

Is It Time to Back Out of Your Garage Coverage?

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By Matthew T. Joffe, JD and Joseph A. Magyar, CPA

Many dealers have seen their garage liability insurance premiums skyrocket over the last few years, prompting them to explore alternative risk financing techniques. Under the right circumstances, a captive insurance arrangement can be an appealing option. Captives may be appropriate for other types of insurance as well, but soaring premium costs make garage liability an especially suitable candidate for captive coverage.

Simply put, a captive is an insurance company owned and controlled by the businesses it insures. Captive insurers can take many forms. Examples include:

- Single-parent captives, owned and controlled by a single entity;
- Group captives, owned and controlled by two or more unaffiliated insured parties who pool their risks to share in cost savings and other benefits; and last but certainly not least ...

- Cell captives, single legal entities that offer some of the benefits of group captives but segregate members' assets and liabilities into "cells" insulated against other cells' losses.

You can establish a captive in a variety of jurisdictions, both offshore and domestic. Or, you can join an existing captive operated by a trade association, manufacturer or dealer group. Some dealers may find captive insurance

a suitable medium for all their risk financing needs. Others may find it makes better economic sense to structure a combination of insurance formats: for example, captive insurance for smaller losses and an umbrella policy for catastrophic loss coverage.



How do captives provide cost savings?

Captives have the potential to significantly reduce owners' commercial insurance costs by:

- Offering more stable premiums and lower fixed costs than those associated with traditional insurance companies;
- Allowing owners to participate in the captive's underwriting profits and investment income;
- Providing owners with direct access to reinsurance markets;
- Strengthening owners' negotiating leverage with commercial insurers; and
- Generating tax benefits for owners.

Whether a captive will work for you comes down to economics: If a captive will allow you to save money on commercial insurance premiums, and if you have a good loss history and the risk-management skills needed to minimize losses, it may be worth a look.

Taxes are also a key consideration. Specifically, if a captive can be designated an "insurance arrangement," both the captive and its owners may enjoy significant tax benefits.

Capturing tax benefits.

If a captive qualifies as an insurance arrangement for federal income tax purposes, then the insured operating companies can deduct their premiums.

The captive itself, moreover, is taxed as an insurance company, which means it can deduct most of its loss reserves. This allows the captive to defer significant amounts of income.

Smaller captive insurance companies are entitled to even more attractive tax breaks. Under the current tax code, for example, captives whose annual premiums fall below \$1.2 million can elect to be taxed only on their investment income.

Example: leveraging savings from a captive.

Here is a hypothetical example that illustrates the captive's cost-saving potential. An auto group with good loss history pays \$750,000 a year in garage liability premiums to its insurance provider. The auto group's policy provides for coverage of \$500,000 per occurrence, with an annual aggregate of \$4 million. In an attempt to reduce its insurance costs, the auto group renegotiates its garage liability policy, self-insuring its first \$250,000 in liability in exchange for a \$225,000 premium credit from its insurance provider. The auto group then forms a captive insurance company to cover its first \$250,000 in liability, for which it pays premiums of \$247,500 per year.

The result: The auto group's overall insurance coverage is unchanged. It continues paying premiums to its insurance provider each year. In

addition, the auto group pays annual premiums to its captive to cover the larger deductible it took on the insurance provider's policy. All of the auto group's premium payments, including those paid to its captive, remain tax deductible. The key difference is that, instead of paying the entire premium to its insurance provider (the only benefit of which is the coverage the vendor provides, regardless of the auto group's excellent annual loss record), part of the premium is paid to the auto group's newly established captive, which is wholly owned by its shareholders. If the auto group sustains its fine loss history, it stands a very good chance of seeing a return of the premiums it has paid to its captive, in addition to whatever investment income those funds may have earned while held by the captive.

Evaluate your options.

After you have analyzed the projected costs and benefits associated with forming or joining a captive, you may find a captive offers a cost-effective alternative to commercial garage liability policies and other types of insurance coverage.

Matthew T. Joffe can be reached at 954.202.2923 or mjoffe@crowechizek.com.

Joseph A. Magyar can be reached at 954.489.7439 or jmagyar@crowechizek.com.

