Bringing Captives' Benefits to Smaller Employers

by Norma L. Nielson, Ph.D.

Captives, used for the corporate cash flow and tax advantages afforded their parent firms, "came of age" following the Carnation tax decision in 1974. Today, experts know (almost) all of the rules which enable a captive to provide the many advantages which have been touted over their three-decade history.

A captive insurer has been defined as "... an organization whose stock is generally owned by one business firm undertaking insurance company ownership in an attempt to obtain insurance for its business at a lower cost than coverage purchased from other insurers."[1] Captives are usually classified into two or three categories. The Vermont Special Insurer Act of 1981 recognizes "pure" captives, which are more than 50 percent owned by a parent company,[2] "association" captives, which are wholly owned by the member organizations of a pre-existing association, and "industrial insured" captives.[3] This latter category is similar to workers' compensation pools as discussed by Gerald P. Brunker in the December, 1982 issue of *Risk Management.*[4] It permits firms to affiliate informally for the purpose of pooling risks and procuring insurance coverage from a commonly owned captive.

For the small- to medium-size firms, pools and industrial insured type captives dominate the discussion and literature regarding alternatives to traditional insurance. Both the pooling mechanism and the permissible domestic captives offer the commonly known advantages of improved cash flow and investment earnings from reserves, but each has severe limitations. The pools require an indemnity agreement, signed by all participants, that must generally include an assessment clause or some other form of unlimited liability for losses of other members of the pool as well as for your own firm.[4] The Vermont captive regulations concerning industrial insured captives contain several important restrictions that do not apply to offshore captive companies. For example, the parent organizations of a Vermont-based industrial insured captive must utilize the services of a full time employee acting as an insurance manager or buyer. This stipulation alone precludes many smaller firms from gaining the advantages of the captive concept. In addition, the parent organization is subject to all the criteria of its own jurisdiction governing participation in insurance business or direct placements.[3]

Yet another concept in captives is the agency-owned offshore captive company which is designed to allow an agency writing a profitable book of business to share in that profitability. A new source of revenue is generated for the agent by reinsuring a portion of his/her book of business and garnering a share of the investment and underwriting income from that business.[5] Still, the firm paying the bill is not gaining the advantages of the investment earnings and underwriting profit.

The newest captive shape, which has appeared in the California market for workers' compensation insurance, passes all these advantages along to the insured while avoiding the disadvantages of pooling and domestic captives. Employers with at least $50,000 in workers' comp premiums are joining together to establish their own offshore captive. In addition to paying the annual premium, each employer (or a person or entity designated by the employer) buys stock in the captive. The amount of stock offered to any one employer increases depending upon the annual premium charge, but never exceeds eight percent of the stock in the captive, and the purchase price for the stock begins at $1,500 for employers with premiums in the $50,000 to $100,000 range.[6]

Tax and Cash-Flow Advantages

With captives, each employer receives all the advantages of tax deductibility of its insurance premiums while greatly increasing its control over the cash (reserves) of the captive through proxy or a seat on the board of directors. The employer's risk is diversified among companies which vary in both indus-

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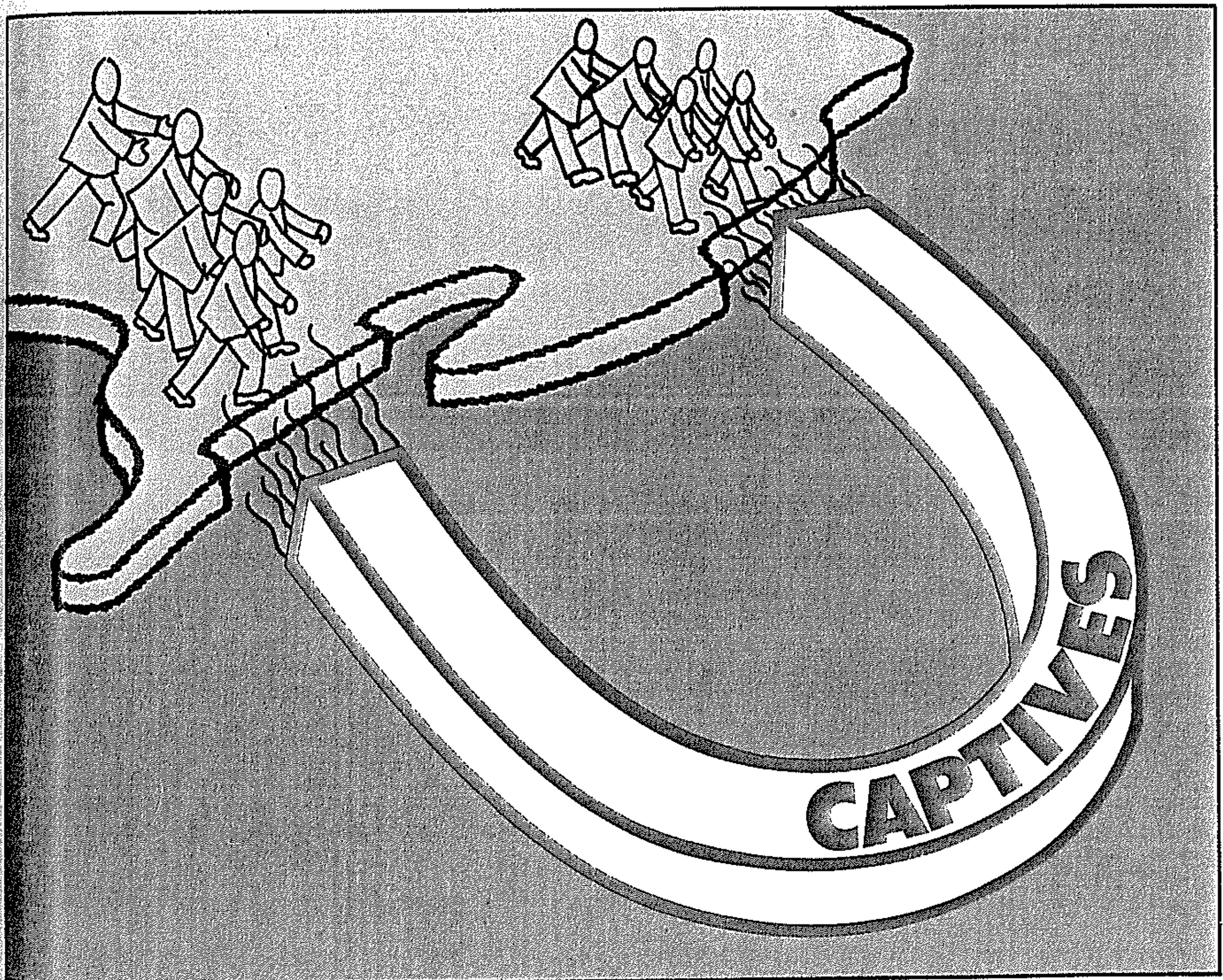

try and size. The insurer has no incentive for overreserving and, even if overreserving does inadvertently occur, the resulting increase in investment income falls through to the bottom line and increases the equity value of the employer/owner. In a traditional insurance situation, all such gains from overreserving inure to the benefit of the insurance company and are passed on to the employer through the insurer's dividend policy. Underwriting profits are more likely to occur and be more accurately measured when the incentive to overreserve is removed.

Table 1 illustrates the most important benefit of the captive: the investment income earned on funds backing reserves.[7] The example assumes a $2.5 million premium, a loss ratio of 40 percent and a 12 percent investment return. Under these assumptions,

the adjustment is entirely in the first year, increases present value by approximately the same amount. The levels of investment income using other loss ratios and interest rates are shown in Table 2.

The value to the individual employer/owner of these investment earnings is maximized by the tax-free treatment of these earnings in the offshore captive. If each individual employer's ownership share in the offshore captive is less than 10 percent, the captive will not be considered a controlled foreign corporation under current tax law. This provides the valuable advantage that offshore investment earnings are tax-free until repatriated to the U.S.[8] This is a very large advantage, but no firm should enter into the captive insurance business solely for long-term tax-free returns. These are a terrific bonus, but may not last indefinitely.

"California workers' comp is particularly suited to this 'joint venture' approach"

This captive arrangement offers: tax advantages; diversification; cash for investment; and underwriting profit. These four reasons motivated 71 percent of the respondents in a recent survey of "pure" captives that entered into the business of selling insurance to unrelated firms.[9] These advantages (which Mr. Porat's survey indicates even the largest firms are seeking for their captive companies), when enhanced by the limited liability of the corporate form of ownership and the tax-free nature of savings offshore, compare quite favorably with even domestic captives and pooling arrangements.

Golden Gate WC Opportunities

California workers' compensation is particularly suited to this "joint-venture" approach to captives. The premium rates, set by state law, have built into them an average 65 percent loss ratio with 35 percent allowed for insurer expenses and profits. No deviation is permitted from this expense factor, and the only deviation permitted from the loss ratio is through the experience modification factor which is generally based upon a three-year average of loss experience. The experience modification factor moves very slowly in response to underwriting conditions. A second important reason for the attractiveness of the captive plans for California workers' compensation business is that, even though employers are allowed to self insure, it is illegal for an employer to purchase stop-loss types of coverage that would make self insurance a more viable alternative for medium- to large-size employers.[10] Currently, only California's largest employers can comfortably self-insure even their biggest losses. Clearly, this new type of captive arrangement would face much stiffer competition in states where open competition is permitted in rating, or where self insurance is permitted to operate freely in the insurance market.

This captive arrangement, as do all others that eliminate some of the traditional insurer's roles, requires the employer to become much more involved with the insurance process. The risk manager must accept responsibility for safety inspections, for assuring a satisfactory loss adjustment procedure, for the captive's obligations for the losses of other insureds, for the adequacy and viability of the reinsurance program and for their many other duties as a director of an insurance company. The rewards for the owners of a firm with a history of favorable loss experience and sound risk management practices can be substantial. They may well be worth the time and effort the additional responsibilities require. **RM**

Footnotes

[1] *Glossary of Insurance Terms,* National Association of Professional Surplus Lines Offices, Ltd. (1983).

[2] A few authors use the "pure" classification of captives to mean that 100% of the capive's insurance business is written with relation to the parent's business.

[3] Johnson, James F., Sarchio, John J. and Beane, Reginald E. "Captive Insurance Companies: The Vermont Alternative," *Risk Management* (June 1981), pp. 20-22.

[4] Brunker, Gerald P. "Pooling Workers' Compensation: A Viable Alternative?" *Risk Management,* (April 1982), pp. 61-64.

[5] Barile, Andrew J. "New Profit Center for Agents," *National Underwriter* Property & Casualty Edition, (October 8, 1982), pp. 27, 34.

[6] The prices and percentage ownership figures given here are for the captive arrangements offered through Bolton and Company, South Pasadena, CA. Other plans may vary.

[7] The author wishes to express sincere thanks to Captive and Self-Insurance Services, Inc., San Bruno, CA, for providing these computations.

[8] Details regarding the definition and tax treatment of controlled foreign corporations can be found in Section 951 of the Internal Revenue Code (IRC).

[9] Porat, Moshe M. "Marketing and Claims Management Functions of Offshore Captives," *Best's Review* (January 1983) pp. 26-30, 81-82.

[10] Ohio is the only other state to prohibit self insurers' purchase of stop-loss coverage. The captive concept described here cannot be applied in Ohio, however, because all insurance in that state must be purchased from the state fund.

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