The case against the cell

Stewart Feldman suggests it may be time to examine your LLC, PCC, series or cell planning, and consider returning to a traditional captive arrangement

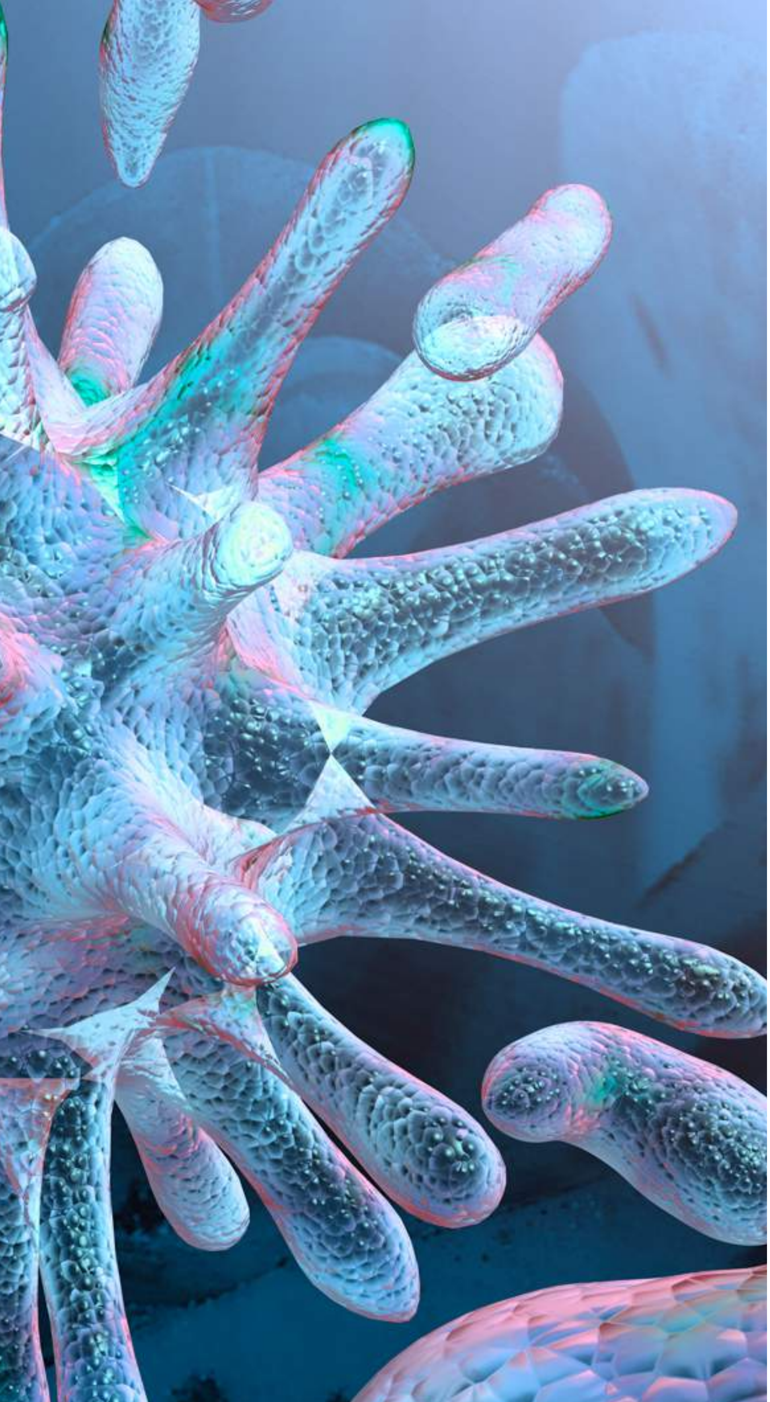
I am both a tax and corporate lawyer, and I am asked to resolve problems daily. Lately, what seems to be crossing my desk with frequency are protected cell companies (PCCs), segregated cells, series limited liability companies (LLCs) or other cell arrangements that are 'held together with bubble gum'.

While known by various names, the arrangements are generally the same: a promoter, who is typically not a professional, forms a core company offering clients easy access to a captive insurance arrangement.

The promoter is usually a wealth adviser, financial planner, a property and casualty insurer or a life agent or, even worse, a lawyer or certified public accountant (CPA) who is not your adviser or your fiduciary, but who works for the captive sponsor. In some ways, it is akin to the old rent-a-captive arrangement in which the client, in effect, rents a hotel room.

The common characteristic of these arrangements is that they frequently fail from both federal income tax and insurance standpoints. Captive insurance is complicated. It involves many moving parts and a variety of service providers.

Anyone who thinks otherwise is doing their clients and themselves a disservice. Anyone who has gone through an Internal Revenue Service (IRS) tax controversy on captive issues knows better than to brush aside the complexity of alternative risk planning.



The scant attention given to tax compliance by some cell promoters is disconcerting. Even worse is their inability to support or survive an IRS examination, let alone to mount a US Tax Court challenge. The cell structure unfortunately provides a veneer of unwarranted comfort to the cell or series owner.

In many cases, the client's money is exposed to serious unknown financial risks from the insureds of other cells. We have been retained for projects where the client's sole objective was to extract himself, his insureds and his cell from the tentacles of the series captive structure and the poor protections afforded to cell owners.

Like many planning ideas, cell captive arrangements, in theory, might work. The core supports the cell, often allowing for easier and less expensive entry into the planning. The cell's capital might be supported by that of the core. In practice, with many promoters, this strategy often takes the form of a classic bait and switch arrangement where the client is lured away from a standalone captive into a cell or series arrangement.

Theoretically, the cell structure should have the benefit of walls separating the cells or series LLCs. Often in practice, the sloppy corporate and legal oversight, the incomplete legal documentation, the dearth of corporate law supporting the cell arrangements, the commingling of funds, and the commonality of the core all lead to porous walls. Using the high-rise condominium as an example, if you are in one unit, a water leak from above, or fire and smoke damage from another unit on the same floor, will usually wreak havoc on all of the buildings' occupants. Thinking otherwise is naive.

Common problems

In a recent project reviewed by our team, a cell arrangement was domiciled in a 'questionable' offshore domicile where the sponsor's cell arrangements constitute 80 percent of all of the captives in that island nation. The domicile was not a British territory benefitting from British regulation, but a notorious independent offshore domicile better known for crime and financial impropriety. The regulation was scant and ineffective.

There was no requirement for audited statements, and none were produced. Reports to the domicile were misleadingly based on the consolidation of the core and cell arrangement, not each client's individual cell. The client had no right to receive and was unable to obtain financial information on the other cells or their insureds. The core provided most of the capital, but the cell's capital didn't support the individual cell's losses. The cell granted broad-based powers of attorney to the core to execute policies and other contracts on behalf of each cell. The cell actually granted the core signature authority over its bank and brokerage accounts.

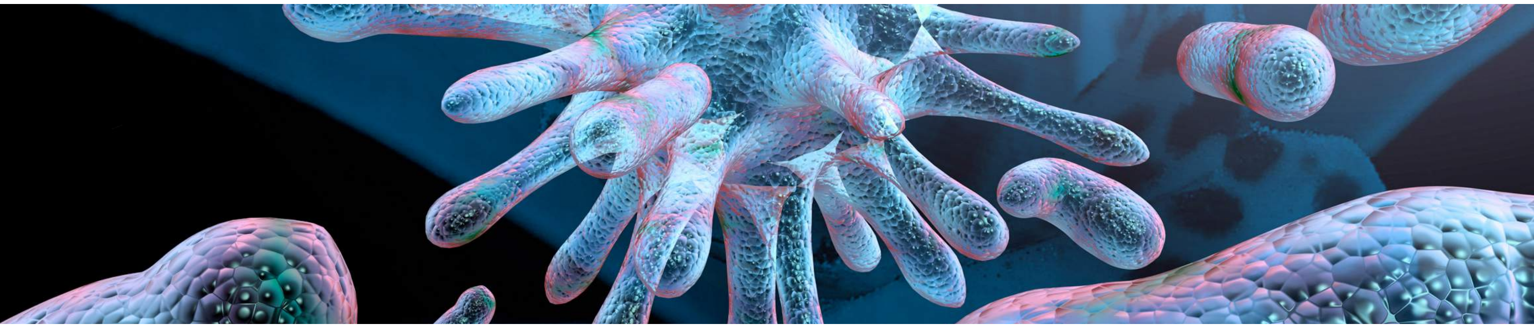
The $5 million of client money in the cell was outside of the client's practical control. The core's capital, intended to support its cells, wasn't there, even though the client's capital was inadequate to support the cell's level of insurance activities. When the client wanted out of the cell arrangement, the core refused to sign the documents.

Meanwhile, the core's sponsor disclaimed all legal and tax responsibility for the planning. There was no fiduciary obligation owed by the core or the sponsor to the cells because the captive sponsor, although a lawyer, inserted in the documents that he was the lawyer for the plan sponsor and captive manager—essentially, he was the opposing lawyer.

Buried deep in the captive documents, the client had ceded to the core's manager the role typically taken on by the officers and directors and owners of the captive. Under the documents presented by the core's manager and executed by the client, the core manager, being the captive sponsor, had the right to control the cells. The captive cell owner granted co-control over the bank account to the core's manager, leaving the client with little authority. The client stood helpless, losing control of the entity in which he had invested millions.

Traditionally, captives are regulated by the domicile, however, regulation of a captive as an insurance company is a characteristic cited by the US Tax Court as one of the key factors in establishing treatment as an insurance company for federal tax purposes. The captive must function as a bonafide insurer for it to benefit from the tax status as a property and casualty insurer. There was scant evidence of this throughout the promoter's documentation. In general, at some point both the IRS and the domicile's regulatory examiners will likely audit a cell captive. This is when its core manager will likely do the 'Texas two-step' and disappear.

More often than not, the captive manager disclaims all tax and legal responsibility and the client is left to piece together the planning and



handle the audit or tax controversy on his own. Realistically, this is a nearly impossible task.

Captive planning has many moving pieces. It is subject to regulation and oversight by its domicile, by the insured's home state, and by the IRS. A client must 'thread the needle' of all these regulators and do so with the recognition that it operates on limited premium and a constrained administrative budget.

Can you imagine needing a new car but instead choosing to buy the individual component parts and assemble it yourself? As the purchaser, you are then left to assemble the pieces. This is a recipe for certain disaster.

Too often even sophisticated clients hire a captive manager and then find that the actuary is located in one state, the corporate lawyer—if one exists—is in another states, the tax lawyer in another, the auditors still somewhere else. At best, each is taking responsibility for only their piece of the puzzle and disclaiming broader responsibility. Even if that car makes it out of the driveway it is destined to be abandoned by the side of the road, with each of the component suppliers blaming another. No one warrants or stands behind the project as a whole.

So why are there a plethora of cell arrangements in the marketplace? Often a cell structure allows for a promoter with little to no captive experience to sell a sophisticated financial product with a tax and legal overlay, but with none of the costs, responsibility, or care. Imagine a sponsor able to present the client with form contracts, fill in some blanks and then collect a $75,000 annual fee and offer a captive for only $25,000 in capital.

Sometimes this is bolstered by a fill in the blank feasibility study, but rarely based on an on-site, professional evaluation. The manager types the client's name into an LLC agreement and the captive is in place. Even the domicile cooperates upon payment of its formation fee.

Questions to ask

Who are the tax and legal professionals that designed the captive planning? Speak to them and have them explain their roles. Who stands behind the planning? Get it in writing and have the legal and professional team acknowledge that they represent you.

Visit the sponsor's offices and meet your captive planning team. Many 'captive managers' operate virtual offices with the 'team' holding full-time jobs or working from home. The question is whether there is a team of professionals in place that can support and carry out the planning. This is often not the case.

Don't expect your company's consumer protection association or lawyer to know very much about captive and alternative risk planning. In the same way, you wouldn't expect your ophthalmologist to be able to provide an appropriate treatment for your arthritis. You may get an answer, but don't rely on it.

Will you control your own company? Is there a company manager who supersedes your role as the owner, director or officer? Examine the documents. Make sure that you will be receiving annual, audited statements of your own cell.

Require access to the other cells and to the core's financials, and take precautions to ensure that your cell isn't exposed to the acts of other cells or the core. Better yet, don't choose a cell or a series arrangement—opt instead for a standalone captive.

Who is the captain of the ship? Captive planning is complicated. Who is taking overall responsibility? Get it in writing.

Who is responsible for evolving the planning as the tax law changes as it did in 2004, 2008 and again in 2015. Who is paying for the redesign of the captive when—not if—new legislation is enacted?

Is there a third-party component, for example, a pool, as part of the planning? Who has designed this and has it been tested? Understand the insurance and tax risks associated with the pool or risk sharing arrangement, and find out if it is audited and who controls it.

If you're the type that wants to assemble a high-performance car on your own then a cell arrangement may be right for you. However, given that you're about to embark on a long trip, you might want to pray that all of the components are working together.

For the rest of the business community that would rather have a turnkey approach, it may be time to examine or re-examine your LLC, PCC, series or cell planning and to consider returning to a traditional, standalone captive arrangement. CIT

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