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An Insurer of One's Own? It's Possible, With Caveats



Chang W. Lee/The New York Times

Ken Sturm, who owns several restaurants and nightclubs, said he became interested in having a captive insurance company when his traditional insurance policy did not cover a claim.

By PAUL SULLIVAN
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EVERY so often I come across a financial strategy that sounds too good to be true. That was how I felt when I heard about the increased use of captive [insurance](#) companies by entrepreneurs and small-business owners.

Wealth Matters

Paul Sullivan writes about strategies that the wealthy use to manage their money and their overall well-being.



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A captive insurance company is essentially a private insurer that is a wholly owned subsidiary of another company. These captives, as

they are called, accept the premiums that the company would have paid to a regular insurer and then cover any claims against the parent company. If the claims are less than the premium, the captive has made a profit, just as a regular insurance company would. The difference is that the company that set it up benefits, not the insurer.

Fortune 500 companies and large nonprofit organizations, like hospitals and medical schools, [have used captives for decades](#) to self-insure against predictable risks, like workers' compensation or malpractice claims. (The New York Times Company has a captive insurance company called Midtown Insurance Company.)

But in 2002, the [Internal Revenue Service](#) issued guidance on how to set up captives to comply with the tax code, and that gave way to a rush to form them, said Jay Adkisson, chairman of the American Bar

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Association's committee on captive insurance companies and a former owner of such a company in the British Virgin Islands.

"Today it's hard to find a major company or university that doesn't have one," he said.

Now [financial advisers](#) are increasingly pitching captives to smaller businesses, including physicians' groups, restaurant owners and companies that want to cut the costs of [health insurance](#) for their employees. They are being portrayed as a way not only to save money on insurance premiums but also to reduce income taxes and transfer money to heirs free of [estate tax](#).

But the rush to set up captives could lead to problems for the business owners and for people filing claims against them.

INSURANCE PURPOSE From the point of view of the companies that set up these entities, captive insurance companies make perfect sense.

If a business paid a premium of \$1 million to a regular insurer and had only \$600,000 in claims, it would lose \$400,000. If, however, it put the same amount of money into a captive, it would keep the extra \$400,000 in the captive. This amount would then increase over the years.

Of course, that company could end up having \$2 million in claims the first year. It would have to have a reinsurance policy to cover the claims, or pay them out of its reserves.

Mr. Adkisson said a captive could be seen like any other subsidiary. "A guy who owns a car lot can buy a carwash and wash his own cars," he said.

So when should a small-business owner think about setting up a captive?

Jeremy Huish, director of business development at Artex Risk Solutions, which administers captive insurance companies, said risk management should be the motivation.

"You need to have enough risk to justify the captive," he said. "If you take a doctor group and they cut people open for a living, they're going to have more risk than an accounting firm."

Jeff Kurz, president of Red Hook Risk Services, a consultancy to hospitals, nursing homes and groups of doctors looking to set up captives, said such an arrangement could generally be worth considering for businesses with more than \$750,000 in taxable income and more than \$1 million in insurance premiums.

But he said it was important to pay attention to risk. "A huge misnomer is I'm going to start a captive and save a lot of money next year," he said. "You might not set aside enough money to pay for the claims down the road."

Ken Sturm, who owns several restaurants and nightclubs, including P. J. Clarke's and Iridium Jazz Club in New York, said he became interested in having a captive insurance company when his traditional insurance policy did not cover a claim. Several years ago, one of his restaurants in Times Square was closed for three days because of work



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in the neighborhood, but his policy had a waiting period of 96 hours before the insurance covered any losses.

The captive he set up covers such losses. “I can write specific policies that go above and beyond my typical commercial liability coverage,” Mr. Sturm said. “Business interruption coverage. Data breach. Legal fees. You can do deductibles.”

He said he paid \$25,000 to set up a captive and pays Artex \$36,000 a year to maintain it.

TAX SAVINGS The administrators of captive insurance companies are quick to play down any tax savings, which is an issue that regulators are watching.

“The easiest ‘no’ is when a company comes in and talks about taxes, taxes, taxes and doesn’t mention insurance for half-hour into it,” said Dave Provost, deputy commissioner for captive insurance at Vermont’s Department of Finance.

But saving on income taxes is a big draw. While a company would get the same tax deduction for paying premiums to a captive as to a regular insurer, the real advantages come to people whose company profits flow through to their personal income tax.

A person setting up a captive under section 831(b) of the Internal Revenue Code can put up to \$1.2 million a year into a captive, tax-free. If the captive pays out less than that in claims, it can eventually start returning the surplus to the business owner in the form of dividends, which are taxed at a lower rate than income.

Put another way: If the business owner had paid \$1 million in premium to an insurer, the owner would have had to pay income tax on the remaining \$200,000.

“It’s truly an opportunity that a small-business owner has to set aside funds and not get taxed personally and have some operational benefits,” Mr. Sturm said.

Charles Massimo, president of CJM Fiscal Management, a wealth manager in Melville, N.Y., said he understood that administrators played down the tax benefits so as not to attract the ire of the I.R.S., but tax savings were the first consideration for his clients.

“Any significant company is going to have an insurance need,” he said. “The vast majority of my clients get more excited about the other benefits of the captive.”

The other advantage comes with estate planning. If a business owner set up a captive in the name of the owner’s heirs, the captive could double as a way to transfer money to them free of estate taxes.

Mr. Massimo said he had set up captives that were 99 percent owned by a person’s children, while giving the business owner voting control with his 1 percent stake.

Mr. Provost said Vermont — which has more than 900 captive insurance companies, the third-highest number of any jurisdiction in the world, behind Bermuda and the Cayman Islands — did not allow captives to be owned this way, but many foreign jurisdictions do.

ABUSES The big red flags are companies that are insuring for risks that they do not have simply to take advantage of the tax savings. Common examples are terrorism risk for a small, domestic company, or a business owner in Nebraska insuring against hurricane risk.

What shocked me, though, was that the likelihood of being penalized for misusing a captive was not great.

“Audit rates among captives are very low,” Mr. Adkisson said.

And the penalty is generally that the deduction is disallowed.

One strategy more likely to attract tax scrutiny is using the money in the captive to buy [life insurance](#). If all the money is tied up in a policy for someone’s heirs, it cannot be used to pay claims.

But it is a gray area. “You’re doing something that is technically in compliance with the law but you’re violating the purpose of the law,” Mr. Adkisson said.

While there have been several audits, the I.R.S. has not taken any formal action, he said.

“The numbers are so big that there is a big incentive to misuse these things.”

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