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Criteria Useful for Evaluating Suitability of a Captive Insurance Company for a U.S. Business Owner

The following criteria and considerations are useful for making a preliminary evaluation of the suitability and practicality of using a captive insurance company (CIC) to insure risks of an operating business.

1. Ownership Structure of Operating Business Influences Ownership of CIC.

Question: What is the ownership structure of the operating business?

A CIC is owned by an operating business (that the CIC insures) or by the owner(s) of the operating business.

1.1 When relatively few owners own a closely-held business, and the ownership is stable over time (i.e., owners are not coming and going frequently, e.g., as in some investment funds), then it is sensible for the owners to own the CIC. The ownership preferably mirror the ownership of the operating business, so that CIC growth benefits the owners proportionally to their equity in the operating business.

Since the CIC is owned by the owners, assets of the CIC are not exposed to the liabilities of the operating business. As the CIC grows, the fortune of each individual CIC owner grows proportionately.

So long as total annual premium payments to the CIC do not exceed $2.2 million, the CIC pays no income tax on the premiums.

1.2 When the operating business has many owners (e.g., a public company) or has an unstable ownership over time, then ownership of a CIC by the owners is impractical. In such a case, the CIC is owned by the operating business.

A CIC can benefit the business by insuring the business risks more efficiently. The CIC can reduce the cost of insurance by keeping the profit and overhead costs of conventional insurance in the "economic family" instead. A CIC makes it possible for the business to build an "emergency" or "rainy day" fund using no-tax money if the CIC qualifies for treatment under IRC 831(b) by receiving annual total premiums less than $2.2 million.

2. Gross Business Revenues Determine Maximum Allowable Amount of Insurance Premiums.

Question: What are the annual total, gross business revenues?

Total amount of insurance premiums paid by an operating business should not exceed ten percent (10%) of annual gross revenues. This rule of thumb is applied to avoid the ire of the IRS.

Therefore, since a CIC makes economic sense only if the premiums received add up to about $250K, the operating business should have **annual gross business revenues of at least $2.5 million**.

3. Operating Business(es) Should Be Able to Afford $250K Premium Payment to CIC.

Question: Does the business's total amount of excess profits plus current retail insurance premiums equal at least $250K?

If the total of current insurance bills plus excess business profits equals about $250K (preferably more), then it might make sense to form a CIC. The term "excess business profits" means profits that the business owners do not need (to pay the mortgage, buy groceries, etc.) and which could be used to buy extra insurance in a CIC.

A very large business might already be paying $250K or more for insurance.

Typically, a smaller business pays less than $250K for retail insurance. By insuring previously genuine, but uninsured business risks, the business (or business owner(s)) can effectively shift otherwise taxable income out of the operating business into a CIC.

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