Potential Benefits of a Captive

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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.
- 53% of Fortune 1500 have Captives
- Effi cient way to manage presently uninsured risks

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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.

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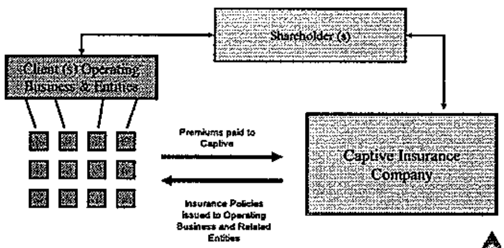
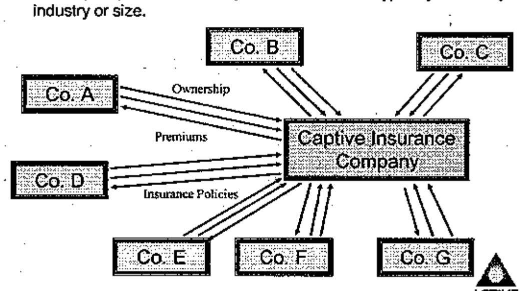
Pure Captive Design

- A Pure Captive insures the risks of related entities



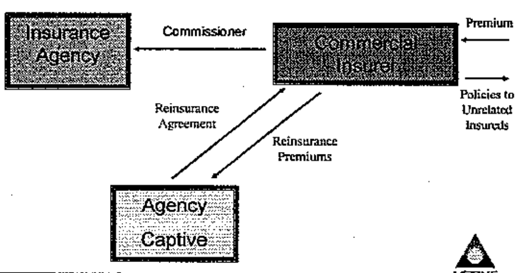
Group Captive Design

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



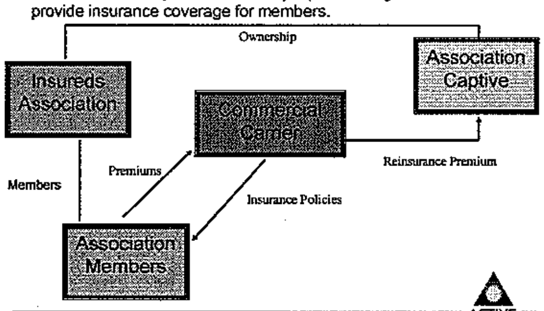
Agency Captive Design

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



Association Owned Captive Design

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



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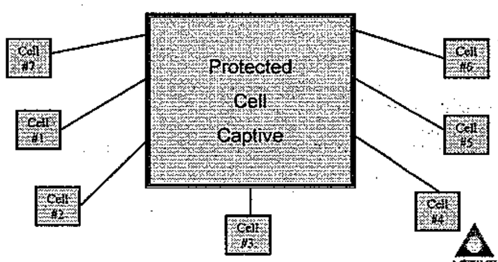
Protected Cell Captive Design

- 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.



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Why Consider a Captive?

- **Control Insurance Costs**
  - Reduce /Stabilize
- **Pre-Tax Asset Accumulation**
  - Risk Management
- **Self Insured Risks**
  - Funding and Coverage for uninsured risks.
- **Tax Advantages**
  - Captives can have ancillary income and estate tax advantages.

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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

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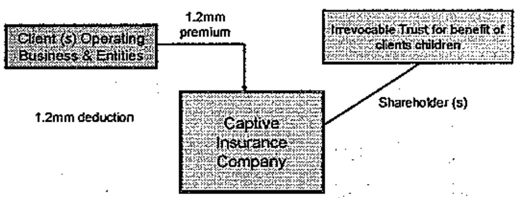
Simple Example



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

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Federal Income Taxation Recognition as an Insurance Company

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

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Risk Distribution

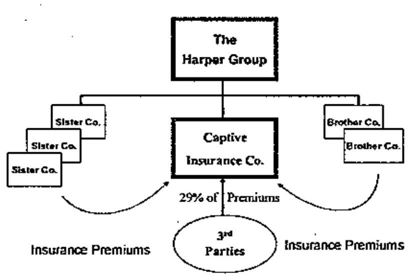
- Case law developed two theories.
  - Theory 1: Sufficient third party premium with related premiums
    - ✓Courts say 30% third-party insurance is adequate
    - ✓Other risk distribution criteria
  - Theory 2: Sufficient related party entities insured to create risk distribution (Balance Sheet Theory)
    - ✓Other risk distribution criteria

Third Party Theory

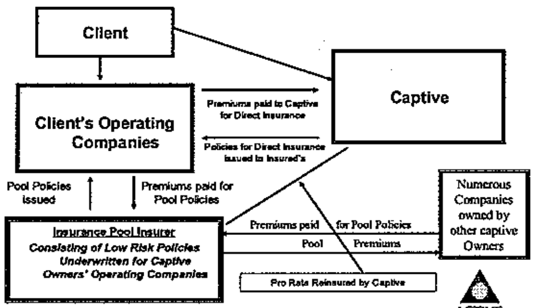
- Courts have ruled that, if the captive writes sufficient unrelated premiums, related business is also deductible.
- Courts allowed 30% unrelated premiums (Sears, AMERCO, Harper Group, Ocean Drilling).
- Courts never established a floor (Gulf Oil – 2% insufficient).
- Rev. Rul. 93-92 for employees benefits seems to recognize employees benefits as third party insurance.

Third Party Case

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



Captive Pooling Design



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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).

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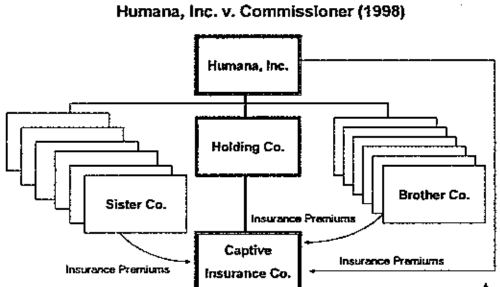
BALANCE SHEET CASE

Humana, Inc. v. Commissioner (1998)



Premiums allocated to Parent would not be deductible

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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?

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Economic Family Doctrine

- Rev. Rul 2001-31 – IRS Announces it will no longer raise economic family doctrine.

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Significant IRS Rulings

- Rev. Rul. 2002-89 – Third Party Risk
- Rev. Rul. 2002-90 – Balance Sheet Theory
- Rev. Rul. 2002-91 – Group Captive
- Rev. Rul. 2005-40 – Disregarded Entities
- Rev. Rul. 2008-8 – Cell Captive
- Rev. Rul. 2009-26 – Reinsurance and Risk Distribution

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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

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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 (reference to floodplain rulings). Risk must be spread.

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Group Captive Ruling

- Rev. Rul. 2002-91 - premiums deductible if paid by unnamed number of unrelated companies, where no insured has 15% of the risks insured or 15% of the shares or votes on any matter.
  - Seven equal shareholders who are insureds.
  - Same industry.
  - Does not require licenses.
  - Does not mention homogeneous risks, although in same industry.
  - Very few captives licensed outside their domicile.
  - No retros or payments upon departure may indicate service concern about rent-a-captives.
  - Acts like an insurance company.

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Disregarded Entities

- 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, they are respected for liability and legal purposes, and that is what is being transferred in insurance transactions. They have separate balance sheets

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Relationship between Insured and Captive Owner

- Rev.Rul. 2005-40 now 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?

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Rev. Rul. 2008-8

- Look to existing rules: apply on cellular basis
  - Risk Shifting
  - Risk Distribution
- Arrangement between X and Cell X is as a parent and wholly-owned sub. Rev. Ruls. 2002-89 &2005-40
- Arrangement between Y and Cell Y is a Brother/Sister relationship Rev. Rul. 2002-90

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Rev. Rul. 2009-26

- To Determine risk distribution regarding a reinsurance contract one must look through the risks of the ultimate insureds – The Primary (underlying) Insurance Contract
- Rev. Rul. 77-316 revoked. (Similar Ruling)
- Rev. Rul. 2009-26 – Confirmed and gave Two Examples

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Domicile Choice

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

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CASE STUDY: NURSING HOME

Scenario: Louisiana Client has 2000 beds, commercial quote of $4,000 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.

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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.

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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.

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Table of Authorities

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