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Creating A New Insurance Industry In Connecticut

With legislation in place, state is in position to capture captive companies

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Connecticut's incoming administration has an opportunity to jump-start a new industry, the captive insurance industry, which could provide additional risk management options to businesses and generate substantial employment with significant tax revenue for the state, without use of general revenue funds.

Captive insurance companies are insurance companies established with the objective of insuring risks generated by their parent entity or entities, or of the parent's customers. To date, more than 5,000 captives have been established. Vermont currently is the third largest domicile in the world, following Bermuda and the Cayman Islands. Other states with substantial numbers of domiciled captives include South Carolina, New York, Hawaii, Arizona, Montana, and Nevada.

Connecticut has none, but is well-suited as such a domicile. Members of the bar should familiarize themselves with this tool to permit their clients to achieve better risk-management results.

The non-tax benefits of captives include:

- **Cost:** The parent avoids paying the commercial premium, which includes the insurer's profit and overhead.
- **Flexibility:** When the insurance market is soft, the captive can take advantage of low rates by reinsuring a relatively large proportion of its risks. When the market hardens, the captive is able to retain a larger proportion of its risks, and can maintain coverage for its parent.
- **Claims management:** Processing a claim with a third-party insurer can be tedious and expensive. Where the insurer is a captive, the claims handling procedures are designed by management, reducing delays and bureaucracy.
- **Claims experience benefits:** Captives generally retain a portion of the overall risk and reinsure the remainder. When claims experience is better than anticipated, the excess of net premiums over claims is retained by the parent. Reinsurance minimizes the group's exposure where claims experience is worse than projected.

The tax benefits include:

- **Tax-free underwriting income:** Insured businesses can deduct up to $1.2 million a year in premium payments made to the captive, which is tax-free to the captives up to the same amount. The captive returns revenue to the parent via lower-taxed dividends.
- **Tax-preferred dividend income:** A qualifying captive also qualifies for a 70 percent deduction against dividends the captive receives from its investment in stock of U.S. corporations.
- **State income tax savings:** Captives generally do not incur state taxes on their net underwriting income or investment income. Instead, they are subject to a lower captive premium tax.
- **Current deduction for future losses:** Captives may deduct a reserve for a reasonable estimate of losses incurred even though the losses will be paid in a future year.

The Vermont Program

In 1981, the Vermont Legislature passed the Special Insurer Act, which was designed to provide a statutory framework for captive formation. Vermont's captive insurance statute has been modified continually to meet the needs of industry and has received consistent support from Vermont governors and state legislators.

The benefits to the Vermont economy are substantial:

- **Jobs:** As of 2006, the captive industry accounted directly for 1,429 relatively well-paying jobs in Vermont. In 2009, notwithstanding the recession, the job count was still about 1,400, with 400 direct jobs and 1,000 additional jobs at banks and law and accounting firms.
- **Revenue:** As of 2008, Vermont expected to collect about $24.5 million from premium taxes.
- **Indirect Revenue:** As of 2005, the benefit to the Vermont economy was estimated to be more than $1 billion annually. Premium tax revenues were kept in-state when they

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might be paid to another state. A source of risk transfer was created by filling gaps where insurance did not exist. And the tourism industry received a boost from the required annual board meetings and a large industry conference.

Because the cost of regulation is financed by the fees collected, the captive insurance industry brings substantial benefits to the Vermont economy at no cost to taxpayers. This is especially striking given that Vermont had virtually no indigenous insurance industry when it started its program in the early '80s.

Status In Connecticut

Connecticut became the 28th state to authorize the creation of captive insurance companies when then Gov. M. Jodi Rell signed P.A. 08-127, An Act Concerning Captive Insurance Companies, into law on June 2, 2008. Modeled on the Vermont statute, it was enacted by unanimous vote, underscoring the lack of opposition from insurers, regulators, or any interest groups.

The Connecticut law, effective Jan. 1, 2009, provides that:

- Captives may be formed by individual companies or groups of companies, associations and other groups.
- The parent entity can be a corporation, LLC, partnership, or other entity that controls 50 percent or more of a captive insurance company.
- The captive may apply for a license to offer life insurance, annuities, health and commercial risk insurance, as well as workers' compensation coverage.
- The capital requirements, filing fees and premium taxes are the same as in Vermont, the latter being a minimum of $7,500 a year and a maximum of $200,000 a year.
- Connecticut requires a minimum capital and surplus of $250,000 for a single-parent captive; $500,000 for an industrial insured captive with at least 25 employees and annual insurance premiums of at least $25,000; $750,000 for an association captive; and $1 million for a risk retention group.
- The captive's principal place of business must be in Connecticut, its board must conduct at least one meeting in Connecticut each year, and at least one member of its board must be a Connecticut resident.
- At least once every five years, and sooner if the Commissioner of Insurance deems it necessary, the Insurance Department will visit the captive and audit its books.
- The commissioner is authorized to use the revenue from the annual license fee of $2,500 to support the program.

The legislation contemplated the creation of a dedicated division within the Insurance Department consisting of a director, an actuary, and one other employee. However, the three new positions were subsequently withdrawn in light of the increasing budget deficit. This is regrettable, especially because the start-up cost could have been funded out of the assessment the Insurance Department levies annually on all insurance companies licensed to do business in Connecticut.

Not surprisingly, no captive insurance companies have been formed in Connecticut to date. However, Connecticut is well-positioned to develop a successful captive insurance industry because it has a reputation as the pre-eminent "Insurance State" and has an unparalleled collection of insurers and their employees. Further, the Insurance Department is extremely experienced in insurance regulation.

The development of the captive insurance industry in Connecticut should be strongly encouraged. Members of the bar will appreciate that allowing the formation of captive insurance companies will present their clients with greater opportunities to manage business risk in a cost-effective manner. The potential economic benefits are significant, and Connecticut is well-suited to become a domicile rivaling Vermont as a leader in the United States. ■