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TAXATION OF A CAPTIVE

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Under the Code, businesses are not permitted to deduct a reserve that has been established for a future contingency because deductions are generally permitted only after "economic performance" has occurred with respect to an accrued obligation. However, if a captive retains the risk, and if the captive is treated as an insurance company under Subchapter L of the Code, the captive may immediately deduct both the reserve for the contingent obligation and the premiums paid to the captive. (The captive recognizes income with respect to the premiums as they are received.) The net result is often a significant acceleration of tax deductions for the contingent obligations that were placed in the captive.

Historically, the IRS has shown great reluctance to embrace the notion that a parent's consolidated group can deduct a captive's loss reserves. It has continued to issue pronouncements that raise concerns for enterprises that seek to deduct captive loss reserves. However, the courts have repeatedly held that captive loss reserves are tax-deductible when the subsidiaries cover sufficient amounts of unrelated risks to enable the captive to shift and distribute risk in accordance with the economic principles of insurance. Presumably in response to the courts' relatively greater receptivity to loss reserve deductions for captives, the IRS began to express a somewhat greater willingness to acquiesce to such deductions.

While captives can offer certain tax advantages to business owners, my tendency is to view a proposed captive arrangement as tax-neutral and make sure that it works without any regard to any tax benefits. This is because to the extent that a captive offers tax benefits, simply enhances the underlying non-tax advantages. That said, it is logical to assume that you expect that premiums paid to your Captive are deductible, income to the Captive will qualify for the same special accounting and tax treatment afforded to traditional insurance under US tax law. If you want to realize any tax benefits, you need to be deemed an insurance company, per the IRS definition.

Under currently applicable tax principles, obtaining favorable tax results for a captive generally depends on whether the captive is regarded as constituting a bona fide insurance company. One of the key requirements for being a bona fide insurance company is to insure substantial amounts of risk attributable to parties deemed, for insurance taxation purposes, to be unrelated to the captive or the corporate parent. (Such risk from unrelated parties is often referred to as "third-party risk" or "third-party business."). A widely used rule of thumb is that a captive has sufficient unrelated third-party risk to be regarded as a bona fide insurer if the captive obtains at least 30% of its insurance business from third-party sources. Presumably, this rule is derived from the case of Harper Group v. Commissioner. The IRS appears to concede, as a "safe harbor," that a captive having over 50% unrelated risk has sufficient unrelated risk to constitute an insurance company under Subchapter L of the Code.

Tax Considerations and Employee Benefits

In the early 1990s, the IRS permitted an employer to deduct the employee benefit premiums it paid to its captive. Under the circumstances presented, the IRS would presumably have disallowed these insurance premium deductions if the underlying employee benefits risks had not constituted third-party risk. Consequently, the captive community now generally views employee benefits as third-party risk, which, as previously discussed, can be helpful in establishing the captive's status as an insurance company under Subchapter L of the Code. In Rev. Rul. 2001-31, the IRS stated that it would henceforth evaluate captive insurance arrangements "based on the facts and circumstances of each case."

Protected Cell Captive structure

Under the Protected Cell Captive (PCC) structure, your Captive Insurance Company is a Series Cell. For tax purposes, it is treated as a C-Corporation. Although your captive is part of the PCC Facility, it has a separate portfolio of assets that, by statute, are treated as if they were held by separate companies. A corporation has one set of tax attributes, such as taxable income or loss, earnings and profits, and capital gain net income or losses. As a corporation, your captive makes its own tax elections, based on the overall tax strategy of its owner.

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). This proof goes beyond simply obtaining an insurance license from a state. The major US tax issues impacting the formation and operation of a captive insurance company are summarized as follows:

1. Non-tax business purpose: Your captive MUST have been created for reasons other than the tax benefits.
2. Common Notion of Insurance
3. Insurance Risk
4. Risk Shifting: Is the transferring of the financial consequences of the potential loss to the insurer (your captive in this case);
5. Meeting one of the following Diversification Tests:
    a. No more than 20 percent of the net written premiums (or, if greater, direct written premiums) of such a company for the taxable year is attributable to any one policyholder.
    b. The ownership of the captive and the ownership of the business being insured are essentially equal. There is a small margin of allowable difference in the ownership of 2 percent between the Captive and the business that owns the captive.
6. Meeting the Risk Distribution Test: Risk distribution, also known as risk sharing, is a fundamental feature of insurance: The actuarially credible premiums of the many pay the (expected) losses of the few. Here are ways to meet this requirement (individually or a combination of the below described):
    a. Since most captives would have difficulty qualifying, they must therefore rely on Revenue. Ruling 2002-89 for guidance as to risk distribution. That ruling states

that the captive must show that "30% or more" of its risk comes from unrelated third parties. "Risk" in this case is typically measured by premium. The way to meet this test is as follows:

i. In Revenue Ruling 2002-89, the IRS ruled on a safe harbor, known as the "third party insurance" safe harbor. This test posits that if the captive derives at least 30% or more of its premiums (not risk) from unrelated third-party insureds, then risk distribution has been met.

ii. In Rev. Rul. 2002-90 & 91:

(90) Revenue Ruling 2002-90 requires that the captive insure at least 12 separate companies (single member LLCs do not count Rev Ruling 2004-40), with no one company representing more than 15% of the total premium paid to the captive. In practice, the IRS seems to accept as few as 6 separate insureds with none paying more than 45% of the total premium, but it is difficult to rely too heavily on such practice as it may change without notice. The IRS addressed a situation in which the captive provided insurance to various sister companies. The arrangement in the revenue ruling consists of a parent corporation owning 12 operating subsidiaries that rendered professional services. The 12 subsidiaries had a significant volume of independent, homogenous risks. The captive insured the risks of the operating subsidiaries on a commercially reasonable basis.

(91) In Revenue Ruling 2002-91, the IRS addressed an arrangement involving a group captive formed by a relatively small group of unrelated businesses involved in a highly concentrated industry to provide insurance coverage. Each of the insureds in the group had no more than 15 percent of the ownership of, or vote of, the group captive, and none accounted for more than 15 percent of the risk. On these facts, the IRS concluded that adequate risk shifting, and risk distribution were present.

iii. If your captive decides to write Medical Stop Loss Coverage, it will meet this Ruling because tax law, properly understood, treats captive insurance of employee benefits risk as unrelated-party risk regardless of whether the policy contract rights run to employees, to the plan, or to the employer. Key Rulings: Rev. Rul. 92–93 characterizes employee benefits risk as unrelated-party risk in the hands of a captive. The risk sourcing rule implied by Rev. Rul. 92–93 was made explicit by Rev. Rul. 80–95 and is unambiguously supported by the courts and the legislative history of the Internal Revenue code.

Premium Deductibility, Gift, Estate, and GST Tax Issues

1. Premiums Deductibility at the Parent Level: Premiums paid to a captive for property and casualty insurance should be deductible under IRC §162 as ordinary and necessary business expenses, or IRC §212 as ordinary and necessary expenses for the production of income (investment assets). Premiums will be "ordinary and necessary" only if they are arm's-length, which requires that they be comparable to those charged in the market for

similar insurance coverage. The insurance company itself must also be respected as an insurance company for federal income tax purposes in order for the premiums to be deductible by the insured. This requires qualified underwriting services to determine the actual cost of similar coverage in the market, or if similar coverage is not available, then by means of underwriting evaluation. When selecting a captive management company, it is crucial that the actuaries and underwriters have the experience required to properly design the policies and determine the premiums.

2. Gift Tax: If the premiums paid to the captive are deductible by the payor, they do not represent a gift for gift tax purposes. Treas. Reg. §25.2511-1(g)(1) provides that "the gift tax is not applicable to a transfer for a full and adequate consideration in money or money's worth, or to ordinary business transactions. . ." Treas. Reg. §25.2512-8 further provides that Transfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of consideration given therefor. However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent) will be considered made for an adequate and full consideration in money or money's worth. [Emphasis added] Insurance premiums are an ordinary and necessary business expense under IRC § 162. xlii Additionally, many courts have determined that the payment of premiums from one entity to another in a brother-sister captive ownership structure qualify as ordinary and necessary business expenses under IRC §162. If the premiums paid to the captive insurance company constitute full and adequate consideration, or are made in the ordinary course of business, then they are not a gift, or a deemed gift, from the owners of the insured to the owners of the captive insurance company. To the extent the amount of the premium is determined in accordance with industry standards by an actuary, then the payment of such amount should be for full and adequate consideration.
3. Estate Tax: The "full and adequate consideration" test under IRC § 2512 is also paralleled in the estate tax inclusion sections under IRC §§ 2036 and 2038. Since there have been many recent Tax Court cases dealing with retained interests and control, the estate planner must use substantial caution in structuring the ownership of the captive. However, if payment of premiums to the captive are for full and adequate consideration, then IRC §2036 and §2038 should not apply.
4. Generation-Skipping Tax: A transfer of property is subject to generation skipping transfer tax ("GST Tax") if there is either a direct skip, a taxable distribution, or a taxable termination. The latter two events deal with transfers in trust and would not apply to the captive arrangement. A direct skip is a transfer to a skip person (i.e. transfers that skip at least one generation) that is subject to either the gift tax or estate tax. If there is no gift for gift tax purposes and there is no inclusion in the taxable estate for estate tax purposes arising from payment of insurance premiums, then there is no transfer for GST Tax purposes. Thus, the value that is created from ownership of shares in the captive and distributions from the captive may be made to a skip person or a GST Tax exempt trust that may never be subject to GST Tax.

Multiple 831(b) Companies

As discussed above, a captive insurance company must receive less than $2.8 million in annual premiums to qualify for the special tax treatment under IRC § 831(b). It is often beneficial to form multiple §831(b) companies to take advantage of this favorable treatment. In an estate planning context, it might be beneficial to have a separate §831(b) company owned by each child or by a trust for each child. The Code provides attribution rules to prevent abuse by formation of multiple captives. xlix Generally, the controlled group rules under IRC § 1563 apply, with some noted exceptions. In a brother-sister controlled group, 5 or fewer persons who are individuals, estates or trusts own at least 80% of the vote or value of the stock, but only if such persons own an identical interest in each corporation. Under the constructive ownership rules, stock owned by a person under the age of 21 is constructively owned by his or her parent and vice versa. An individual who owns more than 50% of the vote or value of stock shall be considered as owning the stock of his or her parents, grandparents, grandchildren, and children who have attained the age of 21. Therefore, when reviewing the potential estate planning and wealth transfer planning of a client, a separate IRC § 831(b) company can be owned by parents and each child or grandchild over the age of 21 without having the controlled group rules apply. For example, parent A has three children, B, C, and D, who are all over the age of 21, and A, B, C, and D each own 100% of separate IRC § 831(b) companies. For purposes of the constructive ownership rules, A is not deemed to own the stock owned by B, C, or D, or vice versa, because they are each over the age of 21 and there is no attribution among siblings, so each of B, C, and D are also not attributed the stock ownership of each other. Applying the general rule under IRC § 1563(a), although there are 5 or fewer persons that own at least 80% of the stock of each company, none of them have identical ownership in more than one company, as they each own 100% of each company. Such structures must be carefully analyzed to ensure that they make economic sense for the insurance planning being done for the group and that each IRC § 831(b) company meets the applicable federal tax requirements.

Asset Protection

Generally, the assets of the captive insurance company will not be subject to claims of creditors of the insured companies or their owners under general corporate law. This assumes that the captive insurance company is not a sham, premiums are reasonable and justified, and the captive is properly formed and operated.

Tax Forms Filed with IRS

Insurance Companies are treated as a C-Corporation. As such, regardless of the fact your Captive is a Series Business Unit, the IRS will deem it a C-Corporation for tax purposes. There are basically 3 options for all captives:

1. Captive not making any special election file Form 1120-PC - U.S. Property and Casualty Insurance Company Income Tax Return.
2. Captives who elect to take the IRC 831(b) election, file Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return. However, you must include a letter (see Appendix A) to accompany your captives tax return.

3. Captive not making any special election and gross revenue is less than $600,000 can file Form 990 - Return of Organization Exempt From Income Tax.

The IRC 831(b) Election

States that have a small Property and Casualty insurance company, of premiums less than $2.2M, are tax exempt on underwriting income, and only must pay taxes on Investment Income. The significant advantage is that the company can accumulate surplus from underwriting profits free from tax. This tax advantage greatly leverages a business' capacity to build risk reserve assCG and retain investment control. When integrated with estate plans, Version 09/18.5 20 the wealth transfer, protection and accumulation benefits can be substantial. While IRC Section 831(b) provides special income tax exemption benefits to underwriting premium revenue of $2.2M or less each year from federal income tax, investment income is still taxed. This special tax benefit helps place small captives insuring risks of affiliated businesses on a level playing field with much larger commercial insurers who have long benefited from special accounting and tax law provisions. As you can see this is a significant benefit, but you MUST first qualify as an insurance company before you can take this election.

IRS Areas of Focus

1. Must be established for business purposes
2. Capitalization & Solvency
3. Insurance contracts must be legally binding
4. All transactions are at arm's length
5. Risk Shifting & Risk Distribution (unrelated risk, done through Risk Exchange)
6. Circular Lending to payee
7. Regular Board Meetings
8. Proper Books & Records
9. Properly Regulated & Managed

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