CAPTIVE INSURANCE COMPANIES

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I. THE CAPTIVE INSURANCE COMPANY

A captive insurance company is an insurance company formed by a business owner to insure the risks of an operating business. The operating business pays premiums to the captive, and the captive insures the risks of the operating business. It must be operated as a real insurance company with reserves, surplus, insurance policies, policyholders and claims. It must be licensed as an insurance company in the venue where it is formed. The insurance policies and the risks covered thereunder must be based on professionally tested insurance experts to provide the same business risk/profit used by all insurance companies. There must be a clear insurable risk for each policy.

While the main focus of this outline will be on the tax benefits, both income and estate, of the captive, the captive provides the means by which a business owner can increase profitability by creating a profit inside the captive and reducing insurance costs in the operating company. The profitability at the insurance company level is higher for companies who have lower claim experience. This lower claim experience can also reduce the costs of insurance at the operating company level by increasing the amount of deductibles or coverages on many insurance policies already in existence at the operating company. The captive then invests the premiums at a profit, and by not having to pay out as many claims as the average insured (the basis upon which the premiums are calculated), additional profits are achieved by both companies.

In addition to these increased revenues, the administrative cost of running a captive is substantial lower than the administrative portion of the premiums charged by insurance companies, including agents commissions, advertising and costs of compliance, and administrative costs which is often based on salaries.

The existence of a captive is also useful in negotiating commercial insurance rates.

The typical insurance company analysis performed by all insurance companies is based on average claimed rates. If your client knows that its claim rate is low, then he also knows that his premium is probably more profitable to the insurance company than most insureds. This give the captive a strategy and opportunity to make more money on the premiums than the average insurance company. Not only are its expenses lower, the captive will not have other non-insurance investments such as real estate, mortgages, etc., the risk of not making a profit is much smaller.

Some other benefits include:

- increased claims control;
- access to reinsurance markets which is usually only available to a licensed insurance company; and
- better policy terms.

Contrary to popular belief, captives are not just for big public companies (most of which own captives). Because of increased use and clear tax understanding, these entities are being set up for smaller companies and professionals who wish to accomplish the above-described goals.

For the smaller groups, the cost of setting the captive up and maintaining it are not nearly as expensive as you might think.

II. INCOME TAX TREATMENT

A. DEFINITIONS

IRC §816(a)(2) defines "insurance company" as "any company more than half of the business of which during the taxable year is the issuance of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Originally, the IRS challenged captives on a theory known as the "Economic Family". But the service lost these cases continuously, ending with its last effort in *United Parcel Service v. C.I.R.*, 254 F.3d 1014 (11th Cir. 2001). After giving up on its "Economic Family" argument, the IRS began to concentrate on the definition of "Insurance", which was defined by the U.S. Supreme Court when it held that "Historically and commonly, insurance involves risk shifting and risk-distribution." *Helvering v. LeGiuse*, 312 U.S. 531, 615 Ct. 646 (1941).

1. Risk Shifting

Risk shifting occurs when risk is transferred to an insurer in return for the payment of premiums. The insureds can be related, however, there is no insurance when a subsidiary insures its parent. *Stearns-Rogers Corporation v. U.S.*, 774 F.2d 414 (1985); *Beech Aircraft Corp. v. U.S.*, 797 F.2d 920 (1986); *Gulf Oil Corporation v. U.S.*, 89 T.C. No. 70 (1987).

2. Risk Distribution

The primary IRS challenge is now on "risk distribution". Risk distribution is the method of reducing the danger of potential loss by spreading costs throughout a group. *Commissioner v. Treganowan*, 183 F.2d 288 (2d Cir. 1950). In other words, is the captive issuing a sufficient number of policies to different insureds? Risk is spread over some undefined number of claims and exists so long as one of the two following safe harbors is met:

a. At least 50% of the risks underwritten are for unaffiliated third-parties. Rev. Rule 2002-89 2002-2 C.B. 984 and 2002-90, 2002-2 C.B. 985. This can be accomplished by finding quality reinsurance risk to underwrite. Reinsurance typically set up amongst several captives by the captive insurance consultant.

b. Underwriting 11 or more separate insureds, even if they are affiliated with the captive (disregarded entities do not count). Rev. Rule 2005-40, 2005-2 C.B. 4.

3. Protected Cell Captive

A protected cell is a captive insurance company formed by a "sponsor". This protected cell company typically establishes multiple accounts, or "cells", each of which has its own name and is identified with a specific participant. Usually, the sponsor owns all of the

common stock of the captive, with all the non-voting preferred stock owned by cell participants. Each participant has its own separate preferred stock and is funded by each separate participant. All the premiums collected with regard to each recipient are defined to their specific cell, out of which their specific expenses are accumulated and offset. Income earned within the cell is paid out on an individual basis to each participant as dividends on his preferred stock. The assets of each cell are statutorily protected from the creditors of any other cell and from the creditors of the protected cell company. In the event a participant ceases to participate, the participant is entitled to receive a return of its assets within its cell.

4. Miscellaneous

A captive can be every type insurance company other than a life insurance company. IRC §831(a). A life insurance company is defined under IRC §816.

B. IRS REQUIREMENTS

1. In addition to fitting with the definition of an insurance company, all captives must meet the following criteria in order to be taxed as an insurance company:

a. The captive is regulated as an insurance company in whatever venue it does business;

b. An adequate amount of capital is present within the insurance company;

c. The insurance company is able to pay claims;

d. The insurance company's financial performance is adequate;

e. The captive's business operations and assets are kept separate from the business operations and assets of its shareholders; and

f. The captive maintains separate financial reporting from the parent and any affiliated companies.

2. In addition, the captive must also operate like an insurance company, including:

a. The insured parties truly face hazards;

b. Premiums charged by the captive are based on commercial rates;

c. The risks are shifted and distributed to the insurance company, since the entities are commercially and economically related;

d. The policies contain provisions such that the covered risks may exceed the amount of premiums charged and paid;

e. The validity of claims are established before payments are made;

f. The premiums of the operating subsidiaries were determined at arms-length;

g. The premiums were pooled such that a loss by one operating subsidiary is borne, in substantial part, by the premiums paid by others; and

h. The captive and its insureds conducted themselves in all respects as unrelated parties would in a traditional relationship.

C. INCOME TAXATION

1. If the captive qualifies as an insurance company under IRC §831(a), so long as the net premiums for the taxable year are greater than $350,000 but do not exceed $1,200,000 and the permanent election required by IRC §831(b)(2)(ii) is made, the captive will be subject to corporate income tax only on its investment income. IRC §831(b). Thus, a captive does not pay income tax on ordinary income up to $1,200,000.

2. IRC §834 states that taxable investment income is gross investment income from:

(i) interest;
(ii) rents;
(iii) royalties;
(iv) gains from the sale of exchange of capital assets; and
(v) income from partnership.

LESS deductions including:

(i) tax-free interest under IRC §103;
(ii) investment expenses;
(iii) real estate expenses;
(iv) depreciation;
(v) interest paid or accrued;
(vi) capital losses;
(vii) dividend received deductions;
(viii) trade or business expenses other than those attributable to the insurance business; and
(ix) depletion.

3. The payment of reasonable premiums by an ongoing business to a captive insurance company are deductible for federal income tax purposes. IRC §832(b). If not

reasonable, the entire deduction may be challenged by the IRS. If the IRS prevails and the deduction is disallowed, back taxes, interest and penalties may be assessed. If it can be shown that otherwise deductible insurance premiums were for coverage that was intended to be excessive, the courts have exercised their discretion to disallow all or part of that deduction. See Neonatology Associates, P.A. v. Commissioner, 115 T.C. 43 (2000), aff'd., 299 F.3d 221 (3d Cir. 2002). Accordingly, each participating Member's premiums should not be increased in a manner designed to achieve a refund of unused reserves at the end of the policy.

4. The entity must be a regular C corporation, not an "S" corp or partnership for tax purposes. See §1361(b)(2)(R) prohibiting insurance companies from electing "S" corp status.

5. "Controlled Groups" are defined under IRC §1503(a) - except that "more than 50%" shall be substituted for "at least 80%" - shall be treated as one for purposes of calculating the premium limits set forth in IRC §831(b)(2)(A).

6. Foreign domiciled insurance companies are subject to reporting requirements, the passive foreign investment company tax under IRC §1297, federal excise tax on premiums paid under IRC §4371. Foreign Captives usually make an election under IRC §953(d) to be taxed as a U.S. domiciling entity to avoid these problems.

III. ESTATE PLANNING

A. WEALTH TRANSFER

In addition to the business and income tax benefits described hereinabove, the payment of premiums by the operating company to the captive effectively transfers cash from the operating business into the captive. To the extent that the captive is owned by junior family members, a wealth shift has taken place. Moreover, because the premiums are deductible to the operating company and the first $1.2 million of premium payments to the captive are not subject to federal income tax, the operating company is in effect transferring pretax income into a vehicle that will not pay tax on such premiums and likely be shielded from the creditors of the owners of the operating company. This strategy can be accomplished by organizing the captive in a favorable asset protection venue and having the stock of the captive be owned (i) directly by the junior family members of the operating company shareholders, (ii) by a family limited liability limited partnership ("FLLLP"), or limited liability company ("LLC"), or (iii) by a trust for the benefit of the junior family members. This strategy should not trigger any adverse transfer tax consequences if the entity is owned by junior family member from creation without any fraudulent conveyance issues. Thus, up to $1.2 million of income tax can be transferred out of the business owner's estate every year without utilizing either annual gift exemptions or by a lifetime gift exemption. Such pre-tax premium income would, of course, be subject to the insurance risks applicable to the captive.

This type of family planning is commonly referred to as a closely-held insurance company ("CHIC"). There are a variety of ways to provide for the business owner's children:

1. The CHIC can be structured with the parents owning voting shares and the children owning nonvoting common or preferred stock. This keeps the parents in control but the majority of the value of the CHIC out of their estate. To the extent desired, preferred dividends, salaries or other compensation could be retained by the parents.

2. The children's share of the CHIC could be owned by a trust for their benefits. The benefits of this structure are:

a. The value of the CHIC is kept out of the parents' estate;

b. The value can be protected against the creditors of the operating company, the parents and the children (including future creditors, predators and ex-spouses);

c. A Generation Skipping Tax ("GST") dynasty trust would avoid estate tax for junior family members and their lineal descendants; and,

d. Taxation of the CHIC income may under certain circumstances be borne by the beneficiaries, which may be useful if they are in a lower bracket than the parents. Alternatively, the income tax burden can be borne by the parents of the trust beneficiaries to the extent a defective grantor trust created by the parent is the owner of the shares.

3. The stock of the CHIC could also be owned by an LLLP or an LLC which provides "charging order" protection to their equity interest holders. Caveat re current "Chinks" in the Armor of the LLC charging order.

B. <u>ASSET PROTECTION</u>

1. Rather than issuing the stock of the captive directly to the shareholder of the operating company (or to a holding company), for better asset protection, their stock could be issued to an offshore trust. Utilization of an Alaska, Wyoming, or Delaware asset protection trust also provides asset protection benefits; albeit, not as good as foreign asset protection trusts. Moreover, the registration and maintenance costs in the United States may not be as appealing as in offshore countries. In countries such as Nevis, the trust which owns the company’s shares should not be susceptible to piercing by creditors of the operating company or its shareholders, or the creditors of the children or their heirs. The states referenced above have not yet been proven in court to be as effective against creditors.

2. If the shareholder does not want to go to the expense of locating and operating an offshore company, a limited liability company ("LLC") or, better yet, a limited liability limited partnership ("LLLP") can be used to hold the captive stock. As long as it is a multi-membered entity located within a state that has sole "charging order" protection, the asset protection needs may be enough. However, the insurance requirements, the capital requirements and administrative costs of such state should be analyzed to confirm it really is cheaper. Some examples are Vermont, Arizona, Kentucky, Montana, Delaware, Maine, Nevada and Florida (with respect to LLLPs only). Vermont has been offering Captives on a reasonable basis for a

long time. Delaware has recently revised its statute to make it a more alluring venue for Captives.

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