# Captive audience

How starting your own captive insurance company can benefit your business **Interviewed by Kristen Hampshire**

For very sound reasons, your business carries various types of insurance coverage to protect it from liabilities and reduce risks. But some insurance policies — such as cyber risk, environmental and pollution liability — are expensive or difficult to obtain.

As a result, many businesses forgo insuring for these risks through traditional insurance channels, essentially self-insuring, but not setting aside funds, for those critical liabilities.

"Businesses have a lot of self-insured risk, whether they realize it or not," says Bill Goddard, CPCU and director of insurance consulting at Brown Smith Wallace LLC. "A company may go out and buy a policy to cover its building in case of a fire, but it may not buy insurance to cover the building in case of an earthquake. Most companies buy insurance policies with deductibles — another form of self insurance."

Rather than exposing your business to risks that could drain profits, you might want to consider starting a captive insurance company, essentially an insurance company owned and operated by your business. It serves as a tool to cover those self-insured liabilities and can also provide your company with tax benefits.

"In today's marketplace, it makes sense for small and medium-sized businesses to at least consider starting their own captive insurance company," says Alan Fine, CPA, JD, and a tax partner at Brown Smith Wallace LLC in the insurance services practice.

"A captive insurance company will allow you to smooth out the cost of insurance over a longer period of time," Fine adds.

*Smart Business* spoke with Fine and Goddard about how starting a captive insurance company could make sense for your company, no matter what its size.

**Bill Goddard**
Director of insurance consulting
Brown Smith Wallace

**Alan Fine**
Tax partner
Brown Smith Wallace

### What is a captive insurance company?

A captive insurance company is an insurance company owned by a business. It allows a business to organize and formalize a program of self insurance and to buy insurance for risks that are very difficult or expensive to obtain in the traditional insurance market.

This arrangement is attractive for businesses of all sizes because, by owning a captive insurance company, you are, by definition, keeping the profit. On the other hand, when you pay a premium to a commercial insurer, part of what you pay is profit to the insurance company.

Also, if you buy insurance from an insurance company and your company is a better risk than others insured by that company, you will still pay a higher premium because the insurance company has to cover the losses of the other insureds.

If your company is a good risk, you can probably self insure your business for less by starting a captive.

### How does a captive insurance company work for businesses of all sizes?

By setting up a captive insurance company, you are creating a rainy day fund in case your business confronts a risk that is not covered by the traditional insurance policies you buy from a commercial carrier. A captive insurance company is like a forced savings plan: You put money aside into the captive in case you need it to cover a risk.

### What should a business consider before making the decision to start a captive insurance company?

A captive insurance company is a fit for businesses that can answer yes to the following questions. Do you have risks that you are presently self insuring? Does your company have positive cash flow? Is your business profitable? Many owners want to know how much money they can save annually by starting a captive.

While each situation is different, most small to mid-sized captives tend to save between $200,000 and $400,000 each year. You don't have to wait for a renewal period to start a captive — and the sooner you start one, the faster you begin saving money on insurance costs over the long term.

### Are there tax advantages businesses can realize by starting a captive?

Assuming your business is structured properly, you receive a tax deduction for your premium payment into the captive. Should you need to use the funds to cover a risk, the money is there.

Also, if insurance premiums paid to the captive are less than $1.2 million, your business might not have to pay tax on the underwriting profits. So, if you charge your business insurance premiums that are less than the $1.2 million cap, according to Section 831(b) of the Internal Revenue Code, and do not use the money to cover liabilities that year, those profits are tax-free.

Keep in mind that you must have a business reason for setting up a captive insurance company. An adviser who understands the tax and insurance aspects of captives can provide valuable insight to your specific situation.

### What are the estate planning advantages?

One of the estate planning tools associated with a captive insurance company is the ability to have a captive insurance company owned by successors (e.g. grandchildren). For instance, a grandfather who started a captive might pay $1 million for earthquake insurance. If no earthquake occurs that year, those dollars are passed tax-free to a grandchild (who owns the captive). Experienced estate planners can assist businesses with such arrangements.

### What are the first steps to establishing a captive insurance company?

The first step is to evaluate your risks and make an assessment of what your business is currently or should be self insuring. This is best done by hiring an adviser who is well versed in both the tax and insurance portions of captives. It's not enough for a professional to just understand the tax angle, or only focus on insurance. From there, the adviser will help you structure a captive that will truly benefit your company and ensure that the captive qualifies as an insurance company for tax purposes. <<

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