PHYSICIAN PRACTICE
NEWS

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CAPTIVE INSURANCE COMPANIES

The Physician's "Hat Trick"

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I. THE CONCEPT

Forming your own captive insurance company offers you the chance to reduce expenses, limit risk and shift income.

The concept of the captive insurance company (the "Captive") was born of necessity, parented by large corporations seeking to underwrite risks for which coverage either did not exist or was unreasonably priced. These insurance subsidiaries were typically domiciled offshore, giving the Captive concept a rather exotic aura. However, in recent years, closely-held business owners have learned that Captives can be both affordable and domestic. In the world of physicians, the Captive can be the proverbial "hat trick," incorporating: (i) expense reduction; (ii) tax advantages; and (iii) accumulation opportunities. This article will summarize the benefits of forming and operating a Captive in the context of a physician's practice.

II. FORMATION

The formation of a Captive is an involved process which will include the performance of feasibility studies, the preparation of financial projections, the determination of domicile and the submission of an application for an insurance license. It is for these reasons that a physician's group will either utilize the services of a Captive Management Company or participate as a "Cell Company" or series limited liability company ("LLC") in conjunction with a "Master Cell" or "Master LLC". In either case, an entity will be formed. A corporation for a wholly-owned Captive and a limited liability company for a cell-type Captive is the norm. An initial requirement is the determination of the amount of capital required by the chosen domicile to offset the projected risk assumed by the Captive. The loss history of the physicians' practice will provide a basis for analysis of the risk. In addition, it is assumed that the Captive will underwrite the manageable risks and those of a catastrophic nature will be shifted to commercial carriers. The manageable risks can be of low probability but must be true insurance risks in order to allow the Captive to qualify as a valid insurance company. This qualification is necessary to ensure that payments by the physicians' practice to the Captive will be deductible as an insurance expense.

III. OWNERSHIP

A Captive formed as a corporation can issue multiple classes of stock. Accordingly the investment ownership benefits of preferred and common stock as well as the control characteristics of voting and non-voting stocks can be incorporated in the planning process. Ordinarily the physicians in the practice would be the owners of the stock. However, there are no restrictions on spouses, children, trusts or other entities being the owners of the stock. In light of the potential for significant accumulations outside the practice, a physician can engage in the mitigation of personal litigation risk as well as income and estate tax planning by shifting the ownership of the Captive.

Physicians are typically concerned about malpractice exposure, so ownership by a spouse provides immediate protection. In addition, ownership of the stock in the Captive by adult children or trusts for the benefit of minor children can shift the income earned and distributed by the Captive to the lower tax brackets of the adult children. Further, such transfers can remove all future appreciation in the value of the Captive from the estate of the physician. Finally, incorporating the use of "dynasty" type trusts in conjunction with such transfers can mitigate the dilution caused by estate taxes imposed on multiple generations.

Further, if the physician would like to have the opportunity to shift income tax and mitigate estate taxes but retain access and control, the concept of a family LLC as owner of the stock in the Captive could be considered. Finally, if rewarding the key employees of the practice is a concern,

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the issuance of preferred stock in the Captive to such employees can provide a type of "golden handcuff" with respect to those employees.

IV. OPERATION

The fundamental operation of the Captive is almost intuitive. The physicians' practice will pay an annual premium to the Captive and deduct the expense for income tax purposes. The Captive will insure the specified risks, pay the related claims and invest any excess premium. To the extent the risk is well-managed by the physicians' practice, the potential for accumulation is significant. Nonetheless, it cannot be forgotten that the Captive is an insurance company. Accordingly, the realities of annual actuarial reviews, financial statement audits, continuing tax compliance and oversight, claims management, and regulatory compliance continue to exist. As noted above, a Captive Management Company or the Master Cell and Master LLC would likely attend to these tasks.

V. TAX ASPECTS

In 1986, Internal Revenue Code (the "Code") Section 831 was modified by Congress, creating a significant planning opportunity for small insurance companies. Code Section 831(b) provides that if a property and casualty insurance company of $1.2 million or less (a "mini captive") makes an election, it avoids tax on premium income and pays taxes only on investment income.

A Captive will likely be formed as a C corporation or as an LLC. If formed as an LLC, it must make an election to be taxed as a corporation. The downside of this treatment is the potential for double capital gains tax on liquidation. However, if the Captive will continue irrespective of the departure of individual physicians then retiring or terminating physicians should be subject to only one level of capital gains tax on the sale of their interest.

One additional requirement for federal tax purposes is that more than fifty percent (50%) of the total revenues of the Captive must be from the issuance of insurance. Although this requirement would appear to be easily satisfied, the tangential benefit of significant accumulations and the resulting earnings on the accumulations could challenge this threshold.

The Internal Revenue Service ("IRS") gave its approval to Captives for physicians' practices in Private Letter Ruling 201114015. The issue of major concern to the IRS is that there be sufficient risk shifting to support the payment of insurance premiums as a tax deductible expense. Accordingly, the Captive must be liable for loss protection similar to that of a third party independent insurance carrier.

VI. STATE INCENTIVES

Connecticut's insurance law was revised in 2011 to make it a more attractive domicile for Captives. Incentives include a first year tax credit of Seven Thousand Five Hundred ($7,500) dollars. The law change also: (i) clarified ownership and control issues for tax aggregation purposes for multiple insurers; (ii) expressly recognized different types of captive entities; and (iii) helped to simplify the task of satisfying IRS requirements for qualification as an insurance company. The most popular domicile for Captives is currently Vermont due to the beneficial statutes enacted in that state.

VII. ANCILLARY BENEFITS

In addition to the benefits already mentioned, consider the following:

1. Funds accumulated in the Captive can be shielded from the creditors of the physicians' practice by transferring ownership to a spouse or trust for the benefit of children;
2. Coverage can be obtained for previously self-insured risks;
3. Policies of coverage can be custom tailored;
4. The Captive can have its own counsel in the event of litigation;
5. Claims can be administered on controllable terms; and
6. Increased focus on risk management by the physicians in the practice.

VIII. CONCLUSION

In the context of hockey jargon, scoring three goals is the player's "hat trick." In the context of the physicians' practice, the Captive is the equivalent in that it can reduce expenses, generate wealth, and mitigate taxes. Consult your Murtha Cullina attorney for further assistance.

If you have questions about the issues addressed in this newsletter, please feel free to contact the following attorneys:

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