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The benefits of captive insurance companies

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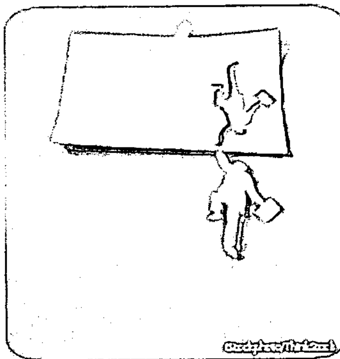

For many years, large corporations in this country have enjoyed many benefits from operating their own captive insurance companies. Most were established to provide coverage where insurance was unavailable or unreasonably priced. These insurance subsidiaries or affiliates were often domiciled offshore, especially in Bermuda or the Cayman Islands. The risk management benefits of these captives were primary, but their tax advantages were also important.

In recent years, smaller, closely held businesses have also learned that the captive insurance entities can provide them significant benefits. These include the attractive risk management elements long appreciated by the larger companies, as well as some attractive tax planning opportunities. A properly structured and managed captive insurance company could provide the following tax and nontax benefits:

- Tax deduction for the parent company for the insurance premium paid to the captive;
- Various other tax savings opportunities, including gift and estate tax savings for the shareholders and income tax savings for both the captive and the parent;
- Opportunity to accumulate wealth in a tax-favored vehicle;
- Distributions to captive owners at favorable income tax rates;
- Asset protection from the claims of business and personal creditors;
- Reduction in the amount of insurance premiums presently paid by the operating company;
- Access to the lower-cost reinsurance market; and
- Insuring risks that would otherwise be uninsurable.

Since captives became accepted in the United States, a number of types have evolved. These include "pure captives," where the insurance company insures the risks of one group of related entities; "association captives," where the captive insurance company covers the risks of the members of a particular association; and "agency captives," where the captive is owned and operated by one or more insurance agents to insure the risks of their clients. Because the benefits of "pure captives" are much more significant, this article is limited to discussing that type of entity (see the sidebar "Case Study" for an example of situations in which it may be advantageous for a small business to set up a captive insurance company).

IDEAL CANDIDATES FOR CAPTIVES

The use of a captive should be considered for entities that meet the following criteria:

- Profitable business entities seeking substantial annual adjustable tax deductions.
- Businesses with multiple entities or those that can create multiple operating subsidiaries or affiliates.
- Businesses with $500,000 or more in sustainable operating profits.
- Businesses with requisite risk currently uninsured or underinsured.

- Business owner(s) interested in personal wealth accumulation and/or family wealth transfer strategies.
- Businesses where owner(s) are looking for asset protection.

INSURANCE REQUIREMENTS

For the premium payment to the captive to be deductible as an insurance expense, the captive must be able to prove that it is a valid insurance company (payments for self-insurance generally are not deductible (*L.A. Thompson Scenic Railway Co.*, 9 B.T.A. 1203 (1928)). Besides obtaining an insurance license from a state or a foreign jurisdiction, the captive must provide insurance to the operating company or its affiliates. Insurance was defined for tax purposes in *Helvering v. LeGierse*, 312 U.S. 531 (1941), which stated that insurance must include elements of risk shifting and risk distribution.

To meet the risk-shifting requirement, the operating company must show that it has transferred specific risks to the insurance company in exchange for a reasonable premium. In *Kidde*, 40 Fed. Cl. 42 (1997), the Court of Federal Claims described the risk-distribution concept as follows:

> Risk distribution occurs when particular risks are combined in a pool with other, independently insured risks. By increasing the total number of independent, randomly occurring risks that a corporation faces (i.e., by placing risks in a larger pool), the corporation benefits from the mathematical concept of the law of large numbers in that the ratio of actual to expected losses tends to approach one.

Thus, the captive must be accepting risks from multiple separate entities to satisfy this requirement.

The IRS has issued a number of revenue rulings that provide guidance to captives to ensure compliance with these factors (see, e.g., Rev. Rul. 2002-89). In addition, in Rev. Proc. 2002-75 the IRS stated that it would begin to issue private letter rulings on specific companies' risk distribution and risk shifting and whether the captives are true insurance companies.

There is one additional requirement for the captive to be considered an insurance company for federal purposes. More than 50% of its total revenue must be from the issuance of insurance or annuity policies (Sec. 816(a)). In the early years of a captive's existence, this requirement should not present a problem, but in later years, assuming the captive and its investment program succeed, this would need close monitoring to assure compliance.

FORMATION OF A CAPTIVE

The formation of a captive insurance company is a lengthy process including feasibility studies, financial projections, determining domicile, and, finally, preparing and submitting the application for an insurance license. The need for a qualified insurance manager on the planning team is very important, particularly in the formative stages.

The requirement for adequate initial capitalization of the captive is dependent in part on the level of risk projected to be assumed by the captive and the requirements of the particular domicile chosen. In some cases, this initial capitalization can be accomplished through the use of irrevocable letters of credit. The irrevocable letter of credit would be obtained by the sponsor applying to the bank for this letter of credit. This will involve a fee for the issuance of such a credit facility and may restrict the sponsor's other borrowing capability.

One critical function to be performed during the formative stages is the identification of the risks to be insured by the captive. The operating company is presently paying premiums to one or more commercial insurance companies to protect it from specific risks, some of which could be catastrophic if they were to occur without such insurance. The goal of smaller captives would be to maintain the transfer of the catastrophic risks to the commercial carriers, but to assume the underwriting associated with more "manageable" risks.

The policies that are written need to be for "real" insurance risks but with low probability of occurrence. Should the captive see a need to protect itself in the case of a higher-risk policy, it may be able to buy reinsurance at premiums that are less than the premiums that it has charged the parent company. On an annual basis, the premiums paid to the captive in excess of its claims and operating expenses will transfer to the earned surplus account and be available for more aggressive investment activities.

Care should be taken in the process of selecting "risks" for the captive to insure because true insurance requires a certain amount of fortuity. As was pointed out in Rev. Rul. 2007-47, any "risk" that is assured of occurring, even if the amount of the risk is not clearly determinable, is not a true insurable risk. In that case, payments into the captive would take on the aspects of deposits into a sinking fund to help liquidate an existing liability.

One of the risk management benefits that the captive may provide is the flexibility to opt for higher deductible levels on the existing property and casualty insurance policies. In keeping with the above desire to minimize, but not eliminate, claims experience, the selection of the risks that the captive is willing to assume should be prudent.

OPERATION OF THE CAPTIVE

The attractive tax benefits associated with the smaller captives can sometimes cause business owners to forget that the captive must operate as a true insurance company. The use of an experienced and capable captive management company is an essential element of the normal operations of such an entity.

The need for annual actuarial reviews, annual financial statement audits, continuing tax compliance oversight, claims management, and other regulatory compliance needs puts the day-to-day management of a captive insurance company beyond the skills of most general business people. Likewise, the involvement of the management company in the investment activities of the captive is essential from a planning perspective to assure that the captive's liquidity needs are met.

TAX ASPECTS

In 1986, Congress inserted a provision into Sec. 831 that opened up a significant planning opportunity for small insurance companies. Under Sec. 831(b), if a property and casualty insurance company with gross premium income of $1.2 million or less (known as a mini-captive) makes an election under that section, it avoids tax on its premium income and owes tax only on its investment income. Once made, this election is irrevocable without the IRS's consent, but the election is automatically terminated if the company's gross premium income exceeds the prescribed limit. Nothing precludes the company from making another election if its gross premium income level subsequently decreases to $1.2 million or less.

In general terms, an insurance company must be taxed as a C corporation and must file its return on a calendar-year basis, unless it is being included in a consolidated tax return. If an insurance company is established as an LLC or a partnership, it must elect to be taxed as a corporation under the check-the-box regulations of Sec. 7701. Since the C corporation tax rules apply, the captive can issue more than one class of stock and can pay out "qualifying" dividends, which are eligible for preferential taxation. Unfortunately, upon liquidation, the corporation and its shareholders could be subject to double taxation because the entity is a C corporation.

The structure of the captive's equity ownership provides other planning opportunities. If the shareholders of the captive are family members of the owners of the parent company or trusts with family member beneficiaries, any income of the captive would inure to their benefit. Since this is a transaction in the ordinary course of business, no gift or estate tax would attach to the intrafamily transfer of wealth. Likewise, some shares of preferred stock of the captive might be distributed to key employees of the operating company and then redeemed upon retirement. The capital gains tax on the redeemed shares should be less than the tax on any other form of deferred compensation.

The possible use of *multiple captives* also should not be ignored. If the shareholders need a captive that could accept more than $1.2 million in premiums, but do not want to forfeit the tax benefits of having a mini-captive, multiple captives could be established with different shareholders. Care should be taken to avoid the attribution rules under Sec. 1563 that could cause the captives to be "aggregated" and possibly exceed the $1.2 million limitation. Using multiple captives, or cells (discussed below), could also accommodate shareholders with different retirement goals and investment philosophies.

The federal tax structure had been in a state of flux, but the American Tax Relief Act of 2012, P.L. 112-240, has increased the tax rate on long-term capital gain and dividend income for high-income taxpayers from 15% to 20% beginning in 2013. As a result, the benefits of operating a captive insurance company may be slightly reduced, but they are not eliminated.

The state taxation of the captive depends on the state in which the captive is domiciled, which need not be the state in which the operating company is located. At inception, part of the entity formation process is determining the captive's proper domicile, including both domestic and offshore venues. Selecting a domicile depends on a number of factors, including taxation. In addition, many states have adopted a form of "procurement tax," which taxes the payment of premiums to an insurance company that is not licensed to do business in that particular state. Under these rules, the operating company could be assessed a tax of approximately 2% to 5% of the premiums paid to the captive.

SERIES LLC OR CELL COMPANIES

Recent legislation in a number of states has created a new form of entity that is viewed as an attractive structure for captive insurance operations. The use of "series LLCs" or "cell companies" allows for the formation of a "master LLC" or "master cell," which would procure the insurance license for the entire operation.

A number of "series" or "cells" would then be created that would function as autonomous units within the entity's contractual structure. Each cell would have one or more owners, and each cell's assets and liabilities would be insulated from the assets and liabilities of the other cells or master LLC. Proposed regulations under Sec. 7701 (REG-119921-09) would treat each cell as a separate entity for federal tax purposes if it is established under a state statute that would recognize the cell as a separate legal entity in that jurisdiction.

The attractiveness of this arrangement for captive insurance purposes is the ability to operate a captive insurance entity at lower costs and using much smaller levels of risk and premiums, making it available to a broader spectrum of companies.

POTENTIAL RISK AREAS

The IRS has modified its approach to captives since they first appeared in the 1950s. Instead of attacking captives, the IRS now has started to formulate "safe harbor" rules to keep the captives regulated while reserving the right to evaluate the captive insurance arrangements based on their individual facts and circumstances. Thus, proper adherence to the principles of risk shifting and risk distribution is essential, as is a properly administered investment program. Excessive loan-backs to the operating company as well as attempts to provide life insurance arrangements should be avoided. Likewise, proper levels of capitalization need to be maintained, which precludes excessive distributions to the shareholders.

CONCLUSION

The planning, formation, and management of a captive are complex undertakings, and compliance with the formalities of running a true insurance company is mandatory. Establishing a captive insurance company is not feasible for all companies but, where appropriate, it can provide substantial tax and nontax benefits to successful shareholders and their families.

Case Study

The following case study examines a situation in which the owner of a small business would find it advantageous to set up a captive insurance company:

- Bill, age 40, is the owner of a hedge fund. Bill has a significant personal net worth.
- Bill would like to maximize wealth accumulation, reduce current income taxes, and distribute as much of his wealth as tax-efficiently as possible to his heirs. Bill is married and has three children.
- After bonuses to all employees, the hedge fund has $1.2 million of taxable income that is taxed at a 45% rate, including federal and state taxes. Bill would like to minimize the income tax liability associated with his funds and accumulate funds on a more tax-advantaged basis beyond the reach of his personal and corporate creditors.
- The shares of the captive would be owned by three trusts for the benefit of Bill's children so that the shares will not be part of Bill's taxable estate. This technique will also avoid gift and generation-skipping transfer (GST)

taxes. Bill and his wife will be the co-trustees of the trusts, and the assets of the captive will not be subject to the claims of Bill's personal creditors.
- The captive manager performed a feasibility study analyzing the hedge fund's current coverage to determine risks that are either self-insured or underinsured. That feasibility study identified 10 risks and designed separate coverage for each of those risks.

Recommendations. The premiums for the 10 separate policies were determined by applying the usual and customary insurance industry underwriting principles and were believed to be reasonable in relation to benefits provided without regard to any experience-based premium refund or benefit. The premiums totaled approximately $1,150,000.

Results. The state approved the business plan and issued the necessary insurance license, and the hedge fund formed Hedge Insurance Co. Hedge elected to be taxed under Sec. 831(b) and has operated since 2006. This small-captive strategy delivers a combination of significant tax and nontax benefits (see **Exhibit 1** to compare the tax benefits of using a captive versus not using a captive):

- The premiums paid by the hedge fund to its captive are fully deductible for income tax purposes. The captive is not taxed on premium income, and only the investment income is taxed as a result of a Sec. 831(b) election.
- The distributions to the trusts qualify as dividends and have been taxed at 15% and will continue to be taxed at a slightly higher 20% rate for high-income individuals (income over $450,000 for married taxpayers filing jointly) beginning in 2013. This creates a large and favorable income tax arbitrage for Bill.
- The captive's surplus, after approval of the state insurance department, is permitted to be reinvested back into the hedge fund at a lower tax rate than the hedge fund manager's own tax bracket.
- The captive and its assets are not subject to the claims of the hedge fund creditors or Bill's creditors for asset-protection purposes.
- The captive and all of its future growth will *not* be part of Bill's personal taxable estate. Bill's children's trusts will maintain significant assets outside of his taxable estate.

EXECUTIVE SUMMARY

Captive insurance companies are often used by large corporations to lower their insurance costs and are often created in offshore tax havens.

However, small, closely held companies can take advantage of a number of tax and business benefits if they set up their own captives. These captives can be set up in the jurisdiction that makes the most sense for the captive's business.

Case law and the IRS require captive insurance companies to meet certain requirements. There must be actual risk shifting and risk distribution.

Small captive insurance companies that elect under Sec. 831(b) to be "mini-captives" are particularly tax-favored. Their premium income is not subject to tax; only their investment income is.

Captive insurance companies can also be used for estate planning. A captive can be owned by family members of the parent corporation's owners or a trust set up for the benefit of those family members. Because there is a business purpose for setting up the captive, the transaction should be respected.

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