# Captive Insurance News

## Buying an 831(b) Captive—How Is the Back Office?

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Some captive providers can sell ice to an Eskimo, but can they really deliver effective captive management service over time?

Much has been written about the benefits of forming and operating a captive insurance company that qualifies for the tax benefits available under section 831(b) of the Internal Revenue Code. Large businesses can pay up to $1.2 million a year in tax-deductible premiums to their related captive insurance company. Yet that insurance company can elect to have that premium income received tax-free. The profits of the insurance company can then be accessed by its owners at capital gains rates. And, depending on the ownership of the captive, it can become an integral part of an entrepreneur's estate plan.

These benefits make it relatively easy to sell the concept to a business owner and his or her advisors. Once the contract is signed with the captive manager, the risks to be transferred to the captive are underwritten and priced. Policies and other documents are drafted. The last step is filing with the chosen domicile to form the new corporation and to receive a captive insurance license—the certificate of authority. Once that license is approved, the client pays the annual premium to the captive and immediately deducts that payment from his taxable income.

But there remains much more work to be done for this new captive, and that work will continue annually. The great sales person moves on to the next prospect. The client then must deal with the "back office," that part of the captive management firm that deals with the ongoing accounting and administration of its licensed and managed captives. Unfortunately, in many cases, the back office is a weak link in an otherwise strong-looking captive management firm.

Client responsiveness is the first thing to go when a back office is unable to handle the workload. In one case personally known by this author, an owner of a captive insurance company requested that his captive manager apply to the state in which the captive was domiciled to allow the captive to make a secured loan to a relative. After over 6 months of unresponsiveness, the client fired the captive manager and hired a new one who had the loan approved in 10 days.

Accounting and annual reports are a very important part of maintaining the captive's license. In most domiciles, the annual report is due by March 1 of each year (for captives with a December 31 year-end). At the same time, the captive must file a Premium Tax Return and Franchise Tax Return. The annual report is in turn an important requirement in order to generate the required audited financials for the captive, its annual tax return and the required annual actuarial opinion.

The annual report cannot be completed until the captive's accounting information is closed for its fiscal year. Generally, the accounting for the captive is done by the captive manager based upon bank statements and other information provided by the client.

This is a lot of activity for every captive manager early in each year. As new captives are added, people, resources and procedures must constantly be increased or upgraded. The deadlines for filings are not extended simply because a captive manager's back office is overwhelmed with the number of captives under management. Failure to meet statutory deadlines can put the captive's certificate of authority at risk, which in turn would destroy the tax benefits that the client was expecting from funding his or her new insurance company.

One well-known captive manager with a large number of captives under management apparently keeps track of the captives, their accounting and filings on Excel spreadsheets! Apparently the front office is not willing to provide advanced software to the back office to insure that the captives that have been sold remain compliant. Some day that short-sightedness may hobble future growth. And if captive owners feel that a poor back office has financially impaired their expected results, the manager may have serious professional liability exposure.

Annual filings are not the only administration required for captive insurance companies. As indicated above, if a captive wishes to make a loan, declare a dividend, make an ownership change, dissolve, or change captive managers, the licensing domicile will require additional filings. Delays or a failure to respond to these requests could make a big financial difference to captive owners.

For example, as the "fiscal cliff" approached at the end of 2012, many captive owners decided that they wanted to take a large dividend or even dissolve completely to save on potential increased taxes. Delays in responding to such requests would have cost captive owners an additional 8.8% in federal income taxes against such ordinary or liquidating dividends.

As a prospective buyer, it is difficult to judge whether the back office of the captive provider will adequately support your new captive. Ask for specific numbers of captives under management and the number and types of personnel supporting those captives. Buyers can also contact the office of the captive insurance regulator in the proposed captive domicile to determine if the regulator has any complaints regarding that manager. Perhaps best of all is to talk to other clients of the provider as well as outside support staff (such as accounting firms or actuaries) to judge how responsive the manager has been to their needs.

It is natural for most of the focus with captives to be on the "front-end" and the wonderful tax and financial planning benefits that should follow from a properly formed and managed 831(b) captive. But those benefits will fade and disappear if the captive manager does not give equal or greater attention to the back office that nurtures the captive through its regulated life.

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