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ALTERNATIVE APPROACH

Construction Firms A 'Captive' Audience For Cutting Insurance Costs

Products Provide Many Benefits

BY MATT LANZA
SPECIAL TO BANKER & TRADESMAN

In 2015, construction firms continue to carry with them strategies for staying lean, an idea that kept many construction firms afloat (albeit sometimes barely) throughout the recession. Yet despite the emphasis on cost-cutting measures, many firms continue to sign up for conventional guaranteed cost insurance to guard against workers' compensation, automobile and general liability exposures, unhappily and unaware that alternative insurance and risk management solutions – including various captive options – may offer better financial outcomes for their firm.

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"Traditional captives," which are insurance companies owned by their members for the benefit of their members, have been commonly misconceived as an option only for the likes of Fortune 500 companies. However, captives are advantageous for any company that has good loss ratios, operates in a difficult industry (such as construction) and generates combined workers' compensation, automobile and general liability insurance premiums of $200,000 a year or more.

A construction firm would join a group captive with other companies. Doing so allows them to become a part owner of an insurance company. This approach provides many benefits and allows them to earn 100 percent of the profits and investment income on their account, broaden their insurance coverage, gain more control of the claims handling process and enjoy enhanced premium stability while still taking advantage of full tax deductibility for the total annual premiums paid.

In addition to traditional captives, there are other risk management products that give tremendous benefits to small and mid-size insureds. These alternative captive products, also known as "non-traditional captives" or "mini-captives," can be effective in addressing a company's enterprise risks such as regulatory change, loss of license, breach or loss of contract, loss of key supplier, product recall, equipment maintenance, reputational damage, warranties and faulty workmanship to name a few. Instead of self-insuring or un-insuring these risks due to marketplace conditions, the route that many firms take is the implementation of a self-owned mini-captive. A mini-captive is a captive that does not receive more than $1.2 million a year in premiums and elects, under tax code 28 U.S.C. sec. 831(b), to be taxed on its investment income only.

Mini-captives override the need to pay income taxes on the underwriting profits; instead, only the investment income earned on the premiums within the captive are taxed. As a result, construction firms that opt for this strategy are able to set aside funds to insure against potential losses caused by enterprise risks. Furthermore, for any losses that can be controlled or avoided, 100 percent of the profits and investment dollars would come back to the captive owner as a qualified dividend, which creates a significant tax advantage.

In addition to protecting a firm against uninsured risks, controlling premiums and losses and maximizing corporate tax deductions, captives can also be used to accumulate significant wealth, protect assets and maximize future distributions. For instance, a captive may allow the owners of a family business to move

assets from one generation to another as part of the captive's ownership structure. Ownership of the captive can be established inexpensively in the form of a trust for younger generations, allowing underwriting profits from the captive insurance company to accrue to those younger generations with little or no tax consequences, as well as offer asset protection from bankruptcy, litigation or divorce.

Captives allow companies that are an exception to their industry norms to be rewarded for their good loss experience. Given the myriad benefits offered by captives, many construction firms are finding at the conclusion of each risk management process that the solution is not always to buy traditional insurance. Instead, a customized and creative risk financing technique – through the use of captives – can both safeguard and enhance a firm's bottom line. ■

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