

## Captivating Captives

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Publicly traded Fortune 500 firms know the benefits of captive casualty insurance companies (captives). Now successful small to midsize businesses are discovering many of the benefits larger companies have long enjoyed. Planners should know the pros and cons of captives to help business-owner clients assess the viability of establishing one.

Forming captives may be one of the best risk management and wealth planning tools available to business owners. Captives can help control the rising cost of insurance, provide added insurance protection by filling the holes and exclusions of current policies and provide gap coverage for either self-insured or non-insured risk. Other benefits include current and future income tax savings, asset protection, investment diversification and estate-tax mitigation through ownership flexibility. Legislative changes and safe harbor rulings have opened the door for many business owners to look at captives as a viable planning option.

A captive is a property and casualty insurance company established by businesses and individuals to insure a broad range of risks for affiliated companies. For example, a group of attorneys can form and own a captive to insure against legal malpractice risks. The captive can even insure against risks unrelated to legal malpractice, such as loss of a key employee, wrongful termination, loss of license or loss of electronic information. Captives established under IRC 831(b) are often referred to as wealth captives.

Captives can be formed in 39 states or in a foreign jurisdiction, depending on the needs and concerns of the captive shareholders. A business owner in California can form a captive outside the state of California and retain all of the benefits irrespective of the domiciled jurisdiction. Captives domiciled outside the United States must file a U.S. federal corporate tax return and pay yearly corporate income taxes on any taxable gains regardless of where they are domiciled.

### **REDUCING RISK**

Physicians are a group of business-owner clients who could benefit from captives. In many areas of the country, the cost of medical malpractice insurance has spiraled out of control. In states like Florida, malpractice premiums for certain specialties have become unaffordable, forcing physicians to eliminate specific high-risk procedures from their practice or move out of the area and establish a practice in a more physician-friendly state. And due to higher malpractice costs, physicians are electing to forgo coverage.

To provide relief for healthcare providers, many states capped medical malpractice judgments for pain and suffering, hoping to help reduce runaway malpractice premiums. This has had little impact on overall malpractice costs, however.

Establishing a captive allows physician groups to underwrite medical malpractice insurance for shareholders or other doctors and achieve two strategic goals: control the quality of coverage and monitor the expenses and claims-paying process. Malpractice attorneys are familiar with the process and know that it's often better for an insurance company to settle a case rather than risk a substantial jury judgment. The decision to settle is often out of the control of the practicing physicians, but they suffer the damages to their reputations, increased premiums, and even loss of privileges and license.

Captives put physicians in full control of their coverage, letting them respond to claims, hire attorneys and agree to settle or pursue legal action to fight claims. And if the claims are effectively managed during the life of the captive, the insurance reserves inside it can be paid out to the physicians upon retirement (or sooner).

Commercial insurance is typically priced at a 50% loss ratio, meaning that only 50 cents of every dollar in premiums is expected to be paid out in claims. The insurance company uses the other 50% for overhead and profit.

Captives may allow business owners to retain a portion of their premiums. For example, a group of physicians can form a captive and pay \$1 million in total malpractice premiums to the captive. If the group has average claims, members can keep the extra

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\$500,000 per year inside their captive, and as they retire they can cash out their stock in the captive-a lofty \$5 million after just 10 years, not counting investment income.

In order to protect against catastrophic claims, physicians can obtain reinsurance to limit excess exposure per claim. In addition, physicians have a better feel for who should be allowed to participate in their captive. If a group of physicians come together, form a captive and manage the risk exposure by limiting the group to physicians with a small number of past claims, their future claims exposure could be much lower than that of a large group of physicians.

## **SAVING ON TAXES**

Captives also provide tax benefits to businesses and high-income business owners. The IRS provides favorable tax treatment for insurance companies in part to encourage them to provide adequate business and liability risk management protection. Regardless of business structure, small and midsize companies that pay premiums of up to \$1.2 million per year for certain business insurance can take current premium deductions. The premiums received by the captive aren't subject to current taxes, since such premiums are necessary to cover current actuarial losses. The insurance captive is taxed annually on taxable investment gains. Captive directors and owners must know tax-efficient investment management techniques to minimize corporate income taxes.

Owners of captives should follow proper insurance guidelines for premiums to be reasonable and customary. Due to the costs of establishing, capitalizing and operating a captive, significant due diligence should be performed before moving forward. Ongoing costs of operating a captive may become a barrier in the future for many business owners, so it's critical for them to evaluate the effectiveness, tax savings and risk management benefits.

But for the right owners, establishing a captive can be one of the best financial decisions they make. For instance, a business owner paying \$1 million in premiums to a captive will receive a business deduction for the insurance payment, but the captive won't pay tax on the payment, nor will the shareholders of the business or the captive pick up additional current taxable income. This may result in a \$400,000 or greater income tax savings each year of premium payments.

Most business owners unknowingly self-insure a tremendous amount of business risks, including malpractice deductibles, professional liability, employment practices, accounts receivable, administrative actions (such as Medicare or HIPAA), disability, loss of business license or professional license and business interruption. Self insurance without a captive is not tax deductible. However, with a properly structured captive, insurance can create substantial tax deductions, resulting in significant tax savings.

## **TRANSFERRING WEALTH**

In addition to managing risk and reducing income taxes, captives can be effective for wealth transfer. Captives are established as C corporations that can be owned by multiple individuals or entities. Ownership can be split between business owners, key employees, children, grandchildren, family partnerships, limited liability companies or estate trusts.

As the captive receives premiums, excess value accumulated in the captive above costs and claims may be distributed at death, liquidation or sale of the captive outside the estate and not subject to gift tax. Life insurance can also be purchased, with insurance reserves further enhancing the estate benefits for liquidity and tax elimination on insurance reserves.

There are a number of exit strategies for captives during distribution phases of life cycle planning, such as dividends, loans, salaries, stock sales or even wind-downs of the captive itself. These can easily be accomplished in a matter of months at favorable tax rates.

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## **ASSET PROTECTION**

Captives are one of the best-if not the very best-asset protection tools available to business owners. Assets in a captive are not reachable by creditors and attorneys, and they are only available to pay valid claims-those approved by the claims department of the captive company.

A captive also lets its owners use specifically tailored and customized policies that are often too expensive or unavailable through larger commercial carriers. For example, many physicians would like a malpractice policy that pays legal fees, lets them chose an attorney, reimburses for out-of-pocket expenses and time off from the practice in support of the legal action brought against them, but couldn't be used to pay creditors or claimants, so the physician doesn't appear to have deep pockets. Most large insurers don't provide this type of policy.

Typically, when a physician invests in mutual funds or real estate, the assets stay in his or her name, or in the name of the practice, leaving assets available to lawsuit claimants, creditors, divorce settlements or bankruptcy trustees. Using a captive, though, a physician's captive shareholders can direct the investment of captive reserves into such funds and investments. Any lawsuit, claim, divorce, tax or other action against physicians or their practices is entirely separate from the captive, meaning the funds in the captive are fully protected against any litigation risks.

## **MAKING IT WORK**

A business owner with 50-plus employees, current insurance premiums for business coverage exceeding \$250,000 per year, risks that are uninsured or self-insured, net business income of \$1 million per year or gross business revenue exceeding \$20 million may want to explore how a captive can improve risk management, reduce taxes, protect assets, transfer wealth and further diversify net worth. Even if their premiums are not as large, smaller businesses or groups of individuals with like businesses can combine to form captives to cover the hidden risks of operating a business, reduce the inherent risks caused by these litigious times and receive the benefits of owning an insurance company.

But remember, captives are specialized risk and business management tools that require special management expertise. Experts in the field must properly create and maintain the structure, or the insurance, asset protection and tax benefits may be jeopardized or lost.

Regardless of the tax benefits, the primary objective in establishing a captive is risk management. The strategy is to protect the business and shareholders from real and future liability exposure that could cripple or destroy the ongoing viability of the business.

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