TAKE NO PRISONERS: PITFALLS AND POSSIBILITIES WITH CAPTIVE INSURANCE COMPANIES

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Agenda

- What is a captive?
- Why consider a captive
- Types of risks insurable in a captive
- Types of captives
- Tax advantages, treatment and issues
- Choice of domicile
- Implementation process
- Identifying prospects
- Brief Case studies
- Business planning opportunities
- Estate planning opportunities
- Potential problem areas

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What is a Captive?

An Insurance Company formed by a business owner to insure the risks of related or affiliated businesses.

(Over 50% of the Fortune 1500 have Captives)

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Why Consider a Captive?

- Access to reinsurance market
- Allows flexibility over claims management
- Provides limited tax benefits
- Establishes "best practice" risk management procedures
- Provides coverage for uninsured or hard-to-insure risks
- Potential estate planning opportunity

Types of Insurable Risk

Insured Risks

- Worker's Comp
- General Liability
- Health Insurance
- Auto
- Collision
- Professional Liab.
- E & O
- D & O
- Builder's Risk

Retained Risks

- Deductibles
- Construction Defect
- Loss of Key Customer
- Loss of Key Employee
- Loss of Key Supplier
- Administrative Actions
- Litigation
- Some D & O
- Excess E & O
- Policy Exclusions
- Mold
- Contract Claims
- Earthquake

Types of Captives

Pure Captive

Association Captive

Group Captive

Agency Captive

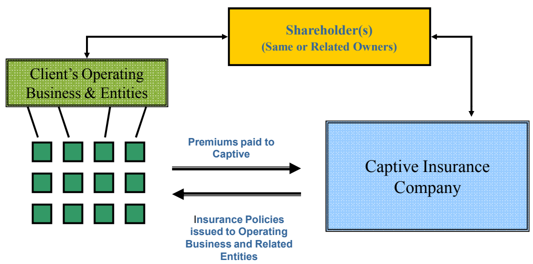
Rent-a-Captive

Protected Cell Captive

Every Captive structure is unique and requires operational and feasibility analysis to determine the optimal structure.

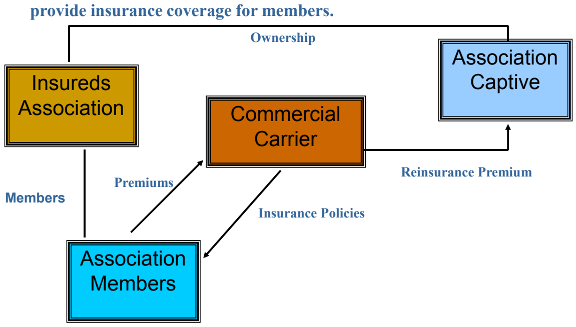
Pure Captive Design

A Pure Captive insures the risks of related entities



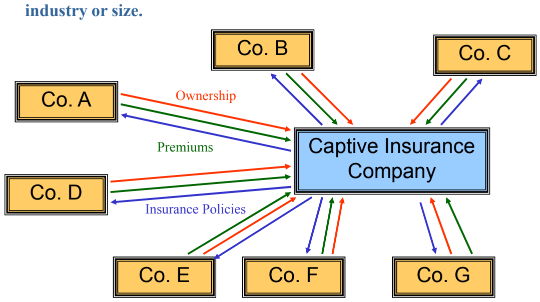
Association Owned Captive Design

An Association Captive is formed by a pre-existing association to provide insurance coverage for members.



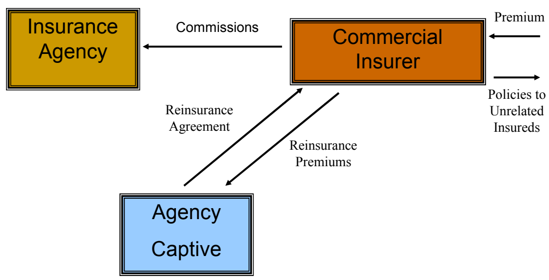
Group Captive Design

A Group Captive is owned by unrelated owners typically similar by industry or size.



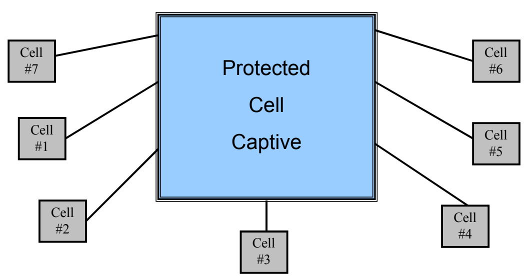
Agency Captive Design

An Agency Captive is typically a reinsurance company owned by an agent or group of agents.



Protected Cell Captive Design

Protected Cell Companies are essentially Rent-a-captives which allow renters to shield their capital and surplus from other renters in the captive as long as the owner remains solvent.



Tax Advantages of a Captive Insurance Company

Deduction of premiums by Insureds

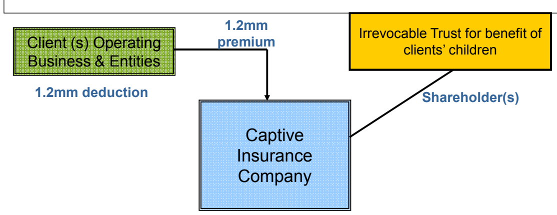
Generally, the loss reserves are deductible by a captive which shelters Premium Income to the captive

831(b) election allows Captive with 1.2 million or less Premium Income to elect to be tax exempt from Premium Income

Tax Treatment of "Small" Captives

- 831(b) Captive
  - If premiums are less than $1.2 Million per year, no tax on premium income
  - Tax is paid on investment income at corporate rates
    - C-Corporations do not have the preferential individual capital gains income tax rate, so real estate may be a bad investment
    - High cash value or private placement life insurance may be an appropriate vehicle to defer corporate taxation
      - Also need to watch out for corporate AMT on death benefit paid to a C-Corporation
      - Not a panacea, and should only be used as part of an overall plan
      - CAVEAT: Beware of promoters "selling" captives as a way to buy "tax deductible life insurance"

831(b) - Simple Example.



Captive pays NO income tax on 1.2mm of premium income
Wealth Transfer of underwriting net profit
Qualified dividend or capital gain to shareholder(s)

Federal Income Taxation as an Insurance Company

Requirements:
- Bona-fide Business Purpose
- Risk Transfer
- Risk Distribution
- Operates as an insurance company
- Reasonable premiums
- Adequate capitalization

Federal Income Taxation as an Insurance Company

What is insurance?

Helvering v. Le Gierse, 312 U.S. 531 (1941)

- Risk Shifting
- Risk Distribution
- Uninsurable 80-year-old woman purchased a life policy and an annuity policy from the same insurance company one month before death
- Executor did not report death benefit on estate tax return
- Supreme Court found no risk shifted because of offsetting positions; this was just an attempted tax dodge
- First case to set forth the standard for true insurance as required to have both risk shifting and risk distribution

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Federal Income Taxation
Risk Distribution and Shifting

Case law developed two theories.

Theory 1 (Third Party Theory):
- Sufficient third party premium with related premiums
  - Courts say 30% third-party insurance is adequate

Theory 2 (Balance Sheet Theory):
- Sufficient related party entities insured to create risk distribution and shifting

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Federal Income Taxation
Risk Distribution

Third Party Theory

Courts have ruled that, if the captive writes sufficient unrelated premiums, related business is also deductible.

Courts allowed 30% unrelated premiums (Sears, AMERCO, Harper Group, Ocean Drilling).

Courts never established a floor (Gulf Oil – 2% insufficient).

Rev. Rul. 93-92 for employees benefits seems to recognize employees benefits as third party insurance.

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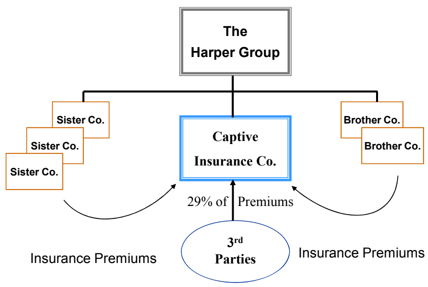
Third Party Case

The Harper Group, Inc. v. Commissioner (1992)



Federal Income Taxation
Risk Shifting

Some History

Revenue Ruling 77-316, 1977-2 C.B. 53

- Service creates the "economic family doctrine"
- Risk must be transferred outside of the economic family to be true insurance
- Key focus was on a lack of risk shifting, therefore not insurance and premiums not deductible

Federal Income Taxation
Risk Shifting

More History

Revenue Ruling 78-338, 1978-2 C.B. 107

- Adequate risk shifting with 31 unrelated companies
- This was a group captive, not a pure captive, so this was not terribly helpful to closely held business owners
- Service noted that no single member had a controlling interest

Federal Income Taxation
Risk Shifting

More History

Court Rejection of Economic Family Doctrine

- Carnation Company v. Commissioner, 640 F.2d 1010 (9th Cir. 1981) (taxpayer loss – largely on other grounds)
- Clougherty Packing Co. v. Commissioner, 84 T.C. 948 (T.C. 1985) (taxpayer loss – largely on other grounds)
- Humana, Inc. v. Commissioner, 881 F.2d 247 (6th Cir. 1989) (taxpayer victory - mostly)
  - Particularly explicit rejection of economic family doctrine. After a detailed discussion of prior courts rejecting the Service's theory, the court concluded that "under no circumstances do we adopt the economic family argument advanced by the government."

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Federal Income Taxation
Risk Shifting

Explicit Rejection of Economic Family Doctrine

- Harper Group v. Commissioner, 979 F.2d 1341 (9th Cir. 1992) (taxpayer victory)
  - Affirmed tax court opinion, which stated, in part: "We have repeatedly rejected respondent's economic family theory."

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Federal Income Taxation
Risk Shifting

- The Service won in most cases where the captive insured the parent (still problematic today), but lost in cases where the captive insured affiliates owned by a common parent
- The taxpayer losses were never on the basis of the economic family doctrine, as the courts consistently refused to apply this bright-line test as too overly inclusive and instead applied a facts & circumstances test

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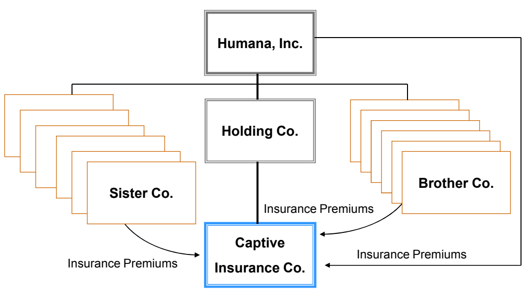
Federal Income Taxation
Risk Shifting

The Balance Sheet Theory

Allows deduction of premiums paid to a brother-sister captive without unrelated business.

Originally had favorable decisions only in the Sixth Circuit (Humana, Hospital Corporation of America); subsequently expanded to all taxpayers (Kiddie).

BALANCE SHEET CASE
Humana, Inc. v. Commissioner (1998)



Premiums allocated to Parent would not be deductible

Federal Income Taxation
Risk Shifting/Distribution

Important Issues in Brother-Sister Structures

Brother-sister risk is not unrelated risk for purposes of insulating parent risk. Will not provide a deduction for parent's premiums.

How many brother-sister insureds do you need?

Is the correct measure the number of insureds or number of risks?

Federal Income Taxation as an Insurance Company

Revenue Ruling 2001-31, 2001-1 C.B. 1348

- Service determines it will no longer raise the economic family theory
  - Explicitly acknowledged that no court had fully adopted the economic family theory set forth in Rev. Rul. 77-316
- Analysis is now a case-by-case analysis
- Service promised more challenges based on facts and circumstances
  - Focus is on risk shifting, risk distribution, inadequate capitalization, and parental guarantees

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Other Significant IRS Rulings

Rev. Rul. 2002-89 – Third Party Risk

Rev. Rul. 2002-90 – Balance Sheet Theory

Rev. Rul. 2005-40 – Disregarded Entities and More

Rev. Rul. 2008-8 – Cell Captive

Rev. Rul. 2009-26 – Reinsurance and Risk Distribution

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Safe Harbor Rulings

Rev Rul 2002-89 – Third Party Risk

Rev Rul 2002-90 – Balance Sheet Theory

Rev Rul 2005-40 – Disregarded Entities and More

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Third Party Revenue Ruling

Rev. Rul. 2002-89 - ruled on deductibility of parent's premiums where captive had 10% unrelated business (unfavorable ruling) and 50% unrelated business (favorable ruling).

- Note Harper's 30% decision is in the middle.
- Gulf Case – 2% third party business was insufficient.
- Unrelated premium percentage was determined on both gross and net basis; gross should not be relevant.
- Requirement for homogeneous risks does not make sense from an actuarial approach or from case law.
- Captive was licensed in multiple U.S. States; captives are traditionally not licensed in multiple U.S. States.
- The risks were from different States.
- Risk must be spread.

Balance Sheet Revenue Ruling

Rev. Rul. 2002-90 - ruled on premiums paid by sister companies to a captive owned by their parent, with 12 subsidiaries, none with more than 15% or less than 5% of The Total Risk insured on a net and gross basis

Postulates 12 fairly equal-sized subsidiaries.

Note none less than 5% requirement.

Requires that risks be homogeneous.

Requires that risks be from different States.

Requires that captive be licensed in all 12 States

Disregarded Entities Ruling

Treatment of disregarded entities (*i.e.,* LLC's) – Rev. Rul. 2005-40 says they are disregarded, risk of a single member LLC is risk of the parent

Inconsistent with the Balance Sheet theory.
Inconsistent with treatment IRS wants for partnerships.
Single member LLC's are respected by the IRS in other contexts.

Section 965 repatriation of profits; separate entities for liability for taxes.

Most importantly, disregarded entities are respected for liability and legal purposes, and that is what is being transferred in insurance transactions. They have separate balance sheets

Relationship between Insured and Captive Owner Ruling

Rev.Rul. 2005-40 says that, even if the insurer is adequately capitalized and completely unrelated, if there are an insufficient number of insureds, you may not have risk distribution, and thus no insurance.

If not insurance, what is it? - Insured has paid an adequately capitalized, unrelated entity for goods or services

What is the rationale? - If an insurer insures 10,000 buildings in 500 cities against fire, does the law of large numbers work differently, from the insurer's perspective, if one entity owns them all?

12 or more insured can ensure risk distribution

Related parties that are separate taxpayers are considered separate premium payers

50% third party risk is adequate

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Other IRS Guidance

TAM 200816029 Service will not count limited partnerships with a common general partner as separate entities

No logic to the Service's argument that the common general partner bears all risk of loss

Rev Rul 2008-8 Protected Cell Captives - Service requires risk distribution within each cell, not just within the overall organization, as cells are segregated from each other for liability purposes

Rev. Rul. 2009-26 – To Determine risk distribution regarding a reinsurance contract one must look through to the risks of the ultimate insured – The Primary (underlying) Insurance Contract

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Domicile Choice

- On Shore vs. Off Shore
- Local Taxes
- Federal Taxes
- Capitalization
- Reserve Investment
- Favorable Environment
- Loan Backs

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Implementation Process

- Feasibility study prepared by actuary
- Choice of domicile
- Corporate formation
- Underwriting process
- Policies written
- Regulatory application/license received
- Ongoing management costs

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Implementation Process

- First year costs: $75,000+
- Annual costs: $36,000+ for management fees, plus about $20,000+ more for audit, tax, licensing fees, actuarial fees
- Third party risk costs for clients without 12+ insureds
  - 2.5%-4% cost for risk pool insurance purchases plus loss of use of funds while held by risk pool (4-14 months)

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Identifying Prospects

- Ideally $2 Million or more of business taxable income
  - Group captives may allow companies with as little as $500,000 in taxable income to take advantage of this structure
- Business must face substantial risks that are not entirely within its control (fortuity)
- Estate planning motivation may help clients get over the complexity hurdle

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Business Planning Opportunities

- S-Corp. Owners
  - Captive is a C-Corporation, so it is possible to create multiple classes of stock, vesting schedule, liquidation preferences, etc.
- Key Employee Incentives
  - May be used to help indirectly fund nonqualified deferred comp
  - Ownership by key employees can be used to incentivize better risk management/create more of an owner mentality for key employees

Estate Planning Opportunities

- Captive can be owned by children or trust for their benefit
  - GSTT efficient
  - Equity buildup can be used to provide seed money to defective grantor trust for future purchase of estate assets
- Captive can be initially capitalized inside of children's trust or gifted/sold later
- Captive profits could potentially be used to fund life insurance more tax-efficiently, either as a direct investment of the captive or by taking dividends and paying premium

CASE STUDY: HEALTH CARE PRODUCT DISTRIBUTOR

Scenario: Single entity distributor with rapid growth and brand recognition challenged with expanding insurance coverage needs mechanism to insulate the companies brand name product from competition.

Solution: Formation of a pure (single) captive, to be paid 57% of the direct insurance premium, aligned with an insurance pool which receives the remaining 43% of the premiums. By pooling a portion of the insurance premiums, Synergy is able to satisfy revenue ruling 2002-89 and there by be considered an insurance company for tax purposes. An Estate Trust was established for the benefit of the ownerships heirs.

Results: Captive provided access to cost effective coverage of; Unfair Competition, Independent Distributors Liability and Product Recall.

CASE STUDY: SERVICES COMPANY

Scenario:

Kerlan & Jobe Orthopedic
Administration Action – Illegal- Medicare
Was not covered – Insurance broker advised client had coverage.

Judgment $ 2.5 M
LA Times - February, 2004

Solution:
If Kerlan & Jobe had a captive they would have had the money set aside on a tax efficient basis to cover the judgment, excluded by its commercial insurance.

CASE STUDY: CONDO CONVERTER AND REAL ESTATE DEVELOPER

Scenario:
Wrap Insurance: 2mm /1mm
Premiums: $1.4 million
Coverage for Construction Defect

Solution:
Form Captive to cover construction defect liability, invest premium, and when the 10 year statute of limitations is up, they will have > $2 million available to pay claims on this policy.

Result: Approximately $15mm in assets in captive since 2003, claims low, tax advantaged.

CASE STUDY: NURSING HOME

Scenario: Louisiana Client has 2000 beds, commercial quote of $4,000 per bed for Professional Liability.

Solution: Instead of self insuring, Client formed a Captive to cover these risks with custom policy drafting and controlled claims management.
Property Insurance – Flood & Wind
Workers Compensation – Deductible Reimbursement

Results: Cost per bed was reduced to $1,400. With a tax advantage position, Client increased investment savings and saw a decrease in the number of claims.

CASE STUDY: EMERGENCY ROOM DOCTORS

Scenario: $1.8mm quote for Professional Liability coverage. Claims run approximately $500,000 per year.

Solution: Obtain new quote with $250,000 deductible. Captive formed and owned by trust for Children to cover the $250,000 deductible, with premiums of $900,000 per year.

Result: $900,000 Premium to Captive, underwriting profit of $400,000 in Captive with tax advantage, and wealth transfer to next generation.

CASE STUDY: ESTATE PLANNING

Scenario: Real estate owner with a 21 year old son, and estate planning concerns. Real Estate not covered by commercial insurance for mold and earthquake.

Solution: Formed Captive owned by son. Captive provided coverage for depreciated property, mold and low level earthquake.

Results: Tax deductible premiums for owner with wealth transfer to son.

831b Captive Insurance Company - $1.2mm Premiums

Hypothetical Example

Cost-Benefit Analysis

			YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	YEAR 10
Cash at end of year WITH captive (page 3)			$ 1,389,921	$ 2,629,502	$ 3,906,889	$ 5,223,237	$ 6,579,733	$ 14,059,544
Cash at end of year WITHOUT captive (page 4)			$ 1,063,475	$ 1,903,388	$ 2,770,598	$ 3,665,992	$ 4,590,487	$ 9,683,664
(Cost) Benefit of Captive Investment			**$ 326,446**	**$ 726,114**	**$ 1,136,291**	**$ 1,557,245**	**$ 1,989,246**	**$ 4,375,879**
Captive Liquidation Considerations:								
Cash at end of year 5 and year 10 with captive							$ 6,579,733	$ 14,059,544
Tax on Liquidation of Captive in year 5 and year 10:	*- $250k basis is tax-free; remaining appreciation taxed as capital gains at 15% federal and no state tax (est.)*	15%					$ 949,460	$ 2,071,432
Cash to Shareholders of Captive upon Liquidation							$ 5,630,273	$ 11,988,112
Cash to Investors without Captive at end of Year 5 and Year 10							$ 4,590,487	$ 9,683,664
(Cost) Benefit of Captive with Liquidation							**$ 1,039,786**	**$ 2,304,448**
Estate Planning Considerations:								
With Estate Planning and Captive owner is an Irrevocable Trust, then heirs receive							$ 5,630,273	$ 11,988,112
Incremental value in estate without Captive at end of Year 5 and Year 10							$ 4,590,487	$ 9,683,664
Less Estate Taxes		45%					(2,065,719)	(4,357,649)
Net to Heirs without a Captive							$ 2,524,768	$ 5,326,015
Benefit to heirs of Captive where Captive is owned by heirs' trust v. doing nothing							$ 3,105,505	$ 6,662,097
Adjust for gift of $250k to fund the capital that increases the tax liability at death							(112,500)	(112,500)
Adjusted Benefit to Heirs							**$ 2,993,005**	**$ 6,549,597**
% Improvement							119%	123%

CAPTIVE CASE STUDIES

Captive Insurance Company	Year	Parent Capital Required	Annual Premiums Paid by Affiliates	Net Value (Losses), Including Premiums, Excluding Cash Expenses
CMM Development Company	2003	2,021,500	650,000	1,685
Residential and Commercial	2004	-	4,194,744	218,976
Properties	2005	800,000	3,662,833	165,773
	2006	545,846	1,941,198	(1,961,314)
	2007		2,160,289	2,348,687
Cumulative Totals		3,367,346	12,609,044	[illegible]

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CAPTIVE CASE STUDIES

Captive Insurance Company	Year	Parent Capital Required	Annual Premiums Paid by Affiliates	Net Value (Losses), Including Premiums, Excluding Cash Expenses
USA Medical Group	1998	100,000	25,000	(47,098)
	1999		70,000	[illegible]
	2000	[illegible]	185,000	1,957
	2001	20,550	242,000	(170,361)
	2002	18,000	160,000	(149,416)
	2003	[illegible]	335,000	[illegible]
	2004	22,775	116,800	15,957
	2005	15,350	180,000	(59,540)
	2006	15,500	300,000	[illegible]
	2007	-	240,000	[illegible]
Cumulative Totals		270,075	1,853,800	(264,978)

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Potential Problem Areas

- Thinly capitalized
- Related party loan-backs
- Investment in life insurance
  - Can be a signal to the Service that this was a sham transaction/lacking in economic substance
  - Let the captive mature before buying life insurance, and be sure there is a substantial, nontax purpose (estate planning/buy-sell purpose may be helpful)
  - Service has issued summonses for Aviva Life, AmerUs (now Aviva), and Indianapolis Life (now Aviva) related to ongoing scrutiny of captive promoters maintaining alliances with life insurance companies
- Inadequate third party risk
  - Less than 12 insureds
  - Risk pools that pay no claims
  - Protected cell companies (Rev. Rul. 2008-8)
- Heavy investment in the activities of affiliate companies (Service could use this as evidence in a sham transaction)
- Heavy investment in illiquid assets (not "acting like" an insurance company)

Potential Problem Areas

- Accessing captives through any sort of "alliance", "institute" or other title used to notate a consortium of individuals banded together to sell tons of life insurance through the aggressive marketing and inappropriate use of tax-advantaged structures
- This is a sure way to get a target painted on your back or your client's back
  - No attorney-client privilege
  - The Service can and does get customer lists from these groups
  - These groups tend to be more reckless in their marketing materials since they need the "sizzle" to attract the attention of life insurance producers
  - The Service can and does use reckless marketing materials to hang taxpayers
    - Such as materials marketing captives as a way to deduct life insurance premiums and never pay tax on the proceeds
- Like any advanced planning tool, captives should be accessed through an attorney as part of a comprehensive approach in arranging a client's affairs
  - Attorney-client privilege will apply

Do It Right

- Like any advanced planning tool, captives should be accessed through an attorney as part of a comprehensive approach in arranging a client's affairs

Captive Services To Expect

- **Captive Design**
  - Insurance coverage and risk analysis
  - Business entity
  - Feasibility study and financial Proforma
  - Insurance coverage design
  - Coverage premium assessment with actuary and broker
  - Domicile selection
- **Licensing and Formation**
  - Insurance license application assistance
  - Incorporation and legal advice
  - Selection of Actuary, Auditor and Accounting
  - Insurance jurisdiction approval
- **Captive Regulatory Compliance**
  - Insurance company accounting and records
  - Regulatory filing
  - Quarterly financials
  - Annual Captive efficiency review
  - Regulatory reporting
  - Liaison with Investment Manager
  - Liaison with Tax Preparer
  - Liaison with Audit
  - Liaison with Regulatory Body
- **Insurance Management**
  - Draft and publish insurance policies
  - Annual risk coverage analysis
  - Ongoing coverage assessment
  - Annual Meetings
  - Domicile Presence

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J. SCOT KIRKPATRICK (B.A., Emory University, 1979; J.D., Wake Forest University, 1982; LL.M., Taxation, New York University, 1984). Scot's practice focuses principally upon estate and income tax planning for high net worth individuals and their businesses. Scot was admitted to the Georgia Bar in 1982. He entered New York University School of Law earning a Masters in the law of taxation in 1984. From 1984 until 1989, Scot practiced with an Atlanta law firm specializing in income and estate tax planning. In 1989, he became associated with the Chamberlain, Hrdlicka law firm and was elected a shareholder of that firm in 1992. Since 1989, he has been head of the firm's Atlanta office trust and estates practice group.

Scot is a frequent lecturer at various seminars on these subjects for attorneys, accountants, insurance agents and financial planners. In October 2001, Scot co-authored with Robert L. Frank an article entitled *Its Death Has Been Greatly Exaggerated! Highlights of the Estate Tax Changes Made by Economic Growth and Tax Relief Reconciliation Act of 2001*, Today's CPA, September/October, 40-46, 2001). The article discusses the estate, gift and generation-skipping tax changes in the 2001 tax bill and the opportunities this new law creates. The article was also published in the January, 2002 issue of Trusts & Estates magazine. Another of Scot's articles entitled *Estate Planning in the Wake of Reform,* was published in the Fall 2001 edition of Taxpro Journal (Kirkpatrick, J. Scot, Esq. and Jones, Jr., Thomas E., Esq.). This article also discusses the radical changes in the 2001 tax bill.

Scot is a member of the American Bar Association and the State Bar of Georgia. Additionally, he is a member of the sections of taxation and real property, probate and trust of the American Bar Association, as well as a member of the fiduciary and taxation sections of the State Bar of Georgia. Scot is also a member of the Atlanta Estate Planning Council. In 2005, Scot was named a member of *Georgia's Legal Elite*.

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Senior Wealth Management Director

Geoff Seaman is a wealth planning strategist with more than 30 years of experience delivering customized solutions to wealthy individuals, families and businesses. He specializes in the coordination of estate and income tax planning, charitable planned giving, business succession, and investment management consulting.

Prior to joining the firm in 2004, Geoff was with City National Bank of Beverly Hills, California. He held the position of vice president and senior financial and estate planning advisor.

Geoff received his bachelor's degree from Indiana University, his master of business administration from the University of Chicago, and his juris doctor from Southwestern School of Law. As a Member of the Society of Trust and Estate Practitioners (STEP), he has the designation of Registered Trust and Estate Practitioner (TEP). .Geoff currently holds FINRA series 7, 24, 65, and 63 licenses. He has been an active participant in the Los Angeles community.

Frederick E. Turner
President
Active Captive Management

President, Active Captive Management whose subsidiaries and affiliates are licensed captive managers in Utah, Kentucky, Delaware, Bermuda, British Virgin Islands, Nevis and Anguilla. B.S. Economics, California State University, Long Beach, 1977, with high distinction; J.D., Loyola Law School, 1980, cum laude; admitted to practice, California, 1980. Admitted to practice in United States Supreme Court, United States Court of Appeals for the Ninth Circuit, United States District Court, Central District of California, and Southern District of Cali-fornia. Member of the State Bar of California, Orange County Bar Association, and Los Angeles County Bar Association. Rated by Martindale Hubble as “av,” the highest rating for competence and ethics for an attorney. Actively involved in alternative risk solutions since 1986. Board of Directors, Utah Captive Owners Association.