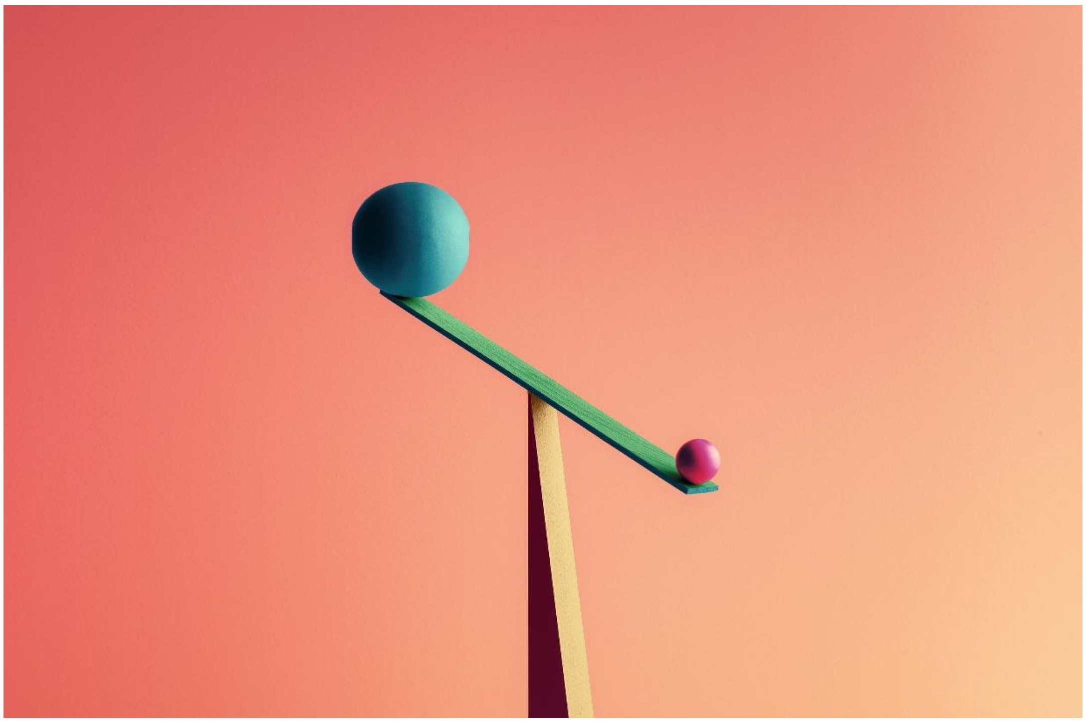
PFS | PHYSICIANS FINANCIAL SERVICES

ClientAdvisor
APRIL 2022

Insure risks not covered elsewhere

Secure tax-advantaged protection and earn additional profits through a captive insurance company



Due to their growth, strength, and utility, the use of captive insurance companies to protect against unique risks is now seen as an integral part of general business management for successful medical practices and other endeavors.

In addition to protecting your practice, captives offer tax benefits and can even provide additional income.

The parent company can immediately deduct the premiums paid to the captive, rather than deferring the deduction under the self-funding plan until claims are actually paid. The captive can also accumulate profits which ultimately add to the wealth of the owner.

“Captives” Explained

A captive insurance company is simply an insurance company that writes insurance business to an affiliated business entity.

The term "captive" means the owners of the insurance company are generally the same as, or related to, the parties whose risks comprise a substantial portion of what the company insures. Generally, a captive insurance company operates at the behest of and for the benefit of a non-insurance parent company. Stated another way, a captive insurance company is one that is owned by those whose risks it insures.

Captive insurance became popular in the 1970s when large companies started using captives to get around a "hard" market in which insurance premiums were very costly.

The captive insurance industry has grown tremendously over the past 50 years. Thousands of businesses have witnessed great benefits from the use of "captives." While initially used only by large multinationals, the concept has caught on, and today captives are found in a wide variety of business endeavors.

The business reasons for creating a captive insurance company include the following:

Obtaining coverage otherwise unavailable. Commercial insurers are unwilling to insure certain risks, or are impractical, and not always dependable. There are some types of coverage (hazardous waste, acts of terrorism, intentional acts) commercial insurance companies simply will not protect against.

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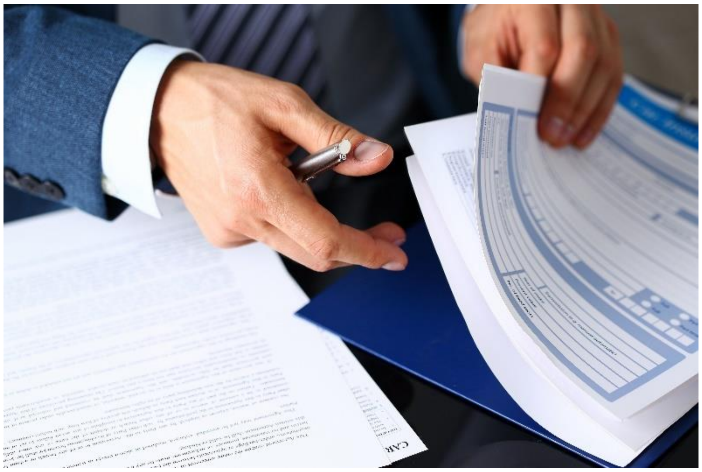
Reduced premium payments. Creating a captive enables the parent company (your medical practice) to reduce certain costs that are often added to the premium by a commercial insurer, allowing the parent to obtain the same coverage at a lower cost. These costs include general overhead, administration and settlement of claims, taxes, brokerage fees, and miscellaneous fees.

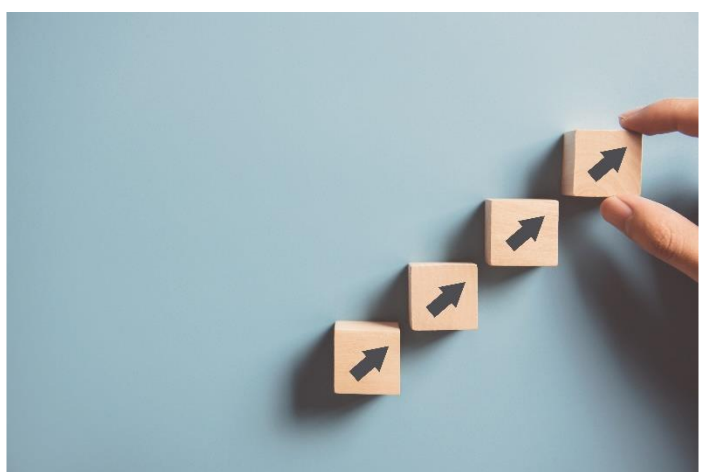


Control of Claims. With a captive, the risk management of the entire enterprise can be controlled. Claims can now be handled and managed according to what is best for the enterprise, and not simply best for the large insurance carrier. With a captive, businesses will manage insurance claims much more effectively when the claim is to be paid by a business affiliate (i.e., the captive), and not an unrelated insurance carrier.

Control of risk. Effective risk management allows a captive to control subsequent losses. Net retention can be adjusted as market conditions change to achieve cost effective risks.

Cash flow. The commercial insurance industry has traditionally relied on investments as a primary source of income. With a captive, this investment income is now captured by the business enterprise.

Access to reinsurance market. Spreading of risks among insurance companies is called reinsurance (i.e., insurance for an insurance company). A captive may gain direct access to the international reinsurance market, i.e., the wholesale market for insurance. Frequently, captives can obtain reinsurance that is less expensive than the reinsurance available in the commercial market. Access to the reinsurance market can generally be accomplished only through a licensed insurer.



Diversification into a profit center. A parent cannot insure its risks in a wholly owned captive unless the captive holds some amount of third-party risk. The sale of insurance to third parties provides leverage if the parent holds most of the risks. It is possible for a captive to diversify and offer insurance services to

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independent third parties and operate as a separate commercial profit center. This will not only allow the captive to generate more investment income, but will also provide more risk distribution.

Balanced coverage. Economic fluctuations, poor underwriting, and normal commercial industry changes often lead to significantly increased premiums in commercial insurance. Captives are less affected by these external factors and thus have steadier premiums that can be factored into the parent's long-term budget, allowing the parent to be in a better position to reach its financial target.

Why are Doctors Setting Up Small Captive Insurance Companies?

As business owners, doctors self-insure risks which are either not available or too expensive to obtain through commercial carriers. Cyber Liability, loss of licensure, loss of hospital privileges, and litigation expense are examples. The tax treatment of small captives greatly improves the efficiency of this strategy.

A compliant captive strategy is very beneficial to successful Physicians and Dentists. A practice with an annual premium budget of $50,000 or more can insure important risks which are not available through commercial carriers, and the captive can earn profits on its business activity.

A captive with a long run of profitable years will accumulate profits which ultimately add to the wealth of the owner of the captive. Assets can ultimately be distributed from the captive, and are treated as capital gains.

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"Captive Insurance" Defined

The term "captive" has been broadly applied to any insurance company with owners who are generally the same as, or related to, the parties whose risks comprise a substantial portion of those insured by the company. Generally, a captive insurance company operates at the behest of and for the benefit of a non-insurance parent company or group (e.g., "group captive"). Thus, a captive insurance company is one that is owned by those whose risks it insures. Ownership may be by a single parent or by a group of shareholders. From an organizational perspective, these entities resemble mutual insurance companies but for a limited number of participants. A significant component of the alternative risk market is represented by "captive" insurance companies. Due to their growth, strength, and utility over the past decade, captive insurance companies are no longer considered by many insurance professionals to be merely an "alternative" insurance market. In fact, the use of a captive is now seen as an integral part of general business risk management.

Foreign Captives

Led by Bermuda in the 1960s, foreign jurisdictions were the first to establish laws for captive insurance companies. In 1981, Vermont became the first U.S. state to offer captive insurance companies, and since then, many states have enacted captive insurance statutes. The captive operational costs in most foreign countries continue to be less than found in the U.S. The majority of all captives are located in foreign jurisdictions, although hundreds of captives each year are formed in the U.S.

Many foreign captive insurance companies with U.S. shareholders make an election under Section 953(d) of the IRC to be taxed as a U.S. corporation for all purposes. For companies utilizing this election, there is no unique tax benefit to forming a captive in a foreign country. However, because of the lower regulatory burden and operational costs in many foreign countries, captive insurance companies continue to be formed in foreign jurisdictions in large numbers.

An important decision in establishing a captive insurance company is determining where it will be domiciled. As stated above, U.S. companies can form the captive onshore (located within the jurisdiction of the United States, or offshore (located outside the jurisdiction of the United States). The various alternatives have advantages and disadvantages for the owners. Four key areas a company should focus on when choosing a domicile for a captive are: (1) the regulatory environment, (2) the infrastructure of the country or state, (3) the tax consequences, and (4) the cost of maintaining the captive. This decision on the choice of domicile must be made on a case-by-case basis, and sometimes ongoing basis, for each captive.

One advantage many offshore locations have over U.S. domiciles is a flexible regulatory environment. For example, one of the most important regulations governing captives involves capitalization requirements, i.e., the amount of capital necessary to qualify as an insurance company.

Initial capitalization requirements vary widely, with some jurisdictions as low as $100,000, and others much higher. In recent years, states in the U.S. have become more competitive with the foreign domiciles, and have implemented more reasonable capital requirements.

831(b) Insurance Company

Under IRC § 831(b), if an insurance company receives premium income of $1.2 million or less per year and files the appropriate tax election, the entire premium is exempt from tax. For a captive so qualifying, the business(es) paying the premiums would receive a deduction of (up to) $1.2 million per year, and the captive insurance company would not be taxed on the receipt of that (up to) $1.2 million in premium. Importantly, this is not for the first $1.2 million, but only applies if the total premiums are $1.2 million or less each year. Section 831(b) companies pay tax on any net investment income at normal "C" corporation rates.

To gain status under IRC § 831(b) or § 501(c)(15) (discussed directly below), the captive's primary business ("more than half') must be the issuance of insurance contracts or the reinsurance of risks. Thus, each year, the premium income to the captive should exceed all other income to the captive.

In addition, the captive must meet the tests of risk shifting, risk distribution, and traditional notions of insurance. Section 83 l (b) insurance companies file federal tax return Form 1120-PC.

501(c)(15) Insurance Company

Section 501(c)(15) of the tax code permits a captive to qualify as a tax exempt company if the "gross receipts" of the company are $600,000 or less each year (as of 2004). "Gross receipts" is a technical term, but it includes insurance premiums and all investment income. In addition to this gross receipts limit, the annual premium income must exceed all other "receipts" to the insurance company (i.e., the "more than half' rule). Thus, the theoretical maximum investment "receipts" is $299,999 per year. For example, if the premium income was $250,000 in a given year, then other "receipts" could not exceed $249,999. However, premium income in theory could consume the entire $600,000 amount.

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If a captive does not qualify for Section 501(c)(l5) status for a particular year, it may still qualify under Section 831(b). The qualification is done on an annual basis. When a captive is sold or liquidated, its owners will pay tax on gain in the value of their stock at long-term capital gains rates (currently 15% federal).

Section 501(c)(l5) captives will pay tax on any unrelated business taxable income (UBTI) generated by the insurance company. This UBTI rule applies to all tax-exempt entities (such as retirement plans) and not just section 501(c)(l5) insurance companies. UBTI means "the gross income derived by [the insurance company] from any unrelated trade or business regularly carried on by it."

While general "investing" is not considered an unrelated business, the operation of a typical business would be considered "unrelated" and therefore taxable.

Section 501(c)(l5) insurance companies file federal tax return Form 990. Form 990 is the same form filed by other tax - exempt entities, and requires additional disclosure about affiliated entities. Clients desiring qualification under IRC § 501(c)(l5) generally file Form 1024 to apply for exemption recognition from the IRS. Form 1024 and related information (including information about the captive) is deemed to be information available for inspection by the public. Section 501(c)(l5) insurance companies were more popular prior to the 2004 change in law. Since that time, they have not been used frequently. The Form 990 disclosures require the captive's owner to disclose all sources of income, and this tax return is a publicly-available document. Also, it is often difficult to keep both premium and investment income under $600,000 per year. Furthermore, if a prior 501(c)(15) company becomes taxable, there may be additional taxes paid on gains within the captive.

Qualifying as an Insurance Company

Factors to be considered in determining whether a captive insurance transaction is insurance, and therefore whether premiums can be deducted, include whether (1) the parties that insured with the captive truly face hazards; (2) premiums charged by the captive are based on commercial rates; (3) the validity of claims was established before payments are made; and (4) the captive's business operations and assets are kept separate from the business operations and assets of its shareholders.

In meeting the "commonly accepted notions of insurance" standard, captive owners should carefully invest the captive's capital and reserves. Investment of the captive insurer's funds in the parent or another affiliate, whether in the form of loans or purchases of other securities of the parent, may lead to disqualification of the captive. Captives should avoid "circular cash flows" or loans from the captive to the insured or any other related party. If there are loans of this sort, they should be done on an arm's-length basis, be commercially reasonable in all respects, and be secured. Interest, as well as principal, should be paid on a current basis, as provided in the loan documents. In Notice 2005-49, the IRS identified loans to affiliates as a possible audit issue.

In addition, captives should not be undercapitalized or significantly overcapitalized, and should invest conservatively in a diversified portfolio of assets. As a general rule, a captive's investment should mirror the nature of investment of a conventional insurance company: no personal assets (e.g., vacation homes) should be owned by the captive.

Expenses

The biggest challenges to making small Captives efficient are expenses and taxes. Who gets paid?

<u>The promoter</u>: The promoter is generally the person or persons who offer their services to establish and administer your captive. The Promoter may also be the person(s) who establish the Core Insurance Company which reinsures risks to your Cell or Series Business Unit. The fees paid to a promoter for Captive set up include attorney fees, actuary fees, rights paid to use copyright policy language, administrative expenses including bookkeeping, regulatory reporting, claims administration and corporate records. The Promoter also builds in fees for himself/herself above the direct expenses to outside providers and regulatory fees.

<u>The domicile</u>: The State, Indian Tribe, or offshore sovereign entity receives premium taxes and charges fees for regulatory actions such as regular regulatory audits.

<u>Investment management</u>: The assets inside the company are held at a custodian that may also provide investment advice. Expenses for money management are driven by the type of investments held and the size of the portfolio.

The combination of promoter fees, regulatory fees, premium taxes and investment management fees affect the efficiency of the captive. Many of the expenses are fixed costs. The premium budget for captive insurance must be large enough to keep the expense ratio reasonable.

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Clients of Physicians Financial work with Providers where fees are disclosed in writing and expenses are efficient. The Domiciles have very low premium taxes and investment management expenses are at institutional rates (much lower than retail)

We continue to review developments in this industry which provide further opportunity for efficiency.

Tax Treatment captives are popular because they have very favorable tax treatment which offsets much of the expense of running the captive and allows potential to accumulate wealth if the company has good claims experience. Any program with favorable tax treatment which comes into broad use becomes an item of interest to the IRS.

Clients of Physicians Financial do not fund life insurance with captive assets or captive dividends. If one feels strongly that they want to fund life insurance contracts with captive insurance company funds, they should also expect to defend that position over the next several years or until some safe harbor guidelines are provided by the IRS.

It is possible that the use of captives and other tax favored programs can reduce your personal taxable income close to zero. That kind of aggressive planning will invite an IRS challenge, which will be expensive to defend and likely result in taxes, interest and penalties. Captives can provide a number of benefits while avoiding extremely aggressive positions that will invite unneeded scrutiny.

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