

831(b) Captive Insurance Companies

A summary guide to self insured businesses

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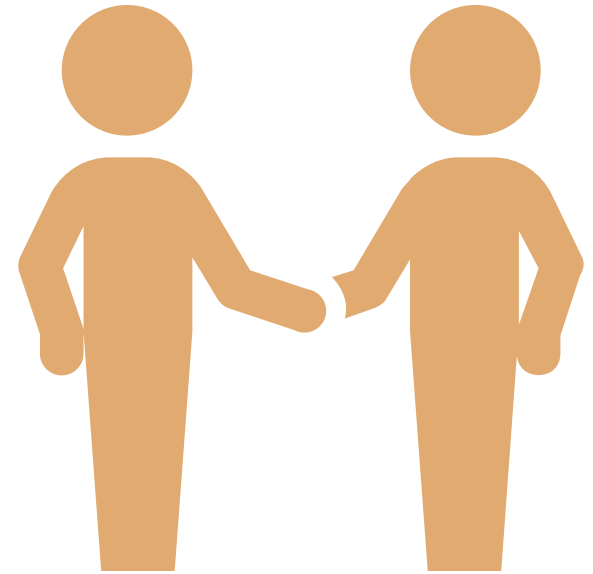
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Introduction

What is a captive insurance company?

A captive insurance company (CIC) is a licensed insurance company formed to write policies for a related entity or group. A small captive has annual income exclusions up to \$1.2 million under the IRS code section 831(b).



Chapter 1: Benefits

- Annual premiums received by a small CIC are tax-free if the total amount received is less than \$1.2 million.
- Premium payments are tax-deductible to the operating company IRS code section 162.
- The CIC's net investment income is taxed at a C Corporation income tax rate.
- Once collected, the 831 (b) cannot be revoked without permission of the Secretary of Treasury.
- Companies with high cash flow businesses can create multiple CIC's each having a \$1.2 million per year contribution for each child (code 1563 attribution rules apply).



Chapter 2: Ground Rules for a Captive

- Premiums and policies must be market-comparable
- Actuarial support is needed
- Insurance formalities compiled with risk distributions must be present
- Initial capitalization is required and is letter of credit accepted in many states, 4:1 ratio of premiums to capital, with certain minimums, and use of gift tax return form 709

Chapter 3: Operating Company Types

Examples of Operating Company Types That Set up 831 (b) CICs



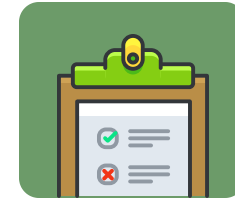
Contractors

Engineers and contractors providing engineering, construction, and fabrication services to petrochemical and refinery industries



Medical Practice

Medical practice with annual revenues of approximately \$4.6 million four doctor partners and 26 employees



Real Estate

Midwest real estate firm that engages in development and management of multi-family properties in the U.S.

Chapter 4: Why Own a Captive Insurance Company



Tax Planning

Premiums can be tax deductible, a benefit to the family can be the estate/gift tax-free, profit can be accessed at lower tax rates.



Buyout Retirement Planning

CIC can tie into a business buyout/retirement plan/employee benefits, more tax efficient than traditional methods.



Estate Planning

CIC owned by the dynastic trust for heirs, jurisdiction is shopping for an unlimited rule against perpetuities: AK, DE, FL (360 yrs.), can structure to allow client shared access to investments.

Chapter 5: Risk Management

Each business or practice has a risk that it currently does not ensure against including:

- Deductibles and copayments in existing policies: medical malpractice, commercial general liability, premises and products liability, E&O, D&O and others
- Liability risk that has no coverage: employee claims, partnership liability, government liability, etc.
- The economic risk for which there is no coverage: loss of income, revenue cutbacks, loss of a key person, loss of key contract, etc.

Chapter 6: Buyout and Retirement Concept

Business owners and employees are always looking for tax efficient ways to transfer wealth during, by and of younger partners and buyout of older ones.

- A business can concentrate on an internal buyout 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 of such arrangements can be significant.
- Operating a 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.



Chapter 8: Insurable within a Company



Self-Insure

Everything a business currently self-insures: deductibles, excess loss of coverage limits, construction defects



Loss of Income

Loss of income as a result of: losing key employee/salesperson, loss of license/professional risk, loss of key contract, weather terrorism, etc.



Liability Defense

Liability defense expenses: employee lawsuits for sexual harassment, wrongful termination, discrimination, environmental issues, professional claims. Anything that might be considered a "Lloyds" risk

Summary

Captive insurance company?

A CIC is a bona fide insurance company licensed and domiciled in the jurisdiction with specific laws governing captive insurance companies. A CIC writes policies to an operating company. The CIC and an operating company have the related party or affiliate ownership, hence a “Captive insurance company” (operating company can be a partnership, S Corporation, etc.)

In a “small” 831 (b) CIC, up to \$1.2 million of premiums are taxed at 0% rate, per IRS code 831 (b). The premiums are deductible by the operating company per IRS code section 162. The CIC is taxed on net investment income at C Corp. rates.

Case Study Tax Savings With or Without a Captive

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 show 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%; (31)(f) Captive are taxed on Net Investment Income (non-qualified dividends)

*** 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
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
			At Death***	Estate Tax	0
			Total Retained		10,635,312
			Percentage		106%

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

** Non-qualified dividends, i.e. non-qualified dividends, 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).

About the Author

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Susan is a Licensed Tax Strategist at Balcomb Financial Associates where she manages financial strategies for different clients. Susan is an active business entrepreneur and Director for Denver Entrepreneur Education Network. She is also recognized for her contribution to B2B education.

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