# SHOULD YOU SET UP A CAPTIVE INSURANCE COMPANY FOR YOUR BUSINESS?

What do many highly successful business owners have that you might not?

One answer: A captive insurance company. And setting one up for yourself could potentially save you millions of dollars. That said, captive insurance companies can be tricky to manage and oversee. While they're advantageous for many entrepreneurs, they're not a perfect fit for others.

Here's a closer look at this powerful tool—and how you can assess whether a captive insurance company might make sense for your business.

## Key Takeaways:

- A captive insurance company is a closely held insurance company that's set up to insure risks the parent company faces or could face.
- Captives can help entrepreneurs create their own customized insurance solutions and avoid being completely subject to the decisions of large insurance companies.
- Smaller businesses might consider a cell captive for their insurance needs.

## What is a captive?

A captive insurance company (often referred to as simply a "captive") is a closely held insurance company that's set up to insure risks the parent company faces or could face. The owner of the parent company almost always owns the captive. That means the business owner controls the captive's operations—including underwriting, claims decisions and the investment strategy.

With a captive insurance company, successful business owners can design property, casualty, liability, employee medical insurance and workers' compensation insurance that is customized to their specific companies. It can also enable business owners to gain greater control over the cost of insurance, improve claims handling and boost cash flow.

There are two main types of captive insurance companies:

- **Regular captive insurance companies.** Here, the captive insurance company recognizes as income the premiums paid. There are deductions for insurance reserves, expenses and claims that have been both paid and incurred but not yet reported. There are corporate taxes on insurance company earnings.

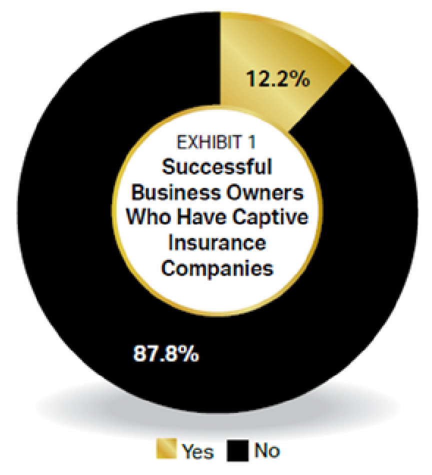
- **Micro-captive insurance company.** With this type of captive insurance company, the annual premiums are currently capped at $2.65 million. The premiums received as well as the underwriting profit are not taxed. The captive only pays corporate taxes on realized investment earnings.

As Exhibit 1 shows, relatively few surveyed successful business owners (defined here as those who have at least $1 million in financial assets) have established captive insurance companies.

## What can it do, potentially, for business owners like you?

Clearly, captives have gotten the attention of top entrepreneurs. That's because a captive gives control to you, the business owner, by allowing you to (among other things):

- Create your own customized insurance solutions
- Avoid being completely subject to the decisions of large insurance companies
- Access the global reinsurance market
- Receive tax benefits




N = 262 successful business owners.
Source: Russ Alan Prince and John J. Bowen Jr., *Becoming Seriously Wealthy: How to Harness the Strategies of the Super Rich* and *Ultra-Wealthy Business Owners*, AES Nation, 2017.

By essentially creating your own insurance company, you can manage your risks in a much more systematic, tax-efficient and potentially profitable way than you can through traditional insurance providers. What's more, you—as an insurance company owner—have the power to reinsure your exposure to catastrophic risk that might otherwise lead to large claims.

Some of the most powerful benefits of captives typically include:

- **Lower insurance costs.** Bypassing the retail insurance market can often lead to cost savings (through the elimination or reduction of profit loads, administration and other costs).
- **Favorable tax treatment.** Captives are able to accrue tax-deductible reserves for unpaid claims, whether known or estimated.
- **Recapture underwriting profit and investment income.** The parent company can recapture underwriting profit and investment income that typically stay with commercial insurers.
- **Incentive to control losses.** Business owners who are involved in daily operations tend to have deep knowledge of the specific risks of their own companies and how to best manage them. In some cases, rather than subsidizing the claims of a large risk pool, captives enable the insured company to cover only its own losses—creating greater incentives to control those losses.
- **Coverage not otherwise available.** Captives can potentially provide coverage for unique or specific risks that would not otherwise be transferable in the retail insurance market.
- **Opportunity to reinsure.** Within captives, the business owner decides how much risk to retain. Through reinsurance agreements and excess policies, captives' exposure can be tailored to better meet the business owner's comfort level and objectives.

What's more, captives aren't simply a tool for the biggest businesses out there. Whether large, small or midsize, captives can potentially help companies address specific business risks in a highly tax-efficient way. (More on that later.)

Finally, if the claims are not considerable, the business owner gets to profit from premiums they otherwise would have had to pay to traditional insurance companies.

**Warning:** Beware of any advisor who positions captive insurance companies as a good way to transfer wealth to children or grandchildren. Due to changes in the tax laws, captives are not an effective wealth transfer vehicle.


## Cell captives for smaller companies

Traditionally, captive insurance companies have presented a particular problem for many business owners: The expenses involved in setting up and maintaining a captive can be prohibitive for smaller companies.

The good news is that small and midsize businesses can join existing “cell captives” as a lower-cost way to get involved in the captive insurance arena. Now, these smaller companies can share the cost of a captive insurance company while keeping their assets and risk separate from the other “cells.”

Essentially, a cell captive is an insurance company composed of a “Core” (or “Parent”) and an unlimited number of cells. The Core is a licensed captive insurance company. The cells are sub-insurance companies, which can be owned by business owners. The cells are segregated from each other—each one has its own distinct insurance license. This means that each cell is protected; insurance risk, liabilities, assets and all information are legally walled off from every other cell. So, for instance, the assets in one cell cannot be used to pay the liabilities in another.

There are several different ways to structure a Core and its cells. In some cases, the Core can issue shares to each cell owner. Other times, the relationship is set up using participation contracts. There also can be different capital or collateral funding arrangements. But the bottom line is that the future owner of a cell—in this case, a small- or midsize-business owner—arranges with the Core to establish a cell. The business pays premiums to the captive for coverage.

Some advantages of cell captives include:

- Setup costs are lower than with a stand-alone captive insurance company.
- Initial capital and surplus are lower than with a single-parent captive.
- Can be a stepping-stone to a single-parent captive insurance company as it is relatively easy to make the conversion.
- Cells are available for most lines of business such as general liability, cyber-risk and property protection.

That said, with a cell captive, the underwriting profit is tax-deferred, but you are taxed annually on the investment income at corporate rates. Also, distributions are taxed as long-term dividends, and the liquidation of the cell is taxed as long-term capital gains.

Like typical captives, cell captives can be used in a wide variety of ways, such as:

- **Funding the deductibles of traditional policies.** A business may have a $50,000 deductible on its workers' compensation, health insurance or commercial auto. Instead of funding that out of the cash flow of the business, the business could buy coverage from the captive to cover that deductible. It would pay premiums annually to the captive to cover those deductibles.

- **Professional liability.** This would cover the errors and omissions of performing the business's own work.

- **Writing "niche" coverage.** The captive is used to write coverage the business owner feels is necessary but that is either unavailable or expensive. Example: a manufacturer needing a punitive damage policy for a defective product or manufactured drug.

## Risks and disadvantages of captives and cell captives

Be aware, however, that captives and cell captives do come with certain risks that may make them less-than-ideal or inappropriate for some companies. Potential drawbacks and disadvantages to recognize include:

- **Capital risk.** Because the business owner owns the captive, they're putting their own capital at risk. If you have a captive and your company sees a large number of claims or extremely large claims, for example, you could potentially lose that capital. Companies that lack strong risk management policies and procedures—or that are engaged in high-risk pursuits--therefore may find captives too risky.

- **Start-up costs and regulations.** Unlike buying an insurance policy from an existing provider, setting up your own captive insurance company comes with legal fees and many other costs that can add up - as noted above. If you really want your own captive, be prepared to incur significant start-up costs and ensure you're staying compliant with various insurance regulations. Expect to pay for actuarial and underwriting expertise, admin staff, ongoing financial reporting and compliance.

- **Service quality.** As a captive owner, it's up to the entrepreneur to ensure that high levels of service and skill are delivered when it comes to dealing with claims, assessing risk and regular management of the captive. It' unlikely that most business owners themselves possess the requisite expertise, making it necessary to invest potentially considerable time and effort finding qualified professionals with the right experience to run the captive well.

- **Taxes.** While (as noted) cell captives can help smaller companies access this approach, there may be unappealing tax consequences. With a cell captive, the underwriting profit is tax-deferred, but investment income is taxed annually at corporate rates. Also, distributions are taxed as long-term dividends, and the liquidation of the cell is taxed as long-term capital gains.

- **Control.** A cell captive by its nature offers less than full control to the entrepreneur because it's operated by a core company—the licensed insurance company. That core company may limit the coverages they make available to the cells.

## Assessing captives

It's important to carefully assess whether a captive of some kind or other is a good solution for your company and its needs and goals. The first step is to engage with a professional who can conduct a feasibility study to identify the insurance you currently have in place as well as those areas where you are self-insuring, and then determine the likely return on investment you would generate by setting up a captive insurance company.

What if you're among the many business owners already using a captive? Given the complexities involved in setting up and managing a captive correctly, business owners with captives can potentially benefit greatly from taking their captives through a stress test to see whether the company they've currently got in place is still set up to deliver what the business owners expect it to. Likewise, stress tests can help entrepreneurs see whether their captives could be revised and improved to potentially work even better going forward.

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VFO Inner Circle Special Report
By John J. Bowen Jr.