Course Objective

This course was created to teach advisors (CPAs, EAs, accountants, attorneys, financial planners, and insurance advisors) about a relatively unknown business tool to help clients reduce their insurance premiums and grow wealth in a tax favorable manner through the use of a Captive Insurance Company.

Most advisors hear clients (especially business clients) complain about how their property and casualty insurance premiums have nearly doubled in the last few years (due to the 911 bombing and large class actions lawsuits on topics like Asbestos and Mold). The typical response to these business owner clients is to offer sympathy and indicate that the advisor also has the same problem. With knowledge on how a Captive Insurance Company can be used to help your clients reduce their insurance premiums while at the same time paying those premiums into their own insurance company, advisors can truly show a benefit to those who can use captives.

Captive Insurance Companies

What is a Captive?

A CAPTIVE is an insurance company that insures or reinsures risk on behalf of its shareholders.

Types of Captives

Single-Parent Captives (Wholly-Owned)

The Captive is controlled by the corporate owner and acts exclusively as insurer or reinsurer of the corporate owner's risks. The tax-deductibility of premiums paid to the captive may be challenged. By writing third-party business in the captive, tax-deductibility may be obtained for the parent, as well as create an opportunity for additional revenue.

Group Captives

The Captive is controlled and acts exclusively as insurer or reinsurer of a group of owner's risks and includes an element of risk sharing and distribution within the group. Premiums are tax deductible.

Entrepreneurial Captives

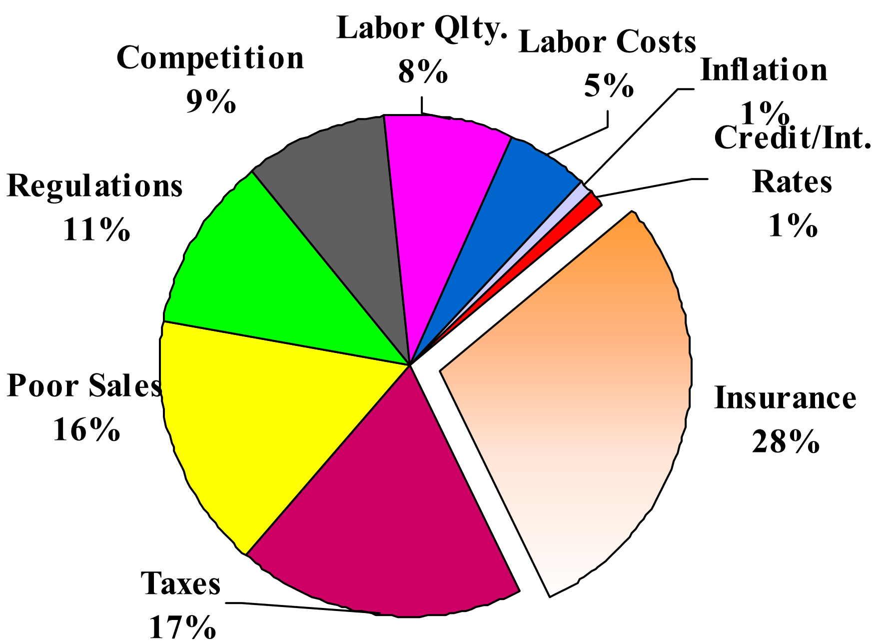
The Captive is controlled by an owner but acts as insurer or reinsurer of third party risks. Multiple ownership structures exist. Rent-a-Captives (including Protected Cell Captives) are Entrepreneurial.

Why are Captives formed?

Primary insurance companies typically wish to only retain the predictable levels of risk and "cede" or transfer unpredictable levels of risk to others (reinsurers). A CAPTIVE allows an insured to assume the benefits normally enjoyed by a primary insurer.

Insurance is the Biggest Concern of Small Business Owners

Over the past few years, business owners have experienced skyrocketing insurance costs. This is particularly true for certain industries and certain lines of business. Here is their ranking of principal concerns.



Source: National Federation of Independent Business (November 2003); Insurance Information Institute

What are the benefits of a CAPTIVE?

- Puts the Control of your insurance program in your hands
- Reduced operating cost
- Improved cash flow
- Cost-effective mechanism for risk retention
- Equitable rating
- Availability of special coverage
- Enhanced risk management perspective
- Direct access to the reinsurance market
- Writing unrelated risks for profit
- Tax minimization and deferral
- Stable marketplace
- Improved services
- Estate planning
- Continuity of risk management operations

There are *ONLY* 3 ways to reduce your Cost of Risk:

1. Reduce FREQUENCY of losses (i.e. prevention initiatives)
2. Reduce SEVERITY of losses (i.e. claim cost containment initiatives)
3. Cost-effective FINANCING

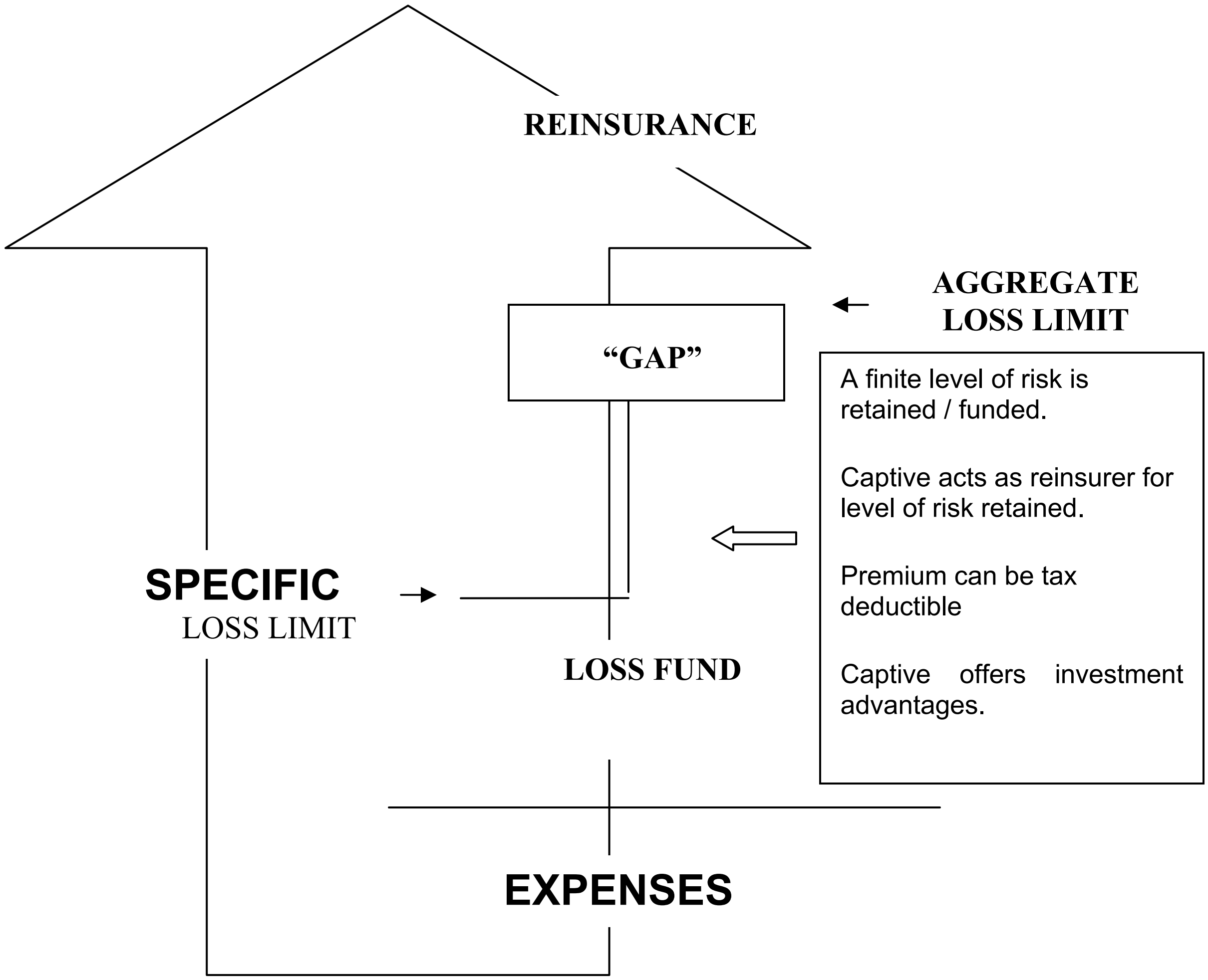
The following matrix will allow you to review the most common risk financing alternatives available today.

Notes

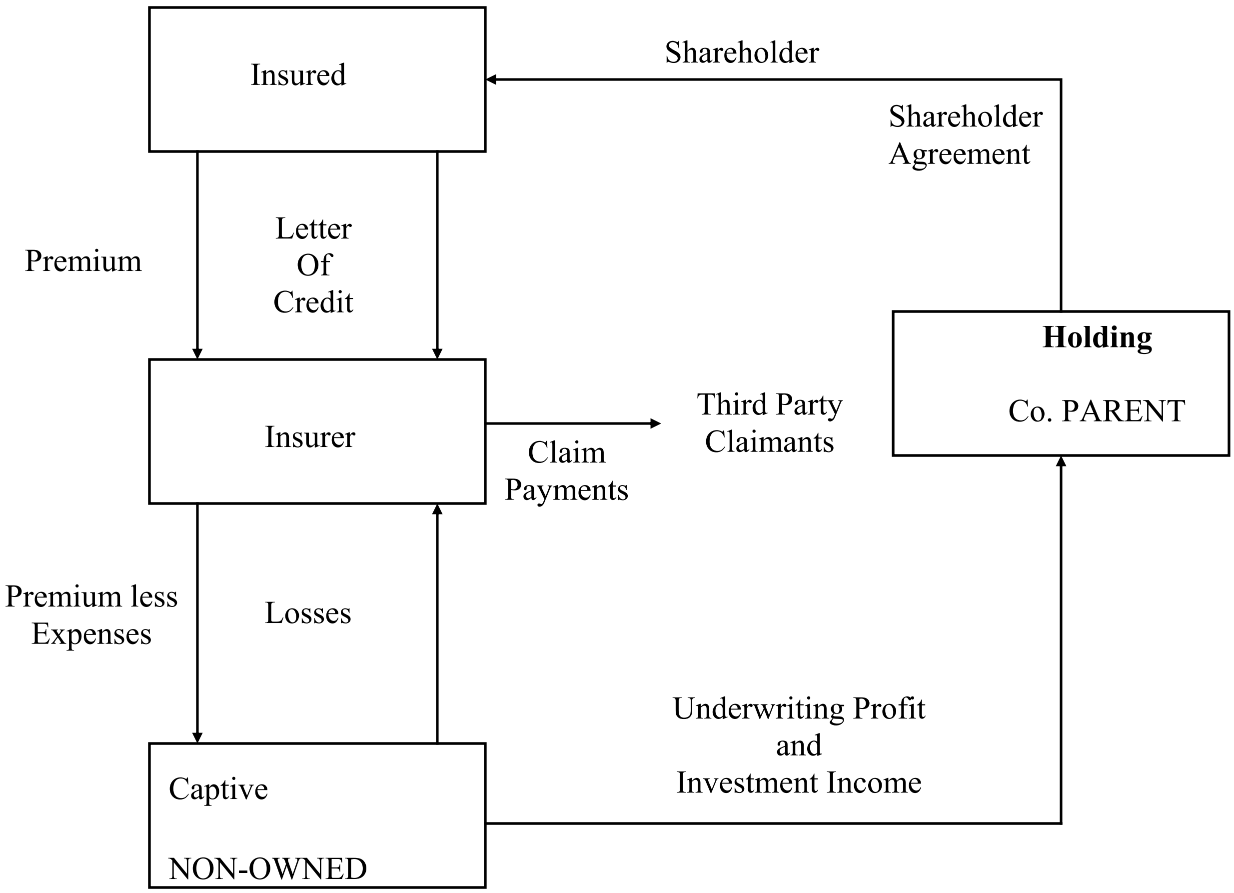
1. Upside risk with retros depends on plan maximum premium
2. IRS propensity is to dissect the retro into its insurance elements and self-insurance elements-retro premium layer
3. Deductible = $100,000+
4. Deductible = Policy Limit
5. Need for loss forecasting and degree of loss sensitivity depends on the number of participants and type of rating plan used

COMPARISON POINTS	GUARANTEED COST	DISCOUNTED GUARANTEED COST	LARGE DEDUCTIBLE	SINGLE PARENT CAPTIVE	RENT-A-CAPTIVE	GROUP CAPTIVE	POOLING	SELF-INSURANCE
COMMON PREMIUM RANGE	$0-250,000	$50,000+	$750,000+	$2,000,000+	$1,000,000+	$250,000+ (SINGLE)	$50,000-$250,000	$750,000+
NEED FOR LOSS FORCASTING	LOW	MODERATE-HIGH	HIGH	HIGH	HIGH	MODERATE 5	LOW	HIGH
LOSS SENSITIVITY	LOW	LOW	HIGH	HIGH	HIGH	MODERATE	MODERATE	HIGH
UPSIDE RISK	LOW	LOW	HIGH	HIGH	HIGH	MODERATE	MODERATE	HIGH
CASH FLOW	LOW	LOW-MODERATE	HIGH	MODERATE	LOW-MODERATE	MODERATE	LOW-MODERATE	HIGH
EARLY TAX DEDUCTION	YES	YES	LIMITED	LIMITED	LIMITED	YES	YES	LIMITED
ACCOUNTING TREATMENT AS INSURANCE	YES	YES	LIMITED	LIMITED	LIMITED	YES	YES	LIMITED
INTERNAL ADMIN.	LOW	LOW	MODERATE-HIGH	MODERATE-HIGH	MODERATE-HIGH	LOW	LOW	HIGH
SECURITY REQUIRED	LOW	LOW	HIGH	HIGH	HIGH	MODERATE	LOW	HIGH
DOCUMENTATION	LOW	LOW	HIGH	HIGH	HIGH	MODERATE	MODERATE	HIGH

Typical Captive Program Schematic



Rent-a-Captive Program Structure



What Are They, and Why Would a Client Want One?

As the focus of the insurance and finance industries turn to new alternatives, a relatively mature solution is receiving renewed attention, that of a captive insurance company. This material is intended to inform those who have little understanding of captives and refresh the recollections of those who have looked into them previously. The views expressed may be different than those to which you have been exposed elsewhere. That is the purpose.

The Purpose of a Captive

The accepted definition of a "captive," an insurance company that is owned by the insured, is true, but not useful for decision making in a time of challenge. To begin, let us be clear that captives are all about money. Clients want one to make money. It will cost money to have one and clients who have one will pay their own losses, when and if losses materialize.

Captives are another method by which risk of loss is financed. They are not inherently mysterious, or illegal, nor are they a silver bullet for all situations. The fact that the insured, or an entity closely related to the insured, is the owner/operator is a separate and distinct fact, which may or may not intrude on the captive transaction.

Captives versus Traditional Insurance

To this point, your clients may have applied for insurance by giving underwriting information to a party who enters into a contract with client to provide repayment of losses under certain circumstances. There are many variations on this theme, but all of that is known as "traditional insurance." To go outside this structure is alternative risk finance, which can take many forms, one of which is a captive insurance company.

With a captive, instead of "just writing a check," your clients will see all the components of the premium and play a part in its pricing and delivery. This is called "unbundling."

Another critical point is that alternative risk finance is not in opposition, or the enemy of, the traditional insurance company. In fact, most traditional companies work daily with captives and other forms of risk finance. As a part of the process, someone of financial strength must agree to reimburse claims. For large losses, a large insurer is required. That is probably not the captive.

For small losses, the traditional insurer often prefers that the insured handle those. This provides an opportunity for the insurer to shift costs to the insured through the device of a captive. These costs can also be shifted through deductibles, retentions, and coinsurance, but a captive can create the illusion of control for the insured, while eliminating nuisance costs for the insurer. This illusion can be a highly successful marketing tool for a traditional insurer.

Structuring a Captive

Why a captive instead of deductibles/retentions or self-insurance? That is the magic of insurance. Current accounting and tax rules do not permit deductions for reserves held for the payment of losses in the future. But, if those funds are bundled, and collectively called an "insurance premium," they are deductible. Self-insurance is a legal form that is difficult, complex, and really only for the very large risk.

Thus, if your clients are to consider a captive as a cost-effective solution, they must structure it in such a way as to participate in the profits of their own risk, not just accept unwanted costs. Clients must structure and partner in such a way as to achieve a real cost savings. To do that, they must finance more than just small risks.

To gain the advantages discussed here, several elements are required. First of all, the premiums paid must be sufficiently large, say over $750,000 annually, to gain economic advantage, or coverage necessary to the operation of the business must be unobtainable. It is also possible, if it is the client's intention to establish a new profit-center, that the projections of acquiring the insurance business of others will make the captive seem like a good idea.

Second, clients must be able to pay the claims, and secure the future losses. Full projected amounts are rarely required to be posted in advance, but the ability to ultimately pay must be demonstrable. This cannot be overstated.

Third, clients must recognize that a captive is a business separate and apart from their other business, no matter what structure is ultimately selected. Close attention must be paid to the establishment and operation of the captive or the consequences will eradicate any hoped for advantage.

Determining the Feasibility and Goals of a Captive

The process begins with an actuarial analysis of a client's past claims. This is a straightforward determination of the accepted level of claims for the business, which gives clear trends and attachment points for premiums, costs, and reinsurance. It also helps clients determine if they wish to proceed, which is why this work is called a feasibility study. It is quite worthwhile to determine early in the game if the proposed solution has a chance to deliver the hoped-for results.

After the actuary has advised on the numbers, time should be spent on the goal of the captive. The original inquiry may have been driven by high insurance premiums, or even lack of availability, but there are other reasons to consider a captive. These include control of premium fluctuations, choice of vendors, choice of reinsurance structure, personal tax advantages, and even a new profit center. It can be difficult to place a dollar value on all of these, but collectively they could materially affect the view toward cost effectiveness.

Costs for a feasibility study can vary dramatically depending on your needs and availability of data (preferably electronic). The feasibility study has many components, including but not limited to: Actuarial; Pro Forma; Structure and Design; Business Plan; Sample Policy Form; Fronting and Reinsurance price indications; and domiciliary considerations..

The costs to establish a group captive are typically higher than a single parent captive. Range of fees could be from $30,000 to $250,000, depending on what the client is planning to do. The average price for a small singe parent captive should be around $50,000; the bulk going toward actuarial, consulting, regulatory and legal.

Domicile Selection

With a feasibility study clearly meeting your goals, it is time to select a domicile. Basically these are onshore, with one of the 24 States permitting captive formation; or offshore, outside the United States (i.e. Bermuda, Cayman Islands, British Virgin Islands leading the way). There are many reasons for making the decision, and careful consideration should be given to the goals of the captive. Costs and profits can be materially affected more by structure and choice of vendors than whether the client is in or outside of the United States.

Domiciliary criteria are as follows: Proximity, ease of communication, regulatory history, costs, availability of service providers, and a captive friendly environment. A more detailed explanation of choosing a domicile is discussed later.

The larger issues to be addressed as to selection of domicile relate to the goals of the captive. A principal difference between onshore and offshore is potential ease of regulation. Ease does not mean laxity, but rather is based on the fact that offshore regulators tend to permit captive to insure risks that fall outside of the corporate structure of the owners. By definition, a captive cannot insure said risks but offshore jurisdictions have used this to solicit business. Note: the success of your captive hinges on your ability to control the cost of claims. Insuring risks of non-related entities is very risky and somewhat defeats the purpose of the captive. The quality and quantity of regulation and support services should be seen to bring the best fit to the goals of the captive.

A visit to the chosen domicile is required. All regulators want to have face-to-face knowledge of their owners. Maintaining a relationship with them is primarily the domicile manager's job, but the owner's attendance is important to success. Some venues require annual meetings to be held at their location, which can be an opportunity to solidify relationships with regulators.

Partner Selection

Following selection of a domicile, it is time to select partners. Depending on circumstances, clients will need a U.S. consultant, a domicile manager, a risk-sharing entity, attorney, accountant, banker, and, of course, the actuary. Some of these may be vendor/partners that a client is using currently.

The manager or consultant will prepare, or assist the client in preparing, a business plan, which is necessary to receive regulatory approval and risk-sharing support. It is critical that they be knowledgeable about captives, the client's goals, and expectations.

A company must be formed. This calls for officers and directors. The domicile manager and/or attorney can handle this task. Depending on domicile, there can be extensive referencing required, which can be off-putting to some potential participants. New regulations on money laundering and transfer add materially to the time involved, so this activity should run concurrently with other tasks.

Critical to the success of the captive is selection of the risk-sharing partner. This is the entity that is on the line for the largest and most frequent claims. This is generally a U.S. licensed and admitted insurance company. It will often offer many necessary services, including underwriting, risk engineering, loss adjusting, claims reserving, litigation and regulatory support. Clients may need to issue certificates of insurance to third parties, assuring coverage. Generally, a certificate from the captive will not suffice.

This partner may be the client's current, traditional insurer. The client may have to form a new relationship. In the current times, it is imperative that clients begin exploring the dynamics of this relationship from the beginning of the captive process. The risk-sharing Partner will likely have strong opinions on the client's plan and the other partners. This partner will rely heavily on the work of the actuary.

This partner may have restrictions and requirements on practices, procedures, and vendors that will make or break the captive, so a solid relationship is essential. Management of this relationship should be conducted in such a manner that both sides are aware of all other arrangements and are fostering each other's profitability and growth in accordance with the business plan.

Operating a Captive

With all of these elements completed, the captive is ready to begin operation. The captive will likely be a reinsurer to the risk-sharing partner, accepting a predetermined level of risk and the accompanying premiums. The captive is now a "reinsurance" company. It will also likely purchase reinsurance. It behooves the owners to set up appropriate committees, such as underwriting, claims, investment, and audit.

In the early stages, the most important of these is the Investment Committee. Funds will be received almost immediately and must be prudently invested so that they are available to pay claims. This is a major source of revenues for the captive, which previously went to the traditional, primary insurer. Earnings from these investments can, over time, be considerable and become the primary reason for the existence of the captive. Improperly managed, however, they can cost the owner substantial sums and even imperil the continuation of the captive. The domicile manager will do the actual investing and offer advice, but the manager will not decide what instruments to purchase.

If the captive is to entertain risks other than that of the owners, then an Underwriting Committee must be established along with underwriting standards, lines of authority, and procedures. This committee may also be responsible for arranging reinsurance. This is an opportunity to improve costs from pre-captive structures.

At some early stage, a Claims Committee must be in place. It will regularly review claims reports to determine trends, underwriting violations, and reserving practices. It may be involved in selection of adjusters, attorneys where appropriate, and reserve management. This is another area in which costs can be improved from the traditional placement.

Captive Advantages

There are many, many other considerations and structures to a captive. It can reinsure traditional lines such as workers compensation, general liability, auto liability, product liability and professional liability. This is due to the relative ease and certainty of projecting losses and revenues with coverages in which claim payments occur years after the incident of loss, known as long-tail losses. More and more captives are entering property fields, or short-tail losses. The traditional view of restricting captives to long-tail business has encountered the reality of escalating prices and lack of availability.

A captive can also be used to provide coverage and limits not available in the market, such as credit risk and terrorism and Medicare fraud for physicians. The captive can provide a “tax-sheltered” approach to large retentions. If no certificate is required, it can accept direct placements.

With considerable effort, there are occasional personal tax advantages that can be obtained with a captive, but these require a sophisticated, knowledgeable consultant, and there are the usual caveats about taxing bodies.
Some captives have performed so well for their owners that they have re-domesticated to the United States, filed for licensing as an admitted insurer, and offered primary coverage, replacing their risk-sharing partner.

If your client's approach is well thought out, properly executed and diligently managed, a captive can be an ongoing source of profit for years to come.

Captive Structures

There are many different structures for a captive insurance company. This material will discuss the most common structures and their potential uses. Some of these are merely variations on a theme, and no doubt some structures will be overlooked as new structures are being proposed every day. It is an exciting field.

The basic captive structures consist of:

- Single parent
- Group/association/RRG
- Rental captives, Segregated protected cell

Common Characteristics

Regardless of the structure chosen, there are some basics common to all captive structures. One of these is the participation of a risk sharing partner, or traditional insurer. Risk sharing partners provide such necessary and desirable services as certification of coverage and limits; reinsurance; loss control and mitigation; claims reserving, adjustment, and oversight; risk management; underwriting and regulatory response and assistance. This often-overlooked service has become one of the most valuable services offered by insurers to captives today.

The insured who decides to establish a captive must carefully choose a risk sharing partner, since providing certificates to outside parties is often a material service. The risk sharing partner must carry an A.M. Best's rating as required by regulators, mortgage holders and lenders in order for the certificate to be accepted. The risk sharing partner must be involved from the inception of discussions and will have a say in the ultimate structure chosen. There is little point in choosing a structure and then learning that no one will partner with you.

Single Parent Captive

The single parent captive is still the most prevalent structure in use today. This is an insurance company owned by one company, usually the insured. Its usual purpose is to provide some risk transfer or financing for a corporation on a specific line of coverage. It is not usually admitted to write insurance other than its own risks in a domicile.

This form has been in use for over 50 years, and has stood the test of time and challenge. It is an effective alternative to traditional insurance when organizing the financial risks of a commercial business. This structure is welcomed in all domiciles by all partners.

A single parent captive is most often used to provide coverage either directly, where permitted, or as reinsurance of a traditional primary insurer. Frequently this captive provides reinsurance on workers compensation programs. Increasingly we see them used for property insurance, directors and officer's liability, terrorism, and toxic mold.

Recent developments have opened the door for writing certain employee benefits programs in captives. The single parent structure would work well for this exposure, and we expect to see a tremendous increase in this use for captives. The single parent captive structure is a corporation; therefore some thought must be given to who will serve as owners, directors, and officers. In most captive domiciles the standard C-corporation is the form allowed. Few domiciles allow limited liability forms, although some will allow a structure somewhat akin to an S corporation. Often, the parent corporation is the owner of the shares.

The single parent captive was often used for tax issues, but is now used more for coverage or limits otherwise unavailable. It is sometimes seen as a new profit center for the parent firm. All captives should be initiated with a serious commitment of time and financing, and this form is often a new venture within a larger firm in which the risk management department is planned to generate profits and contribute to the parent company's bottom line.

The offshore domiciles have been addressing criticisms of the Organization for Economic Cooperation and Development and the Financial Action Task Force for not knowing their customers. Many new procedures have been introduced recently that may surprise some who have knowledge of captives. Most of the procedures are reasonable and not burdensome, but they should be reviewed with care before the owners, directors, and officers are selected. There may be issues to address that will slow down formation or even preclude the participation of key organizers.

It may seem obvious that the insured corporation would be the owner, since the form is a single parent captive, but in the case of a private or closely held business, there may be multiple shareholders, and the captive will still be referred to as a single parent. There may be a family trust as owner. The essential element for being called a single parent is that it really insures a single insured, does not entertain risks outside its business enterprise, and the ownership is tightly related.

All regularly recognized domiciles and risk sharing partners welcome single parent captives. The choice of partners is then determined by the other goals of the owner, in terms of obtaining coverage not otherwise available, creating a profit center, or smoothing out the future costs of risk finance. By increasing and diminishing the amount of risk held by the captive, the parent company can smooth its risk costs over time. This is viewed very favorably by many CFOs and treasurers.

Seeking a tax advantage is a bit more challenging with single parent captives and the use and advice of qualified counsel is strongly recommended. Indeed, there may be no tax advantage at all under this structure. While the current operating philosophy of the Internal Revenue Service (IRS) is fairly accommodating to captives, it is widely acknowledged that what the IRS giveth, the IRS taketh away.

Group or Association Captive

The group or association captive is a structure in which multiple businesses join together either through a formal association or an informal relationship to use a captive to obtain coverage or limits otherwise unavailable. This form has become a source of revenues and industry cohesion for many trade groups. These groups can be artificial in the sense that an entrepreneur forms the captive and offers coverage to otherwise unrelated insureds, and the insured group can be either heterogeneous or homogeneous in nature.

The Risk Retention Group is a group captive formed under the LRRA of 1986 which is a federal law. The main advantage is that a RRG can write liability exposures on a direct basis and is regulated by its state of incorporation. Therefore, no fronting carrier is needed.

This structure usually involves a corporate structure with more than one class of share. These different share classes can enable the group to use a dividend policy to reflect the actual claims profile of each separate member of the group or association.

A group or association captive can be a management challenge as it can bring risk related, non-group issues to the fore, such as appropriate loss control and the ability of some members to promptly address security against future claims. Playing well together is an important element.

Rental Captives

Rental captives gained popularity over 20 years ago as a reaction to the costs of forming and operating a captive. The potential insured finds an existing captive, often owned by a traditional insurer, which creates a separate set of books within its own structure to reflect the singular risk of the potential insured. Usually this method restricts the choices of risk sharing partners and service providers.

The use of someone else's captive necessarily means that you will be paying increased fractional costs. These may be offset by not having the costs of establishing and operating your own facility. It is important to know these costs, compare and contrast them, and consider the control and partner/provider issues before making a decision on a rental captive.

In recent years, the IRS has had success in challenging the deductibility of premiums paid to some rental facilities based on an apparent lack of real risk transfer. Very careful consideration must be given to this aspect, and the use of qualified tax counsel is again highly recommended.

Some rental facilities have also had difficulty with risk sharing partners due to under-reserving for future losses. Before committing to a rental facility, you should have a discussion with the primary risk sharing partner about their reserving practices, and perhaps even consider an independent actuarial review of the reserves.

Segregated Protected Cells

For the above reasons, plus IRS challenges and reserve inadequacies, several domiciles introduced the Segregated Protected Cell structure. While very similar in approach to a rental facility, there are marked differences that make this structure a very popular choice today.

The segregated protected cell, or sponsored captive, which is not permitted in all domiciles, has a structure in which an existing insurer or "captive," owned by an insurance company or service provider, assists in the creation of cells within itself. These cells must follow similar procedures for establishing a single parent captive, but stop short of ultimate regulatory approval as the regulators look to the sponsor for compliance with their regulations.

All lines of coverage can be underwritten in a cell structure. This is of course subject to the agreement of the sponsor and the risk sharing partners. Indeed, a company could establish a captive and then segregate lines of risk, subsidiaries, or businesses by creating cells within its own captive.

Legislation protects a cell and its owners from claims by creditors of other cells within the sponsored company. To many people, this lack of a "firewall" is a flaw in the typical rental structure. In the typical rental structure, there is no absolute protection from each and every creditor, as at some level the sponsored company has some joint liabilities. With the protected cell approach, however, the firewall is sound and should provide considerable protection against creditors of other cells.

The proposed owner of a cell will be asked to provide information and references similar to what is asked of owners of single parent captives. Indeed, the ownership of an individual cell can take the same variety of forms as a single parent or group captive, or take no structure at all. It may be only a policy of insurance.

Since the cell is within an approved company, with its own already established owners, officers and directors, risk partners, and service providers, it is essentially an approved insurance company. The liabilities and responsibilities fall to its owners in terms of ultimate success or failure. The regulators will want to be knowledgeable of who and what is in each cell, but they will look to the sponsor for assurances of legitimacy and competence.

Each cell will be required to post its own security against future claims on its own risks. This makes it feasible to have more than one risk sharing partner involved with the sponsor. The cell will have to provide an annual audit and actuarial certification of reserve adequacy to the cell's owners, and thus the regulators. The cell may have a different attachment point for reinsurance than other cells within the holding structure. This feature makes the segregated cell structure attractive to heterogeneous groups or groups with members of very different premium sizes. This also greatly complicates the process and adds to frictional costs.

The Non-Controlled Foreign Corporations Issue

Non-controlled foreign corporations are more of a tax approach than the other structures. When forming an offshore captive, one of the early decisions is to determine the tax status going forward. Thoughtful consultation with well-qualified tax experts is highly recommended for the decision as to whether or not to take the 953(d) election of the Internal Revenue Code, and be taxed as a U.S. entity, or not. Fines and penalties for doing it the wrong way are formidable.

If the decision is made to not be taxed as a U.S. taxpayer, then several "gateways" must be traversed to assure compliance with all regulations. Again, knowledgeable counsel is highly recommended. In general, the participation and rights of U.S. taxpayers are limited, so this structure is most often used where there are more than a dozen unrelated non-U.S. entities involved in ownership of the captive. The tax advantages for the owners, if they establish the captive properly and manage it prudently, can be considerable in some cases.

Choosing the Right Captive Domicile

Each captive must be legally, and perhaps physically, located in a specific geographic entity with a recognized government. This place is called the domicile.

There are over 100 domiciles in the world, but most are not worth a general discussion. For the purposes of this material we will chiefly consider domiciles for U.S.-based parent organizations.

What does one look for in choosing a domicile? I would suggest the following points:

- Political stability
- Enlightened regulation
- Access
- Support services
- Cost

First of all, when a U.S.-based entity chooses a domicile, the initial decision is onshore versus offshore. This means sitting the company inside the United States or outside the United States. There are many reasons to eliminate a particular choice. One that arises early is called patriotism. Without offending those who are zealous in their defense of all things American, it is important to point out that five of the last six Louisiana Insurance Superintendents have served time in jail for insurance-related violations.

If your clients are troubled by choosing an offshore domicile, then by all means have them choose a U.S. domicile. There are many good ones that will likely meet your client's needs. For most people there are other reasons used to make a decision, and those are the audience for this piece.

Political Stability

Political stability means an analysis of the support for captive enabling legislation and enlightened regulation that can be identified as being present in all major political parties vying for control of the government. This applies not only to offshore domiciles, but also onshore. If the Democrats have promoted captives, and appointed a big Democrat donor as Insurance Superintendent, and the Republicans win the next election, things may change rapidly, and not for the better.

Obviously this applies to offshore domiciles too. It has happened that control of the government changes, and the new people in charge sometimes view captives as exploitive, and wish to tax and over-regulate them. The Bahamas was at one time a major domicile. The government changed, and captives did not care for the new laws. The captives left.

Enlightened Regulation

Enlightened regulation is a term for regulation that adequately and professionally addresses the issues of the character, capacity, and capital of the organizers and managers of the captive to perform their responsibilities and competently manage their business. No risk-sharing partner, for fronting or reinsurance, will be willing to work with a captive that is domiciled in a territory where there are no regulators, or the regulators are deemed not competent. The risk sharing partner wants to be assured that some governmental official with skill and experience is looking over the shoulder of the captive, so to speak. Such oversight constitutes another set of eyes and ears for the primary underwriter and risk taker.

However, if this regulation becomes burdensome for the captive owner/manager then the captive may feel forced to weigh other options. Striking the proper balance is key and is difficult. Most major domiciles have individuals who have been able to strike that proper balance.

A key point to use when evaluating a domicile is the budget appropriation to the Department for captive promotion and regulation. If there are no funds, then there will be no people. If there are no people, the domicile is not serious, and is not a real domicile. A very real part of regulation is promotion of the benefits of establishing your captive in a particular domicile. This promotion requires people and travel and expenses. If the legislature chooses to reduce or eliminate or never fund such expenses, the captive in that domicile will be frustrated and short-lived.

Access

As most captive domiciles require an annual meeting in the domicile, access to that domicile is a consideration. Some people do not care for long airplane flights. Many captive owners have pressing schedules and do not wish to spend an inordinate amount of time traveling for a captive meeting.

Some captive owners relish and anticipate visiting their captive domicile and constructing a vacation around the captive meetings. While many say that such softer points are not important, they are more important that most will admit. Smokers do not want 4-hour plane rides. Non-golfers do not wish to spend time at a golf resort. No one wants to be marooned on an island, by any definition, unable to leave when one wishes, or in a convenient mode.

Support Services

Support services are those ancillary but necessary or even required services that the captive must purchase. These include a domicile manager, an actuary, an attorney, an accountant, or even a banker. All of these must be arranged, and there will be regular interface. If each service provider is in another physical place, and time zone, the coordination can be aggravating.

The domicile manager is the firm that keeps the books, contracts, and records of the captive. In some domiciles, this person acts as the first line of defense for the regulators. In almost all cases, they must be local and known to the regulators.

The other service providers may be of your own choosing, but some domiciles require that the attorneys, accountants, actuaries, and so forth be formally recognized and perhaps even have an office in the domicile. Such a requirement may demand extensive inquiries into the local providers' qualifications, competence, and fit with your client’s company.

Capitalization and costs

These vary depending on structure more so than jurisdictions. It ranges from as little as $120,000 to $1 million. Note: Minimum capital is the amount you need to maintain regardless of whether you write any policies. All jurisdictions require that your captive maintain additional surplus in an amount of $1 of surplus for every $3 to $5 of net premiums written. Net premiums are premiums after the costs of fronting and reinsurance. In addition, your risk sharing partners may require collateral to cover any difference between their attachment point and your captive’s retention. As such, a domiciliary decision based solely on capital is wrong.

Additional costs will include annual fees, payments of bureaus and boards of review, the annual meeting, if required in that state, and Federal Excise Tax. These do not vary much between jurisdictions but generally are less expensive in the US versus any legitimate offshore jurisdiction.

The purpose of a jurisdiction electing to become a domicile is to promote jobs and increased tax and fee revenue. Many domiciles require the domicile manager to report periodically on the amounts of money spent on meetings held in the domicile. These revenues become critical at budget time.

All of the above factors should be considered when considering your domicile.

Actuarial Projections and the Captive

In the process of evaluating whether or not to form a captive, an early part of the process is working with an actuary to determine the probability of future losses. In this article we will examine this process, and how to use it to the best advantage for achieving maximum efficiency in risk financing.

Understanding Claims

Recalling the basic idea of forming a captive was to use the owner's better risk profile to achieve maximum efficiency, it is imperative to understand the claims, their history, and origin. A primary advantage of a captive over traditional forms of risk financing is the ability to choose claims managers, risk managers, and other vendors. Central to all of the process is an actuarial feasibility study. Central to the feasibility study is the projection of future loss payments.

When a claim occurs, it has a value. If it is not immediately settled, which is usually the case with liability claims; the time value enters the equation. Projecting that value to the ultimate payout is one of the chief roles of the actuary.

The Actuary's Role

An actuary is a professional not often encountered by most business people, including many insurance people, even though their work is highly regarded and widely quoted. However, their work is also widely misunderstood and misused.

The point of the actuarial review and forecast is to analyze the past loss record of the client, compare this to the industry, and develop trends and project the probability of the timing and amount of future claim payments. Actuaries are trained in, and use, very sophisticated mathematical probability, forecasting formulas, and patterns of logic based on experience with statistics and actual claims results. Few, if any, captives will be formed or approved, or find a risk sharing partner without an actuarial feasibility study.

The actuary is a highly skilled and trained professional whose work can be used, like the Bible, to prove a variety of points, some of them in opposition to each other. For this reason most actuaries today require that their work is closely controlled as to distribution, and they prefer to explain their results in person.

It is worth noting that not all actuaries are trained in all lines of coverage, or are familiar with captives. Additionally, in many cases it is individual actuaries who are recognized by regulators, so that time and investigation in choosing an actuary can save money.

Working with the Actuary

Considering that a captive is usually formed to insure the risks of its owner(s), it is wise to carefully study and analyze the probability of future loss. At this stage in captive formation, many owners become confused and uncertain. Owners very well may not agree with the conclusions and recommendations of the actuary, but it behooves them to understand them. If the mathematical part is not easily understood, perhaps the logic can be followed. The owner may not accept either part, but others will give them great credence.

When a traditional insurer uses an actuary to project future losses, it will often do so based on the statistics for the entire industry class. It is then up to the underwriter, and/or the agent, to determine the specific characteristics of the individual client that make it a better (hopefully) risk than the class. Such matters as specific client claims history, risk management programs, and claims practices can cause the underwriter to favorably modify the rate projections of the actuary.

For the captive owner, this process takes on a more personal perspective, since the owner often does not share the perspective of the class, or the wider view of the underwriter or actuary. The belief that one is better than the class is not enough to persuade a risk sharing partner, or a regulator. Nonetheless, history has demonstrated that the actuary's projections should be heeded, if not adhered to absolutely.

IBNR Losses

The history of captives is replete with meetings in which IBNR is explained to the novice captive owner. IBNR, which stands for "incurred but not reported," is the industry phrase for losses that statistically will occur, but practically have not yet been reported. Most people will agree that the concept is sound. Disagreement comes at the point of determining the amount and timing of the loss, and the form of security required to meet the obligation. Captive owners must pay their own losses, excepting layers of coverage that are transferred elsewhere. Most would agree with that point also. Getting agreement on amounts and form can be quite confusing, frustrating, and painful.

In order for the captive owner to achieve the desired goals of maximum risk financing efficiency, the actuary and the owner must effectively communicate their positions. The captive owner should understand the actuarial projections, as the actuary should understand the reasons why the owner believes that his company will outperform the class, and utilize that view in his projections if he believes them to be valid.

Supporting the views of the actuary is the fact that many claims, closed for years, can be reopened and require additional payments. This usually occurs in the workers compensation class in a jurisdiction where the state has increased benefits on claims, awarding increased payments to claimants. While a new captive owner may wish to deny this possibility, the actuary, and his audience, must consider the probability. If there is a probability, then the security must reflect that fact. It does happen.

The issue of providing security against future claims can become the turning point of the decision to proceed with a captive, which is why the role of the actuary becomes critical. If the security required to assure payment of future losses exceeds the owners' ability or need to self finance, then the better decision may be to stay within the traditional market, and use premiums to finance the risk. Of course, the traditional underwriter will also have an actuary, who may see the projections in the same vein and recommend additional security through increased premiums or a letter of credit to secure an increased self-insured retention.

Somewhere in this process the captive owner must demonstrate to the actuary, and the risk sharing partners and regulators, that the insured firm(s) has a risk management program that will clearly achieve a claims result superior to the class. This can be demonstrated through showing a thorough analysis of exposures, alternatives to financing, aggressive claims management, and proactive senior management.

Establishing Premiums

Another key role of the actuary is to establish the premiums for the captive. Probably the most difficult part of any insurance transaction is to determine what to charge for the risk. If the premium is too low, the losses will aggregate to cause a loss in real dollars, or an increase in security, and possibly a close regulatory review and meetings with the risk sharing partner. If the premium is too high, the loss ratio may cause a regulator to inquire as to the true purpose of the captive in regard to deductibility of premiums for tax purposes.

In the purchase of traditional insurance, the actuary works with the underwriter and others to provide a premium. In a captive situation, the actuary often works largely unaided to calculate a premium that will cover the claims, and provide an underwriting profit. Negotiation becomes important to provide the actuary with as complete an explanation as possible of the potential risk.

An important point to bear in mind in the ownership and operation of a captive is that the owner does not necessarily want to reduce his premiums. The true goal should be seen as controlling and predicting premiums. Actuarially derived premiums substantiate the owner's position on security, and on possible tax deductibility. Reducing premiums to show an improved bottom line in the parent can have dire consequences for the captive in terms of security for increasing future claims payouts against declining premiums.

If the premiums are deductible by the parent/insured(s), then reducing them in the face of contrary actuarial information can raise issues with regulators, risk sharing partners, and others about the long-term viability of the captive. It is usually far better to go with the actuarially derived premiums, and generate funds for other uses by the parent/insured(s).

Profit Projections

Finally, the actuary provides a pro forma estimate of the profitability of the proposed captive. If the captive is projected to lose money, there will be questions from many quarters as to the wisdom of proceeding to formation. Many factors go into the pro forma, including assumptions. The assumptions are delineated and explained in the notes to the pro forma, and need close scrutiny. Included in the assumptions are such items as interest rate income derived from funds on deposit, payout profiles, and expenses.

The assumptions become as important as any other component in the formulas, and are often overlooked. The assumptions can make or break the profitability. None of them should be unexamined or taken for granted. There will be funds available for investment, and there will be independent vendors to expense. There will be meeting expenses. There will be annual review and certification of loss reserves by the actuary, and a certified audit. Often, in the haste to do the deal, managers and actuaries will use "plug" formulated percentages and numbers. These must be questioned. They may be right. They may be way off.

Timing of these funds, availability for claims payments, liquidity, all these things are considered by the actuary and the other partners of the captive. Focused discussions are needed here in the low interest climate of today. There was a time, and there will be again, when interest from invested funds was a major component of insurers and captives balance sheets. To project above 4 percent today would require a detailed explanation to gain credibility.

Reduce Taxes?

As discussed earlier, a captive insurance company can reduce your client's income tax liability. If structured properly, the premiums paid by a business to a captive insurance company are deductible business expenses. Additionally, the premium income could be tax-exempt income to your captive insurance company. The Internal Revenue Code provides certain tax advantages to insurance companies depending on the amount of premium income received.

-Large Insurance Companies - Insurance companies with annual premium income of more than $1.2 million are allowed to deduct reserves for losses even though payments of claims might be five to ten years in the future. This is similar to banking institutions that are allowed a deduction for a loan loss reserve. Other taxpayers are not allowed to deduct reserves for losses. The insurance company pays tax on its net (premium and investment) income at ordinary C-corporation rates.

-Small Insurance Companies - Insurance companies with annual premium income of less than $1.2 million can elect to be taxed only on investment income. Premium income is tax free. However, investment income earned on the funds held inside the insurance company is taxable at ordinary C corporation rates. **(Internal Revenue Code section 831(b))**

-**Very Small Insurance Companies** - Insurance companies with gross receipts of less than $600,000 and premium income representing more than 50% of the gross receipts - premium income **and** passive investment income are free of federal income tax. **(Internal Revenue Code section 501(c)(15))**

The second option listed above (the 831(b) captive) is where there is a lot of opportunity for small business owners.

The third option (the 501(c)(15) captive) does not present as great an opportunity because in calculating the gross receipts limitation clients must include the gross receipts of other business that are within a controlled group of corporations as specifically defined by Internal Revenue Code Section 831(b)(2)(B)(ii). See below for further explanation.

Let's look at an example of how a captive can be beneficial to a small business owner:

Sam is a successful real estate investor and business owner. He sets up a bona fide captive insurance company to help control his insurance costs and reduce income tax. He raises the deductible on his current insurance policies with traditional insurance companies. He insures the deductible amount through his captive. Once his deductible is higher, his traditional insurance premiums are $50,000 lower. He uses the $50,000 of savings to insure the $50,000 deductible through his captive and to buy others types of insurance through his captive insurance company.

In addition, Sam obtains new types of insurance coverage from his captive insurance company, which he had not previously purchased from a traditional insurance company. These new coverages include business interruption, terrorism, employment practices and fire damage to his tracts of timber. These are legitimate business risks that he has whether he chooses to insure for them or not. His premiums for this coverage are $400,000. He doesn't mind paying the $400,000 because the cash will be held inside his captive insurance company.

Under Internal Revenue Code section 831(b), the $450,000 of premium income received by Sam's insurance company is free of federal income tax. Additionally, if his captive insurance company is properly structured, his operating businesses will be allowed to deduct the $450,000 as insurance costs. At a 40% income tax rate, this saved Sam and his companies $180,000 of income tax.

Physicians and captives

It seems like the client that least fits the profile for a captive is the one that wants to have one in the worst way. Physicians very much like the idea of a captive as they see their malpractice insurance premiums going sky high. While a large captive for a very large group (with a good claims history) might make actuarial sense, a traditional single parent malpractice captive for a 1-5 doctor group makes little sense.

The reason physicians pay so much for malpractice insurance is because they get sued quite often and lose quite often. If the odds that a client will get sued and will lose are quite high, is that client a candidate for a captive? No. Physicians have the added problem of a high volume of frivolous lawsuits. While the claim might eventually be dismissed or at trial found in the client's favor, the high volume will be very expensive just looking at the litigation costs.

One area that a physician could justify is a large premium for a type of coverage that is very important is on the issue of Medicare fraud. At $10,000 per violation (and there could be multiple violations per patient), a physician could have millions of dollars in federal fines that are not dischargeable in bankruptcy. If the client does not insure against that loss, the federal government will take everything the client owes to satisfy the debt. The fines for Medicare fraud cannot be paid as a deductible practice expense and so insuring the potential loss with tax deductible premium does make a lot of sense. Add to that the fact that a doctor is not likely to have a Medicare audit and it makes the use of a captive a viable thought.

Estate Planning

Captive insurance companies can help reduce estate tax as well. In the above example, if Sam's adult daughter owned the captive insurance company, Sam's businesses could pay premiums into the captive for legitimate insurance coverage. This would help reduce his estate because the cash would be transferred to the captive insurance company owned by the daughter. If we assume a 49% estate tax rate, the estate tax savings in the above example could be $220,500.00.

In this example, the total potential tax savings for paying $450,000 into a captive insurance company could be as much as $400,500. The breakdown is as follows:

Income tax savings	$180,000.00
Estate tax savings	220,500.00
Total	$400,500.00

This is on top of any potential insurance savings that might be realized by increasing his deductible on insurance policies that he has with traditional third party insurance companies.

The savings actually approach the cost of the premiums on the new insurance coverage. And if no claim is filed on the business interruption, terrorism, or timber coverages, the $450,000 remains in the daughter's insurance company.

The following table illustrates the maximum potential benefit with 30% unrelated party business:

Year	Allowable Related Party Insurance Premiums	Federal Tax Deduction @ 35%	State Tax Deduction @ 7%	Potential Estate Tax Savings @ 49%	Annual Potential Tax Savings	Cumulative Tax Savings
2005	$840,000	$294,000	$58,800	$411,600	$764,400	$764,400
2006	840,000	294,000	58,800	411,600	764,400	1,528,800
2007	840,000	294,000	58,800	411,600	764,400	2,293,200
2008	840,000	294,000	58,800	411,600	764,400	3,057,600
2009	840,000	294,000	58,800	411,600	764,400	3,822,000
	Five Year Total	1,470,000	294,000	2,058,000	3,822,000	

Revision to "Small" Insurance Company Tax Law

On April 10, 2004, the President signed new legislation, The Pension Funding Act of 2004, which will include provisions that will change the manner in which "small" property and casualty insurance companies are taxed. Small property and casualty insurance companies are those that take advantage of Sections 501(c)(15) or 831(b) of the Internal Revenue Code. Pursuant to these sections certain property casualty insurance companies, including many formed under various captive laws, could either be exempt from federal income taxation or alternatively taxed only on investment income. These changes are effective for tax years beginning after December 31, 2003.

Fueled by articles in the press, Congress and the IRS perceived that a number of insurance companies were formed primarily to take advantage of the provisions of Sections 501(c)(15) or 831(b), rather than primarily to conduct the business of a property casualty insurance company. Accordingly, Congress and the IRS sought to change the Internal Revenue Code to combat the proliferation of these companies for unintended uses.

Historically, the Internal Revenue Code did not include any definition as to what constitutes a property casualty insurance company. The Pension Funding Equity Law of 2004 now includes such a definition by referencing existing Code section 816(a), a section that previously applied only to life insurance companies. Thus, an insurance company is now defined as, "any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies".

Prior Law Requirements For Tax-exempt Status

Under prior tax law, a property and casualty insurance company was exempt from federal income tax if the greater of net or direct written premiums was $350,000 or less. Under the prior law, for the purpose of the premium determination, premiums of all members of a "controlled group" were required to be aggregated. "Controlled group" is a term defined in the Internal Revenue Code but generally includes entities under common control and generally includes for this purpose, the insurance company's parent company, brother/sister corporations if a parent corporation owns 50 percent and brother/sister corporations if five or fewer persons own 50 percent or more of the insurance company and the brother/sister corporations.

New Law Changes Related to Tax-exempt Status

Under the new law different rules apply to mutual companies than apply to companies formed as stock companies or reciprocals.

Section 501(c)(15) has been amended to indicate that a stock property casualty insurance company or reciprocal is tax-exempt if: 1) its gross receipts for the tax year do not exceed $600,000, and the premiums received for the tax year are greater than 50% of its gross receipts. For purposes of the premiums and gross receipts testing, the premiums and gross receipts of all entities that are members of the same controlled group are aggregated. The definition of controlled group for this purpose did not change.

A mutual property casualty insurance company will be exempt from the income tax if the gross receipts for the taxable year do not exceed $150,000, and more than 35 percent of such gross receipts consist of insurance premiums. For purposes of the determination of premiums and gross receipts, the premiums and gross receipts of all entities that are members of the same controlled group are aggregated. The controlled group test for mutual companies includes a new special provision that provides that tax-exempt status shall not apply to a company if any employee of the company, or a member of the employee's family is an employee of another company exempt from taxation by reason of this section (or that would be exempt except for this section).

Prior Law Related to Taxation of Investment Income Only

Under prior tax law, a property and casualty insurance company could elect to be taxed only on investment income if the greater of its net written premiums, or direct written premiums, were between $350,001 and $1.2

million. Once made, the election was irrevocable without consent of the IRS Commissioner. The controlled group rules described above are applicable for purposes of determining applicability.

New Law Related to Taxation of Investment Income Only

Under the new law a property casualty insurance company that has less than $1.2 million in direct premium (or written if greater) can make the election to be taxed on investment income only. Once made, the election is irrevocable without the consent of the IRS Commissioner. The prior tax laws concerning controlled groups continue to apply. A significant change relates to the ability of a company to make the election when its premiums are less than $350,000, which under prior law they could not. There is no gross receipts test for purposes of the election, only a premiums test.

Limited Transition Rules

The 2004 Pension Funding Act has enacted a transition rule for companies in bankruptcy, or other similar proceedings, for tax years beginning after 2003. A company that on April 1, 2004 meets the pre-2004 Pension Funding Act Code tax-exempt requirements of Section 501(c)15 and is in receivership, foreclosure, or similar proceeding in a state court, will be treated as tax-exempt after April 1, 2004, for so long as the company continues in the proceeding. The transition rule will not be in effect for tax years beginning after 2007.

Conclusion on tax law changes

The changes in the tax law recently enacted should be reviewed carefully by all companies that previously were treated as "small" property and casualty insurance companies pursuant to Sections 501(c)(15) or 831(b) of the Internal Revenue Code. As a consequence of this law many previously tax-exempt insurance companies may no longer be tax-exempt. For those companies that fail the gross receipts test under section 501(c)(15), they now may have the ability to elect under section 831(b) to be taxed on investment income only.

Asset protection

You might wonder how a captive insurance can protect your client's assets. Many business owners are familiar with setting up multiple entities (corporations and LLC's) to segregate their risk into multiple baskets. A captive insurance company is another basket into which a client can place funds via legally deductible insurance premiums.

Let's look at an example. Assume that an employee who delivers product to clients took a long lunch and drank five gin and tonics. After lunch the employee drives the company car to the next client's office to make a delivery. Assume the employee got into a bad car accident where four other people were severely injured. The injured parties will sue the employee and the employer because the employee was working and driving a company car at the time of the accident (and let's assume the employer also knew that the employee had a habit of drinking over lunches and never stopped it).

In the worst case scenario, the injured people would go after the entire net worth of the business, so all the company assets would be at risk. If the employer had been paying $1,000,000 a year into a captive for legitimate insurance coverage, the money in the captive would not be subject to the creditors. The captive insurance company is a separate business and the assets themselves are not subject to the creditors. (Let's also assume the employer did not buy additional auto insurance from the captive).

As a rule of thumb, captives are not "asset protection tools" even thought they have terrific asset protection features.

Summary on Captive Insurance Companies

While captives are not an every day topic for most of an advisor's business clients, it is one that can be very beneficial when used for the right client. The CWPP™ program revolves around educating advisors matters that can benefit the high income/net worth client and in order to be a full service advisor to business clients, it is essential to have a working knowledge of captive. Knowledge on captives will, like many of the topics covered in the CWPP™ program will set local advisors apart from their competition and re-emphasize why a CWPP™ should be the team leader when helping the high net worth/income client.

