

The Captive Insurance Company

The Captive Insurance Company (CIC) concept is an elegant financial alternative for a successful small business owner. Although a CIC is not formed initially for tax purposes, there are significant tax reasons for establishing a CIC. It has been described as the ultimate financial solution for **risk management, asset protection, retirement planning and estate planning.**

A CIC is a company formed primarily for the purpose of insuring or re-insuring the risks of the parent company. Some of those risks are already identified and insured against; many are not. Until recently, CICs only made sense for big corporations. However, new IRS rulings and guidance allow CICs to serve as profit centers for small and mid-size companies. To the extent there are profits to be gained, those profits will flow to the owners of the captive for later use under very favorable tax circumstances.

To justify the expense of establishing a CIC, the business must have a strong financial status. It should have current taxable income of \$1,500,000, a strong balance sheet, and 3 or more years of business history. It should exist within an industry with inherent risk such as medicine, construction, manufacturing, entertainment, trucking, or sales. The CIC can be owned by the business owner, his spouse, his relatives, a Trust, or any of the companies he owns.

Captive insurance companies have four significant incidental tax benefits:

- Premiums paid to your captive are **tax deductible** (within limits)
- These premiums, within limits, are **not taxable income** to the captive
- They create the ability to transfer dollars before tax such that some of them reappear later as retirement income, which can be tax free
- If a captive is owned by an heir, each premium dollar transfers from the estate to the heir without gift or estate tax consequences

A CIC, as we envision it, falls under Internal Revenue Code Section 831(b). As such it can accept up to **\$1,200,000 of annual premium exempt from taxation.** The CIC is taxed exclusively on investment gains. In order to comply with Internal Revenue Service rules and regulations, the CIC must be established and maintained with the following in mind:

- The CIC is a legitimate insurance company with proper capitalization
- The premiums charged by the CIC to the parent must be market comparable and actuarially legitimate

- There must be appropriate risk shifting and distribution
- All insurance contracts must be legally binding
- All transactions are arm's length transactions
- There is no circular lending to the premium payee or payer
- It is a bona fide business with regular board meetings
- Proper books and records are maintained
- Claims administration is properly regulated and managed
- There is always a "business purpose", which can include asset protection, formalization of risk management, incentives for key employees, savings on medical malpractice premiums, and tax considerations.

The resulting funds, categorized as Reserves and Surplus, are held by the CIC and subject to an approved list of acceptable investments. These include:

- Cash or cash equivalents (i.e. money market, cash & checking, CIC owned life insurance cash surrender values)
- Tax-exempt securities
- Secured loans
- Stocks, bonds, mutual funds, managed portfolios, etc.

The process we follow for evaluating whether a CIC is appropriate for any individual small business, and the subsequent implementation, takes the following steps:

- A discussion between the client and advisor on basic information to pre-qualify the client
- A conference call to include the client and his advisors (CPA, Attorney, etc.) to educate the client parties on Captive Structures
- Securing the necessary financial information, including copies of existing insurance policies, etc. from the client
- Preparation of a preliminary feasibility study based on the clients' specific circumstances
- Signing of an engagement letter coupled with a retainer
- Develop the business plan and forecast
- Formalize the CIC as a bona fide enterprise
- Obtain necessary insurance license in the jurisdiction of choice
- Underwrite the policies
- Choose from among several captive management companies to process all details and ongoing administration, if outsourcing is appropriate.

Call or email NOW to better understand the cash flow implications.

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