A Captivating Short Story... Ignore At Your Peril

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Sitting in a partner’s seat at VIP Insurance, I get the privilege of seeing a lot of trends first hand and often first in line to do so.

Why? Our distribution only serves P&C agencies and financial institutions. With more than a thousand P&C agents and over two thousand financial advisors turning over rocks, we get calls every day about our clients’ (you) best clients.

The trend of late is the discussion & formation of captive insurance companies or CICs - most notably, the small captive market known as 831(b).

"…if you are not exploring this with your client, you are at extreme risk to the person who does."

Now Google University may provide you with more ammo and cerebral comprehension on this subject, but for the sake of keeping this a “short story”, I will define CICs in simple insurance speak. First, we know that insurance is a “hedge” against an unknown loss. Second, our larger clients have the potential for large unknown losses that they are forced to “self insure”. Third, they rarely actually segregate that “hedge fund” for those unknown losses.

With the 1-2-3 above in mind, a CIC is the formation, ownership and business of putting away those self insured funds as a premium tax deduction in a small regulated insurance company.

One analogy I find that seems to help cement the idea in clients’ & producers’ heads is the ownership of the building they are in. Not all, but most of the clients we are consulting own the building that the primary company occupies. Usually, at the advice of their CPA, they set up a separate company to handle the real estate occupied by the primary company. With a CIC, You are merely setting up another company to handle some of the risk the primary company occupies.

The title of this article includes the line “Ignore at Your Peril”. So, let’s get to that part straight away before discussing the other benefits and reasons for CIC popularity.

If you do not have or wish to have large, high cash flow clients, you have nothing to worry about. If you do, and you are not exploring this with your client, you are at extreme risk to the person who does. The fact is that the benefits can be huge (in the millions) and the expense to do it right is not cheap up front – so a feasibility study is always recommended.

If another P&C broker brings this to your client and is a part of the feasibility (risk analysis), the coverage is likely to move.

Let’s explore briefly some of the insurance and financial reasons a high cash flow business would want a captive:

Insurance Reasons:

By Example

Recently we have seen more disputes in the oil & gas industry arising from liability in project delay or continuation & due to a product liability or warranty issue. A captive could help you provide this C.I.C.

- Coverage not provided in traditional policy
- Increased control over claims management
- Cash outlay control

Financial Reasons:

- Building wealth outside current estate or company assets
- Asset protection
- Legacy business planning
- Favorable gifting strategy
- Income tax planning
- Estate planning

What happens when you need to shut it down or redeem your interest?

- The tax deductible premiums going into the captive could convert to long term capital gains, less expenses & above basis (not ordinary income taxes).