

“Multiple Captive Insurance Company Planning - Risk Management, Wealth Creation, Asset Protection and Wealth Succession Planning Objectives,” ©Tom Cifelli, JD, CPA, October 26, 2012. All rights reserved.

About the Author:

Mr. Cifelli is the Managing Director of CaptiveExperts.com. He practiced law and public accounting in multiple states and was the Managing Director of Investment Banking with registered US broker-dealer firms. He also held CFO and General Counsel positions with publicly traded Internet companies, one of which he co-founded. He worked as a tax consultant with the world's largest tax firms early in his career, and was the lead researcher updating the leading law school tax text at the time. His clients have included veteran industry management firms both on and offshore. He was selected for the 2012 US Captive Newcomer of the Year Award. Mr. Cifelli currently works closely with Artex Risk Solutions, one of the world's largest captive design and management firms.

Introduction:

Sophisticated and experienced insurance and financial planning professionals increasingly consider a multi-captive approach to risk management program dynamics to amplify potential benefits. Multiple captive structures expand client risk management and other planning objectives in ways not possible with one captive or a self-insured program. For US and non-US businesses alike, captives present truly enormous tax, asset protection and wealth succession planning benefits.

This article offers an example of a multi-captive application, explains how to navigate the complex US tax rules bearing on corporate control groups to protect the value of tax leveraged loss reserve asset accumulation, and discusses the use of an advanced legal cell structure to help minimize required capital and ongoing costs associated with this complex multiple captive program design.

Many developed countries like Canada tax entities on a stand-alone basis. Some including Canada do not tax offshore income of related entities unless repatriated (and sometimes not at all where favorable treaties are in place). For businesses based in these more favorable non-US countries, the risk management and loss reserve wealth accumulation and asset protection planning benefits possible by using captives are more easily achieved without need to navigate the cumbersome affiliate control group and foreign activity tax rules of the US Treasury discussed below.

Discussion:

The valuable risk management, tax savings and other business and economic benefits possible create a compelling case for successful small to mid-sized closely held family businesses to own their own captive insurance company. The special US IRS Section 831(b) small insurance company election exempts from income tax the premium income of qualifying small insurance companies provided they do not write more than \$1.2 million in annual premiums. This special tax policy subsidy has, as intended, begun to stimulate small to mid-sized companies creating captive insurance companies to improve risk management, build loss reserve assets, increase stability and become more competitive.

As a primer, consider the tax leverage value of structuring a business's captive insurance program to qualify for the 831(b) tax election which excludes from US federal income tax all underwriting premium income for qualifying small insurance companies that write no more than \$1.2 million in annual insurance premium.

SAMPLE ONE YEAR HYPOTHETICAL IMPACT OF A BUSINESS WITHOUT AND WITH A CAPTIVE Uninsured (or self-insured) Business:

Pre-tax net income	\$1,200,000
Estimated Taxes	\$ (480,000)
Net After Tax Cash.....	\$ 720,000 (available to pay losses)

831(b) Captive Program - Operating Business: (pays \$1,200,000 in deductible premium):

Affiliated Captive Impact:	
Premium income	\$1,200,000
Income Taxes	\$ (0)
Net After Tax Cash.....	\$1,200,000 (available to pay losses)

Special Note: If the captive ownership is structured correctly, this \$1.2 million moves gift and estate tax free to a successor generational level without regard to annual or lifetime gift and estate tax allowances, exclusions or credits which would all be preserved.

The discussion below focuses on how multiple captives can be used by the same corporate group with each captive qualify for the special 831(b) election even where in aggregate more than \$1.2 million in total premium revenue is received by the “related” multi-captive family. As mentioned above, clients who reside in many countries other than the US can achieve equivalent and in some cases superior benefits of 831(b) captives by using multiple captives. On a global scale, the opportunity for qualified parties to offer design-build-manage services for multiple captive structures is enormous.

A basic understanding of the US case law, statutory and regulatory history underlying the use of captive insurance companies by US resident companies is assumed herein, as is underwriting, lines of coverage allocation and business purpose issues. Our analysis focuses on how to protect the use of the 831(b)'s special election in multiple captive application contexts.

Control Group Rules Impact:

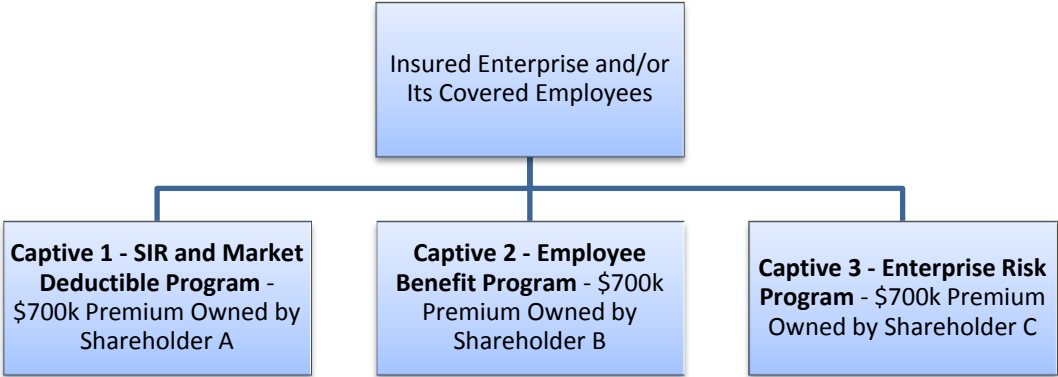
US IRC Section 1563 requires consolidating company tax reporting with other companies deemed affiliates or part of a control group, which could have adverse tax consequences and result in a loss of intended tax deductions, credits and exemptions. For example if you form three (3) captives each writing \$700,000 of premium and making the 831(b) election, if they are deemed part of a control group or subject to the consolidated reporting requirements, then the aggregate \$2.1 million of premium exceeds the 831(b) limit of \$1.2 million, making the election ineffective and subjecting all 3 captives to income tax on premium income. However, structured correctly, all \$2.1 million of premium would be exempt from US income tax under 831(b) even though all 3 captives insure the same corporate group.

The IRS defines a control group in Section 1563 as parent-subsidary structures with 80% common ownership or control, and in brother-sister situations, where **“5 or fewer persons who are individuals, estates or trusts own (within the meaning of subsection (d)(2)) stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50% of the total value of shares of all classes of stock of each corporation...”** IRC Section 831(b)(2)(B)(ii)(1) makes the 50% test essentially the only threshold of concern applied to captives; otherwise additional tests apply to determine if a control group exists.

In designing a multiple captive program, you must structure ownership to avoid having 5 or fewer parties owning more than 50% of more than one captive if you want them to qualify for the 831(b) election (assuming the aggregate premium of the multiple captives exceeds \$1.2 million).

Case Study: Assume a car dealership group, medical practice group, a large construction firm, or any other successful business has \$50,000,000 in annual revenues and an underwriting and actuarial analysis determined uncovered risks and other coverage objectives require \$2,100,000 in annual premiums to adequately insure. Assume the business has at least three (3) unrelated owners. The following diagram shows an example of a multi-captive approach that should enable any particular captive in this related multi-captive group to qualify for the 831(b) election, irrespective of what the other owners do with their captive:

The Chart below Shows the Special 831(b) Election Integrated with a Multiple Captive Structure to Enable Exclusion of Over \$1.2 Million in Annual Premium with Multiple Unrelated Owners of the Insured Businesses



In the above illustration, assuming US law applies, how ownership is structured is critical if qualifying for the advantageous 831(b) special tax election is desired. If 2 or more of these owners have more than 50% common ownership in more than one captive, as explained below, they would run afoul of other provisions of the US tax code that would disqualify some or all of the captives from making the favorable 831(b) election.

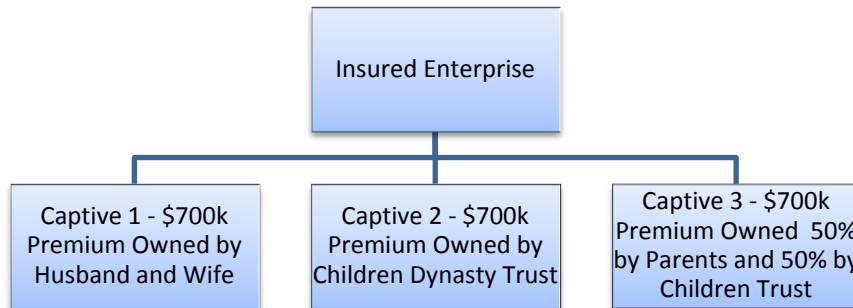
Attribution of Ownership Potential Pitfalls:

For US taxpayers, constructive ownership rules under IRC Section 1563 may attribute ownership and control of stock held by spouses, children under 21 and by companies or other entities including trusts that you own 5% or more of. In the case of trusts, an actuarial ownership interest has to be determined assuming maximal use of discretion by a fiduciary in favor of a beneficiary to determine if the 5% threshold is breached. Constructive ownership rules in IRC Sections 671-679 must also be considered. In creating family dynasty trusts owned by children, its best to make sure the parents have no actuarial or constructive interest if these trusts will be used in a multi-captive structure to enable independent use of multiple 831(b) elections by US owned captives.

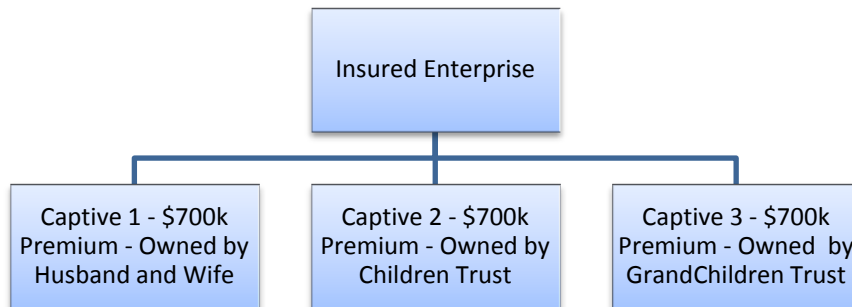
Some retained powers over a trust by a grantor that cause constructive ownership under IRC 674 and 675 include revocation power, control over enjoyment and benefit of trust assets and income, income rights without adverse third party, and retaining other administrative powers.

In some cases a spouse may qualify as a separate person and not have their ownership attributed to the other spouse. The following diagram shows an example of a multi-captive approach where there is only one (1) business owner that should meet the no more than 50% common ownership brother-sister control group safe harbor to protect use of multiple 831(b) elections:

The Chart below Shows the Special 831(b) Election Integrated with a Multiple Captive Structure to Enable Exclusion of Over \$1.2 Million in Annual Premium Without Unrelated Business Owners



Alternatively consider the potential benefits of something structured like this:



If children are 21 years old, they could own one of the multiple captives directly without their ownership attributed to a parent. If the owner of the insured enterprise has concerns about trusting the owners of the other two captives with the enterprise loss reserve assets, an LLC layer between the captive and the captive ownership entity could enable one party to retained control over the captive operations and distributions without the captives being deemed a control group requiring consolidation for application of US tax law.

Of course the above examples and discussion herein is for information purposes only and qualified tax experts should be engaged to assist when setting up multiple captive programs. Done correctly, not only may the 831(b) tax election be leveraged to exclude from income tax far more than \$1.2 million in premiums paid by the same corporate group, but a myriad of asset protection and family estate planning objectives can be achieved to protect business assets from potential creditors and avoid gift and estate taxes on accumulated captive loss reserve assets altogether.

Incorporated Cell Captive Value to Multi-Captive Projects:

The downfall of creating multiple captives rather than one larger captive is the increased formation, capitalization and operating expenses. While the formation, licensing and operating expense increases are unavoidable, you may be able to minimize the need for additional capital by utilizing the emerging Series Limited Liability Company (Series LLC), Protected Cell Company (PCC) or Incorporated Cell Company (ICC) structures. Theoretically any of these structures can work well. An ICC however affords the greatest overall predictability should one of the cells ever find itself in the unfortunate situation of administrative review or litigation in a foreign jurisdiction not familiar with these complex and sophisticated emerging legal vehicles. In the absence of an incorporated cell, despite best efforts in drafting of enabling legislation and transactional documentation, another jurisdiction may not recognize unincorporated cells/series as separate legal entities and aggregate all of the cells/series with the core as one entity in their legal opinion. Over time this will be more fully vetted in the courts although many experts agree these special legal vehicles are sound and effective.

Minimum capital requirements for US domiciled pure captives generally start at \$250,000. For many established offshore domiciles with no income tax and low regulatory fees, the minimum capital is \$120,000 and in some cases potentially much less. Strategic use of a Series LLC, PCC or ICC vehicle could enable only one minimum capital contribution being required for the first captive, with great flexibility on the incremental capital required of the other two (2) cell captives.

Conclusion and Caveat:

If you decided a multiple captive program makes sense for your client's size and scope of operation, consideration should be given to the use of a Series LLC, PCC or ICC legal entity structure to minimize the need for duplicate minimum capital being required of each participating "related" captive in multi-captive applications. Be sure to retain qualified tax and legal counsel when designing captive insurance company business applications if the tax impacts are of concern.

Endnotes/References:

1. IRC Section 831(b) code and regulations.
2. IRC Section 1563 code and regulations.
3. IRC Sections 671-679 code and regulations.
4. **Bright Future for ICCs**, Tom Jones of McDermitt, Will & Emery:
<http://www.captivereview.com/features/1719582/bright-future-for-iccs.thtml>
5. Other 831(b) captive articles: http://captiveexperts.com/831b_Captive_Insurance.html