

Possibilities and Pitfalls With Captive Insurance Companies

Profitable family businesses can use captive insurance companies to manage business risk and shift wealth accumulated in a profitable captive from senior to junior generations thereby avoiding inclusion of those funds in the senior generation's estates.

Author: KIMBERLY S. BUNTING, J. SCOT KIRKPATRICK, AND KAREN S. KURTZ, ATTORNEYS

KIMBERLY S. BUNTING is a shareholder in Chamberlain, Hrdlicka, White, Williams & Martin LLP's Atlanta, Georgia, office. She practices in the areas of commercial and corporate law, and has significant experience with risk management and captive insurance companies. J. SCOT KIRKPATRICK is also a shareholder in Chamberlain, Hrdlicka's Atlanta office. His practice focuses principally on estate and income tax planning for high net worth individuals and their businesses. KAREN S. KURTZ is an associate in the Tax Section of Chamberlain Hrdlicka's Atlanta office, concentrating in estate and gift tax planning and litigation.

A captive insurance company ("Captive") is an insurance company formed by a business owner to insure the risks of related or affiliated businesses. A Captive permits a business to manage its risks while potentially providing substantial benefits to that related business. The premiums received by the Captive are invested and thus not "lost" if not used to pay claims in the same sense that commercial insurance premiums are when paid to an unrelated insurer. This one benefit drives the use of Captives for the family business more than any other.

Captives may issue property or casualty insurance coverage against a wide variety of possible liabilities. In addition, Captives provide an opportunity to insure against risks that are generally uninsurable or hard to insure due to the lack of coverage available in the commercial market or the excessive cost of such coverage. Critically important, a client must realize that the Captive is

a *licensed insurance company*, and therefore, claims must be expected. Thus, commercial insurance must be maintained for certain risks the Captive should not insure because the possibility of catastrophic loss is too high, or the number and types of claims present a significant risk.

Business owners' profits are reduced by the cost of commercial insurance and further threatened with uninsured risks. Through the implementation of a Captive, a business owner can reduce and contain his or her commercial insurance and deductible costs, and provide insurance for those previously uninsured risks.

With the prospect of very significant tax increases on the horizon, the captive insurance company is also being touted as one of the best solutions for business owners to cope with the impending avalanche of taxes Washington may unleash. In addition to the income tax benefits, Captives may provide significant estate planning, wealth transfer, and asset protection opportunities.

Because a Captive is owned within the family of the business owner, either by the business owner, an affiliated entity, or a trust for the benefit of the owner's family, any premiums paid and investment earnings on those premiums are kept inside that "family." Thus, any profit remaining after the payment of administrative costs and claims remain within the family business structure. This ownership provides significant wealth retention opportunities because funds that otherwise would have been paid to a third party to purchase insurance are retained within the family. Furthermore, a Captive owned by a trust may be established so as to avoid inclusion in the estates of the senior generation. Such an ownership structure provides not only significant wealth retention and preservation opportunities, but also significant wealth transfer opportunities.

Reasons for using Captives

Captive insurance companies should be formed, of course, not for tax reasons, but for economic and business reasons. Risk management and risk financing are the main drivers of Captive formation and operation. These and other reasons are more fully summarized as follows:

- *Lower insurance costs.* Commercial market insurance premiums must be adequate to meet the cost of claims, overhead, and profit for the insurance company. By establishing a Captive, the parent/owner seeks to retain the profit within the business family, rather than

see it go to an outside party. A Captive may also reduce insurance costs by charging a premium that more accurately reflects the parent's loss experience.

- *Cash flow.* Apart from pure underwriting profit, commercial insurers rely heavily on investment income. Premiums are typically paid in advance, while claims are paid out over a longer period. Until claims become payable, the premium is available for investment. By using a Captive, premiums and investment income are retained by the owner and, where the Captive is domiciled offshore, that investment income may be untaxed if U.S. tax treatment is not elected. Additionally, the Captive may be able to offer a more flexible premium payment plan, thereby offering a direct cash flow advantage to the parent.
- *Risk retention.* A company's willingness to retain more of its own risk, particularly by increasing deductible or self-insured retention levels, may be frustrated by the inadequate discount offered by insurers to account for the increased deductible/self-insured retention and by the fact that the company is unable to establish reserves to pay future claims. Establishment of a Captive can help address both these problems.
- *Unavailability of coverage.* Where the commercial market is unable or unwilling to provide coverage for certain risks or where the price quoted is unreasonable, a Captive may provide the insurance desired.
- *Risk management.* A Captive can act as a focus for the risk management and risk financing activities of its parent organization. An effective risk management program will result in recognizable profits for the Captive. Risk management can be viewed by a Captive owner not as a cost center but as a potentially profitable part of the company's activities.
- *Access to the reinsurance market.* Reinsurers are the international wholesalers of the insurance world. Reinsurers are able to provide coverage at advantageous rates by operating on a lower cost structure than direct insurers. By using a Captive to access the reinsurance market, the parent/owner can more easily determine its own retention levels and structure its program with greater flexibility, thereby "laying off" some of its risk to a third-party company.
- *Tax minimization and deferral.* The tax considerations in forming a Captive will depend on the domicile of both the parent and the Captive. For example, a Captive that qualifies and makes an election under [Section 831\(b\)](#) is then exempt from income tax on the first \$1.2 million of premiums received without having to establish a reserve deduction actuarially.

Due to the complexity of a Captive, professional legal and tax advisors are essential to the integration of a Captive as part of an overall business, risk, and tax planning strategy.

Of course, formation and administrative costs are incurred in the implementation and maintenance of a Captive, but its substantial benefits should far exceed those costs. However, it is imperative to emphasize that while Captives potentially provide substantial benefits, the client must be willing to undertake the cost and management of their formation and administration and run the risk of claims just as a commercial insurance company does. Thus, an ideal candidate for a Captive would be a very profitable business. As a rule of thumb, a company having only \$250,000 or more of profits would probably be too small, while a company with profits of \$1 million or more would be ideal.

Grounds for IRS challenges

Given the substantial tax benefits associated with a captive insurance company, it is not surprising that the IRS has challenged certain aspects of Captives over the years. The primary arguments for those challenges are:

- (1) The Captive is not writing "insurance" in the usual sense, due to a lack of risk shifting and risk distribution.
- (2) Excessive premiums are being paid.

Consequently, it is critical that a Captive not only be formed and administered correctly, but also that it issue *true insurance* to its affiliates.

PLANNING TIP

A captive insurance company can reduce the cost of doing business and protect a company from costs associated with litigation, natural disaster, or other unexpected events and, ultimately, provide substantial income, estate, and asset protection benefits. In order to achieve the intended tax benefit, however, care must be taken with respect to the structure, operations, and risk associated with the entity.

History and fundamental requirements

Captive insurance companies have been used for years to provide insurance options for large businesses and Fortune 500 companies. Captives cover risks otherwise uninsurable due to difficult insurance markets that result in the inability to purchase coverage from commercial insurance carriers at cost-effective rates, or the inability to get certain types of coverage from the commercial insurance market. Because Captives have been used for several decades, the law surrounding the topic has been developed reasonably well.

There are numerous types of Captive insurance companies. Some of the most common types are:

- (1) Single-parent captives formed primarily to insure the risks of its parent or affiliates.
- (2) Association Captives owned by a trade, industry, or service group for the benefit of its members.
- (3) Group Captives created to provide an option to meet a common insurance need for multiple companies.
- (4) Agency Captives whose purpose is to reinsure a portion of an insurance company's clients' risks.
- (5) Rent-a-Captives that provides "captive" facilities to others for a fee.
- (6) Protected Cell Captives in which assets and liabilities can be segregated among different cells separate and apart from each other as well as its overall Protected Cell Company. (The Service issued [Rev. Rul. 2008-8](#) ,¹ specifying that each cell of a Protected Cell Captive must meet the definition of an insurance company and have appropriate risk shifting and risk distribution.)

The two following sections of this article provide a detailed discussion of the evolution of tax law surrounding Captives. The IRS and the courts have issued substantial rulings and opinions that provide assurance for planners when developing a Captive structure for clients.

IRS's required elements for insurance

To obtain the benefits of a Captive, it must actually provide "insurance" and have appropriate risk shifting and risk distribution. The concept of what constitutes insurance has long been debated in the courts, but more specific guidelines and some safe harbors have now been developed. These

guidelines and safe harbors, if followed, should protect a Captive in the event of an IRS challenge.

The Code does not provide a definition for the term “insurance.” In *Helvering v. Le Gierse*,² the Supreme Court set forth the standard that true insurance must have risk shifting and risk distribution. In *Helvering*, an elderly taxpayer who was uninsurable purchased a life policy and a life-only annuity policy one month before her death. By purchasing the annuity policy from the same insurer, the taxpayer offset the insurer's risk. The taxpayer's primary purpose for purchasing the life insurance policy was to obtain special estate tax advantages that were available for a life insurance death benefit. The Court decided that there was no risk shifting in this case because the life insurance policy and the life-only annuity contract offset one another. As a result, the taxpayer was in the same economic position before and after purchasing the policies.

Insurance requires *both* risk shifting and risk distribution. Risk shifting is the actual transfer of the risk from the insured to the Captive insurance company. On the other hand, risk distribution is the Captive insurance company's exposure to adequate third-party risk to obtain the risk-pooling effect had by most traditional insurance companies. Although theoretically these two concepts are separate, the courts often analyze them together. In addition to risk shifting and risk distribution, the policy must be insurance in a commonly accepted sense. Thus, the transaction must have some degree of fortuity or uncertainty.

Achieving appropriate risk shifting and distribution

Adequate risk shifting has been a frequent topic since the 1970s. Taxpayers and the Service have spent decades litigating the issue of what establishes adequate risk shifting. To thwart the taxpayer's use of Captives, the Service initially pressed the “economic family doctrine.”

Economic family doctrine. In [Rev. Rul. 77-316](#) ,³ the Service created the “economic family doctrine” to attempt to deny taxpayers the benefits of being a Captive. This doctrine stated that the risk must be transferred *outside* of the economic family to be true insurance. Under this approach, the parent-child Captive structure and the brother-sister Captive structure both were not insurance companies in the Service's view.

Under the parent-child Captive structure, the parent company owns the Captive as a subsidiary. In a brother-sister Captive structure, the company paying the premiums is an affiliate company to the Captive, usually via a common parent company. The Service's main focus was on a lack of risk shifting. The Service determined if no risk shifting occurs outside of the economic family, the Captive is not providing "insurance," and the premiums are not deductible.

Rejection of the economic family doctrine. The economic family doctrine was at odds with the Supreme Court decision in *Moline Properties, Inc.*⁴ The Court held that separate corporations must be treated as separate taxable entities, provided they have a business purpose. Even the early cases that failed to adopt the economic family doctrine did not adequately deal with *Moline Properties*.

As an alternative to the economic family doctrine, some courts implemented the "balance sheet test" to disallow deductions for premiums paid. The balance sheet test states that a company will be able to deduct premiums paid only if the company's balance sheet will have a net change when the loss is paid. This test works by not allowing deductions by companies that are too closely related to a Captive (like in a parent-child Captive structure), while allowing deductions by companies that are related less closely to the Captive (like in a brother-sister Captive structure).

In *Carnation Company*,⁵ and *Clougherty Packing Co.*,⁶ the Tax Court and the Ninth Circuit relied on the balance sheet test in its determination that premiums paid from a parent company to a subsidiary Captive were not deductible insurance premiums. Based on that test, the premiums were not paid for insurance, but rather nondeductible reserves against future losses.

In *Humana, Inc.*,⁷ the Sixth Circuit stated that "under no circumstances do we adopt the economic family argument advanced by the government." The court allowed subsidiary corporations to deduct premiums paid to an affiliate Captive Insurance Company. This ruling meant that a brother-sister Captive structure would be allowed by the courts. The court went on to state that the parent could not deduct premiums paid to its subsidiary, thereby holding that a parent-child captive structure was not permitted. This holding was based primarily on inadequate risk distribution in a parent-child captive structure under the balance sheet test. The parent's balance sheet is effectively unchanged in this structure. As a result, the premiums would be characterized as nondeductible reserves.

In 1992, the Ninth Circuit explicitly rejected the economic family doctrine in *Harper Group*,⁸ The court held that premiums paid to a Captive insurance company by *both* the parent and subsidiaries were deductible if third-party insureds made up approximately 30% of the total premiums paid to the Captive insurance company each year. As a result, it appears that if the Captive insures only a parent and its subsidiaries, the parent will not be able to deduct the premiums; however, if the Captive insures other third-party insureds as well, the court is more likely to find risk distribution.

Finally, the Service gave up its economic family doctrine. In **Rev. Rul. 2001-31**,⁹ the Service stated that it would no longer raise the economic family doctrine. Rather, the Service explained that it would use a case-by-case analysis. The Service appeared to be making a statement that it would continue to challenge risk shifting and risk distribution but under different theories than the economic family doctrine. In addition, the Service indicated that it would carefully scrutinize capitalization and parental guarantees. This Ruling is clearly representative of the Service's consistent attitude towards and willingness to challenge Captives.

Safe harbor Rulings. Beginning in 2002 the IRS issued a series of Revenue Rulings that would finally provide safe harbors for the concepts of risk distribution and risk shifting, thereby providing taxpayers with an element of comfort in assessing whether a Captive was truly issuing insurance.

Under **Rev. Rul. 2002-89**,¹⁰ 50% of premiums from unrelated businesses paid to a subsidiary Captive are sufficient for risk shifting and risk distribution. The Service also stated that 10% of the total premiums coming from unrelated businesses is not enough for risk shifting or distribution.

In **Rev. Rul. 2002-90**,¹¹ the Service explained that 12 subsidiaries, with each subsidiary having no more than 15% and no less than 5% of the total risk insured, which are paying premiums to an affiliated Captive insurance company was enough for risk distribution and risk shifting.

Rev. Rul. 2005-40,¹² held that the 12-subsiary test detailed under **Rev. Rul. 2002-90** was satisfied if all of the insureds have a common owner, provided that each entity was a non-disregarded entity. This meant that single-member LLCs could not be counted as a subsidiary. This Ruling stated that, even if the insurer was adequately capitalized and completely unrelated, if the number of insureds was insufficient, there may not be risk distribution. If this is the case, no insurance was provided.

In a much disputed decision, [TAM 200816029](#) stated that the Service will not treat limited partnerships with a common general partner as separate entities. The Service explained that this was because the common general partner bears all risk of loss. This TAM has been highly criticized because a general partner is liable only if all limited partnership assets have been exhausted or are unreachable by creditors. No authority has been issued on whether a general partnership, S corporation, or Q-sub is treated as a separate entity for purposes of the 12-sub subsidiary test.

In [Rev. Rul. 2009-26](#) ,¹³ the Service stated that when determining risk distribution and risk shifting in a reinsurance contract, the risks of the ultimate insured must be examined. This contract would be the primary (underlying) insurance policy.

Each of these holdings and rulings provide guidance in an area that was previously quite uncertain, but they also demonstrate the Service's inclination to challenge many aspects of a Captive. However, through the application of these safe harbor Revenue Rulings, a Captive insurance company program can be implemented successfully if care is taken.

Risk distribution—30% or 12 subsidiaries. Risk distribution generally refers to the sharing of insurance risks and is a required element of “insurance.” [Rev. Rul. 2002-91](#) ¹⁴ provides that the distribution of risk allows the insurer to reduce the possibility that a single claim will exceed premiums received. The Ruling indicates a pooling of premiums is necessary to reduce the potential that the related insured is, in essence, paying for its own risks while obtaining a tax deduction. Accordingly, the elements of risk distribution are driven by the number of "exposure units" and the pooling of premiums from which to pay losses. The combination of sufficient exposure units and pooling of premiums smoothes out losses so that they more closely match premiums received.

The Service had previously argued that insurance would never exist between a common owner and insured under the economic family theory. As discussed above, the courts did not agree with this argument, and the Service is no longer using the economic family theory to challenge Captives. Courts determined that insurance could exist, despite a common owner and insured, provided that sufficient unrelated insurance existed. This conclusion is based on the rationale that the existence of the unrelated insurance creates sufficient risk distribution for insurance legally to

exist. The courts have never established a floor for sufficient unrelated business, but they have ruled that 2% is insufficient and that 30% is sufficient.¹⁵

Risk distribution pool. The unrelated premiums requirement is a substantial concern if a Captive is insuring a business with common owners and does not have a sufficient percentage of unrelated insurance or does not insure an adequate number of affiliated subsidiaries (12 subsidiaries that are not disregarded entities). To acquire a 30% unrelated premium, a Captive may participate in a “risk distribution pool.” A risk distribution pool is formed for the exchange of insurance business among Captives to spread risk and enhance participation in a non-related business. The participation of multiple Captives in the pools is the element making a pool useful for satisfying risk distribution requirements.

A risk distribution pool combines the investments of many Captives into a single account that is held by a reinsurance company. Risk is transferred from each individual Captive through a quota share reinsurance agreement whereby the reinsurer accepts a stated percentage of each and every risk within a defined category of business on a pro rata basis. This quota share agreement provides a fixed and certain risk for all Captives that bought coverage from the reinsurance company. A contract is issued between the reinsurance company and each Captive for the reinsurance company to retain funds in its trust account for a certain period. A number of pools can be invested in, and access to them can usually be gained through a captive management company.

How a Captive can work for clients

A common issue among business owners considering a Captive is the concern about taking on additional risk. In reality, however, most businesses unknowingly self-insure significant risk. The problem is that self-insurance without a Captive is not tax-deductible for federal or state income tax purposes. Loss reserves cannot be set aside and deducted to finance future lawsuits and other risk exposure. Thus, given today's maximum income tax rates, self-insuring these risks can cost almost twice as much because they must be paid from profits on which the business has already paid tax.

On the other hand, businesses that have structured a Captive insurance company can finance that risk using pre-tax dollars. With a Captive, self-insured risk can be converted into tax-

deductible premiums that are paid into a privately held and licensed insurance company. Risks can now be addressed with this pre-tax nest egg. In the event that claims do not materialize, the Captive will capture a substantial pre-tax sum to be used for the future business risks, or for distributions to owners, family members, or key executives, all at favorable tax rates over time.

Self-insured risks. A middle-market or smaller business typically structures a Captive to fill in gaps where conventional commercial insurance markets do not provide coverage, or where the cost is deemed economically unattractive. Common areas of risk that can be included in a Captive are found in commercial insurance policy deductibles and exclusions. Here, the business has not assumed additional risk, as it is already exposed to such risks before establishing a Captive.

Industries such as construction, manufacturing, distribution, and professional services regularly face industry-specific risks that are excluded by general liability insurance and errors and omissions policies. For example, construction-defect liability, product liability, distributor liability, and administrative actions are all highly common risks not covered by general commercial insurance policies. Furthermore, Captives can provide coverage for risks currently self-insured—such as pollution, regulatory and other types of exposures, insurance deductibles, loss of tenants, key employees, key customers or suppliers, breach of contract, and natural disasters.

Ultimately, actuaries and underwriters quantify the self-insured risk. That risk is converted into insurance premiums, which are deducted from the taxable income of the parent company. The Captive then invests the funds and uses them to pay claims. The profits, after claims and expenses, may be distributed to shareholders as dividends at a later date or invested in other businesses.

The business owner's selection of risks to either transfer to a commercial insurer, shift to a Captive, or retain are *critically important* business decisions having very real repercussions. These decisions can affect the future health of a business. Thus, a first step in any Captive discussion is to analyze or “audit” the existing insurance coverage and risk management program so that the Captive-issued policies will coordinate with the existing insurance coverage. For example, most business owners would not transfer all risk property insurance coverage, including fire risk, to a Captive where a catastrophic fire loss could destroy the business and perhaps the

Captive. However, it might be wise to transfer the first \$500,000 of property loss risk to a Captive and purchase commercial insurance for the coverage above \$500,000.

These decisions must be made with advice and counsel of someone knowledgeable in risk management and risk analysis. That analysis will include a review of the business' current insurance program and policies, provisions, and limits of insurance, including a review of all current exclusions from coverage. Additionally, an overview of the business and analysis of risks associated with the business must be conducted, along with a review of actual loss experience for the previous three to five years and a determination of the amounts and types of any uninsured losses over the same time period.

If a Captive is used to provide insurance for currently insured risks that could potentially result in large claims, the Captive can purchase reinsurance to protect against those claims.

"Reinsurance" can be thought of as a means by which an insurer transfers some or all of the risk under a policy of insurance to another insurer or insurers. For example, a Captive may want to be exposed to only \$500,000 per general liability claim. As a way to limit its exposure, it could purchase reinsurance to pay 50% or all of a claim exceeding \$500,000.

Reinsurance and its benefits. Purchasing reinsurance stabilizes loss experience, increases capacity for undertaking risks and limits liability on specific risks. While the cost of reinsurance is lower than standard commercial insurance, it is almost always more expensive than the actuarial cost of the risk being transferred. Therefore, the cost vs. benefit must be carefully analyzed.

With reinsurance, an insurer, the Captive in this instance, transfers premiums collected from customers to a reinsurer. In return, the reinsurer accepts part of the risk assumed by the insurer. In calculating the price of the risk transferred, the reinsurer takes into account the loss experience during the previous three to five years and the expected future losses according to the types of risks insured and the loss experience using actuarial analysis. Interestingly, this is the same analysis that a commercial insurance company undertakes in analyzing and pricing commercial insurance policies.

The benefit to a Captive, and therefore to its owner, is that it can insure risks and then spread the risk of losses through reinsurance at a cost much lower than commercial insurance. Direct access to the reinsurance market is a significant benefit that a Captive provides, which typically would not

be available to a business owner. Over time, as a company gains comfort with its Captive, it can shift risks that it has covered through the commercial insurance market to its Captive and protect its capital by reinsuring those risks to minimize its loss exposure to those risks.

How is a Captive formed?

From a practical perspective, the Captive must be formed in the jurisdiction in which it will operate, either a domestic or foreign jurisdiction. Various factors must be analyzed in determining where to form the Captive, including operational and tax considerations. Appropriate licensing must be obtained, and required capital considerations must be determined.

"Captive" tax definitions and elections

A Captive is an insurance company formed, licensed, and governed under the laws of a particular state or country that issues insurance policies to related businesses in exchange for premiums. To form a Captive, one must incorporate an insurance company. The Code defines an "insurance company" as a company where more than half of the business during the tax year is derived from issuing insurance or annuity contracts or reinsuring risks underwritten by insurance companies.¹⁶ In accordance with the entity classification rules, an insurance company must be a corporation for U.S. income tax purposes.

The entity classification rules found under [Section 7701](#) and its accompanying Regulations determine the classification for business entities recognized for tax purposes based on the entity's ownership. Under those rules, an insurance company is treated as a per se corporation and, thus, is ineligible to elect any other classification than a C corporation for U.S. income tax purposes.¹⁷ To be clear, an insurance company must be taxed as a C corporation and not as a partnership or S corporation.

Large versus small election— [Section 831\(b\)](#) . A property and casualty insurance company may either be "large" or "small." Small captive insurance companies are those eligible to elect to be taxed only on investment income and with net written premiums not exceeding \$1.2 million in a tax year, provided that the company also makes an affirmative election under [Section 831](#) .¹⁸ The [Section 831\(b\)](#) election requires tax to be paid only on investment income at corporate rates. However, net operating losses do not offset investment income and cannot be carried to or from any tax year for which the company has made an election under Section 831(b).

The benefits of making the election to be a "small" property and casualty Captive insurance company is that the operating company (i.e., the insured) deducts the premiums, and those premiums (up to \$1.2 million) are free of income tax for the Captive. Specifically, the business would receive a deduction for premiums paid to the Captive under [Section 162](#) , and up to \$1.2 million of those premiums would be exempt from income tax at the Captive level under [Section 831\(b\)](#) .

Congressional intent behind [Section 831\(b\)](#) was specific. First, Congress desired to encourage the formation of new insurance companies. Congress also wanted to create equality between businesses that choose to insure certain of their own risks and those that choose to use third-party insurance. In addition, [Section 831\(b\)](#) was looked at as a chance to provide incentives for small businesses that were not purchasing insurance from commercial insurance companies to prepare for uninsured risks.

An election must be affirmatively made under [Section 831\(b\)](#) to receive the exemption from income on premiums. If the election is not made, the Captive is taxed in the method prescribed by [Section 831\(a\)](#) . The election is made by attaching a statement to the Captive's tax return. A Captive operating as a small property and casualty company must file a Form 1120-PC income tax return and report its income on Schedule B. An [831\(b\)](#) election will apply to an insurance company as long as the company's premiums do not exceed \$1.2 million or until the election is revoked with the consent of the Service.¹⁹ The Service generally does not consent to the revocation of an election unless a material change in circumstances is shown.

The election status does not affect the deductibility of premiums paid by the operating companies. An additional benefit provided by the election under [Section 831](#) is the ability of the Captive to accumulate surplus from underwriting profits free from tax. The owners of a small property and casualty Captive are, however, taxed on dividends received from the company. This also implies that investment income earned by the Captive will ultimately be double taxed when paying dividends or making liquidating distributions of investment income.

Choice of jurisdiction. A Captive may be formed as either a domestic entity or a foreign entity. The domicile chosen for a Captive has large implications on its capitalization, reporting, and other requirements.

Offshore foreign jurisdictions have been a popular choice for the domicile of a Captive. Generally, Caribbean nations have had relaxed standards for Captives, including lower capitalization requirements. Some nations, however, may not be as responsive or accommodating as domestic choices. The hours and accessibility of government agencies in charge of Captives are generally substantially limited as compared to those in a domestic jurisdiction.

An additional consideration when determining a Captive jurisdiction is the [Section 953\(d\)](#) election, which is made by an offshore Captive to be treated as a domestic corporation for income tax purposes. If a foreign jurisdiction is chosen, the entity should consider making an election to be treated as a domestic C corporation for income tax purposes under [Section 953\(d\)](#). The effect of such an election is for the Captive to be taxed as a domestic corporation despite its formation and existence in a foreign jurisdiction. This provides an opportunity to benefit from the relaxed standards of a foreign jurisdiction without having to deal with the complexity of the taxation of an international entity.

Some domestic jurisdictions have recently become more accommodating to Captive owners. However, they still have larger capitalization requirements, which may sway many owners toward offshore jurisdictions despite administrative hassles.

Captive implementation and administration

The implementation and administration of a Captive requires analysis of many elements and multiple decisions that will have long-term effects. The following is a list of considerations for implementing and administering a Captive:

- (1) Conduct an insurance audit/feasibility study to determine what risk the contemplated Captive should consider insuring.
- (2) Determine the appropriate type of Captive for the particular situation.
- (3) Determine who will be the shareholders of the Captive—businesses, trusts, or individuals.
- (4) Determine the appropriate jurisdiction for the Captive, and take the necessary steps to appropriately incorporate it in that jurisdiction.

- (5) Determine if a large or small Captive is appropriate, obtain an Employer Identification Number, and file any required elections with the IRS.
- (6) For offshore Captives, determine if a **Section 953(d)** election should be made to treat the Captive as a U.S. taxpayer.
- (7) Arrange for adequate capitalization. To obtain an insurance license, Captives must have a minimum amount of capital on formation. For business and IRS purposes, a Captive must maintain adequate capital relative to the risk underwritten.
- (8) Hire a management company. Due to the complexity and reporting requirements of a Captive, it is generally recommended that a management company be engaged to handle its insurance operations. Members of the management company (or the management company itself) may also serve as most of the officers and directors of the Captive.
- (9) Conduct underwriting and develop policies. An actuary is often used to review the type and amount of insurance that will be issued to the operating company.
- (10) Obtain one or more insurance licenses, as appropriate for the Captive's jurisdiction.
- (11) A separate bank account should be opened for the Captive.
- (12) The Captive may be subject to local reporting requirements, depending on the jurisdiction in which it was organized.
- (13) Adhere to restrictions for how the premiums paid to a Captive may be invested.
- (14) Maintain reserves as required by the local law of the jurisdiction issuing the insurance license.²⁰
- (15) As discussed, a Captive must maintain adequate risk distribution, which may be accomplished through participation in a risk distribution pool.
- (16) Procedures for the handling and payment of claims must be implemented.
- (17) Regulatory management of Captives should include: (a) insurance company accounting and records; (b) regulatory filing and reporting; (c) quarterly financials; (d) annual Captive efficiency review; and (e) liaison with investment manager, tax preparer, auditor, and regulatory body. The Captive management company can assist in processing claims.

The implementation of a Captive is time and cost intensive; therefore, exiting a Captive should be done only after careful analysis and determination by experienced professionals that the continuation of the Captive is not in the client's best interest.

Avoiding, or at least winning, an IRS challenge

Of course, a Captive insurance company can be extremely beneficial in many aspects, as insurance profits are kept within the group and tax benefits may be obtained. As is true with any business planning, however, the Captive must be a legitimate business entity and be in compliance with the law. There are opportunities for the Service to challenge Captive insurance companies; therefore, proper formation and ongoing administration is essential. The Service may have given up on the economic family doctrine, but the Service specifically stated in [Rev. Rul. 2001-31](#) that it may continue to challenge Captives based on the facts and circumstances of each case.

Legitimate business reason. As is true with any business planning, a Captive must possess a legitimate business reason to avoid being characterized as a sham by the Service. Some legitimate business reasons are as follows:

- (1) To obtain coverage where insurers are unwilling to do so.
- (2) To reduce premium payments.
- (3) To control risk.
- (4) To increase cash-flow.
- (5) To gain access to the reinsurance market.
- (6) To create diversification.
- (7) To balance coverage.²¹

In addition, [Rev. Rul. 2001-31](#) suggests that taxpayers can now list tax planning as a reason for forming a Captive.

Each legitimate business reason for forming a Captive should be fully analyzed and documented from the planning stage through the formation of the entity. Any evidence that could be produced

on audit to show the business purposes of formation may be extremely useful in combating sham characterization by the Service.

As mentioned previously, management and operation of the Captive is essential to its success, leading to the recommendation that professional advice be sought regarding not only the formation but the ongoing operation of the Captive. It is critical that advice from a professional in risk management matters be obtained to set up and run the Captive, and even in the selection of a Captive Management company. Care should be exercised to avoid Captive “Mills” that eventually just set up the Captive, but do not provide any true risk management services for the Captive both to insure success of the venture and to avoid problems with the Service.

Avoiding excessive premiums. Under [Section 162\(a\)](#) and [Reg. 1.162-1\(a\)](#), insurance premiums paid by a taxpayer are deductible if they are connected directly with the taxpayer's trade or business. However, the insurance premiums must be an ordinary and necessary business expense in order to be deductible. Therefore, a business must be able to prove that any premiums paid to a Captive are an ordinary and necessary business expense in the event of a challenge by the Service.

The Service has challenged premiums as being "excessive" and not an ordinary and necessary business expense on two grounds. First, taxpayers that pay overly high premiums for the insurance they are receiving will not be able to deduct those premiums.²² Second, taxpayers that are suddenly obtaining a significantly higher and unnecessary level of insurance will not be able to deduct those premiums.

Reliable actuarial method. In *Gulf Oil Corp.*,²³ the Tax Court decided that insurance premiums charged by a Captive insurance company and the amount of insurance provided by the Captive must be based on a reliable actuarial estimation of the risk of loss. Having premiums that are consistently in great excess of the actual losses paid is an indicator that one of two things is occurring. First, the taxpayer could be attempting to evade taxes by taking advantage of the [Section 831\(b\)](#) exclusion. Second, the company could, in reality, be retaining the risk, and the Service might conclude that the Captive was not actually providing insurance. As a practical matter, the Captive should actually pay claims to its insureds every year.

A red flag for the Service has also been when the Captive is charging exactly \$1.2 million in premiums.²⁴ Under **Section 831(b)** , a small insurance company can deduct up to \$1.2 million dollars in insurance premiums. If a Captive is charging exactly that amount, it may suggest to the Service that an actuarial method was not used and that the Captive is a tax fraud.

Consequences of excessive premiums. If the Service or a court determines that the insurance premiums being charged by the Captive are excessive, undesirable consequences follow. First, the premium-paying company loses the income tax deduction and, most likely, also has to pay interest and penalties. Second, the Captive may have taxable income.

There also could be gift tax issues with the transfer for Captive business structures where the Captive is owned by the business owner's descendants or trusts. If the taxpayer-owner did not file a gift tax return, the taxpayer may be subjected to failure to file penalties, as well as other penalties. For this reason, the client may consider filing a gift tax return every year a premium is paid to a Captive. By filing the Form 709 and making proper disclosure, the gift tax statute of limitations will begin to run, and, thus, the transfer tax risk should be reduced.

How to avoid paying excessive premiums. To avoid a determination that the premium payments are excessive and at the same time increase the deduction available, the company can attempt to find insurable risks for which third-party insurance is not commercially available or not commercially affordable.²⁵ An insurable risk must have some degree of fortuity or uncertainty. Traditional business or investment risks do not have the necessary degree of fortuity and thus, are not insurable. By obtaining insurance on risks that the company would not normally be able to insure through a third-party insurer, the company will potentially be able to pay higher premiums without the insurance or the premiums becoming excessive. This may result in the justification for a higher income tax deduction under **Section 162(a)** .

The role of life insurance in a captive. Since Captives must be taxed as C corporations, investment vehicles that are not subject to current income tax are attractive assets. In that respect, permanent life insurance policies would seem an ideal asset for a Captive to consider owning because increases in cash value are not subject to current income taxation. On the other hand, **Section 264** states that life insurance premiums cannot be deducted either directly or indirectly. Therefore, when a Captive owns life insurance, the Service could conceivably attempt to collapse the business' payment of premiums to the Captive and the Captive's payment of

premiums to the life insurance company, deeming them to be a single payment of premiums directly to the life insurance company. Such classification would result in a determination that any income tax deductions taken for premiums paid to the Captive were improper.

Because there is no authority on this issue, prudence and common sense are advisable to reduce any IRS risk. For instance, if life insurance is being contemplated as an investment for a Captive, the client should apply for it only after the Captive has been formed. Also, its purchase should be for a significant nontax purpose. When life insurance is not a primary asset of a Captive, but a minority portion of a diversified investment portfolio, the likelihood of a successful challenge by the Service under **Section 264** should be significantly reduced.

Loan-backs. A Captive's lending money back to an operating business that the Captive insures is often referred to as a "loan-back." A loan-back is used to invest Captive funds in the operating business. The arrangement usually takes the form of a bond issuance but is fundamentally no different than a loan. The Service carefully scrutinizes loan-backs and has contemplated issuing regulations relating to them. To date, the Service has issued limited guidance on loan-backs and has not provided an objective standard to determine whether a loan-back will be considered a bona fide debt.

Loan-backs are often analyzed in terms of the loan-back to premiums-paid ratio. If a significant portion of the premiums paid are borrowed, concerns of a circular cash flow arise.²⁶ In a situation where a Captive loaned 97.5% of its assets to the operating business, the Service determined the loan-back to be invalid and stated by "loaning out substantially all of its assets to an affiliate, Insurance Subsidiary resembles an incorporated pocket-book, representing a reserve for self-insurance...."²⁷ Therefore, a loan-back must be issued with great caution, must be a bona fide debt, and should not represent a significant portion of the Captive's assets or premiums paid.

Conclusion

Captive insurance companies provide many business and tax planning opportunities. A Captive provides a business with the opportunity to obtain commercially unavailable or commercially unaffordable risks and an income tax deduction for premiums paid. The **Section 831(b)** election provides the Captive with the opportunity to receive \$1.2 million of income tax exempt premiums annually with significantly less administrative costs and burdens than a large Captive.

Despite the benefits of creating a Captive insurance company, it is important to recognize the risks and responsibilities that accompany them. A refusal to abide by the requirements in creating a Captive could be a costly mistake. The Captive must write "insurance" in the traditional sense of fortuitousness, risk shifting, and risk distribution.

Also, the Captive must be properly formed and structured so as to withstand IRS scrutiny. Choices must be made regarding the type of Captive, place of domicile, amount of capitalization, use of a management company, shareholders of the Captive, and the drafting of the insurance policies. Formal requirements must be satisfied as well, such as obtaining an insurance certificate, obtaining a separate bank account, and following reporting and investment requirements. The Captive must have a legitimate business interest and may not charge excessive premiums.

Although formation and administrative costs are incurred in the implementation and maintenance of a Captive, its substantial benefits outweigh those costs. Captives can be an invaluable tool for business and estate planning. A profitable Captive can over time transfer wealth to future generations where a trust for the benefit of the client's spouse or descendants owns the Captive. By using a dynasty trust with a generation-skipping transfer tax provision, the Captive can be excluded from the taxable estates of the family for generations.

Overall, clients should enter into the Captive insurance company realm with their "eyes wide open" and with highly qualified advisors. When done properly, a Captive insurance company can be an invaluable planning tool for the appropriate client.

¹

2008-5 IRB 340.

²

25 AFTR 1181 , 312 US 531 , 85 L Ed 996 , 41-1 USTC ¶10029 , 1941-1 CB 430 (1941).

³

1977-2 CB 53.

⁴

30 AFTR 1291 , 319 US 436 , 87 L Ed 1499 , 43-1 USTC ¶9464 , 1943 CB 1011 (1943).

5

47 AFTR 2d 81-997 , 640 F2d 1010 , 81-1 USTC ¶9263 (CA-9, 1981).

6

84 TC 948 (1985).

7

64 AFTR 2d 89-5142 , 881 F2d 247 , 89-2 USTC ¶9453 (CA-6, 1989).

8

70 AFTR 2d 92-6053 , 979 F2d 1341 , 92-2 USTC ¶50572 (CA-9, 1992).

9

2001-1 CB 1348.

10

2002-2 CB 984.

11

2002-2 CB 985.

12

2005-2 CB 4.

13

2009-38 IRB 366.

14

2002-2 CB 991.

15

See Gulf Oil Corp., **89 TC 1010** (1987); Sears, Roebuck & Co., **70 AFTR 2d 92-5540** , 972 F2d 858 , 92-2 USTC ¶50426 (CA-7, 1992); AMERCO, Inc., **70 AFTR 2d 92-6048** , 979 F2d 162 , 92-2 USTC ¶50571 (CA-9, 1992); Harper Group, **70 AFTR 2d 92-6053** , 979 F2d 1341 , 92-2 USTC ¶50572 (CA-9, 1992).

16

Sections 816(a) and **831(c)** .

17

Regs. 301.7701-2(b)(4) and **301.7701-3(a)** .

18

Section 831(b) .

19

Section 831(b)(2)(A) .

20

Reg. 1.801-5(b).

21

See Hahn and Bailey, "Captive Insurance Companies: More Viable Than Ever?," 29 Corp. Tax'n 12 (Sept./Oct. 2002).

22

See Non Docketed Service Advice Review, 2002 I.R.S. N.S.A.R. 20160 (4/17/2002).

23

Note 15, *supra*.

24

See note 22, *supra*.

25

Id.

26

See FSA 199945009.

27

FSA 200202002.