

# HOW CAPTIVE INSURANCE CAN ENHANCE YOUR BUSINESS STRUCTURE

TRANSFORM YOUR RISK INTO WEALTH



WEALTH STRATEGIES  
ADVISORY GROUP



## KEY POINTS

- > You can form and own your own “Captive” insurance company to insure your own business risks.
- > Premiums paid to your own insurance company are *tax-deductible* and, conversely, are *tax-free* for your Captive insurance company.
- > You can potentially save millions of dollars by creating and owning your own insurance company.

# WHAT DO NEARLY ALL FORTUNE 500 COMPANIES HAVE THAT YOU PROBABLY DON'T?

**Answer:** A Captive insurance company.

What is it? A strategy that can help you better manage your business risks while also saving you millions of dollars and building additional wealth.



# WHAT IS A CAPTIVE?

A “Captive” is an insurance company formed by an individual to insure his or her own business. Your Captive can insure certain risks of your business. With good risk management practices, you can build significant equity in your Captive.

Captives are well-established tools. They have been used for about 65 years. Allstate was originally formed as a Captive for Sears. Federal income tax rules for Captives haven’t changed in 30 years. There are two main types of Captives that can be used by business owners:

## > REGULAR CAPTIVE

Premiums paid to a regular Captive are deductible. However, premiums are recognized by the Captive as income as they are received. Deductions are taken for additions to insurance reserves, expenses and claims paid. A regular Captive pays corporate taxes on its insurance profits which are generally equal to premiums received minus expenses and claims paid.

## > MICRO-CAPTIVE

A Micro-Captive gets its name from a limitation on the amount of annual premium: \$2.2 million *per year* (indexed) per section 831(b) of the Internal Revenue Code. The premiums are tax-deductible by the insured business. Those same premiums are *tax-free* for a Micro-Captive. Additionally, Micro-Captives do not pay taxes on insurance profits. The only tax paid by a Micro-Captive is a tax on investment income.

The Internal Revenue Code contains generous provisions that allow you to build equity in your Captive. For example, premiums paid by your business to your Captive are tax deductible. Those same premiums are tax-free when received by your Micro-Captive. This is a rare instance in the Internal Revenue Code that pairs “tax-deductible” with “tax-free” for a business owner. This allows the Captive to build insurance reserves and equity for you. It also provides you a new profit center.

# WHY SHOULD YOU OWN A CAPTIVE?

## A CAPTIVE GIVES YOU GREATER CONTROL OVER RISK MANAGEMENT FOR YOUR BUSINESS AND ALLOWS YOU TO:

- > Create customized insurance coverage not available through commercial carriers
- > Design coverage for risks commercial carriers deem uninsurable
- > Receive significant tax benefits

By adhering to guidelines established by the IRS, you can tax deduct premiums paid by your business to your Captive. Premiums not consumed by claims become retained earnings of your Captive. These retained earnings are available for later distributions to you. There are many other benefits from your Captive insurance strategy:

**Enhanced Coverage.** Through your Captive, you can design and implement coverages not otherwise available for your business. The tax incentives afforded Captives allow you to build up significant reserves that back these enhanced coverages.

**Asset Protection.** Retained earnings of your Captive are out of the reach of creditors of the business the Captive insures. This protection can be further enhanced with a domestic asset protection trust.

**Investments.** Premiums paid to your Captive can grow through investments that you and your advisors oversee. Investment returns are paid to your Captive.

**Risk Management Practices.** You are rewarded for your risk management practices and lower claims. As a business owner, you are best suited to understand, monitor and mitigate the risks of your business. Better risk management leads to lower claims which, in turn, increase the tax-free profits in your Captive.

**Profit Center.** A Captive is a new profit center for you. Rather than paying insurance premiums to an outside insurer that profits from the transaction, you pay the premiums to your own insurer and stand to reap the profits.

## WHAT TYPES OF COVERAGES ARE INVOLVED?

Captives insure risks that you currently "self-insure" because regular insurance does not cover the risks, or because the cost of coverage is prohibitive. Here are some of the risks that a Captive can insure:

Brand Protection

Business Interruption

Construction Defects

Crop

Cyber Risk / Data Breach

Deductibles

Employment Practices

Exclusions in Policy

Food-borne Contaminants

Independent Contractor  
& Chargebacks

Key Person

Key Customer/Supplier

Litigation Defense

Mold

Pollution

Products liability

Professional Liability

Regulatory Risk

Reputation Risk

Supply Chain Interruption

Warranties

An insurance actuary will determine the appropriate amount of premiums for each coverage. Premiums paid to a Captive tend to be stout (?) since these risks are difficult to underwrite and insure in an ordinary commercial policy.

Bear in mind that the premiums are deducted by your Operating Company and tax-free to your Captive. Through these premiums, you have an opportunity to transform your business risk into wealth.

## WHAT ARE THE CHARACTERISTICS OF A SOUND CAPTIVE STRUCTURE?

A Captive is a powerful tool for managing risks, reducing insurance costs and saving taxes. These benefits are contingent upon having a compliant Captive design. Here are the keys to a Captive structure that has real economic substance, is properly structured, is defensible if examined and is compliant with respect to insurance and tax rules:

**Plausible Risk.** Risks insured by a Captive must be genuine, plausible and reasonably possible. For example, hurricane risk in Des Moines, Iowa is not plausible. Consider this excerpt from an actual client's Actuarial Report. "Using the data described above as the key basis for the analysis, we selected loss rates giving consideration to various outcomes that we believe are reasonably possible (i.e., outcomes that have occurred in the past, either to the business entity that will be insured or to other business entities having similar characteristics of the insured.)"

**Supplemental.** Captive insurance coverage supplements appropriate commercial coverages. It neither duplicates nor supplants appropriate commercial insurance coverage.

**Actuary Study.** Premiums for Captive insurance must be determined by an independent actuary using insurance industry data.

**Claims Process.** The Captive must have an established claims-paying process administered by knowledgeable and experienced insurance professionals. Claims must not be handled on an "ad hoc" basis.

**Investments.** Investments must be appropriate for an insurance company. Sufficient safety and liquidity is essential.

**Profits.** Captive insurance profits may be distributed to its owners. Distributions of insurance reserves or unearned premium are inappropriate.

# GETTING STARTED

## WANT TO FIND OUT IF CAPTIVE INSURANCE IS A GOOD FIT FOR YOUR BUSINESS?

The first step is a feasibility review. Our team of professionals including Fortress Risk Management, LLC will review your existing business coverages and risk management practices. Risks that you currently self-insure will be identified and quantified. The cost of providing the coverage can be estimated. The tax savings and investment potential can also be projected. Then you will be able to make an informed decision about proceeding with your Captive insurance solution.

## ALREADY HAVE A CAPTIVE?

Captive insurance can be designed in various ways. One size does not truly fit all. At times, a Captive structure can be upgraded to a more effective and cost-efficient structure. As with all business tools, it is wise to have your Captive structure reviewed periodically to ensure that it is as efficient as possible, and it is keeping pace with evolving caselaw and IRS guidelines. We will be happy to review your existing Captive structure and administration to help you determine whether it is the best fit for you and your business.

## OUR UNIQUE PERSPECTIVE

We understand Captive insurance. We work with employers of all sizes to design, implement, fund and improve their Captive insurance structures.

Managing risk is a key function in modern business. Proper risk management may determine whether a company will thrive or merely survive. Poor risk management may lead to a company's downfall.

We are pleased to introduce our clients to a unique approach to risk management. This approach combines risk management strategies, tax efficiency, scalability and administrative ease to help our clients control risk, improve cash flow and accumulate wealth.

A February 2013 article in the Journal of Accountancy lists some of the advantages of using a Captive:

- > Tax deduction for the parent company for the insurance premium paid to the captive;
- > Various other tax savings opportunities, including ...income tax savings for both the captive and the parent;
- > Opportunity to accumulate wealth in a tax-favored vehicle;
- > Distributions to captive owners at favorable income tax rates;
- > Asset protection from the claims of business and personal creditors;
- > Reduction in the amount of insurance premiums presently paid by the operating company;
- > Access to the lower-cost reinsurance market; and
- > Insuring risks that would otherwise be uninsurable.



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