



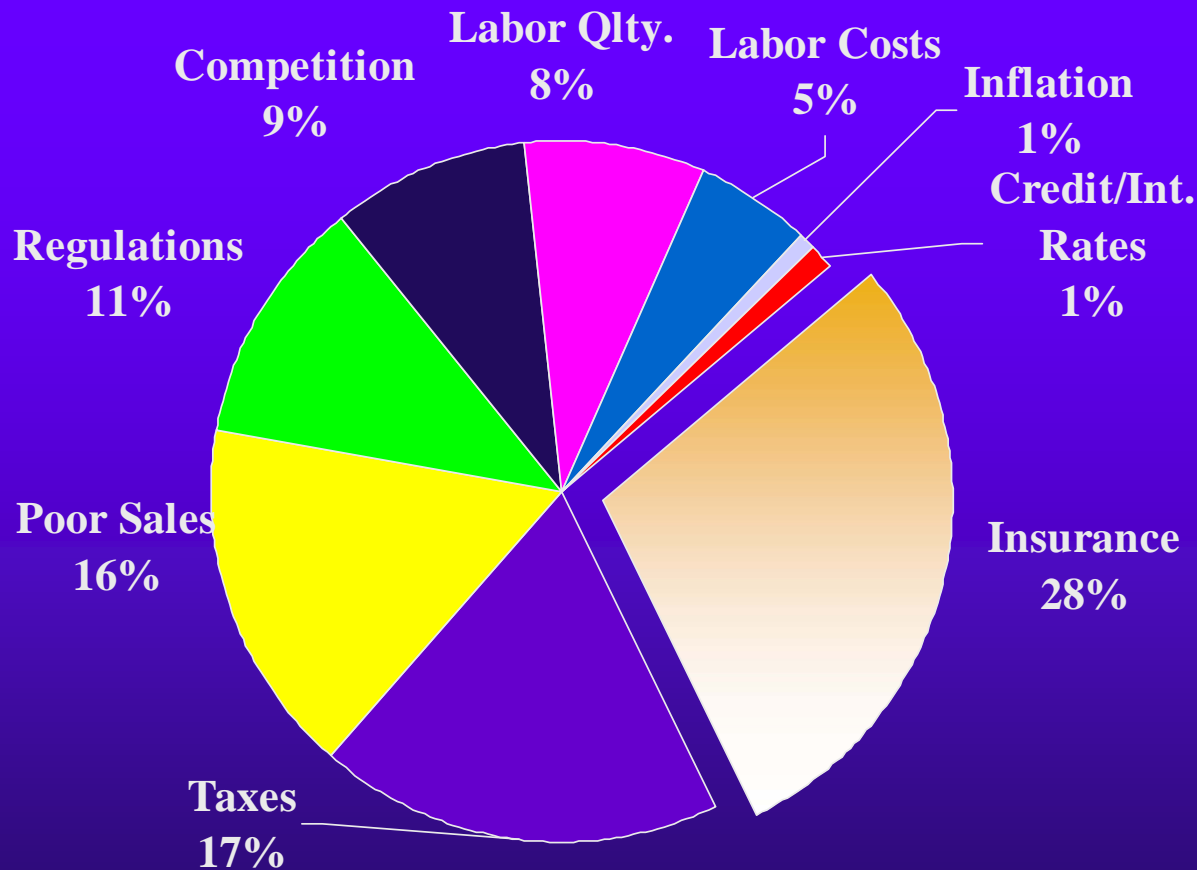
The Financial and Tax Benefits of Captive Insurance Companies

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What is a Captive Insurance Company?

- ◆ A captive insurance company is a private insurance company that is set up to insure the risks of a single parent company, the risks of an association's members, or the risks of an industry group. It is a tax-advantaged way to self-insure a portion of your risks. Captive insurance companies are an alternative to traditional insurance arrangements

Insurance is the Biggest Concern of Small Business Owners



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



- ◆ Why are Captive Insurance Companies becoming popular?

They help control insurance costs and provide the opportunity to reduce taxes.




Financial Benefits

- ◆ Why is the cost of insurance increasing?

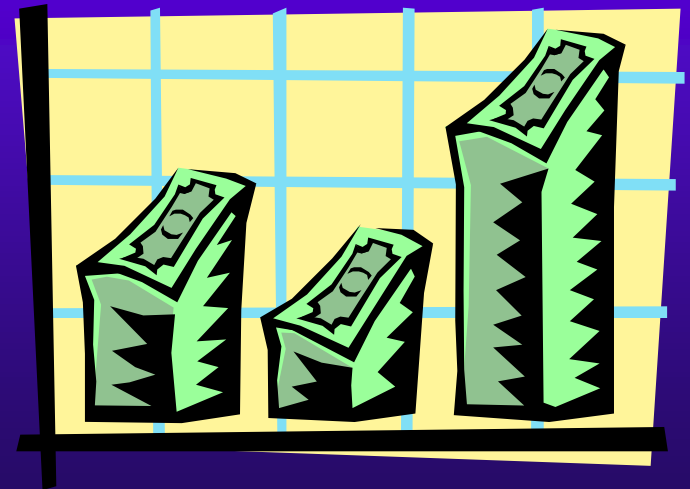
Increase in risk

Increase in the cost of doing business



Recent events have affected the risks of doing business

- ◆ The World Trade Center terrorism
- ◆ The Enron / WorldCom / Andersen crisis
- ◆ Increase in lawsuits
- ◆ Increase in medical costs



Lets talk about risks



Financial Risks	Traditional Risks	Non-Traditional
Equity Risk	Property Risk	Price Volatility
Currency Risk	Liability Risk	Warranty Risk
Interest Rate Risk	Casualty Risk	Inventory Risk
Price Commodity Risk	Worker's Comp	Frequent Stay Programs
Credit Risk	Employee Benefits Risk	Patronage Risk
Correlation Risk	Business Interruption	Catastrophic Risk
Investment Risk		Residual "GAP" Risk
Guarantees		Environmental
Covenants		Employment Practices
Refinancing Risk		Liability
		Lease-End Risk
		Performance Risk

TORT-ure

- ◆ Asbestos
- ◆ Tobacco
- ◆ “Toxic” Mold
- ◆ Aftermarket Parts
- ◆ Lead
- ◆ Arsenic Treated Lumber
- ◆ Construction Defects
- ◆ Guns
- ◆ Genetically Modified Foods (Corn)
- ◆ Nursing Homes/Med Mal
- ◆ *Sept. 11??*
- ◆ *What’s Next?*





Insurance costs will continue to rise

- ◆ Tillinghast-Towers Perrin, insurance industry consultants, estimate that tort costs could increase twice as fast as the economy, rising to \$298 billion, or 2.4% of GDP, by 2005.





What are the alternatives?

- ◆ Continue to pay premiums to an insurance company under conventional arrangements and hope to be able to pass along your increased costs to your customers
- ◆ Go out of business
- ◆ Stop carrying insurance – This is already being done in the nursing home industry
- ◆ Set up a captive insurance company and insure your own risks



Types of Captive Insurance Companies

The five basic types are:

1. **The Pure Captive:** A captive that essentially insures the risk of its economic family.
2. **An Association Captive:** A captive company formed to insure the risks of member companies when they have a legal association for purposes other than insurance and the association has been in existence more than one year.



Types of Captive Insurance Companies

3. **An Industrial Captive:** A captive company formed to insure the risks of the industrial insureds that comprise the industrial insured group and their affiliated companies.
4. **A Sponsored Captive:** A captive entity that insures the risks of separate participants through a contract that segregates each participant's liability through one or more protected cells.
5. **A Special Purpose Captive:** A captive insurer that does not meet the definition of any other type of captive.



Surviving Soaring Insurance Costs

May 2002 Journal of Accountancy

- ◆ **SAVVY BUSINESSES ARE RESPONDING** to the huge property and casualty insurance premiums prompted by September 11 by forming their own captive insurance companies so they not only get reduced premiums but also access to economy-priced reinsurance.
- ◆ **ONE ADVANTAGE OF A CAPTIVE** is that it offers its corporate owner a way to gain greater control over its risk exposures, since the captive is managed by those whose sole responsibility is to reduce corporate exposure to loss. If losses can be reduced, the captive will make a profit for its owner—the insured.
- ◆ **BY RETAINING MORE OF ITS OWN RISK** and running it through a wholly owned captive, the captive's corporate owners also get to keep the investment income earned on the money reserved for future losses.
- ◆ **ANOTHER ADVANTAGE OF CAPTIVES** is the availability of a tax deduction for the premium paid by the insured, as well as a deduction for the loss reserves.
- ◆ **THE IRS TRIED TO BLOCK** those deductions but lost a round of court battles and finally issued revenue ruling 2001-31 that, in effect, abandoned its fight.



Are other companies doing it?

- ◆ Many Fortune 500 companies have benefited from captive insurance companies for years. In fact, Allstate Insurance was founded as a captive insurance company for Sears. Even if you are not a Fortune 500 company, you can realize financial as well as tax benefits from establishing a captive insurance company.
- ◆ Other examples:
- ◆ Wal-mart
- ◆ UPS
- ◆ Exxon
- ◆ Mobil
- ◆ Delta Airlines
- ◆ TWA



Ways to use a captive

- ◆ Self Insurance
- ◆ Reinsuring third party risk
- ◆ Credit insurance
- ◆ Extended warranty contracts
- ◆ Mortgage insurance



What are the benefits?

1. Lower insurance costs
2. Control over the amount of risk assumed and premiums paid associated with the risk
3. Obtain and tailor coverage to meet your specific needs



What are the benefits?

5. Accumulate investment income to
Control claims and loss management
help reduce net loss costs
6. Control over cash flow
7. Asset protection
8. Reduce taxes



Did you say Tax Benefits?

- ◆ What are the tax benefits?





REDUCE TAXES???

Owning a captive insurance company can actually reduce your income tax liability. If structured properly, the premiums paid by your business to your captive insurance company are a deductible business expense.

Additionally, the premium income could be tax-exempt income to your captive insurance company. The Internal Revenue Code provides certain tax advantages to small insurance companies depending on the amount of premium income received.




- ◆ Insurance companies with annual premium income of less than \$1.2 million - the company 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))



CAUTION

- ◆ The insurance company must be operated as a bona-fide insurance company. The corporate entity must be respected, premiums should be properly structured and set at arms length rates and circular cash flows should be avoided. The tax benefits listed above are only available to bona-fide insurance companies.



Who should set up a captive insurance company?


Every industry has its areas of risk. Every business may have unique areas of exposure. If you are a business owner, you should determine the amounts you are paying to obtain coverage and evaluate the costs vs. the benefit of establishing a captive insurance company to insure a portion of your risk.



When should you consider forming a captive insurance company?

You should consider setting up a captive insurance company if your business is experiencing the following:

1. You are having difficulty obtaining the coverage you desire at affordable rates
2. You have risks that you can insure that have a low probability of claims – an example of this might be extended warranty insurance offered to customers when they purchase products. This type of insurance has a low claim rate.




When should you consider forming a captive insurance company?

3. You wish to reduce your insurance costs by assuming a limited level of risk, while obtaining catastrophe reinsurance to limit your financial exposure
4. You want to take advantage of the long term investment potential and significant tax advantages that are currently available to a small insurance company



When should you consider forming a captive insurance company?

5. You want a deductible reimbursement plan where funding of frequent non-catastrophic losses may be more economically handled than by dealing with traditional insurers. You could contribute the savings from changing your insurance from a low deductible to a high deductible to your small insurance company and use the savings to fund the deductible if any claims are filed.



When should you consider forming a captive insurance company?

- ◆ You are a high net worth individual and have significant wealth to protect and pass on to your heirs.
- ◆ You have a highly profitable business and you wish to diversify your assets. A captive can help you protect your assets in addition to insurance and tax savings.



Is this strategy right for everyone?

- ◆ No!
- ◆ However, in the future, we will see more and more businesses assuming more risk to lower insurance costs. If set up and managed properly, a captive insurance company allows the business owner to deduct amounts set aside to insure his or her own risk.



Is this strategy right for everyone?

- ◆ Over 4,500 companies and associations have established captive insurance companies. By setting up a captive insurance company, they have been able to take advantage of cost savings, product and service options not available through commercial insurance, as well as tax benefits that are available.
- ◆ By establishing your own captive insurance company, you can realize reduced insurance costs, optimize its risk management program and provide greater flexibility to meet the corporate family needs.



Next Step

- ◆ Contact us if you want to know more about captive insurance companies to determine the financial and tax benefits your company can achieve.



PrimeFortress Management, LLC

The tailored alternative to traditional insurance

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Managing Member