“Mini-Captive” Insurance Companies

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The Uses of Captives for Small- and Mid-Sized Companies

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In the past few decades, large corporations have increasingly used captive insurance companies as a supplement or alternative to commercially available insurance coverage. In more recent years, a combination of new revenue rulings and more cost-efficient service providers has opened the door to captives for small- and mid-sized businesses. Moreover, the type of captive available to these firms has the potential to offer certain tax and estate planning benefits beyond those offered by most large-company captives.

The type of captive insurance company that is of most interest to small- and mid-sized firms is the 831(b) captive, also known as the “mini-captive.” The following discussion will provide some basic information about mini-captive insurance companies, the steps required to determine whether a mini-captive might be an attractive solution, and information on how a mini-captive can be formed and managed.

What is a captive?

There are many possible ways to describe a captive insurance company, in part because such companies can take a variety of forms. But in general, a captive can be thought of as a wholly-owned subsidiary whose stated purpose is to provide insurance to the company or entity that owns it.

From this description, one can deduce that a captive is really a form of self-insurance. A captive, however, is more formal than what many may think of when they think of “self-insurance.” It has a corporate structure, clearly defined roles for officers and third parties, rules of governance, and operations that are documented and reported. Typically the insured company has significant influence in the captive’s creation and operations, although the captive legally remains a separate entity, and may also have slightly different ownership than the insured company.

With some types of traditional captives, and to an even greater extent with mini-captives, the parent company or entity may be able to realize certain tax and/or estate planning benefits. These benefits can potentially be significant. What the parent business must bear in mind is that, whatever the mix of benefits that a mini-captive may yield, the mini-captive must be constituted, and must operate, as an insurance-providing entity. One role of the mini-captive’s manager, working in tandem with the mini-captive’s CPA and legal counsel, is to help ensure that the mini-captive meets all of the structural tests and ongoing operating requirements that are required for a mini-captive to be recognized as a bona fide insurance company.

Section 831(b) and What It Means for Captives

Under the scenario of a single-parent captive, the essential business relationship between the captive and the parent is relatively straightforward: the parent pays premiums to the captive, and the captive provides insurance to the parent. For tax purposes, the premiums that the parent pays may be deductible by the parent as a business expense, while the captive would treat the premium as taxable income.

Under Section 831(b) of the Internal Revenue Code, however, captives that meet certain requirements do not have to count premiums as taxable income. Instead, the captive is only taxed on its net investment earnings.

What must a captive do to qualify for this special treatment as a mini-captive? The most salient standard is the $1.2 million ceiling in premiums written. Any captive that receives more than $1.2 million in premium income in a given year — even a single dollar more — will fail to qualify under Section 831(b). It is also worth noting that the limit applies to all companies within an affiliated group (for instance, companies with common ownership). For all of these reasons, any captive that seeks mini-captive status must be designed so as to meet the $1.2 million limit.

Who May Want to Consider a Mini-Captive?

The factor that makes a mini-captive of little value to a Fortune 500 corporation — the $1.2 million premium limit — makes it ideal for many small- and mid-sized businesses. At the same time, a company can also be too small to benefit economically from establishing a mini-captive.

Mini-captives often make sense for business owners whose companies collectively meet all of the following criteria:

- pay at least $300,000 to $400,000 a year in premiums to commercial insurance companies for property and casualty insurance
- have pre-tax earnings of at least $1.5 million a year
- have the following asset or income levels:
  - general contractors: over $70 million in annual revenue
  - developers: over $100 million in property
  - banks: over $250 million in assets
  - all other businesses: over $25 million in annual revenue

A mini-captive can be an especially good fit for private companies (in part because set-up and operation for these firms tends to be faster and easier), but public companies can benefit as well. Closely held private companies, especially family companies, may be in a position to utilize a mini-captive's estate and gift tax benefits.

Potential Insurance Benefits

As noted earlier, even though it may be the non-insurance benefits that ultimately yield the most value to a mini-captive’s owners, the mini-captive must first and foremost be a bona fide insurance company. This being the case, it is only logical to examine the possible insurance benefits that a properly designed mini-captive can provide.

- **Customized coverage:**

Unlike large commercial insurance firms, the mini-captive can design its insurance to suit the client from the ground up. In particular, this means the mini-captive can be used to write coverage that supplements or extends existing commercial policies. For example, a mini-captive’s policies might cover deductibles or exclusions. A mini-captive might also write coverage in areas where commercial market prices are unacceptably high or where “off-the-shelf” products are either unavailable or are a poor fit for the insured’s situation.

Note that adding a mini-captive does not necessarily mean increasing overall insurance costs. The creation of a mini-captive can be an opportunity for a business to significantly lower its commercial premiums by raising its deductibles, then insuring some or all of a portion of those deductibles through the mini-captive.

In addition to deductibles, which may exist in any coverage area, there are several types of coverage that a business might consider handling primarily or entirely through a mini-captive. These include:

- all-risk property (including weather or natural disaster risk)
- construction defects
- product or professional liability
- product warranty
- employment practices
- subsidence
- wrongful acts
- mold/pollution
- cyber risk
- litigation defense

Whether the coverage a mini-captive writes is for a deductible/exclusion or for a specific type of risk, one important point to keep in mind is that typically, these are exposures that currently are being self-insured directly, with no attendant tax benefits. Shifting such coverage to the mini-captive allows the business to continue to self-insure, but now in a way that may include advantageous tax treatment.

- **Control of the claims process:**

Filing a claim with a commercial insurer can be an arduous process, and such insurers may make extensive efforts to reduce or deny claims. With a mini-captive, the business owner can, within the terms established by the insurance policy, influence both timing and outcome.

- **Access to wholesale reinsurance:**

By virtue of being an insurance company, a mini-captive can buy insurance on the wholesale market, where rates are significantly discounted from the retail rates available to end customers.

Potential Income Tax Benefits

- **Deductibility for self-insured reserves:**

A business typically can deduct as a business expense any payments it makes on commercial premiums as well as any actual losses incurred, whether for deductibles or for wholly uninsured losses. Both premiums and losses can be deducted at the time they are paid, but in practice, this means that while premium payments can essentially be deducted in advance of a loss, loss payments can only be deducted after the event has occurred and the costs have been determined. A company cannot take any deduction for cash that it sets aside as a reserve against potential future losses.

With a mini-captive, the business can change this situation to its advantage. Because a properly established captive is considered a separate insurance entity, even if ownership and control are identical or similar, the business can deduct the premium it pays to the mini-captive at the time it pays the premium. Meanwhile, the mini-captive, as discussed earlier, does not have to recognize the premium it has received as income; only its net investment earnings are taxable. Thus the common owners gain an immediate tax deduction for what used to be a non-deductible loss reserve.

- **Potential for lower effective tax rate:**

A mini-captive can invest untaxed the entire premium it receives, and the premium can remain invested until a loss payment is due. As a rule of thumb, a captive may expect to invest premiums for six to eight years before paying any dividends. (The actual period of time depends on how long it takes for the captive to accumulate adequate reserves, and the value of claims paid out in the intervening years, among other factors.) Once a distribution is paid, there is still the potential for a further tax benefit: the distribution may be taxed as a long-term capital gain, which may be a lower rate than would otherwise apply.

> "Even though insurance may not be the factor that initially prompted a firm to explore mini-captives, many firms end up being pleasantly surprised at the level of insurance benefits they can realize."

Potential Estate and Gift Tax Benefits

- **Inter-generational transfer of wealth:**

Although the primary purpose of Section 831(b) is to stimulate competition among insurance firms and not to facilitate the tax-advantaged transfer of wealth, a mini-captive can be used to accomplish this. Under one common scenario, the owner of a private company or group of companies establishes a mini-captive that is owned by the entities or individuals to whom the business owner wishes to transfer wealth. The business owner may or may not also have partial ownership or control of the mini-captive (either directly or through irrevocable trusts, corporations, or other entities).

To the extent that the business owner does have ownership or control of the mini-captive, a portion of the assets of the mini-captive will be treated as part of the business owner's estate. So, for example, if the mini-captive is 90% controlled by the business owner's family members and 10% controlled by the business owner, only 10% of the mini-captive's assets would be counted as part of the owner's estate. If the family controlled 100% of the mini-captive, then the entire mini-captive would be considered to be outside the owner's estate, and therefore exempt from estate tax. In a similar fashion, such an ownership structure can play a role, in combination with other elements, in an overall program designed to manage exposure to gift and Generation-Skipping Transfer taxes.

Structural Considerations

The past ten years have brought additional clarity to the captive world, and especially mini-captives, mainly through a series of court rulings and a resulting change in policy on the part of the IRS. One result of these developments has been the establishment of two structural models for mini-captives, each of which spells out a "safe harbor" for meeting risk distribution requirements. In essence, adhering to one or the other of these models is a key step for a captive in being recognized as an independent insurance company — and this, in turn, is essential if the captive is to provide tax or estate planning benefits of the type described earlier.

Before we look at the two structural models, it's important to understand that in each case, there are both "safe harbor" standards and case law standards. The safe harbor standards are more conservative: by meeting these, you can be certain you have complied with a known IRS standard. The case law standards are based on the ways that various courts of law have interpreted the tax code. These generally are less stringent. Both standards have their advocates, and both are widely used. The decision on which to use typically depends on the comfort level of the advisers and decision-makers involved in establishing and operating the mini-captive.

"Brother-Sister" Model

This structure can be used when the parent company or business owner has multiple related companies that can be insurance clients of the mini-captive. The safe harbor standard calls for at least 12 of these "brother-sister" companies. None of the 12 companies can be a pass-through entity, and each of

the 12 must represent from 5% to 15% of the overall risk insured by the mini-captive. Tax experts believe that seven "brother-sister" companies, each placing equal amounts of risk with the mini-captive, is adequate. Obviously, the greater the number of brother-sister companies involved, the greater the flexibility in balancing the percentages of risk that each company must place, although regardless of how many brother-sister companies are involved, it is desirable to keep their risk contributions as balanced as possible.

"Unrelated Party" Model

In the majority of cases, the owners who desire to set up a mini-captive do not have enough brother-sister companies to make a brother-sister structure possible. In some cases, even if they do, there may be other considerations that make the brother-sister model impractical. In these cases, the "unrelated party" mini-captive model can be a viable alternative.

The main concern that potential mini-captive owners tend to express about the unrelated party model is that it involves the mini-captive taking on risks from outside parties. In order to qualify as an independent insurance firm under the model, the mini-captive must take on a certain amount of its risk from companies with unrelated ownership. The safe harbor standard calls for 51% of risk to come from unrelated firms; the case law standard is less restrictive at approximately 30%. With either model, the concern of many potential mini-captive owners is that this could expose the mini-captive, or even the owners themselves, to levels or types of risk that are beyond their knowledge or control.

> **"If current industry trends continue—which seems very likely—the majority of American businesses will have a captive by 2010. Most of these new captives, by far, will be mini-captives."**

While such concerns are entirely logical, they are not necessarily well founded. There exists an established line of "packaged products" offered by several insurance vendors that are explicitly designed to be used by mini-captives to meet their unrelated risk requirements. The firms who design these products are well aware of the types and levels of risk that are consonant with the financial goals of mini-captives. The loss potential is also carefully managed; for instance, the risk that is included in the packaged risk pool is typically for a certain segment of risk only, and may not include the responsibility to pay the first portion of a claim.

In addition, the various available pools typically offer different types of diversification: diversification of insured parties, of risk types, of industries, or a combination of these. Such diversification reduces the risk of multiple losses in any given time period. Moreover, the risk pool is effectively "reset" each year as policies renew, with the mini-captive receiving its share of dividends from the finished year.

Financial Performance Expectations

A mini-captive does not have to be loss-free in order to meet its financial goals. Because of the tax benefits that a mini-captive can realize, losses generally would have to be significant in order to outweigh the year-to-year benefits of operating a mini-captive. Moreover, so long as the claims made against a mini-captive's policies (either by third parties or by the parent owner's businesses) are not excessive, the mini-captive may stand to earn a profit from its underwriting activities.

This in part helps to provide a certain level of flexibility when it comes to capital commitment in a mini-captive: typically, once a mini-captive has been in existence for a few years, and has established an operating history as well as a level of capital reserves, the owner begins to have some flexibility as to whether to remove some capital from the mini-captive (which can be done in several ways) or to keep it in the mini-captive and allow it potentially to grow through investment.

Domiciles

The question of where a captive should be domiciled has many potential answers. In addition, what many consider the "right answer" for a given situation has changed in recent years.

Historically, captive insurance companies have been associated with offshore locations, such as Bermuda, the Cayman Islands, and Barbados. However, certain events of the past decade, such as September 11th, the Enron debacle, and the accountability required by Sarbanes-Oxley, have tipped the scales in favor of onshore locations for many captive owners. There are now roughly 30 states with some form of a captive statute on their books.

In general, an offshore domicile would most often be retained for three leading reasons: they are more accepting of third-party risk; they offer greater regulatory flexibility, in particular lower capital requirements; and they potentially offer better asset protection.

Leading reasons to consider an onshore domicile include lower costs of operation, easier accessibility, and a higher perception of probity.

The bottom line is that there is no one "right" domicile. The situation is complex and should be decided not by any general rule or any one factor, but by a careful analysis of the circumstances and goals of the mini-captive and its owners.

Types of Assets in which a Mini-Captive may Invest

As an insurance company, a mini-captive needs to be prudent in its investments, and to avoid an undue level of risk. Accordingly, most types of aggressive or speculative assets, such as stocks, commodities, or futures, may not be appropriate. Most of the following types of investments are considered appropriate, either as individual securities or as mutual funds or other pooled investments:

- fixed income securities
- municipal securities (for tax-free income)
- Treasury Bills and other types of money market securities

Pitfalls to Avoid

This white paper describes some of the issues and potential benefits that can be involved in setting up a legitimate mini-captive insurance company. As the white paper makes clear, any mini-captive must look and function in all important ways like an insurance company. The requirements to qualify as a mini-captive are now well defined. So long as a mini-captive passes a number of known tests, its owners should have no reason to fear any adverse action from the IRS or insurance regulators. The bottom line is that a properly structured mini-captive is recognized as a legitimate entity.

The key phrase here is "properly structured." Before setting up any type of mini-captive, it is important to be aware of the various abuses of mini-captive status that have been attempted in recent years — with notably adverse consequences in most cases. There are a number of examples of questionable practices and even outright scams involving real or purported captive insurance companies, but most of them involve one or more of the following characteristics:

- **Inflated premiums:**

As an insurance company, a legitimate captive must rely on an honest and competent actuary to set insurance rates. In some tax-fraud operations, captives have "charged" their clients exorbitant rates, the goal being to allow the parent owners to realize a tax deduction on "premiums paid" while actually simply transferring large sums of money to the captive.

- **No real shifting of risk:**

One of the key tests of a legitimate captive is whether or not risk is actually transferred to it in the course of its business dealings. If risk is not actually transferred, the captive can be disallowed, and all the benefits lost. This can be an issue in particular with some third-party risk pools that are offered to the mini-captive market. Before buying into any pools, it is essential that adequate due diligence be done to assure that the pool is a legitimate third-party risk transfer pool and not a sham designed for tax evasion purposes.

- **Secret return of asset control:**

In some fraudulent schemes, a firm pays a captive for "insurance," while the captive secretly remits most of the money back to the parent owners, typically by placing it in an offshore account. The bogus captive, in other words, simply serves as a front for funnelling funds to offshore accounts while allowing the U.S. firm to claim a phony tax deduction for premiums paid along the way.

In some versions of this scam, control of the funds is actually relinquished to another owner (typically an offshore entity) for a period of time, with the agreement that it will later be returned, in perhaps five years. These often turn out to be true scams: in several documented cases, the offshore entity (or its promoter) has absconded with the clients' funds, and, when threatened with legal action, has threatened to expose the clients to the IRS as tax evaders.

The lessons to be drawn for any potential captive owner are twofold: first, do not be tempted by any type of captive program that is either manifestly illegal or that mysteriously promises significantly greater benefits than a legitimate captive could deliver. The risks, whether from IRS scrutiny or predatory deception, are both significant and likely.

The second point is that even with a legitimate captive, it is important to have an experienced, knowledgeable, and reputable manager overseeing the creation and operation of the captive in order to help make sure it is not caught up in the same nets that are being laid for those committing actual fraud.

The Process: How to Form and Launch a Mini-Captive

1 Determine that your firm meets all of the following criteria:
   - annual revenue of at least $25 million
   - EBIT of at least $1.5 million
   - business(es) is currently profitable
   - current property/casualty premiums are at least $300,000–400,000

2 Gather all of the following:
   - all commercial policies currently in effect
   - loss data for past five years
   - corporate organizational chart
   - details of business ownership
   - audited financial statements

3 Working with an underwriter and a representative of the proposed mini-captive's management firm, conduct a pre-feasibility study to identify uninsured risks and to determine if a mini-captive would be economical.

4 If desired, obtain a tax status memo on the proposed mini-captive from a CPA or an attorney.

5 Engage the underwriter and captive manager for the full feasibility study. This study will include all of the following:
   - underwriter's report of risks to be insured
   - estimated premium
   - captive manager's business plan

6 Make a go/no go decision based on the study.

7 Begin the formation/application stage by engaging an actuary to perform loss reserve analysis and premium forecasts and to develop proformas to be filed with the application.

8 Captive manager finalizes business plan, completes application, and communicates with domicile regulators to answer questions.

9 Mini-captive receives license, is capitalized, and begins operations.

Estimated Mini-Captive Costs

IMPLEMENTATION EXPENSES	
Feasibility Stage	
Underwriter's policy review	7,500
Captive manager's business plan	12,500—22,500
	$20,000—30,000
Formation / Application Stage	
Actuarial feasibility study and loss reserve opinion	7,500—15,000
Captive manager's completion/filing of domicile application	15,000—32,500
Underwriter's policy issuance	5,000
Incorporation	2,500
	$30,000—55,000
Total Implementation Expenses[1]	$50,000—85,000

ANNUAL OPERATING EXPENSES	
Captive management	30,000—40,000
Actuarial loss reserve analysis	7,500—15,000
Audit and tax preparation	14,500—25,000
Underwriter policy review and issuance	10,000
Legal fees	2,500—5,000
Premium tax annual filing fee (varies by domicile)	5,000—7,500
Miscellaneous expenses	5,000
Total Operating Expenses[2]	$74,500—107,500

Mini-Captive Potential Benefits

SAMPLE COMPARISON	Without Mini-Captive	With Mini-Captive
Underwriting Income		
Premium written and expensed by parent	—	1,200,000
Cash set aside for business risk	1,200,000	—
Paid losses (estimated 10% loss ratio)	–120,000	–120,000
	$1,080,000	$1,080,000
Operational Expenses		
Average mini-captive annual operating expenses[3]	—	–83,750
State premium tax	—	–7,500
	—	–$91,250
Pre-tax Earnings	$1,080,000	$988,750
Taxes		
Federal income tax	–378,000	—
State income tax (estimated 10% rate)	–108,000	—
	–$486,000	—
Net Income	$594,000	$988,750
Proceeds Transferred to Heirs[4]		
Estate tax (estimated 50% rate)	–297,000	—
Adjusted Net Income	$297,000	$988,750

1 Does not include fees for obtaining legal and tax consulting memoranda. Many clients set up mini-captives without such memoranda; however, if a client prefers to obtain these, the cost is likely to be an additional $50,000 to $100,000.

2 Does not include fees for pooling. If pooling is necessary, the annual fees average between 1% and 3% of the gross premium.

3 See "Mini-Captive Costs" table at left.

4 Applies to heirs who are at least 21 years old.

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Rich is responsible for managing all administrative and business operations for Wilmington Trust SP Services, Inc. and its subsidiaries. These companies provide a wide array of nexus services to a variety of special purpose vehicles involved in either securitizations, structured finance transactions, corporate reorganizations, risk management, or financial planning strategies that take place domestically and in the Caribbean. Rich serves as director and officer for many high profile client companies.

Rich joined Wilmington Trust SP Services in 1996 and spent four years leading our Las Vegas, Nevada subsidiary prior to his current position. He holds a Juris Doctor from Widener University School of Law and earned a bachelor's degree in Accounting, with a minor in Economics, from the University of Delaware. He received his Certified Public Accountant certificate in Delaware.

Rich serves as a board member and president of the Delaware Captive Insurance Association and as chairman of the board of Ingleside Homes, Inc., a local nonprofit organization that provides various care levels of retirement living to senior citizens. He also serves on the board of directors of Midway Girls Softball and Hockessin Montessori School. He is a member of the American Institute of CPAs, the Delaware Society of CPAs, and the American Bar Association JD Division.

Rich has been involved in the captive insurance industry since 2005 and was instrumental in founding the Delaware Captive Insurance Association. He participated on the committees that completely revised the Delaware captive insurance statute in 2005, added special purpose financial captive language in 2007 and added branch and agency captives in 2010. He has advanced thought leadership related to captive insurance by authoring journal articles and formally presenting on the industry and its nuances.

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