



legal matters

Captive Insurance Companies The tax benefits, individual control, and enhanced liability protection offered by these offshore entities may make them worthwhile investments for individual physicians or group practices.

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Fortune 500 companies have long used Captive Insurance Companies (CICs) to manage risks and gain tax advantages. In the last decade or so, medical groups have begun to take advantage of them as well. Certainly, CICs can be ideal tools for physicians if they are established and maintained properly, and if they are suited to a practice's needs.

The CIC is a legitimate insurance company, licensed to write insurance in the U.S. and registered with the IRS, but typically based in an off-

shore jurisdiction, such as the British Virgin Islands. Most CICs are established in countries which have favorable insurance laws and tax treatment, although funds in CICs can be maintained and managed in the U.S.

The physician or group practice writes premiums to the CIC. The physicians then direct the CIC as to how to use these funds to protect against the risk. They can simply invest the funds, allowing them to grow, or they can pur-

chase a separate re-insurance policy through the CIC for a certain amount and invest the balance for growth. Reinsuring may be necessary only to cover a more immediate risk, particularly early in the life of the CIC. Either way, the invested funds or the additional insurance policy protect the physicians and the practice against various liabilities.

The CIC has a number of risk management benefits. First, a physician can use the CIC to supplement his existing

malpractice policy so that he will not be wiped out by a lawsuit award in excess of traditional coverage limits. As doctors see more and more outstanding jury awards in medical malpractice cases (such as the one recently reported in Los Angeles for \$6.6 million), this protection can be significant. Further, the CIC may even allow the doctor to reduce existing insurance coverage, as the CIC policy will step in to provide additional coverage, if needed.

In addition, the physician's CIC has the flexibility to add coverage for liabilities ignored by traditional malpractice policies, such as wrongful termination, harassment, or even HCFA violations. The awards in these areas can be

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CASE STUDY

Dr. Steve and His Captive Insurance Company (CIC)

Dr. Steve is a successful physician in Phoenix who was concerned about protecting his assets from a judgment beyond his \$1 million/\$3 million policy and wanted to build tax-favored wealth beyond his profit-sharing plan. He established a CIC individually. Let's take a look at the benefit Dr. Steve enjoyed from his CIC:

Effects on His Practice's Bottom Line

	Before the CIC	Year 1
Malpractice protection coverage	Traditional \$1/\$3 million	Traditional (\$1/\$3) plus additional \$2 million
Practice income (net)	\$300,000	\$300,000
CIC premium paid	\$0	\$100,000 ^a
Personal income: stock transactions	\$75,000	N/A
CIC income: stock transactions	N/A	\$75,000
Taxable income	\$375,000	\$200,000
Federal & state income taxes ^b	\$168,750	\$90,000
Adjusted after-tax wealth ^c	\$206,250	\$285,000
After-tax costs associated with the CIC		\$22,500
Benefit to Steve's bottom line		\$56,250

(a) Deductible premiums can be as high as \$1.2 million per year. (b) Assumes combined federal and state income tax rates of 45 percent. (c) Exclusive of transactions costs.

Building His Tax-Free Nest Egg

	Before the CIC	Year 1	Year 2	End Year 10 (projected)
Annual premium paid to CIC	N/A	\$100,000	\$100,000	\$100,000
CIC income: return on prior reserves	N/A	\$10,000*	\$21,000	\$159,374
CIC reserves	N/A	\$110,000	\$221,000	\$1,753,117

*Assumes 10 percent return on investments. The CIC will pay no tax on its earnings.

over \$1 million per case, so physicians are well advised to use the CIC for this purpose alone.

Although physicians may be able to obtain insurance policies to cover such liabilities from traditional insurers, they would not enjoy the powerful tax advantages that a captive insurance company would provide. If you are going to use insurance to protect against risk, why give away the potential tax benefits to the insurance company when you could own the company yourself? Let's examine this more closely.

Tax benefits

You may not realize that to this point, you have been "self-insuring" against potential losses like the ones named above. You have savings or a cash reserve which will be used to pay any lawsuit expenses which arise. While this planning may be wise, you would be better off using a

CIC to insure against such risk. That is because premiums paid to the CIC are fully tax deductible, while amounts saved to "self-insure" are not. The CIC allows a doctor to get a full deduction each year of the money dedicated to protecting against the same risks she previously saved after-tax money to cover.

Moreover, when the physician "self-insures," the funds stay in her name or the name of the practice. Thus, they are available to lawsuit claimants, creditors, divorce proceeding, bankruptcy trustees, etc. Simply put, there is no asset protection tool shielding the "self-insured" funds.

Using the CIC, the physician has transferred such funds to an independent operating, fully-licensed insurance corporation. Any lawsuit, claim, divorce, tax or other action against the physician or her practice is completely separate from the CIC. Thus, the assets in the

CIC are ideally protected against any litigation risks. Use of the funds is at the complete discretion of the physician or group owner. Although obviously all legal claims must be met, whether you actually use the CIC funds to pay those claims is up to you.

When it comes time to dissolve the CIC, the experts who have helped you establish and maintain the CIC will help you decide on the best course of action. The simplest scenario is when the physicians retire, the CIC is closed and the stock is redeemed for a capital gain. The funds can also be distributed at regular intervals, in which case the tax advantages are similar to a retirement fund. Other, more complex plans which account for physicians leaving a covered practice and new physicians entering into coverage under the CIC, can be part of the CIC structure.

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No loss of control

The CIC structure allows for complete and discloseable control by the physician.

There is no need for the physician to trust any other person or entity with his assets.

To create a CIC structure properly, it is critical to use professionals who have expertise in the area—especially the attorneys, accountants, and insurance managers involved. Ideally, your CIC structure will involve a multi-national “big five” accounting firm or a subsidiary of such a firm. While this may mean that the CIC is more expensive than some of the cheaper alternatives touted on the Internet or at seminars, this is one area where doing it right is the only way to enjoy the CIC’s benefits and stay out of trouble with the IRS.

As you might expect, the professionals most experienced in these matters charge significant fees to create and maintain CICs. A small group can expect to pay about \$45,000 to set up the CIC and \$35,000 per year to maintain it. However, if your practice’s exposure to medical and non-medical risks outweighs the costs of the CIC structure, it’s a viable option. Given the CIC’s potential risk management and tax benefits, it can enhance the financial security of many individuals and practices. ■

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