Estate planning with **small captives**

Captives can provide an extremely tax-efficient way for business owners to transfer wealth down the generations, as Patricio A. Suarez, Phillip England and Andrew M. Walsh explain.

Captive insurance companies are usually formed and controlled by businesses to insure or reinsure their own risks. When a business that is otherwise well suited for a captive programme is closely held and privately owned, an opportunity exists to make use of the captive for estate planning purposes. By putting some or all of the ownership of the captive in the hands of future generations, directly or indirectly, through trusts or partnerships, the business owner can transfer wealth in an extremely tax-efficient manner.

When a business owner pays reasonable insurance premiums to a captive, the business owner can deduct that payment as a business expense. On the other side of the transaction is an insurance company, which by law is provided with certain special tax incentives. As such, premiums received may be completely non-taxable to the captive or in large part offset by a deduction for reserves.

The tax benefits of small captives

Of particular interest to small business owners is the so-called 831(b) captive. Like small business corporations which are taxed as pass-through entities under Subchapter S, smaller insurance companies, including captives, have the option to be taxed under Section 831(b) of the Internal Revenue Code instead of the default Section 831(a).

Under Section 831(b), insurance companies earning no more than \$1,200,000 in annual written premiums can opt not to pay taxes on those premiums, being taxed only on their investment income. Clearly this creates a tax arbitrage opportunity when the insured can take a \$1,200,000 deduction, and the insurer is exempt from tax on the \$1,200,000 in premiums received.

By combining the tax benefits already inherent in captive programmes with the tax benefits available from more traditional estate planning devices, such as intentionally defective grantor trusts (IDGT), a business owner can maximise the amount of pre-tax cash that can be transferred from the business to children or grandchildren without paying gift or generation skipping transfer taxes.

If the business owner funds an IDGT for the benefit of his or her child with a cash gift, the trust can use that cash to capitalise a captive. While the gift of funds to the trust is treated as a completed gift for estate tax purposes, so that the funds are no longer considered as owned by the business owner upon his or her death, the income the trust receives from the captive is taxable to the grantor, ie, the business owner.

As such, the business owner can take a deduction for premiums paid to the captive, and report the net profits from the captive as a qualified dividend, even though the cash flows from the business to the captive, to the trust and finally to the trust's beneficiary, the child.

Another common technique is to own the captive in a traditional family limited partnership structure. This allows the parents to gift interests in the partnership to their children every year, using the annual gift exclusion. Since each partnership interest entitles its owner to a share of the profits from the captive, in time a great deal of the captive and its profits will belong to the children. The family limited partnership structure also allows the parents to take certain valuation discounts on

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the value of the partnership and the underlying captive should a parent die sooner than expected.

When a captive is owned by one or more family members, the insurance premiums paid and the investment income earned will remain within the family unit. After paying claims and administration costs, net profits that are not reinvested can be distributed to the owners of the captive as qualified dividends.

Depending on the ownership structure, such dividends can be accumulated at the holding company level (in trust or by the company) or distributed straight through to the ultimate individual owners, partners or beneficiaries, usually the children.

Risk shifting: the balance sheet theory

Because of the obvious and substantial tax benefits available to owners of captives, the Internal Revenue Service (IRS) has challenged various programmes and certain aspects of programmes in particular. Of particular importance are two requirements which must always be present in order for the captive financial arrangement to be considered 'insurance': risk shifting and risk distribution.

The fundamental query then in captive insurance cases is whether payments to the captive insurer should be classified as 'insurance premiums' and whether risk shifting (also known as risk transfer) and risk distribution are present.

Risk shifting occurs when a policyholder is 'indifferent' to the occurrence of a fortuitous (bad) event, save for the risk of increased premiums going forward. In order to determine whether risk shifting is present, one looks at whether some feature of the captive insurance arrangement negates risk shifting.

Under the balance sheet theory articulated in *Humana* and refined in *Kidde Indus. v U.S.*, 40 Fed. Cl. 42 (1997), risk shifting is negated in a situation where (in absence of third-party risk assumed by the captive) a wholly-owned captive insures its parent company. That is, from the perspective of an outside stakeholder of the parent (a creditor or stockholder), the assets of the parent wouldn't be insulated from the effect of third-party claims asserted successfully against the parent and paid by its wholly-owned captive subsidiary.

To the extent that the captive subsidiary incurs gains or losses because of such claims, the parent's assets are presumed to reflect an identical gain or loss in value because the stock of the captive is an asset of the parent.

However, in a captive insurance arrangement that involves only brother-sister related-party risk, the balance sheet theory has led to the conclusion that risk is shifted from the policyholders to the captive, under the *Moline Props. v. Commissioner*, 319 U.S. 436 (1943), doctrine. The reason for this (according to the balance sheet theory) is that a brother-sister policyholder that has no ownership interest in its sibling's capital has no stake in the captive's underwriting results.

By contrast, a captive's underwriting of its parent's risk doesn't result in risk shifting because the parent's assets include its stock in the captive insurance subsidiary. For every dollar of insurance proceeds that the parent receives from the captive, the parent's gain in net worth will be offset by a decrease in the value of its stock in the captive.

Thus, the balance sheet theory tests risk shifting solely on the basis of whether the policyholder affiliated with the captive would ultimately incur a loss in economic value if a claimant were successful against the captive. By this test, risk shifting could occur for any related party policyholder that isn't in the vertical chain of ownership of the captive. The separate legal status of the policyholders is respected.

The legal construct has controlling effect for the federal tax purpose of defining risk shifting in a captive insurance context. The legal analysis takes priority for characterising the insurance transaction, and the federal tax treatment should follow from that legal analysis.

Because the balance sheet theory relies on the separate legal status of the subject insured entity, and the insulation of that entity's assets from the loss incurred by the captive, in order to determine risk shifting, the balance sheet theory proceeds without regard to how tax law may aggregate the income and tax attributes of legally separate persons for other income tax purposes.

For example, whether or not the parent and its captive subsidiary file a consolidated tax return, where the parent is a partnership that owns 100 percent of a captive insurance company that insures only the parent's risk, or where an individual is the owner of an insurance company that insures only such person's risks, no risk shifting might be deemed to have taken place. By contrast, where a father owns the insured and his adult child owns the captive, application of the balance sheet theory would urge that risk shifting

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has taken place and that the captive is unrelated to the insured because a creditor of the father generally wouldn't be able to assert successfully (absent fraud) a claim that assets of the father include the assets of the child.

In *Kidde Industries*, the Court of Federal Claims construed the balance sheet theory to mean that where a common parent owns a captive insurer and operating subsidiaries and the captive insures both operating divisions of the parent and the brother-sister subsidiaries, then the insured risks of the brother-sister operating subsidiaries are to be deemed related-party risk in the captive's risk pool, with the result that risks of the parent (including the parent's operating divisions) are neither shifted nor distributed by being in the captive's risk pool. The premise behind the court's reasoning is that the 'relatedness' of related-party risk arises from common ownership of the insurer and the insured.

By implication, where there is no common parent (whether corporate or individual) of the insurer and the insured, the insurer's risk pool necessarily consists of unrelated risk. By contrast, if one were to apply attribution rules usual in an income tax setting to the analysis of risk shifting, and risk distribution, then brother-sister subsidiary risk would be treated the same as parent risk vis-à-vis the captive.

Risk distribution: the law of large numbers

Risk distribution incorporates the statistical phenomenon known as the law of large numbers. In *AMERCO*, the Tax Court stated: "The concept of risk distributing emphasises the pooling aspect of insurance: that it is the nature of an insurance contract to be part of a larger collection of coverages, combined to distribute risks between insureds." The Second Circuit Court of Appeals explained that by "diffusing the risks through a mass of separate risk-shifting contracts, the insurer casts his lot with the law of averages. The process of risk distribution, therefore, is the very essence of insurance"—*Commissioner v Treganowan*, 183 F.2d 288 (2d Cir. 1950).

Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim.

"By assuming numerous relatively small, independent risks that occur over time, the insurer smoothes out losses to match more closely its receipt of premiums," the IRS has said in many rulings, citing *Clougherty Packing Co. v. Commissioner*, 84 T.C. 948 (1985).

Risk distribution necessarily entails a pooling of premiums, so that a potential insured party is not, in significant part, paying for its own risks. The question of how many policyholders are needed to create risk distribution is an issue that has been debated in the courts for some years.

In 2002, the IRS issued Rev. Rul. 2002-90, which stated its position on the subject: the answer was 12. According to the IRS, an insurance arrangement between a captive and 12 operating subsidiaries would be respected and would constitute insurance for federal income tax purposes. According to the IRS, risk distribution was found to exist because a loss by one insured was substantially borne by the premiums paid by the others.

Rev. Rul. 2002-90 doesn't literally preclude the conclusion that risk distribution can exist only where a captive insures 12 or more policyholders. In *Gulf Oil Corp. v. Commissioner*, 89 T.C. 1010 (1987), the Tax Court majority opinion stated: "'unrelated' risks need not be those of unrelated parties; a single insured can have sufficient unrelated risks to achieve adequate risk distribution".

But even if there is merit to the notion that a captive must pool risk of more than one insured, the minimum number of insureds, theoretically at least, should be not more than two, as long as both insureds pool risk to an extent that significantly spreads the risk of loss among them. At the very least, Rev. Rul. 2002-90 should be compared to *Humana* where the Sixth Circuit held that insuring the risks of seven brother-sister companies was sufficient risk distribution to constitute insurance.

Captives provide many business and tax planning opportunities. Combining a captive programme with a larger estate plan can maximise the benefits to both business owners and their children. However, given the extent of the benefits and the complexities of such structures, potential captive owners should always seek competent and conservative advice. A captive should always be formed and structured so as to withstand scrutiny from both the IRS and insurance regulators.

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