

Small Captive Insurance Companies Create Tremendous Insurance and Tax Benefits

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insurance that is not otherwise available on the commercial market. For example, some businesses find commercial coverage difficult or cost prohibitive to purchase because its particular industry is historically susceptible to certain claims, or to certain conditions; and (3) a CIC allows a business to develop a customized insurance plan that matches its needs and objectives. The CIC can draft policies that are based on the specific needs of the business such as increasing deductibles, the scope of coverage, and controlling premiums. This flexibility is clearly desirable, but often not available from commercial carriers. Common policies written by CICs include: Errors and Omissions, Directors and Officers Liability, Employment Practices, Copyright Infringement and Property Damage, to name a few.

Finally, the tax benefits of a CIC are undeniably attractive. Premiums paid to a CIC for property and casualty insurance are 100 percent deductible as ordinary and necessary business expenses if they are comparable to those charged in the market for similar insurance coverage. Therefore, if the CIC is properly set up as an insurance company, the payment of premiums is at arm's length, and the policies fall within the parameters of commercial reasonableness, the business can deduct the premiums it pays to its CIC.

In order for a CIC to avail itself of these tax benefits, it must qualify as an insurance company. This means the CIC must provide "insurance." The definition of insurance has been debated and defined in several court cases, most notably in *Helvering v. Le Gierse*, in which the Supreme Court stated that insurance must involve "risk shifting and risk distribution." 312 U.S. 531, 539 (1941).

For years, the Internal Revenue Service argued that no risk distribution could exist between companies within the same "economic family." However, the economic family doctrine has been rejected by the Tax Court and multiple appellate courts, and was officially abandoned by the IRS in 2001. **The IRS has issued a series of Revenue Rulings since 2002 and following, which provide safe harbors for the legitimate creation of CICs.**

There are other characteristics that a CIC must have in order to be considered an insurance company. The CIC must be able to pay claims that may arise, must maintain an adequate amount of capital and must maintain separate finances from the insured business. Additionally, the insured business must be facing risk, the premiums charged by the CIC must be at commercial rates and the CIC and the operating business must conduct themselves as separate businesses.

Several states, such as Kentucky, Utah and Vermont, have instituted statutes pertaining to the formation and management requirements of CICs domiciled in that state. Each domicile may vary in terms of the capitalization requirements for the CIC, as well as licensing requirements, annual fees and other various requirements.

The ownership of a CIC can lend itself to beneficial estate planning opportunities. Though the business owner can own the CIC, if it is owned by a dynastic trust for the benefit of the business owner's descendants, the value of the CIC (i.e. annual premiums) can ultimately be transferred to the business owner's descendants without gift, estate or generation-skipping transfer tax consequences.

The benefits of creating a CIC are undeniable. A CIC can provide risk coverage options for an operating business that would otherwise be unavailable. Additionally, the income tax and estate planning benefits that a CIC can provide are unparalleled.

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The risks inherent in running a business and the cost of insurance to protect from those risks can be prohibitive. Business owners looking for alternatives to relying solely on the commercial insurance market to cover their risks may find that a captive insurance company ("CIC") can be the solution they are seeking. In addition to allowing for greater risk coverage and insurance flexibility, CICs provide significant tax benefits to the business, and, where appropriate, can serve as a highly effective estate planning tool.

Here are a few CIC benefits: (1) the operating company can shift risks that it currently self-insures to the CIC. For many reasons, it is likely that most businesses are susceptible to risks that they are not adequately insured against. These businesses are forced to self-insure for those risks with after tax dollars; (2) a CIC can lower the cost of insurance and/or help obtain

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Additionally, Section 831(b) of the Internal Revenue Code allows CICs to elect to receive up to \$1.2 million of insurance premiums income tax free. Only the CIC investment income is subject to income tax. The effect is to allow up to a \$1.2 million annual deduction that is received tax free in the same year by an affiliated company (i.e. CIC).