

## Here's How to Bill Your *Best* Clients for an Incredible Planning Opportunity

Dear Tax/Finance Professional:

**Do your high-income clients think they pay too much tax on their income? Do they face business risks that could threaten that income? If so, a closely held insurance company, or CHIC, may help solve both problems – and make *you* a hero in the process!**

The CHIC lets your client deduct from \$60,000 all the way up to \$1,200,000 annually to fund potential insurance claims in the future. Your client funds that coverage annually based upon the needs and cash flow of the business. This gives them flexibility to change contributions to suit their unique cash-flow resources.

### What is a Closely Held Insurance Company?

**A CHIC is a licensed property and casualty insurance company that your client establishes separate from their operating company.** Your client can own the company directly, or establish an independent entity to own it. They can use coverage to supplement traditional property and casualty insurance for risks like legal defense or tax audit defense costs, product liability, or malpractice expense reimbursement coverage. They may even use a CHIC to replace commercial coverage in some cases.

**CHICs are generally formed outside the U.S. to take advantage of favorable regulations.** Offshore jurisdictions generally give your clients more flexibility to manage the CHIC's assets. And, while the company itself may be chartered outside the U.S., there's no requirement that the *assets* move outside the country. This lets the client's funds stay safely here in the U.S.

An offshore CHIC can elect favorable tax treatment usually elects to be taxed as a U.S. insurance company under I.R.C. §953(d). If the net written premiums received by the CHIC do not exceed \$1.2 million per year, then I.R.C. §831(b) lets the company pay tax only on its investment income and *not* on its insurance underwriting income.

**Example:** In 2008, your client contributes \$1 million in premiums to his CHIC and pays out \$100,000 in losses that year. That \$900,000 underwriting gain is *not* taxed; only the investment income it earns on its capital, reserves, and surplus is taxed.

**Insurance companies also avoid state income taxes.** The most significant state taxes (if any) for insurance companies are premium taxes, which for an insurance company like

this one, would be significantly less than income taxes on a non-insurance corporation with the same amount of income.

If the \$1 million in net premiums are paid by related companies and are deductible as ordinary and necessary business expenses for insurance premiums, then the related companies deduct a total of \$1 million in premium payments. But the CHIC avoids tax on that \$900,000 underwriting income. So, there has been a net financial gain to the group of related companies (including the CHIC) equal to the tax that would have been payable on the \$900,000. Depending on the state income tax rate applicable to those companies, this benefit would be worth \$300,000 to \$400,000 in that year alone.

**Proper structuring protects the CHIC's assets from claims against its owners.**

Creditors must deal with the insurance regulators in the insurance company's jurisdiction in order to reach those assets. Most insurance regulators would be reluctant to allow insurance company assets to be reached in this manner.

## **What Are the Benefits?**

Clients who structure their CHIC program correctly enjoy these benefits:

1. The operating company deducts reasonable premiums it pays for coverage from the CHIC.
2. The insurance company avoids income taxes on its underwriting income.
3. The insurance company avoids state income taxes.
4. If and when the company is liquidated, its assets will be distributed to the shareholders. At that time, if the proceeds distributed to the shareholders exceed their adjusted basis in the stock, the gain will be taxed at capital gain rates. That rate is currently just 15% for stock held for more than twelve months.

This favorable treatment on liquidation gives your clients two powerful tax benefits:

1. They can use proceeds from the sale of the company (net of the capital gains tax) at their shareholders discretion just like the proceeds from the sale of any other asset .
2. They can use the CHIC as an estate planning tool by designating their *heirs* as owners. This lets your clients gift shares in a company when it is established that has no initial value *without* affecting their estate tax unified credit.

## What's "the Catch"?

**It's important that your client understand that a CHIC is not a "tax dodge."** The CHIC must qualify as a bona fide "insurance company" in order to qualify for favorable tax treatment:

1. The IRS requires that the company be in the business of issuing insurance contracts. The term "insurance contract" is not defined in the I.R.C. or the regulations. However, in *Helvering v. LeGierse*, 312 U.S. 531 (1941), the Supreme Court held that insurance involves risk shifting and risk distributing. Thus, an insurance contract must shift the risk of loss from the insured to the insurer and must be part of a plan to distribute the risks of numerous insureds with an insurer.
2. In order to reach an adequate level of risk shifting and risk distribution, the IRS requires that either (1) a substantial portion (30% to 50%) of the covered risks of the insurer come from unrelated insureds; or (2) where the insureds are related to the insurer through common ownership, that the premium payments be distributed among a dozen or more insureds, with no one insured paying more than 15% of the total premiums. It's important to operate within the allowable safe harbors that have been established through case law.
3. The insurance company's premiums and reserves must be based on actuarial calculations. Simply declaring an arbitrary amount for annual premiums is not permitted, nor is basing premiums on industry averages or standards without using the services of an actuary.
4. The company's reserves must be certified by an actuary on an annual basis.

## What Does it Cost?

CHICs have traditionally cost north of \$50,000 to establish, plus \$45,000 or more each year to administer. This has put them out of reach of most business owners. But Benefit Administrative Services, LLC has pioneered the use of "unitized" CHICs. This lets us establish each "unit" for just \$6,000 and administer it for just \$5,500 more per year.

These fees make the CHIC a reality for clients who previously could only have dreamed of such a powerful tool.

## How Does it Work?

Here's what happens when your client chooses to take "the next step":

1. We assess your client's insurance needs.
2. We secure the services of an actuary to perform an actuarial feasibility study to define the financial parameters of the proposed CHIC's insurance program and to determine whether the insurance program makes financial sense.
3. We determine where to incorporate and license the CHIC and secure the services of an insurance manager in the jurisdiction.
4. We incorporate the insurance company and apply for an insurance license in the applicable jurisdiction.
5. Your client transfers sufficient assets to capitalize the company and provide adequate surplus.
6. Your client's new CHIC issues insurance contracts to your client and, if applicable, to certain unrelated third parties.
7. If applicable, we help your client reinsure some of the insurance company's risk with other insurers.
8. We file your client's 953(d) election, if applicable, and 831(b) election before the due date of the insurance company's initial income tax return.

**In short, we do it all on a turnkey basis.** The initial stages of organizing a CHIC (from initial assessment to the first issuance of insurance contracts) generally takes 60 to 180 days, depending on the complexity of the insurance program and on the speed with which the licensing jurisdiction processes the license application.

There are several ways that you can benefit from helping establish a CHIC. You can bill for your time and service in supervising formation. You can earn referral fees from BAS. Or you can earn commissions for investing the CHIC's premium reserves.

## **What's the Next Step?**

**If the CHIC sounds like an appropriate tool for your client, call Ed Lloyd at (704) 544-7600.**

We'll evaluate your client's needs and determine together whether our program is a good fit.

There's still time to create substantial savings in 2009. So don't delay!

