



# Top Tax Planning Strategy: Captive Insurance Companies **WHITE PAPER**

By

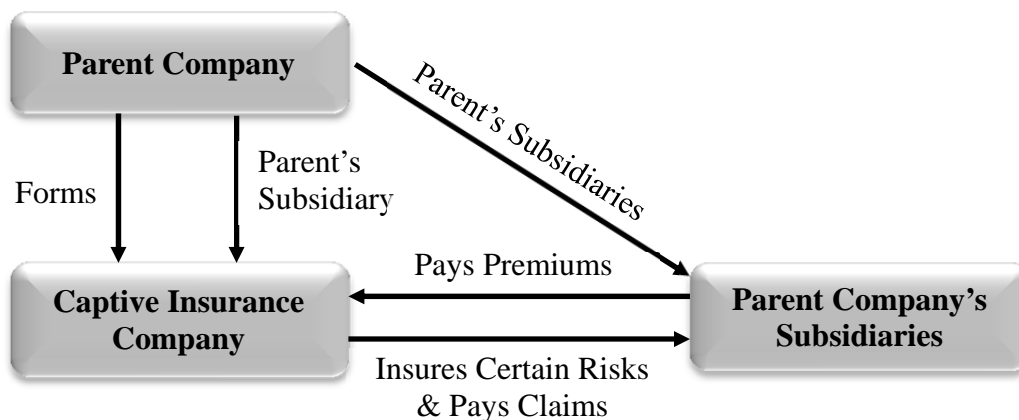
**Robert S. Keebler,  
CPA/PFS, MST, AEP (Distinguished), CGMA**

NOTE: This white paper is just one chapter out of a 148-page white paper entitled, "The Top 30 Tax Planning Ideas for 2014". For more information, [click here](#).

**Top Tax Planning Opportunity #16:  
CAPTIVE INSURANCE COMPANIES**

Captive insurance companies (“captives”) may greatly benefit small to medium sized businesses by formalizing their business’ uninsured, self-insured and underinsured risk management programs. While larger captives still benefit from general insurance accounting and tax advantages enabling deduction of reserves against uncertain future losses, a “mini-captive,” or a section 831(b) captive, has greater tax advantages. This topic will focus on § 831(b) captives.

Basically, a captive is a privately held insurance company that is a subsidiary or affiliate of a parent company that is formed to insure certain risks of subsidiaries or affiliates.



The business reasons for creating a captive insurance company are that commercial insurance for the business is either over-priced or difficult to find for certain types of risks. Like commercial insurance companies, a captive insurance company issues policies, collects premiums, and pays claims; only it is not offered to the public. Businesses form captives to insure different enterprise and catastrophic risks that were uninsured, self-insured or underinsured; such risks include, insurance policy exclusions, operating risks, credit default, disability, business interruption, extended warranty, technology risks, regulatory risks, key employee risks, key customer risks, key supplier risks, construction defects, natural disasters and others. Most businesses already self-insure against these risks; but, without a captive, this self-insurance is not tax-deductible. Furthermore, the captive policies must be written for “real” insurance risks; but they can still have a low probability of occurrence. For example, the policy cannot be written for hurricane insurance for a Wisconsin business – not a “real” insurance risk. In addition, the policy cannot be for a “risk” that is sure to happen; in other words, it has to be a risk not a certainty.

In order to determine if a captive is the right strategy, the operating parent company should generally have the following characteristics:

- Be a profitable business entity with \$500,000 or more in sustainable operating profits, and seeking substantial annual adjustable tax deductions;
- Have multiple subsidiaries or be able to create multiple operating subsidiaries or affiliates;
- Have the requisite risks currently uninsured, self-insured, or underinsured;
- Have a business owner(s) interested in personal wealth accumulation and/or family wealth transfer strategies; and
- Have a business owner(s) looking for asset protection.

### Tax Benefits

Taxpayers ordinarily cannot deduct claims until the claims are paid. If the taxpayer is an insurance company, however, it can claim a current deduction for “incurred, but not reported claims” before payments are made. A company can claim the same timing benefit if its captive qualifies as an insurance company.

By forming a section 831(b) captive, a business could accelerate deductions on up to \$420,000 annually in federal income taxes, allowing that savings to be retained within the business and the family. This is because the IRC section 831(b) election allows the operating company to deduct premiums paid (up to \$1,200,000/year), while also allowing the related party captive to exclude premium income from federal income tax (up to \$1,200,000/year); provided the 831(b) captive is designed properly to meet the business purpose and economic substance tests. Furthermore, if the captive is properly designed and managed, the captive’s asset reserves accumulate outside the business owner’s estate, protecting assets and enabling the business to survive unexpected disruptions and more easily accumulate business succession reserves.

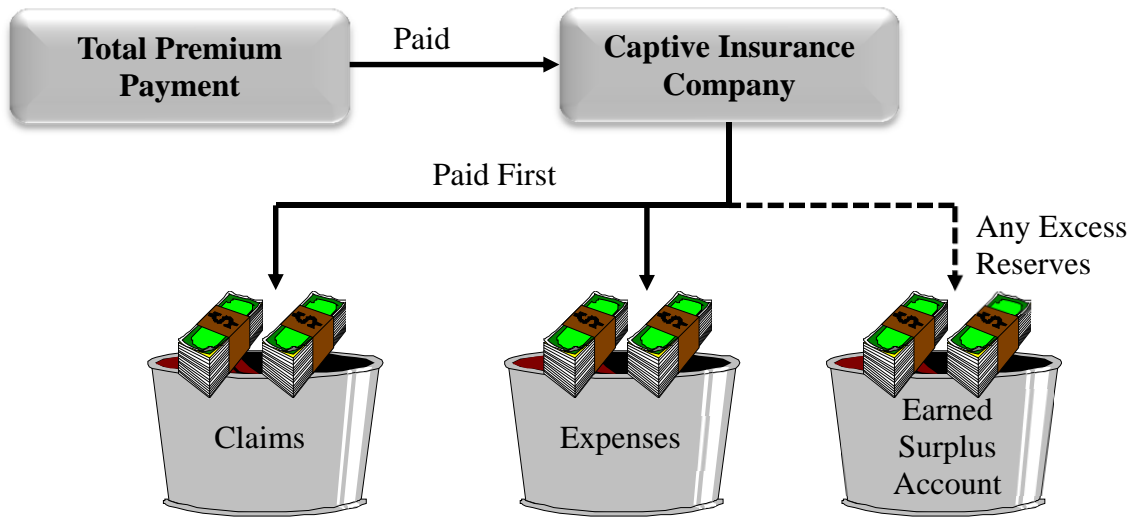
***Example 1.*** Assume that ABC Family Business has \$1,200,000 of consolidated pre-tax operating income subject to the federal marginal tax rate of 35%. Consider the following two scenarios.

Scenario 1: ABC does nothing. Its \$1,200,000 of taxable operating income will result in \$420,000 of income tax liability ( $\$1,200,000 \times 35\%$ ). This leaves ABC with \$780,000 after taxes to invest and protect its business.

Scenario 2: ABC forms an 831(b) captive that writes \$1,200,000 of insurance to its subsidiaries to protect them from otherwise uninsured / self-insured risks. ABC takes an insurance expense deduction for \$1,200,000, saving it \$420,000 ( $\$1,200,000 \times 35\%$ ) in federal income taxes. In other words, ABC is not taxed on any of that income. ABC’s captive keeps the \$1,200,000 to invest. Furthermore, if the captive does not have any significant losses to pay, any distributions to its shareholders of its excess reserves will be taxed at a lower dividend or capital gains rate.

Any premiums paid to the captive in excess of its claims and expenses each year will be transferred to an earned surplus account and such excess reserves will be available for more aggressive investment activities. Most of the restrictions that apply to retirement plans do not apply to the excess reserves in an 831(b) captive. The excess reserves accumulating in the 831(b) captive may be used for a variety of purposes:

- Loaned to the insured operating company who paid the premiums (or other family businesses);
- Invested in related family businesses;
- Invested in real estate;
- Distributed as dividends (historically taxed at more favorable rates);
- Distributed on a liquidation wind-up (historically taxed at more favorable rates); and
- For the most sophisticated families, an 831(b) captive can allow the family business to exit the insurance business, retain its accumulated reserves, and evolve into a family fortress entity of one type or another.



The greatest benefit that an 831(b) captive offers a company is that it is able to accumulate surplus from the premium payments tax-free. This allows the operating business to build up risk reserve assets while retaining investment control over the premiums. Furthermore, a captive can insure risks (with pre-tax dollars) that were previously self-insured with after-tax dollars. However, the investment income in a captive is still taxable.

**Example 2.** Assume that XYZ Company has net business income of \$1,200,000 per year. In Scenario 1 below, XYZ does not use a captive. The income is taxed at a rate of 35% and then the after-tax amount is invested at 3%, an after-tax rate of 1.95% ( $3\% \times (1-.35)$ ). Each year for the next two years, XYZ has the same \$1,200,000 net business income. In year 2, XYZ experiences \$600,000 in uninsured risks and in year 3, it experiences \$1,200,000 in uninsured risks. In

Scenario 2 below, XYZ uses a captive. XYZ pays a premium of \$1,200,000 to the captive. The operating expenses per year are assumed to be \$65,000 and the excess reserves are invested at 3%, an after-tax rate of 2.55% (3% x (1-.15)). Each year for the next two years, XYZ pays a premium of \$1,200,000 to the captive. In year 2, the captive pays out \$600,000 in claims and in year 3, it pays out \$1,200,000 in claims. Furthermore, the captive pays out a 10% dividend distribution after expenses and claims to XYZ each year. XYZ then invests the paid claims and dividends (taxed at 20%), after tax, at an after tax rate of 1.95% (3% x (1-.35)) above.

**Scenario 1: XYZ Company - No Captive**

	<b>Year 1</b>	<b>Year 2</b>	<b>Year 3</b>
Business Income	\$ 1,200,000	\$ 1,995,210 <sup>46</sup>	\$ 2,124,571
Uninsured Risks (Loss)	\$ 0	\$ (600,000)	\$ (1,200,000)
Net Business Income	\$ 1,200,000	\$ 1,395,210	\$ 924,571
Income Taxes	\$ (420,000)	\$ (488,324)	\$ (323,600)
After-Tax Inv. Income	\$ 15,210 <sup>47</sup>	\$ 17,684	\$ 11,719
Total	\$ 795,210 <sup>48</sup>	\$ 924,571	\$ 612,690

**Scenario 2: XYZ Company - With a Captive**

	<b>Year 1</b>	<b>Year 2</b>	<b>Year 3</b>
Business Income	\$ 1,200,000	\$ 1,292,571	\$ 1,788,022
Premium Paid	\$ (1,200,000)	\$ (1,200,000)	\$ (1,200,000)
Claims Received	\$ 0	\$ 600,000	\$ 1,200,000
Net Business Income	\$ 0	\$ 692,571	\$ 1,788,022
Income Taxes	\$ 0	\$ (242,400)	\$ (625,808)
Dividends Rec. After-Tax	\$ 90,800	\$ 126,604	\$ 111,649
After-Tax Inv. Income	\$ 1,771 <sup>49</sup>	\$ 11,247	\$ 24,840
Total	\$ 92,571 <sup>50</sup>	\$ 588,022	\$ 1,298,704

<sup>46</sup> The 2<sup>nd</sup> year “Business Income” = “Total” income from year 1 plus the \$1,200,000 of income in year 2.

<sup>47</sup> The “After-Tax Inv. Income” = the total net income (“Net Business Income” – “Income Taxes”) times the after-tax rate of return of 1.95%

<sup>48</sup> The “Total” = “Net Business Income” – “Income Taxes” + “After-Tax Inv. Income”

<sup>49</sup> The “After-Tax Inv. Income” = the same as in footnote 2 except that the total net income includes the “Dividends Rec. After Tax”

<sup>50</sup> The “Total” = “Net Business Income” – “Income Taxes” + “Dividends Rec. After-Tax” + “After-Tax Inv. Income”

### *The Captive*

	<b>Year 1</b>	<b>Year 2</b>	<b>Year 3</b>
Captive Premiums	\$ 1,200,000	\$ 2,247,548	\$ 2,660,613
Operating Expenses	\$ (65,000)	\$ (65,000)	\$ (65,000)
Paid Claims	\$ 0	\$ (600,000)	\$ (1,200,000)
Paid Dividends	\$ (113,500)	\$ (158,255)	\$ (139,561)
After-Tax Inv. Income	\$ 26,048 <sup>51</sup>	\$ 36,319	\$ 32,029
Total	\$ 1,047,548 <sup>52</sup>	\$ 1,460,613	\$ 1,288,081
Net Gain with Captive	\$ 344,909	\$ 1,124,064	\$ 1,974,095

Other benefits of a captive include:

- Asset protection from the claims of business and personal creditors;
- The ability to distribute profits to shareholders of the captive as dividends or upon liquidation;
- Ownership of the captive by a family trust, LLP, FLP, or other entity for the benefit of future generations; and
- The ability to give key employees restricted ownership in the captive, in order to provide increased incentives.

When a captive is integrated with an estate plan, the wealth protection and accumulation benefits can be substantial. This is because the tax-free asset build-up may avoid gift, estate and generation-skipping tax consequences and later transfer directly to the business owner's children and grandchildren. Furthermore, if the shareholders of the captive are family members or trusts with family members as beneficiaries, any distributions will not be taxed at the gift and estate tax rate, only the applicable dividend or capital gains tax rate. That is because the transaction would be in the ordinary course of business, and therefore, no gift or estate tax will attach to the intra-family transfer of wealth.

Note that sufficient research must be done before forming a captive; not only must an insurance license be obtained but the captive must provide insurance to the operating company or its affiliates. Insurance has been defined for tax purposes as including elements of risk shifting and risk distribution. Those elements are even further defined. Plus, formation of a captive will include feasibility studies, financial projections, determining domicile, actuarial reports, and more. The use of an experienced and capable captive management company should be used. But beware, if the captive is set-up improperly, substantial tax and penalties are possible.

---

<sup>51</sup> The "After-Tax Inv. Income" = the total net income ("Captive Premiums" – "Operating Expenses" – "Paid Claims" – "Paid Dividends") times the after-tax rate of return of 2.55%

<sup>52</sup> The "Total" = "Captive Premiums" – "Operating Expenses" – "Paid Claims" – "Paid Dividends" + "After-Tax Inv. Income"