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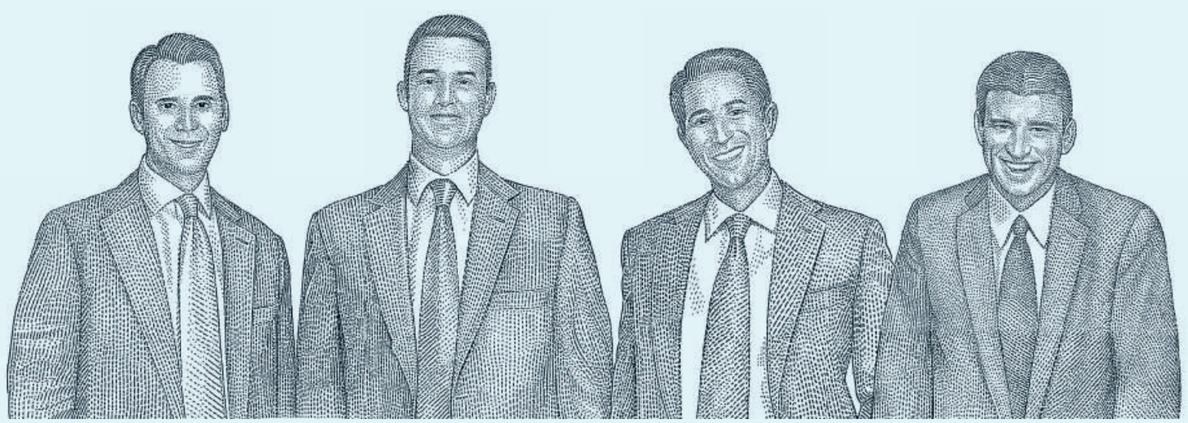
What can a captive insurance company do for my business?

BY JAMES L. DINARDO, CLU®, CHFC®, CFP®, MSFS®



Left to right:
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ILLUSTRATION BY KEVIN SPROULS

Recently, clients and their advisors—accountants, specifically—have been asking for information about captive insurance companies ("captives"). Questions revolve around how a captive might help their business, from both a risk-management and a cash-flow perspective.

A captive is a licensed insurance company that insures or reinsures the risks of its parent, affiliates or certain unrelated entities. One of the more popular types, a small-enterprise risk captive, generally insures property and casualty risks not exceeding $1.2 million in annual premiums. It is governed by IRS Code Section 831(b). Captives owned by a parent company may accept premiums that normally would be paid to a third-party commercial insurer and may use them to cover claims.

Captives must follow the general rule of insurance: to transfer and distribute risk. Transferring risk occurs when losses pass from an insured to an insurer. Risk distribution mandates that a captive pool enough independent risks of unrelated parties to invoke the law of large numbers. Captives accomplish risk distribution via the reinsurance market. Companies seeking to establish one should retain the services of a third-party administrator specializing in formatting, licensing and administering captives.

Captives provide their parent company distinct advantages: One is more comprehensive, versatile insurance options: The parent is not beholden to the "off-the-shelf" coverage insurance carriers offer. Captives may also insure unique risks rarely offered in the marketplace. Another advantage is their ability to reduce overall insurance costs by removing third-party insurers.

> "Captives are an excellent risk-management tool for businesses with unique risks."

Only after demonstrating legitimate insurance needs may a captive provide ancillary, non-insurance-related benefits. One benefit here is that the parent company may shift up to $1.2 million per year in deductible premiums. This deduction is not counted in gross earnings for that specific year and is not realized as income for the captive.

To the extent that claims are less than the premiums collected, the captive's reserves increase. A loss ratio of 50 percent is not unreasonable for a properly managed captive. Then there are tax advantages. The parent company is using pre-tax dollars to insure risks previously not insured or insured with post-tax dollars.

Second, should the captive be dissolved, a dividend distribution may be paid to the owners and taxed as a qualified dividend. While captives enjoy certain tax benefits, their primary objective should not be tax mitigation!

Asset protection is another non-insurance-related benefit. The assets of the captive are no longer owned by the parent company, and thus are not subject to creditors.

William Knox of HDH Group emphasizes that captives are suitable for businesses with: genuine insurance needs; steady strong cash flows, to make the yearly premium contributions; and should have qualified leadership to adequately manage the business.

Captives are an excellent risk-management tool for businesses with unique risks. Like other financial planning strategies, the captive should be part of an overall financial plan. ●

ABOUT US

PIONEER FINANCIAL AT NORTHWESTERN MUTUAL PROVIDES FINANCIAL SERVICES TO HIGH NET WORTH AND EMERGING HIGH NET WORTH INDIVIDUALS, FAMILIES AND BUSINESS ENTERPRISES. Pioneer Financial's team of 20 associates/staff serve clients nationwide from their Park Avenue office in New York City. Kevin R. Luchetta, Stephen A. Schwartz and James L. DiNardo are wealth-management advisors and CERTIFIED FINANCIAL PLANNER™ practitioners. The practice is focused on assisting clients through comprehensive financial planning that includes asset management, retirement funding, risk management, estate preservation and distribution. ●

[1] *For more information, ask for the Pioneer Financial article on cash-balance plans for a pure tax deferral strategy, by James L. DiNardo CLU®, ChFC®, CFP®, MSFS®.*

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