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September 2013

Captive Insurance: A Niche for the Middle Market

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With insurance premiums on the rise and the uncertain state of the federal tax system, middle market business owners may be looking for a source of stability that allocates the risks associated with operations. A "small" captive insurance company may provide such stability. Small captives are a unique way for a closely-held, middle market business to take advantage of cost savings, tax planning and business succession planning all in one

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The idea of a captive insurance company has been around for a while. A captive insurance company is a company formed for the purpose of underwriting property and casualty insurance to a related insured. In other words, a captive insurance company is a way for a business to self-insure against the risks of operations. A captive insurance company normally must be formed as a "C" corporation for tax purposes and is subject to subchapters L and C of the Internal Revenue Code ("IRC"). Effectively, a captive insurance company provides an alternative mechanism for a business to shift the risks of operations.

"I already have adequate insurance, so why would I need to create a captive insurance company?" Well, the reasons may not be obvious. The typical middle market company may already have its own insurance policies,

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which are necessary to cover some of the risks associated with operating a business. However, while necessary, these policies are usually inadequate and do not cover all risks. A captive insurance company may be set up to augment the shortfalls of these policies. For example, a common uninsured risk facing a business is the deductible in most commercial insurance policies. A captive can ensure that a company will not lose a hefty deductible when it seeks to recover on a claim to its insurer. Other reasons a middle market company might form a small captive include: (i) obtaining insurance that is otherwise unavailable; (ii) custom tailoring of an insurance policy; (iii) investing of the insurance company reserves; (iv) controlling the claims process; and (v) tax and estate planning benefits.

The IRC defines a "small" captive insurance company as one that meets the requirements of IRC § 831(b). This section of the IRC allows a small captive insurance company earning premiums from its parent or affiliated company to exclude up to $1.2 million in premiums per year from gross income, thereby escaping tax paid on a large portion of income earned by the parent. Assuming that the parent company is taxed at a rate of 35%, this can result in tax savings of up to $420,000 on premiums of $1.2 million. The § 831(b) election also allows the captive to be taxed only on investment income earned on funding the captive's reserves.

The beauty of this vehicle is that it can be used for wealth transfer as well. For instance, owners of a closely held corporation can designate a trust for the benefit of a family member as owner of the captive. In turn, the captive could pay preferential dividends to the trust, which would be taxed at a lower rate than the ordinary income rate (15% or 20% depending on the individual's tax bracket). The transfer to the trust also gives the business owner the ability to avoid the Generation Skipping Tax. Yet another advantage of this vehicle is that the premium paid by the parent corporation to the captive is deductible by the parent as an expense of doing business. This increases tax savings at the parent level as well.

While a small captive has its advantages, a middle market business owner should also consider the legal and financial implications of using this vehicle. The captive must meet the requirements of the IRC in order to obtain the benefits of being a small captive. The Internal Revenue Service ("IRS") has issued Revenue Rulings that provide "safe harbors" for captive insurance companies. Compliance with these IRS rulings will ensure that the entity receives small captive treatment and all the benefits that come along with that treatment. Business owners should also be aware that despite the tax benefits of forming a captive insurance company, the IRS will penalize captives designed solely for the purpose of tax avoidance.

Not only does a small captive have to comply with § 831(b) and the applicable Treasure Regulations and Revenue Rulings, but it must also comply with the rules and regulations of the jurisdiction it is organized in. Certain jurisdictions have relaxed the laws relating to the insurance industry so that companies can obtain the benefit of using a small captive to self-insure.

A middle market business owner should be aware of the costs associated with formation and operation of the captive. For example, most

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small captives are formed and operated by outside consultants called captive managers. Moreover, a business will need to retain the services of other professionals to ensure proper tax and legal planning and compliance with applicable state insurance rules and regulations. Furthermore, a feasibility study must be performed to ascertain the risks to be insured. Another cost incurred upon formation is capitalization of the entity. Depending on which jurisdiction the captive is formed in and the risks insured, the premium to capitalization ratio may vary. Although there is an initial cost of forming and repeated cost operating a captive, the premium savings combined with the tax savings in forming such an entity can be enormous.

A small captive is an excellent way for a middle market company to benefit from an advantageous section of the IRC while also helping to plan for business succession and wealth transfer. Small captives can also provide a business with the possibility of cheaper insurance premiums and allow it to allocate risks away from the business nucleus. Business owners should consider forming this type of entity if they wish to maximize tax savings, reduce the costs of operations and insure risks not normally insured.

Marion Livermore, a Law Clerk at Ruskin Moscou Faltischek, assisted in the preparation of this article.

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