Advanced Designs
Pocket Guide

Captive Insurance Companies and the Role of Life Insurance

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Introduction

Interest in captive insurance companies ("captive") as a planning strategy has increased in recent years. There are several possible reasons for the increased popularity of captives:

1. Rising property and casualty insurance costs.
2. A sense that the number of available tax-deductible planning strategies for business owners is dwindling due to increased IRS activity -- captive planning may be looked at as being one of the few tax-deductible strategies left that hasn't been adversely impacted by IRS guidance.
3. A perception, albeit a not entirely accurate one, that a captive can be used as a way to buy life insurance on a tax-deductible basis.

This pocket guide will address some of the benefits, issues and concerns that are inherent with captive planning.

What is a Captive Insurance Company?

A captive insurance company is a C-Corporation (or a legal entity taxed as a C-Corporation) created for the purpose of writing ***property and casualty insurance*** to a relatively small group of insureds. The operation of a captive is similar to that of any insurance company. The captive issues policies to its insureds, collects premiums and pays claims. It must also set aside reserves to meet its legal obligations and cover its operating expenses.

The most common type of captive is the single parent captive. A single parent captive primarily insures risks of the parent company and its subsidiaries and may be formed as a subsidiary company. This pocket guide will primarily focus on single parent captives. Other types of captives include:

- Association captives, which insure the risks of members of an industry or trade association.
- Group captives, which are owned and controlled by multiple insureds.
- Rent-a-captives, which essentially rent their services to other parties in exchange for a management fee. The main purpose of a rent-a-captive is to provide captive facilities to parties that cannot afford the fixed cost of a captive company or are not interested in the ownership and maintenance responsibilities. The insureds generally do not share each other's risk.
- Agency captives, which are companies typically owned by groups of brokers or other insurance intermediaries.

With a single parent captive, the parent company is transferring certain property and casualty risks to the captive, including some risks that the parent company would otherwise self-insure. Whereas a sinking fund set aside by the company to cover any self-insured risks would not be currently deductible (however, the losses would be deductible when incurred), premiums paid by the parent company to the captive to cover the same risks are currently deductible.

It is rare and certainly not recommended that a business that creates a single parent captive would eliminate its traditional property and casualty insurance and fully self-insure all its risks. Rather, the captive will generally supplement existing coverage by insuring gap and excess risks not covered by traditional insurance. In addition, uninsured risks such as deductibles, exclusions, and coverage that otherwise may not be available in the commercial marketplace or are difficult to obtain at a reasonable price can be transferred to a captive.

Who are potential candidates for a captive?

Suitability of a business for a captive depends upon the particular facts and circumstances of the business. Business owners interested in establishing a captive should consult their

independent legal and tax advisors to help evaluate their suitability. Pacific Life does not provide such services. In general, a captive may be appropriate for businesses that meet many of the following factors:

- Businesses with substantial risk (e.g., real estate developers)
- Businesses that feel that the commercial insurance marketplace is unresponsive to their needs
- Businesses with excellent claims experience
- Businesses which adhere to a comprehensive risk management program and have a strong commitment to loss control
- Businesses looking to currently tax-deduct some of their self-insured risks
- Businesses with sufficient revenue to justify the cost of forming a captive (generally at least $10 million of revenue)
- Businesses with adequate cash flow and annual net income of at least $1 million
- Businesses that are paying in excess of $1 million for property and casualty insurance

What are the benefits of forming a captive?

There are many potential benefits of a single parent captive, including the following:

- **Favorable tax treatment** – premium contributions made by the parent company are deductible when paid pursuant to Internal Revenue Code ("IRC") Section 162 as an ordinary and necessary business expense. In addition, the receipt of premiums by the captive may be tax-free (depending upon the overall premiums written by the captive -- see below discussion of captive taxation).
- **Improved cash flow management** – the parent company may be better able to manage its cash flows via regular

premium payments to the captive as opposed to paying self-insured expenses as they occur.

- **Cost savings** – to the extent the captive has favorable claims experience, this cost savings can be passed on to the insureds in the form of lower premiums. This ability to participate in favorable claims experience doesn't typically occur with commercial insurance arrangements. In addition, premiums charged by a captive typically don't include as large a profit component as commercial insurance, and any profit earned by the captive insures to the benefit of its owners as opposed to benefiting a traditional commercial insurance company.
- **Ability to potentially obtain better property and casualty coverage** – policies issued by the captive can be custom designed to meet the needs of the parent company. In addition, a captive can provide coverage that the commercial market is unable or unwilling to provide.
- **Estate planning opportunities** – ownership of the captive can be held directly by the heirs of the owner(s) of the parent company. Alternatively, ownership could be held by a trust, family limited partnership or limited liability company ("LLC") set up for the benefit of the heirs. To the extent that the captive has favorable claims experience, the value of the captive will increase. Since this growth is outside the taxable estate of the owner(s) of the parent company, there is a net wealth transfer without gift, estate or generation-skipping tax consequences.
- **Potential asset protection** – pursuant to general corporate law, assets of the captive will generally not be subject to the claims of creditors of the owners of the parent company.

What are the disadvantages of forming a captive?

Captives are not for every business. In fact, a captive probably isn't appropriate for most businesses due to several key disadvantages. One of the main disadvantages is cost. Forming a captive may require a substantial outlay for start up and

maintenance costs, and the cost to set up and maintain a captive can be prohibitive for businesses that do not have sufficient revenue and income, not to mention sufficient uninsured insurance risk. It can oftentimes cost as much as $75,000 or more to form a captive, and annual operating costs can be $50,000-$70,000 or more.

In addition, establishing a captive insurance company requires a substantial initial financial outlay in the form of initial capital and surplus to ensure that the captive starts out financially healthy (minimum capitalization and surplus can be $250,000 or more). In general, the average premium to capitalization ratio is 3 to 1, which means that the amount of capital generally must be equal to one-third of the premiums written by the captive.

Another key disadvantage of captives is the potential for the captive owner to suffer adverse financial consequences if actual losses exceed the captive's reserves. In such an event the captive owner may need to contribute additional capital to the captive in order to keep it financially healthy.

A third disadvantage of captives is their complexity. Formation and maintenance of a captive requires extensive expertise. An improperly formed and maintained captive could have severe adverse consequences. For example, the Internal Revenue Service ("IRS") could deny the favorable tax advantages of using a captive if it is not properly established and administered.

What are the tax consequences of captives?

Assuming that a captive qualifies as an insurance company for federal tax purposes, premiums paid to the captive by the parent company should be deductible as an ordinary and necessary business expense pursuant to Code Section 162 (assuming they are reasonable and justifiable).

The U.S. federal income tax treatment of the receipt of the premiums by a captive depends upon the tax status of the captive

and also whether it is treated as a U.S. domestic captive. The Internal Revenue Code provides certain U.S. domestic captives with tax advantages that are not available to typical corporations. Offshore captives (see section titled, "Where to Domicile the Captive: Offshore vs. Onshore?") may not be subject to the U.S. federal corporate income tax. However, special U.S. tax provisions may apply to offshore captives.

Code Section 501(c)(15) permits a captive to qualify as tax-exempt if the gross receipts of the captive don't exceed $600,000 each year. Gross receipts include premium income as well as investment income. In order for these "micro" captives to meet the requirements of Section 501(c)(15), premium income must make up more than half of all gross receipts. It is apparently very difficult for a captive to qualify under 501(c)(15) because of a requirement in 501(c)(15)(B) that the $600,000 maximum limit for gross receipts applies not just to the captive, but to all other companies that are members of the same controlled group. Thus, it appears that the gross receipts of the parent company may have to be included, which would likely disqualify most captives from qualifying as tax-exempt. In addition, these types of captives have been added to the list of "listed transactions" by the IRS, which makes them potentially unattractive to taxpayers who are concerned about attracting the attention of the IRS.

Code Section 831(b) permits captives that receive less than $1.2 million of premium income each year to be taxed only on their investment income. Thus, these "mini" captives are not taxed on their premium income. Captives must elect 831(b) treatment and must qualify every year. Section 831(b) treatment only applies if the total premiums received by the captives are less than $1.2 million in a given year, as opposed to the first $1.2 million of premium received. The fact that the captive does or does not make the 831(b) election does not impact the ability of the parent company to deduct its premiums paid to the captive. It should be noted that many single parent captives qualify as 831(b) captives. Also, it is possible for a parent company (and its related

subsidiaries) to potentially create multiple 831(b) captives if their premiums will exceed $1.2 million.

Captives that are treated as U.S. domestic captives that do not qualify under 501(c)(15) or 831(b) are taxed for federal income tax purposes just like any other corporation. Thus, these "regular" captives will pay ordinary income taxation at the corporate level on their premium and investment income. Although regular captives are taxed on their premium income, they can deduct legitimate reserves and other expenses, and may be able to avoid having their premium income taxed if they have sufficient deductions.

A captive may be subject to taxation at the state level as well. Typically this is not in the form of an ordinary income tax. Rather, if a captive is admitted to do business in a state, the state may impose a premium tax on the gross premium written by the captive. If a captive is not admitted to do business in a state but conducts transactions in the state through a broker, then a direct placement tax may apply.

To the extent that a captive pays a dividend to its shareholders, irrespective of the tax status of the captive, the shareholders are taxed on the dividend. In addition, when a captive is sold or liquidated, the shareholders will pay capital gains tax on the value of any appreciation of their stock.

What are the IRS requirements for captive insurance companies?

In order to obtain the tax benefits of a captive (e.g., amounts paid to the captive are deductible as insurance premiums), it must be considered an insurance company. The IRS has indicated that a corporation qualifies as an "insurance company" for a particular year if more than half of the corporation's business during that year consists of activities that, for federal tax purposes, constitute "insurance." In order for an arrangement to constitute insurance, two requirements must be met: there must be (1) risk shifting and (2) risk distribution.

Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences to another, so that a loss does not affect the insured because the loss is offset by the insurance payment.

Risk distribution occurs when the party assuming the risk distributes its potential liability among many insureds. Risk distribution incorporates the statistical phenomenon known as the law of large numbers and allows the insurer to reduce the chance that a single claim will exceed the amount of premiums taken in.

Risk shifting is generally the easier of the two requirements to meet. Risk distribution is typically the more difficult requirement to satisfy, especially if a single parent captive is involved. The IRS has issued several "safe harbor" rulings that help define what constitutes sufficient risk distribution.

In Revenue Ruling 2002-89 the IRS indicated that risk distribution is present if at least 50% of the premium received by the captive relates to unrelated third-party risk (i.e., less than 50% of the premium comes from the parent company and the liability coverage provided to the parent company accounts for less than 50% of the total risks insured by the captive). Although the IRS safe harbor percentage is 50%, it should be noted that a Tax Court case has indicated that 30% unrelated third-party risk may be sufficient (see *Harper Group v. Commissioner* (1992)).

In Revenue Ruling 2002-90 the IRS indicated that sufficient risk distribution was present where the captive insured only the risks of twelve related parties. Subsequently, in Revenue Ruling 2005-40 the IRS clarified that a disregarded entity, such as a single member LLC, would not count as an entity for purposes of the twelve entities required. Although the IRS safe harbor number is twelve related parties, one court case has indicated that insuring the risks of seven related parties may be sufficient risk distribution (see *Humana, Inc. v. Commissioner* (6th Cir. 1989)). It should be noted that each related party should generally comprise no less than 5% and no more than 15% of the overall risks insured by the captive.

In situations where potential captive owners cannot meet either of the above criteria for risk distribution, some captive programs offer them the ability to participate in risk pools. This involves each of the member captives in the pool insuring the other captive owners against certain types of risks, thus potentially enabling them to meet the requirement that they insure sufficient third-party risk.

Additional factors that the IRS may consider in determining whether a captive insurance transaction is insurance include: (1) whether the parties that are insured by the captive truly face hazards (i.e., whether the risks transferred are real and not illusory); (2) whether premiums charged by the captive are based on commercial rates; (3) whether the validity of claims is established before payments are made; (4) whether the captive's business operations and assets are kept separate from the business operations and assets of its shareholders (e.g., separate financial reporting); (5) the amount of capitalization of the captive; (6) the ability of the captive to pay claims; and (7) adequacy of corporate governance and formalities of the captive.

Where to domicile the captive: offshore vs. onshore?

A captive domicile is the legal jurisdiction in which a captive is incorporated. A captive may incorporate in a U.S. state with legislation that permits captives (onshore) or in a Caribbean, European, or Asian country that permits captives (offshore). In the past, offshore jurisdictions were perceived to be poorly regulated tax havens that offered greater cost savings and more flexibility (in terms of the ownership structure, operations, allowable investments, and lower capitalization requirements), and thus most captives were established offshore. However, the reality is that most of the advantages that offshore domiciles had over onshore domiciles have been greatly reduced or eliminated. Thus, onshore domiciles are becoming increasingly popular and have been gaining market share at the expense of offshore domiciles.

Although offshore domiciles don't have all the advantages they used to have, they can still be attractive. They still may have lower

capital and surplus requirements than many U.S. states that permit captives and may offer a more favorable regulatory environment. They may also be attractive if there is a desire to write insurance that can't be written domestically. In addition, whereas onshore captives may be subject to the rules and regulations of the National Association of Insurance Commissioners (NAIC), offshore captives are not. The NAIC imposes stringent requirements regarding the amount of minimum capital and the basis for calculating reserves for future liabilities.

Offshore captives have also typically been subject to more favorable taxation in certain foreign jurisdictions in the form of lower tax rates. Onshore captives, on the other hand, may be subject to U.S. state premium taxes that don't apply to offshore captives, and may also be subject to higher corporate tax rates (it should be noted that certain captives receive preferential tax treatment – see prior section titled, "What are the tax consequences of captives?"). Due to the federal tax provisions below, the tax advantages offered by some foreign jurisdictions are now less significant as a result of the IRS leveling the playing field.

- A federal excise tax applies to premiums paid to most offshore captives (depending upon the foreign country, the excise tax may not apply as a result of a tax treaty). For direct premiums the rate is 4% and for reinsurance it is 1% of the premium.
- Captives domiciled offshore are subject to United States income taxes if the captive is classified as a controlled foreign corporation (i.e., treated as controlled by U.S. shareholders). The U.S. shareholders must include the captive's income as a deemed dividend on their federal income tax return whether or not any cash dividend is actually paid by the offshore captive.

An offshore captive can avoid these special taxes by making an IRC Section 953(d) election to be treated as a domestic captive. This domestic election allows the offshore captive to be treated to nearly identical tax laws as an onshore captive, including the

ability to qualify for preferential tax treatment under IRC Section 831(b). Most offshore captives with U.S. shareholders will make the 953(d) election.

The leveling of the playing field for tax purposes is not the only reason that onshore domiciles have increased in popularity. Other reasons include:

- Offshore captive transactions will likely be subject to greater scrutiny by the IRS and the FBI due to concerns over money laundering, tax evasion, and defrauding creditors (i.e., there is a certain taint associated with offshore strategies and concern that they may "red flag" the client for IRS scrutiny);
- Onshore domiciles are becoming more flexible and creative in order to compete with offshore jurisdictions;
- If ERISA employee benefits will be provided by the captive, it must be domiciled onshore due to a requirement by the U.S. Department of Labor;
- Offshore jurisdictions may have a greater risk of political and economic instability; and
- Service providers in offshore domiciles may charge higher fees.

NOTE: Pacific Life does not permit the use of its products with offshore captive insurance company arrangements. In addition, the payment of life insurance premiums with source funds from an offshore captive is also not permitted, even if they have made a 953(d) election or have established a domestic subsidiary (e.g., an LLC).

What role does life insurance play with captives?

Captives provide property and casualty insurance coverage, not life insurance coverage. However, once a captive has been properly established and capitalized, it may be possible to use some of the reserves and profits to purchase life insurance to benefit the captive or its shareholders.

As is the case with any other type of business entity, there may be reasons for a captive to purchase and own life insurance. Death benefit needs could include key person or stock redemption coverage. Of course, the captive will need to possess an insurable interest in the life of any person covered, and the amount of any coverage to be purchased will need to satisfy a life insurance company's financial underwriting guidelines.[1]

To the extent that there is a justifiable death benefit need, it may make sense for the captive to max fund any life insurance coverage that it owns. A captive is required to maintain adequate reserves in order to be able to pay any property and casualty claims. Any reserves that they set aside and invest in a taxable investment will likely create investment income that will be subject to the corporate income tax (assuming the captive is subject to the U.S. income tax). Max funding a cash value life insurance policy can be a way to set aside some funds on a tax-deferred basis to help meet reserve needs.

Another possible use of captive funds to purchase life insurance is to assist a shareholder to obtain coverage for estate planning purposes. The captive could use a split dollar or loan arrangement to pay premiums for a policy which is owned by the shareholder's children or an irrevocable life insurance trust ("ILIT").

If a captive has operating profits, an alternative way to use these profits to assist a shareholder in purchasing needed life insurance coverage is to distribute the profits to the shareholder as a dividend. The shareholder can then use the distributed dividends to pay premiums for personal life insurance coverage.

A question that sometimes comes up is how much of a captive's assets can be used to pay life insurance premiums. From a

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[1] As with all uses of life insurance, the amount of life insurance coverage asked for in conjunction with this concept may be limited by Pacific Life's financial underwriting guidelines. Financial underwriting is an assessment of whether the proposed death benefit is a reasonable replacement for the financial loss caused by the death of the insured.

practical standpoint, an insurer's financial underwriting guidelines may effectively limit the amount of captive funds that can be paid as premiums via limiting the amount of death benefit coverage the captive can own. However, aside from that limitation, it is important that the purchase of life insurance with captive assets in no way inhibits the captive's reserve requirements or its ability to pay claims. Thus, it may be wise to only use a relatively small portion of the captive's assets to pay life insurance premiums. This is due to the fact that borrowing from a life insurance policy's cash value in order to pay claims should probably only be done as a last resort, as taking policy loans can adversely impact a policy's performance. In addition, with split dollar and loan arrangements the captive may have limited ability to access its interest in the policy when needed.

NOTE: Any Pacific Life policy sold to a captive insurance company must be accompanied by the Pacific Life Captive Insurance Companies Disclosure and Acknowledgment form.

What are some potential issues involving captives?

Some captive programs marketed by promoters are more aggressive than others, and may be considered abusive by the IRS. Given the increased IRS scrutiny in recent years of many tax-advantaged planning strategies, it is important that anyone considering a particular captive program conduct thorough due diligence. The following potential concerns should be considered as part of any due diligence (NOTE: This list is not intended to be comprehensive). Most importantly, you should seek advice from a tax and legal advisor with expertise in captives that is not associated with the captive provider.

Captive Implemented Primarily for Inappropriate Reasons

A single parent captive should first and foremost be about providing property and casualty protection that is truly needed by the parent company and its subsidiaries. There are, of course, other benefits of creating a captive (see the prior section titled, "What are the benefits of forming a captive?"). However, these

others benefits should be incidental and should not be the primary motivation for creating the captive. You should probably avoid captive programs that focus their marketing on the following:

- *It's all about the tax deduction*
  Too often captives are marketed to high wage earners, such as physicians, as a way to reduce their taxable income. Although the creation of a large tax deduction is one of the primary incidental benefits of forming a captive, it generally should not be the reason the captive is created (i.e., it should not be the tail wagging the dog). In many cases the requisite property and casualty need is lacking, and the attempt to create a large deduction out of thin air oftentimes leads to the inability to meet the risk shifting and risk distribution requirements.

- *Tax-deductible, discriminatory deferred compensation*
  Another inappropriate way to market captives is to promote them as a way to provide the owners of the parent company with tax-deductible deferred compensation. It is true that premium payments to the captive are deductible upfront if reasonable and necessary. It is possible that if the captive has favorable claims experience then there may be value to distribute to the owners upon liquidation of the captive (and such value may receive favorable capital gains taxation). However, the amount of premiums going into the captive have to be actuarially justified and the captive needs to be properly administered and operated as an insurance company. If this is done, there is no guarantee that the captive will be profitable. The captive prospects should not be led to believe that the captive arrangement is serving as a deferred compensation plan. The illustration of optimistic profits may suggest that there is a lack of risk shifting or that premiums are unreasonable.

NOTE: Pacific Life does not permit the use of its products with captive insurance company arrangements that market or represent the arrangement as providing deductible deferred compensation.

- *Tax-Deductible Way to Buy Life Insurance*
  As previously discussed in the question titled, “What role does life insurance play with captives?”, there may be some valid reasons to purchase life insurance in a captive or use captive funds to assist in the purchase of life insurance. An incidental benefit of a captive is that using captive reserves and profits is indirectly using tax-deductible dollars to purchase the life insurance. That said, it is not appropriate to market and promote captives as a way to buy tax-deductible life insurance.

<u>Illusory Insurance Coverage</u>
Some captive arrangements involve insuring risk that may be considered illusory (i.e., there is no real possibility of an economic loss). The risk may be obscure and not something that would normally be considered a risk to the business that can justify a large premium payment. For example, terrorism coverage for a business in Sioux City, Iowa may not be deemed as appropriate as the same coverage for a business in New York City.

Oftentimes the idea with such coverage is to create a large current tax deduction for the business with no real expectation that the business will ever suffer a loss. Thus, the amounts deducted will likely be returned to the business owner as liquidation proceeds subject to favorable capital gains rates (this is related to the issue discussed above of entering into a captive transaction for the purpose of obtaining “tax-deductible, discriminatory deferred compensation”).

If the insurance risk covered cannot be justified, it is likely that the IRS may take the position that arrangement does not meet the “risk shifting” requirement (see the question titled, “What are the IRS requirements for captive insurance companies?”) and deny the deduction. Clients considering a captive should consult with their tax and legal advisors as to the appropriateness of the risks they are considering insuring, as well as the appropriateness of the premiums that will be charged for those risks.

Mass Marketing of Captives to Small Business Owners

Captives have long been used by Fortune 500 companies and are to a greater extent being used by mid-sized companies. Increasingly, they are also mass marketed to small businesses that may not be good prospects for a captive (see the question titled "Who are potential candidates for a captive?"). Oftentimes these smaller businesses are targeted due to above inappropriate reasons for forming a captive.

From a technical standpoint, a primary concern would be the ability of smaller businesses to satisfy the IRS risk distributions requirement (see the question titled, "What are the IRS requirements for captive insurance companies?"). These businesses simply do not have the requisite 12 or more related parties that are outlined in the IRS safe harbor guidance. Thus, some captive promoters are marketing arrangements to smaller businesses which involve more liberal interpretations of the safe harbor guidance on risk distribution, such as having only 30% third-party risk (as opposed to the 50% plus third-party risk outlined in the IRS safe harbor guidance) or establishing a captive for as few as six related parties.

Although it is possible that such arrangements could be upheld by courts, they do involve a higher level of risk, and captive prospects should seek advice from a qualified tax and legal advisor before establishing a captive outside the parameters of the IRS safe harbor guidance.

A common way that captive promoters help smaller businesses that don't have a sufficient number of related entities meet the risk distribution requirements is through the use of risk pools. The idea is that by participating in a risk pool, each captive owner is insuring the other captive owners, thus potentially enabling them to insure a sufficient amount of third-party risk.

The problem with some of these risk pools is that there may be very little risk involved, as may be evidenced by a general lack of claims experience within the pool. Of course, if there is very little

risk involved in participating in a risk pool, then such participation should not help much with respect to meeting the third-party risk requirement, as the amount of premium charged should be correspondingly low.

If a captive prospect cannot meet the requirements for risk distribution without participating in a risk pool, they should seek advice from a qualified tax and legal advisor regarding whether a captive is appropriate for them. They should also do due diligence on the risk pool to ensure that it truly involves a sharing of risk.

Loan-backs

Loan-backs involve the captive lending back funds to the parent company that the parent company originally paid as premium. In Notice 2005-49 the IRS requested taxpayer comments regarding the tax impact of loan-backs from a captive to its owner(s). It would appear that the IRS may be prepared to challenge such transactions and could take the position that loans from the captive to the parent or other affiliates may affect deductibility.

Conclusion

Captive insurance companies can create substantial benefits when properly structured and administered. Although the market for captives may not be as large as some promoters would lead one to believe, a captive may be appropriate for certain businesses. Keep in mind before forming or participating in one that the captive environment is constantly changing and the IRS will likely continue to issue guidance to deter perceived abuses.

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