BY MARK RYSBERG & DAN HATCH

IMPROVE YOUR BOTTOM LINE *with Captive Insurance*

Insurance has long been a necessary tool for contractors and subcontractors and is commonly viewed as an inevitable cost of engaging in business.[1]

As a result, many tasked with procuring insurance for construction companies evaluate their options based on the cost of annual premiums and their provided coverages.[2]

Captive insurance is an alternative to traditional third-party insurance that, if properly implemented, can:

- reduce premiums by more than 25%,
- improve coverage and risk management,
- recover unused premiums for losses or claims,
- create a cash surplus to increase bonding capacity, and
- boost overall company value.

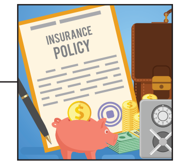
This article will detail some of the ins and outs of captive insurance programs, provide tips for the formation process, and debunk some common misconceptions about this risk management tool.

An Overview of Captive Insurance

Captive insurance is a risk management vehicle that offers an alternative to purchasing open-market insurance through an agent.[3] There are several types of captive programs that range from custom-created for one specific company or group to pooled programs that provide an entry point into the captive insurance market for companies whose insurance premiums may not justify the cost of creating a custom program.[4]

Let's discuss how captive insurance programs generally work.

A captive insurance program requires a captive insurance company. In the case of a custom program, this company is a corporation that is usually owned by the same people who own the operating



company to which the captive provides insurance. Group and pooled captives are generally owned by the contracting and subcontracting companies that participate in those programs.

In either situation, the purpose of a captive insurance company is to provide the same insurance and services that are provided by insurance policies obtained through traditional third-party insurance agency arrangements. In that sense, the coverages and services provided through a captive insurance program are indistinguishable from the coverages and services provided through traditionally procured insurance.

A contractor or subcontractor using a captive insurance program will often obtain insurance policies, certificates of insurance, and claims management from a rated insurance carrier just as if they had worked through an insurance agent.

Micro-Captives & Section 831(b)

Let's now focus on 831(b) captives, or micro-captives.[5] Understanding the benefits of these types of captive insurance programs requires delving further into the specific functions of captive insurance companies.

Similar to open market insurance, a captive insurance program requires the contracting or subcontracting company to pay annual insurance premiums to receive insurance coverage from licensed carriers. The main distinction with captive insurance is that insurance premiums are paid to the captive insurance company rather than to a third-party insurer.

Immediate savings occur in a captive insurance program because the insurer does not pay commission to an insurance agent. Therefore, premium costs can be lower.

The premiums retained by the captive insurance company remain with the captive to fund losses and claims. Any part of those premiums not used for claims and losses remain in the captive, which creates a cash surplus over time.

Micro-Captives: Considerations

A captive insurance program can provide an opportunity for a contractor or subcontractor to create a large cash surplus with insurance premium payments not used for insurance claims. This occurs due to the difference between what happens to insurance premiums when they are paid to acquire open market insurance through a third-party insurance agent, and what happens when they are paid into a captive insurance company owned by the principals of contracting or subcontracting companies.

In the open market model, when insurance premiums are paid, the insurer (contractor or subcontractor) receives an insurance policy. The insurance company retains those premiums even when no claims are made.

Similarly, a captive insurance company retains the premiums it receives. However, when the captive insurance company is owned by the insured (i.e., operating company), the result is that the insured, through ownership of the captive, retains any unused premiums as shown in Exhibit 1.

Exhibit 1
Captive Ownership vs. Premiums Retained

Year	Annual Premium Payments (4% annual increase)	Less Deductibles & Claims Paid	Premiums Returned by Open Market Insurer	Captive Insurance Company Cash Surplus (20% expenses)
2013	$500,000	$0	$0	$400,000
2014	$520,000	$0	$0	$416,000
2015	$540,800	$0	$0	$432,640
2016	$562,432	$0	$0	$449,945
2017	$584,929	$0	$0	$467,943
Totals	$2,708,161	$0	$0	$2,166,528

Exhibit 2 **Ordinary Income vs. Qualified Dividend Tax Rates**

Ordinary Income Tax Rates[9]	Qualified Dividend Tax Rates[10]	Tax Filer Income
10%	0%	Single taxpayers with incomes between $0 and $9,525 and married couples filing jointly with incomes between $0 and $19,050.
12%	0%	Single taxpayers with incomes between $9,525 and $38,700 and married couples filing jointly with incomes between $19,050 and $77,200.
	15%	Single taxpayers with incomes between $38,600 and $38,700.
	15%	Married couples filing jointly with incomes between $77,200 and $77,400.
22%	15%	Single taxpayers with incomes between $38,700 and $82,500 and married couples filing jointly with incomes between $77,400 and $165,000.
	15%	Married couples filing jointly with incomes between $77,400 and $165,000.
24%	15%	Single taxpayers with incomes between $82,500 and $157,500 and married couples filing jointly with incomes between $165,000 and $315,000.
32%	15%	Single taxpayers with incomes between $157,500 and $200,000 and married couples filing jointly with incomes between $315,000 and $400,000.
35%	15%	Single taxpayers with incomes between $200,000 and $425,800.
	20%	Single taxpayers with incomes between $425,800 and $500,000.
	15%	Married couples filing jointly with incomes between $400,000 and $479,000.
	20%	Married couples filing jointly with incomes over $479,000.
37%	20%	Single taxpayers with incomes of $500,000 or more; and married couples filing jointly with incomes of $600,000 or more.

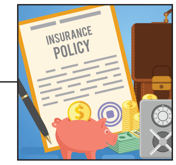
Exhibit 1 assumes no claims were made or covered during the trailing five-year period.[6] While this scenario is not uncommon, none of the premiums paid for open market insurance will be returned, even if there are no claims. In short, unused premiums can aggregate in a captive, be reinvested to increase in value, and ultimately be distributed back to the operating company that paid them or to the owners of the captive insurance company.

An 831(b) captive can also provide significant tax benefits. A captive insurance company can elect to be taxed under IRS Section 831(b), which provides that the premiums collected by the captive insurance company are not subject to federal tax so long as the total amount of annual premium does not exceed $2.2 million.[7] This means that the cash surplus can accumulate in the captive insurance company, and the only federal income tax liabilities will apply to the income derived from reinvestment of the cash surplus.

There are many benefits to 831(b) captives for contracting and subcontracting companies. If a contractor or subcontractor elects to self-insure or carry a high self-insurance retention, then the money saved flows to the bottom line and increases company profit. Those funds would first be taxed at the corporate level and again at the individual level when distributed to the owners of the company.

In contrast, if the contracting or subcontracting company uses a wholly-owned 831(b) captive insurance company for the first layer of coverage, those premium payments can become profits to the captive insurance company, which are not taxable so long as they do not exceed $2.2 million annually.[8] In short, there is no federal corporate tax on premiums with a qualifying 831(b) captive.

Moreover, an 831(b) captive provides additional tax benefits when retained premiums are distributed to the captive



owners. When an 831(b) makes distributions to its owners, those distributions are made as qualified dividends. In contrast, if that same money was paid out to an owner of a contracting or subcontracting company whether as employment income or an owner distribution, those payments would be subject to the tax rates applicable to ordinary income.

Notably, as illustrated in Exhibit 2, the tax rates for qualified dividends are generally much lower than the rates for ordinary income. It is intended to show the favorable tax treatment of dividends from distribution of cash surplus created by retaining insurance premiums that would not be recoverable in insurance purchased on the open market through an insurance agent.

Additionally, a captive insurance program can increase a company's value by turning an operating expense into a source of cash flow. When a contractor or subcontractor purchases insurance – whether on the open market or through a captive program – the cost of that insurance is deductible and can be used to reduce the operating company's taxable revenue.

When those premiums are paid to a captive owned by the contractor or subcontractor, what is accounted for as a deductible expense for the contracting or subcontracting company is accounted for as revenue by the captive insurance company. The revenues received by the captive are then reduced by operational expenses and the costs of losses or claims. What remains is profit for the captive insurance company. These incomes and profits can then be reported in consolidated financial reports. Consequently, two situations can occur.

First, for single-parent captives (i.e., when the captive is a subsidiary of the contracting company), the assets of the parent company can increase by the amount of the unencumbered cash surplus held by the captive, which can increase bonding capacity and borrowing ability.

Second, the cash flow into an 831(b) captive creates an income stream and potential profits that allow for the captive to be valued based on its current assets (unencumbered premiums) as well as for projected future earnings. In that sense, the historical net cash flow of an 831(b) can be capitalized on a prospective basis, resulting in an increase valuation of the captive or the contracting or subcontracting company that owns the captive.

For example, the cash flow of an 831(b) captive that has a historical annual profit of $500,000 would result in it being worth $5 million based on a capitalization rate of 10%. This could be added to the value of an affiliated contracting or subcontracting company for purposes of bonding capacity, financing, or sale. A company simply changing how it procures insurance can help increase its overall valuation.

Captive Formation Process

Deciding to form or participate in a captive insurance program is not a simple task. There are several types of captive insurance programs, so determine which program provides the best benefits with the least amount of risk on a case-by-case basis. Further, not all existing group captive programs are created equally – the operating costs, management structure, and premium costs can vary significantly.

The following provides a simple path to follow when considering whether a captive insurance program is suitable.

Engage Qualified Professional Service Providers

Captive insurance programs involve nuances in the legal, accounting, and risk management professions. Not all attorneys, accountants, and insurance professionals have the experience and resources to evaluate or structure a captive insurance program.

The legal counsel you engage to facilitate this process can potentially form the most important part of your team. In contrast with their traditional roles, attorneys are positioned to assemble teams of qualified captive insurance professionals and to address issues that may be specific to your particular industry.

For example, an attorney experienced in the construction industry will likely understand the contracting process, along with the insurance and risk transfer mechanisms involved within the modern families of contract documents. In that sense, their role is focused on facilitating other service professionals to properly tailor or evaluate a captive insurance program in a manner that is best suited for your particular industry.

Define Specific Goals

Next, define the goals you wish to accomplish with a captive insurance program. Companies approach the concept of using captive insurance for different reasons, including:

- the desire to reduce operating expenses by compressing insurance premiums
- an opportunity for global risk management
- a means to accomplish those ends while also providing a strategic path for cash-surplus accumulation, increased company valuation, increased bonding capacity, and succession planning

Ultimately, identifying and communicating your goals to the professional service providers you engage is important to guide them in evaluating a group captive insurance program or tailoring a custom program.

Develop a Preliminary Feasibility Study

Lastly, develop a preliminary feasibility study. This may be the easiest part of the process and dovetails with the need for qualified professional service providers. Professional service providers who have expertise with captive insurance programs can perform a preliminary feasibility study very efficiently, and sometimes at no cost.

Debunking Myths About 831(b) Captive Insurance Programs

This section will address and debunk some of the more common myths about captive insurance and help provide a better understanding of how these programs function.

Myth #1: An 831(b) Captive Insurance Program Is Only Suitable for Large Companies

The first issue that arises when discussing the implementation of an 831(b) captive insurance program is typically whether the company considering this strategy is large enough to justify implementing such a program. This issue concerns a theoretical break-even point, whereby a company considering forming an 831(b) program can pay enough annual premiums to a captive insurance company to justify the formation and operation costs.

Importantly, there is no universally accepted minimum amount of annual premiums that are necessary. Rather, what is perceived as a minimum amount of annual premiums will vary among insurance agents, insurance brokers, accountants, and attorneys. Generally speaking, these thresholds can vary from requiring an annual premium of $400,000 to $1 million. However, the amount a contractor or subcontractor currently pays in annual premiums is not a complete litmus test.

This inquiry should consider the types of coverages that are currently being purchased, in addition to coverage lines that should or could be purchased to provide further risk management strategies. In other words, whether the annual premium load will justify forming an 831(b) captive program should be determined after considering the goals of the contractor or subcontractor, in addition to the possibility of increasing current insurance premiums by underwriting lines of insurance coverage that the contractor or subcontractor does not already maintain.

At first glance, the idea of paying additional insurance premiums may appear counterproductive to the purposes of forming a captive insurance company. However, when a contractor or subcontractor does not currently maintain insurance coverage for certain risks, it is essentially self-insuring those risks without receiving any of the benefits that can be provided by a tailored captive insurance program (e.g., the ability to improve risk management while generating a cash surplus from accumulating insurance premiums).

Further, captive insurance opportunities still exist for companies whose individual premium load does not, by itself, justify the formation of an 831(b) captive insurance program. Smaller companies can access captive insurance by collaborating with other small companies with the help of an advisor to form a group captive.

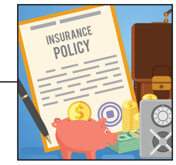
Note that there are existing group captives that are openly marketed as serving the middle market construction space. However, these opportunities are not always the best fit for some companies, as most of the existing group captives are not structured in a way to maximize the benefits available. The solution to this problem is simple: smaller contracting and subcontracting companies can engage qualified attorneys and insurance brokers whose expertise allows them to craft tailored captive insurance programs that are not openly marketed through insurance agencies and that would otherwise not be accessible.[11]

Myth #2: An 831(b) Captive Insurance Program Is a Vehicle for Tax Evasion

831(b) captive insurance programs are subject to abuses by those seeking to avoid tax liabilities and have, as a result, received scrutiny from the IRS.[12] But, to be clear, simply having a captive insurance company elect to operate under IRC § 831(b) does not by itself make a captive insurance program an improper tax shelter or scheme to avoid tax liability. Rather, the risk lies with the purpose for forming a captive, how the captive is structured, and how the captive is operated.

In other words, such risk exists when 831(b) captive insurance programs do not possess the characteristics of a true insurance company – actual risk transfer in return for premiums are based on actuarially supportable studies, in addition to traditional operating characteristics.

The IRS has provided some guidance on characteristics that suggest that an 831(b) captive insurance program is being used for improper purposes,[13] including the following recommendations:



1) Premium amounts are not based in underwriting or actuarial analysis that is consistent with common insurance industry standards;

2) Premium amounts are excessive when compared to similar insurance coverage available on the open market;

3) The coverage provided by the captive is duplicative of insurance being provided to the insured by an unaffiliated insurance company;

4) The coverage provided by the captive does not insure a real business risk of the insured;

5) The captive insurance company is undercapitalized; and

6) There is a flow of funds between the captive and the insured such as loans.

These characteristics are illustrative and not exhaustive. However, they reveal traits of a captive insurance company that is not fulfilling the obligations of a traditional insurance company and are implemented merely to facilitate improper tax arbitrage.

When properly structured, an 831(b) captive insurance program has the ability to provide significant reductions to the tax liability of contracting and subcontracting companies. However, to do so in a manner that avoids an unfavorable tax scrutiny requires the assistance of professional service providers who understand these points and make sure that a captive insurance program is structured, operated, and properly formed.

Myth #3: Insurance Agents Will Not Advise You About Captive Insurance Programs for Fear of Losing Commissions

It is true that captive insurance programs benefit contractors and subcontractors by reducing insurance costs through reduced insurance premiums paid to third-party insurance agents that procure open market insurance.

However, a qualified insurance agent or broker should be part of the team assembled for purposes of evaluating and forming a captive insurance program. Insurance agents and brokers with captive insurance experience view their role as consultants.

As such, captive insurance programs provide ways for insurance agents and brokers to procure fees that are alternatives to commissions, allowing their clients to enjoy reduced premiums and improved risk management programs.

Conclusion

The use of captive insurance programs within the contracting and subcontracting industry is increasing. The principle reason for such growth is the recognition that those programs provide alternative risk management strategies to conventional open-market insurance that provide additional benefits associated with opportunities to reduce operating expenses, improve risk management, and to increase an insurer's economic bottom line.

The simple questions that contractors and subcontractors should be asking themselves are: 1) is a captive insurance program a good fit? 2) Is the current program the best opportunity to maximize the benefits available (if already participating in a captive insurance program)?

If these questions have not already been sufficiently answered, then each day that passes represents a lost opportunity to take advantage of captive insurance benefits. ■

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Endnotes

1. *www.americanbar.org/content/dam/aba/events/construction_industry/2017%20Meetings/3_aia.authcheckdam.pdf.*
2. Typically, this can be seen in the situation of shopping insurance quotes through various agencies.
3. See generally Captives and the Management of Risk (3rd Ed.) by Kathryn A. Westover § 1-2.
4. Id.
5. Micro-captives or 831(b) captives are captive insurance programs that elect taxation under IRC 831(b).
6. This illustration does not consider any income derived from the investment of premiums collected or reinvestment of income from investments.
7. IRC § 831(b).
8. To be clear, although premiums of less than $2.2 million are not taxable as income under IRC 831(b), income received by the captive based on the reinvestment of such premiums is taxable.
9. IRC Rev. Rul. 2018-06 § 3.
10. *www.irs.gov/forms-pubs/about-publication-550.*
11. Notably, these concepts arise most often with contractors and subcontractors whose interest in captive insurance programs is driven by the recognition of the ability to generate a cash-surplus, increase the value and financial stability of their companies, enjoy the benefits of favorable tax treatment under IRC § 831(b), and have an entrepreneurial spirit.
12. See, I.R.C. Notice 2016-66.
13. Id.

When a contractor or subcontractor purchases insurance – whether on the open market or through a captive program – the cost of that insurance is deductible and can be used to reduce the operating company's taxable revenue.

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He frequently assists contractors, subcontractors, and suppliers with a myriad of issues including the evaluation, structuring, and implementation of captive insurance programs. He is also a speaker, author, and participant in numerous construction industry associations including CFMA, ABC, AGC, MITA, and ASA.

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