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Captive Insurance Company - Reduce Taxes and Build Wealth

Summary: For a business owner paying taxes in the United States, a captive insurance company saves taxes, builds wealth and improves insurance protection. A captive insurance company utilizes two key tax benefits: insurance premium payments from a business to the captive insurance company are tax deductible; and the captive insurance company receives premium payments up to $2.2 million annually income-tax-free.

For business owners paying taxes in the United States, captive insurance companies reduce taxes, build wealth and improve insurance protection. A captive insurance company (CIC) is similar in many ways to any other insurance company. It is referred to as "captive" because it generally provides insurance to one or more related operating businesses. With captive insurance, premiums paid by a business are retained in the same "economic family", instead of being paid to an outsider.

Two key tax benefits enable an economic family containing a CIC to build wealth efficiently: (1) insurance premiums paid by a business to the CIC are tax deductible; and (2) under IRC § 831(b), the CIC receives up to $2.2 million of premium payments annually income-tax-free. In other words, a business owner can shift taxable income out of an operating business into the low-tax captive insurer. An 831(b) CIC pays taxes only on income from its investments. The "dividends received deduction" under IRC § 243 can provide additional tax efficiency for dividends received from its corporate stock investments.

Starting about 60 years ago, the first captive insurance companies were formed by large corporations to provide insurance that was either too expensive or unavailable in the conventional insurance market.

Over the years, a combination of US tax laws, court cases and IRS rulings has clearly defined the steps and procedures required for the establishment and operation of a CIC by one or more business owners or professionals.

To qualify as an insurance company for tax purposes, a captive insurance company must satisfy "risk shifting" and "risk distribution" requirements. This is easily done through routine CIC planning. The insurance provided by a CIC must really be insurance, that is, a genuine risk of loss must be shifted from the premium-paying operating business to the CIC that insures the risk.

In addition to tax benefits, principal advantages of a CIC include increased control and flexibility, which improve insurance protection and lower cost. With conventional insurance, an outside carrier typically dictates all aspects of a policy. Often, certain risks cannot be insured conventionally, or can only be insured at a prohibitive price. Conventional insurance rates are often volatile and unpredictable, and conventional insurers are prone to deny valid claims by

exaggerating petty technicalities. Also, although business insurance premiums are generally deductible, once they are paid to a conventional outside insurer, they are gone forever.

A captive insurance company efficiently insures risk in various ways, such as through customized insurance policies, pooled risk, and favorable "wholesale" rates from reinsurers. Captive companies are well suited for insuring risk that would otherwise be uninsurable. Most businesses have conventional "retail" insurance policies for obvious risks, but remain exposed and subject to damages and loss from numerous other risks (i.e., they "self insure" those risks). A captive company can write customized policies for a business's peculiar insurance needs and pool risks efficiently. A CIC is particularly well-suited to issue business casualty policies, that is, policies that cover business losses claimed by a business and not involving third-party claimants. For example, a business might insure itself against losses incurred through business interruptions arising from weather, labor problems, computer failure or loss of key personnel.

As noted above, an 831(b) CIC is exempt from taxes on up to $2.2 million of premium income annually. Total insurance premiums paid by an operating business should not exceed 10 percent of annual revenues. As a practical matter, a CIC makes economic sense when its annual receipt of premiums is about $250,000 or more. A group of businesses or professionals having similar or homogeneous risks can form a multiple-parent captive (or group captive) insurance company and/or join a risk retention group (RRG) to pool resources and risks.

A captive insurance company is a separate entity with its own identity, management, finances and capitalization requirements. It is organized as an insurance company, having procedures and personnel to administer insurance policies and claims. An initial feasibility study of a business, its finances and its risks determines if a CIC is appropriate for a particular economic family. An actuarial study identifies appropriate insurance policies, corresponding premium amounts and capitalization requirements. After selection of a suitable jurisdiction, application for an insurance license may proceed.

Fortunately, competent service providers have developed "turnkey" solutions that include initial evaluation, CIC formation, licensing, ongoing management, actuarial analysis, policy underwriting, claims management, auditing and tax compliance of captive insurance companies. The annual cost for such turnkey services is typically about $50,000 to $150,000, which is high but readily offset by reduced insurance costs, reduced taxes and enhanced investment growth.

A captive insurance company may be organized under the laws of one of several offshore jurisdictions or in a domestic jurisdiction (i.e., in one of 39 US states). Some captives, such as a risk retention group (RRG), must be licensed domestically. Generally, offshore jurisdictions are more accommodating than

domestic insurance regulators. As a practical matter, most offshore CICs owned by a US taxpayer elect to be treated under IRC § 953(d) as a domestic company for federal taxation. An offshore CIC, however, avoids state income taxes. The costs of licensing and managing an offshore CIC are comparable to or less than doing so domestically. More importantly, an offshore company offers better asset protection opportunities than a domestic company. For example, an offshore irrevocable trust owning an offshore captive insurance company provides asset protection against creditors of the business, grantor and other beneficiaries while allowing the grantor to enjoy benefits of the trust.

For US taxpayers having insurable business risks, a captive insurance company efficiently reduces taxes and builds wealth and can be easily integrated into asset protection and estate planning structures. Up to $2.2 million of taxable income can be shifted as deductible insurance premiums from an operating business to a low-tax CIC.

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