

# Accreting wealth with captives: The middle market solution

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## Is a captive insurance company the right vehicle for you?

Historically, captives were economical only for the ‘big boys’: UPS, Carnation, Mobil, Humana, Harpers, and Columbia Energy to name a few. Today, captives have become an invaluable tool for the successful middle market company. A captive may be the only safe vehicle that allows an owner to more efficiently manage business risk by using the governments’ money in the form of substantial federal and state income tax savings. A qualifying company can take a guaranteed loss (taxes) and utilise those tax savings to fund other business risks and increase shareholder distributions.

Sound too good to be true? The big boys paved the way by winning court cases, Congress has blessed it, and the IRS has provided safe harbours.

## Why form a captive?

Pre-tax wealth accumulation;  
favourable distribution rules;  
estate planning/wealth transfer;  
reduce/stabilise insurance costs; and  
retention of key employees.

## Who is this for?

The owners, shareholders and CFO must study the potential benefits of a captive. Captives are typically lost at the risk manager or insurance broker level. Risk managers and brokers predominantly focus on only the cost of existing insurance. They often neglect to focus on the net

dollars to the owners at the end of the day. At the end of the day it is not about how much you make, but how much you can safely tuck away. A captive will create a substantial pre-tax nest egg, ultimately used for risks of the business, its owners, family members and/or key executives (see Exhibit 1).

A captive will not work for everyone. An appropriate company will meet several of the following criteria: (1) they will be profitable with taxable income ranging from \$1.5m to \$50m; (2) they will have substantial self-insured risks; (3) may have an employee base or (4) large third party insurance premiums.

Ideal companies include: real estate developers, manufacturers, and service and hospitality industries. These companies will typically have substantial self-insured risk, as well as traditional risk that may be acquired on a wholesale basis via the captive.

## What is Self-Insurance?

Most business owners fail to recognize that they already self-insure a large amount of risk (see Exhibit 2). Self-insurance without a captive is not deductible for federal and state income tax purposes. However, with a properly structured captive, self-insurance can create substantial current tax deductions.

The most common areas of self-insurance include: deductibles and exclusions on existing policies, product warranty/liability, construction defect, mould, subsidence, employment practices, sexual harassment, accounts receivable, government and administrative actions, and disability. The most common areas of savings on traditional insurance coverages



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would include: workers’ compensation, health, malpractice, D&O, and E&O insurance.

## Insurance is a bad investment

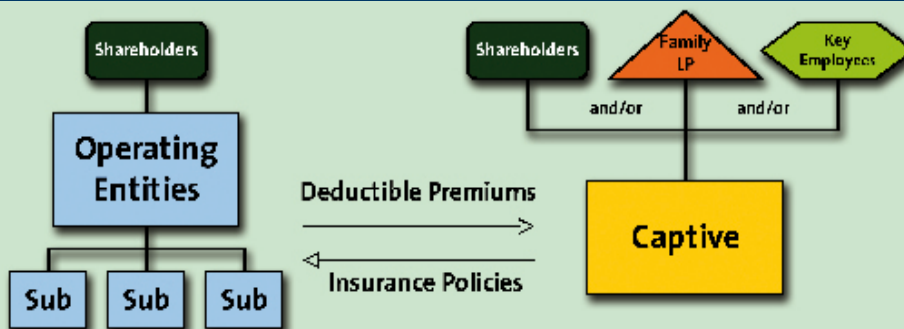
AIG is a \$600 billion company; Buffet’s assets grow every day. They were not able to accumulate massive amounts of assets because insurance is a good investment. Owning an insurance company, on the other hand, may be the best investment available today. There are well over 8000 captives operating in the US today. Why? Skyrocketing insurance rates, and large exclusions and deductibles, combined with the IRS providing tax incentives and ‘safe harbours’ make for the most favorable environment in history for owning your own insurance company.

Traditional insurance has become extremely expensive and has taken on the form of ‘swiss cheese’. As a result, many companies have chosen to actively participate in their insurance portfolios by taking on large deductibles and/or self-insuring.

## I don’t want to take on risk!

A common thread amongst business owners is their lack of desire to take on additional risk. In order to qualify as an

Exhibit 1: Captive study



insurance company for federal income tax purposes, a captive must take on risk. However, if that risk consists solely of risk they were otherwise self-insuring, have they actually taken on additional risk? If there is a loss in a later year, the loss will actually cost the company less if they utilise a captive, because approximately half of the loss would be funded with federal and state income tax savings.

Example: Company A self-insures for product liability/warranty coverage. As of December 31, 2006 Company A will have taxable income of \$20m. They will pay 45 percent in federal and state income taxes, leaving them with 55 percent or \$10,100,000 to cover future losses or distributions to its shareholders. If Company A chose to fund \$5,000,000 into premium payments to its wholly-owned captive, they would have an additional \$2,250,000 available to pay costs, claims, or make additional distributions to its shareholders. One thing is certain, if they don't pay the premiums, the money they pay in taxes is a guaranteed loss!

Example: Company B has over 200 employees. Although their actual losses for workers compensation are low they are paying substantial insurance for workers' compensation due to industry averages. Company B forms a captive to insure up to \$1m of their actual losses, with excess coverage provided by an A+ rated insurance company. Company B utilises the captive to partially self-insure its workers' compensation thereby driving down its cost of insurance by over \$750,000 per year.

Example: Company C is a builder/contractor. It is cost prohibitive to obtain insurance for construction defect, mould, and subsidence. Company C forms a captive in order to insure its self-insured risk. They pay their captive annual

premiums less than \$1,200,000. Their captive qualifies as an electing IRC section 831 (b) company. As such, Company C is able to obtain an ordinary income deduction of \$1,200,000 and the captive is exempt from both federal and state income taxes on the premiums it receives.

### What does the IRS have to say?

The IRS provides favourable tax treatment for insurance companies. They provide an exemption for small companies that allow the electing small companies to receive up to \$1,200,000 per year tax-free. They allow larger insurance companies to take a current deduction for estimated future losses. Both provisions make owning an insurance company a favourable type of companies to own under the proper circumstances.

The IRS has also provided 'safe harbours' to help taxpayers navigate the myriad rules and tax traps. It may sound fairly easy; it's not. Captives can be fraught with tax landmines. They should only be structured via management companies who have expertise in underwriting, US income taxation, and insurance company management. A qualified captive management company will assist each captive in navigating the extensive IRS rules and regulations, including the requirement for adequate risk shifting and risk distribution.

### Jurisdiction-offshore/onshore

The discussion whether to form a captive insurance company onshore or offshore is worthy of its own article. Domestically, most states have determined that they should be in the captive game. The state where a business is operating may influence which domestic jurisdiction one chooses. We are currently leaning towards Arizona as our domestic

jurisdiction of choice. Arizona is one of the few jurisdictions that have favourable interaction with some of the federal insurance statutes.

As far as foreign jurisdictions go, the British Virgin Islands remains our top pick for middle market companies. They are respected worldwide as both a friendly and well-regulated jurisdiction. The majority of the captives that we form are in the BVI. However, these companies are domesticated for US income tax purposes. Foreign insurance companies with domestic owners are the only foreign corporations that are permitted by the IRS to make an election to be taxed and treated as a US income taxpayer.

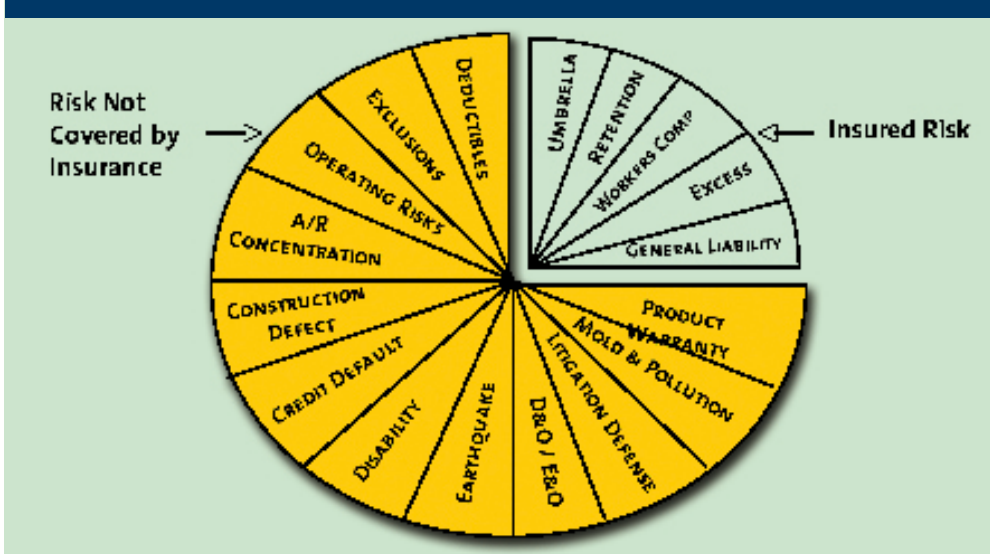
### Captive types - pros and cons

There are many different types of captive arrangements. They include: single-parent captives, group captives, cell-captives, and agency captives. Wholly-owned captives, also known as single-parent captives are the only type of captive providing the client ultimate control of his destiny. The client will be in control of all insurance, investment, and underwriting decisions.

Captive insurance taxation is complex and ever-changing. It is easy to make a mistake and hit one of the many deadly tax landmines, leading to the entire captive arrangement being discarded. While captive insurance is a powerful tool, it must be accompanied by quality tax advice and counsel. If an arrangement sounds too easy or too good to be true, seek a second, independent opinion from a qualified tax professional with experience in insurance company taxation.

It is important to work with a firm that has tax, legal, and underwriting expertise. It takes years of experience to balance the insurance regulations, IRS requirements and client needs. ■

Exhibit 2: Wheel of risk



Alta Holdings, LLC is recognised as one of the global leaders in captive structuring, formation, and management. They have utilised these structures to assist clients worldwide with wealth preservation, risk management, and tax optimisation. They maintain strong relationships with rated insurance carriers and major re-insurers allowing them to structure proprietary reinsurance and risk-management transactions unparalleled in the alternative risk management industry.

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