As of September 1, 2013, Texas joined some 31 other states in passing legislation that allows the state to license and oversee captive insurance companies, or “captives.” Under this new business-friendly law, Texas companies or companies with operations in Texas can form a Texas captive to insure certain risks that they may currently self-insure, insure through a non-Texas captive, or otherwise insure commercially.

Insuring through a Texas captive means that a parent company forms a wholly separate insurance subsidiary and licenses it through the Texas Department of Insurance (“TDI”). Once licensed, the parent transfers selected company-wide risk and pays the attendant premium for that risk to the insurance subsidiary. Then, the Texas comptroller charges the parent company premium taxes on the premiums paid to the captive at a rate of .5 percent.

Although the formation of a captive is novel to Texas, utilizing captives to self-insure risk is not a new concept. As early as the sixteenth century, ship owners would meet in London coffee houses and pool funds to cover the cost of risks associated with their ships — a rudimentary form of a group captive.

Considering a Captive? Why Now?
Many of the large companies such as AT&T, Microsoft, Google, Apple, Dow Chemical, Coca Cola and Disney have been forming modern captives and licensing them in non-Texas domiciles for the better part of fifty years. However, small and mid-size companies which are sufficiently capitalized have started to follow suit. Many smaller business entities have found the use of captives to be a more efficient answer to either self-insuring or securing traditional coverage for certain risks. But why the sudden spark in interest over an industry that has been around for so long? Several factors have contributed to the recent influx in captives formation.

Evolution of the Micro-Captive
Over the past decade, smaller companies have discovered that captives are a viable alternative to self-insurance through electing to treat a captive insurance company as a “Section 831(b) micro-captive.” As long as a micro-captive is structured properly as an independent insurance company and the parties obtain appropriate risk transfer and distribution, Section 831(b) of the Internal Revenue Code allows for an insurance company that collects $1.2 million or less in premiums per year to pay tax only on its investment income, not on premiums collected. What that means is that an insured paying insurance premiums to a properly structured insurance company receives a tax deduction for insurance premiums paid in its current taxable year for amounts that companies who self-insure risks traditionally cannot deduct until amounts are paid on claims from these self-insured risks.

For example, a company who self-insures without a captive typically sets aside amounts as a reserve against potential future losses for any number of risks, such as professional liability, litigation defense, mold/pollution, subsidence, environmental clean-up, or product warranty. The amounts set aside are not deductible until actual claims are paid or settled under the traditional self-insurance model. But if the risks are insured by a properly structured insurance company, the insured may deduct the premium it pays to the insurance company, while the insurance company pays taxes only on its net investment earnings, not its premium income.

Growth in Economies of Scale for Captives Advisors
Even if companies are too large to consider forming Section 831(b) micro-captives, the increase in the pool of competent alternative risk management professionals available to help customize companies’ insurance needs paves the way for more mid-size companies to play in the captives space. Some counsel may incorrectly assume that a company must have significant insurance competence in order to obtain the benefits of captives formation. But companies need not have in-house insurance specialization in order to form a captive; indeed, very few do.

Pure economies of scale have driven the price of securing these types of advisors down so that captives formation is no longer limited to the elite Fortune 500 companies who can afford in-house risk managers. As the market for captives grows, the necessary advisors become cheaper, thereby allowing smaller companies to afford to form a captive.

Increase in Customization and Control
Engaging competent alternative risk management advisors to assess a company’s insurance picture is not necessarily cost prohibitive in the modern captives market. Thus, more companies are beginning to understand that customizing captives to fit their insurance needs could benefit the company’s bottom line.

Perhaps the best example of using a captive to customize insurance needs is illustrated in the area of professional liability or business litigation protection. Business owners and/or licensed professionals have long been concerned that a potential lawsuit could jeopardize their licenses, businesses, or both. However, the cost of “off-the-shelf” traditional insurance products may...
either be unacceptably high or a poor fit for their risk profile. These owners may find it more cost effective to secure a high deductible insurance policy, then insuring the cost of the deductible through a captive.

A captive could also prove beneficial if a company desires to maintain greater control over its insurance coverage. For example, uncommon and unpredictable disasters like hurricanes and/or cyber-attacks often leave businesses with either rejected or uncovered claims. As part of the feasibility study and risk analysis that occurs when captives are formed, alternative risk management advisors will assess where companies are left uncovered or vulnerable. Then, the captive will fill those gaps in coverage, thereby affording the company greater control over what to cover and whether claims will ultimately be paid.

Positioning a Captive — Why Texas?
If a company desires to form a captive, the first consideration is where to domicile that insurance company. Before Texas had a captives law, Texas companies had to domicile their captives elsewhere, then pay a 4.85 per cent self-procurement tax on all premiums their captives wrote in Texas as non-admitted insurers. Obviously, this made operation of a captive a headache for Texas companies large and small. For most small companies, maintaining an insurance affiliate outside of Texas was cost prohibitive because most captives laws require at least one resident captive employee and at least one captive board meeting to be held within the domiciliary state. But even those companies who can afford such operational costs have found it inefficient to deal with multiple state compliance hurdles, uncertain tax consequences, and various other administrative hassles inherent in operating an insurance company affiliate outside of a parent's home state.

Now that the Texas captive market is open for business, there are several reasons that any company who has significant operations in Texas would be wise to consider Texas as the domiciliary home to its captive.

- **Greater Taxation Predictability:** The Texas law provides a capped .5 percent premium tax on “each kind of property or risk without regard to the location of the property or risk.” This provides a more certain regulatory structure in the wake of the federal Dodd-Frank legislation’s Nonadmitted and Reinsurance Reform Act (“NRRA”). The NRRA has left some question over whether parent companies could be taxed in their home states for captive insurers based elsewhere. The Texas law provides extra predictability by ensuring that captives pay the low Texas rates for all risks underwritten by a captive without regard to the risk’s location.

- **Relaxed Regulatory Scrutiny:** The TDI is a national leader in insurance regulatory oversight, and it was TDI’s recommendation that the legislature adopt a Texas captives law to make Texas competitive with the other 30 domiciles open for captives business. The TDI is actively promulgating rules that will regulate the licensing process in a transparent and efficient manner. Also, Texas captives will have to maintain capital and surplus of at least $250,000 — the common minimum requirement among other captive laws throughout the nation. The proposed rules for annual reporting requirements and standards by which a captive can make loans to its affiliates with the prior approval of the commissioner illustrate TDI’s desire to ensure the Texas law remains competitive and business friendly.

- **Restrictive Confidentiality Provisions:** While the TDI has the ability to receive and share some of the Texas captive’s confidential information, that authority is more limited than what information can be obtained from traditional insurers. For example, the law limits access of a captive’s confidential information to only certain entities who are acting in their official capacities, absent written approval from the captives.

- **Redomestication of Captives:** The Texas law provides a process by which an existing non-Texas captive can redomesticate to Texas upon the approval of the commissioner. The commissioner is authorized to postpone or waive the imposition of any fees or taxes upon the redomesticating captive for up to two years.

Since the rules implementing the new captive law are currently in draft form at TDI and are expected to be in effect in the early part of 2014, companies would be wise to begin discussions with counsel about the formation of their captive as soon as possible.

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