

Captive Insurance Companies

What are they?

How do they work?

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What are captive insurance companies?

A captive insurance company (a “captive”) is an insurance company organized primarily for the purpose of insuring or reinsuring the liabilities of the owner.

Who uses captive insurance companies?

Captive insurance companies are widely used by:

1. Public Companies – Over 50% of Fortune 1000 companies use captive insurance companies (ie. “UPS case”)

2. Private clients – those with businesses that have insurance needs.

Reasons for forming a captive insurance company.

1. A client who wants to take advantage of their favorable underwriting experience
2. A client who needs coverage that is otherwise unavailable
3. Obtaining insurance at a lower cost – insurance overhead and profit often account for 40% of premium.
4. Creating a new profit center by writing unrelated or currently uninsured risks for profit
5. Increase cash flow and investment income through tax and insurance expense savings
6. Underwriting advantages –knowledge of business and experience rating
7. Tax advantages

What types of coverages are typical?

General liability

Loss of key employee

Professional liability

Environmental

Excess/Umbrella

Disability/Living benefits

Construction defect

Loss of key supplier/customer

Etc.

IRS Rulings and Pronouncements

Revenue Ruling 2001-31 – discards economic family arguments

Revenue Ruling 2002-89 – announces safe harbor provisions

Revenue Ruling 2002-90 – further refines safe harbor provisions

Revenue Ruling 2002-91 – Guidelines on risk shifting

Notice 2004-50 Producer owned Reinsurance Captives are “delisted”

Notice 2005-40 – IRS further clarifies 12 entity safe harbor provisions.

What is the ideal captive candidate?

The ideal client is an individual business owner whose business has taxable income in excess of \$500,000 with insurable and identifiable risks, who has available cash flow to fund insurance premiums of \$250,000 per year. Typical industries include:

- Real estate developers/construction
- Manufacturing operations
- Nursing Homes
- Hotel/Restaurant/Other Franchises
- Distribution companies
- Transportation companies
- Etc.

Costs associated with captives?

- Set up fees -----\$75,000
- Annual management fees
(this includes all legal, accounting
and fees associated with management
and compliance)----- \$53,000
- Initial capitalization – This amount, as a rule of
thumb, will always equal to about 25% of the first
years premium payment.
- Premium expense charge – 2 1/2 percent of the
annual premium.

Sample captive illustration

Captive insurance company

Annual premium: \$1,200,000

Return on investment 8%

Captive

Description Year 1

Beginning value	-0-
Premium Payment	\$1,200,000
Set up fee	(75,000)
Premium expense	(30,000)
Annual fees	<u>(53,000)</u>
Subtotal	\$1,042,000
Return on investment	<u>90,000</u>
Total	\$1,132,000

Without captive

Description

Add'l Co profit	\$1,200,000
Taxes at 40%	<u>(480,000)</u>
Net after tax	\$ 720,000
Return on investment	<u>57,600</u>
Total	\$ 777,600

Comparison

Value with Captive	\$ 1,132,000
Value without Captive	<u>\$ (777,600)</u>
Captive savings	\$ 354,400

Sample captive illustration

Captive insurance company

Annual premium: \$1,200,000

Return on investment 8%

Captive

Description Year 2 & thereafter

Beginning value	-0-
Premium Payment	\$1,200,000
Set up fee	(0)
Premium expense	(30,000)
Annual fees	<u>(53,000)</u>
Subtotal	\$1,117,000
Return on investment	<u>90,000</u>
Total	\$1,207,000

Without captive

Description

Add'l Co profit	\$1,200,000
Taxes at 40%	<u>(480,000)</u>
Net after tax	\$ 720,000
Return on investment	<u>57,600</u>
Total	\$ 777,600

Comparison

Value with Captive	\$ 1,207,000
Value without Captive	<u>\$ (777,600)</u>
Captive savings	\$ 429,400

Are captive right for you?

Everyone must make their own personal choice based upon their needs and expectations. It is our belief that captive insurance companies, when properly structured, can safely provide significant insurance and tax benefits.

Other aspects of captives

- Roll up on termination - Captives that we establish are term insurance and therefore should you choose to terminate the policy, the roll up time is relatively short (approximately 6 months). The accumulated earnings can be distributed to the captives ownership at capital gains rates.
- Excellent estate planning tool – Set up your heirs as the initial owners of the Captive (when it has little or no value) then the accumulation of wealth via the investment plan will be outside of your estate.

Thank you!

Please contact Ralph Minto, Jr. at 412-201-5525, if you have any questions, require any additional information pertaining to captive insurance companies, or are interested in forming such a company.