

Small Captive Insurance Companies

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Presented To:

MSA Super Conference

Chicago, Illinois

August 5, 2011

Small captive insurance companies are an emerging device which can be used advantageously by mid-sized companies; a properly structured captive offers both added insurance coverage and enormous tax planning opportunities. When set up in line with IRS guidelines, a captive can receive up to \$1.2 million in premiums tax free from its parent company, who then receives a deduction for the amounts paid as a legitimate business expense. Proper structuring and implementation can be accomplished through the use of experienced professionals and advisors, who ensure all steps, are completed properly to seize all benefits available.

The information in this presentation will concern small captive insurance companies set up under IRC Section 831 (b); the information in this presentation is primarily applicable to pure captive insurance companies (a number of other types of captives, including association captives and special purposes captives, are permitted by certain jurisdictions).

Statutory Background for Captive Insurers

Case law, in tandem with IRS issuances, have established the validity of tax deductions for captive insurance arrangements, and given guidelines on how such entities are to be structured. Section 162(a) of the Federal Tax Code (“Code”) provides for a deduction for all ordinary and necessary business expenses incurred during a year while carrying on a trade or business. 26 U.S.C.S 162(a). Section 1.162-1(a) of the Federal Tax Regulations delineates what is included under Section 162(a)’s allowable deduction, and includes “insurance premiums against fire, storms, theft, accident, or other similar losses in the case of a business.” 26 CFR 1.162-1(a). Validity of the deduction sought under Section 162(a) has thus hinged on whether captive arrangements are to be considered “insurance” under the Code.

Section 831 of the Code provides for the taxation of insurance companies; Section 831(a) provides that taxes “shall be imposed for each taxable year on the taxable income of every insurance company other than a life insurance company.” 26 U.S.C.S. 831(a). However, Section 831(b)(1) offers an exception to this general rule, stating that certain insurers may elect to have only their investment income taxed at applicable corporate income tax rates. 26 U.S.C.S. 831(b)(1). Section 831(b)(2) provides that such exception applies as follows:

“This subsection shall apply to every insurance company other than life ... if--

(i) the net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed \$1,200,000, and

(ii) such company elects the application of this subsection for such taxable year.

The election under clause (ii) shall apply to the taxable year for which made and for all subsequent taxable years for which the requirements of clause (i) are met. Such an election, once made, may be revoked only with the consent of the Secretary.”

26 U.S.C.S. 831(b)(2).

Under the requirements of Section 831(b)(2), a captive insurer (or any insurer) is limited to \$1.2 million in premiums per year if it wishes to avoid taxation on non-

investment income. The company must also elect to be taxed under this section; if not electing, default taxation will be of all income under Section 831(a). Multiple captives (each receiving less than \$1.2 million in premiums annually) can be set up to provide greater benefits. However, companies setting up multiple captives must ensure that each captive is owned by a different party and ensure that no attribution of ownership will occur in order to avoid classification as a controlled group. Premiums received by the captive are not taxed until they are distributed to the captive's shareholders. Such distributions are deemed to be dividends, includable in the gross income of the recipient and are considered qualified if held for more than twelve (12) months. 26 U.S.C.S. 301(c). Under provisions of the Code, qualified dividends are taxed at the capital gains rate; this rate is currently set at 15%. 26 U.S.C.S. 1(h). At cessation of the captive insurance company, any funds remaining within the captive are distributed to shareholders, and correspondingly taxed at the capital gains rate. *Id.*

Section 831(c) of the Code states that the definition of an insurance company shall be provided by Section 816(a); Section 816(a) states that an "insurance company" shall be "any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies." 26 USCS 816(a). The deductibility of premiums paid, and the exemption for small insurers, thus depends on whether the company's activities are to be considered "insurance" for tax purposes.

Captive Insurance Authority

The concept of "insurance" is not defined within either the Code or its accompanying regulations; guidance on what constitutes as "insurance" for tax purposes, and how captives are to be structured in order to be considered valid insurers, has thus primarily come from case law and issuances by the Internal Revenue Service ("IRS"). The first guidance on how the concept was to be defined came from the Supreme Court in *Helvering v. LeGriese*, a 1941 case. *Helvering v. LeGriese*, 312 U.S. 531 (1941). The case centered upon whether an insurance policy taken out by a decedent should be considered 'insurance' (and thus excluded from the decedent's gross estate for federal tax purposes). *Id.* at 537.

The Court began its analysis by pointing out the dearth of guidance from governmental sources, and then pointed out the concepts of risk shifting and risk distribution which previously had been promulgated by the courts. *Id.* at 539. Because the laws relating to the decedent's deductions were relatively new, and that, in passing the laws, Congress made explicit mention of the term insurance without making any attempt to define it, the Court determined that Congressional intent was to give the term its common meaning – that is, the one previously promulgated by the courts. *Id.* at 540. In the matter presented before it, the *Helvering* Court determined that the two elements of insurance, risk shifting and risk distribution, were not met: the 'insurance' contract was sold only in conjunction with an annuity contract, thereby counteracting any risk validly taken on by the insurer. *Id.* at 541.

The IRS's initial view of transactions where a parent company paid premiums for insurance to a subsidiary was that they were not valid, as they did not achieve adequate risk distribution. The IRS first espoused this theory in Revenue Ruling 77-316, concerning numerous structures where parent companies and their subsidiaries paid insurance premiums to a related captive insurer (stating such an arrangement would not be valid insurance). Rev. Rul. 77-316. The ruling set forth three situations. In the first, a parent and its subsidiaries were insured directly by another subsidiary of the parent. In the second, a parent and its subsidiaries engaged in an insurance arrangement with an unrelated entity, which then entered into a reinsurance agreement with a subsidiary of the parent. In the third, a parent and its subsidiaries were insured directly by another subsidiary of the parent; the insuring subsidiary then entered into reinsurance agreements with an unrelated entity. *Id.*

The ruling began its analysis with the risk shifting and risk distribution concepts discussed in *Helvering*, and also pointed out the IRS's long-standing view that, where a taxpayer holds funds in reserve as self-insurance, no deduction would be allowed. *Id.* The Ruling declared that, under all three arrangements, no valid risk shifting occurred; in all three, the IRS felt that the risk was retained by members of the parent's "economic family." *Id.* Under this view, the party bearing the risk of loss was thus also the party who would be suffering the loss itself, and the arrangements were determined to be tantamount to self-insurance. *Id.* No deduction was allowed, because, under this view, the amounts paid by the parent remained within its economic family, and thus no amounts had been "incurred" validly as required under Section 162. *Id.*

Humana, Inc. v. Commissioner – Parent and Captive as Separate Entities

The "economic family" theory of Revenue Ruling 77-316 was summarily rejected by the Sixth Circuit Court in *Humana, Inc. v. Commissioner*, a 1989 case concerning a captive arrangement. *Humana, Inc. v. Commissioner*, 881 F.2d 247 (1989). In the case, Humana (a hospital operator), after having its commercial coverages terminated, established a captive insurer to insure both Humana and its subsidiaries. *Id.* at 248. Humana and their subsidiaries took a deduction under Section 162(a) for the amounts paid as insurance; the Commissioner, under Revenue Ruling 77-316, disallowed the deductions involved, and the Tax Court initially upheld the Commissioner's determination (while stating that it was rejecting the "economic family" determination of Revenue Ruling 77-316, the Tax Court reasoned that no insurance existed in the present matter because no risk shifting occurred). *Id.* at 248-249. Humana then appealed the ruling of the Tax Court to the Sixth Circuit. *Id.*

The Court in *Humana* began its analysis by stating its concurrence with the Tax Court on the determination that premiums paid by Humana to the captive were not to be considered insurance, because no valid risk shifting occurs between the parent and the insurer (and these sums are thus more of a loss reserve than valid insurance). *Id.* at 251. However, the Court reversed the Tax Court's determination on the deductibility of insurance premiums paid by Humana's subsidiaries to the captive. *Id.* at 252. The Court emphasized that Humana and its subsidiaries should be treated as separate entities; as

such, payments from a subsidiary to the captive should not be considered a loss reserve (as the captive, while related to each subsidiary, is not a subsidiary of any entity but Humana). *Id.* Because of this, valid risk shifting could be found, and because risk distribution also was determined to exist, the insurance arrangements between Humana's subsidiaries and its captive were determined to be valid, deductible insurance agreements. *Id.*

In making this determination, the Court cited that the insurance company itself was formed validly under the laws of Colorado, and that the subsidiaries themselves contributed no amounts to the initial capitalization of the captive (these amounts were contributed only by Humana). *Id.* at 253. The Court stated that the economic reality of a transaction is to determine the validity of its taxation; while the captive is owned by the parent entity, no such relationship exists between the captive and the parent's subsidiaries. *Id.* In this way, the Court reasoned that, while the Tax Court stated it rejected the economic family doctrine, the Tax Court's determination of invalidity of insurance between the subsidiaries and the captive required them to dismiss the economic reality that the subsidiaries were separate legal entities. *Id.* at 254. As separate entities need to be respected as such, the only way to regard the premiums paid by the subsidiaries to the captive as not constituting valid risk shifting would be application of a modified version of the "economic family" theory of Rev. Rul. 77-316; such application was determined by the *Humana* Court to be improper. *Id.* at 255.

Harper Group v. Commissioner – Further Rejection of Economic Family Doctrine

The Tax Court in part recanted its prior support for the IRS's position that no risk distribution exists where a parent pays premiums to its captive subsidiary in *Harper Group v. Commissioner*. *Harper Group and Includable Subsidiaries v. Commissioner*, 96 T.C. 45 (1992). The case centered on a holding company which held a number of subsidiaries; the holding company then established a captive insurer to insure the risks of these subsidiaries. *Id.* Harper and its subsidiaries had previously obtained insurance on the commercial market; however, because of issues which had arisen with its commercial insurers, the companies formed a captive to replace them. *Id.* at 49. The captive conducted itself fully as an entity separate from the holding company, and the liabilities of the captive's insurance contract were fully borne by the captive. *Id.* at 50. Additionally, the captive did not solely insure Harper Group; approximately 30% of the insurance it wrote was for unrelated entities (specifically, customers of Harper Group). *Id.* at 51. The captive also obtained reinsurance on the open market to cover the risk of losses which were very large. *Id.* at 53.

The Court's opinion in *Harper Group* began by differentiating it from past precedent on captive insurers, in part because of the fact that the captive insured risks from unrelated parties; thus, the Court was not bound by rulings in the prior cases. *Id.* at 56. In its analysis of the present matter, the Court again rejected the "economic family" theory proffered by the Commissioner (as it had also done in *Humana*, as noted previously). *Id.* at 57. Based on expert opinions heard during the case, the Court introduced the idea that, to determine validity of an insurance arrangement, the agreement

should be examined from the perspective of both the insured and the insurer, stating: “From the insured's perspective, insurance is protection from financial loss provided by the insurer upon payment of a premium, i.e., it is a risk transfer device. From the insurer's perspective, insurance is the pooling of a large number of similar risks of a group of insureds out of which pecuniary benefits for a fortuitous loss to any insured member are paid, i.e., it is a risk distribution device.” *Id.*

The Court then stated that whether a captive insurance arrangement should be considered valid insurance would be determined based on the facts and circumstances of each case, and must meet three prongs: a valid insurable risk must exist, risk shifting and risk distribution must occur, and the arrangement must be for “insurance” in the commonly accepted sense of the term. *Id.* In *Harper Group*, the first prong was met easily – the captive insured risks previously provided for as insurance by the commercial market. *Id.* at 58.

As to the second prong, the Court determined that, where a sufficient number of unrelated insured parties exist, risk distribution could validly occur; here, 30% was seen as a sufficient number. *Id.* at 59. By pooling risks together and using the pooled premiums to pay for any losses incurred, the captive is able to establish itself as a valid insurer. *Id.* Risk shifting also was determined to exist – the captive was validly incorporated as a separate entity from the other subsidiaries, and, according to the Court, should be respected as such. *Id.* The captive negotiated premiums with its insured parties (both related and unrelated) at arms length; it was also liable to pay claims where they occurred (and in fact did so). *Id.*

For the third prong, the arrangements constituted “insurance” in the commonly understood meaning of the term – as previously mentioned, the captive was validly incorporated as an insurance company and held significant capital in order to pay out claims once compensable events occurred. *Id.* at 60. The Court thus held that the captive was engaged in valid insurance arrangements, and all funds paid to the captive by Harper Group were deductible insurance expenses under Section 162(a). *Id.* The Court also clarified that premiums paid by Harper Group to the captive were not to be regarded as dividends (the Commissioner alleged that this is how the payments should be classified if valid insurance agreements were not found to have existed). *Id.*

Revenue Rulings: IRS Abandons Economic Family Doctrine

The IRS finally abandoned the “economic family” doctrine of Revenue Ruling 77-316 in Revenue Ruling 2001-31. Rev. Rul. 2001-31, 2001-1 C.B. 1348. Rather, the IRS determined that the validity of a captive insurance engagement as a valid insurance transaction would be determined on a case-by-case basis. *Id.* The Ruling cited the lack of support from the courts (noted above) for the “economic family” doctrine as its rationale for abandoning the approach. The Ruling did make clear, however, that the Service would continue challenging captive insurance transactions they felt were invalid; however, limited guidance was provided on what would constitute an invalid arrangement. *Id.*

The IRS later gave guidance on how captives could be structured to avoid scrutiny in three consecutive Revenue Rulings. In Revenue Ruling 2002-89, the Service provided the first safe harbor for captive insurers. Rev. Rul. 2002-89, 2002-2 C.B. 984. The Ruling proposed two situations – in both, a corporation opens a captive subsidiary to insure its professional liability risks; the subsidiary also insures professional liability risks from unrelated entities. *Id.* The only distinction between the two situations was the amount of unrelated risks insured – in the first situation, unrelated risks accounted for 10% of the risks insured by the captive, while unrelated risks constituted less than 50% of the risks insured in the second. *Id.* Analysis began by pointing out that no court has ever held that a captive subsidiary insuring only its parent constituted valid insurance; some insurance of outside parties must occur. *Id.* According to the Ruling, a captive insuring its parent’s risks can still be held to be valid insurance where unrelated risks are insured and where the three prongs of the test in *Harper Group* are met. *Id.* The Ruling held that, where only 10% of the captive’s insurance premiums regard unrelated risks, inadequate risk shifting and risk distribution has occurred for it to be considered a valid insurer. *Id.* However, where less than 50% of the captive’s insurance premiums are for unrelated risks, risk shifting and risk distribution will exist, and, if the arrangement meets the other requirements of the three-prong test, a valid insurance agreement will be found to exist between the captive and its parent. *Id.*

Revenue Ruling 2002-90 evaluated how multiple entities owned by the same parent affected the presence of risk shifting and risk distribution. Rev. Rul. 2002-90, 2002-2 C.B. 985. In the Ruling, a parent holding company had twelve subsidiaries engaged in business throughout the United States; each subsidiary operated the same type of business but had individualized risks. *Id.* The holding company then opened a captive insurer for valid, non-tax purposes; the entity solely insured the risks of the twelve subsidiaries. *Id.* Each of the subsidiaries constituted at least 5% of the captive’s premiums, but no subsidiary constituted more than 15% of the captive’s premiums written. *Id.* Negotiations of all premiums are stipulated to occur at arms’ length, and the captive itself is properly licensed. *Id.*

The Ruling analyzed the risk shifting and risk distribution requirements for insurance, and stated that, for the latter to exist, a pooling of premiums from numerous entities must occur so that no one entity could potentially be paying for its own risks in large part (thereby engaging in self-insurance). *Id.* On the concept of pooling and its effects on insurance, the Ruling stated, “[b]y assuming numerous relatively small, independent risks that occur randomly over time, the insurer smoothes out losses to match more closely its receipt of premiums.” *Id.* In the situation presented, the Ruling stated that sufficient risk pooling existed so that any loss experienced by one subsidiary would be borne mostly by the premiums paid by the other entities. *Id.* Because of this, valid insurance was seen to exist, and the fact that all twelve entities were owned by a common parent did not adversely affect this determination (because all involved entities fully conducted themselves as separate units and thus were required to be regarded as such in analysis of the insurance arrangements). *Id.*

Revenue Ruling 2002-91 presented a situation where a number of unrelated entities set up a group captive insurer to provide coverage for their risks. Rev. Rul. 2002-90, 2002-2 C.B. 991. The companies were involved in an industry which experienced significant loss events, high enough so that commercial coverage of their risks could not be obtained without paying huge premiums. *Id.* The industry also faced significant regulation, in part requiring all companies to maintain adequate insurance. *Id.* To this end, a number of companies unified to form a group captive; the group captive provided insurance coverage only to member companies (from which it maintained a separate existence). *Id.* An unspecified number of entities were involved as members; each member constituted less than 15% of the captive's premiums. *Id.* The Ruling pointed out an analogous situation presented in a previous ruling: in Revenue Ruling 78-338, 31 unrelated entities forming a group captive were found to have engaged in a valid insurance arrangement. Rev. Rul. 78-338, 1978-2 C.B. 107. In drawing from this ruling, Rev. Rul. 2002-91 determined that the arrangement presented constituted valid insurance for all parties involved – adequate risk shifting and risk distribution was determined to have occurred in part because each member had the potential to incur a loss greater than the premiums which it paid (and, if this occurred, the entity suffering the loss would not be required to pay in additional funds – as such, the risk of loss was pooled among all involved entities, as in Rev. Rul. 2002-90). *Id.*

Revenue Ruling 2005-40 was later issued in part to provide a clarification of and limitation for the holding of Revenue Rulings 2002-89 and 2002-90. Rev. Rul. 2005-40, 2005-2 C.B. 4. The Ruling presented four situations; in the first, a company (X) enters into an agreement with another company (Y) to insure its risks for valid, non-tax purposes; (X) is the only company which (Y) insures. *Id.* The second presents the same situation, except that the company insuring the risks (Y) also enters into an agreement with another unrelated company (Z) to insure its risks; (Z)'s risks constitute approximately 10% of the risks insured by (Y). *Id.* Under both situations, the Ruling stated that a valid insurance agreement could not be found. *Id.* Though risks were shifted (since the entities were unrelated), these risks are not adequately distributed among other parties to the extent required by valid insurance arrangements. *Id.* In the first, no distribution of any kind occurred; in the second, only 10% of the premiums came from sources besides (X), a setup that had previously been deemed inadequate by Rev. Rul. 2002-89. *Id.*

The third and fourth situation presented by Rev. Rul. 2005-40 delved into a fact pattern similar to the one presented by Rev. Rul. 2002-90 and provide further clarification to the portion of Rev. Rul. 2002-89 addressed by the first two situations. *Id.* In the third situation, a corporation conducted a courier business through the use of twelve limited liability companies; the LLCs were disregarded entities. *Id.* The LLCs entered into an arrangement with an unrelated entity to obtain insurance coverage for valid, non-tax purposes; each entity accounted for at least 5%, but not more than 15%, of the insurer's business. *Id.* As in the first situation, the LLCs are the only entities insured by the insurer. *Id.* In the fourth situation, the same arrangement occurred, except the LLCs elected to be treated as associations. *Id.* The Ruling determined that, while the facts of the third situation do not constitute insurance, the fourth does. *Id.* Under Section

301.7701-2(a), where an entity chooses to be treated as disregarded, its activities will be treated as being the same as the owner's. 26 CFR 301.7701-2(a). Because of this, all twelve entities are treated as one for risk distribution purposes; because the insurer only insures these risks and no others, it is treated as insuring only one entity (the parent of the disregarded entities), and no valid insurance agreement thus exists. *Id.* However, under the fourth situation, the entities are respected as separate from the owner as associations; the situation presented here is thus analogous to Rev. Rul. 2002-90, and valid insurance agreements were determined to exist. *Id.*

Private Letter Rulings – Further Backing for Captive Insurers

Since these rulings, a number of private letter rulings have been issued further supporting the legitimacy of properly structured captive insurance arrangements. PLR 200907006 concerns a company attempting to obtain an advance ruling on its captive structure. PLR 200907006. The company requesting the ruling had established a captive insurer in a foreign country; the captive was set up to fully conform with the laws of the jurisdiction. *Id.* The captive insured two companies (a parent and its subsidiary) and five partnerships, and offered employment related practices liability policies, executive liability policies, commercial crime policies, and a policy related to business-specific coverages (all insureds operate in similar lines of business). *Id.* The captive then cedes these risks to a reinsurance pool in which it participates; each insurer operating in the reinsurance pool assesses risks based on actuarial studies and investigates risks before paying out any claims. *Id.* The captive itself is stipulated to be well capitalized, and no individual company will account for more than 15% of the risks insured by the captive within the reinsurance pool. *Id.*

In its analysis, the Ruling discussed Rev. Rul. 2002-91, illustrating how the group captive formation achieved risk shifting and risk distribution. *Id.* The Ruling then drew a parallel to how the present company operates; stating that, on the direct policy level, the group captive and the captive in the present ruling operate in a similar fashion. *Id.* The Ruling itself went on to state that the captive had achieved adequate risk distribution and risk shifting on the direct level with the seven entities (two companies and five partnerships) insured; according to the Ruling, the captive “is functioning as an insurance company both as a direct writer and as a reinsurer.” *Id.* Accordingly, the Ruling determined that the captive was to be considered a valid insurer. *Id.*

PLR 200950016 concerns a captive incorporated for the benefit of a number of entities; these entities were also insured by an unrelated commercial insurer. PLR 200950016. The unrelated insurer retains most of the risks insured; however, for a portion of the risks, it engages in an agreement with a reinsurer, who then also reinsures a portion of the risks involved. *Id.* The second reinsurer then provides quota share reinsurance to the captive (as well as a number of other entities); the reinsurance of risk pursuant to the quota share reinsurance arrangement is the only business in which the captive is engaged. *Id.*

The captive requested rulings that the reinsurance arrangement should be classified as insurance, and that the captive itself should be classified as an insurer. *Id.* The Ruling stated that, on the first issue, both risk shifting and risk distribution was present. *Id.* The Ruling classified reinsurance as basically being tantamount to “insurance for insurers;” here, since the underlying agreements between the unrelated insurer and the entities insured were found to have all the required elements of insurance, the reinsurance agreement was found to be a valid insurance agreement. *Id.* On the second issue, the captive was found to be a valid insurer; its only business was the reinsurance agreement which, as stated above, was found to be valid insurance. *Id.*

PLR 201114015 centers around a letter request from a medical practice engaged in staffing health care centers. PLR 201114015. The center proposed to form a risk retention group in tandem with a number of other medical practices for valid, non-tax purposes; the risk retention group provided medical malpractice insurance for risks underserved on the commercial market and extended reporting coverage for physicians no longer in practice. *Id.* A holding company owned varying amounts of the practices which formed the risk retention group – it owned the majority of some, a minority interest in others, and had no ownership interests in a few of the remaining group members. *Id.* Some of the practices were treated as disregarded entities for federal tax purposes; others were not (the letter provided limited specificity on both the number of DREs involved and the details of the holding company’s ownership share in each entity). *Id.* The practices involved in the risk retention group put in place stringent hiring standards (evaluating the potential risks carried by each physician in their practice) for new physicians. *Id.* No entity made up more than 15% of the risk pool of the group, and the risk retention group made no loans to any member practice. *Id.*

In its analysis, the Ruling drew an analogy from its fact pattern to Rev. Rul. 2002-90, and determined that the proposed structure given in this letter would constitute valid insurance for federal tax purposes; the Ruling also determined that valid risk shifting and risk distribution was present. *Id.* The letter itself unfortunately does not indicate how many entities are insured by the risk retention group or how many of these entities are not disregarded (though, by reference to each comprising less than 15% of the premiums paid, there is a minimum of seven non-disregarded entities insured). *Id.*

Lessons from Case Law on Proper Captive Approach

Based on the thorough amount of authority presented above, it is abundantly clear that captives, when properly structured, are to be considered valid insurers. Captives can thus take advantage of tax benefits relating to insurance companies (i.e. those provided by Section 831 (b)), and the entities insured are entitled to tax benefits related to paying for insurance from them (i.e. the deduction under Section 162). However, as specified in a number of the rulings above, captives must be entered into for valid, non-tax purposes; valid business reasons beyond tax deductions must motivate the decision to form the captive. To this end, captive managers assess risks faced by a company for which current coverage is either lacking or nonexistent; the amount of coverage required for such risks,

and the premiums required to provide this amount, are then determined through actuarial analysis (via processes described in more detail later in this presentation).

It is advisable to structure the captive itself conservatively in order to ensure compliance with the IRS guidance detailed above. In accordance with *Harper Group*, the typical captive will have more than 30% of its risks insured come from unrelated entities. In accordance with Rev. Rul. 2002-90, each entity insured by the typical captive will comprise between 5% and 15% of the captive's premiums written. While allowing a captive to have unrelated entities provide less than 30% but more than 10% of its premiums (the gray area between *Harper Group* and Rev. Rul. 2002-89) or having one of the entities insured by a captive make up for more than 15% of its premiums would not necessarily be fatal for the captive's viability (as no case law against such a structuring exists), doing so runs a risk of potentially having the captive subject to litigation and invalidation (since the IRS has yet to sign off on such a structure). Structuring the captive in full compliance with the IRS safe harbors outlined above both lessens the likelihood of examination by the IRS and ensures that, if an audit occurs, the captive will be respected as valid.

Domicile of Captives

As mentioned within the case law outlined above, captives must be established validly under the insurance laws of its chosen jurisdiction; captives may be set up either onshore (i.e. established and incorporated under the laws of a state within the United States) or offshore (established outside the United States; Bermuda and the Cayman Islands are among popular choices for offshore captives). Under Section 953(d) of the Tax Code, a captive insurance company domiciled offshore can make an election to be taxed as a United States corporation. 26 USCS 953(d). Each jurisdiction maintains separate costs for establishment of a captive, and requires the captive to adhere to different requirements. The captive insurance company does not need to be domiciled in the same jurisdiction as its parent company (and in most cases will not be).

Initially, most captives were domiciled offshore to take advantage of favorable legislation in those jurisdictions. However, in recent years, onshore domiciles have passed legislation much more favorable to captives, sparking a growing trend of incorporating captives within the United States¹. Currently, thirty-four states provide for captive formation². There are significant benefits to onshore formation. Use of an onshore domicile seems likely to lessen the chances of audit by the IRS (as compliance with IRS and court mandates for captives is presumed to be more likely), and prior tax benefits to offshore formation have largely evaporated.

Choice of domicile is a number of factors which are variable based on a client's profile. Many domestic domiciles borrowed from each other when drafting captive legislation and as a result most captive statutes are similar. However, there are distinctions among domestic statutes which may be important to clients. Certain

¹ http://www.tax-news.com/news/Onshore_Domiciles_Attract_Captive_Formation____49174.html

² http://www.billingsgazette.com/business/article/_1c9e12db-1abf-5a6a-71ac-b0d3e38off17.html

jurisdictions require an annual board meeting in the state of formation, (S.C Code 1976 38-90-25 (B(2)) as well as requiring certain board members and/or incorporators be a resident of the jurisdiction . §38-90-55 (B) and E).

All domiciles require certain fees to be paid to become licensed within the state, and have yearly fees associated with maintaining the license. Jurisdictions also tax captives on the amount of premiums received. Fees are variable based upon the jurisdiction chosen; jurisdictions with lower fees hold obvious appeal. However, infrastructure provided within a jurisdiction to support captive formation and maintenance is another often-cited factor in choosing a domicile; jurisdictions with more experience in the captive realm are often preferable in this regard. Certain jurisdictions also offer greater flexibility in the lines of coverage available (a full discussion of lines of coverage in which a captive can engage will occur later in this presentation).

Another important factor in choosing a domicile is the amount of capital required at formation, and the flexibility in how this can be provided and invested. Most states require that a pure captive receive capital and surplus of no less than \$250,000 at inception. Ky. Rev. Stat. Ann. 304.49-040, S.C Code §38-90-40 (A)(1)(a) and S.C Code § 38-90-50 (A)(1)(a). Jurisdictions vary on how this start up funding can be invested however most prefer that it be invested in cash equivalents. Certain jurisdictions also allow this funding to be in the form of an irrevocable letter of credit. KRS 304.49-040. Jurisdictions also require financial statements to be filed for their captives; these reports detail the investment and insurance activities of the captive over the applicable period. KRS 304.49-070. Most jurisdictions also mandate the captive be examined by the domicile within a given timeframe (in Kentucky, for example, each captive is examined once every five years). KRS 304.2-210. Each jurisdiction also provides the commissioner within the domicile certain guidelines for suspending or revoking the license of the captive (once incorporated and approved); jurisdictions where discretion is narrow can be preferable.

Captives – An Illustrative Example of Benefits Involved

The tax benefits of using a captive as opposed to self-insuring can be illustrated by an example. A company operating without a captive still must insure the same risks as one operating with a captive; as previously detailed, all risks insured by a captive are legitimate, and would be encountered by the company irrespective of their decision to use a captive insurer.

Companies which do not use a captive (and who do not obtain coverage for a portion of their risks on the commercial market) are self insuring against these risks through self-insurance. These companies retain funds internally to deal with potential risks faced; as detailed above, the IRS does not consider this to be deductible insurance because there is clearly no risk shifting. If a company earns \$1.2 million of funds as a loss reserve to prevent against potential losses and retains them, these retained funds would be taxed as ordinary income at a current rate of 35%, leaving \$780,000. Pub. L.

111-312, 124 Stat. 3296, HR 4853. If this occurs over a period of ten years, the company will have \$7,800,000 in loss reserves to pay off potential losses.

Conversely, if a company uses a captive, it pays \$1.2 million to the captive rather than retaining these funds at the company level; it receives a full deduction for the amounts paid to the captive if the captive is structured properly. The captive itself will have costs associated with it; costs primarily concern funds paid to the captive management company and to the state in which the captive is incorporated. Costs are typically highest in the first year (where the captive manager is establishing the captive, and not primarily engaged in maintaining it). For purposes of this example, costs associated with the captive will be assumed to be \$80,000 for the first year and \$55,000 each year thereafter. As previously mentioned, the captive also can make investments of premiums to increase its available funds; for these amounts, it is taxed (though taxation depends on the type of investment in which the captive engages – certain investments will be tax-free). For purposes of this example, the captive will earn \$60,000 in investment income annually (projecting a 5% rate of returns on the captive's funds – from experience, this rate of return is conservative), and will be taxed on half of this amount (assuming that half the captive's investments are taxable); taxation will occur at the ordinary income rate of 35% (meaning it will owe taxes for 15% of \$30,000, or \$4,500 – under this example, the captive would retain \$55,500 in investment income annually).

Over a ten year period, the captive could thus be paid \$12 million in premiums deductible to the companies paying the premium without the captive being taxed. Over a ten year period, costs associated with the captive would total \$575,000, and the captive would retain \$555,000 in investment income (based on the above amounts). The captive's total retained earnings (or available funds to pay out claims encountered by the companies it insures) will then be \$11,980,000. Thus, by operating a captive, a company can create more than \$4 million in additional loss reserve funds when compared to self-insuring the same risks.. Additionally, when the captive eventually liquidates, all retained funds are distributed after being taxed at the capital gains rate as mentioned previously; the capital gains rate is currently set to become 20% in 2013, if no extensions to the current 15% rate are passed. Pub. L. 107-16, 115 Stat. 38, June 7, 2001. Even assuming a 20% rate, the captive would be taxed \$2,396,000 at liquidation, leaving \$9,584,000 to be distributed to its shareholders (almost \$2 million more than if no captive was used).

Retirement Planning Benefits of Captives

The reserves of captives offer significant tax planning benefits, and can also be used as funds for buy-outs of retiring senior partners in a business. As previously mentioned, the captive's retained funds can be distributed to its shareholders as qualified dividends throughout the life of the captive. There are certain restrictions on dividends – for example, some domiciles mandate the captive maintain a minimum level of capital and surplus throughout its existence, and dividends which would lower the retained amount beyond this minimum would not be able to occur. KRS 304-49.050. However,

beyond these restrictions, dividends can occur at the time and in the manner of the captive's choosing.

As the captive and its shareholders have wide leeway in directing how retained funds are distributed, the captive can choose to distribute dividends when the tax consequences for doing so are most appealing. For example, as previously noted, the capital gains rate on dividends is fluid, shifting in 2013 with the potential for more revisions existing – the captive can choose to issue dividends either right before a higher rate is set to occur or right after a lower rate comes into effect.

Distributions (and the eventual liquidation of the captive) can also be delayed until the time of retirement in order to optimize the chances of encountering a preferable tax rate for doing so. The captive itself can be structured to have senior partners of a business as the owners in order to provide amounts to them which can be withdrawn at their respective retirements. As illustrated above, the amounts a captive can earn in premiums over time can be significant. If few or no loss events triggering the policies occur, the funds can be used by the company as an internal buy-out plan, with these retained funds distributed to the senior partners of the business. The investments of the captive and the captive itself can be structured to maximize retirement benefits where so desired.

Business owners can provide non-qualified deferred compensation benefits to key employees by having such employees own a portion of the captive. This way the business owner can avoid the some times strict ERISA rules while providing an incentive for valued employees to remain with the operating business. The portion of the employees salary that is deferred can be used to purchase most any investment allowed by the jurisdiction of formation including life insurance on the life of the key employee.

Estate Planning Benefits of Captives

Captives can also provide ancillary estate planning benefits; where ownership of the captive is properly structured, captives can be used to pass assets to future generations while avoiding estate and gift taxes in full. The type of trust used to own captives shares can be dependant upon individual client needs, and a number of trust forms can be used; however, for a typical client, utilization of a dynasty trust provides the greatest benefits.

Dynasty trusts are designed specifically to help families avoid estate and generation-skipping transfer taxes. Dynasty trusts are permitted in every state; however, formation in states which have either abolished their rule against perpetuities in regards to dynasty trusts or have granted an extension for dynasty trusts is most advantageous. For example, Florida, a state in which dynasty trusts are often established, allows these trusts to exist for 360 years. Fla. Stat. 689.225.

A dynasty trust is created to hold shares of the captive insurance company; the trust itself is treated as owner of the captive (and not the trust's grantor or beneficiaries).

The dynasty trust would be irrevocable with the grantor's heirs (children, grandchildren, and future generations thereafter) beneficiaries.

As the captive's parent pays the captive for insurance coverage provided, the captive builds up value; the funds retained by the captive, less claims and annual maintenance expenses, build value within the company. As the captive builds up reserves on an annual basis, its owner (the dynasty trust) builds value in an appreciating asset. As the insurance contracts between the captive and the parent company are valid insurance transactions, no gift occurs (and thus, no gift tax consequences occur upon funding of the trust itself). At the time of dissolution of the captive, any remaining funds in the captive are thus functionally transferred to future generations without any estate tax consequences; structuring a captive in this manner allows a business owner to potentially transfer significant wealth to future generations with no estate or gift tax consequences of any kind.

Other types of trusts can be used by a client where the client's primary desire is asset protection. In particular, domestic asset protection trusts (DAPTs) can be used where the grantor seeks heightened protection of funds involved from their creditors, and the grantor of the trust (the owner of the parent company) already has engaged in significant independent estate planning. A number of states allow for the creation of this type of trust; each state allowing for the formation of DAPTs offers varying structures for protection from creditors. In Tennessee, a state often used for domestic asset protection trust formation, there is a four year statute of limitations for assets transferred to a DAPT; once this period passes, assets generally cannot be seized by creditors. Tenn. Code Ann. 35-16-104. However, assets can be seized for certain purposes regardless of the statute of limitations; in Tennessee, these include past due alimony and child support obligations of the grantor. Tenn. Code Ann. 35-16-104.

Once the statute of limitations period is over, the trust assets are not considered "owned" by the grantor once transferred to the trust (which is irrevocable); however, the grantor can retain a certain degree of control over the assets. In Tennessee, for example, the grantor can veto distributions made by his or her appointed trustee and act as an investment advisor for the trust. Tenn. Code Ann. 35-16-109, 35-16-111. The grantor of the trust may also retain rights to a revenue stream from the trust; in Tennessee, the grantor is permitted to receive all income from the trust and up to five percent of principal on an annual basis. Tenn. Code Ann. 35-16-111. For domestic asset protection trusts formed in Tennessee, the assets comprising the trust corpus must be held (at least in part) in the state (this is the rule in most other states as well). Tenn. Code Ann. 35-16-102. For cash, this can be accomplished by opening a bank account in the state where the trust is formed.

Estate Planning Benefits: An Illustrative Example

The manner in which trust ownership can assist in facilitating benefits from a captive can be illustrated by an additional example. As in the previous example, a company establishes a captive and pays the captive \$1.2 million for insurance on an

annual basis. For purposes of this example, the company insured experiences no losses triggering its policies (for simplicity purposes for the given example), so the captive retains all funds. The company functions for ten years, and thus is paid \$12 million total in premiums (all of which it retains).

Similar to the first example, the captive's management and establishment costs are \$80,000 for the first year, and \$55,000 for all years thereafter (totaling \$575,000), and the captive earns \$60,000 in investment income annually, with half of this amount being taxed at a 15% rate annually. This would lead to an additional \$55,500 being retained by the captive on an annual basis (and \$550,000 after ten years), meaning that, when all costs and income are considered, the captive will have retained \$11,980,000 at the end of the ten year period.

At the end of ten years, the captive liquidates; at liquidation, all funds of the captive are taxed at the capital gains rate. Assuming even a 20% rate, the captive would thus be taxed \$2,396,000 at liquidation, leaving \$9,584,000 in after-tax earnings (none of the foregoing factors in state tax rates, which are variable but, in any case, will only marginally affect the after-tax amount).

If the captive is owned outright (without a trust) by the same person who owns the related companies, the \$9,584,000 will face additional taxation at that person's death. Currently, the federal estate tax sits at 35% on any amounts over \$5 million the decedent transfers at death to anyone other than a spouse (the federal estate tax was modified in December 2010, and the 35% rate on amounts over \$5 million will stay in place until the end of 2012). Pub. L. 111-312, 124 Stat. 3296, HR 4853. If the party owning the captive has at least \$5 million in other assets at the time of their death (which will be the case for the majority of those considering a captive) and chooses not to give those funds to their spouse, they will be taxed \$3,354,400 under current law at their passing. This ends up leaving only \$6,229,600 of the original \$12 million amount stated above to be passed to their heirs.

The results could be even more dramatic after the current estate tax provisions lapse. As noted above, the current estate tax is set to expire in 2012 and, if no revisions occur, will be replaced by the pre-Economic Growth and Tax Relief Reconciliation Act rule. Under the current provisions set to take effect in 2012, all estates are to be taxed at a rate of 55% for any amounts over \$1 million not directly passed to their spouse. Pub. L. 107-16, 115 Stat. 38, June 7, 2001. If this replaces the current law, the estate tax incurred on \$9,584,000 would instead be \$5,271,200, leaving only \$4,312,800 to be passed to the estate's heirs. The above calculations also do not take into account state estate taxes, which can increase the amount taxed further.

Conversely, as illustrated above, if a dynasty trust is used, taxation ceases at the point of liquidation; the \$9,584,000 is retained by the trust and passed to its beneficiaries tax-free, increasing the amount passed by millions of dollars. The trust also has the ability to continue investing its funds, further increasing the amounts available to beneficiaries. Thus, using a captive/dynasty trust structure for a business owner

interested in engaging in estate planning can clearly provide huge benefits, and help increase amounts passed to future generations by avoiding taxation to the greatest extent feasible. As previously mentioned, the dynasty trust can also be structured to allow the grantor shared access to the investments, allowing the grantor to receive additional non-estate planning benefits as well.

Considerations for Setting Up Multiple Captives – Control Group Rules

As previously mentioned, companies seeking to set up multiple captives can do so. However, these captives must be structured carefully so that they are not considered to be owned by the same party; doing so creates a controlled group of corporations under Section 1563 of the Code, and creates potentially adverse tax consequences. Control group status primarily exists where a brother-sister control group is found; a brother-sister control group exists where

“Two or more corporations if 5 or fewer persons who are individuals, estates, or trusts own (within the meaning of subsection (d)(2)) stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation.”
26 USCS 1563(a)(2).

Where multiple captives exist, ownership of the captives must thus be structured to avoid having five or fewer of the same parties (whether individuals, estates, or trusts) own more than fifty percent of more than one captive. However, under Section 1563(d)(2), stock ownership for brother-sister control group purposes is determined both by reference to direct ownership and constructive ownership under Section 1563 (e). 26 USCS 1563(d)(2). Under Section 1563(e), a number of attribution rules exist – for example, a party is considered to own any stock owned by their spouse and their children under the age of 21. 26 U.S.C.S. (e)(5)-(6). Any stock owned by a corporation or partnership will be attributed in full to any shareholder or partner who owns at least a 5% interest in the corporation or partnership (i.e. where individual A owns 5% of corporation B, and corporation B owns 60% of corporation C, all 60% of the shares corporation B owns in corporation C will be attributed in full to individual A). 26 U.S.C.S. 1563(e)(2), 26 U.S.C.S. 1563 (e)(4).

Most pertinent to captives is a similar rule attributing a trust’s ownership interest in a company to any beneficiary where the beneficiary has more than a 5% actuarial interest in the stock; for purposes of making this determination, “the actuarial interest of each beneficiary shall be determined by assuming the maximum exercise of discretion by the fiduciary in favor of such beneficiary and the maximum use of such stock to satisfy his rights as a beneficiary.” 26 U.S.C.S. 1563(e)(3)(A).

Thus, unless a beneficiary is specifically excluded from having an interest in the stock, they will be treated as owning the stock involved (as the fiduciary would have the discretion to use the stock to satisfy their interest), and all stock owned by the trust will be attributed to all trust beneficiaries. For functional purposes, this means that, where

multiple captives are owned by multiple dynasty trusts (or any other type of trusts), the trusts cannot share common beneficiaries (because if two trusts share a common beneficiary and each trust owns more than 50% of the stock of a captive, all shares owned in each captive by each trust will be attributed to the beneficiary, creating a control group).

Additional attribution rules for trusts also exist regarding those who could be considered constructive owners of the trust. Section 1563(e)(3)(B) provides as follows: “Stock owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner under subpart E of part I of subchapter J (relating to grantors and others treated as substantial owners) shall be considered as owned by such person.” 26 USCS 1563(e)(3)(B). Subpart E of part I of subchapter J is contained within Sections 671-679 of the Tax Code, and details circumstances under which the grantor of the trust shall be considered its owner for tax purposes, and thus have the trust attributed to them (this can raise issues where a parent company’s sole owner creates multiple dynasty trusts for the benefit of separate children; if the trusts are attributed back to the grantor, a control group will be created).

Under Section 674, a grantor cannot retain the power to control the benefit or enjoyment of trust assets. 26 U.S.C.S. 674(a). This power also cannot be held by trustees where more than half are related or subordinate to the grantor (“related or subordinate” is defined in Section 672 as including the grantor’s spouse, parents, siblings, children, employees, or a corporation in which the grantor holds significant voting power). 26 U.S.C.S. 672(c). The grantor also cannot retain the power to revoke the trust, or to have income given to the grantor or their spouse without the approval of an adverse party (defined as a party “having a substantial beneficial interest in the trust which would be adversely affected by the exercise or non-exercise of the power which he possesses respecting the trust”). 26 U.S.C.S. 672, 676-677. Under Section 675, the grantor is also not permitted to retain certain administrative powers, including the power to deal with the trust for less than full and adequate consideration and the power to borrow from trust funds without providing the trust adequate security and suitable interest payments. 26 U.S.C.S. 675.

Types of Risks Insured by Captives

As previously discussed, captives function as legitimate insurance companies; one of the requirements for setting up a captive insurance company is the parent of the captive having valid risks to be insured. To ascertain whether such risks exist, captive managers and actuaries go through a process of assessing company risks currently insured or under insured on the commercial market. Since all commercial coverage provide exclusions in their policies and most companies do not insure the outer limits of all of their potential risk, a typical company will not have problem finding additional opportunities to supplement its current coverage.

Certain policies can assist individuals within particular industries; two which are often used for health care professionals are professional misconduct liability coverage

and electronic data loss/HIPAA liability coverage. Professional misconduct liability coverage is a type of policy primarily written for service professionals; this type of policy provides for both indemnification and defense costs, and covers situations where an insured's commercial liabilities have gaps (this type of gap coverage is something for which captives are often utilized). HIPAA liability coverage concerns potential claims a health care provider could face under the Health Insurance Portability and Accountability Act of 1996; the Act mandates standards for use and disclosure of certain protected health information. Coverage is provided regarding potential liability for actions which violate the standards provided by the Act.

For service professionals (such as doctors), captives can often be used to provide additional professional liability coverage (in excess of what typically would be covered on the commercial market). Policies issued by the captive can be used to pay both defense costs related to liabilities and actual damages themselves (by comparison, many commercial policies will only cover the former). Billing audit liability coverage is also available on the market for professionals, and can provide coverage for both defense costs and actual indemnification where liability is found.

Director and officer liability coverage is structured to protect against claims affecting officers and directors of a company (whether brought by employees or others associated with the company or brought by third parties). The policy is structured to pay the company where it needs to pay out amounts on behalf of a director or officer (due to the director or officer's negligence). Coverages can also be used for issues that could come up with employees, such as breach of an employment contract or harassment by the employer (or a representative thereof).

Contractual liability policies can provide a company coverage for liabilities assumed within a contract for warranties implicitly and explicitly provided within the contract itself; this coverage can apply both where the company's commercial policy does not cover a given risk and where the commercial policy provides only limited coverage (the captive's policy is used as supplemental coverage for the latter). Cyber liability coverage is an emerging line of coverage for assorted businesses; it gives a business a wide scope of protection against actions by employees committed online (coverage can include actions like slander, libel, trademark infringements, and negligent acts, and can cover both employees and officers/directors).

Policies themselves will be structured to provide different coverage limits, depending on the type of coverage and the risk involved for the particular company. Premiums paid for the coverage will be dependant upon the coverage limits and the likelihood of the occurrence of a compensable event. Actuarial studies will also assist in determining the proper amount to be paid for the policies; premiums and policies must be market comparable to be respected as valid insurance. As mentioned in the case law analysis, contracts for the policies are to be conducted as arms-length transactions to further substantiate the independence of the captive. Coverages are for legitimate insurance risks; where a covered risk actually occurs, the captive will pay the insured company under the terms of their contract.

The above are examples of risks commonly insured by captives; however, captives can essentially insure any valid risks a company may face. As an insurer tailored to a particular company, the captive can shape its policies in line with risks legitimately faced by the company it insures (so long as these risks are legitimate – as stated previously, actuarial studies and analysis by captive management professionals are used to this end in order to confirm the legitimacy of the risks insured).

Risk Pooling by Captive Insurers

To meet requirements that it achieve valid risk distribution, the captive also typically will insure unrelated entities (where there are not at least seven entities it insures on a direct basis, due to the 15% requirement previous discussed) through a risk pooling arrangement. In a typical risk pool, a number of captives arrange to provide coverage for a specified type of risk to all of the captive's parents; because of the larger number of entities providing insurance, the limitations on dollar amount of coverages are significantly higher.

The most effective pooling arrangements are done with risks where likelihood of loss is tremendously low (i.e. a policy where entities outside of major metropolitan areas are insured against losses related to terrorist attacks). In a typical pool, the captive is given a list of potential clients it would insure, and can exclude those which it deems to have a heightened chance of experiencing a loss; some reinsurance arrangements (like the terrorism pool) attempt to spread risks out over wide geographic areas, further lessening the risk of multiple compensable events. Risks within a reinsurance pool are evaluated in a similar fashion to the direct risks – an actuary is engaged to determine likelihood of an event's occurrence and premiums required for a set amount of coverage.

Captive Insurers - Conclusion

Captive insurance companies provide companies and their owners with both beneficial insurance coverage and significant tax savings, both during their lifetimes and at the point where funds are passed to their heirs. Consultation with experienced captive management professionals can help gauge the appropriateness of a captive insurance company for each potential client, and use of captive management professionals in setting up a captive can ensure that all potential benefits are maximized.