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COMBINING CAPTIVE INSURANCE COMPANIES WITH ESTATE PLANNING!

By William York, VP of Marketing

Since the recent pandemic, there has been a lot of "buzz" in the marketplace about captive insurance companies. A lot of confusion accompanies the "buzz" as business owners attempt to understand what captive insurances companies are, how they work and who they work for. It can be a complicated conversation at first.

However, they are not something new, nor are they particularly aggressive.

In fact, estimates are that 460 of the S&P 500 companies now operate their own captive companies. What is most important to know is that in the right circumstances, captive insurance companies can be a powerful planning tool.

First, you must realize that every business normally pays for various types of insurance. These payments may be for property coverage, employee disability, worker's comp, business interruption and a myriad of other risk. These premiums often represent a large portion of the business overhead and can vary unpredictably from one year to the next. In many areas of the country, these costs have quadrupled since the recent pandemic. While insurance is a necessary cost of doing business, it can also be a source of frustration for the business owner.

However, what if the business owner could establish his own insurance company that would insure some of the specific risks affecting his enterprise? And, what if the company paid out less in claims and other costs than in premiums as most insurance companies do? When this happens, the profit accrues to the new insurance company and its owner. This is essentially what captive insurance companies do. Obviously, it's a little more complicated both in structure and by regulations, but the concept is like all other insurance companies.

What makes captive insurance companies intriguing for the appropriate company?

There are several reasons.

First, as previously mentioned, insurance is a necessity for every business. If it is possible to take on some of the lower risk items and retain some of the profit, that would otherwise go to a commercial carrier, then there certainly is a compelling economic incentive and the creation of <u>another profit center for a business.</u>

Next, the captive insurance company is a new, separate business entity. As an estate planning and wealth accumulation tool, a new captive company may be unsurpassed. To establish a new captive insurance company, a new business entity must be formed. As the assets in the new insurance company grow, they may be used to secure a loan to pay for life insurance premiums through a third-party lender. Over time, through the growth of the life insurance policy, the loans will be eradicated and the life insurance can be used to pay estate tax for the insureds family.

This may sound complicated; however, this technique is utilized regularly. It is referred to as premium life insurance financing. The benefit to utilizing and leveraging captive insurance excess reserves in this manner is that it is accomplished with tax deductible dollars. If these two unrelated techniques are used together, a business can gain tax deductible property and casualty insurance while an individual (ie. business owner) can minimize the effect of estate tax at death. This utilization of two unrelated planning techniques will produce a result which was not possible before because of the complications inherent in the process and the assets being unavailable from your commercial insurance company.

CASE STUDY

Take the case of Edward and Muriel. They are in their late 40's and own a successful real estate development business in Florida. Currently, their net worth is approximately $50 million and like many business owners most of their wealth is reflected in the value of their business. Both of their sons are expected to develop the capabilities to take over the leadership of the company in the future.

The business employs over a hundred employees and has a lot of inherent risk. Ed and Muriel are interested in the continued growth of their business while at the same time developing a future estate plan that will successfully transfer the business to their two sons in the future. They would also like to ensure that there is adequate liquidity available to their sons should something unforeseen occur before their sons have matured into their future roles.

During the course of their planning, it was suggested that they implement a captive property and casualty insurance program to replace their commercial insurance expense -- redirecting close to $3 million annually from commercial insurance into a private insurance program. They actually lowered their total property and casualty insurance expense.

In parallel, Ed and Muriel established a life insurance trust designed to be used to pay the calculated future estate tax of over $100 million or to provide a lifetime tax free annual income stream for Ed and Muriel in the future when the boys would assume control of the business. A major bank, utilized in their real estate business, granted a 12-year loan to finance the life insurance policy being held in the bankruptcy remote entity life insurance trust.

By using a captive insurance company, an Irrevocable Life insurance Trust and collateral from the captive reserve account, the result permitted the family to ensure its current level of insurance expenditure, created a generational planning program, provided future income to Ed and Muriel and at the same time insured the major financing banking institution the certainty they sought throughout the entire process. No additional monies over their current expense for their current property and commercial insurance premiums were used!

With all of these potential benefits, it would seem that every business would utilize some form of this structure. Unfortunately, captives aren't for everyone. Normally, a business should have $15 million in sales and have enough net profit to comfortably deposit $500,000 per year into their captive property and casualty insurance company.

There are many additional considerations regarding the captive property and casualty insurance company structure that are beyond the scope of this report. What state will the captive be located in, what risk will be insured and at what level? How much will capitalization be computed in order to provide economic substance? Who will administer the captive and pay the claims?

Obviously, many questions need to be answered before undertaking such a major commitment. However, the resources have been developed to make this process less cumbersome and threatening than it appears. Finding the expertise to help you through this new territory can provide huge benefits for many business owners and is certainly worth the effort.

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