USE OF CAPTIVE INSURANCE IN ESTATE AND BUSINESS PLANNING

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Rising insurance costs coupled with increasing self-insured risk is a major issue faced by many businesses. In order to mitigate these risks, an increasing number of businesses are implementing captive insurance programs. A captive insurance company is a subsidiary or affiliate of the business entities that is formed to insure or reinsure the risks of those entities. Reasonable insurance premiums paid to a properly structured captive are deductible by the affiliated companies. Captive insurance companies are provided with special tax incentives so that their premium income may be non-taxable. This creates an exceptional opportunity for the owners of mid-market companies to transfer substantial wealth without gift, estate or generation-skipping tax consequences to the extent the captive insurance company is capitalized and owned by or in trust for younger generations. Captive ownership can also be structured to provide incentives for key management and business succession. These results are available by statute and IRS safe harbor rulings to carefully planned and implemented captives.

This article will describe the Internal Revenue Code, case law and ruling requirements for a valid captive insurance company and focus on the estate and business planning opportunities that result.

WHAT IS A CAPTIVE INSURANCE COMPANY?

A captive insurance company is a corporation formed either in a U.S. or foreign jurisdiction for the purpose of writing property and casualty insurance to a small, usually related group of insureds. The captive must be formed as a C corporation and is subject to Chapter L and Chapter C of the Internal Revenue Code. There are many types of captive insurance companies, including pure captives, group captives, risk retention groups, and producer-owned reinsurance companies. This article focuses on pure captives, which insure risks of business entities related by ownership to the captive.

HISTORY OF CAPTIVE INSURANCE

Modern captives began in Bermuda in the early 1960s, and captive insurance was formalized in the late 1970s, with a medical malpractice captive for Harvard University. In recent years, the growth of captive insurance and related risk transfer mechanisms has boomed, driven by businesses seeking to better manage insurance needs, including cost, coverage, service and capacity. When segregated cells, risk retention groups and rent-a-captives are included, the number of captive and alternative risk arrangements today is in the tens of thousands, and is rapidly growing. The market for alternative risks far exceeds $100 billion of annual insurance premiums[i].

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In the early years, captives were commonly used by Fortune 500 companies to reduce insurance costs and commissions. These large organizations insured general liability, workers' compensation, auto and property insurance through their captives, which became a profit center for the entire organization. Between 2001-2008, the IRS issued guidelines that provided clarification and "safe harbors" for captive insurance companies. These new rulings have opened the door to mid-market, privately owned captives, and the resulting estate planning and business succession opportunities.

REASONS TO FORM A CAPTIVE INSURANCE COMPANY

The focus of the pure captive is to economically assume risk that is currently self-insured. This may include increasing deductibles on existing policies, assuming all or some of the risk of traditional insurance, or merely taking on the risks of existing deductibles and exclusions. Certain types of coverage are unavailable or difficult to obtain, often due to historic loss experience for a sector or industry, such as medical malpractice, or conditions such as environmental, construction defect, earthquake, or wind and weather.

In addition, conventional insurance is typically provided on a guaranteed cost basis and there is little incentive to improve risk management since there is no participation in the profitability of the insurance program. However, with a captive insurance company, the parent or related companies will benefit from good claims experience, and surplus in the insurance company inures to its shareholders.

Since the client has control of the insurance company, policies can be custom designed. This flexibility allows the captive owner to craft the policy to meet its specific needs from time to time in terms of deductibles, scope of coverage, levels of risk and premiums.

Control of the captive also allows for control of the claims process - this is important as there is often litigation with third party insurance companies regarding coverage issues. Control of the captive also means that the client has investment control of its assets, a major benefit not available for premiums and surplus paid to a conventional property and casualty company.

Finally, significant income tax benefits are available for captive insurance companies that are formed and administered in compliance with the Internal Revenue Code and Treasury Regulations. These are explained in detail below together with the numerous estate planning and business planning opportunities.

PRACTICAL ISSUES WITH FORMATION OF A CAPTIVE

A. RISKS TO INSURE

Most companies have commercial property and casualty insurance. The first step in evaluating if a captive is appropriate is to review the client's existing insurance coverage. This typically includes workers compensation, errors and omissions, employee practices and general liability. These coverages are necessary, but they are usually inadequate. Many captives are utilized to take on a large deductible for such policies. The captive seldom replaces traditional policies, but rather augments and provides excess coverage and coverage for many exclusions and differences in condition. Common uninsured risks, in addition to deductibles and exclusions, are business interruption, loss of key customers, credit default, extended warranty, directors and officers, errors and omissions, litigation defense, construction defect, mold, earthquake, environmental, and wind and weather.

B. CHOICE OF JURISDICTION

Selecting a domicile for the captive is an important early consideration. Factors to consider are the economic and political stability of the jurisdiction, tax and regulatory environment, local employment issues and the quality and quantity of service providers such as insurance managers, auditors and legal counsel. Cost, administrative flexibility and geographic proximity are also relevant. A domicile must have the regulatory and business infrastructure to support the effective operation of an insurance company.

The captive insurance marketplace is worldwide. Several states have modern captive insurance statutes, including Utah, Nevada, Montana, Kentucky, Arizona, Vermont, Delaware, District of Columbia, and Hawaii. The number of states continues to grow in response to recent IRS "safe harbor" rulings. However, there are regulatory and financial requirements for domestic captives that do not exist in certain foreign domiciles. For example, a licensed captive may be subject to compliance with rules and regulations of the National Association of Insurance Commissioners (“NAIC”). The NAIC has complex regulations with respect to the amount of minimum capital (“risk-based capital”), and the basis for calculating reserves for future liabilities (“statutory accounting”).

Captive incorporations offshore have also continued to grow for both public and private companies, in places such as Bermuda, the British Virgin Islands, and the Cayman Islands. The initial capitalization requirements and incorporation expenses were often lower and the insurance regulators supported creative structuring of captives.

C. CAPITALIZATION OF INSURANCE COMPANY

Most domestic and foreign jurisdictions have a minimum capitalization requirement. For example, Utah requires a minimum of $250,000 in capital. Some industry professionals will suggest a minimum ratio of premium to capital such as 3 to 1 or 4 to 1. For example, if the first year premium paid to the captive is $1,000,000, then the capital required under a 4 to 1 ratio would be $250,000. However, the safest approach is to have an actuary analyze the amount of capital that should be contributed as part of the captive's business plan. This provides an analysis of the capital that a particular captive will need based upon the type of coverage it is providing, the amount of coverage, and the loss history of the insureds.

D. COSTS OF FORMATION

Most captives are formed by outside consultants on a "turn key" basis. The costs included in such a solution include attorneys, actuaries, the regulatory licensing process, underwriting and issuing policies. In addition, the client typically engages personal tax and legal advisors to advise on ownership of the captive, business entity structures and tax planning. Total formation costs can range from $60,000 to $100,000 for most mid market companies.

E. COSTS OF ADMINISTRATION

Most captives are also administered by outside consultants, often on a "turn-key" basis. The services provided include claims administration, accounting, actuarial reserve analysis, yearly audit, tax returns and other state compliance requirements. Annual administration costs can range from $50,000 to $75,000 for most captives formed by mid market companies.

WHAT CONSTITUTES "INSURANCE" FOR TAX PURPOSES

Insurance companies that are not life insurance companies are subject to special Federal income tax provisions under Subchapter L of the Internal Revenue Code ("IRC") [ii]. These provisions define an “insurance company” as “any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.”[iii] Regulations caution that:

…. though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code.[iv]

The terms “insurance” and "insurance contract” are not defined in either the Code or Regulations. However, the Supreme Court in *Helvering v. Le Gierse*, and subsequent courts, have regularly determined that a contract of insurance must involve: (a) risk shifting, and (b) risk distribution.[v]

A. RISK SHIFTING AND RISK DISTRIBUTION

In basic terms, the concept of risk shifting focuses on the insured - is the insured transferring its risk to another? The concept of risk distribution focuses on the insurance company - does the insurance company distribute its risk among many insureds? The IRS described these fundamental aspects of an insurance contract:

> *Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer, such that a loss by the insured does not affect the insured because the loss is offset by the insurance payment. Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smoothes out losses to match more closely its receipt of premiums.*[vi]

Many courts, including the Tenth Circuit Court of Appeals in *Beech Aircraft Corp. v. United States* have denied an income tax deduction for premiums paid by a parent to its wholly-owned subsidiary, since in a parent-sub relationship, the risk does not really leave the taxpayer.[vii]

A third test has been added by several courts, to determine whether, under all the facts, the contract is "insurance" in its commonly accepted sense.[viii] Among the factors considered by these courts are whether the company issuing the contract is properly organized and operated and has sufficient capitalization, and whether the policies it issues are commercially reasonable in their terms and premiums.

B. ECONOMIC FAMILY DOCTRINE

In many of the early captive insurance cases and rulings, the IRS attacked the structure by stating that the risk shifting prerequisite cannot exist for tax purposes when a corporation purchases insurance within the same “economic family.” For example, Rev. Rul. 77-316,[ix] a parent corporation acquired insurance policies for itself and its subsidiaries through a foreign wholly-owned subsidiary. The Ruling concluded that “one economic family” existed among the parent and its subsidiaries for purposes of the risk shifting and risk distribution tests. According to the IRS:

> *there is no economic shifting or distributing of risks of loss with respect to the risks carried or retained by the wholly owned foreign subsidiaries. . . In each situation described, the insuring parent corporation and its domestic subsidiaries, and the wholly owned "insurance" subsidiary, though separate corporate entities, represent one economic family with the result that those who bear the ultimate economic burden of loss are the same persons who suffer the loss. To the extent that the risks of loss are not retained in their entirety by (as in Situation 2) or reinsured with (as in Situation 3) insurance companies that are unrelated to the economic family of insureds, there is no risk-shifting or risk-distributing, and no insurance, the premiums for which are deductible under section 162 of the Code.*

Insurance did not exist for Federal income tax purposes under these facts. Following substantial litigation, many courts rejected the "economic family" doctrine and in Rev. Rul. 2001-31[x], the IRS abandoned this line of attack.

C. CASE LAW

One of the most important early captive insurance cases was *Humana Inc. v. Commissioner* [xi]. In *Humana*, the Sixth Circuit Court of Appeals directly addressed the issue of a brother-sister captive arrangement and held that amounts paid by subsidiaries of the parent to a captive insurance company were deductible insurance premiums. Humana, Inc ("Humana") and its seven subsidiaries operated hospitals. Humana created a Colorado captive insurance company which provided coverage to Humana and its subsidiaries. The Court found that premiums paid by Humana to the captive were not deductible as insurance, stating that under the principles of *Clougherty Packing Co. v. Commissioner* [xii] and *Carnation Company v. Commissioner* [xiii], premiums paid by a parent to its subsidiary captive are not deductible as insurance because the risk of loss did not leave the parent corporation.

However, with respect to the payment of premiums by Humana's subsidiaries to the captive, the Court looked to the basic principles of *Le Gierse* and asked whether there was risk shifting and risk distribution. The Court stated that "we must treat Humana, Inc., its subsidiaries and Health Care Indemnity [the captive] as separate corporate entities under *Moline Properties*. When considered as separate entities, the first prong of L*e Gierse* is clearly met. Risk shifting exists between the subsidiaries and the insurance company." [xiv] In finding that there was valid risk shifting, the Court held that the arrangement between the Humana subsidiaries and the insurance company was not a sham, the insurance contracts were bona fide arms-length contracts entered into with legitimate business purpose. There was economic reality in the transaction because when a loss occurred, it would be paid by the insurance company and would not affect the balance sheets of Humana or its subsidiaries. The Court, therefore, rejected any substance over form argument by the IRS and stated that "the test to determine whether a transaction under the Internal Revenue Code §162(a) (1954) is legitimate or illegitimate is not a vague and broad 'economic reality' test. The test is whether there is risk distribution and risk shifting. Only if the transaction fails to meet the above two-pronged test can the court justifiably reclassify the transaction as something other than insurance." [xv]

Finally, the *Humana* Court held that risk distribution was present in the brother-sister arrangement, satisfying the second prong of the test: "We see no reason why there would not be risk distribution in the instant case where the captive insures several separate corporations within an affiliated group and losses can be spread among the several distinct corporate entities." [xvi]

Several subsequent cases involved facts and analysis similar to *Humana*. In *Hospital Corporation of America v. Commissioner* [xvii] the Tax Court held that payments made by subsidiary corporations to a captive insurance company, which was also a subsidiary of the parent, were deductible as insurance. HCA owned and operated hospitals commonly held in separate corporate subsidiaries. HCA formed a Colorado captive insurance company, which was later reincorporated in Tennessee. The subsidiaries of HCA entered into an insurance arrangement with the captive for general and professional liability as well as workers' compensation. One of the subsidiaries, Ideal Mutual, was given a letter from HCA whereby HCA offered to indemnify Ideal Mutual against the captive's nonperformance related to workers' compensation liabilities. The Court first addressed whether a bona fide insurance transaction existed, and found that based upon the *Humana* case, the captive insurance company was fully capitalized, provided insurance to the operating subsidiaries, and was formed for a legitimate business purpose. It seemed notable to the Court that the captive was formed in a domestic jurisdiction, as it used this fact to establish that the transaction was a valid insurance contract. [xviii]

Risk distribution was not disputed by the IRS because of the numerous (over 100) subsidiaries that were insured by the captive. The Court then addressed whether there was risk shifting and found that "under the balance sheet and net worth analysis adopted by the Court of Appeals for the Sixth Circuit in *Humana, Inc. v. Commissioner*, the sister subsidiaries shifted insurance risks to Parthenon [the captive], except for the workers' compensation liability covered by the indemnification agreement between HCA and Ideal Mutual. . ." [xix]

In *Kidde Industries, Inc. v. United States*, [xx] Kidde was a large conglomerate with approximately 100 subsidiaries. In 1976, there was a products liability crisis and many insurance carriers restricted or ceased to provide coverage. This same year, Kidde formed a wholly-owned captive subsidiary in Bermuda called Kidde Insurance Company LTD ("KIC"). KIC provided coverage to the Kidde subsidiaries, and then it reinsured such coverage through two American International Group (AIG) subsidiaries, There was an indemnity agreement between KIC and one of the AIG subsidiaries.

The Court of Federal Claims held that except for the period when the indemnity agreement was in effect, the payment of insurance premiums by the Kidde subsidiaries to KIC was deductible under IRC §162 as insurance. The Court further held that KIC was not a sham and was formed for legitimate business purposes. In addition to finding that risk shifting and risk distribution existed in this arrangement, the Court found that the arrangement was consistent with commonly accepted notions of insurance because the insurance contracts allocated risk (the risk that one party will face uncertain and variable claims against it) and there was an established claims process.

In *Harper Group v. Commissioner*, [xxi] Harper owned thirteen subsidiaries and primarily conducted an airfreight operations company. Harper formed an insurance subsidiary in Hong Kong, named Rampart, to provide mainly marine legal liability insurance coverage to customers of a Harper subsidiary and directly to two of the Harper subsidiaries. Rampart obtained partial reinsurance for its potential liability to the customers. The premiums derived from customers was equal to approximately 30% of Rampart's total premium received in any given year.

The Tax Court in *Harper* stated that to determine whether insurance deductions are proper, a three pronged test must be satisfied: (1) whether the arrangement involves the existence of an insurance risk; (2) whether there was both risk shifting and risk distribution; and (3) whether the arrangement was for insurance in its commonly accepted sense. The Court found that an insurance risk did exist, there was risk shifting, and insurance existed in its commonly accepted sense. More notably, the Court also held that risk distribution was present even though the captive received 70% of its premiums from two Harper subsidiaries and 30% of its premiums from unrelated third parties. The Court stated that "In *Amerco and Subsidiaries and Republic Western Insurance Company v. Commissioner*, we held that where unrelated insureds comprise over 50 percent of a captive insurance company's business, there was risk distribution; in *Gulf Oil Corporation v. Commissioner*, we held that where less than 2 percent of a captive insurance company's business comes from unrelated insureds, there was no risk distribution. Here, the relatively large number of unrelated insureds comprise approximately 30 percent of Rampart's business; such a level of unrelated insureds, in our opinion, constitutes a sufficient pool of insureds to provide risk distribution." [xxii] The Court held that payments by Harper to Rampart were in form, as well as substance, insurance payments and that such payments were deductible.

Finally, in Rev. Rul. 2001-31[xxiii], the IRS stated that the “economic family” doctrine would no longer be applied to captive insurance arrangements. However, the IRS indicated that it would continue to challenge captive insurance arrangements based on the "facts and circumstances of each case.”

D. "SAFE HARBOR" RULINGS

In 2002, the IRS issued three Revenue Rulings that provide so called "safe harbors" for captive insurance arrangements. Thus, if the requirements of any of these rulings is satisfied, the IRS generally will not challenge the deductibility of premiums paid to the captive. Rev. Rul. 2002-89[xxiv] deals with parent-subsidiary captive insurance arrangements, and Rev. Rul. 2002-90[xxv] deals with brother-sister captive insurance arrangements. Rev. Rul. 2002-91[xxvi] deals with a group captive arrangement and will not be discussed in this article.

1. Revenue Ruling 2002-89 (Third Party Risk)

In Rev. Rul. 2002-89, the IRS covered two situations. The first involved a wholly-owned subsidiary captive that insured the risks of its parent. The premiums earned by the captive from the parent company constituted 90% of the gross and net premiums earned by the captive annually and the liability coverage provided by the captive to the parent accounted for 90% of the total risks borne by the captive. The IRS stated that no court has held that an arrangement constitutes insurance when a wholly owned subsidiary insures only the risks of the parent. Since there was only nominal true risk shifting from a balance sheet perspective, the arrangement did not constitute insurance for federal income tax purposes.

Situation two involved the same facts as situation one, except that the premiums earned by the captive from the parent company constituted less than 50% of the gross and net premiums earned by the captive annually with the balance coming from insurance for unrelated third parties. In addition, the liability coverage provided by the captive to the parent accounts for less than 50% of the total risks borne by the captive. The IRS stated that this was insurance for federal income tax purposes because the premium and risks of the parent company and subsidiary captive are pooled with unrelated insureds so that the elements of risk shifting and risk distribution were present.

Therefore, in a parent-subsidiary arrangement, a captive can fit within the first safe harbor introduced by the IRS if at least 50% of the premium received by the captive relates to unrelated third party risk. This Revenue Ruling should be compared to the Harper Group case where the Tax Court held that because the captive had approximately 30% unrelated third party risk, the arrangement constituted insurance for federal income tax purposes.

2. Revenue Ruling 2002-90 (12 Entity)

In Rev. Rul. 2002-90, a parent-owned all of the stock of twelve operating subsidiaries that provided professional services, which were similar for each subsidiary (homogeneous risks). The parent formed a wholly-owned domestic captive with adequate capitalization. Each of the operating subsidiaries purchased professional liability insurance from the captive for premiums determined by industry standards. No parental guarantees were issued to any of the insured entities. No insured had less than 5%, or nor more than 15% of the total risks of the captive. None of the funds of the captive were loaned back to the parent or to the operating subsidiaries. The arrangements were consistent with the standards applicable to an insurance arrangement between unrelated parties.

The arrangements between the captive and the twelve operating subsidiaries were held to constitute insurance for federal income tax purposes. Risk distribution was found to exist because a loss by one insured was substantially borne by the premiums paid by the others. This Revenue Ruling should be compared to the Humana case where the Sixth Circuit held that insuring the risks of seven brother-sister companies was sufficient risk distribution to constitute insurance.[xxvii]

In Rev. Rul. 2005-40,[xxviii] the IRS stated that for purposes of the twelve entity rule, single member LLCs would not count as an entity toward the twelve entities required.

In its most recent Revenue Ruling[xxix], the IRS addressed what is commonly known as a protected cell company ("PCC"). A PCC is a property and casualty company formed by a sponsor with various separate and protected cells. Each cell is treated as a separate captive insurance company, and each cell issues insurance policies only to its participant(s). In Rev. Rul. 2008-8, the IRS held that the policies issued to the participant were not insurance for federal tax purposes because this was similar to a parent-subsidiary arrangement which lacks risk shifting and risk distribution. However, if the participant had twelve subsidiaries that generally meet the same fact pattern in Rev. Rul. 2002-90, then the policies issued from the cell company to the subsidiaries of participant would constitute insurance for federal tax purposes. Prior to Rev. Rul. 2008-8, PCCs were often used as a less costly alternative to the pure captive and to avoid the twelve entity requirement of Rev. Rul. 2002-90. [xxx]

TAXATION OF CAPTIVE INSURANCE COMPANY

A. FEDERAL TAXATION

In general, the Internal Revenue Code permits property and casualty insurance companies certain deductions against taxable income, including premium income and investment income, that are not available to regular corporations. As a result, an insurance company may have little or no taxable income from premiums received.

1. General Rules

Section 831(a) imposes a tax on the taxable income of every insurance company other than a life insurance company. The term "taxable income" means gross income as that term is defined in Section 832(b)(1), less the deductions allowed by Section 832(c). "Gross income" includes the sum of "the combined gross amount earned during the taxable year, from investment income and from underwriting income. . ." [xxxi] Underwriting income is defined as "the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred." [xxxii] The deductions allowed, in addition to those available to all corporations, include an accrual based deduction for losses that are incurred, but not reported (IBNR). [xxxiii] For example, when a new building is constructed and placed in service, construction defects may already have been incurred, for example, improper soil compaction, or defects in plumbing pipes. Many of these defects may not be recognized (reported) for years to come. Real estate developers often use captive insurance to set aside pre-tax dollars from development profits for future claims as defects are reported.

2. Section 831(b) Companies

Internal Revenue Code § 831(b) provides a very powerful tax advantage for qualifying small insurance companies. If the company receives less than $1.2 million of premium each year, it may elect to be taxed only on its investment income. [xxxiv] Thus, premiums are not taxable income. The § 831(b) election may not be revoked once it is made without consent from the Secretary of the Treasury. [xxxv] Section 831(b) status does not affect the deductibility of premiums paid by the operating companies. Under this structure, the significant advantage is that the company is able to accumulate surplus from underwriting profits free from tax. While a § 831(b) company pays no taxes on underwriting profit, its owners are taxed on dividends received from the company similar to large property and casualty companies.

B. STATES

The taxation of a captive by a State is wholly dependent on the State's law and is usually not an ordinary income tax. The most common types of taxing regimes are a premium tax and a direct placement tax. A direct placement tax is usually imposed on transactions through an in State broker with a non-admitted insurer in the State. A premium tax is usually levied on the gross premium received by the insurance company and applies only to admitted insurance carriers doing business in the state.

ESTATE AND BUSINESS PLANNING WITH CAPTIVES

A. OWNERSHIP OF CAPTIVE

There are many choices regarding ownership of the captive insurance company. As a C corporation, it can have multiple classes of stock with different rights, restrictions and privileges. To the extent that the claims against the captive's reserves are less than those projected by the actuaries and reflected in the premiums, the reserves grow and the stock becomes more valuable. This value can be returned to the shareholders as qualified dividends[xxxvi] (currently taxed at the capital gains rate for Federal tax purposes) or as a capital gain distribution on complete liquidation of the corporation[xxxvii]. There are numerous other tax planning opportunities with respect to the growth in value of the captive.

1. Ownership by or in Trust for Children and Grandchildren

If the captive is owned directly or indirectly by or for the benefit of the business owner's children or grandchildren, there will be a net wealth transfer without gift, estate or generation-skipping tax consequences (as discussed more fully below). Since the captive's assets are outside the taxable estate of the business owner and beyond the scope of the generation-skipping tax, this presents many additional estate planning opportunities, such as the purchase of life insurance. It also creates an asset that is ideal for a generation-skipping dynasty trust, since there is no need to apply generation-skipping tax exemption to the premium payments[xxxviii], although it may be necessary to do so with respect to the initial capitalization of the captive.

2. Family Limited Partnerships or LLCs

As with many estate planning structures, the captive insurance company could be owned by a family limited partnership (FLP) or limited liability company (LLC). The FLP or LLC could in turn be owned by various family members or trusts with differing classes of interests and rights. This could provide continuing control by the senior generation over investment of the captive's surplus and distributions. Caution must be used in structuring family partnerships and LLCs in light of the IRS' recent aggressive litigation positions in this area. [xxxix]

3. Ownership by Key Management

Another common ownership structure involves creating restricted shares for key management. Since the captive is a C corporation, one or more special classes of stock can be designed with appropriate vesting and transfer restrictions as an incentive and retention tool for management. This also provides incentives for employees to manage risk more effectively. If the premiums paid to the captive are ordinary and necessary business expenses (as discussed below) they should not result in an element of compensation to the employees owning shares in the captive[xl]. A more thorough treatment of this subject is beyond the scope of this paper.

B. GIFT, ESTATE AND GST TAX ISSUES

1. Premiums Deductible

Premiums paid to a captive for property and casualty insurance should be deductible under IRC § 162 (ordinary and necessary business expenses) or IRC § 212 (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[xli]. 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. [xliii]

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[xliv], 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. [xlv] 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. [xlvi]

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.

C. FUNDING OF CAPTIVE

1. Contributions to Capital

Depending on the jurisdiction in which the captive is formed and the nature of the risks being insured, the premium to capitalization ratio required may be in the range of 3:1 to 4:1. Thus, for a captive to write $1 million of premium in a domestic jurisdiction may require the captive owners to contribute $250,000 to $300,000 of capital.

If the captive is owned by or in trust for the business owner's children or grandchildren and if the business owner provides the capital, this will constitute a gift for gift and generation-skipping tax purposes. [xlvii] The capital could be provided as loans to the captive owners who in turn make the capital contributions to the captive. There may be other sources of capital available based on prior estate planning for many clients.

The best practice may be to form an irrevocable trust for the benefit of children and/or grandchildren, and then make a gift of cash to the trust in the amount necessary to capitalize the captive. The trustee of the trust would then form the captive and own all the stock, or alternatively multiple trusts could own all the stock. This avoids potential issues with valuation of the captive insurance company stock if the client transferred stock to the trust after formation of the captive rather than cash with which the trust made its original capital contribution. The trust can be drafted so that no future estate tax applies to the trust and the client's GST Tax exemption can be allocated to this transfer on a federal gift tax return to ensure that no future GST Tax applies to the trust.

2. Letters of Credit

Some business owners prefer not to tie up capital in the captive and use a bank letter of credit to fund the captive's capital requirements. Captive insurance regulators in some jurisdictions will not accept this form of capitalization. Certain banks and trust companies have devised a secured trust structure to serve as a substitute for funding by letter of credit. [xlviii]

D. MULTIPLE 831(B) COMPANIES

As discussed above, a captive insurance company must receive less than $1.2 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. [l] 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. [li] 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. [lii]

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. [liii]

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.

E. 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.

CONCLUSION

A captive insurance company can provide some businesses an effective means of funding self-insured risks, lowering the cost of certain types of insurance, and maintaining greater control of the risk management process. If a captive insurance company makes sense for a business, exceptional opportunities exist to transfer substantial wealth to younger generations or key management without income, gift, estate or generation-skipping tax consequences. Business owners should consult with experienced captive consultants and tax and legal advisors to determine if a captive insurance company is suitable to their circumstances.

USE OF CAPTIVE INSURANCE IN ESTATE AND BUSINESS PLANNING
by Gordon A. Schaller and Scott A. Harshman

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[i] Karl, Holzheu, Raturi, *The Picture of ART* (December 9, 2002) Swiss Re, *Sigma* No. 1/2003.
[ii] *See* IRC §§ 831-835.
[iii] IRC § 816(a).
[iv] Treas. Reg. § 1.801-3(a)(1), issued prior to the 1984 revisions to Subchapter L of the Code. The 1984 legislation changed the test from "primary and predominant business activity" to "more than half of the business" of the company.
[v] 312 U.S. 531 (1941).
[vi] Rev. Rul. 2002-90, 2002-52 C.B. 985
[vii] 797 F.2d 920 (10th Cir. 1986). *See also Clougherty Packing Co. v. Commissioner*, 84 T.C. 948 (1985), *aff'd* 811 F.2d 1297 (9th Cir. 1987); *Gulf Oil Corp. v. Commissioner*, 914 F2d 396 (3d Cir. 1990); *Malone & Hyde Inc. v. Commissioner*, 62 F.3d 835 (6th Cir. 1995).
[viii] *Harper Group & Subsidiaries v. Commissioner*, 96 T.C. 45, aff'd, 979 F.2d 1341 (9th Cir. 1992); *Ocean Drilling & Exploration Co. v. United States*, 69 AFTR2d 92-338 (Cl. Ct. 1991), aff'd, 988 F.2d 1135 (Fed. Cir. 1993).

[ix] 1977-2 C.B. 53. See also Rev. Rul. 88-72, 1988-2 C.B. 31
[x] 1977-2 C.B. 53. See also Rev. Rul. 88-72, 1988-2 C.B. 31
[xi] 881 F.2d 247 (6th Cir. 1989).
[xii] 84 T.C. 948 (1985), *aff'd* 811 F.2d 1297 (9th Cir. 1987).
[xiii] 71 T.C. 400 (1978), aff'd 640 F.2d 1010 (9th Cir. 1981), cert. denied, 454 U.S. 965 (1981).
[xiv] *Humana*, 881 F.2d at 252.
[xv] *Id* at 255.
[xvi] *Id*. at 257.
[xvii] T.C. Memo. 1997-482 (1997).
[xviii] *Id.* at 25. *See also* Malone & Hyde Inc. v. Commissioner, 62 F.3d 835 (6th Cir. 1995).
[xix] *Id.* at 30.
[xx] 40 Fed. Cl. 42 (1997).
[xxi] 96 T.C. 45 (1991).
[xxii] *Id.* at 59-60.
[xxiii] 2001-26 C.B. 1348.
[xxiv] 2002-52 C.B. 984.
[xxv] 2002-52 C.B. 985.
[xxvi] 2002-52 C.B. 991.
[xxvii] *Humana Inc. v. Commissioner*, 881 F.2d 247.
[xxviii] 2005-27 C.B. 4.
[xxix] Rev. Rul. 2008-8, I.R.B. 2008-5.
[xxx] Rev. Rul. 2008-8. In Notice 2008-19, the IRS requested comments regarding the status of a protected cell as an insurance company under Sections 816(a) and 831(c). Another recent IRS ruling is Rev. Rul. 2007-47 where Company X engaged in Business Process and government regulations required X to incur costs to remediate the harm caused by Business Process. Insurance company and X entered into a contract where Insurance company would pay costs incurred by X above a certain amount, if applicable. The IRS held that this arrangement did not constitute insurance for federal tax purposes because no insurance risk exists as to whether X will have to incur remediation costs, rather the arrangement is akin to a timing and investment risk.
[xxxi] IRC § 832(b)(1).
[xxxii] IRC § 832(b)(3).
[xxxiii] IRC § 832(b)(4) and IRC § 832(b)(5).
[xxxiv] IRC § 831(b)(2)(A).
[xxxv] IRC § 831(b)(2)(A)(ii).
[xxxvi] IRC § 1(h)(11).
[xxxvii] IRC § 331.
[xxxviii] See V.B.3, *infra*.
[xxxix] See *Estate of Bigelow v. Commissioner*, No. 05-75957 (9th Cir. 2007); *Erickson v. Commissioner*, T.C. Memo 2007-107; *Rector v. Commissioner*, T.C. Memo 2007-367; *Estate of Korby v. Commissioner*, 471 F.3d 848 (8th Cir. 2006); *Estate of Strangi v. Commissioner*, 417 F.3d 468 (5th Cir. 2005); *Estate of Kimbell v. Commissioner*, 371 F.3d 257 (5th Cir. 2004); *Estate of Thomson v. Commissioner*, 382 F.3d 367 (3rd Cir. 2004).
[xl] See V.B.2, *infra*.
[xli] See *Harper Group & Subsidiaries v. Commissioner*, 979 F.2d 1341 (9th Cir. 1992).
[xlii] Treas. Reg. §1.162-1(a).
[xliii] *Kidde Industries, Inc. v. United States*, 40 Fed. Cl. 42 (1997); *Harper Group & Subsidiaries v. Commissioner*, 979 F.2d 1341 (9th Cir. 1992); *Humana, Inc. v. Commissioner*, 881 F.2d 247 (6th Cir. 1989).

[xliv] See F.N. 39, *supra*.
[xlv] Treas. Reg. § 26.2611-1.
[xlvi] Treas. Reg. § 2612-1(a).
[xlvii] IRC § 2511.
[xlviii] Merrill Lynch; Wells Fargo Bank.
[xlix] IRC § 831(b)(2)(B).
[l] IRC § 1563(a)(2).
[li] IRC § 1563(e)(6)(A).
[lii] IRC § 1563(e)(6)(B).
[liii] See Treas. Reg. § 1.1563-1T(a)(3)(iii), Example 1.