



831(b) Small Captive Insurance Companies

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Captive Insurance Companies

What is a “captive” insurance company (CIC)?

A CIC is a licensed insurance company formed to write policies for a related entity or group.

Captive Insurance Companies (CIC) can be set up in two categories:

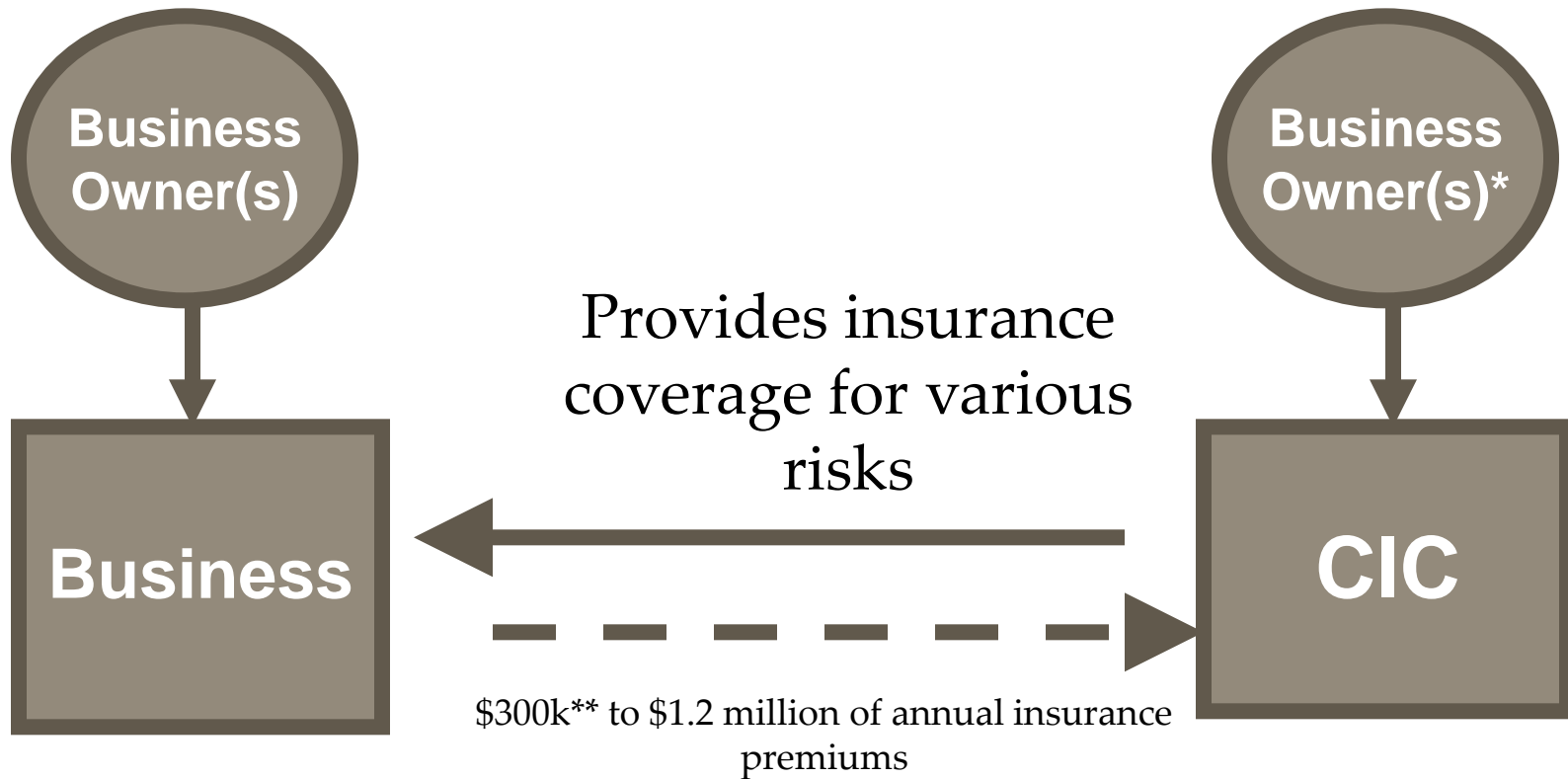
Standard VS. 831(b) “Small”

831(b) “Small” captives have an annual income exclusion up to \$1.2 million under IRS code section 831(b).

IRS Code Section 831(b)

- Annual premiums received by a Small CIC are tax-free if the total amount received < \$1.2 million.
- Premium payments are tax-deductible to the operating company, per IRS code section 162.
- The CIC's net investment income is taxed at C Corp income tax rates.
- Once elected, the 831(b) cannot be revoked without the permission of the Secretary of Treasury.

Structure of IRS Code Section 831(b) Small Captive

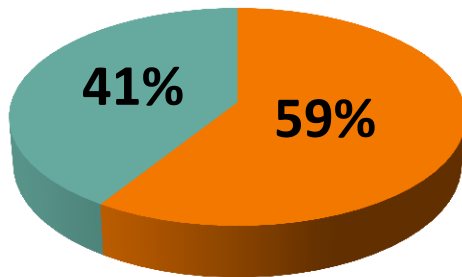


**Directly or indirectly*

*** Practical not statutory*

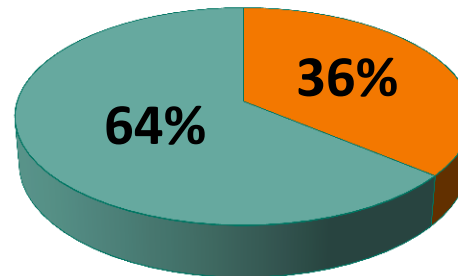
A Picture is Worth...

No Captive



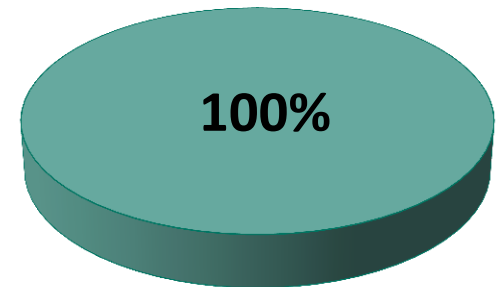
At Liquidation

Captive – No Trust



At Death

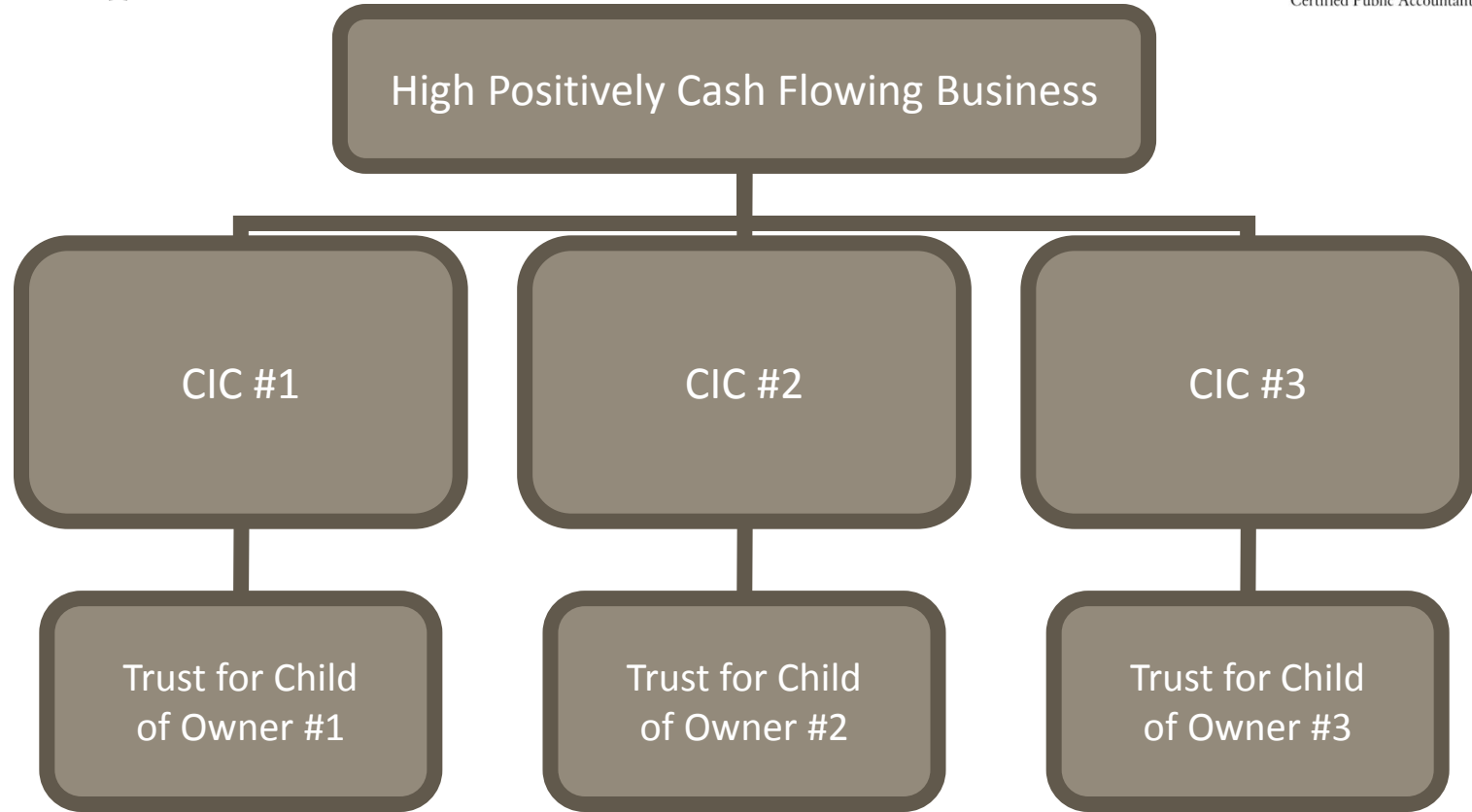
Captive – With Trust



At Death

 Retain  Tax

Multiple CIC Structure Added Benefit



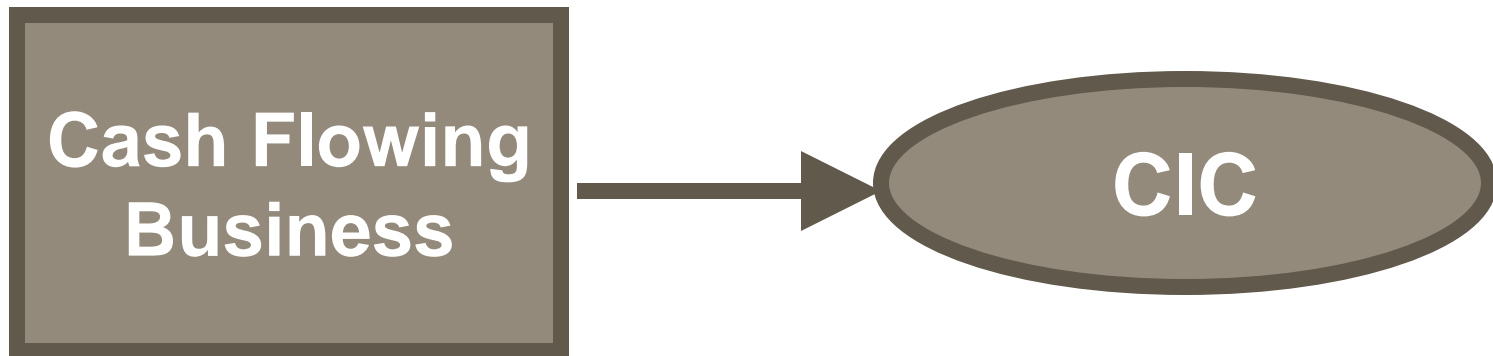
Parent's Business could pay up to \$1.2 million per year into EACH child's CIC or into a CIC for each owner's children. §1563 attribution rules apply. Children under age 21 are attributed to the parent.

The Ground Rules

- Premiums and policies must be market-comparable
- Actuarial support needed
- Insurance formalities complied with
- Risk distribution must be present
- Initial Capitalization required
 - Letter of Credit accepted in many states
 - 4:1 (premiums to capital) with certain minimums
 - Gift tax return Form 709

Tax Treatment of Premiums

- Positively cash flowing business pays up to \$1,200,000 in premiums each year



- Premiums may be deductible under sec. 162 (Recurring Expense Item Rules; Annual renewable policies, do not extend past 12 months)

Examples of Types of Operating Companies that set up 831(b) CIC's

- A is a specialty pharmaceutical company in the Southeast. They have \$65 million in gross revenues and employ approximately 15 employees.
- B is a Midwest real estate firm that engages in the development and management of multi-family properties in the US.
- C is a medical practice. Annual revenues are approximately \$4.6 million. C has 4 doctor partners and 26 employees, three of which are physicians assistants.
- D is a specialty health & wellness supplement company, \$60 million in worldwide revenue and 3 owners.
- E is a single owner dermatology practice with annual revenues of \$4.5 million.
- F Engineers & Constructors provides engineering, construction, and fabrication services to the power, chemical, polymers, special metals, and petrochemical and refining industries.

Examples of Operating Companies

- Dr. G is one of five partners at The ABC Clinic an orthopedic surgery practice who set up a captive. The other 4 partners are not participating in a captive.
- H is a service based company specializing in logistics information management and transportation consulting. Current revenues are approximately \$4.5 million.
- XYZ Cancer Center specializes in cancer treatment and is active in radiation therapy and chemotherapy.
- J is a multiple location chiropractic provider.
- K is an engineering company that designs and maintains airport ground structures. Annual revenues are approximately \$5.3 million.
- L offers a single source for legal, technology, and records management. Annual revenues are approximately \$17 million.
- M is a privately held buyer of precious metals & jewelry with annual revenues of \$60 million.

Why Own a Small Insurance Company?

- **Estate Planning**
 - Best practice: CIC owned by dynastic trust for heirs
 - Jurisdiction shopping for unlimited Rule Against Perpetuities: AK, DE, FL (360 yrs)
 - Can structure to allow client shared access to investments
 - **Buy-out Retirement Planning**
 - CIC can tie into a business buy-out/retirement plan/employee benefits
 - More tax efficient than traditional methods
 - **Tax Planning**
 - Premiums can be tax deductible
 - Benefit to family can be estate/gift tax free
 - Profit can be accessed at lower tax rates
-

Risk Management Concept

Each business or practice has risks that it currently does not insure against, including:

- Deductibles & co-payments in existing policies:
 - Medical malpractice
 - Commercial general liability
 - Premises and products liability
 - E&O, D&O, and others
- Liability risks for which there is no coverage
 - Employee claims, partnership liability, government liability, etc.
- Economic risks for which there is no coverage
 - Loss of income, revenue cutbacks, loss of key person, loss of a key contract, etc.

Buy-Out and Retirement Concept

Business owners and employees are always looking for tax efficient ways to transfer wealth during buy-ins of younger partners and buy-outs of older ones.

- A business can create an internal buy-out plan using the CIC reserves.
- With particular structures, funds can be accessed by senior (retiring) partners during their lifetime in a tax-favored manner.
- The total retirement benefit from such arrangements can be significant.
- Operating business or practice will pay tax deductible premiums to the CIC owned by the senior partners so funds will accrue to older owners for their retirement.

Captive Insurance Company Policies

- Everything a business currently self-insures:
 - Deductibles
 - Excess losses above coverage limits
 - Construction defect
- Loss of income as a result of:
 - Losing key employee/salesperson
 - Loss of license/professional risks (professionals)
 - Loss of a key contract (Gov't. contractors)
 - Weather, terrorism, etc.
- Liability defense expenses:
 - Employee lawsuits – sexual harassment, wrongful termination, discrimination, etc.
 - Environmental issues
 - Professional claims
- Anything that might be considered a “Lloyd’s” risk

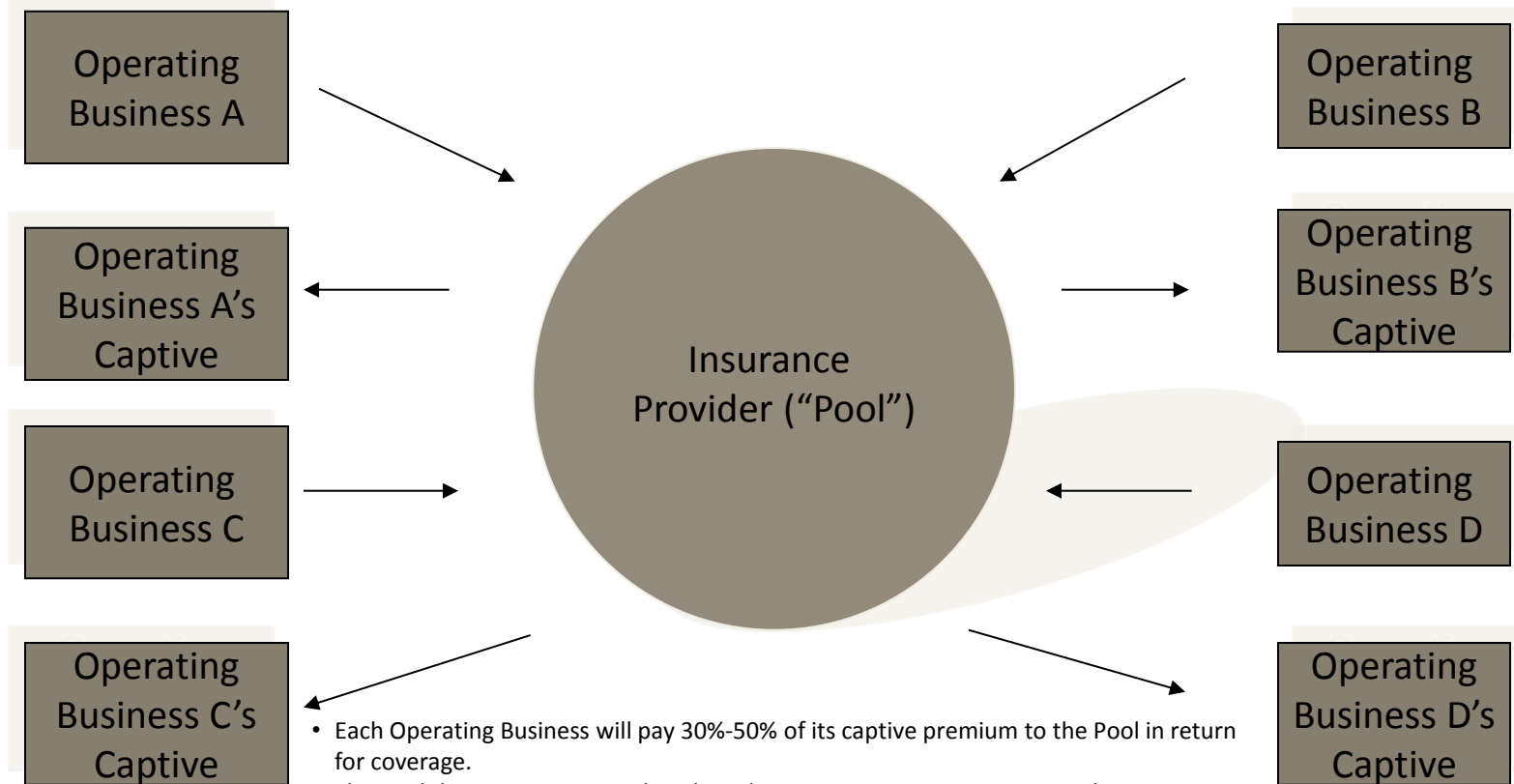
Examples of Captive Insurance Policies Written

- Professional liability Gap Coverage
- HIPAA/Billing Audit Liability
- Contractual Liability
- General Liability Gap
- Cyber Liability
- Environmental Liability
- Excess Environmental Liability
- Labor Shortage/Strike Loss Reimbursement
- Employment Practices
- Employee Dishonesty
- Patent Infringement/Intellectual Property
- General Liability Gap
- General Liability Retention
- Property Management Professional
- Professional Misconduct
- Product Recall
- FDA Administrative Actions Liability
- Product Liability Gap
- Directors and Officers Liability
- Punitive Damages
- Loss of Key Employee
- Deductible Reimbursement (Property, Workers Comp, General Liability, Product Liability)

Risk Distribution

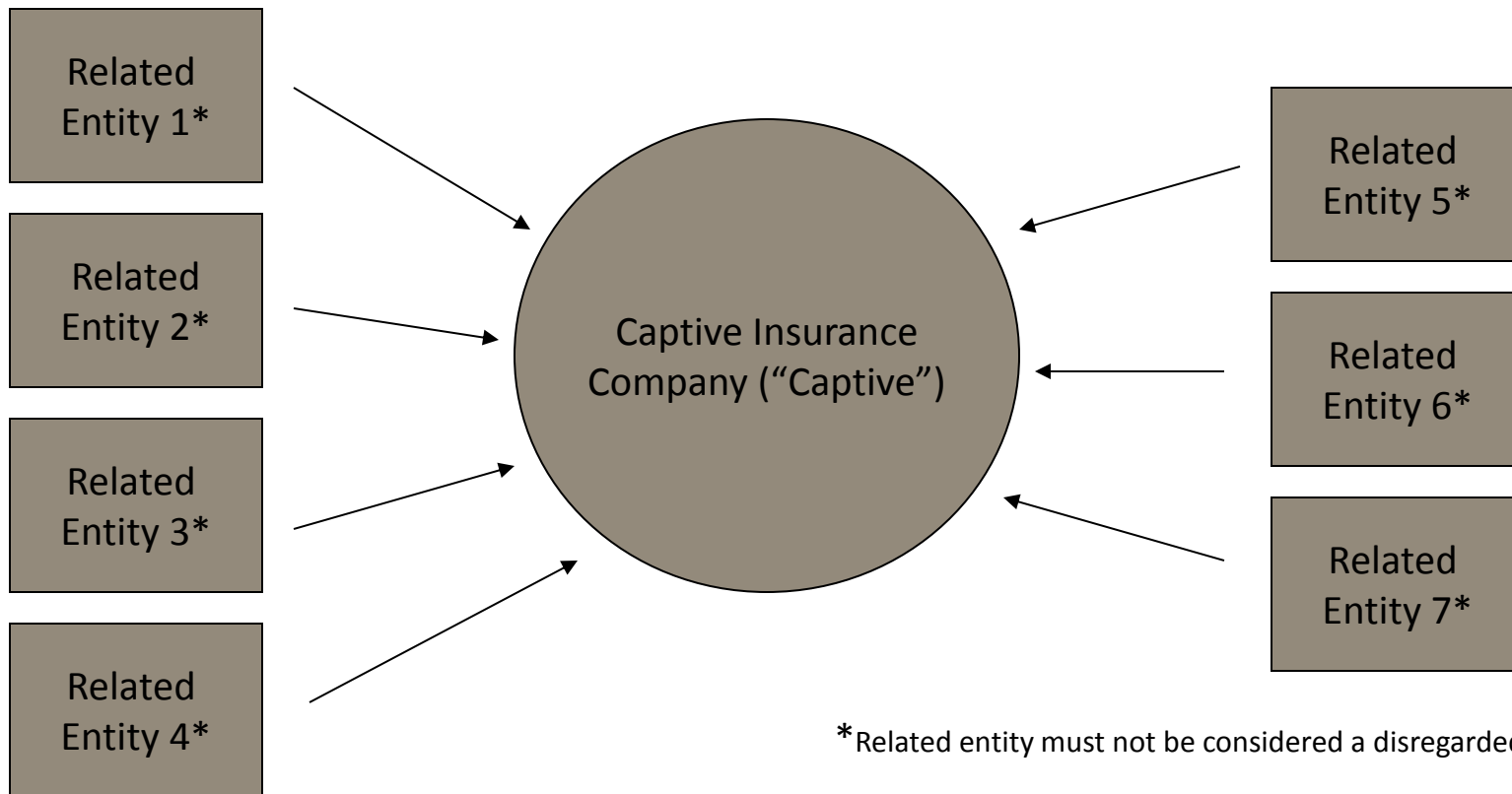
- Risk Distribution – does the insurance company distribute its risk to other insureds?
 - Rev. Ruls. 2002-89 (50%); 2002-90 (with related entities, no single entity can pay more than 15% or less than 5% of total premium); 2002-91 (Group Captive-7 unrelated insureds)
 - Harper Group and Includable Subsidiaries v. Commissioner, 96 T.C. 45 (1991): Because the CIC had at least 30% unrelated third party risk, the arrangement constituted insurance
 - Rev. Rul. 2005-40: risk distribution requirement is met if CIC has 12 or more insureds (10% risk distribution insufficient; disregarded entities do not qualify)
 - Affiliated companies count, but not single-member LLCs
 - Compare to Humana, Inc. v. Commissioner, 881 F.2d 247 (6th Cir. 1989) in which sums paid to parent company's Captive Insurance subsidiary, on behalf of several dozen parent company subsidiaries, was sufficient risk distribution to constitute insurance

Achieving Risk Distribution under Revenue Ruling 2002-89



- Each Operating Business will pay 30%-50% of its captive premium to the Pool in return for coverage.
- The Pool then reinsures its risk with each Operating Business Captive in the same percentage that the Operating business's premium represents.
- Example: Assume Operating Business A pays \$200k to the Pool and that \$200k premium represents 2% of all premiums received by the Pool. The Pool will then pay Operating Business A's Captive \$200k to reinsure 2% of the Pool's total risk (i.e., 2% of all of the other participating Operating Business's risk).

Achieving Risk Distribution under Revenue Ruling 2002-90



*Related entity must not be considered a disregarded entity

- Related entities pay premiums directly to the Captive for various lines of P&C insurance.
- Each Related Entities' premium cannot be less than 5% nor more than 15% of the total premiums received by the Captive.

Economic Family Doctrine

- Adopted by the IRS in 1977 (Rev. Rul. 77-316)
- Parent corporations and their subsidiaries form an economic family.
- If the ultimate burden of loss is retained in the family, there is no risk shifting or risk distribution (requirements to be considered insurance as set forth by the Supreme Court in Helvering v. LeGierse, 312 U.S. 531 (1941))
- Therefore, premium payments are treated as capital contributions or dividends and are not deductible under Sec. 162

Economic Family Doctrine

- IRS economic family doctrine was not accepted by the courts (See Humana Inc., 881 F. 2d 247)
- IRS abandoned doctrine in Rev. Rul. 2001-31
- Adopted instead a facts and circumstances approach for determining if transactions constitute insurance (See Malone & Hyde, Inc., 62 F.3d 835, 76 AFTR2d 95-5962 (CA-6, 1995), rev'g TCM 1993-585)
- IRS continued to apply facts and circumstances test (See TAM 200149003, FSA 200202002, Notice 2002-70)

Other Guidance

- December 31, 2004 - IRS releases rulings showing non-sham, bona fide captive insurance companies (TAMs 200453012 & 200453013)
- Rev. Rul. 2005-40, 2005-2 CB 4. A company that insures a single corporation cannot be an “insurance company”, even if the insurer is unrelated to the insured, premiums are arm’s length and the insurer is adequately capitalized, since there is no risk distribution.

Other Guidance (cont)

- Ltr. Rul. 200644047. An insurance subsidiary insured the risks of its parent. Although various physicians performing work for the parent were also insured, the Service concluded that the risks insured were essentially that of the parent. (Rev. Rul. 2005-40)
- TAM 200816029. For purposes of applying Rev. Rul. 2005-40, the common GP of several ltd. partnerships is treated as one insured.
- PLR 200907006. Service concluded that there was adequate risk distribution to warrant the company being treated as an insurance company. (Rev. Rul. 2002-91)

Other Guidance (cont)

- PLR's 200950016 & 200950017. Service finds reinsurance pools adequately satisfy risk distribution requirements as provided in Rev. Rul. 2002-90.
- PLR 201030014. Service finds that a Small Captive (831(b)) is recognized as a valid insurance company. "Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim."

Small Captive Insurance Companies (CICs) Summary

- A CIC is a bona fide insurance company licensed and domiciled in a jurisdiction with specific laws governing captive insurance companies. The CIC writes policies to an operating company. The CIC and an operating company have related party or affiliated ownership hence a “Captive” (operating company can be a partnership, S Corporation, etc).
- In a “small” 831(b) CIC (vs. a “standard/large” captive), up to \$1.2MIL of premiums are taxed at a 0% rate, per IRS Code Section 831(b). The premiums are deductible to the operating company per IRS Code Section 162. The CIC is taxed on net investment income at C Corp rates.
- An insurance company must achieve risk shifting and risk distribution to meet the IRS definition of an insurance company. The following are safe harbor rulings by the IRS to obtain risk distribution:
 - The most commonly used, Revenue Ruling (RR) 2002-89, states that adequate risk distribution is achieved if 50% of total premiums are from unrelated parties. Therefore, the CIC enters a reinsurance risk sharing pool. After about 14 months 100% of the premiums paid to the pool revert to the captive.
 - Rev. Ruling 2002-90 states that adequate risk distribution is achieved if premiums are paid by at least 12 entities (all non SMLLC’s). Generally, the 12 entities are affiliated, closely held or related in ownership.
 - Rev. Ruling 2002-91 expands on 2002-90, not one insured (operating company) pays more than 15% of total premiums received by the Captive.

Small Captive Insurance Companies (CICs) Summary: Continued

- A CIC can provide important GAP coverage to the operating company, (i.e., Product liability, Loss of Key Employee, Vendor, and/or Contractor), Employment Practices.
- Benefits – A benefit of a 831(b) CIC is wealth and/or estate planning for business owner(s). Payouts to the owner(s) in the future are taxed at lower rates, rather than being subject to ordinary tax rates now.
- Several states, such as Hawaii, Delaware, Montana, Vermont and Kentucky, have favorable CIC rules.
- Premiums are actuarially determined.
- Each CIC is required to be capitalized. The capitalization requirements are determined by the CIC's domicile.

Example: No Captive

Year*	Income	Annual Captive Costs	Amount Earned	Amount Taxed**	Total Retained	No Exemption
1	1,000,000	0	0	(400,000)	600,000	
2	1,000,000	0	18,000	(400,000)	1,218,000	
3	1,000,000	0	36,540	(400,000)	1,854,540	
4	1,000,000	0	55,636	(400,000)	2,510,176	
5	1,000,000	0	75,305	(400,000)	3,185,481	
6	1,000,000	0	95,564	(400,000)	3,881,046	
7	1,000,000	0	116,431	(400,000)	4,597,477	
8	1,000,000	0	137,924	(400,000)	5,335,402	
9	1,000,000	0	160,062	(400,000)	6,095,464	
10	1,000,000	0	182,864	(400,000)	6,878,328	
Total 1-10	10,000,000	0	878,328	(4,000,000)	6,878,328	6,878,328
			At Death***	Estate Tax	(651,331)	(2,751,331)
				Total Retained	6,226,997	4,126,997
				Percentage	62%	41%

* Calculations only uses the federal income tax rate of 40%; the tax calculation does not include state income tax rate, Georgia highest rate is 6% on all income.

**Highest Federal Income Tax Rate is 40%; 831(B) Captive are taxed on Net Investment Income (scenario assumes tax free investments)

*** At death, all assets on the decedent are taxed currently at a 40% rate (i.e. the estate tax), with a \$5.25 million exemption amount (the exemption is graduated for inflation).

Example: Captive without Dynastic Trust

Year*	Income	Annual Captive Costs	Amount Earned	Amount Taxed**	Total Retained	No Exemption
1	1,000,000	(90,000)	0	0	910,000	
2	1,000,000	(70,000)	27,300	0	1,867,300	
3	1,000,000	(70,000)	56,019	0	2,853,319	
4	1,000,000	(70,000)	85,600	0	3,868,919	
5	1,000,000	(70,000)	116,068	0	4,914,986	
6	1,000,000	(70,000)	147,450	0	5,992,436	
7	1,000,000	(70,000)	179,773	0	7,102,209	
8	1,000,000	(70,000)	213,066	0	8,245,275	
9	1,000,000	(70,000)	247,358	0	9,422,633	
10	1,000,000	(70,000)	282,679	0	10,635,312	
Total 1-10	10,000,000	(720,000)	1,355,312	0	10,635,312	10,635,312
			At Death***	Estate Tax	(2,154,125)	(4,254,125)
				Total Retained	8,481,187	6,381,187
				Percentage	85%	64%

* Calculation uses a federal income tax rate of 40%; the tax calculation does not include state income tax, Georgia highest rate is 6% on all income.

** Scenario assumes tax free investments, i.e. municipal bonds, etc.

*** At death, all assets on the decedent are taxed currently at a 40% rate (i.e. the estate tax), with a \$5.25 million exemption amount (the exemption is graduated for inflation).

Example: Captive with Dynastic Trust

Year*	Income	Annual Captive Costs	Amount Earned	Amount Taxed**	Total Retained
1	1,000,000	(90,000)	0	0	910,000
2	1,000,000	(70,000)	27,300	0	1,867,300
3	1,000,000	(70,000)	56,019	0	2,853,319
4	1,000,000	(70,000)	85,600	0	3,868,919
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9	1,000,000	(70,000)	247,358	0	9,422,633
10	1,000,000	(70,000)	282,679	0	10,635,312
Total 1-10	10,000,000	(720,000)	1,355,312	0	10,635,312

At Death***

Estate Tax

0

Total Retained

10,635,312

Percentage

106%

* Calculation uses a federal income tax rate of 40%; the tax calculation does not include state income tax, Georgia highest rate is 6% on all income.

** Scenario assumes tax free investments, i.e. municipal bonds, etc.

*** At death, all assets on the decedent are taxed currently at a 40% rate (i.e. the estate tax), with a \$5.25 million exemption amount (the exemption is graduated for inflation).

Captive Insurance Companies: A Valuable Resource for U.S. Businesses

By Robert Greenberger, partner, Seth Peabody, senior manager and Thomas Prevatt, manager

A Captive Insurance Company ("Captive") is a licensed property and casualty (P&C) insurance C corporation. Its function is to write insurance policies for either an operating company's¹ self-insured risks or for risks specifically excluded in the operating company's primary P&C insurance policy. Examples of insurance coverage written by a Captive include: professional liability gap; billing audit liability; loss of key employee; electronic data loss/HIPAA liability; professional misconduct liability; malpractice deductible reimbursement; employment practices liability; and unattainable or unavailable coverage in the market place.

By forming a Captive, an operating company can **reduce its primary insurance costs**. For example, this can be accomplished by increasing the operating company's insurance deductible threshold. The Captive will then write what is called a 'deductible reimbursement' or 'deductible buy-down' policy for the amount of the operating company's primary insurance deductible. Furthermore, operating companies may have gaps in their primary coverage and are therefore essentially "self-insuring" their gap. Covering gaps in coverage through a Captive can

provide the operating company with (1) an immediate tax benefit because the insurance premium is treated as a tax-deductible expense under IRS code section 162, and (2) additional coverage for their exposed risks.

Although this additional insurance coverage is advantageous, the **tax advantages** can also be a very significant benefit. When premiums are paid to an 831(b) Captive, the operating company is in essence moving money from a 'taxed' pocket to a 'non-taxed' pocket. Additional details about how this is accomplished are described below.

In addition, under IRS code section 831(b), a Captive can make an election, such that up to \$1.2 million of premiums paid to the Captive are taxed at a zero rate. Therefore, if an 831(b) Captive writes insurance policies for the operating company, the operating company will expense the insurance premiums and the Captive is not taxed on the receipt of the premium income.

However, the 831(b) Captive's net investment income is taxed at C corporate rates. This tax can easily be avoided if the 831(b) Captive invests in non-taxable assets, such as municipal bonds.

Therefore, assuming a 45% combined U.S. and state income tax rate and \$1.2 million in annual premiums/insurance expenses, an operating company or its owners can reduce its annual income tax by an estimated \$540,000 per year due to the 831(b) Captive.

So how does the operating company owner's² money move from one 'taxed' pocket to a 'non-taxed' pocket? The operating company's owner simply purchases the stock of the 831(b) Captive, either directly or indirectly. Purchasing stock indirectly means the stock is purchased through a LLC, a child, or a trust.

Over 30 states are now valid jurisdictions for setting up a Captive. However, some states currently offer more favorable regulations for 831(b) Captives than other states.

Owners can also receive **additional personal wealth and/or estate transfer advantages** when establishing an 831(b) Captive. Distributions from the Captive to

the Captive's stockholder(s) are considered qualified dividends. Although the tax benefit of the Property and Casualty Insurance deduction may be 45% when funding the Captive, as funds are paid out of the Captive the qualified dividend maximum tax rate is only 20%. In addition, if structured properly, the operating company owner(s) may be able to transfer wealth to the next generation while avoiding estate tax, which can save an additional 40%.

The following is a simple example of the benefits a dermatologist received after establishing a Captive insurance company:

ABC is a dermatological practice in Georgia. ABC has 13 employees including 1 physician, 2 nurse practitioners and 1 physician assistant. ABC has approximately \$5 million in revenue per year. ABC is engaged in dermatological practices using modern technologies and the most effective skin care treatments available. Skin care services provided are general conditions, however the practice has several specialties. The 1 physician owner is chair of 2 Professional committees and authors several articles a year. Patients' medical files are stored on a server located in the office of the practice.

Dr. John Smith, ABC's owner, formed an 831(b) Captive, called XYZ, 10 years ago. XYZ is domiciled in Delaware. XYZ has issued several insurance policies in the years since its incorporation. Examples include: professional liability gap, professional misconduct liability, electronic data loss/HIPPA liability, contract liability, and loss of key employee. ABC's annual premiums average \$1 million per year. XYZ has paid claims of \$650,000 since its inception. The funds have grown at a rate of 4% per year. Over the 10 years, XYZ has saved John Smith \$4 million in ordinary income tax (10 years X \$1 million in premiums per year X 40% tax rate). After 10 years XYZ's assets now total approximately \$11.5 million. If the Captive is owned by a trust for John Smith's children, he would have transferred \$11.5 million estate tax free.

While this article has provided a brief overview of a Captive Insurance Company and has discussed the benefits for U.S. companies, please contact Seth Peabody, CPA, Senior Manager at Habif, Arogeti and Wynne, LLP at seth.peabody@hawcpa.com or 770-353-3012 for more specific information about how establishing a Captive Insurance Company might benefit your individual situation.

¹An operating company is typically a business with a positive cash flow.

²The term 'operating company owner' can also refer to multiple owners of an operating company.

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Thank you!

Please contact us if you have any questions.

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