

# 2017 SMIC Update

What to do now.

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Physicians and medical practice executives are often looking for ways to protect the practice from potential claims, reduce risks, and reduce taxes. That is why small insurance companies (SMICs), often referred to as “captives” or “closely-held insurance companies,” have been popular planning tools for the last 20 years. In fact, those authorized under tax section 831(b) can trace their structure to this code section back to at least 1986.

However, just in the last year, we have seen several potential changes to how these companies are being looked at by the federal government, both good and bad. At the outset of 2017, this article provides an update on the changes impacting SMICs.

## WHAT IS A SMALL INSURANCE COMPANY (SMIC)?

The SMIC we will discuss here is a properly-licensed, US-based insurance company—domiciled in one of the states that have special legislation for small insurance companies. While some advisors promote insurance arrangements in small international jurisdictions to take advantage of lower creation and maintenance costs, we think it is advisable to domicile SMICs in the US. As several states’ captive insurance statutes allow formation for reasonable costs, we find domestic options to be the best choice.

## SMIC AS A RISK MANAGEMENT TOOL

Though it may have significant tax benefits, the SMIC must always be established with a real insurance purpose. There are requirements for an insurance company to be a facility for transferring risk and protecting assets. Practitioners who specialize in this area have found ways to maximize long term profit while reducing unnecessary risk within the insurance statutes. How risk is managed and how much risk can be insured in a captive will be answered based on your particular situation. The nice thing is that there is a great deal of flexibility in how the SMIC can benefit a client.

Specifically, clients can use the SMIC to supplement their existing insurance policies. The SMIC can insure deductibles, copayments, and excluded risks. Such “excess” protection gives the client the security of knowing that the company

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and its owners will not be wiped out by a lawsuit award exceeding traditional coverage limits. In this case, you could think of the SMIC as a tax-efficient, asset-protected war chest to cover potential future losses.

Most doctors are acutely aware of medical malpractice, but there are many other risks to doctors as employers and recipients of insurance (and Medicare). The SMIC can be used to protect the doctor and practice from employment liability, insurance audits, HIPAA defense and a variety of other risks that will vary based on your practice size, revenue, number of employees, and other factors. This protection can be of significant value and potentially very profitable to the SMIC if you manage risk well. In some instances, the SMIC may even allow the client to reduce existing insurance, as the SMIC policy will provide additional coverage.

Some doctors choose to use an SMIC to provide flexibility by using customized policies not easily found in the commercial space. For example, you may desire a liability policy that would pay your legal fees (and allow full choice of attorney) but would not provide any benefit to creditors or claimants (what we call “Shallow Pockets” policies). This prevents the client from appearing as a “Deep Pocket” (a prime lawsuit target). Avoiding this appearance is a valuable asset-protection strategy that is stressed in our book *For Doctors Only: A Guide to Working Less and Building More*.

The SMIC has the flexibility to add coverage for liabilities excluded by traditional general liability policies, such as wrongful termination, harassment, or even ADA violations.

Given that the awards in these areas can be over \$1 million per case, the SMIC can provide valuable protection here.

While these risk management and asset protection benefits remain unchanged, the federal government has recently implemented changes to the tax aspects of SMICs. We will describe those below.

### NEW STATUTE IMPACTING SMICS

In December 2015, Congress passed and President Obama signed a so-called “Tax Extenders” bill titled H.R. 34, which included Section 262 titled, “Modifications to Alternative Tax for Certain Small Insurance Companies.” This law, effective January 1, 2017, increases the potential annual coverage for an 831(b) SMIC from \$1.2 million to \$2.2 million—the first such increase in 30 years. It is also now indexed for inflation. This a great boon to SMICs which have up until this point been restricted to the \$1.2 million annual limit when their insured companies could justify higher premium amounts.

While this law expanded the annual premium limit, it also codified a restrictive ruling as to who can own 831(b) SMICs. In the past, many SMICs were owned by estate planning vehicles for future generations, such as trusts and family-owned limited liability companies. The new law limits the ability to have owners of the CIC different from the owners of the insured companies, virtually eliminating such estate planning options going forward. As a result, many clients with such estate planning tools in place must re-mediate their structures or close them and potentially open new SMIC structures that are compliant with this new law. (See below for more on closing such SMICs).

### NEW NOTICE REQUIREMENTS IMPACTING SMICS

In November 2016, the IRS issued Notice 2016-66 that impacts SMICs and their owners and advisors. This notice, while recognizing that 831(b) SMIC structures can be legitimate, also now states that such tools are considered “Transactions of Interest,” in the IRS’ efforts to reign in abuses in the field. This “Transaction of Interest” designation requires clients and advisors involved with 831(b) SMIC arrangements that meet the criteria in the Notice to file Form 8886 “Reportable Transaction Disclosure Statement” or Form 8918 “Material Advisor Disclosure Statement.” As one would imagine, the idea of having to file special notices to the IRS is troubling for many clients, even if their attorneys, CPAs, and captive managers feel that this is a positive development for the industry to weed out abusive players.

### WHAT TO DO NOW: YOU DON’T HAVE A SMIC

As we have discussed, 831(b) SMICs are still part of the tax code and the new favorable statute went into effect on January 1, 2017. On the other hand, the new reporting requirements

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may prove to have a chilling effect on clients considering implementation of a new SMIC—as many clients may not want to step into an environment where they will need to send a disclosure to the IRS about their “transaction of interest.”

Two other factors may lead to a prudent “wait and see” approach: (1) a few tax court cases on SMICs that may further impact the area are expected to be decided in the first half of 2017; (2) the new Administration in Washington, with a new Treasury secretary, may change priorities for the IRS which could also impact the area.

### WHAT TO DO NOW: YOU ALREADY HAVE A SMIC

Clients who already have SMICs in place will likely be subject to the reporting requirement even if they close their SMICs in 2017—although such clients should discuss with their captive managers and tax advisors to be sure. In our experience, many SMIC owners are now seriously considering closing their existing captive, not only because of the new notice requirements, but also to comply with the new overall-beneficial statute.

Per above, while this statute expanded the possible insurance premiums per year by \$1 million, it also restricted the types of owners who can own the SMIC going forward. For many SMIC owners who had an estate planning element of their SMIC structure, the new law means they must shut down their existing SMIC and start up a new one. For others, closing is just one of several options.

Regardless, because of the new notice requirements and changes due to the estate planning elements of the new statute, most SMIC owners need to do something. Many of them are now looking at the economics of several different exit strategies, if only to keep their options open—and perhaps finally get some liquidity out their SMIC.

### CONCLUSION: SMICS CAN BE GREAT TOOLS, BUT NEW REQUIREMENTS ABOUND

Because successful doctors have significant risks, are interested in better management of these risks, desire asset pro-

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tection, and want to build tax-favored wealth over the long term, there is a good reason to review the benefits of the SMIC as an important planning tool—although a “wait and see” approach may now be prudent.

Additionally, clients who have SMICs in place are looking at exit strategies as new IRS changes and requirements are implemented. We are actively helping clients analyze such exit strategy numbers and would be happy to speak with anyone interested in reviewing options regarding an existing SMIC. ■

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