

Closely Held Business Can Enjoy Captive Insurance Opportunity

Although associated with large corporations, captive insurance companies can be available and beneficial to closely held businesses too.

BERNARD EIZEN AND STEVEN S. POULATHAS, ATTORNEYS

Closely held businesses and professionals may be able to use a small captive insurance company in order to achieve many of the same insurance cost conservation and income tax advantages traditionally available only to the largest corporations. Unlike large and widely held companies, these taxpayers can combine significant estate planning, wealth transfer, and asset protection opportunities that complement the income tax and insurance advantages of captive insurance companies.

Background

Most insurance companies issue policies broadly to the general public. In the 1960s, businesses began forming affiliates or subsidiaries purposed to provide insurance principally within a controlled group of companies. These companies are referred to as “captives” because of their related-party relationship with most and sometimes all of their insureds. Over the years, a sub-

stantial majority of the largest companies in the U.S. established captive insurers to cover risks not generally underwritten by commercial insurers; to access broader markets; to address anomalies in coverage availability; and to control the cost of coverage, commissions, and overhead charges.¹ In this period of development, however, it seemed that only the largest companies could achieve the economies of scale needed for this purpose.

Insurance companies, other than those in the business of life insurance, are taxed under Subchapter L of the Internal Revenue Code. Section 831(a) imposes the corporate income tax on insurance companies, making them all C corp-

BERNARD EIZEN, LL.M., CPA, and STEVEN S. POULATHAS, LL.M., are shareholders in the law firm of Flaster/Greenberg, P.C. The firm’s principal offices are in Philadelphia, Pennsylvania, and Cherry Hill, New Jersey. The authors thank Victor S. Levy, of Leon L. Levy & Associates, for his editorial review of this article.

orations for federal tax purposes. The taxable income of an insurance company, as defined by Section 831, is determined like any other corporation (with taxation on the entity level and also at the shareholder level on distributions), but there is an additional deduction allowed for additions to claim reserves. An exception to the reserve deduction is now provided for “small” captive insurance companies, which forego reserve deductions in favor of a blanket exclusion of premium income. Additions to reserves for uninsured or self-insured claims are not deductible by other taxpayers.² As further developed below, insurance premiums paid to a small captive are deductible. Key principles that apply under Section 831 are outlined below.

The 1986 Act. The 1986 Tax Reform Act added a new Section 831(b) to assist smaller insurers, which provides:

(b) Alternative tax for certain small companies.

(1) In general. In lieu of the tax otherwise applicable under subsection (a), there is hereby imposed for each taxable year on the income of every insurance company to which this subsection applies a tax computed by multiplying the taxable investment income of such company for such taxable year by the rates provided in section 11(b).

(2) Companies to which this subsection applies.

(A) In general. This subsection shall apply to every insurance company other than life (including interinsurers and reciprocal underwriters) if—

(i) the net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed \$1,200,000, and

(ii) such company elects the application of this subsection for such taxable year.

The election under clause (ii) shall apply to the taxable year for which made and for all subsequent taxable years for which the requirements of clause (i) are met. Such an election, once made, may be revoked only with the consent of the Secretary.

....³

Practical implications. This provision, sometimes called the “small captive” election, created a potential tax subsidy and reduced administration costs to smaller insurers by eliminating the need to justify specific reserves for tax deduction purposes. This tax-driven incentive is analogous to the creation of mutual funds and REITs to expose financial and real estate investments to individuals and smaller businesses.

The small captive provision effectively eliminated the costly actuarial studies and individual analyses of claims needed to establish loss reserves. It thereby provided encouragement for affiliates and groups to form small insurers for much the same purposes as many of their larger counterpart companies had done a decade or two earlier.⁴

Congress intended principally to allow farmers and small businesses to respond to claim cycles or other conditions that cause traditional insurance markets to contract, sometimes making traditional coverage—such as for crop loss, medical malpractice, and product risks—not possible to obtain at reasonable prices.⁵ Yet the impact of the 1986 Act changes was much wider in scope. Closely held, mid-market, and other affiliated groups can use the 831(b) election to provide through a captive for risks that are self-insured or are of a non-routine nature and not fully recognized or assessed. The small captive provision added by Section 831(b) made it possible for almost all taxpayers to take advantage of alternative structures to cover this myriad of risks.

While insurance premium income of a small captive can be excluded from taxation, investment income remains subject to the corporate income tax. The status of an insurance company is lost, however, if investment income ever exceeds gross revenue from insurance premiums in the tax year. This is because, in order to be classified as an insurance company, more than 50% of the gross revenue, on a year-by-year basis, must come from insurance contracts. For mature captives, monitoring these ratios is of obvious significance.

Mature insurers tend to build investment reserves and retained earnings. Income generated by these funds must be managed so as to avoid violating the insurance premium income rule mentioned above. Dividends paid by the captive out of earnings and profits in order to distribute unneeded reserves or to manage and adjust the investment income ratio are qualified dividends and eligible for taxation at currently favored rates.⁶

The application of Section 831(b) is elective, and once made the Service must consent before it can be revoked.⁷

What is insurance?

For insurance company treatment, a majority of the gross income of the entity must come from insurance contracts. Insurance requires two key elements:

1. Risk shifting.
2. Risk distribution.⁸

If a contract lacks either or both elements, the resulting income is not considered to arise from insurance.

It has taken many years to bring a degree of clarity and a reduced risk of controversy in planning around whether, and if so how, a captive insurance company can meet these two elements of insurance. With the advantage of Section 831(b) dependent completely on the entity being treated as an insurance company (with substantially all of its business activity and a majority of its income meeting the definition of insurance), many taxpayers decided that the risk of classification as a regular (non-insurer) C corporation and the resulting loss of the premium exclusion was real and substantial. This became a clear deterrent to the formation of captive insurance companies.

¹ “Issues Paper on the Regulation and Supervision of Captive Insurance Companies,” International Association of Insurance Supervisors (October 2006).

² A deduction for claims made against a trade or business can be claimed only when the claim is paid by a cash-method taxpayer or when the liability is fixed and payment can be determined for an accrual-method taxpayer. For a general discussion, see BNA Tax Management Portfolio 522-3rd.

³ P.L. 99-514, section 1024(a)(4), amended Section 831, effective for tax years beginning after 1986.

⁴ H.R. 99-841, 99th Cong., 2d Session (1986).

⁵ *Id.*

⁶ Section 1(h)(11).

⁷ Section 831(b)(1)(A).

⁸ *Helvering v. Le Gierse*, 312 U.S. 531, 25 AFTR 1181 (1941).

Case law and rulings

For decades, the Service advanced the position that most related parties could not demonstrate risk shifting in circumstances where covered risks were largely within a controlled group of companies. The Service stridently articulated and relied on the “economic family doctrine,” having a chilling effect on the potential use of the small insurance company provisions of Section 831(b) for related companies, as well as larger companies that sought to use captives to cover principally related-party risks. Under the economic family doctrine, the Service asserted that it would be impossible to spread or distribute risk between affiliates if the net financial effect at the controlling corporate level would be a wash.

The Service’s position was officially set forth in Rev. Rul. 77-316⁹ issued almost a decade before the current 831(b) small captive election was enacted. The Ruling held that one economic family existed between a parent entity and its several subsidiaries, precluding one of the two key components of insurance, risk shifting. It was implicit that the economic family also precluded risk distribution. The same principle would apply to all entities under common ownership, whether in a parent-subsidiary, brother-sister, or a combined or hybrid type relationship.

Court decisions that followed generally were unfavorable to the government’s position. Where enterprises under common control held a brother-sister relationship with the captive, courts had no difficulty finding in a consistent pattern that the elements of insurance risk distribution and shifting could be established.¹⁰ The courts also routinely proceeded to dismiss other alternative arguments advanced by the Service in many of these cases, such as a lack of economic substance and that the captive insurer was a sham arrangement. Unlike the economic family doctrine itself, however, the Service would not abandon these alternative arguments, and they serve to emphasize the importance in practice of treating the relationships between a captive insurer and its affiliates as if they were unrelated.¹¹

Courts nevertheless also consistently denied favorable tax treatment to insurance of risks between a parent insured and its captive subsidiary based on the rationale that risk between parent and subsidiary, viewed alone, cannot readily be shifted.¹² Other financial ties between the parent and the captive, such as guarantees and stop losses, also have been found by the courts to defeat otherwise effective risk shifting.¹³

Planning considerations. The parent or affiliated controlling party

must capitalize the captive sufficiently. Guarantee and other risk protection devices that connect the non-insurance company parent or affiliate to risk can and should be avoided, so as not to cloud the underpinnings of the contractual relationship of insurer and insured.

Recently, the Service challenged the bona fides of a captive that held treasury stock of its parent as its sole asset, and where the parent entity also took a key role in the design and implementation of insurance for its several subsidiaries.¹⁴ Litigation in this case, although resolved favorably to the taxpayer, might have been avoided altogether had the insurance subsidiary been adequately and independently capitalized and operated independently of the parent as a free-standing insurer.

The decided cases have dealt with a varying number of subsidiary or affiliated entities and with different levels and distributions of insurance allocated to each entity. The cases have consistently relied on a facts-and-circumstances analysis as being necessary in order to establish the two key elements of insurance. No mechanical test or formula has emerged or is seemingly deduced from the case law. Levels of coverage among insureds appear to be far less important than the nature and extent of risks covered. Even where a limited number of related insureds existed, risk distribution still has been found where the nature of risk was also well distributed and of a diverse composition.¹⁵

Similarly, courts have also weighed qualitatively the level and extent of outside risk needed for risk distribution to be established in cases where there were limited related insureds. In one case, 30% of insurance business outside the control group was enough, and 70% of related-party businesses

⁹ 1977-2 CB 53 *amplified and clarified by* Rev. Rul. 88-72, 1988-2 CB 31 *and obsolete by* Rev. Rul. 2001-31, 2001-1 CB 1348.

¹⁰ See e.g., *Humana Inc.*, 881 F.2d 247, 64 AFTR2d 89-5142 (CA-6, 1989); *Sears, Roebuck & Co.*, 972 F.2d 858, 70 AFTR2d 92-5540 (CA-7, 1992); *Kidde Industries Inc.*, 40 Fed. Cl. 42, 81 AFTR2d 98-326 (Ct. Fed. Cl., 1997); and *Hospital Corporation of America*, TCM 1997-482.

¹¹ See *Rent-A-Center, Inc.*, 142 TC No. 1 (2014) (evidencing the Service’s most recent attempts to challenge captives using alternative argument involving economic substance and sham transactions).

¹² See e.g., *Clougherty Packing Co.*, 811 F.2d 1297, 59 AFTR2d 87-668 (CA-9, 1987), and *Carnation Co.*, 640 F.2d 1010, 47 AFTR2d 81-

997 (CA-9, 1981) (discussing the parent subsidiary relation).

¹³ See e.g., *Malone & Hyde, Inc.*, 62 F.3d 835, 76 AFTR2d 95-5952 (CA-6, 1995) (holding that a reinsurance arrangement was not bona fide because the captive was undercapitalized and the parent guaranteed the captive’s obligations to an unrelated insurer); *Carnation Co.*, 71 TC 400 (holding that a reinsurance arrangement lacked insurance risk where the captive was undercapitalized and, at the insistence of an unrelated primary insurer, the parent agreed to provide additional capital); and *Kidde Indus., Inc.*, *supra* note 10 (holding that a reinsurance arrangement lacked risk shifting because the parent indemnified the captive’s obligation to pay an unrelated primary insurer).

¹⁴ See *Rent-A-Center, Inc.*, *supra* note 11.

¹⁵ *Humana*, *supra* note 10.

from two related entities was not too much.¹⁶

After decades of litigation, decisional law had established a clear path recognizing captives as being eligible for favorable income tax treatment as insurance companies. But challenges from the Service still loomed large, and there was no clear guidance as to the standards the Service would follow without challenge.

Revenue Rulings establish planning guidelines

Following its losses in court, guidance from the Service changed the captive landscape. In 2001, the Service announced in Rev. Rul. 2001-31¹⁷ that it would no longer assert the economic family doctrine, and that it would revert to a factual analysis in each case in order to determine if the elements of insurance exist and are bona fide. This step, coupled with the numerous decided cases that established parameters for assessing the insurance elements (i.e., risk shifting and distribution), reduced the level of uncertainty and risk in planning. But planners remained uneasy as the 2001 Ruling did not define or explain when the Service would challenge brother-sister or other related insurers and how it might use its reliance on a facts-and-circumstances analysis.

In 2002, the Service issued a series of published rulings,¹⁸ which are sometimes referred to as the safe harbor rulings. They present fact patterns that are more conservative than an analysis of the decisional law would appear to require, but nevertheless provide paths to avoid controversy in planning.

In the first of the Rulings, covering an assessment of non-affiliate risk, the Service held that if more than 50% of the risk insured by a captive is placed with unre-

lated third parties, the remaining coverage can be placed with a parent company without violating the principles of insurance.¹⁹

In another Ruling, where 12 (or more) subsidiaries of a common parent purchase professional liability insurance from a brother-sister captive insurer at arm's-length rates, where the common parent had no financial involvement, and where risk distribution was found to be substantial, in a range of 5% to 15% per subsidiary, the elements of insurance were established, even though the insurer did not issue policies to anyone else.²⁰

By contrast, consider judicial decisions such as *Humana* where only seven subsidiaries could facilitate risk distribution, and *Harper* where only 30% unrelated risk was enough to establish risk distribution in a circumstance in which 70% of premiums were collected from a limited number of affiliates.²¹

Planning tips. Measuring and applying the risk of a tax controversy and the likelihood of an adverse result when the safe harbor rules cannot be satisfied is likely to remain an art form. Overall, consider these observations:

- Capitalize the captive to meet insurance industry standards and consistent with independent actuarial advice, even if state minimum capitalization rules require less capital.
- Avoid dependence on any collateral or guarantees from a parent or affiliated entity.

- Where possible, organize the captive as a pure brother-sister company; that is, without a common parent between the insurer and the insured.
- Make sure that coverage levels and premiums are all at arm's length and set by independent actuarial professionals.
- Seasoned professional actuarial advice should be obtained in planning and feasibility, and well before placing coverage of non-routine risks outside the general insurance market. These risks are often the most important facet of risk shifting through a small captive, and relate directly to the business benefits of the captive insurer.
- Carefully analyze any difference between client's fact pattern and the safe harbor rulings. Consider a private letter ruling where appropriate and if available.²²

Starting a captive insurance company

A captive insurance company is at its core still an insurance company. Its policies must be compliant with the laws of the jurisdiction where the captive is organized and where it does business. It must operate like any other insurer with real underwriting and insurance policies, and it must be capitalized at a level commensurate with its risk profile.

In the early years, most captives were organized in politically stable foreign jurisdictions such as

¹⁶ *Harper Group*, 979 F.2d 1341, 70 AFTR2d 92-6053 (CA-9, 1992).

¹⁷ Note 9, *supra*.

¹⁸ Rev. Rul. 2002-89, 2002-2 CB 984; Rev. Rul. 2002-90, 2002-2 CB 985; and Rev. Rul. 2002-91, 2002-2 CB 991.

¹⁹ Rev. Rul. 2002-89, *supra* note 18.

²⁰ Rev. Rul. 2002-90, *supra* note 18.

²¹ See footnotes 14 and 15, *supra* and the related discussion.

²² While this area is not currently listed as one where the Service will not issue a private let-

ter ruling, the authors have been unable to identify any private letter rulings actually issued since the safe harbor rulings outlined above on the subject of risk shifting or distribution.

²³ Currently, 37 states, the District of Columbia and the U.S. Virgin Islands have enacted laws that regulate captive insurance companies. In recent years, Montana, Delaware, and Utah have been the fastest growing U.S. domiciles.

Bermuda, the Cayman Islands, and similar offshore locations. Subsequently, states began to enact laws favorable to the formation of small insurance companies. Now a vast majority of states have some form of captive insurance company legislation with the states distinguished mainly on the basis of regulatory environment, taxation of premiums, and capital requirements.²³ Premium taxation is often the only state tax regimen for captives.

In general, captives are taxed by states at lower rates, based on premiums collected. Often insurance companies generally are excluded from state income tax requirements. Typically the premium tax is capped at the state level. For example, Delaware assesses a .2% tax on direct premiums with a cap of \$125,000, but an annual minimum of \$5,000. Vermont taxes premiums on a sliding scale where the first \$20 million of premiums is taxed at .38%, the next \$20 million at .285, the next \$20 million at .19%, and in excess of \$60 million at a rate of .072%. In contrast, Oregon has removed premium taxes from cap-

tives and simply charges a \$5,000 annual fee.

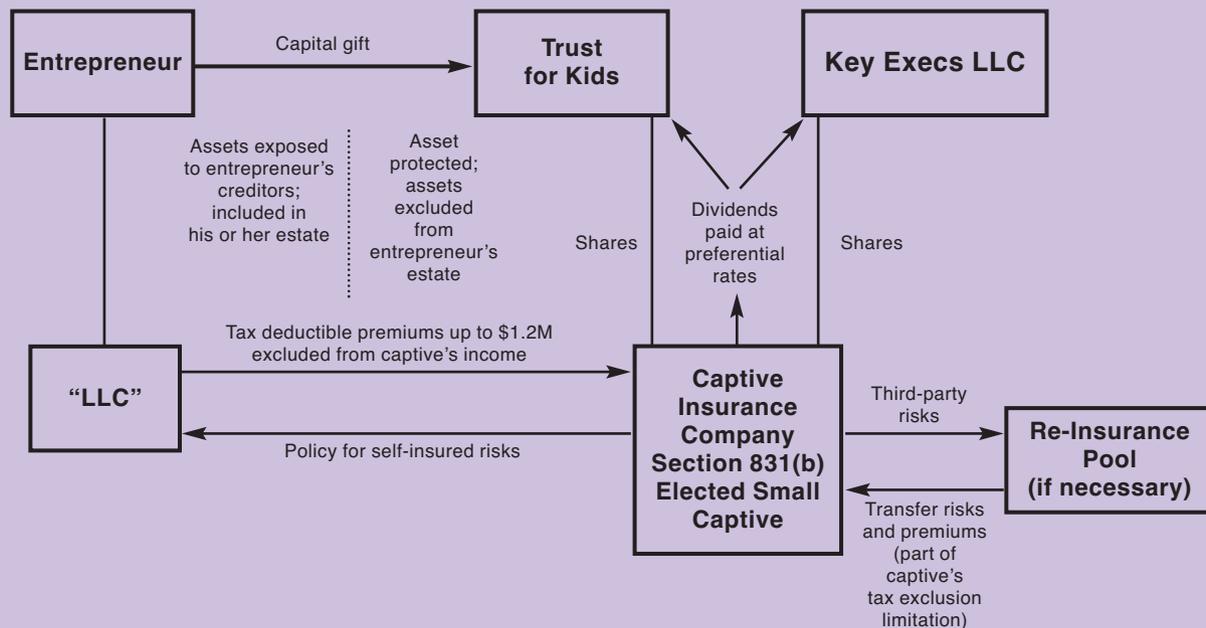
Analyze risks. Before proceeding with any in-depth planning, the client should explore the feasibility of a captive. An actuarial firm should be engaged to examine insurable risks, with special focus on risks that are significant to the business, its operations and reputation, and that must otherwise remain self-insured, because they may not be readily or economically provided by traditional property and casualty insurers. If it appears that there are substantial risks that can be underwritten, the decisional law and safe harbor rules should be examined to determine the level of risk that can be underwritten for affiliates without controversy, and to vet the two elements of insurance (i.e., risk distribution and shifting). Part of the feasibility study should focus on related third-party risk that the captive may need to underwrite, how best to measure the likely profitability and exposure of such arrangements, and how the captive can limit its outside risk of large claims.

Like any other sophisticated planning technique, it is important to assemble a capable team of advisors. Once feasibility is established, a consulting firm often is hired to advise on the best jurisdiction to select for organization, adequate capitalization, and to provide ongoing administration of and claims processing for the captive.

Although tax advantages are significant, tax benefits will be of limited value unless the enterprise as a whole is consistently profitable, producing taxable income substantially in excess of net related-party premiums. To the extent that risks outside the affiliated group are underwritten to meet safe harbor guidelines, the business considerations of such outside-the-group risks, if any, must be fully understood. The client's traditional advisory team of counsel and tax advisors has an important role in assisting in these decisions as part of a feasibility analysis.

Investment activity. State law, regulations, and guidelines control reporting to the state insurance regulatory body, the audit and publication of financial statements, and

EXHIBIT 1 Proposed Structure of a Captive for the Entrepreneur's LLC



the investments of captives, particularly those investments associated with loss reserves. Because captive insurance companies are regulated by state law, each state has a vested interest in the financial health of all insurers it regulates. Accordingly, permissible investment types are often limited by state regulation and administrative practice.

As a result, it appears clear that most investment structures, in the early years, can be expected to be more conservative than modern portfolio theory would dictate over the long term. But any such administrative restrictions should not be problematic when made a part of an overall family and business investment plan, and also because a more balanced portfolio can be developed as retained earnings grow in proportion to insured risk.

Asset protection

The captive insurance company as an enterprise allows its affiliated operating business to remove

assets from its balance sheet that otherwise might need to be reserved for self-insured claims. Setting aside bankruptcy law principles, in either a parent-subsidary or a brother-sister ownership arrangement, and assuming corporate formalities are observed, the assets of the captive insurance company should be fully insulated from the non-insured claims and losses incurred by the related operating businesses.

If the owners of the business also own the equity in the captive, guarantees and other collateral arrangements might expose the shares of the captive or its assets to creditor claims. Differences in ownership can be used to avoid such arrangements and to achieve both asset protection and estate planning goals. Where common ownership cannot be avoided, it may be possible for the shares of the captive to be held by a limited liability company or asset protection trust for the benefit of the ultimate owners, thereby providing further ongoing creditor protection. Discussion

of these techniques is beyond the scope of this article.

Estate planning

In operation, a captive can help achieve estate planning, business succession, and management goals. In some circumstances these goals may be more meaningful from an economic perspective than the underlying business purposes of the captive itself. Most commercial insurance companies budget for at least a 40% profit and overhead charge, adding to the actuarially predicted costs of reserves and incidence of loss. This model may be expected to be a minimum base line for captive economics. In addition, general principles would appear to dictate that at arm's length, an insurer would demand a higher return for insurance products that are non-routine or for which there is either no established commercial market or a market that is not robust.

Of course, actuarial counsel should be sought to review and confirm these principles. By providing

the potential for significant accumulated profits and reserves, effectively enhanced by tax deductibility, the captive can produce an exceptional opportunity to grow and accumulate wealth, and thus wealth transfer.

Tax consideration. Dividends paid by the captive should qualify for the maximum 20% tax rate, and liquidating distributions should produce long-term capital gain. If, however, a shareholder's net investment income meets a threshold for being assessed a Medicare tax, dividends received from the captive may be subject to an additional 3.8% Medicare tax under Section 1411.

Business standards. It is most critical for the captive to have sound business underpinnings. Its primary objective as an enterprise should be achieving the insurance goals of its affiliates for a profit, such as covering otherwise self-insured risks, obtaining efficient pricing, and obtaining otherwise unavailable coverage. The primary objective should not be estate planning, or any other collateral advantage. But these advantages will follow from a well conceived and implemented insurance plan, and they can be very significant.

Related-party insurance policies must also conform to all regulatory requirements of the jurisdiction of organization and be priced at arm's length by seasoned actuarial professionals.

Structuring the entity. As the decisional law demonstrates, a parent-subsidiary structure for a proposed captive can cause unnecessary complexity in consideration of the corporate relationship that indirectly calls in question the existence of the elements of insurance, particularly where the insured is the parent. No such risk is present in a

brother-sister relationship. Moreover, the brother-sister structure affords numerous estate planning options and opportunities.

Ownership options include:

- Substantial or all equity of the captive being held by a younger generation of members of the business ownership family.
- One or more long-term trusts with asset protection characteristics for the benefit of the business owners and family members.
- Key business managers and candidates for future business ownership or succession.

Of course, any combination also is possible.

Equity provided to key managers or employees can be restricted and subject to risks of forfeiture. If compensatory in nature, it will be treated as covered by Section 83 and eligible for a Section 83(b) election, with corresponding valuation considerations. Because capital requirements in most states are a small fraction of the maximum annual premiums a captive insurer can earn, other realistic options include grossing up currently realized compensation, or loans with appropriate interest charge provisions.

Structuring family ownership. Similar factors apply to the capital attributable to family or trust ownership. In order to help avoid the future assertion that a transfer would have been made with some element of retained control or enjoyment, the transfer of shares of stock of the captive should be avoided in favor of direct monetary gifts or bona fide loans used to acquire capital. For trust ownership, general principles of trustee independence should be observed.

Under present law, the use of an intentionally defective grantor trust (IDGT) to own some or all shares of the captive can enhance capital accumulation by allowing future dividends and other distributions from the captive or respecting its shares to pass to the IDGT free of income taxes at the trust level. Such a structure also could more readily facilitate loans to and from the trust in preparation for and during the ownership of equity in the captive.

Since captives, like other insurance companies, are taxed as C corporations, they can have classes of shares. Preferred stock can be held by senior generation equity holders so as to limit the need to make monetary gifts or compensation arrangements to support

common stock equity that might be held by members of a younger generation, trusts, and key managers. Shares can also hold varying voting rights. Care should be taken to consider the possible application of Chapter 14 of the Code to such equity ownership plans.

If business arrangements between the captive and its insureds are squarely at arm's length and operate as part of a normal business model, no gifts or compensation should arise from premiums paid to the captive or as to the profit it earns. With careful ownership design and planning, all funds accumulated at the captive level can be arranged to be fully outside of the estates of business owners. If a multigenerational trust is used, generation skipping also can be effectuated without using any part of the generation-skipping transfer (GST) exemption amounts of the senior generation, with the exception of gifts made to capitalize the captive.

Importantly, the assets that leave the insured's balance sheet are also effectively removed from the current and potential future creditors of the insured. This effect serves as a potential hedge against a doomsday scenario for an operating business or professional practice if a business down-turn results in uninsured creditor claims against the business that exceed the remaining business equity value.

Example

An entrepreneur (e.g., doctor, attorney, accounting, engineer, architect, manufacturer, etc.) owns and operates a successful limited liability company (LLC). The LLC consistently nets between \$2 million and \$4 million after all operating expenses and payroll, including the entrepreneur's salary. The LLC maintains general commercial

liability, professional, health, and worker's compensation insurance, but self insures many risks of its business.

Together with the entrepreneur, the success of the LLC is driven by two key executives, that the entrepreneur constantly seeks ways to incentivize and retain. Aside from incentivizing these two executives, the entrepreneur and executives have fully tapped out all the avenues for income deferral using the LLC's existing pension and profit sharing plans.

On the personal side, the entrepreneur wants to start long-delayed estate and asset protection planning, but also wants to increase effective savings for his two children who will be of college age in a few years. How can a captive help the entrepreneur? Exhibit 1 has a proposed structure of a captive for the entrepreneur's LLC.

This example presents key components of when a captive should strongly be considered and some of the benefits. Primarily, a captive may present an opportunity for the LLC to obtain coverage for risks the LLC self-insures and some aspects of coverage for risks it currently covers by traditional retail policies. Additionally, the LLC has consistent profits (in excess of the \$1.2 million premium cap) to cover premiums to the captive and assure the continued economic viability of the captive.²⁴

The captive should remain profitable with growing reserves, after claims for the risks it has assumed are satisfied directly or through more cost-effective reinsurance arrangements.

The premiums paid to the captive should be tax deductible by the LLC and excluded from the income of the captive, leaving only investment income of the captive to be subject to federal income tax. Dis-

tributions from the captive in the form of qualified dividends, redemptions of stock ownership, and the ultimate liquidation of the captive should be taxed at preferential income tax rates. Finally, to further estate and asset protection goals, the captive can be held by trusts for the benefit of the entrepreneur's spouse and children, after appropriate gifts of necessary capital for the capital requirement, and start-up and operational costs of the captive.²⁵

This permits the value and appreciation of the captive to grow outside of the entrepreneur's estate and outside of the reach of his or her potential creditors. Likewise, the key executives can also be shareholders of the captive to act as a further incentive and to retain their future services in a tax-efficient manner.

Conclusion

In the right circumstances, captive insurance companies can provide a variety of tax and nontax benefits to business entities. While the captive insurance arrangement is generally associated with very large corporations, closely held businesses may use the strategy as well. For the owners of these companies, captive insurance company strategies may provide estate planning advantages that are not relevant in the large-corporation context. ■

²⁴ The ability of the captive to insure these risks or to shift the risks and participate in insurance pools to satisfy risk shift and distribution requirements must be examined depending on the organization structure of the LLC and its affiliates.

²⁵ The capitalization requirements vary by state. On the lower end, minimum capital is about \$250,000. The start-up costs for a captive can be expected to range from \$50,000 to \$100,000, and annual operation costs can be expected to range from \$25,000 to \$75,000. These figures represent ranges, and in planning for feasibility more accurate estimates would be required based on specific facts and circumstances.