Presenting a live 90-minute webinar with interactive Q&A

Captive Insurance Companies in Estate Planning: A Profit Maximization and Risk Reduction Tool

Leveraging the Benefits for Asset Protection, Wealth Transfer and Retention, and Tax Minimization

THURSDAY, SEPTEMBER 13, 2012

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

J. Scot Kirkpatrick, Shareholder, **Chamberlain Hrdlicka White Williams & Aughtry**, Atlanta

Kimberly S. Bunting, Shareholder, **Chamberlain Hrdlicka White Williams & Aughtry**, Atlanta

Karen S. Kurtz, Attorney, **Chamberlain Hrdlicka White Williams & Aughtry**, Atlanta

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 10**.

Tips for Optimal Quality

Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory and you are listening via your computer speakers, you may listen via the phone: dial **1-866-961-9091** and enter your PIN -when prompted. Otherwise, please **send us a chat** or e-mail **sound@straffordpub.com** immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

Viewing Quality

To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.

Continuing Education Credits

FOR LIVE EVENT ONLY

For CLE purposes, please let us know how many people are listening at your location by completing each of the following steps:

- In the chat box, type (1) your **company name** and (2) the **number of attendees at your location**
- Click the SEND button beside the box

Conference Materials

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the + sign next to “Conference Materials” in the middle of the left-hand column on your screen.
- Click on the tab labeled “Handouts” that appears, and there you will see a PDF of the slides for today's program.
- Double click on the PDF and a separate page will open.
- Print the slides by clicking on the printer icon.

CAPTIVE INSURANCE COMPANIES: A PROFIT MAXIMIZATION AND RISK REDUCTION TOOL

September 13, 2012

J. SCOT KIRKPATRICK, ESQ.
(404) 658-5421
scot.kirkpatrick@chamberlainlaw.com

KIMBERLY S. BUNTING, ESQ.
(404) 658-5428
kim.bunting@chamberlainlaw.com

KAREN S. KURTZ, ESQ.
(404) 658-5438
karen.kurtz@chamberlainlaw.com

Chamberlain Hrdlicka
Attorneys at Law

What is a Captive?

An Insurance Company formed by a business owner to insure the risks of related or affiliated businesses.

- **Over 50% of the Fortune 1500 have Captives**
- **There are an estimated 5,000 to 7,500 Captives world-wide, and that number is expected to double in the next three years.**

Business And Economic Reasons For Forming A Captive

- Risk Management and Risk Financing
- Lower Insurance Costs
- Increased Cash Flow
- Access to Coverage Typically Unavailable in the Commercial Market
- Access to the Reinsurance Market
- Ability to Retain Risks
- Tax Minimization and Deferral
- Asset Protection and Wealth Preservation

Steps and Considerations in the Structure and Formation of Captives

- Insurance audit/Feasibility study
- Determine Type of Captive – "Pure"
- Determine if Captive will be "Small" or "Large"
- Income Tax Considerations
- Corporate Formation and Place of Domicile
- Capitalization
- Management
- Shareholders
- Underwriting/Development of Policies
- Insurance Certificate
- Bank Account
- Reporting Requirements
- Investment Restrictions
- Captive Regulatory Management

Risk Management Analysis

The first step in implementing a captive insurance company program involves a risk management analysis for the company and other assets owned by the owner of the company individually. The risk management analysis contains the following three steps.

- **Review Existing Insurance Program**
- **Review and Analysis of Business Operations and Assets to Determine Insured Risks**
- **Recommendations for Risk Management / Captive Insurance Program**

Types of Risks Typically Insured vs. Uninsured/Retained Risks

Insured Risks

- General Liability
- Auto Liability
- Worker's Compensation
- Health Insurance
- Professional Liability
- E & O
- D & O
- Property
- Management Liability – D&O, Fiduciary, EPL, Fidelity

Uninsured/Retained Risks

(Risks that can be insured by a Captive)

- Deductibles for Insured Risks
- Loss of Key Customer
- Loss of Key Employee
- Loss of Key Supplier
- Administrative Actions
- Litigation Expense
- D & O (excess)
- E & O (excess)
- Employment Practices Liability
- Fiduciary Coverage
- Fidelity Coverage
- Insured Policy Exclusions
- Contract Claims
- Business Risk Indemnity
- Excess General Liability
- Other coverages tailored to company's risk profile

Coverage and Premium Determination

- Detailed application for coverage similar to commercial insurance policy applications
- In depth review of existing insurance policies for types of coverage in place, deductibles, gaps and exclusions
- Actuarial analysis of proposed coverages, loss data and loss factors for coverage
- Determine premiums for Captive Insurance company to charge including projected losses, costs, overhead and profit

Structural Considerations

- The inclusion of a captive insurance company in a business's risk management program is ideal when the business has a substantial amount of self-insured risk. Businesses with sufficient risk and substantial profits may be ideal candidates for "pure" captive insurance company implementation.
  - Such a business would potentially have risk significant to justify $1.2M in premiums paid to the "pure" captive insurance company.
  - A "pure" captive insurance company is formed by business owners (or a trust for the benefit of business owners and their family) to provide insurance to the business. Participation in a risk management pool may be required depending on the business's structure.
- Captives may also be an option for operating businesses that have lesser profits and/or that cannot justify a $1.2M per year premium.
  - Cell captive arrangements may permit business owners to efficiently participate in a captive program without implementing a "pure" captive structure. A cell captive arrangement involves unrelated 3rd parties and the organization of those parties is generally accomplished through a captive management company.
  - In situations where annual premiums would be $500,000 or less the use of a cell captive is generally preferred to a "pure" captive.

Federal Income Taxation as an Insurance Company

- Requirements:
  - Bona-fide Business Purpose
  - Risk Transfer
  - Risk Distribution
  - Operates as an insurance company
  - Reasonable premiums
  - Adequate capitalization

Case Law - Federal Income Taxation as an Insurance Company

An insurance company must offer insurance…what is insurance?

<u>Helvering v. Le Gierse</u>, 312 U.S. 531 (1941) –

This was the first case to set forth the standard that true insurance must have both risk shifting and risk distribution.

<u>Harper Group, Inc. v. CIR</u>, 979 F.2d 1341 (9th Cir. 1992) –

A three prong test was developed by the Court (i) insurance risk must exist, (ii) risk shifting and risk distribution must exist, and (iii) the captive must offer insurance. In addition, the Court set the 30% risk distribution standard.

Safe Harbor Rulings and Other Rulings That Provide the Requirements for Risk Shifting, Risk Distribution, and Captive Formation

Revenue Ruling 2002-89 – 50% Unrelated Risk

Revenue Ruling 2002-90 – 12 Subsidiaries

Revenue Ruling 2002-91 – Group Captive

Revenue Ruling 2005-40 – Disregarded Entities and More

Revenue Ruling 2008-8 = Cell Captive

Revenue Ruling 2009-26 – Reinsurance and Risk Distribution

Tax Advantages of a Captive Insurance Company

- **Deduction of premiums by Insureds**
- **Generally, the loss reserves are deductible by a captive which reduces Premium Income to the Captive**
- **831(b) election allows Captive with $1.2 million or less Premium Income to elect to be tax exempt on Premium Income and taxed only on its investment income**

Potential Problem Areas and Repair

- Thinly capitalized
- Large loan-backs
- Investment in life insurance
  - Can be a signal to the Service that this was a sham transaction/lacking in economic substance
  - Let the captive mature before buying life insurance, and be sure there is a substantial, nontax purpose (estate planning/buy-sell purpose may be helpful)
  - Service has issued summonses for Aviva Life, AmerUs (now Aviva), and Indianapolis Life (now Aviva) related to ongoing scrutiny of captive promoters maintaining alliances with life insurance companies
- Inadequate third party risk
  - Less than 12 insureds
  - Risk pools that pay no claims
  - Protected cell companies (Rev. Rul. 2008-8)
- Heavy investment in the activities of affiliate companies (Service could use this as evidence in a sham transaction)
- Heavy investment in illiquid assets (not "acting like" an insurance company)

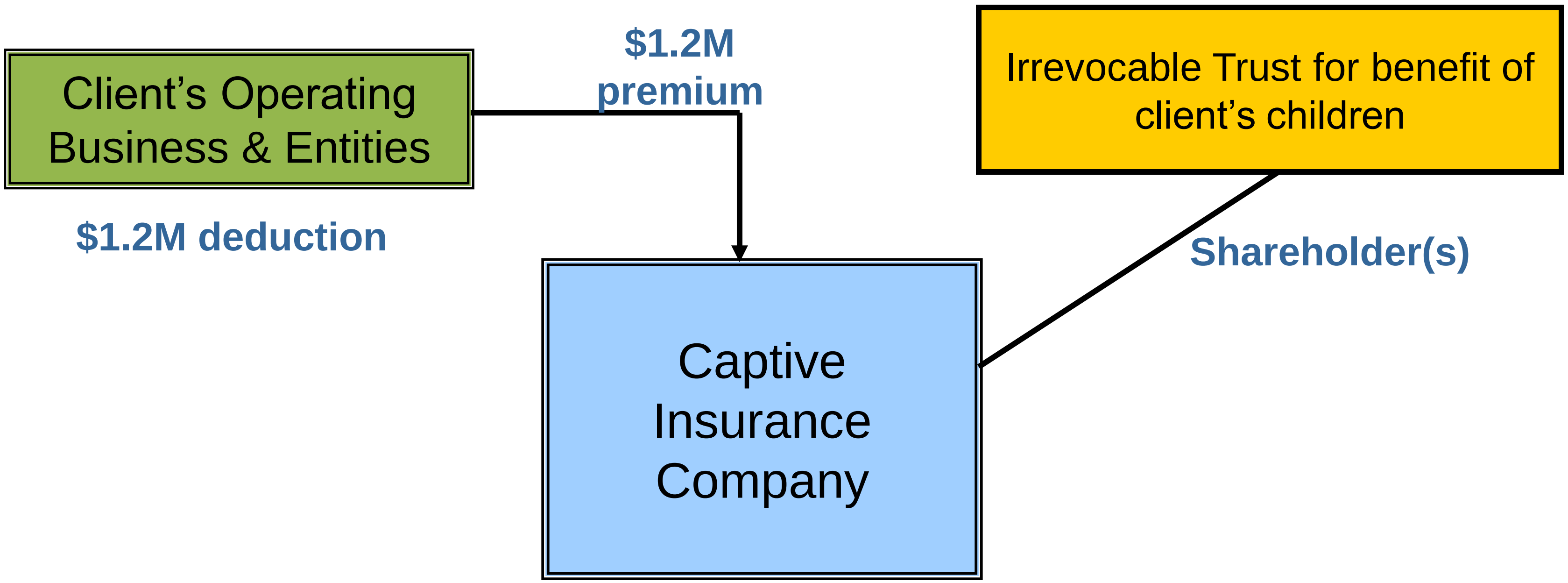
Potential Problem Areas and Repair

- Accessing captives through any sort of "alliance", "institute" or other title used to notate a consortium of individuals banded together to sell tons of life insurance through the aggressive marketing and inappropriate use of tax-advantaged structures
- This is a sure way to get a target painted on your back or your client's back
  - No attorney-client privilege
  - The Service can and does get customer lists from these groups
  - These groups tend to be more reckless in their marketing materials since they need the "sizzle" to attract the attention of life insurance producers
  - The Service can and does use reckless marketing materials to hang taxpayers
    - Such as materials marketing captives as a way to deduct life insurance premiums and never pay tax on the proceeds
- Like any advanced planning tool, captives should be accessed through an attorney as part of a comprehensive approach in arranging a client's affairs
  - Attorney-client privilege will apply

Do It Right…But If Problems Exist, Captive Repair Is An Option

Like any advanced planning tool, captives should be accessed through an attorney as part of a comprehensive approach in arranging a client's affairs. However, if problems exist take the necessary steps to repair the captive.

831(b) - Simple Example

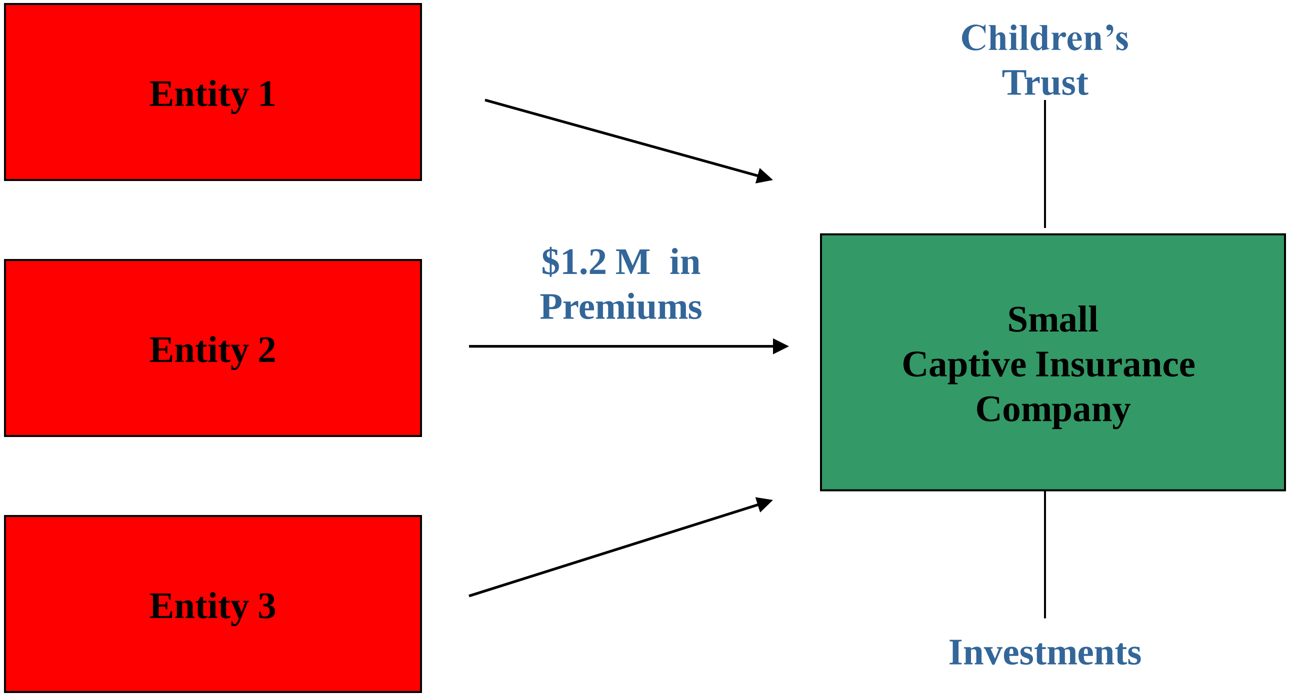


Captive pays <u>NO</u> income tax on $1.2M of premium income

Wealth Transfer of Captive net profit (Premium income plus investment income minus expenses and claims payments) Qualified dividend or capital gain to shareholder(s)

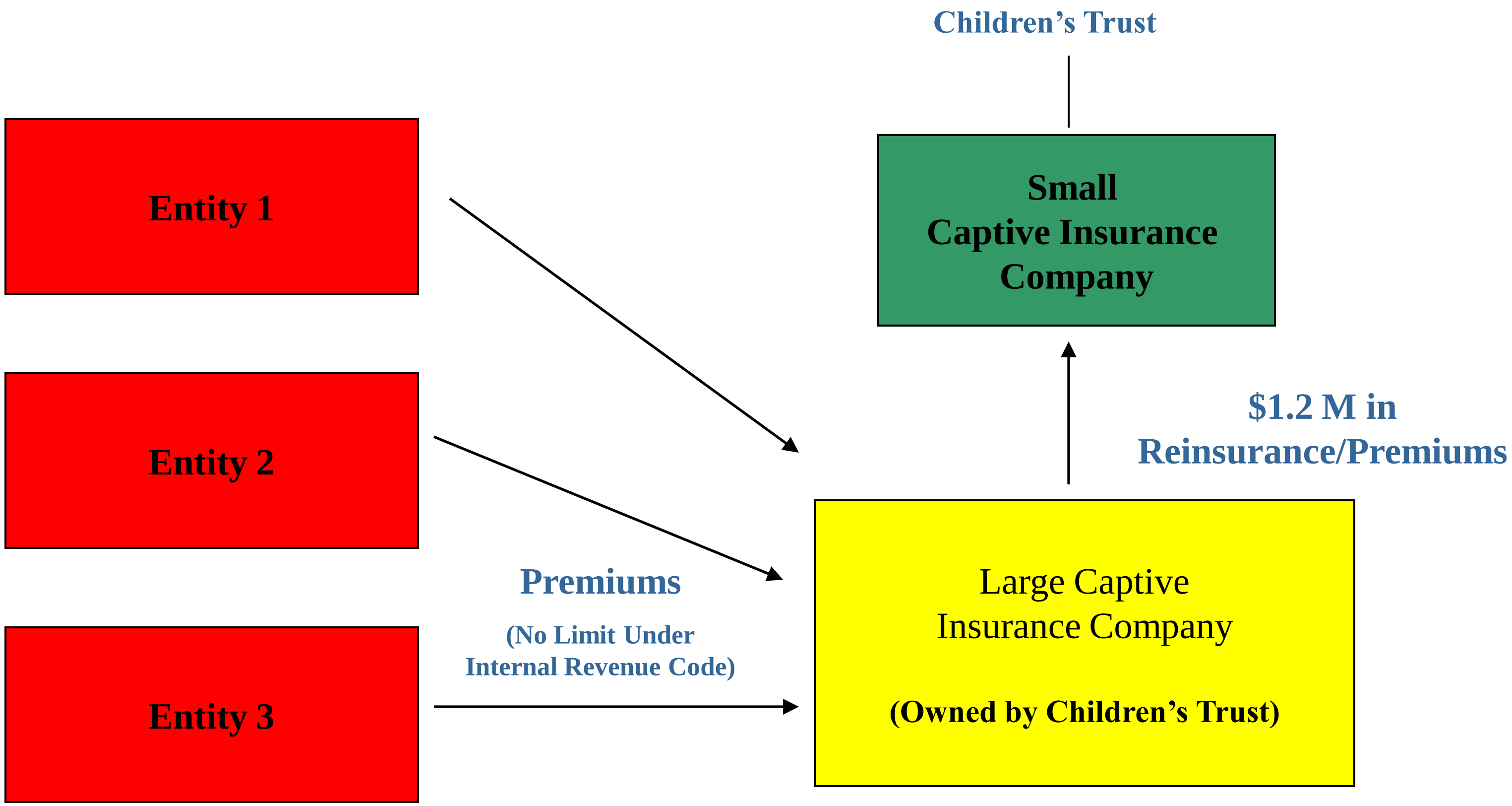
CIC Structure – Option I

Multiple Entities can obtain insurance from a single Small Captive Insurance Company.



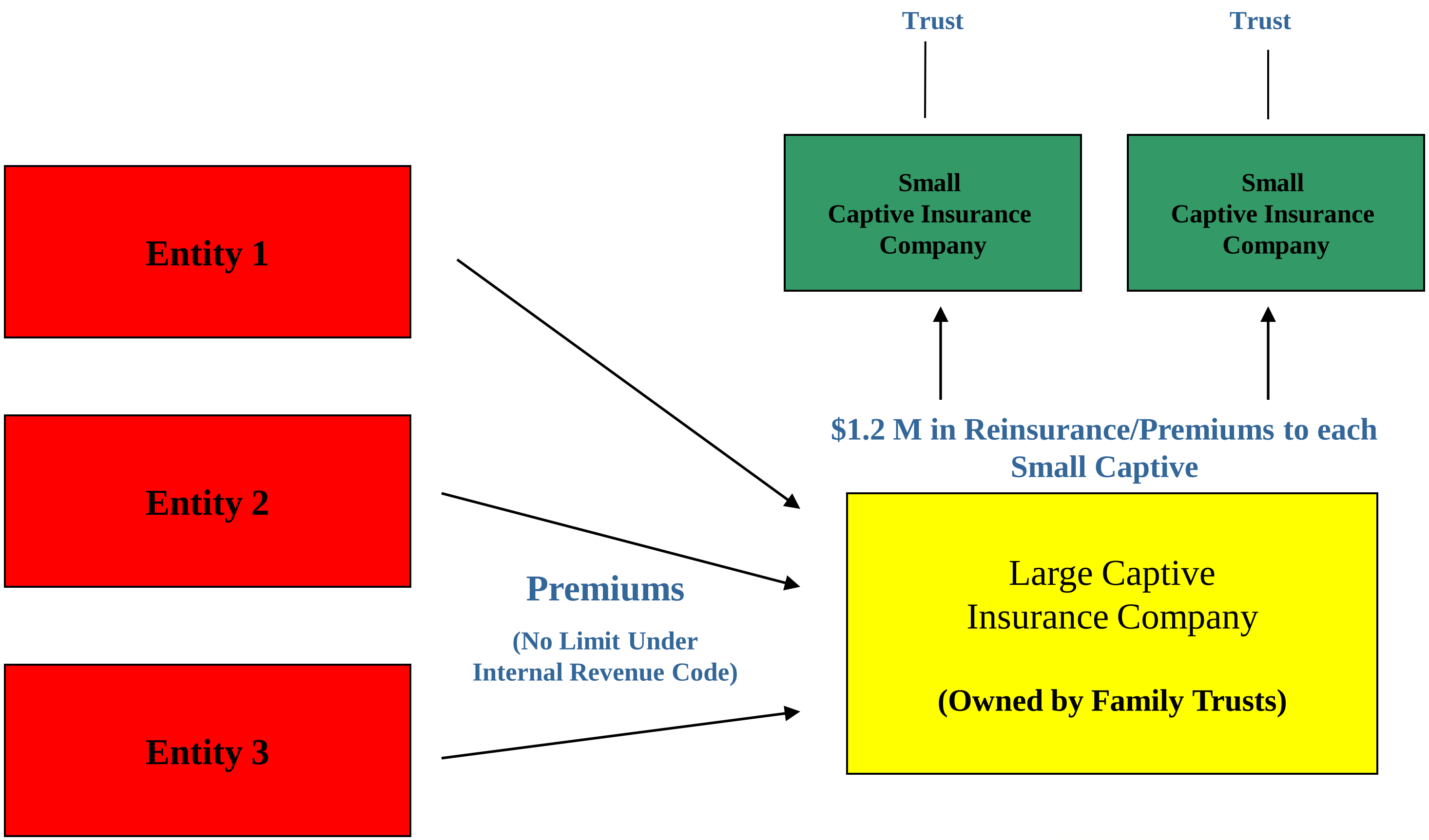
CIC Structure – Option II

One Large Captive that pays reinsurance premiums to a Small Captive. Both the Large Captive and the Small Captive will own investments. Multiple entities can obtain insurance from the Large Captive.



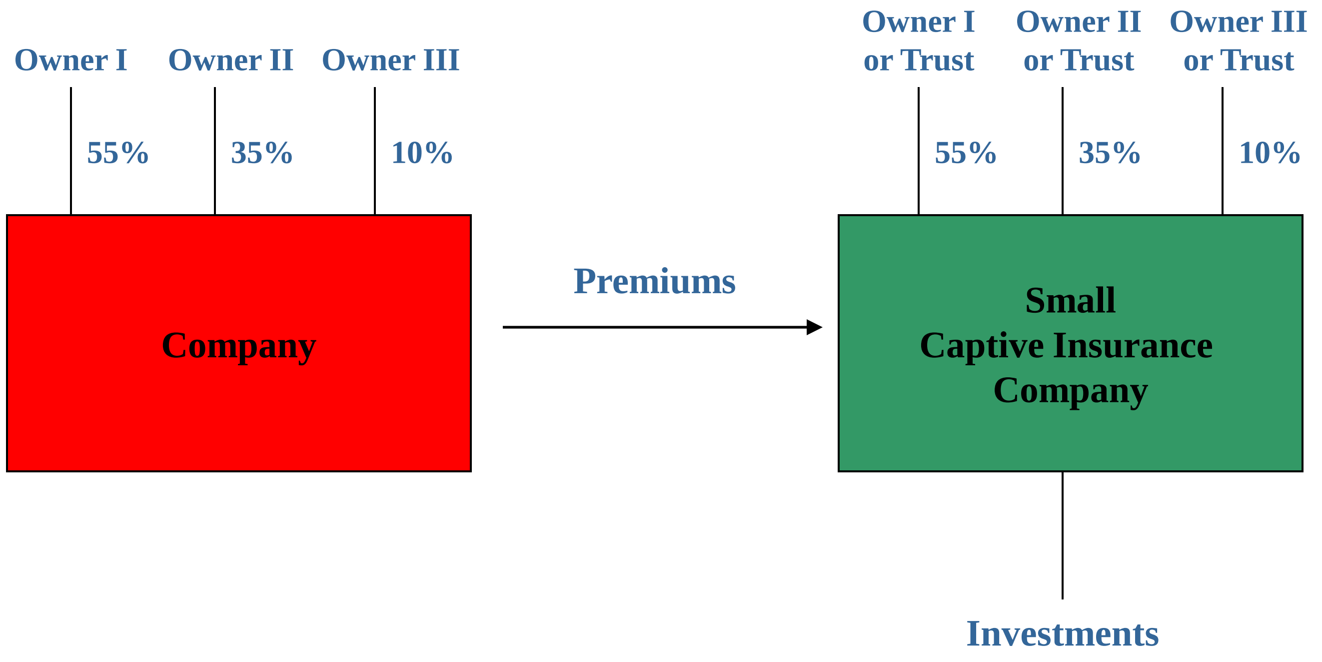
CIC Structure – Option III

One Large Captive that pays reinsurance premiums to multiple Small Captives. Both the Large Captive and the Small Captive will own investments. Multiple entities can obtain insurance from the Large Captive.



CIC Structure with Multiple Owners

The preceding captive structures can involve more than one owner/family. The diagram below shows a sample structure with multiple owners.



Case Study : Formation of a Captive in Conjunction with the Sale of a Business

A traditional Small Captive Insurance Company structure is most appropriate in many situations where the sale of a business is involved. For many reasons, including asset protection and wealth preservation, it is recommended that a trust be the owner of captive insurance company interests.

Husband is the Grantor

Delaware Dynasty Trust

Wife is the Trustee,
Wife and the children are the beneficiaries

100%

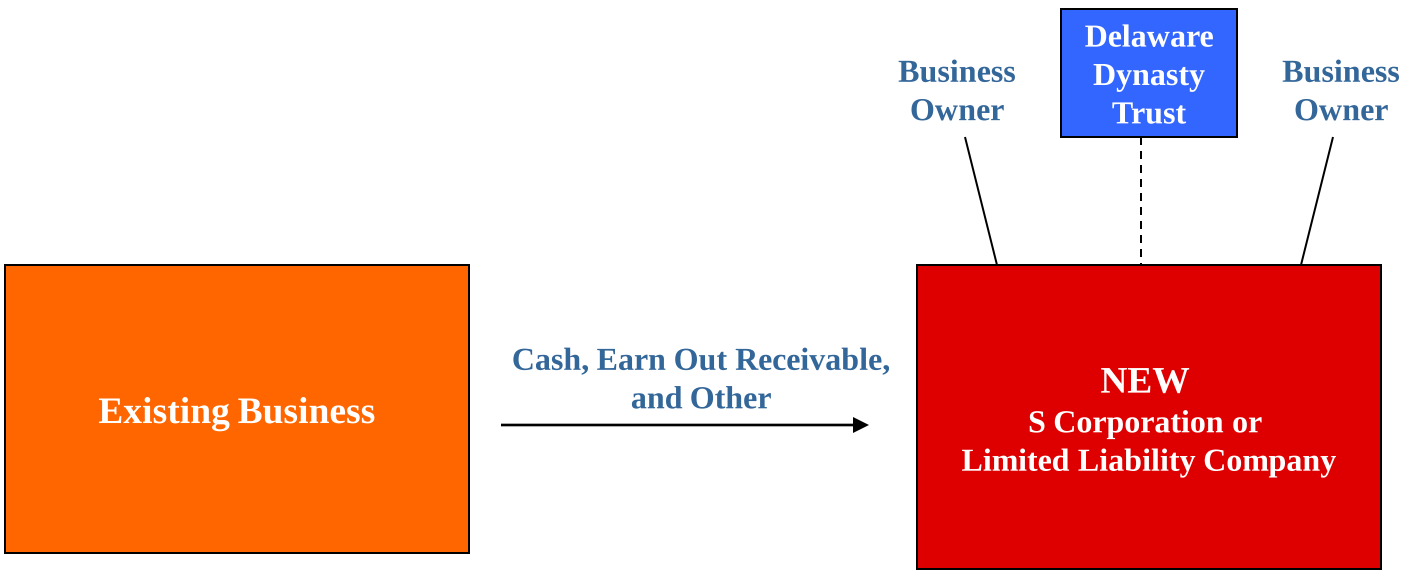
Small Captive Insurance Company*

Investments

*Please note that different ownership structures are possible. A "Small" captive insurance company qualifies under IRC Section 831(b) for exemption from income tax on up to $1.2M of premiums received per year.

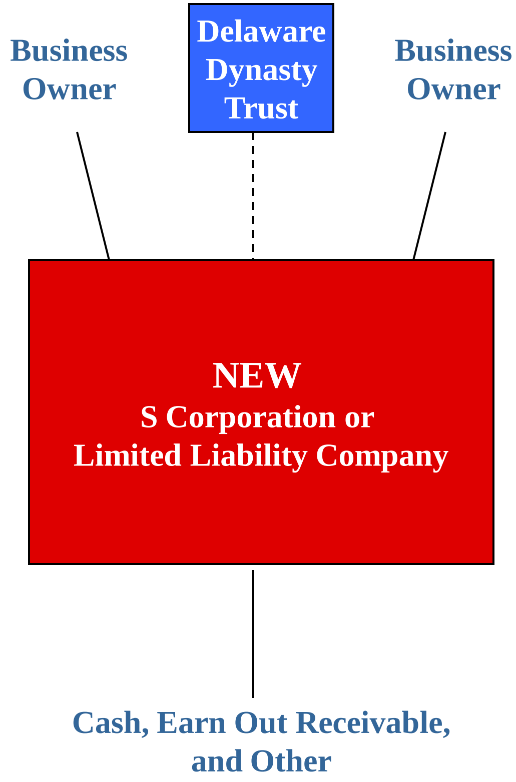
Case Study: Sale of Business

A stock or asset sale of an existing business may create the need to form a new entity that will survive the stock or asset sale and purchase insurance from the Small Captive Insurance Company. The business owners will own the new entity and the Delaware Dynasty Trust may also be an owner. The new entity may be capitalized with cash, earn out receivables, and other assets from the business owner.



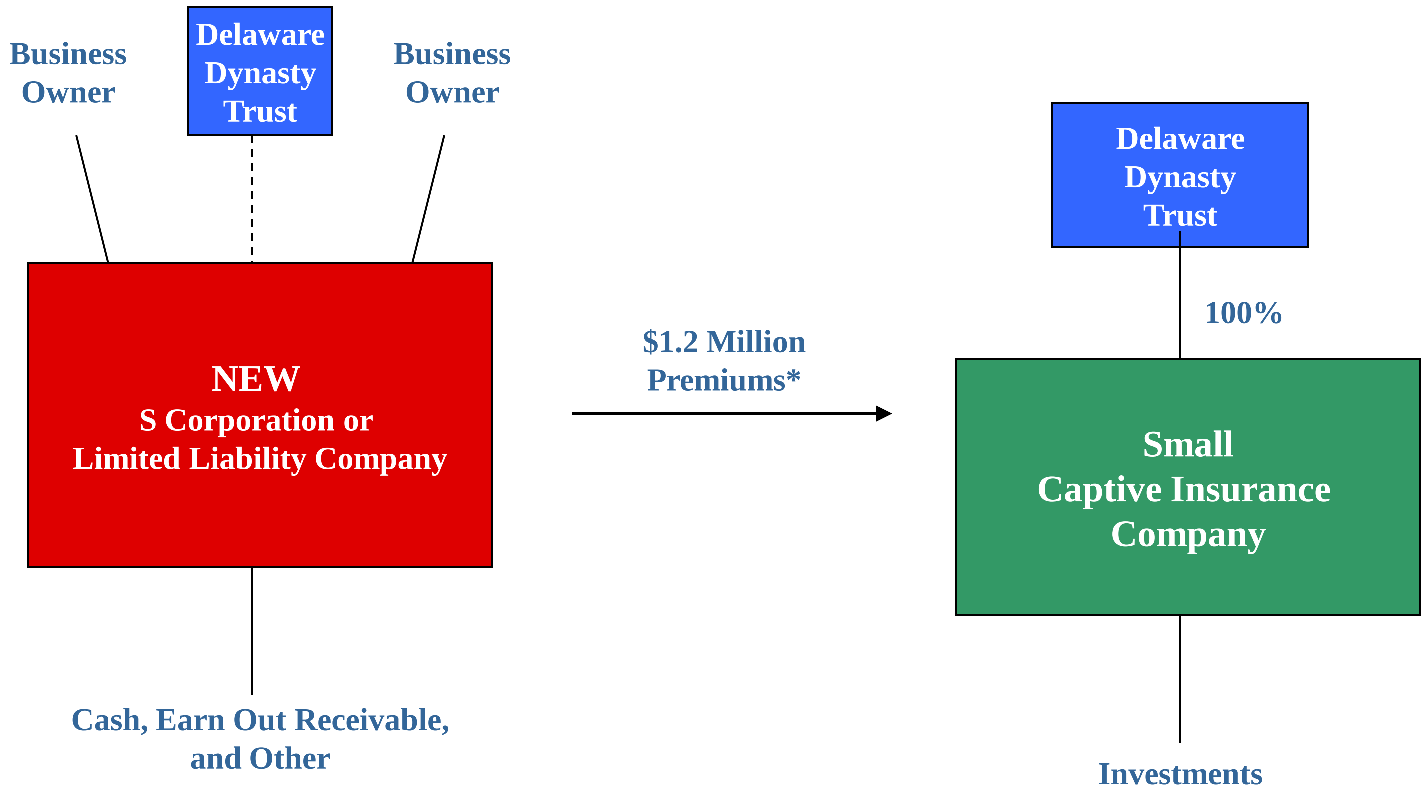
Case Study: Sale of Business

The new entity will provide indemnification for the business owners against certain obligations arising from the stock or asset sale of the existing business including possibly receivables, representations and warranties, and other liabilities.



Case Study: Sale of Business

The new entity will purchase insurance from the Small Captive Insurance Company to insure against various risks, including risk arising from the obligations related to the stock or asset sale of existing business including receivables, representations and warranties, and other liabilities.



***Premiums are deductible by new entity, but exempt from income taxation to the Captive under IRC § 831(b).**

DISCLAIMERS

- The information contained in this presentation is for illustration purposes only and not intended to constitute formal tax or legal advice.
- The rules imposed by IRS Circular 230 require us to state that, unless it is expressly stated, any opinions expressed with respect to a significant tax issue are not intended or written by the practitioner to be used, and cannot be used by the recipient, for the purpose of avoiding penalties that may be imposed on the recipient or any other person who may examine this correspondence in connection with a Federal tax matter.