Multiple Captive Insurance Company Planning - Expanding Business Risk Management, Wealth Creation, Asset Protection and Wealth Succession Planning Objectives

Introduction:
Now armed with basic captive insurance company knowledge, the more sophisticated and adventurous insurance and financial planning professionals are learning how to design multiple captive insurance company applications. Multiple captive structures can expand client risk management and other planning objectives not possible with one larger captive program. This article offers examples of multiple captive applications, explains how to navigate the complex US tax rules bearing on corporate control groups to protect tax advantages, and discusses the use of incorporated cell captive structures for multiple captive applications to help minimize costs. It should be noted that many developed countries like Canada and many others that tax entities on a stand-alone basis, and do not tax offshore income by subsidiaries and/or related entities unless repatriated (under sometimes not at all), the planning benefits of multiple captive programs are easily achieved without navigating the cumbersome affiliate control group and foreign activity tax rules of the US.

Discussion:
The valuable tax benefits coupled with risk management and other business and economic benefits create a compelling case to create a captive for many small to mid-sized closely held family businesses. For US and non-US businesses alike, the use of captives formed in strategically located business friendly domiciles present truly enormous tax, asset protection and wealth succession planning benefits.

The special US IRS Section 831(b) election, which exempts from income tax premium income of qualifying small insurance company captives, has as intended stimulated some small to mid-sized companies to begin using captive insurance companies to improve risk management and build loss reserve assets. This discussion 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 more than $1.2 million in total premium revenue is received by multiple related captive insurance companies. As mentioned in the excerpt, 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 the underwriting, lines of coverage allocation and business purpose issues and nuances related to multi-captive applications. Our analysis focuses on how to protect the use of the 831(b) special election in multiple captive application contexts.

Control Group Rules Impact:

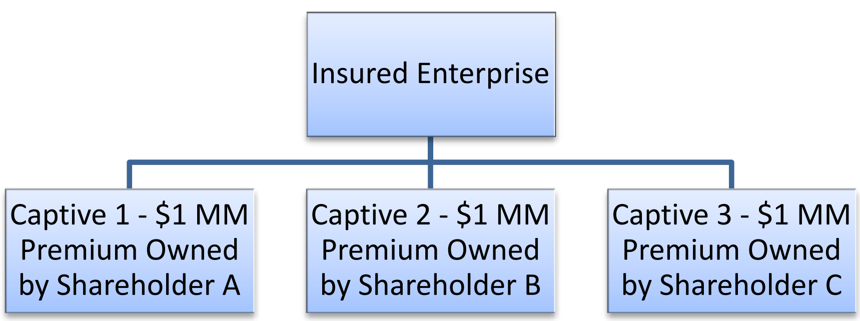
US IRC Section 1563 requires consolidating company tax reporting with other companies deemed affiliates or part of a control group, which could have adverse tax consequences and result in a loss of intended tax deductions, credits and exemptions. For example if you form three (3) captives each writing $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-subsidiary 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, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such 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: A successful car dealership group, or medical practice, or other business, is owned by three unrelated individuals. The overall business group has approximately $50,000,000 in annual revenues and was determined to have uncovered risks of concern requiring $3,000,000 in annual premiums to properly insure. Assume the business has three (3) unrelated owners each of whom desires to own their own captive and qualify for the 831(b) election if possible. The following diagram shows an example of a multi-captive approach that should achieve this objective for any particular owner 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, how ownership is structured is critical. If all 3 owners owned an equal percentage of all 3 captives, as discussed below they would run afoul of other provisions of the US tax code that would disqualify all 3 captives from making the favorable 831(b) election.

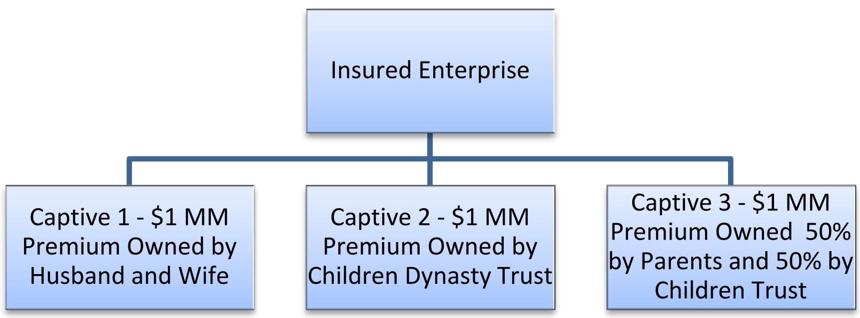
Attribution of Ownership Potential Pitfalls:

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



If the owner's children are 21 years old in the example above, they could own one of the multiple captives directly without their ownership attributed to the parents. If the owner of the insured enterprise has concerns about trusting the owners of the other two captives with the enterprise loss reserve assets, a layer of LLCs could be inserted above each captive and potentially enable increased control in one party without blowing qualification for all 3 captives to make the 831(b) election.

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) captive structures. There is a slight cost saving to forming and operating a Series LLC or PCC over an ICC, but an ICC affords the best 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 and respecting these complex and sophisticated emerging legal vehicles.

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 involving three (3) captives makes sense for your size and scope of operation, and you had business and economic substance objectives to vary lines of coverage and ownership between the 3 captives sufficient to avoid being a control group or running afoul of the economic substance test, 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 counsel when designing any multiple captive application if the tax impacts are of concern.

Main Reference Sources:
Internal Revenue Code & Regulations and articles by Matthew Howard of Moore Ingram Law and Tom Jones of McDermitt Will & Emery

About Tom Cifelli, JD CPA. Mr. Cifelli practiced law and other licensed professions for over 20 years. He is the Managing Director and Executive Editor of CaptiveExperts.com. Mr. Cifelli has experience working with some of the captive industries veteran management firms on and offshore, and today works very closely with the Artex Risk Solutions team on complex captive projects.