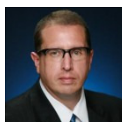

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Ten Favorite Things About Captive Insurance Companies

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A couple of weeks ago, I wrote an article on my 10 pet peeves regarding captive insurance companies, entitled *Tax Shelters, Nebraska Hurricanes And Other Captive Insurance Mistakes*

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(http://www.forbes.com/sites/jayadkisson/2013/07/28/captive-insurance-companies-10-pet-peeves/). Following that article (http://www.forbes.com/sites/jayadkisson/2013/07/28/captive-insurance-companies-10-pet-peeves/), quite a few folks e-mailed me requesting that I write an article on my 10 favorite things about captives. So, for those folks and anybody else who might be interested, here you go:

10. Create A Giant War Chest For The Business

Like any insurance company, captives tend to accumulate a considerable amount of assets in reserves and surplus. While these assets back the policies issued by the insurance company, a portion of those assets may be available to the business owner in a worst-case scenario where the business owner needs the funds to overt a larger catastrophe.

While there may be significant tax ramifications to "cashing out the captive" to meet some emergency not covered by a policy, at least the business owner has the option of so doing, and can weigh the cost/benefit analysis at the time. Certainly, getting money out of a captive is easier and more expedient than obtaining a business loan from a bank in a time when the business is in deep distress.

During the 2008 crash, I had some clients do exactly that — and while they lost their captives, they were able to use the money to save their businesses. While one who is setting up a captive certainly hopes their business never will have such a need, it is nice to know that safety net is there.

9. Retain Key Employees

Occasionally, business owners will award a key employee or two by giving them equity in the captive as part of an overall strategy to retain those employees for the benefit of the business. Giving key employees stock in the captive is sometimes less messy and troublesome than given them equity in the business itself, and can avoid the animosity that can sometimes with other employees who are not given a stake in the business.

While this is rare (I've only seen owners do it a few times), on those occasion it worked swimmingly. While ownership in the operating business is difficult to conceal, particularly for businesses with significant accounting staffs, often nobody in the business except for the owners know what is going on with the captive, and there is much greater flexibility for such arrangements there.

8. Asset Protection

A collateral benefit to a captive is that each dollar paid by the operating business to the captive thereby reduces the assets of the operating business by that same dollar. Thus, if something goes dreadfully wrong for the business, those dollars are no longer available to creditors of the business.

Indeed, captive insurance must rank as one of the best business asset protection strategies ever created. Note that it would be very difficult for creditors of a business to prove that payments to a captive for bona fide insurance coverage would be a fraudulent transfer, since the business received back a substantial economic benefit in the insurance coverage from the captive.

7. Cover Risks Otherwise Exposed

Businesses are often forced to effectively self-insure risks (whether they realize it or not) because either the risk is so unusual that insurance cannot be purchased for it at any price, or because the insurance to cover the risk is exorbitantly expensive. These are ideal risks to be covered by a captive, and indeed this is one of the primary purposes of captive insurance.

Moreover, even where a business has insurance against certain types of risks, the business will still be exposed to deductibles and exclusions. While in the past, general liability insurance (known in the industry as "GL") covered a very broad range of risks, typical modern exclusion give it more holes than Swiss cheese. These days, the typical GL policy may have exclusions for things like employment practices liability, which expose the business to claims of sexual harassment, age discrimination, wage & hourly claims, and the like. The insurance provided by captives can fill these gaps.

6. Draft Your Own Policies

Captives can (and should) draft carefully custom-tailored policies to fit the exact needs of the business. This not only means covering areas of exposure and eliminating exclusions, etc., but the policy can also be drafted in ways that make it nearly impossible for a third-party claimant against the business to assert a claim directly against the policy (unlike most commercial policies).

Because policies can be custom-tailored, they can be much more efficient. With commercial policies, a business might be stuck with $2 million in coverage of some risk, even though as to that particular risk, the business might only need a more precisely-calculated $1.45 million in coverage — so the business need not pay for what it doesn't need, and instead allot those same premium dollars to other risks for which the business is exposed.

5. Choose Your Own Counsel

When you buy insurance from a commercial carrier, typically they retain the right to hire an attorney for you. Theoretically, the attorney that your insurance company hires will be your attorney and only look out for your interests even to the detriment of the insurance company — but will they really be?

Insurance defense counsel may be assigned 200 cases from a particular insurance company in a year, only one of which is yours. Now who do you think they will really owe their loyalty to? Plus, insurance companies are notoriously cheap when it comes to hiring counsel — you may get somebody whose primary qualification to handle your defense was that they bid lower than any other insurance defense attorney for the work.

My advice has long been that if you are ever sued and your insurance company appoints counsel for you, get your own counsel (sometimes known as "cumis counsel") to ride herd on your insurance company's lawyers, i.e., make sure that they competently represent your interests first and foremost, and if possible settle the claim within policy limits.

With a captive, a business doesn't have these problems at all. Since the business owners control the captive, they can select the counsel of their choice to handle particular claims. They have the option of not going for the cheapest insurance defense counsel, but the best. Or, on the flipside, they can retain a good insurance defense attorney to handle most matters at a discount. All this usually has the effect of a better defense at a lower cost to the business.

4. Administer Claims On Your Own Terms

A problem with commercial carriers is that they can allow a small claim to fester, either by not taking care of the claim early or by allowing it to drag on without resolution. Or, the insurance company may settle a frivolous claim just to save defense costs, thus encouraging more such frivolous claims against the business.

With a captive, the business owners can administer their own claims on their own terms, and get on top of claims quickly before they spin into something much larger. The business owner can also choose to not settle frivolous claims, force the plaintiff's attorney to incur time and expense litigating the claim before dismissal, and thus deter future lawsuits.

A captive's ability to draft its own policies, choose its own attorneys, and administer its own claims are all important cost-saving benefits of a captive — which now brings us to the biggest money-saver of a captive of all . . .

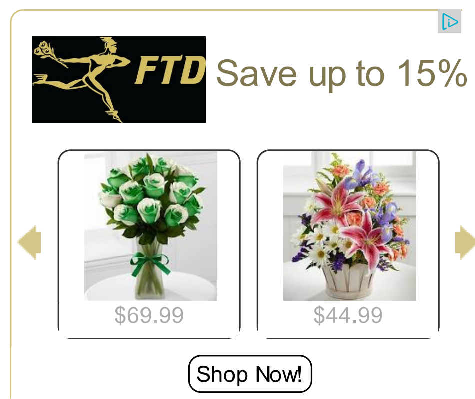
3. Save Money On Insurance

The primary purpose of a captive is to save money on insurance, and in this captives have no equal. There are three main aspects to this:

First, by underwriting the insurance needs of the business, the captive can capture and retain the underwriting profits that would ordinarily be lost to the commercial carrier. Additionally, considering that commercial carriers have enormous costs that must be priced into their policies, such as the expense of compensating agents, marketing and advertising expenses, high executive compensation, etc., there is a great deal of "fluff" having nothing to do with true risk in commercial policies, that can be saved through the use of a captive.

Second, even where the business decides to keep commercial insurance in place against particular risks, the captive can be used to reduce costs by any of raising deductibles, lowering coverage limits, or increasing exclusions — the idea being for the business to find the "sweet spot" where the commercial insurance is most economical, and then use the captive to insure around that area. Since the greatest expense of most insurance policies is the "first dollar" expense, simply increasing deductibles can result in dramatic premium decreases with commercial policies.

Third, the mere existence of the captive and its ability to underwrite risks can save money even if the captive is never used for that purpose at all. This is because the insurance broker knows that if the premium prices offered to the operating business for insurance are not efficient, the operating business may decide to cover them in the captive instead — and once that particular book of business is lost, it may be forever lost to the broker. Thus, the fact of the captive can be used to significantly barter down the commercial carrier into offering insurance to the operating business at rock-bottom prices.



The combination of all three of these factors can result in very substantial savings to the business enterprise, but the benefits of a captive can extend well beyond the immediate savings of insurance bucks, which brings me to . . . .

2. Forces The Business To Focus On Risk Management

When a business is buying insurance from a commercial carrier, the concept of claims is only loosely attached to the economic cost to the business in terms of increased premiums. But when claims are being paid from a captive — effectively, from the business owner's pocket — the focus on claims can become pretty intense, and thus the business becomes focused (often for the first time) on enterprise risk management.

The benefits of enterprise risk management, while sometimes hard to exactly

quantify, are enormous. The focus shifts to analyzing the business so as to spot potential risks. Claims are thus prevented instead of administered. In the end, the business owner gains a better understanding of the business and its limitations, and that is priceless.

And now on to my favorite reason to form a captive . . . .

1. Create A New Business

Many business owners who form captives think of it for what it does, but they don't realize that they have just created a new business — an insurance company — and cast themselves into the business of insurance. The captive thus acts not just as an enterprise risk management too, but also to segue into a whole new business opportunity.

An existing captive with sufficient capital can be converted to a full insurance company that offers insurance to the general public by changing its license and business plan, and meeting certain other state requirements. Indeed, some major insurance companies have grown out of captives.

The business of insurance can be a great business, and not just a few business owners find insurance an even better business than the successful business they are already in. I've had more than a dozen clients go from their captive being just another affiliate in their overall business organization, to running an insurance company and conducting the business of insurance as their primary business.

A Final Note

Note that I haven't mentioned tax savings as one of my favorite benefits of captives. While captives can offer certain tax advantages to business owners, my tendency is to view a proposed captive arrangement as tax-neutral and make sure that it works without any regard to any tax benefits. This is because to the extent that a captive offers tax benefits, that is the icing on the cake — the cake is the numerous other non-tax advantages of captives.

And this cake is pretty good even without the icing.

This article at http://onforb.es/139w7BX (http://onforb.es/139w7BX) and http://goo.gl/tK3kMP (http://goo.gl/tK3kMP)

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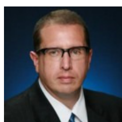

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Tax Shelters, Nebraska Hurricanes And Other Captive Insurance Mistakes

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A captive insurance company (commonly referred to in short as a “captive”) is an insurance subsidiary that is set up by the parent company, to underwrite the insurance needs of the other subsidiaries. For example, British Petroleum wisely set up a captive insurance company (Jupiter Insurance Ltd. (http://www.businessinsurance.com/article/20100509/ISSUE01/305099971)) to provide environmental insurance to its operating units, and the moneys from its captive were used to fund in substantial part the Gulf cleanup.

As the current Chair of the American Bar Association’s Committee on Captive Insurance (https://apps.americanbar.org/dch/committee.cfm?com=CL127000), somebody who used to own a captive insurance

management company (a/k/a "captive manager"), an author of a book on captives, a litigator of issues involving captives and reinsurance, and someone who has been involved in the formation of well over 100 such companies since 1998, I've seen quite a bit in my career — mostly misconceptions about what captive insurance companies are and how they are supposed to function. What follows are my 10 pet peeves.

The vast majority of Fortune 500 companies now have captive subsidiaries (and many companies have several captives, including those for employee benefits), and captives are now also routinely used by small companies for the same purpose. Over 30 states now have captive-enabling legislation, most recently Texas and North Carolina, in addition to states such as Vermont, Utah, Nevada, Kentucky, Missouri, Delaware, etc., which are very active in marketing their states as premier jurisdictions for the formation of captives.

A captive can be a wonderful risk management tool when used correctly — but therein lies the rub, many are not. So, in reverse order, here are my 10 pet peeves:

10. Bogus Risk Pools

A lot of businesses with valid needs for insurance don't have enough subsidiaries to pass what is known as the "multiple insured" test for risk distribution, and so therefore they instead participate in what is known as a "risk pool" so as to obtain risk-distribution.

In a nutshell, a "risk pool" is an insurance arrangement involving multiple, usually unrelated captive owners who share certain risks through their individual captives. Risk pools are usually set up by captive managers to facilitate the needs of certain of their captive clients. In various guidance, the IRS has validated the concept of the risk pool when run correctly.

The problem is the "when run correctly" part. The problem with most pools is that there is in fact very little sharing of risks, and thus the large premiums being charged by the pool are neither actuarially sound nor bear anything but a coincidental relationship to reality. Many of these pools have operated for years with few or no claims, which calls into serious question whether the large premiums they charge were realistic (the answer is they were not).

By like token, if there is true risk sharing in a pool that means that the participants are subject to loss — including the total loss of their premiums paid by their operating businesses into the pool. This is where the wink-wink, nod-nod of "That will never happen, actually you'll never lose anything significant" usually shows up, which is just another way of saying the risk pool is just a vehicle to facilitate the appearance of risk-shifting, i.e., tax fraud.

While the saying around my office is, "Pools are for fools!", the truth is that some clients (including some of mine) cannot meet the test for risk distribution in any other way and so therefore make an informed business

decision to participate in a risk pool. However, for these clients my advice is usually: Do whatever reorganization of your business is necessary to get out of the risk pool as quickly as you can. If a client is still in a risk pool after a few years just because they need the risk-distribution for tax purposes, there has been a serious failure in business planning by someone.

9. Failure To Make Feasibility Study

Before the decision to form the captive is even made, a feasibility study should be conducted that looks at all aspects of the captive and validates its viability and economics, as well that the captive will meet critical tests for risk-shifting and risk-distribution, etc.

If for no other reason, a feasibility study that carefully documents the non-tax purposes of the captive (to distinguish it from a tax shelter masquerading as a captive) should be done since the IRS on audits of captives routinely asks for such documents as part of its evaluation. A good captive feasibility study will go a long way in showing the IRS that the captive is founded on solid business economics and does not exist merely to try to save some bucks in taxes.

8. Ignoring State Tax Issues

There is a misconception that if the underlying business is doing business in State A, and the captive is formed in State B, then by virtue of that alone, State A cannot tax the captive.

Not true. Actually, whether State A can tax the captive depends on a variety of factors. If business decisions regarding the captive are made in State A, for example (probably the most common way to blow this), then State A can probably tax the captive.

Captive owners must be very careful to not let the captive “touch” State A in any way, unless of course the captive is formed in State A (and then it doesn’t matter, which is often the easiest and most sensible approach). This is usually accomplished by using a captive management firm (“captive manager”) to perform all the functions of the captive in State B, but just having a captive manager in State B isn’t enough — diligence is required not to blow this.

7. Single-Line Myopia

Too often, captives are formed to underwrite just one single risk of the organization, without looking at the myriad other risks of the enterprise. This happens the most when the captive is promoted by an insurance broker who is just focusing on helping the client with that one line of business, usually workers compensation, and it misses a lot of benefits for the client.

In a sense, a captive is a lot like a casino — the more games in a casino, the better the risk distribution of the casino, and the same is true with a captive having different types of policies: there is more risk distribution. Also, since

the costs of a captive are often fixed or not dependent on how much insurance the captive underwrites, the more insurance that it underwrites the better the economics of the captive. Which is to say that captives are usually the most efficient when they are underwriting all possible lines of coverage for the organization, not just one singular line.

Often, when a captive is being evaluated only for a single line, the conclusion is reached that the captive will not be economical as to that single line only, when it might be very economical if it takes on other risks. It is difficult to understand why those involved with captives would not look to all the possible coverages the captive might underwrite for a particular client, but such myopia occurs very frequently — frankly, I think there is a lot of "If I don't sell it, I'm not going to worry about it" going on with the insurance brokers, but that attitude doesn't serve their clients well. Good insurance brokers who assist their clients with captives will look at the entirety of the clients' entire books of insurance business, as well as where the clients have chosen not to purchase third-party insurance because it is too costly.

Caution, however, that the IRS now apparently tests for "line-item homogeneity", meaning that it takes the position that each line of coverage must meet the tests for risk distribution separately, i.e., without regard to other lines of coverage being underwritten by the captive. Not just a few captive tax professionals believe the IRS is just flat wrong on that point and will lose a challenge on appeal to a U.S. Court of Appeals, but who wants that fight?

6. Poorly-Drafted Policies

The policies underwritten by a captive should not be substantially different in their form than policies underwritten by any other insurance company. A good captive manager will use modified standard industry forms to draft policies. By contrast, bad captive managers will draft simpleton policies that often omit key insurance contract terms or else unnecessarily expose the captive to lawsuits by third-party claimants.

There is a reason why there is so much boilerplate in typical insurance contracts — it works. But also, one of the biggest benefits to a client is the ability to custom-tailor coverage to more closely fit their needs, by modifying the standard industry forms. Way too many captive managers just slap out some basic policies and call it a day; what a shame for their clients to lose a wonderful opportunity.

5. Bogus Insurance Contracts

I've actually sat in on meetings where some other advisor has told their prospective client something to the effect that, "You'll pay premiums, but you don't have to make claims!" (wink, wink, nod, nod). Then, I've had to inform the client that, "If you don't make and pay valid claims under the policies, then you don't have a captive, but instead you just have a tax fraud."

The U.S. Supreme Court has defined "insurance" as including an "insurance contract". If there is no valid, binding contract, which is fully honored between the captive and the operating subsidiaries, then there is no insurance. What you have then is just a sham.

See my article, Foster & Dunhill Scheme Ends In Denial Of Deductions And Indictments For Bogus Insurance Tax Shelter (http://www.forbes.com/sites/jayadkisson/2013/06/23/foster-dunhill-scheme-ends-in-denial-of-deductions-and-indictments-for-bogus-insurance-tax-shelter/), which ended in the taxpayers being hit with significant penalties and the promoters indicted, based largely on the practice of not paying valid claims as they came due.

4. Inadequate Capital

About once a month, somebody will call me to inquire about a captive, and say that they have already decided to put the captive in X jurisdiction. When I ask why, they say that it is because X jurisdiction only requires $25,000 in capital or some other small number.

The problem here is that while a small amount of capital may be all that is required by local regulatory law, the minimum capital requirements of a captive for tax purposes is usually much higher, and must be set by an actuary. It is very rare that a captive will take in more than 5 times the amount of its capital in the first year, and more than 3 times the amount of capital in succeeding years.

3. Highly Questionable Risks

Particularly with captives that are really just disguised tax shelters, a big problem is that their policies reflect the underwriting of longshot risks. Like, really longshot, as in 10,000,000,000 to 1 an-asteroid-is-likely-to-hit-the-Earth-first longshots. Think, hurricane insurance for a business whose operations are in Lincoln, Nebraska, or terrorism insurance for a business in Little Rock, Arkansas.

Okay, maybe it is possible that a really huge hurricane could make its way to Lincoln, or Al Queda some day decides to take out a firm in Little Rock, but what is the real risk of that happening? And even if one could say with a straight fact that it *might* happen, what is the correct amount of premiums for such a policy? $1 per $100,000,000 in coverage? Well, it is sure not $500,000 for $2,000,000 in coverage, which is how the promoters of sham captives will often write it.

Where a captive is formed as a tax shelter, sometimes the risk that are underwritten are already covered by insurance, such as where a doctor sets up a captive for tax reasons and tries to underwrite her malpractice liability risks

— but then keeps her existing malpractice in policy in place so that there is in actuality nothing being covered by the policy (since she doesn't want her captive to actually have to pay a claim!).

Which brings me to . .

2. Premiums Not Bearing Any Relationship To Reality

There is an old joke in the captive insurance world, which is that "you don't go to the bathroom without first getting an actuary to sign off on it". That is not too far from the truth. Premiums must be set by a qualified actuary, or else they are probably not defensible in tax court. Unfortunately, what happens to often is that a tax attorney and the insurance manager get with the client, and say, "How much do you want to save in taxes?" then they pull some premium numbers out of the sky to get the client to where they want to be.

Sorry, but it doesn't work that way. The premiums of a captive have to be determined like any other insurance company setting the premiums as part of an arm's length transaction would do, which is by, among many other things, assessing the true risks of the operating subsidiaries, their needs for the particular insurance, and the minimum and maximum coverage required.

Going back to the Hurricane Insurance for the business in Lincoln or the Terrorism Insurance for the company in Little Rock, what is the correct amount of premiums? It is going to be really low, as in dig-the-loose-change-out-of-your-couch low. It is not going to be $500,000 or even $100,000, yet such goofy premium calculations are common with captives that are really just tax shelters.

Note that having an actuary sign off on premium calculations is not always going to save you, as those premiums have to be reasonable too. Just like there are real estate appraisers out there whose first question is, "What number do you want?", there are "whore actuaries" out there who will give you either a $1 or $10,000,000 premium number for the exact same policy and risk. But remember: If it is not reasonable, it will not survive a challenge no matter how lengthy the actuary's credentials.

If somebody is trying to sell you a captive, and asks, "How much to you want to save in taxes? **Run.** Which brings me to my #1 pet peeve . . .

1. Captive Insurance Companies Sold As Tax Shelters

The primary use of a captive must be for bona fide risk management purposes, and not to save taxes. Unfortunately, many of the same promoters of tax shelters who a few years ago were selling Son of Boss, CARDS, BLIPS, and other flavor-of-the-day tax shelters, are now selling captives as a way to save taxes, with only the barest lip-service being paid to the risk management function.

Hale Stewart, an author of a book on captive insurance company taxation, told me recently, "Captives sold as a tax mitigation tool and not as a bona fide risk reduction, are not really captives at all. But I keep running into them." So do I, mostly (but not all) so-called 831(b) captive insurance companies, i.e., captives that have made an election to be taxed as a small insurance company under IRS code section 831(b). *While the vast majority of 831(b) captives are quite legitimate*, there is still probably much more abuse going on with these companies than with non-831(b) companies.

These "tax shelter captives" captives usually suffer from significant flaws, including inadequate capital, grossly overpriced premiums, insuring non-existent risks, lack of true risk distribution, or as a scheme to buy life insurance with pre-tax dollars. It is probably only a matter of time before these companies, and their owners, come to grief on any number of theories the IRS could assert.

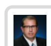
How to avoid getting burned with a bad captive arrangement

Like any other complex legal and financial structure, the money that one spends on a *second opinion* from truly independent counsel will be some of the best money they will ever spend. In this context, "truly independent" means somebody that a client finds themselves and is not related to or recommended by whoever is pitching them the captive.

Frankly, a lot of people in the captive world have gotten away for years with some really bad practices only because the IRS has not spent much time or effort looking in to the practices of captive insurance companies, but as the captive market has dramatically expanded it is unrealistic to think that the IRS's lack of attention will last much longer.

So, either do a captive right, or don't do it at all.

This article at http://onforb.es/17NR17O (http://onforb.es/17NR17O) and http://goo.gl/nlu7sfNYSN (http://goo.gl/nlu7sf)

 2 comments, 1 called-out Comment Now Follow Comments

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