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Volume 4, Issue 4
April 2023

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CASE STUDY

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By Ronald M. Roth, VP of Marketing

CLIENT CHALLENGE

A residential real estate company experienced an acute increase in its traditional commercial insurance renewal premiums. This real estate company owns multi-family residential real estate facilities across the country.

As this company had a solid claims history, this rate hike was unexpected. The organization maintained good safety records, vetted their tenants well, and ensured that their facilities were safe and issue-free. Yet, when they received their renewal estimate they saw a 40% increase in their rates across the board, with some facilities showing rate increases of close to 75%.

This increase was primarily due to two factors:

1) **A hardening insurance market.** The commercial insurance market has been in this hard market cycle for over 20 consecutive quarters, to date, with no end in sight. Commercial insurance carriers are finding results difficult to demonstrate as costs and claims continue to rise significantly.
2) **Changing Reality.** A growing reluctance by commercial insurance markets to offer coverage in Residential Real Estate. They see these markets as unpredictable and many have ceased covering these markets.

The company's traditional commercial insurance broker was unable to provide any solutions that would meaningfully lower their costs. The client was wary of similar pain points being felt across industries and knew that some organizations were turning to a special purpose insurance alternative know as a captive insurance company. They wanted to get more information on this option and determine whether forming a captive insurance company was the right choice for them. To help answer this question, they turned to our firm.

After thoroughly reviewing the client's financial position, traditional commercial insurance coverage, and risk tolerance, we recommended that the real estate company restructure its commercial insurance as well as its overall risk management program by forming a captive insurance company. We conducted a feasibility study to determine what risk should continue to be held in their traditional insurance company policy and what risk should be held in the captive insurance company. There was also a cost study conducted to determine premiums paid by the company to the traditional insurance carrier and the actual claims made and actual claims paid.

A captive insurance company is a special purpose insurance company established by a business and owned by the sponsoring business. A captive serves as a formalized version of self-insurance, providing coverage to its owners and related parties. The captive insurer would cover the parent company and any subsidiaries. This arrangement would give the company the flexibility to control costs and services, reduce premium volatility and better manage risk in a hardened insurance market.

We began by helping the real estate company to restructure what they were insuring in the commercial marketplace. We also recommended that they increase the company's current deductible from approximately $25,000 to $500,000. Our plan was to structure the captive insurance company to insure the resulting gap in coverage. In addition, we also formalized some of the company's other self-insurance or enterprise risks and covered these risks in their captive insurance company as well.

This approach saved the company a significant amount of money in the short term, and over time, they would ultimately be able to build a reserve fund in the captive insurance company that could be used for many ongoing business initiatives.

Our actuaries, accountants, and attorneys also ensured that the captive insurance company was structured properly to comply with all Federal and State regulations. This step is critical because, if the captive insurance company is not properly set up, the premiums paid to the captive would not be tax deductible.

In order for the premiums paid to the captive to be tax deductible, the captive insurance company must qualify as an insurance company for Federal income tax purposes. Courts have formulated a four-factor test to analyze these situations, in which the company must demonstrate that:

- ✓ They are insuring **true risks** faced by their business and these risks can be quantified and priced by an actuary.
- ✓ The required regulatory formalities of an insurance company must be observed.
- ✓ Risks are properly being shifted to the captive insurance company.
- ✓ The risks being insured by the captive insurance company are appropriately distributed.

We analyzed the client's circumstances and helped structure the entity and insurance policies, so they aligned with the four-factor criteria.

As a result, the company was able to qualify and derive captive insurance tax benefits and guarantee themselves as having a valid captive insurance arrangement domiciled in the continental United States.

"When a team of dedicated individuals collaborate and cooperate, they drive a business to higher levels." -- JW Tucciarone.

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