Captive Insurance: A Viable Strategy to Reduce Costs

The high cost of insurance is an issue for most companies. New Jersey business owners rank health insurance as their number one cost concern according to the New Jersey Business and Industry Association 2015 Business Outlook Survey. Other concerns include the cost of workers compensation insurance, wages and labor, taxes and frivolous lawsuits – all of which contribute to increased insurance premiums.

Nationwide, executives in the construction industry echo the concerns of New Jersey business owners. The Wells Fargo 2015 Construction Industry Forecast revealed that contractors are also concerned about the cost of wages and labor, equipment, healthcare benefits, insurance and taxes.

A strategy used by 90 percent of the Fortune 500 companies to help control the cost of insurance is to form a captive insurance company (captive). This is an insurer wholly owned by a parent company which provides insurance to its parent and related companies. Captives are generally used to augment existing commercial policies and provide insurance for risks not covered by traditional insurance.

Captives can cover everything from general and umbrella liability to workers compensation, regulatory changes and legal defense. Some companies are beginning to use captives to fund employee benefit programs like life and disability insurance, retirement and healthcare benefits. Other types of insurance captives offer include: employment practice liability, contractor liability, director/officer/employee liability, contractual liability, property damage and business interruption, fiduciary liability, equipment, and protection against pollution, mold and other environmental claims.

Generally, any type of definable and measureable risk can be covered by a captive as long as the state or country in which it is domiciled (i.e. incorporated, licensed, managed and operated) allow the line of business to be underwritten. Contractors can custom tailor insurance policies to cover their specific needs.

Captives can also be used to decrease the cost of commercial policies. Contractors can elect to reduce premiums by increasing deductibles and then have the deductible paid through the captive.

In the past, captives only made sense for companies with at least $100,000 in insurance premiums and more than $10 million in revenue. Today, it is possible for smaller contractors to form their own captive due to declining capital requirements and operating costs. Ideal candidates are businesses with: $500,000 or more in profits, multiple entities, risk currently uninsured or underinsured, and interest in protecting its assets while possibly minimizing its tax obligation. A properly structured captive offers both added insurance coverage and numerous tax planning opportunities, including but not limited to:

- Tax deductions on insurance premiums paid to the captive
- Lower income taxes
- Possible tax saving on shareholder dividends
- Further opportunities for estate and gift planning

Smaller captives may qualify to be exempt from federal income tax on operating income. Under U.S. Internal Revenue Code section 831(b), a captive with a gross premium income of $1.2 million or less that makes an election under that section is not taxed on premium income but is taxed on investment income. In other words, when set up in line with IRS guidelines, a captive can receive up to $1.2 million in premiums tax free from its parent company. The parent or affiliate company can then take a deduction for the amounts paid to the captive as a legitimate business expense.

The captive can make a profit if claims are less than the premium paid by the company. A portion of the profits can then be reinvested to avoid ordinary income taxation. Or, the funds could be disbursed to the company's shareholders as a qualified dividend which would be taxed at a lower rate. Even so, there is always the risk that claims against the company could be higher resulting in a loss. Therefore, it is important to consider what risks to insure under the captive instead of a commercial policy.

Many contractors join a group captive where a number of businesses come together to form their own insurance company or an association captive which is established by a trade group for the benefit of its members. Participating in a group or association captive allows its members to share, in some degree, the collective risks, as well as the benefits such as potential investment earnings and profits from premiums paid in excess of claims. Since group members make a commitment to minimize risks, participation also serves as a risk management tool.

As with any business strategy a contractor should consult with legal counsel, as well as accounting, insurance and other professionals before establishing a captive. Contractors need to be fully aware of compliance and funding requirements, as well as IRS regulations. It is important to carefully consider all of the costs, risks and benefits to ensure that a captive is right for your company.

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