Anchin Alert

Anchin, Block & Anchin LLP
Accountants and Advisors

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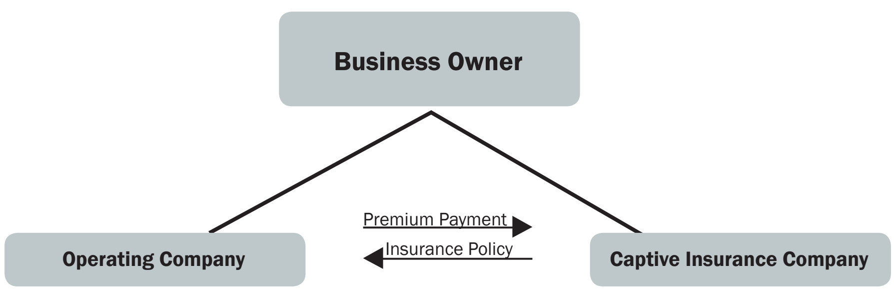
Captive Insurance Companies: Are They Right For You?

Many of you have heard of captive insurance companies but may not know exactly what they are or how they work. Perhaps you have heard of this concept being used by Fortune 500 companies, but assumed it was not for you. Well, captive insurance companies are being increasingly used by middle market companies as promoters and advisors are aggressively pursuing privately owned companies.

What is a Captive Insurance Company?

A captive insurance company is an entity that provides insurance to a group of related businesses. The captive usually provides property and casualty insurance. It is a real insurance company, issuing valid insurance policies for insurable risks and eventually processing and setting claims of the insured. The captive must adhere to the licensing and other special legal rules of the jurisdiction in which it is formed and operates in. It also must follow the proper tax and accounting rules for insurance reserves and surpluses. Sometimes captives are formed in offshore jurisdictions. Several states (Vermont, South Carolina, and Nevada) have been creating business-friendly environments for the formation of domestic captives.



What's Insurable?

Every business has some degree of self insurance, risks that it takes that are not normally covered or insured by its commercial insurance carriers. Historically captives have been used to insure these more "unusual" risks. Lately, we have seen the market change as more companies are using captives to cover their typical business risks that have historically been covered by commercial insurers.

Benefits of a Captive

- Improved insurance program – one can customize their insurance program and insure risks that were previously not insurable and potentially reduce insurance costs.
- Income tax planning – the company receives an income tax deduction for insurance premiums paid. Depending upon how the captive is structured, premiums received by the captive constitute income but may not be taxed upon receipt.

Potential Detriments of a Captive

- Costs – significant start up costs and annual costs to operate make captives most suitable for larger, more profitable companies.
- Risk sharing – payments must be for insurance and real insurance contracts must exist. Hence risk shifting and risk distributions are required elements of "insurance".

- IRS Scrutiny – captive insurance companies are not new and have been around for many years. In fact, special sections of the Internal Revenue Code (IRC) specifically permit their existence and use. Historically however the Internal Revenue Service (IRS) has looked at captives as a potential area for taxpayer abuse. Many court battles have existed in this area and after a period of relative silence, the IRS seems to be attacking and litigating in this area again. Some experts believe the IRS will now be turning its attention to small captives under IRC 831(b) and this will be the next wave of litigation.

Good Candidates

A company is a good candidate for a captive if it is profitable and has a consistent flow of excess cash. We have seen captives adopted by many types of businesses, even some family offices, so most anyone interested, after weighing the risks and rewards, is a potential candidate.

For more information about how a captive insurance company can benefit your business, contact your Anchin relationship partner or Clarence Kehoe, Partner-in-Charge of Anchin's Tax Department at 212.840.3456.

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