RMC CONSULTANTS
791 10th St. South, Suite #202 | Naples, FL 34102
main: 239.298.8210 | toll free: 888.599.5553 | fax: 239.298.8211

Captive Insurance

Executive Summary

THE CONCEPT

Captive insurance was developed to address the inherent risks of business operation, while providing business owners with additional and substantial benefits beyond those available through the purchase of traditional commercial insurance. A captive insurance company ("captive") is essentially an "in-house" insurance company created for the primary purpose of insuring the risks of its parent and/or affiliated companies. Establishment of a captive allows the parent company to take control of its insurance needs by insuring meaningful risks for which coverage may not be available in the commercial insurance market. Often this can be accomplished at a reduced cost to the parent company. Because the captive and the parent company share the same owner, the captive structure offers the potential to act as an additional profit center. A captive that is properly established and managed also offers favorable tax considerations to the parent company, increasing the captive's value as a wealth preservation and transfer tool.

Captive insurance is a proven strategy for risk management that large corporations have employed for years. Many Fortune 500 companies and industry groups have developed their own captives, and several well-known insurance companies got their start as captives. Captive insurance is becoming an increasingly practical alternative for small to mid-size business owners. RMC's captive insurance consulting services are designed to guide business owners through the process of establishing and managing a captive from start to finish.

BENEFITS OF CAPTIVE INSURANCE

Filling the Gaps

The first key advantage of implementing a captive insurance strategy is that the captive can provide coverage as a replacement and/or supplement to the insurance available in the commercial market. Where commercial insurance policies may lack or limit coverage of industry-related or otherwise specialized risks, the captive can provide specific coverage at the direction of its parent company. This can bring peace of mind to the business owner who's unique and specialized risks may be inadequately covered. Captives can also be used to fill the accepted gaps that come along with commercial insurance policies such as significant deductible payments, exclusions, and claims that exceed maximum policy limits in the case of catastrophic loss.

Risk Transfer

Traditional commercial insurance policies do not always offer adequate protection due to the gaps and limits mentioned above. The captive insurance company is designed to take on these outstanding risks, protecting the parent company from serious loss due to claims and changing insurance costs. Removing the burden of self-insuring against these risks allows the parent company to concentrate resources on its own productivity.

Cost Efficiency

Captive insurance can provide more cost-effective coverage than commercial insurance. Reduced costs, access to the reinsurance market, and the shared parent-captive ownership structure all contribute to the captive's ability to provide greater protection for the premium dollar.

The captive strategy can reduce both the costs of insurance premiums paid by the parent company and claims paid by the captive. These reductions are achieved through the parent company's ability to accurately predict the type, magnitude and frequency of its claims. This information allows the captive to develop a premium rate and reserve structure that reflects the risk exposure of the parent company.

Because coverage is tailored to the needs of the parent company, the captive will have fewer overhead expenses (i.e. underwriting expenses, maintenance of reserves, etc.) than a commercial insurance carrier. Reduced costs are passed on to the parent company in the form of lower premiums.

Reinsurance can be thought of as insurance for insurance companies, and is generally not available to the general public. Due to the nature of a reinsurance agreement between multiple insurance companies, coverage can be secured at a lower cost than through traditional commercial policies. A properly structured and maintained captive can obtain reinsurance coverage and provide reinsurance to other insurance companies. Access to this new channel may also improve the parent company's negotiating position with insurance companies holding traditional commercial policies on the parent.

Because the parent and captive company share the same owner, when premium dollars pass from the parent to the captive, their value is retained by the owner.

Profitability

Captives offer the potential to generate increased profit in several ways, none of which are available through the commercial insurance market. The parent-captive ownership structure creates an incentive to implement risk mitigation techniques that will reduce claims by the parent. Premiums received by the captive will remain in the reserve and grow until required to pay the parent's claims. A captive operating with few claims and appropriate reserve allocations can generate profit for the owner. Captives have the potential to provide additional coverage to third parties, directly or through reinsurance agreements, which may generate further profit.

Estate Planning and Asset Protection

In addition to providing many current benefits to the parent company and owner, the captive can also function as a valuable estate planning and asset protection tool. By placing captive ownership with the business owner's children or grandchildren, the assets accumulated in the company can be transferred from generation to generation. Gift taxes are minimal because the majority of assets held by the company come from premium payments, which are ordinary business expenses and not gifts. The initial capitalization costs are the only assets of the captive that are considered gifts when ownership is transferred. Further, in a properly structured captive arrangement, assets of the captive cannot be accessed by creditors of the parent company or owner.

TAX CONSIDERATIONS

Because insurance companies are governed under a different set of federal income tax guidelines than normal operating companies, it is imperative that the captive be structured and maintained correctly to avoid penalties and maximize benefits. The rules governing the determination of premium payment and income as "insurance" for federal income tax purposes are complicated. RMC will ensure that captives are properly structured and operate in compliance with the IRS Code and applicable tax laws.

Premium Deductibility

The ability to deduct operating expenses and ordinary expenses from the parent company's bottom line is essential. Insurance premium payments are considered ordinary and necessary expenses and may be deducted from the parent's taxable income.

Establishment and Administration

Once the owner agrees to proceed, RMC will begin the process of establishing the captive as a viable independent insurance company. Applications for insurance licensure will be prepared and submitted to regulatory authorities for review. Insurance coverages will be defined and premiums will be actuarially determined. Insurance risks will be underwritten, and insurance contracts will be designed and submitted to regulatory authorities. Investments will be made at the direction of the owner. Reinsurance will be obtained where necessary. RMC will administer insurance policies and collect premiums on behalf of the captive.

On an annual basis, RMC will review the captive to ensure that its operation maintains compliance with IRS and domicile regulations. RMC will make administrative adjustments to maintain compliance as necessary and to meet the owner's business goals, where appropriate. Captive administrators, actuaries, and accountants will coordinate review of the captive's reserves to determine when dividend payments from the captive to its owner are appropriate. RMC will remain available throughout the life of the captive to provide consultation services as they are required.

Income Deferral

Captive insurance offers an additional advantage through the deferral of premium income recognition. Reserves maintained by the captive for payment of future claims can legally offset premium income. Only income in excess of the reserves is taxable. Generally, a parent company that self-insures by maintaining its own reserve would not be eligible for this income deferral.

Election of 831(b) Tax Exemption

An insurance company receiving less than $1.2 million in annual premiums may elect to be taxed based on investment income only. This election does not affect the deductibility of premiums paid by the parent company. The net effect is an annual transfer of up to $1.2 million in deductible premiums from the parent company, which is received on an income tax-free basis by the captive.

IRS Compliance

The IRS is aware of the significant tax benefits, and therefore potential abuses, that captive insurance presents. The IRS will challenge captive insurance arrangements that attempt to provide deductions or deferrals without providing insurance as it is defined for federal tax purposes. Potential clients may seek IRS Private Letter Rulings to ensure that a captive will provide the desired coverage and tax benefits.

CAPTIVE IMPLEMENTATION AND ADMINISTRATION

Feasibility Study

The first step toward implementing a captive insurance arrangement is to conduct a feasibility study. This study identifies and quantifies the risk exposure of the parent company. Alternative mechanisms for risk management are also explored. RMC's actuaries and consultants work closely with the owner to ensure that business goals, insurance needs, legal issues, and income tax considerations are represented as accurately as possible. A pro forma analysis is prepared to illustrate the annual effects of captive implementation compared with alternative risk management strategies. In most cases, the captive can provide significant advantages to the owner.

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