

Tax savings

How to lower taxes by using a captive insurance company

For most business owners, taxes chew up half of their profits. Real estate taxes, payroll taxes, income taxes, franchise taxes, sales taxes, ad valorem and other taxes deplete most of the cash generated from a typical business. As if taxes aren't enough, rising insurance costs and increasing self-insured risk are additional and expensive challenges.

With the certainty that taxes are rising in 2011, what is the solution to combat the erosion of taxes, while also protecting your assets, mitigating insurance risk and passing on assets to your heirs? For many businesses, the answer is captive insurance companies (CICs).

Smart Business learned from Robert N. Greenberger at Habif Arogeti & Wynne, LLP about how CICs can be a viable way for businesses to save on insurance costs through tax deductions.

What is a captive insurance company?

CICs have been around since the late 1970s; more than 80 percent of Fortune 500 companies take advantage of some sort of CIC arrangement. Recent years have seen more growth to include small and medium-sized companies. CICs are corporations formed in the United States or a foreign jurisdiction that write property and casualty insurance to a small group of insureds. CICs seldom replace conventional insurance, but are formed to assume risk that is currently self-insured for items not covered by traditional policies. Items such as medical malpractice, natural disaster, high deductibles, credit default, construction defects, disability, loss of key customers and suppliers, policy exclusions, and types of insurance unavailable in commercial markets are currently self-insured by businesses.

How does a business save money with a captive insurance company?

The cost of 'self-insurance' outside of a valid CIC structure is not tax deductible. With a properly formed CIC, the insurance premiums are deductible so that claims are paid with pretax dollars. If no claims are made, the CIC retains the premiums for future business risks or distribution. CIC policies may replace current coverage to cover copyright infringement, errors and omissions, employment practices and property damage.

IRS rules allow businesses to deduct property and casualty insurance premiums paid



Robert N. Greenberger
Tax partner
Habif, Arogeti & Wynne, LLP

to their CIC that is established to insure or reinsure the risks of the business, while the premium income to the CIC may be tax free.

For example, a business could pay \$1.2 million of property and casualty insurance premiums to its affiliated CIC and receive a tax benefit of almost \$500,000. If properly structured, the premium income received by the CIC would not be taxable. If the business has insurance claims, the claims can be paid by the CIC. The remaining funds in the CIC can eventually be utilized by the business owner during retirement by having the CIC pay taxable dividends or utilizing other methods. With proper planning, the funds could also be passed to heirs with no gift or estate tax consequences. CIC ownership may also be structured to provide incentives for key management and business succession.

The IRS has issued Revenue Rulings and other guidelines that provide specific 'safe harbor' rules. Following these guidelines properly will ensure that the CIC is entitled to the benefits of Code Section 831(b), which provides that the first \$1.2 million of insurance premiums received by the CIC each year are tax-free. CIC insurance premiums are 'annually renewable' and can increase and decrease each year to meet the business's needs.

ROBERT N. GREENBERGER, CPA, PFS, AEP, is a tax partner in the Advisory and Business Services Group at Habif, Arogeti & Wynne, LLP. He has more than 25 years of experience with a strong concentration in taxation, estate planning and closely held businesses. He has achieved the Accredited Estate Planner designation and assists with the planning and implementation of captive insurance companies, family limited partnerships, trusts and Subchapter S corporations. Reach him at (404) 814-4949 or robert.greenberger@hawcpa.com.

What are other benefits derived from captive insurance companies?

In addition to favorable tax treatment, CICs provide a business with stronger insurance coverage. Since business owners control the CIC, insurance policies can be customized for their particular business needs in terms of scope of coverage, terms of deductibles, and levels of risk and premiums. With your own CIC, the business owner also has investment control of the assets in the CIC. A properly structured CIC will only be subject to tax on investment income, so tax-free vehicles are sometimes used. CIC owners might also consider investing funds in permanent life insurance policies, which provide tax-free growth, a death benefit to heirs and tremendous investment leverage unmatched by other tax-free investments.

How should businesses mitigate any risks associated with captive insurance companies?

These are not typical life insurance policies but are customized to accomplish several goals within the CIC, and it's crucial that they are managed properly in both the short and long term. That is why having the appropriate professionals involved when considering a CIC is paramount. The attorney, CPA, actuary, CIC management company and insurance professionals should be experts in the CIC area — a minimum of 10 CIC clients will usually ensure that these much-needed professionals have the required expertise.

In addition to helping through the maze of CIC rules, your professional team will help choose the best domestic or foreign jurisdiction for the CIC, determine the appropriate property and casualty insurance for your business, assist with the reporting and tax filing requirements, assist with legal requirements to ensure maximum asset protection, provide options for investment vehicles and provide options for transferring wealth through estate planning.

If properly structured and managed, a CIC could possibly be the risk management, tax reduction and asset protection vehicle for which business owners have been searching. <<

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