

Client Advisory

Captives for Middle Market Companies

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Historically, only large companies formed captives. However, due to favorable Internal Revenue Service (IRS) rulings and captive industry developments, many smaller businesses are now using captives as a way to fund and manage risk. The type of captive insurance company that is most applicable to small and mid-size firms is the “micro-captive” captive, also known as an “831(b)captive.” The term 831(b) refers to the section of the Internal Revenue Code that applies to small property and casualty insurance companies writing annual premiums less than \$1.2 million.

Over the past two years, most of the new single captive formations have been micro-captives. In fact, the majority of new captives formed in Delaware, Utah, Montana, Kentucky, and Nevada over the past two years have been micro-captives. There are now more than 1,000 micro-captives in the United States.

Captives have long been used as an alternative to conventional insurance by large corporations that retain or self-insure risk. More recently, captives have been used to insure risks not covered by conventional insurance policies, such as deductibles, policy exclusions, coverage that is unavailable or exceedingly expensive in the conventional market, or other risks that are retained or otherwise self-insured by a business.



If done properly, retained risk can be converted into tax-deductible premiums which are paid into a micro-captive. The retained risk may then be addressed through the pre-tax fund, which will be almost twice the amount that would have been generated without the use of a captive. In the event that little or no claims materialize, the captive will produce a significant tax advantaged surplus to use as coverage funding for future business risks, or as distributions to business owners, family members, or key executives at potentially favorable tax rates. The premiums that have been successfully deducted can later be taken as qualified dividends and taxed at 15 percent.

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In addition to the potential income tax savings, other benefits of a micro-captive include:

- Estate planning
- Creditor protection
- Direct access to reinsurance
- Business succession planning
- Creation of a new profit center
- Control over insurance coverage
- Captive ownership participation by key employees
- Management of excessive compensation as defined by IRS guidelines

Good candidates for captives generally meet two or more of the following criteria:

- 100 or more employees
- Gross revenues of \$10 million or more
- Preferably a closely held privately owned business
- Profitable operations, with taxable-income exceeding \$1 million

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The reason for these qualification parameters is that the initial formation (\$60,000) and annual management (\$45,000 to \$90,000) of a captive can be somewhat expensive. In order for a captive to become a viable option, actuaries and underwriters must be able to quantify at least \$300,000 or more in risk premiums from the parent company's business operations. In short, the parent company must be large enough to generate enough risk premiums to make the cost/benefit potential of a captive feasible.

When the captive is created to insure the risks of the parent organization, including subsidiary operating companies only (that is, no third party risk), the captive's organizational makeup must meet the IRS requirements for risk sharing and risk distribution; for example, what constitutes an insurance transaction. This means there must be at least 12 operating brother-sister subsidiary companies of which none may represent less than 5 percent or more than 15 percent of the risk.

Many smaller companies wanting to form a micro-captive do not meet the IRS criteria for captives on their own. When the organization doesn't meet the required minimum criteria, it needs to assume true third party risk to meet the IRS qualifying criteria. Wells Fargo Insurance Services has qualified vendors who have established risk sharing and risk pooling which meet the IRS minimum criteria and guidelines.

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