

Are You at Risk?

Successful Business Owners are Turning Risk into Reward

If you own a business in Oil & Gas, Real Estate, Construction, Manufacturing or Distribution, then self insured risk is a major issue to which your company is exposed. In order to mitigate this risk, industry trends reflect that a majority of successful businesses will implement a Captive insurance program by 2010. Thousands of business owners have begun to accumulate vast amounts of pre-tax wealth through Captive insurance strategies.

Strictly defined, a Captive is an insurance subsidiary formed to insure or reinsure the risks of its parent company. Premiums paid to the Captive can be deductible by the business. Often, such premiums flow tax-free income to the Captive, where the money gathers in anticipation of future losses, or shareholder distributions.

For many years, the Internal Revenue Code has provided favorable tax treatment for insurance companies. A long standing exemption for small insurance companies may enable a Captive to receive up to \$1.2 million each year tax free. The IRS allows insurance companies with premiums in excess of \$1.2 million to take a current deduction for estimated future losses. Either tax treatment makes owning an insurance company extremely favorable.

How Do Captives Work?

According to Bruce Molnar, who is Chief Executive Officer of captive specialist Alta Holdings, LLC, "most businesses unknowingly self-insure an alarming amount of risk." The problem is that self-insurance without a Captive is not tax-deductible for federal or state income tax purposes. Nor are loss reserves set aside to finance future lawsuits and other exposures due to implied warranties. As a result, these risks can cost twice as much because they must be paid from profits on which the business has already paid tax.

On the other hand, business owners that have structured a Captive insurance company can finance that risk using tax dollars. With a Captive, self-insured

Roughly 80% of S&P 500 businesses have structured a Captive. There are over 8,000 Captives operating today.

risk can be converted into tax-deductible premiums that are paid into a privately-held insurance company. Risks can now be addressed with this pre-tax nest egg. In the event that claims do not materialize, the Captive will capture a substantial pre-tax nest egg to be used for the future business risks, or for distributions to owners, family members and/or key executives, all at favorable tax rates.

In this scenario, the business owner has not assumed additional risk. Keep in mind that the business owner is already exposed to such risks before establishing a Captive. "Typically, Captives are put in place to help fill in gaps where conventional insurance markets do not provide coverage, or where the cost is deemed economically prohibitive," according to Shawn Goheen, founder of Goheen Financial Group.

Example: As of December 31, 2006, Company ABC will have taxable income of \$10 million. It will pay 45% in federal and state income taxes, leaving it with 55% or \$5.5 million for construction defect claims, or for distribution to shareholders. Instead, if Company ABC funds \$4 million in premiums to its wholly owned Captive insurance company, it would have an additional \$1.8 million available for expenses, claims, or for additional distributions to shareholders.

Who Should Consider a Captive?

Captives will not work for everyone. However, good candidates generally meet several of the following criteria: (1) profitable operations, with taxable income ranging from \$1.5 to \$100 million; (2) substantial self-insured/uninsured business risk; (3) a large number of employees; and/or (4) substantial traditional third-party insurance expense.

What does the IRS have to say?

The IRS has created "safe harbors" to help taxpayers navigate the myriad of rules and tax issues. It may sound fairly easy — it's not. Captive formations and management are fraught with tax landmines, and should only be structured using experienced and qualified professionals, such as management companies with experience in underwriting, U.S. income tax matters, and insurance company management. A qualified Captive management company can assist each Captive in navigating the extensive IRS rules and regulations, including the requirement for adequate risk shifting and risk distribution.



All captive services offered through Alta Holdings, LLC
www.altaholdings.com

For More Information regarding captives contact the OGS Program at: