC reserves and surplus are not exposed to general creditors of the operating business. Insurance reserves are available for paying insurance claims only. At the end of a policy term, corresponding insurance reserves become surplus. CIC surplus is not subject to claims and can be invested to maximize return.

1.13 When owned by one or more asset protection trusts, a CIC is a valuable part of an integrated asset protection, wealth accumulation and generational wealth transfer structure.

2. A well-designed CIC managed by a "turnkey" service provider can be operated and properly reinsured for about 12-16% of annual premium payments. For example, if premiums of $1.0 million were paid to the turnkey CIC, total management costs including the cost of reinsurance could be less than $150K, potentially resulting in a profit of $700+K at the end of the year if there were minimal non-reinsured claims.

Generally, a CIC makes good economic sense when the CIC receives about $250K or more in premium payments annually. The insurance licensing agency in the jurisdiction of formation requires initial capitalization of a CIC, typically about 20 percent of the first year's premiums.

Generally, formation of a CIC is less expensive in one of the traditional foreign jurisdictions than in one of the states in the US. In any case, an 831(b) CIC usually elects to be taxed as a domestic company under IRC § 953(d), its operating account is located in the US, and its investment account (holding the bulk of its assets) can also be located in the US and controlled by its owner(s).

Unrelated owners of businesses (i.e., owners from different "economic families") can form a multi-owner CIC, a so-called "group captive". For example, four unrelated owners of businesses having similar types of risk could form a group captive that insures some or all of their operating business entities.

3. CIC assets can be accessed in several ways.

3.1 Dividends. Qualifed dividends are taxed at 15% for taxpayers in lower tax brackets, at 20% in higher tax brackets.

3.2 Direct investments. The CIC can invest directly in new business ventures.

3.3 Shareholder loans. Loans should be transacted only with strict formalities at arms length to avoid problems with the IRS and licensing agency.

3.4 Liquidation of the CIC will be treated as a long term capital gain.

4. To **qualify as insurance**, an insurance policy must shift a genuine risk from the insured to the insurer. A rule of thumb used by actuaries is that there should generally be a 10% chance of a 10% loss of the policy limit. In any case, a good CIC manager employs underwriting and actuarial skills to provide sound insurance coverage, satisfy statutory and IRS requirements, and maximize profits for a given set of circumstances.

To avoid scrutiny by the IRS concerning the appropriateness of deducting insurance premiums under § 162, total annual premiums paid by a business entity to an 831(b) CIC should not exceed 10% of the business's gross revenue. For example, if a business has annual gross revenues of $3 million, insurance premium payments should not exceed $300,000.

For discussion purposes, risks can generally be characterized as follows.

4.1 Low-frequency/low severity risks. A CIC can issue a policy that is efficiently priced and avoid paying overhead costs of retail insurers.

4.2 High-frequency/low severity risks. Conventional insurance for such risk can be expensive because of high administration costs. The operating business can purchase a low-cost high-deductible (stop-loss) conventional policy and pay the numerous small claims up to the deductible amount. The CIC can then issue an indemnification policy to the business that covers the high deductible.

4.3 Low frequency/high severity risks. A CIC is well suited to insure this type of risk. Some operating businesses often pay high insurance premiums for high severity events that rarely if ever occur. Other businesses are completely exposed to such high severity events because they do not insure against them, simply because they occur so rarely. Such risks are efficiently covered when the operating business purchases a conventional low-cost stop-loss (catastrophic) policy and the CIC writes an indemnification policy to cover rare, high-severity events.

4.4 Premiums approach policy limits of insured risk. There is little benefit from conventional insurance if premiums paid are close to policy limits. A CIC can

underwrite risks more efficiently by reducing overhead costs and investing the premiums in its own accounts.

4.5 Risks that the business manages better than the industry average. A CIC enables the operating business to customize its insurance to meet its own risk profile, rather than indirectly subsidizing other companies having high claims histories.

5 Business Liability Policies. Liability policies cover claims made against the operating business by third-party claimants.

Direct policies directly pay claimants and pay legal fees and expenses. They could create an asset for plaintiffs to pursue and, therefore, are not preferred for a CIC.

Indemnification policies indemnify, or reimburse, the business for third-party claims that the business pays. The business decides whether it will pay third-party claims. In other words, an indemnification policy could cover the risk for the business without offering an asset for plaintiffs to pursue.

Litigation expense policies pay only legal defense fees and expenses. These are good policies for a CIC because they do not create any rights in favor of third-party claimants.

Business liability risks commonly exist in the following exemplary areas:

Vehicle use
Construction and design defects
Performance liability
Structural defects
Title insurance
Environmental impacts
Product liability
Professional malpractice
Advertising liability
Copyright and trademark infringement
Antitrust
Unfair trade practices (e.g., Lanham Act violations)
Director and officer liability
Errors and omissions
Sarbanes-Oxley violations
Employee relations (e.g., discrimination, sexual harassment)
Failure to investigate/control employees and agents
Libel and slander
Workers Compensation (subject to limitations)
Employee Health Insurance (subject to limitations)

6 Business Casualty Policies. A good type of policy for a CIC to issue is a business casualty (i.e., business loss) policy because only the business can assert a claim and no third-party claimant is involved. Most businesses consciously or unconsciously self-insure many potential business casualty risks.

Business casualty risks commonly exist in the following exemplary areas:

Unforeseen administrative action of a governmental body
Changes in state or federal law
Judicial or administrative delays
Extortion (even if not provable legally)
Market volatility
Inability of key individual to work
Loss of professional or business license
Loss of key client or investor
Business credit (e.g., credit loss, delayed or withheld loans)
Labor cost or strike
Property damage
Unfair calling of guarantees
Litigation costs
Tax audit defense
Business interruption (e.g., due to computer, supply chain, weather)
Lawsuit interruption (i.e., interruption by lawsuit into business operations)
Consequential damages
Contract frustration
Advertising and marketing failure
Business reputation
Commercial crimes (e.g., theft of trade secret)
Currency risks

7. Bonds. CICs are also suitable in some circumstances to underwrite surety, performance and other types of bonds.

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