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# Use of Captive Insurance Companies in Estate Planning

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## I. INTRODUCTION

Rising insurance costs coupled with increasing self-insured risk is a major issue that many businesses face. In order to mitigate these risks, an increasing number of businesses are implementing captive insurance programs. A captive insurance company is a subsidiary or affiliate of business entities formed to insure or reinsure the risks of those entities. Reasonable insurance premiums paid to properly structured captives are deductible by the affiliated companies. Insurance companies are provided with special tax incentives. Properly structured, the premiums may be non taxable to the captive or offset by a deduction for reserves. Reserves and free surplus may be invested by the captive and retained in anticipation of future losses or to fund shareholder distributions. Today, the owners of thousands of businesses have begun to accumulate substantial pretax wealth through their captive insurance companies.

The purpose of this article is to describe the history and requirements of captive insurance companies, focusing on the estate and business planning opportunities available to the owners of private companies.

## II. OVERVIEW

### A. What Is a Captive Insurance Company?

A captive insurance company is a corporation formed either in a U.S. or foreign jurisdiction for the purpose of writing property and casualty insurance to a small, usually related group of insureds. The captive must be formed as a C corporation and is subject to Chapter L and Chapter C of the Internal Revenue Code. There are many types of captive insurance companies, including pure captives, group captives, risk retention groups, and producer-owned reinsurance companies. This article will focus on pure captives, which insure risks of business entities related by ownership to the captive.

### B. History of Captive Insurance

Modern captives began in Bermuda in the early 1960s, and captive insurance was formalized in the late 1970s with a medical malpractice captive for Harvard University. In recent years, the growth of cap-

tive insurance and related risk transfer mechanisms has boomed, driven by businesses seeking to better manage insurance needs, including cost, coverage, service, and capacity. When segregated cells, risk retention groups, and "rent-a-captives" are included, the number of captive and alternative risk arrangements today is in the tens of thousands and is rapidly growing. The market for alternative risks was estimated at \$88 billion of annual insurance premiums in 2001.<sup>1</sup>

In the early years, captives were commonly used by Fortune 500 companies to capture insurance premiums. With a captive, these large organizations could write general liability, workers' compensation, auto, and property insurance. These captives soon became a profit center for the entire organization. In 2001, 2002, 2005, 2007, and 2008, the IRS issued guidelines that provided clarification and "safe harbors" for captive insurance companies. These new rulings have opened the door to captive insurance companies.

### C. Reasons to Form a Captive Insurance Company

The focus of the pure captive is to economically assume risk that is self-insured. This may include increasing deductibles on existing policies, assuming all or some of the risk of traditional insurance, or merely taking on the risks of existing deductibles and exclusions. Risks that are already inherent in the business that are currently not being insured are effectively self-insured. The primary reasons that private, middle market companies form captive insurance companies include: (1) to lower the cost of insurance or obtain insurance not otherwise available; (2) custom design of insurance policies; (3) investment of the insurance company reserves; (4) control of the claims process; and (5) income tax, estate planning, and business succession benefits.

Certain types of coverage are unavailable or difficult to obtain, often due to historic loss experience for a sector or industry, such as medical malpractice, or conditions such as environmental, construction defect, earthquake, wind, and weather. By setting up a captive, a business can insure such risks and obtain access to the reinsurance markets that may have greater risk appetite.

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<sup>1</sup> Karl, Holzheu, Raturi, *The Picture of ART* (December 9, 2002) *Swiss Re, Sigma* No. 1/2003.