Financial and Estate Planning Use of Tax Advantaged 831(b) Small Insurance Companies by Successful Closely Held Business Owners

© Tom Cifelli, JD CPA, March 2012, All Rights Reserved

All financial, tax, legal and business advisory professionals need to become familiar with the potential applications for special tax advantaged small insurance companies known as "captives." Captives are formed to insure risks of its owners and related parties, not sell insurance to the public.

Captive formation in the US is a relatively new legal phenomenon. That is why few people know what they are. Vermont was the first state to dedicate insurance department staff to encourage captive formations in the early 90s. Now 20 years later, over 30 US states authorize captive formations. While nearly all Fortune 500 companies today have formed a captive, the special 831(b) tax election available only to small captives has created the needed incentive for smaller closely held businesses to take advantage of them to become stronger and more competitive.

Internal Revenue Code section 831(b) captive insurance companies accounted for most new US taxpayer owned captive formations in 2010 and 2011. Nearly all were formed by small to mid-market closely held family businesses and some successful professionals, especially medical and high-tech professionals.

The 831(b) election allows a small insurance company to receive up to $1.2 million per year in premiums, without paying any income taxes on those premiums. The significant advantage is that the company is able to accumulate surplus from underwriting profits free from tax. This tax advantage greatly leverages a business’ capacity to build risk reserve assets and retain investment control. When integrated with estate plans, the wealth transfer, protection and accumulation benefits can be substantial.

While IRC Section 831(b) provides special income tax exemption benefits to underwriting premium revenue of $1,200,000 or less each year from federal income tax, investment income is still taxed. This special tax benefit helps place small privately held captives insuring risks of affiliated businesses on a level playing field with much larger commercial insurers who have long benefited by special accounting and tax law provisions.

Among elite business financial advisory firms, captives are becoming increasingly popular as these advisers understand how a captive fits with many of their successful business clients, usually high net worth families. There is some industry concern that many advisers over-emphasize the substantial tax and estate planning advantages 831 B captives can offer. While there may be some captive design and management concerns with new firms entering this rapidly growing industry, this concern is overstated. Established captive advisers and managers take great care to make sure the business risk management objectives are well documented and drive the captive design decisions.

While many states approved new 831(b) captive applications in 2010 and 2011, Delaware and Utah experienced the highest percentage growth rates among US domiciles due to low fees and high quality service. A few offshore domiciles, with low initial capital requirements and ongoing operating expenses, continue attracting 831(b) captive insurance company business from US owners due to Internal Revenue Code section 953 elections which allow these foreign domiciled companies to be taxed as US taxpayers, thus qualifying these foreign domiciled captives for the 831(b) election.

US based Cell and Series LLC programs allow the greatest flexibility, easiest application process, and enable initial capital lower than foreign domiciles in some cases. As familiarity with Series LLC and cell programs rises, we expect wider use by smaller privately help companies across all industries to form 831b captives. The most sophisticated will pursue 3rd party risk underwriting they understand and have an existing business connection to (such as Best Buy and Verizon's captives writing product replacement and warranty coverage of their customers) in order to increase underwriting profits of the captive and turn it into a true profit center.

Total formation and annual operating costs can be kept as low as $25,000 including domicile expenses although well established and properly staffed firms cannot maintain high service levels and trained back-up staff without charging more than this. Going with the lowest cost service provider likely increases risks that the formation and operating documentation will have "holes." Risk pool fees may also apply in order for the 831 B captive to meet risk distribution requirements of the IRS in order for the captive to be considered an insurance company for tax purposes. Generally risk pool management fees range in the 2% to 3% of premium range and are paid to a 3rd party managing the risk pool and related documentation. Well run risk pools are careful not to accept risks with high likelihood of loss. Many companies interested in forming a captive are determined unqualified due to their risk management characteristics not meeting pool underwriting requirements.

The minimum required start-up capital of your captive varies greatly. Joining an existing program cell or series program requires far less start-up capital and reduced operating costs over stand-alone pure captives. Most new 831(b) captive owners join existing cell or series programs due to the lower cost of entry and operation. Historically, offshore cell programs were known as rent-a-captives. More detailed information can be found at www.captiveexperts.com.

About the Author:
Tom Cifelli is managing director of CaptiveExperts.com. Mr. Cifelli has written articles for global captive industry publications and speaks at captive insurance conferences. He practiced public accounting for 10 years and law for 20 years. He also was Managing Director of Investment Banking with a regional US registered broker-dealer firm, and served as CFO and General Counsel with fully reporting publicly traded companies.