OVERVIEW OF
ALTERNATIVE RISK TRANSFER

A GUIDELINE FOR A
TAX-DEDUCTIBLE
TAX-FREE
RISK-REDUCTION
CAPITAL RESERVE SYSTEM

The 99% of What You Need to Know
The 1% More that Advisors Ought to Know
And How to Get Value for Your Money and Cut through Mess

MITCHELL LEVIN, MD, CWPP, CAPP

What we don't know, or what we don't know to ask, could be costing us a lot of money now, or cause a major problem in the future.

How many of us have made financial decisions with unexpected or disappointing results. Myths and misconceptions may be the cause. The biggest ones:

- I have a person to handle that, or
- I already have it covered.

Our CPAs are doing what we pay them to do. Our attorneys are doing what we pay them to do. Our stock-brokers and insurance agents are doing what we pay them to do. Yet few of these professionals communicate on a regular basis with the others. And they are under the same myths and misconception that the other professional knows about or is handling the issue that leads to losses.

If only we could have our losses back… And it is not just the losses, but what those losses could have returned over time that often grows to extraordinarily large amounts. That is our definition of Lost Opportunity Cost.

"Avoiding the losses is more powerful than picking the winners."

The process you have in place might be missing key ingredients. The solution is proper discovery. Are you eligible for this powerful strategy that has been used successfully since 1961?

This monograph will explore a solid approach to utilizing the tax code to your advantage, rather than be passively victimized by it.

In short, this is a way to reduce risk, insure otherwise un-insured risk, create deductions from your business(es). The capital grows tax-deferred, and more importantly, the capital may be accessed tax-free. Only the gains will be taxed, at long-term capital gain rates, and only how much and when you deem it wise.

Are you open to employ proven but unconventional planning strategies? The foregoing may sound exotic. That is only because many people harbor myths or misconceptions about this powerful, and common tool.

The ART (Alternative Risk Transfer) of Building a Private Capital Reserve

THE EXECUTIVE SUMMARY TO

Take Back Control ...

And Become Your Own Micro-Insurance Company

The Captive Insurance Companies (CIC)

The benefits of a micro-captive (<$1.2M) include:

- Direct access to reinsurance
- Control over insurance coverage
- Deduct up to $1.2M per year, per business entity
- Wealth Accumulation on Surplus
- Manage excessive compensation as defined by IRS guidelines
- Creditor protection
- Wealth transfer (gift & estate)
- Creation of a family estate planning bank
- Creation of a profit center
- Business succession planning

A. Business is risky. If a business were to buy insurance to cover every contingency, chances are that the insurance company would profit, but the business wouldn't. This reality creates a planning opportunity in situations where the business (or its stakeholders) owns its own insurance company, if only because insurance companies are subject to favorable state and federal income tax treatment.

B. Separately from the tax planning opportunities, forming a captive insurance company adds financing mechanisms and managerial focus to a business' risk retention strategy. Economically, captive insurance is self-insurance housed in an incorporated pocketbook. The organizational formality of incorporating the self-insurance pocketbook (and treating it as an insurance company) tends to influence a business' decisions about which risks to retain vs. which risks to buy insurance for from a commercial insurance company. In this light, a captive insurance company is generally a risk management tool that happens to come with potential tax advantages.

C. Captive insurance planners have a tendency to emphasize the non-tax reasons for forming a captive insurance company, as it is taboo to discuss the tax advantages. The anxiety is misplaced, although certainly a non-tax business purpose and economic substance are essential for qualifying a self-insurance pocketbook as a captive insurance company for tax purposes. For insight into the "taboo," see article by Randall Beckie and Phillip England, "When the Tail Wags the Dog," Captive Review (2009).

A CIC is a Small Business Insurance Company (IRS Sec 831(b)) established to insure the risks of its parent company or a group of companies. In the simplest form, a CIC is an organized plan of self-insurance that operates just like the typical Insurance Company which calculates risk, issues policies, collects premiums, pays expenses, and establishes reserves to pay future claims.

Every business has to self-insure multiple risks that are excluded in the basic traditional commercial insurance contract. If a captive insures these particular types of risk, the planner and the captive owner should be prepared to concede upon IRS examination that such risk is not an insurable risk in the commercial markets. Some examples of these risks are: loss of license for professionals (doctors, lawyers, CPAs, financial planners, etc.), loss of key supplier or key customer, legal defense, or audit defense liabilities – though not for medical malpractice or other types of Errors and Omissions, which are commercially available. A captive can qualify as an insurance company if more than 50% of its premiums qualify as "insurance premiums", as distinguished from self-insurance deposits.

If a business incurs a loss because of one of the aforementioned risks, the business can sustain, sometimes, substantial financial loss as a consequence. Captives are useful mainly for financing risks that the business has otherwise already decided to retain.

Captives are formed for several reasons which include but are not limited to: 1) reduce total insurance costs; 2) to protect against uninsured risks not covered by traditional insurance; 3) to control risk by setting coverage desired by the business owner; 4) greater control over claims; 5) income tax planning; 6) wealth building; 7) estate planning; 8) asset protection.

There have been captive insurance companies in the U.S. at least since 1961, and it took until 2001 for the IRS to acquiesce to the favorable tax treatment of them, with almost 5000 companies in the U.S. alone, including more than 44 of the Fortune 100 Companies and 75% of the Fortune 500, utilizing these structures to decrease the costs of their insurance premiums, underwrite coverage's that are much more comprehensive to protect their particular interests; protect certain assets from lawsuits, while also using this “mechanism” to build wealth on a tax-favored basis. On a smaller scale, many physician practices are beginning to use a Captive to decrease the cost of their Malpractice Insurance, coverage for any administrative charges caused by unwarranted regulatory audits, as well as protecting their assets.

Industry experts estimate that companies with favorable claims history, instead of less favorable loss histories, can recognize significant savings on its cost of business insurance using a Captive Insurance Company. Captives that are set up correctly can receive up to $1.2M in payments from your business tax free, fully deductible to your business under IRS Section 162 of the code as a necessary business expense.

Through our strategic alliances, we will provide “turn-key” services that begin with the initial feasibility study, continue through formation, and include full captive management services. Your team includes captive managers, CPAs, attorneys, underwriters and other professional staff. Because of our collaborative approach, we are able to deliver efficient and affordable captive management services, and avoid the confusion resulting from multiple firms, each providing only a portion of the management service.

In the past, many professionals either were unaware of CICs or avoided them because of their expense. In recent years, competition has lowered the threshold for using these powerful tools, creating great value and great opportunity. Of course, you must “respect the entity” by doing it properly and complying with the guidelines.

In short, a CIC is an excellent way to self-insure, and to establish a large capital pool for risks. Though each contract usually runs in 12-month stretches for premium payments, these CICs are best used when multi-year (we recommend 5-7 years) commitments are anticipated. If there is a bad year and premium payments stress the business, the premium may be “made up” in arrears. The premium is deductible. And in the event that no loss occurs (that is, no judgment or settlement is paid on the risk), the capital may be accessed, when properly structured, in a lump sum, or slowly over time at the owner’s discretion, by the CIC owner tax-free (only the <u>growth of the capital</u> may be taxed).

This monograph is an overview only, organized from the general to the specific with supporting data at the end in the appendix. This is not meant to serve as a "text book", nor does this attempt to be an up-to-date treatise on tax code or insurance regulation. It is intended for the Business Owner and your professional advisers.

The essence of captive insurance company planning, implementation and maintenance is to marry a risk management strategy with a tax strategy while getting all the paperwork right for insurance regulatory, legal and accounting purposes. Accordingly, captives come with a team of service providers. However, at least one of the service providers needs to have a multi-disciplinary orientation in order to lead the process, and generally it is the captive manager who does this.

Because of the captive manager's leadership role, inevitably the captive manager will be involved in the captive's tax strategy. Captive managers differ for many reasons, but one of the most important differences among them is their tax sophistication. A misstep in tax planning or maintenance of tax defensibility is usually fatal to a captive. At bottom, captive management is tax management (among other things).

There are 6,000± captive insurance companies in the world, with most being sponsored by United States entities. Although sponsored by U.S. based companies, most captive are domiciled (incorporated) outside of the U.S.

Many conventional insurance companies began their corporate existence as captive insurers and grew into large-scale insurance companies. USAA, Highlands, and American General are cases in point.

Small insurance companies benefit from tax advantages to help facilitate their growth, which in part compensates for the complexity and cost of their structure and operations.

Captive insurance planning is an alternative risk management and risk financing technique that can be used to accomplish several purposes including insuring the hidden risks of its insureds. Usually a captive insurance company writes insurance coverages on closely affiliated businesses that either include the captive's parent or the affiliated businesses that share a common parent with the captive.

CICs come in a variety of shapes and sizes, some of which are:

SINGLE-OWNER CAPTIVES. A person establishes a "single owner captive" to insure its own risks and the risks of its subsidiaries and affiliates. Many single-owner captives also provide coverage for other, non-affiliated organizations. Single-owner captives that insure only affiliated risks are termed "pure" captives.

GROUP CAPTIVES. These captives are owned by multiple, non-related organizations (policyholders). The captive is usually sponsored by a trade group such as homebuilders, franchisees, group medical practices or hospitals, or other professional or industrial groups.

AGENCY CAPTIVES. These captives are owned by insurance brokers or agents and insure some portion of the insurance sold by its agency or broker shareholders.

RENT-A-CAPTIVES. These captives are pre-established entities that insure the risks of unrelated parties for a fee.

The Captive Formation – It Can Be a Complete 100% Turn-key Package

Feasibility Study

A feasibility study analyzes aspects of establishing an insurance company, which may include the following:

1. Identification and classification of insurance risk, and the analysis of different risk transfer solutions, including a captive
2. Overview of a plan to form and manage a captive
3. Summary of insurance coverage's, premium levels, risk retention amounts, capital and solvency allocation , and financial projections for a captive
4. Fronting arrangements (typically using licensed/admitted carriers) and reinsurance opportunities
5. Discussion of regulatory, accounting, and tax issues

Business Plan

Prepare a business plan that will detail the operation of a captive

Prepare a 5-year pro forma financial statement, including balance sheet and income statement

Licensing

Provide a focal point for all service providers

Prepare application documents to submit to the insurance regulators

Regular communication with regulators to discuss and obtain approval insurance license applications

- Supervise the incorporation of the captive
- File the insurance application, provide any requested additional information, and pay the licensing fees

Captive Management Requirements

Accounting

Prepare customized management reports.

Where required:

- Prepare NAIC filings, or through coordination of services with retained professionals
- Coordinate annual insurance company audits with outside auditors
- Prepare and submit annual reports to the insurance regulators

Tax

- Prepare annual tax return
- Calculate and process quarterly estimated payments
- Prepare tax extension and related documents

Underwriting and Policy Issuance

- Determine premium levels and coverage options
- Underwrite insurance risks for each insured
- Coordinate with actuary the ratings methodology
- Prepare documentation including applications, declaration pages, confirmation of coverage forms, policy forms, insurance binders, premium payment notices, and related documents
- Review existing insurance documentation
- Annual underwriting review
- Coordinate with actuary and other professionals and service providers as required

Regulatory Compliance

- Review and monitor brokerage, banking and financial statements
- Quarterly financial review
- Annual review of compliance with local insurance and corporate legal requirements
- Periodic review of solvency, capital adequacy and asset allocation

requirements
Prepare annual compliance reports

Claims

Claims management
Coverage review
Coordinate with legal counsel where necessary
Coordinate with TPA, where applicable
Annual report of claim settlements
Assistance with claims reserves and coordination with actuary

Corporate

Corporate governance, including items such as:

Communicate with registered office
Communicate with registered agent
Preparation of corporate minutes and resolutions
Coordinate general corporate law matters and compliance where required

Domestic Jurisdictions

While some prefer off-shore jurisdictions, many domestic sites offer significant confidence and benefits. The reporting requirements to the IRS are the same for off shore or domestic sites.

Vermont, South Carolina, Delaware, Kentucky, and Utah to name a few, have considerably well-developed CIC statutes.

General

Communicate with key outside service providers (under direction of client), including, Auditor, Accountant, Registered Office, Registered Agent, Legal counsel, Investment Advisor
Monthly Client Memoranda
Regular discussion and updates with clients.

In the past, only large companies formed captives that had uninsurable liability exposures. Their success led to smaller companies seeing the benefits and forming captives for similar risks. Here are some industry facts:

• Today there are close to 6,000 captive insurance companies worldwide and growing. [1]

• Captive insurance companies account for over 10% of all premium collected worldwide as of the end of 2008. [1]

• There was almost $10 Billion in captive premiums collected in the U.S. alone in 2008. [1]

• In most cases, captives provide unavailable commercial coverage's and issues policies for unregulated lines of business. [1]

The number of business failures in the U.S. is growing at an alarming rate. While many experts have examined specific reasons why companies fail, few have examined the general trends and macroeconomic conditions that affect business failures.

The fact is that all business owners face the reality of failure. As we all have seen over the past 5 years, no one company is immune to this fact. The important role of small business suggests that an understanding of why firms fail and succeed is crucial to the stability and health of our economy.

Most researchers would agree that uninsured risks are a major contributor to business failures. So, if you have market and management experience, and capital but could still fail because of risks you didn't calculate. This is why a captive business strategy may be an invaluable option.

[1] Data from the Insurance Information Institute (III.0rg)

The IRS has tried to distinguish between business risk versus insurable risk.

Section 831(b) of the IRC allows a U.S. corporation, Limited Liability Company, Partnership or Sole Proprietor to pay up to $1,200,000 in premium annually to their own "properly structured" Captive Reinsurance Company (CRC). This premium is deductible under IRC Section 162 as an ordinary and necessary business expense. Additional Captive premiums may be paid to multiple Captives if done properly. A Captive must be qualified by a regulatory authority to operate as a licensed reinsurance company for specific and limited purposes.

A Captive is an organized self-insurance entity that calculates risk, issues policies, collects premiums, pays expenses and establishes reserves to pay future claims. Captive owners control their company, how claims are handled and how reserves or underwriting profits are invested. Reserves in a Captive and the income from those assets directly benefit the Captive owners or their estate depending upon how the structure is established. If the business owner has a good claims history, the tax-deductible premiums accumulate tax-deferred, and can later be taken as dividends or as liquidated capital as capital gains.

One can own all or part of a Captive. Generally, it depends on your annual premium and available funds for capitalization and the number of years Captive premiums will be paid. If you will be averaging premiums of less than $800,000 annually, it is most likely better to own part of a Captive. For example, if you intended to deduct premiums of $250,000, you might own 25% of a Captive with three other firms and thereby only need $62,500 of capitalization as opposed to a considerably higher rate if owned alone. Actuarial studies and underwriting data will assist you in providing the proper information needed to make a prudent decision.

There are a number of complicated rules that must be scrupulously adhered to in establishing and owning all or part of a CIC and maintaining them on an annual basis:

1. Policy construction and risks underwritten;

2. Proper capitalization;

3. Premiums must be actuarially based, and priced at arm's length as in unrelated third party transactions;

4. Annual audits are required;

5. A registered agent may be selected,

6. Risk pools must be established,

7. We enable the business owner to outsource the paperwork and planning of CIC formation and maintenance.

It is critical to choose your Captive formation partners wisely, because you will be in the insurance business and you need the RIGHT PARTNER. In reference to the above-mentioned rules, many Captive companies do NOT meet ALL the necessary minimum standards acceptable to the IRS in case of an audit and many have concealed fees, etc.

THE MECHANISM

Basic Captive Diagram

This is the most basic captive arrangement, where a business pays insurance premiums directly to a captive. There are many variations, however. As the saying goes, "if you've seen one captive, you've seen one captive."

Captive with Fronting Insurer

In this captive arrangement, there is a licensed and rated "fronting insurance company" (a large insurance company) that writes the insurance to the business, and then reinsures some or all of the risks (along with the premiums) to the captive. This arrangement is used frequently in workers' compensation.

Captive Using Self-Insured Retention

If you have a large deductible in your general liability, workers' compensation or other insurance policy, this captive structure can allow the business to pay tax-deductible premiums to the captive for that layer of "self insurance" while paying some premiums to the Large Insurance Company for catastrophic risks. Benefits: current tax deduction; asset protection; and enterprise risk management. Also, if the assets in the captive are used as collateral for the Rated Insurance Company, the rates for the "excess" insurance may decline, provide additional costs savings.

Group Captive

In a group captive, several businesses in the same industry, association or franchise each pay insurance premiums to the group captive, which pools the premiums and losses. Generally, each group member is an owner in the captive. This allows insurance to be tailored precisely to the needs of the group, and can provide substantial insurance savings.

Hidden Risk

<u>A captive can lower the cost of insurance</u>, but captives can also insure "hidden

risk." Most business owners unknowingly self insure a large amount of risk. Many of these are hidden or "below the surface" risks inherent in the operation of a business.

With a captive, self-insured risks can be converted into tax-deductible premiums that are paid to a captive. Any materialized risks can now be paid with pre-tax assets.

If insurance claims are as projected, the captive will retain substantial profits that can be distributed to its owners.

INSURED RISK

Auto
General Liability
Medical Malpractice
Property
Workers' Compensation

SELF-INSURED RISK

A/R Concentration
Business Interruption
Construction Defect
Credit Default
D & O / E & O
Deductibles
Disability
Earthquake/Hurricane
Employment Practices
Exclusions
Litigation Defense
Mold and Pollution
Operating Risks
Product Warranty

CAPTIVES CAN "LOWER" THE COST OF INSURANCE
By incurring a new cost of insurance

A captive raises the cost of insurance, yet that is a good thing, because the insurance company belongs to the same stakeholders who own the policy. A captive may reduce the cost of workers' compensation, general liability, medical malpractice, auto liability, property, or other conventional insurance. There are several methods available. One method, shown below, is to use the captive to retain the low severity risks, and purchase insurance from a large carrier only for catastrophic risks.

Under this arrangement, the insured business takes a large deductible. The captive then issues a policy directly to the business for the deductible (or "retention") layer. The business then funds this retention layer with insurance premiums, and realizes both the insurance cost and tax benefit associated with financing risk through the captive.

Result: More dollars retained within the business group, less premium paid to unrelated insurance carriers, and a business deduction for additional insurance expense. This approach has been used by large corporations for years to substantially reduce their insurance expense and retain underwriting profit. With the growth of the captive market, this strategy is now available to middle market companies.

Taxation

Insurance companies (of all sizes) operate under different tax rules than other companies.

The U.S. Tax Code ("Code") recognizes that insurance companies receive premium dollars up front, but may not pay out claims (associated with those premiums) for many years. Therefore, the Code allows insurance companies more generous current deductions.

Taxation should not be the primary reason for the establishment of a captive or alternative risk transfer vehicle. General business objectives must form the basis for establishing a captive.

Insurance taxation is an extremely complex area and professional advice should be sought to protect the interests of shareholders, insureds and the insurance company.

831a

In general, Code Section 831a provides for the taxation of insurance companies to follow normal "C" corporation rules, with certain significant exceptions. These normal rules start with insurance premium earned plus investment income, less the losses incurred and other expenses.

831b

Under Code Section 831b there is an election for small insurance companies to change the way they calculate their taxable income. This election simplifies the calculation of taxable income and is only available for companies that receive annual premium of $1.2 million or less.

The Captive

This discussion is solely for U.S. captives, and foreign captives that have elected (under Section 953(d) of the Code) to be taxed as U.S. captives. True "foreign" captives operate under different rules entirely.

Captives are taxed on an accrual basis, not a cash basis. The captive files a Form 1120-PC tax return.

Captives are considered "C" corporations. Even though some jurisdictions may allow a captive to be formed as a partnership or LLC, the captive will still be taxed as a "C" corporation for federal tax purposes.

The Insured

The "insured" is the business or organization paying insurance premiums to the captive. Multiple insureds can pay premiums to the same captive. These insureds can be related or unrelated companies.

In order for the insured to deduct the insurance premium as a necessary business expense the captive insurer must conform to the law. Because the Code does not define "insurance," much guidance can be found in precedent-setting court cases and IRS rulings.

In very simplistic terms, the IRS expects that the insurance company is established in a recognized jurisdiction, has professionals managing the company and is not established primarily for tax purposes and is adequately capitalized.

The court cases and IRS rulings hold that to be considered an insurance company, three tests must be met:

- Involve "insurance" risk
- Meet the standards for risk shifting and risk distribution
- Follow the commonly accepted notions of insurance (and insurance companies)

The Shareholder / Dividends

A captive can be owned by almost any person or entity, including estate planning vehicles. A captive shareholder is treated much like the shareholder of a "C" corporation. A captive is organized to have shareholders, and multiple classes of stock can be provided, including preferred and common stock.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 contained provisions that may affect owners of offshore captive insurance companies including provisions that reduced the rate on qualified dividend income from 38.6% to 15%.

Insurance Risk

Neither the Code nor the regulations define the terms “insurance” or “insurance contract.” But the courts have held that the transferred risk must be a risk of economic loss, must contemplate the fortuitous occurrence of a stated contingency, and must not be merely an investment risk.

Thus, for example, “insurance” (for federal tax purposes) would not include the risk of a price decline of a stock. States may have different interpretations for what constitutes insurance.

The IRS view is that insurance is not the mechanism to manage losses that are substantially certain to occur, i.e., that are not the result of fortuitous events. However, some courts and many practitioners disagree with this approach, especially where the timing and amount of loss are uncertain, even though there is certainty about the loss eventually occurring. This is an evolving area of insurance tax law.

Risk Distribution And Shifting

The requirement for both risk shifting and risk distribution to be present in an insurance transaction was first held by the courts in Helvering v Le Gierse, 312 U.S. 531 (1941). In this case, an 80 year old lady took out both a life insurance policy and an annuity one month before her death. The life insurance was a single premium policy and would not have been provided had the annuity not been taken out. The benefit upon death was less than the premiums paid in respect of the life insurance policy and the annuity combined. As such, the courts upheld that there was no transfer of risk from the insured to the insurer and that the contract did not meet the expectation of an insurance policy.

The accepted definition of risk shifting and risk distribution is as follows:

Risk shifting occurs if a person facing the possibility of an economic loss resulting from the occurrence of an insurance risk transfers some or all of the financial consequences of the potential loss to an insurer. The effect of such a transfer is that a loss by the insured will not affect the insured because the loss is offset by the insurance payment. Example: with homeowners’ insurance, you transfer the risk of your house burning down to a large insurance carrier.

Risk distribution incorporates the law of large numbers to allow the insurer to reduce the possibility that a single costly claim will exceed the amount available to the insurer for the payment of such a claim. Risk distribution necessarily entails the pooling of premiums so that a potential insured is not in significant part paying for its own risk. Example: with homeowners’ insurance, the premiums are modest (e.g., $3,000), but the claims can be large (potentially over $1 million). Many homeowners pool their premiums together, even though few have large claims in a particular year.

Risk Distribution And Shifting For Related Entities

Prior to 2001, the IRS looked upon the risk shifting involving entities in the same economic family unfavorably. Their contention was that insurance within the economic family was just an internal financial transaction and effectively did not involve the shifting of risk.

However, in Humana, Inc. v Commissioner, 881 F 2d 247 (6th Cir. 1989) the court ruled that the transferring of risk occurred between brother/sister companies as they were economically independent of each other. Thus, one subsidiary could pay deductible insurance premiums to another subsidiary, of the same parent.

The court stated that risk shifting did not take place in respect of transactions with the parent company and therefore premiums paid by the parent to its subsidiary captive were not deductible. Despite this ruling for a number of years the IRS continued to pursue their economic family theory, even against brother/sister captive arrangements. This changed in 2001.

Economic Family Ruling

Since 2001, there has been a move by the IRS to recognize brother/sister transactions as being deductible. In Revenue Ruling 2001-31 the IRS announced its decision to abandon its long standing position that premiums paid to captive insurance companies are not deductible under the “economic family” theory.

By abandoning its long held argument, the IRS implicitly accepted the “balance sheet” approach to captive taxation. Under this approach, risk shifting will exist if the risk of loss is transferred off the insured’s balance sheet to the captive.

However, Revenue Ruling 2001-31 did not address the issue of risk distribution. (This was addressed by the IRS in 2002, with the “Safe Harbor Trilogy”). The courts have failed to express a coherent and consistent approach to risk distribution. While some courts indicated that risk distribution required the spreading of risk among multiple independent insureds (the independent entity approach), others suggested that risk distribution depends on the number of independent risk exposures (the independent risk approach) assumed by the captive. The IRS provided guidance in 2002 on these issues.

Safe Harbor Trilogy

In 2002, the IRS issued three revenue rulings on captive transactions. These three rulings (discussed in subsequent sections) provide IRS “safe harbors” for captive transactions. For businesses desiring a captive arrangement that is fully tax compliant with IRS guidelines and recommendations, these safe harbor rulings provide a roadmap.

Revenue Ruling 2002-89
Revenue Ruling 2002-90
Revenue Ruling 2002-91

While individual circuit courts have approved captive arrangements that are more aggressive than the revenue rulings above, by structuring the captive according to a “safe harbor,” clients can know in advance that the captive is approved by the IRS.

Third Party Risk to Provide Risk Distributions and Risk Shifting

In Revenue Ruling 2002-89 the IRS discussed two scenarios where a parent made premium payments to its two wholly owned captive subsidiaries.

Scenario 1
The premiums paid by the parent to its wholly owned captive accounted for 90% of the captive’s income for the year (i.e., only 10% of the premiums were from unrelated parties).

Scenario 2
The premiums paid by the parent accounted for less than 50% of the captive’s income for the year (i.e., more than 50% of the premiums were from unrelated parties).

In its determination whether either or both of these scenarios represented valid insurance transactions the IRS further noted that:

- Both captives were adequately capitalized
- Both captives were properly regulated
- The companies transacted business in a manner consistent with the standards applicable to an insurance arrangement between unrelated parties

In their determination as to whether either or both of the scenarios represented valid insurance transactions, the IRS concentrated on factors of risk shifting and risk distribution. The IRS concluded that scenario 1 did not provide sufficient risk shifting or risk distributions; however, scenario 2 did. Where more than 50% of the captive’s risk is with unrelated third parties, the IRS concluded that sufficient risk shifting and risk distribution had occurred.

This “more than 50%” rule is now considered an IRS safe harbor.

Previous case law relating to unrelated risk placed into a captive held that as little as 29% third party business constitutes a valid and bona fide arrangement (Harper Group, 9th Circuit). However, in recent years the IRS has sought to distinguish case law that was below the 50% standard.

IRS Ruling on Brother / Sister Transactions

In Revenue Ruling 2002-90, the IRS concluded that an arrangement whereby a single parent captive insurance company provided professional liability coverage to 12 brother/sister subsidiaries constituted insurance for federal income tax purposes.

Some key facts in the ruling:

- None of the operating subsidiaries had liability coverage less than 5%, nor more than 15%, of the total risk insured by the captive.
- The captive was adequately capitalized and regulated in the states in which the operating subsidiaries conducted their business.
- There were no parental guarantees of any kind were made in favor of the captive.
- The captive did not loan funds to its parent or to the 12 operating subsidiaries.
- The parties conducted themselves in a manner consistent with the standards applicable to an insurance arrangement between unrelated parties.

This ruling gives a test for whether brother/sister transactions involving a captive insurance company provided sufficient risk distribution and risk shifting so as to enable arrangement to be considered insurance.

Revenue Ruling 2002-90 is significant in that it validates brother/sister arrangements as insurance and it also suggests that both the independent risk and independent entity approach are important in the risk distribution equation. Although the ruling refers to facts that form the basis of the independent risk approach, it also stated that risk distribution necessarily entails the pooling of premiums, so that a potential insured is not in significant part paying for its own risk.

Note 1: Revenue Ruling 2005-40 indicates that the related entities must be separately taxable entities (i.e., corporations or taxable LLCs), and not simply LLCs that are "disregarded" for federal tax purposes. Thus, single-member LLCs would not qualify as a separate entity for purposes of

Revenue Ruling 2002-90.

Note 2: Some court cases have held that as few as seven (7) related companies are all that is necessary to have risk distribution, whereas this safe harbor ruling indicates a minimum of 12 related companies.

Group Captives

In Revenue Ruling 2002–91, the IRS addressed group captives and concluded that such a captive that was formed by a "significant number" of unrelated insureds, with each having no more than 15% of the total risk, was held to be a valid insurance arrangement. The ruling also went on to set out other factors that the IRS expects to see in a bona fide transaction:

- Whether the insured parties truly face hazards
- Whether premiums charged are based on commercial rates
- Whether risks are shifted and distributed to the captive
- Whether the policies contain provisions such that the covered risks may exceed the amount of premiums charged and paid
- Whether the validity of claims were established prior to payment
- Whether the assets and operations of the captive are kept separate from the business operation and assets of its shareholders

This ruling paves the way for franchisees, industry groups, and other associations to form a captive with the benefit of an IRS safe harbor ruling.

Cell Captives

The IRS issued Revenue Ruling 2008-8 (January 2008) to give some clarity to structures known as "cell captives," "rent-a-captives" and "protected cell captives." A cell captive is basically a captive with several "cells" within it. The income, expense, assets, liabilities and capital of each cell are accounted for separately from any other cell and of the captive generally. Usually the laws of the jurisdiction provide legal separation between cells. Each cell is generally owned by unrelated owners, such that within the captive there is a wide distribution of risks.

Under the ruling, if company X owns Cell X and pays premiums to Cell X, this arrangement would not be considered insurance because there is no risk distribution within Cell X – all of the risks are from a related party, company X.

However, where company Y owns the stock of 12 domestic subsidiaries, and company Y owns Cell Y, then premiums paid from Y to Cell Y do constitute insurance premiums (if meeting the other insurance tests), because there is risk distribution within the 12 domestic subsidiaries.

This ruling closely tracks Revenue Ruling 2002-90, in terms of its facts and holdings.

Notice 2008-19, which accompanied this ruling, indicates that it may be possible for a cell within a captive to be treated as an insurance company separate from any other entity. More discussion and guidance is expected on this in the future.

Private Letter Rulings

The IRS issued Revenue Procedure 2002–75 as a method to obtain a private letter ruling regarding a captive transaction.

While this appears to be a beneficial option on its face, as a practical matter, a private letter can take well over a year to receive, and the IRS is not issuing private letter rulings that depart from the safe harbor rulings from 2002 (Rev. Rul. 2002-89, 2002-90, 2002-91). As such, few practitioners apply for private letter rulings on a regular basis.

Section 4371 Excise Tax

Under Code Section 4371, an excise tax applies to premiums paid to foreign insurers and reinsurers covering U.S. risks. The excise tax was designed to protect domestic insurance companies from perceived unfair competition from foreign insurance companies that are not subject to U.S. income tax. Under this rule, an excise tax is imposed at the rate of 1% on reinsurance and life insurance premiums and at a rate of 4% on property and casualty insurance premiums.

However, if a corporation makes an election under Section 953(d) of the Internal Revenue Code of 1986, the companies are not subject to the Code Section 4371 excise tax. This allows foreign captives to make the Section 953(d) election, and be taxed for all purposes as U.S. insurance companies.

This election is very common with foreign insurers, including foreign captives. For example, even though a captive is established in Bermuda, with a 953(d) election, the captive would be taxed as if it were a U.S. insurance company, and would file a U.S. tax return for insurance companies.

US Owned Foreign Insurance Companies

If the insurance company does not elect to be a US tax payer there are still tax implications. The company would be considered a controlled foreign corporation ("CFC") and under the IRS subpart F rules, U.S. shareholders with a 10-percent or greater interest in a CFC are subject to U.S. federal income tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to subpart F includes, among other things, insurance income including that relating to risks located in a country other than the CFC's country of organization.

Types of Risk Coverage to Consider

Please note that the descriptions below are but a few examples with basic summaries of the insurance protection available and do not supersede the actual insurance policy and endorsement language for such insurance protection. Please refer to the insurance policy and endorsements for all terms and conditions for any actual insurance protection selected.

1. Commercial Pollution: Provides coverage for clean-up costs resulting from pollution escaping into the environment or buildings.

2. Commercial Property Plus: Provides coverage for any direct or indirect loss of property owned or under control of insured where loss is excluded from all other policies of insurance which policyholder has. In addition, insurance company will cover the deductible of ANY loss under another policy, provided that deductible exceeds 10,000 dollars (loss is not restricted to commercial property.

3. Computer Hardware: Provides coverage for any losses sustained by the named individual insured's company resulting from a computer malfunction or misuse of information on computers by an employee of insured. Coverage is provided for all expenses related to the elimination of computer viruses, data recovery, and loss of income related to the event.

4. Crime/Employee Dishonesty: Provides criminal defense legal expense reimbursement to the named individual insured's company for criminal matters and allegations against the insured's company.

5. Cyber Risk: Provides coverage for costs of data recovery and eliminating computer viruses. Also, coverage is provided for all expenses related to extortion by an individual with plans to damage software or data, expenses related to copyright and trademark infringement as a result of improper content on Insured's website, and loss of income for related event.

6. Disability Income: Provides total disability insurance protection for the named individual insured.

7. Employment Practices: Provides coverage for any loss resulting from a wrongful act. A wrongful act includes any actual or alleged: Termination of an employment relationship in a way that is against the law and wrongful. Wrongful demotion, failure to hire, retaliation, misrepresentation, and interference of contract, which arise from a decision to employ, terminate, evaluate, discipline, promote or demote. Defamation, infliction of emotional distress or mental anguish, humiliation, false imprisonment, invasion of privacy and other personal injury allegations which arise from the terminating, disciplining, promoting or demoting of an employee. Breach of an implied employment contract and breach of the covenant of good faith and fair dealing in the employment contract. Discrimination. harassment. retaliation or any actual or alleged response of the insured to a threat made by an employee to disclose an illegal act by insured.

8. Errors and Omissions: Provides coverage for errors or omissions in the insured's performance of services. Services are defined as activities undertaken by the insured for a client in relation to the following: legal and tax services as they relate to proper formation and operation of an insurance company accounting or tax preparation services in regard to insurance activities any other activity permitted by law and authorized by the board of directors of an insurance entity.

9. Excess Professional Liability Legal/Claim Expense: Provides legal/claim expenses reimbursement to the named individual insured for professional/malpractice liability claims filed against the individual insured in excess of the primary insurance policy.

10. Excess Professional Liability Loss Reimbursement: Provides loss reimbursement to the named individual insured for professional/malpractice liability claims filed against the individual insured in excess of the primary insurance policy.

11. Franchise Legal Defense Costs: Provides coverage for legal costs associated with loss or adverse amendment to a Franchise agreement. For witnesses attending court, company will provide compensation in the amount of 500 dollars per person per day.

12. Injunctive Relief Defense Legal Expense Reimbursement: Provides injunctive relief defense legal expense reimbursement to the named individual insured's company for injunctive relief actions against the insured's company.

13. International Kidnap/Ransom Investigation: Provides kidnap/ransom investigation expense protection to the named individual insured’s company in the event the named individual insured is kidnapped while traveling abroad. This risk can be difficult to quantify and dollarize.

14. Inventory Obsolescence: Provides coverage for the costs of products that cannot be returned to the supplier and have not been sold in the last 24 months by the insured.

15. Loss of Key Customer: Provides reimbursement of expenses due to the loss of a key customer to the named individual insured’s company.

16. Loss of Key Supplier: Provides reimbursement of expenses due to the loss of a key supplier to the named individual insured’s company.

17. Loss of Hospital Privileges: Provides reimbursement of expenses due to the involuntary discontinuation of medical staff membership or involuntary reduction in approved medical procedures at a hospital.

18. Loss of Patient Referrals: Provides reimbursement of expenses due to the loss of a key supplier of patient referrals to the named individual insured's company.

19. Market/COGS Fluctuation Loss Expense Reimbursement: Provides reimbursement of expenses due to the financial losses to the named individual insured’s company due to market/cost of goods sold cost fluctuations that exceed a specified percentage amount.

20. Regulatory Changes: Provides coverage for any business interruption loss for 12 months as a result of a regulatory change that has an adverse effect on business. Regulatory changes include: any legislative changes effecting permits issuing of permits to competitors any changes to environmental, zoning, transportation or safety regulations any changes to import/export laws or tariffs any regulatory changes due to foreign political risk including the collapse of a foreign economy or government, freezing of foreign assets or war.

21. Regulatory Investigation Defense Legal Expense Reimbursement: Provides regulatory investigation defense legal expense reimbursement to the named individual insured’s company for regulatory investigations by governmental units against the insured’s company.

22. Tax Audit Defense Legal Expense Reimbursement: Provides tax audit defense legal expense reimbursement to the named individual insured’s company.

23. Tax Liability: Provides coverage for any unexpected tax liability equal to and above 115% of filed tax liability due to a final legal decision. Also, coverage is provided for defense expenses to determine tax liability in court.

24. Tenant Discrimination, Harassment and Wrongful Eviction: Provides coverage for any claims resulting from actual or alleged discrimination, harassment, or wrongful eviction. A tenant, legal occupant, or non-employee of the individual insured must make claims.

25. Terrorism: Provides coverage for lost, destroyed, impaired, or damaged property resulting from a direct or indirect act of terrorism. Also, coverage is provided for loss of income resulting from direct or indirect act of terrorism. An act of terrorism is defined as an act of any person acting on behalf of or in connection with any organization with activities directed towards the overthrowing or influencing of any government by force or violence. This coverage excludes any property in transit, vehicles licensed for road use or watercraft.

26. Trade Credit: Provides coverage for corporate receivables in the event that debtors to the named individual insured's company file bankruptcy or otherwise become insolvent.

27. Transportation Damages: Provides coverage for loss of income and additional expenses resulting from damage to packages in the care of the insured. Additional expenses include repair or replacement of the packages. Coverage only applies to those customers who constitute 10% or more of the annual revenue. This policy is designed for distribution/transportation companies.

28. Warranty: Provides coverage for all expenses incurred relating to the repair or replacement of products that are manufactured or rebuilt by the Insured. Insurance company is covering risk of dysfunctional products being distributed by insured.

29. Warranty Shortfall: Provides reimbursement of expenses related to work on a product sold by the Insured and not reimbursed by the manufacturer of the product as part of the manufacturer's warranty.

30. Work Stoppage: Provides coverage for all expenses incurred by insured relating to a work stoppage by any producer of the insured's inventory. Coverage includes loss of income and additional taxes that might be due as the result of the loss of a tax benefit in the form of tax savings derived from the LIFO method of accounting. This policy is similar to the loss of key supplier policy, except here, the loss of the supplier is not due to a business decision but rather some type of strike.

Premiums

Underwriters calculate actual Premiums with data provided by the insured on a risk assessment questionnaire and with historical information on claims history.

The policies are classified according to Risks as follows:

1. Class 1 – If the frequency of claim is high and the severity is low

2. Class 2 - If the frequency of Claim is low and the severity is high.

3. Class 2 DI - A policy, which provides disability payments to the corporation in the event of disablement to a key employee.

Most of coverages listed above fall into the Class 2 risk category. The insurer sets up adequate claim reserves to handle normal claims for each class. Also, additional surplus is set aside to cover catastrophic claims.

THE EXIT STRATEGY

Choosing to close a captive is a business decision that may happen to any captive due to many extenuating circumstances. The course of action that this entails is a simple process to follow. The time it takes will vary depending on the captives' domicile but as you will see below, it is an expedient process. Keep in mind that various domicile and industry regulations can change from time to time, so these are general steps that must be examined at the time of this decision:

1. Wait until the captive's closing year premiums are earned and/or cede any unearned premiums out of the captive

2. Settle the "pooling funds", wait for claim reporting period to be over, while waiting for all claims are paid and respective pooling funds are returned

3. A resolution is proposed and approved first by the captives' directors and then the

regulatory authority in the captive's domicile

4. Any remaining management or other fees will be paid out

5. Pay liquidation fees to domicile for "Certificate Of Dissolution"

6. Pay liquidation dividends from the captive's surplus account to shareholders

7. Pay initial capital back that was originally ceded into the captive

8. File final tax returns

This procedure should be self-explanatory and answer general questions related to the process and any tax ramifications.

Insurance is a risky business, too. Since there is a chance that 831(b) could backfire in any one year, it may take several years for the tax efficiency of a CIC strategy to play out. We often recommend, therefore, that you anticipate a five-year strategic plan for your captive.

Frequently Asked Questions

What is a "domicile"? How do I select a domicile?

A domicile is the jurisdiction in which a captive insurer is incorporated and regulated. There are many domicile options, both domestically (i.e., within the U.S.) and internationally. Many of the factors involved in the selection of the best domicile are included as part of a feasibility study that is coordinated by a qualified insurance professional who can marshal input from other professionals as needed.

Some of the questions that bear on the selection of where to locate the captive include: What is the domicile's image in the insurance industry, and how politically stable is it? Is there a supportive infrastructure for needed captive services? Is the domicile respected by reinsurers and fronting companies, and what is the local tax structure? More detailed analysis involves addressing issues such as: capitalization and solvency requirements, initial and ongoing fees and expenses, and specific regulatory requirements regarding approval of coverage forms and types of coverage permitted, policy pricing, loss reserves, minimum premiums, and admissibility of various classes of investment assets.

Even a foreign (i.e., non-U.S.) insurer not operating in the U.S., where it is beneficially owned by U.S. persons, comes under U.S. tax law and is subject to U.S. tax. This is the case even where, for example, the captive is domiciled in Bermuda. Under certain circumstances, a foreign insurer can elect to be treated as a domestic corporation. When this election is properly made, the captive operates as if it were a U.S. insurer, just like any domestically domiciled insurer. Again, in all instances it is subject to U. S. tax laws.

Are there benefits to locating in a well regulated domicile? Or should I merely select the jurisdiction with the most lax regulation, the lowest capitalization requirements, and in general the one that is the least expensive?

There are many things to consider when choosing a domicile, whether such is domestic or international, with some of the international domiciles being better suited for smaller captives. Offshore domiciles are monitored by the Organization for Economic Cooperation and Development ("OCED"), the International Monetary Fund ("IMF"), and other international monitoring organizations in order to ensure that the domicile meets international standards, ensuring compliance with financial controls to prevent money laundering, tax fraud, etc. In less regulated jurisdictions, the absence of strict compliance with these international standards can be a concern. In general, only a bona fide regulatory jurisdiction should be considered. We encourage this. Of course, a bona fide jurisdiction can be onshore or offshore.

A major consideration in selecting a domicile should be the availability of support services which will be needed by the specific captive; such infrastructure support services include local professionals with the requisite work experience, acceptability of the domicile to reinsurers, regulators with specialized knowledge of the captive's industry. Also, the best approach for finding the domicile that best fits your particular needs is to conduct a properly implemented feasibility study.

What are the tax rules related to captive insurers where the ultimate beneficial owners are U.S. persons?

There are both federal and state tax issues to consider. At the state level, most jurisdictions levy a "premium tax" (variously labeled as "independently procured premium tax" or "self-procured insurance tax") that runs 3% - 5% of the gross premium. This tax is the equivalent of a state sales tax targeted at insurance policies from non-admitted carriers, and historically, has been levied against the insured rather than against the insurer.

At the federal level, there is a 4.5% excise tax to consider as well as income tax rules. Federal excise taxes are eliminated by non-U.S. domiciled captives electing to be taxed as U.S. insurers, waiving as well the benefit of any tax treaties. There are also several sections of the Internal Revenue Code ("IRC") that must be mastered to properly determine the income tax position of a particular insurance company. Some IRC sections provide certain income tax advantages for smaller insurance companies to help them level the playing field with their larger, multi-billion-dollar insurance company competitors. Overall, this is a complex area of the tax law, and consultation with a tax expert qualified to advise in this area is strongly advised.

Also, in addition to the tax area, there is a whole host of state insurance laws and regulations relating to the location of the insureds, which must be navigated in designing a captive insurance program. This is all in addition to the regulations governing the captive insurer in its home domicile.

Section 831(b) of the IRC allows a U.S. corporation, Limited Liability Company, Partnership or Sole Proprietor to pay up to $1,200,000 in premium annually to their own “properly structured” Captive Reinsurance Company (CRC). This premium is deductible under IRC Section 162 as an ordinary and necessary business expense. Additional Captive premiums may be paid to multiple Captives if done properly. A Captive must be qualified by a regulatory authority to operate as a licensed reinsurance company for specific and limited purposes.

A Captive is an organized self-insurance entity that calculates risk, issues policies, collects premiums, pays expenses and establishes reserves to pay future claims. Captive owners control their company, how claims are handled and how reserves or underwriting profits are invested. Reserves in a Captive and the income from those assets directly benefit the Captive owners or their estate depending upon how the structure is established. If the business owner has a good claims history, the tax-deductible premiums accumulate tax-deferred, and can later be taken as dividends or as liquidated capital as capital gains.

One can own all or part of a Captive. Generally, it depends on your annual premium and available funds for capitalization and the number of years Captive premiums will be paid. If you will be averaging premiums of less than $800,000 annually, it is most likely better to own part of a Captive. For example, if you intended to deduct premiums of $250,000, you might own 25% of a Captive with three other firms and thereby only need $62,500 of capitalization as opposed to a considerably higher rate if owned alone. We provide actuarial studies and underwriting data that will assist you in providing the proper information needed to make a prudent decision.

What are the essential ingredients for a contract of insurance to qualify as bona fide insurance?

Generally accepted criteria for insurance include:

(a) Bona fide insurance must involve a contract between an insured and an insurer providing indemnification or reimbursement by the insurer to the insured for loss from an insurable risk.

(b) There must be a transfer or shifting of risk. In a conventional insurance arrangement, this criterion is easily met because the insurer is unrelated to the insured. In a captive insurance arrangement, this criterion must be shown by means of formal contractual transfers of risk. These companies can be related, and usually are best structured as brother-sister subsidiaries within the same group of companies.

(c) There must be sufficient distribution of risk. Sufficient risk distribution may be accomplished by means of reinsuring (assuming) risks underwritten by unrelated insurance companies or by directly writing sufficient coverage for unrelated persons. In any case, the specifics of each situation must be evaluated, and differing risk distribution structures should be considered to meet the objectives of each plan.

And of course, the captive should be licensed by the domicile to engage in the lines of business that it is underwriting.

What is the purpose of a “feasibility” study, what information does it contain, and who performs it? What does a feasibility study cost?

As its name implies, a feasibility study determines the practicality of the formation and operation of a captive insurance company for a particular business entity. It also explores alternative risk financing mechanisms available to the insured Although studies are not required by all domiciles, the feasibility study is a key component to establishing the appropriateness of alternative risk planning and are a component of good planning. Additionally, a feasibility study helps establish the bona fide business reasons for a captive's formation. Where required, some domiciles also specify the format in which the final report must be presented. Some require that a formal actuarial study be carried out as well.

As a practical matter, a feasibility study should be conducted whether it is required by the domicile or not; the foremost reason for doing such a study is that it provides management with a formal and contemporaneous compilation of the key factors that went into evaluating the practicality of adopting such planning given their objectives.

Most studies will include a general section on the background of captive insurance companies and their advantages and disadvantages, how the proposed captive sponsor addresses these advantages and disadvantages, and a comparison of captives with other alternative risk management options. The study will also include a summary of the captive sponsor's business operations and its goals with respect to forming a captive insurer, addressing pricing inequity examples, market condition issues, and loss control issues. The substance of the study includes a detailed selection of coverages to insure, a discussion of how policy pricing and loss reserves will be determined (sometimes actuarial data is required), a segment identifying the preferred domicile(s), and sometimes a set of financial statement forecasts for the captive's initial years of operation.

Does a captive insurance program replace my conventional insurance program? Will my business be insuring all of its risks through the captive or only some of them?

A captive insurance program is generally designed to provide the consistency of a stable insurance environment for a particular coverage or set of coverages. Sometimes it replaces parts of your conventional insurance program, sometimes all of it and sometimes none of it. More frequently, a captive program fills the many gaps in conventional coverages or replaces certain parts of that program. In general, the best types of coverages for a captive are those that (i) have premiums that fluctuate significantly from year to year; (ii) where a client's loss experience is different from others in its industry causing a pricing inequity in premiums; and (iii) other coverages that are not practically available on consistent and comprehensive policy forms and at fair prices. Also, the comprehensiveness of a captive insurance program should be evaluated in light of the risk tolerance of the insured. For example, some insureds are very risk averse and seek out a comprehensive risk program that significantly reduces the volatility of losses. These matters should be addressed in further detail in a feasibility study.

What is the difference between risk management and risk financing?

Risk management is a general term referring to the identification, quantification, and handling of all the risks your business is subject to. Risk management includes safety programs, contractual "hold harmless" agreements, regular legal review of your internal procedures, and other non-financial methods of addressing identified risks.

Risk financing is a process that identifies the most efficient way to finance an identified risk. In many cases where insurance is readily available through the conventional marketplace at affordable prices, the answer is to buy conventional insurance. In cases where insurance is not readily available or not affordable, risk financing includes the analysis of other options, including self-insurance (i.e., setting up and paying into reserve liability accounts), and forming a captive insurer.

Does the captive need to have an actuarial review, and does it need to be audited each year by an independent CPA firm?

Respected domiciles will require an annual audit by an independent CPA firm or its equivalent, with industry specific experience in the insurance industry.

Many domiciles require a formal actuarial review of your captive's policy pricing and loss reserve methodology, while some jurisdictions do not. Absent a formal actuarial review of premiums and loss reserves, your captive will, nevertheless, need to properly document its policy pricing and loss reserve methodology.

Is a captive just a "tax dodge"?

Captives have long been used by many prominent companies to manage their insurance risks. However, as with any industry, there are sometimes a few overly aggressive companies which exhibit poor judgment in designing or implementing a captive insurance program. One example, which was the subject of a New York Times article entitled "Tiny Insurers Face Scrutiny As Tax Shields" involves a so-called "captive insurance company" which wrote virtually no insurance coverage, while generating hundreds of millions of dollars in tax free investment income. See NYT article under "What's New". Also see the article entitled "Insurance Loophole Helps Rich," which discusses how this company collected only $33,173 in premiums over four years while making investment profits of over $315 million.

Clearly, this entity on its face appears to be something other than an insurance company. To counter this apparent abuse, <u>the IRS has advised the insurance community that it expects captive insurance companies (which, by design, serve the needs of their affiliated insureds) to be run in a manner similar to</u>

conventional insurance companies, and if operated in this manner, captive insurers should be afforded the same special tax and corporate benefits commonly afforded conventional insurance companies. The positions of the IRS are spelled out in many cases and pronouncements.

Your homeowner's insurance carrier does not expect to pay for your particular house, because of 1) the low probability of loss, and 2) the steps you have taken to reduce the probability and the severity of loss. Thus, you too, will want to underwrite a risk that is unlikely to occur, and one where you have taken steps to mitigate against not only the risk of hazard, but also the loss associated with that risk.

CONCLUSION

Really there are three things the client needs to know: (A) It costs some money to buy the trappings of owning an insurance company, including buying participation in a risk pool; (B) it requires capital contribution; (C) it saves tax costs in various ways; and (D) ultimately, the intrinsic design results in the tax savings that exceed the costs of owning and operating a CIC offset – by a wide margin.

In the past, only large companies formed captives that had uninsurable liability exposures. Their success led to smaller companies seeing the benefits and forming captives for similar risks. Here are some industry facts:

• Today there are close to 6,000 captive insurance companies worldwide and growing. [1]

• Captive insurance companies account for over 10% of all premium collected worldwide as of the end of 2008. [1]

• There was almost $10 Billion in captive premiums collected in the U.S. alone in 2008. [1]

• In most cases, captives provide unavailable commercial coverage's and issues policies for unregulated lines of business. [1]

The number of business failures in the U.S. is growing at an alarming rate. While many experts have examined specific reasons why companies fail, few have examined the general trends and macroeconomic conditions that affect business failures.

The fact is that all business owners face the reality of failure. As we all have seen over the past 5 years, no one company is immune to this fact. The important role of small business suggests that an understanding of why firms fail and succeed is crucial to the stability and health of our economy.

Most researchers would agree that uninsured risks are a major contributor to business failures. So, if you have market and management experience, and capital but could still fail because of risks you didn't calculate. This is why a captive business strategy may be an invaluable option.

[1] Data from the Insurance Information Institute (III.0rg)

Rules

There are a number of complicated rules that must be scrupulously adhered to in establishing and owning all or part of a CIC and maintaining them on an annual basis:

1. Policy construction and risks underwritten;

2. Proper capitalization;

3. Premiums must be actuarially based;

4. Annual audits are required;

5. A registered agent must be selected,

6. On-shore or off-shore managers must be selected;

7. Risk pools must be established since the tax code mandates that,

8. In most cases, the insurance company cannot take on all of its own risk. Generally, the IRS doesn't consider an insurance company to be legitimate if it only insures the owner's risks.

9. We make all this a simple one-step process

It is critical to choose your Captive formation partners wisely, because you will be in the insurance business, and therefore, you need the RIGHT PARTNERS. One must follow the rules, respect the entity, create the proper structure, and engage the appropriate professionals to take advantage of this opportunity and to avoid costly mistakes

<u>Bottom line…when properly structured, a CIC can be an extremely useful risk management, asset protection, wealth preservation, and tax</u>

optimization tool for the right clients.

APPENDIX

Direct From The State of Utah Website:

Formation Decision Issues

Why Form a Captive?

To reduce or stabilize insurance costs

Financing risk in a captive makes sense for a smaller, more homogenous group of insured businesses with more favorable claims experience than the broader insurance market. Captives may benefit from other cost savings through lower premiums, elimination or reduction of broker commissions, and lower administrative costs.

To increase capacity to offer tailored products and access to reinsurance

Businesses insured in the traditional market are limited to coverage, deductibles and limits offered by insurance companies. In some cases, needed coverage is not offered or is too cost prohibitive to obtain. This is partly due to the fact that they are based on the needs of a broader market and therefore may not meet the specific needs of each insured. In other word, insured businesses are limited in the traditional market by a more "one size fits all" mentality. Conversely, companies may not be able to properly finance desired insurance coverage, deductibles and limits under a self-insurance arrangement because they cannot access the reinsurance market. A captive can access the reinsurance market and has the flexibility to tailor products for a specific insured. As a result, a captive may have increased capacity compared to other alternatives.

To control insurable risks

Traditional insurers are subject to the cycles of hard and soft insurance markets. During hard markets insurance coverage is more limited and prices are higher. A captive is less susceptible to these fluctuations and offers the insured more control over underwriting and claims settlement activities.

To establish better-than-average claim experience

Because premium levels are directly impacted by claims experience, a company that has established a favorable claims history relative to the average market has a may be a prime candidate to consider establishing a captive to avoid subsidizing other insured businesses with less favorable claims experience. Since there is a direct financial benefit for improving claims experience in the captive market companies will put greater emphasis on controlling claims costs. As a result, companies may take a more direct role in safety programs and other favorable practices. Since a captive is a more formalized form of self-insurance, the captive may provide better tools for gathering data for cost control efforts.

To capture investment income and accelerate/manage cash flow

There is a difference in the timing of when the insurer receives premiums and when claims are paid to the insured. Because of this difference, premiums collected are invested and reserved until claims are paid. Corporate systems retain the benefit of investment earnings on premiums paid, where as under the traditional market this benefit is forfeited to an independent, third party insurer.

Potential tax advantages

Primary tax advantages for captives are the potential deductibility of premiums and deferred taxation of insurance income. Under certain circumstances, an insured may deduct premiums paid to a captive that are not otherwise deductible under a self insurance arrangement. Due to complexities of tax law it is best for captives to seek qualified tax and legal advice before establishing a captive. Tax issues can be a major consideration in forming a captive, but it should not be the sole reason for establishing a captive. If tax sheltering is the driver, the captive may not withstand the scrutiny of taxing authorities.

Safety and soundness for risk management programs

The captive insurance market is more formalized than self-funding insurance risk and has a regulatory framework to support the captive (for example, a requirement for annual audits and actuarial opinions on adequacy of reserves). This may provide a higher probability (whether perceived or real) of success. Alternatively, the formalized framework still allows for insureds to work within a flexible environment to meet unique and specific needs.

Is a Captive the Right Course for My Organization?

There are a myriad of things to consider in determining whether a captive is right for an organization. As a result, there are no hard and fast rules. However, the following questions should be considered in determining if a captive is right for you:

1. How does your claims experience compare to the average pool of insureds covered in the traditional market?

If your company's claims experience is better than average then current premiums paid to a traditional insurer are probably higher than is necessary for its risk covered in the commercial market and you may want to consider a captive. In other words, you are probably subsidizing the higher risks of other insured businesses and could potentially benefit from lower premiums in a captive. Costs to operate a captive (including fronting and reinsurance costs) usually comprise about 35-40% of captive premium. Given this general guideline, if your current claims experience is less than 60-65% of total premium paid then you should take a closer look at the captive option.

2. Is your current claims experience consistent and predictable?

Captives work best for programs that have predictable losses. The more predictable and consistent the losses, the greater the confidence with which premiums and reserves can be set for the captive program. Volatile lines of coverage can be problematic for captives as they are difficult to quantify. Also, lines of coverage with short claims development patterns can also be problematic as the ability to hold reserves against potential future losses is limited.

3. How well do you know your insurable risks and which risks would you like to move from the traditional market?

Before you consider a captive an organization must have a good understanding of its insurable risks. In some cases questions 1 and 2 above may be answered differently depending on the risk. A captive may make sense for one risk but not another. There is nothing that says an organization must ensure all of its risks in a captive, if established. However, the organization must be able to identify those risks for which it makes sense and there must be sufficient premium volume from those risks to support a captive operation.

If you have a good understanding of your insurable risks and your gut feeling is that there is a more cost effective way to address those risks, you are probably on to something and should dig a little deeper into captives.

4. How much do you currently pay in premiums?

A minimum level of premium volume is required in captive programs to provide stability, absorb the operating costs of the captive and provide a return on the capital invested. Generally, to make a captive program viable, an organization should have at least $750,000 in annual premium for a Pure Captive and $1,000,000 in annual premium for a group captive. Remember that a group captive is owned by more than one insured and therefore each ensured may only contribute a portion of the $1,000,000 in premium volume.

5. What are the demographics of your risks (i.e. international, national, or Utah only)?

The demographics of your risks may make a difference in your risk management or portfolio. You will need to assistance of a qualified risk managers, captive manager, accountants, and attorneys to determine the best options for your company.

6. What is the financial stability of the parent organization?

An insured considering a captive will need sufficient financial resources to support the capital investment and the posting of collateral behind the captive program.

7. Are you willing to commit to the captive as an alternative to the traditional market?

Captives are a way for companies to reduce reliance on the commercial market and provide stable, long-term risk financing. Captives will not be the lowest cost option in all years, so to be successful they will need to be committed to the process long-term. Short-term premium savings should not be the overriding reason for starting a captive. Generally speaking an organization should be willing to commit at least 3 to 5 years to a captive arrangement.

Beyond just taking a long-term approach, the parent of any captive must be committed to the overall process and providing support to the captive management team.

Although the above questions are by no means comprehensive they should provide some initial sense about the feasibility of a captive. If, after answering the above questions, a company believes a captive might be right, it should retain a qualified service provider to conduct a feasibility study.

Will a Feasibility Study Help Determine Whether a Captive is the Right Risk Management Tool for My Organization

Costs for a feasibility study can vary depending on the size and complexity of the organization being studied as well as the service provider retained. However, indications from some service providers appear to be in the $10,000 to $20,000 range for a mid-sized company captive being considered. Costs are typically higher for feasibility studies on group captives than pure captives. A feasibility study will generally look at the following issues:

Quantitative Factors	**Qualitative Factors:**
Coverage & Program Structure	Ownership

Loss Analysis & Rate Development	Governance
Capital & Surplus	Domicile
Claims Projections & Pro Forma	Management
Reserve Requirements	
Fronting & Reinsurance	
Investment Income	
Taxes	

Where should A Captive be Organized?

If the results of the feasibility study show that the captive is a good alternative and the organization decides to proceed, the organization will need to select a state in which to domicile the captive. To meet with the Utah Insurance Department to discuss the business plan for the Captive and to receive instructions regarding the licensing process, contact Ross Elliott at (801) 537-9047 to set up an appointment to meet with the Department.

What Tax Issues Are Involved in Organizing a Captive Insurer?

There are generally four areas of tax consideration related to captives. They are Premium Taxes in the state of domicile, U.S. Federal Excise Taxes, U.S. Income Taxes (includes deductibility of premiums paid and income tax considerations), and Internal Revenue Code (IRC) §953(d) elections. Each is briefly discussed below:

Premium Taxes:
In Utah a $5,000 annual fee and $250 e-commerce fee constitutes the sole tax or fee. However, personal and real property owned by the captive in Utah will be subject to property tax that funds the Uniform School Fund.

Federal Excise Taxes:
This tax would not be applicable for any captive domiciled in the United States, including Utah.

Placing insurance risk with an off-shore insurance entity is viewed as the importation of a service and therefore is subject to Federal Excise Taxes (FET). For P&C companies the tax is 4% for insurance transactions and 1% for reinsurance transactions. For a life business it is 1% whether direct or reinsurance. This tax does not apply if the U.S. has a treaty with that jurisdiction (for example Ireland and the U.K.). However, you cannot run the business through a jurisdiction with a tax treaty and then transfer it to a non-treaty location. If it ends up in a non-treaty location, it is subject to the FET.

You will need to consult with appropriate tax and legal consultants and a qualified captive manager to navigate these tax issues appropriately.

Deductibility of Premiums Paid to Captive:
Premiums paid to captives are not deductible unless some or all of the following factors exist:

6. The transaction is a bona fide insurance transaction, with the captive taking some risk, under a defensible business plan.
7. The captive's owner is organized such that subsidiaries, not the parent, pay premiums to the captive under a "brother-sister" relationship.
8. The captive writes a substantial amount of unrelated business. You will need to consult with appropriate tax and legal consultants and a qualified captive manager to navigate these tax issues appropriately.

Income Taxes:
Onshore captives may consolidate its earnings with the parent, if it is a Pure Captive, for tax purposes. If it is a group captive, it is treated as a taxable entity in its own right. You will need to consult with appropriate tax and legal consultants and a qualified captive manager to navigate these tax issues appropriately.

IRC § 953(d) Election:
Foreign insurance companies can elect to be treated as a domestic company for U.S. Federal tax purposes.

This information regarding tax issues is not complete. Persons or organizations will need to consult with their tax consultants to obtain complete and up-to-date information to comply with the federal and state tax laws involved in the organization and operation of a captive insurance company. You will need to consult with appropriate tax and legal consultants and a qualified captive manager to navigate these tax issues appropriately.

Delaware Statutes (We could have selected any other domicile. This was deliberate. Delaware statutes are sophisticated and well thought out, as well as well written. It may be useful to review other states' statutes to further familiarize yourself with law).

HOME > TITLE 18 > CHAPTER 69

§ 6901 § 6902 § 6903 § 6904 § 6905 § 6906 § 6907 § 6908 § 6909 § 6910 § 6911 § 6912 § 6913 § 6914 § 6915 § 6915A § 6916 § 6917 § 6918 § 6919 § 6920 § 6921 § 6922 § 6923

TITLE 18

Insurance Code

Insurance

CHAPTER 69. CAPTIVE INSURANCE COMPANIES

Subchapter I. General Provisions

§ 6901. Finding; purpose.

(a) It is determined and declared as a matter of legislative finding that captive insurance companies can serve a valuable risk management function, and that their responsible utilization and the growth of the captive insurance industry in the State of Delaware are in the best interests of this State.

(b) It is further determined and declared that the purpose and policy of this chapter shall be:

(1) To provide for the regulation of captive insurance companies consistent with their nature and purpose;

(2) To provide flexibility and opportunity to captive insurance companies and to persons utilizing them; and

(3) To foster economic development in this State through the growth of the captive insurance industry.

75 Del. Laws, c. 150, § 1.;

§ 6902. Definitions.

As used in this chapter, unless the context requires otherwise:

(1) "Affiliated company" means any person (other than a natural person in that person's individual capacity) in the same corporate system as a parent, an industrial insured, or an association member by virtue of common ownership, control, operation, or management.

(2) "Agency captive insurance company" shall mean an insurance company described in paragraphs (2)a. and b. of this section:

a. An insurance company that is owned or controlled by an insurance agency, brokerage or reinsurance intermediary, or an affiliate thereof, or under common ownership or control with such agency, brokerage or reinsurance intermediary, and that only insures the risks of insurance or annuity contracts placed by or through such agency, brokerage or reinsurance intermediary; or

b. An insurance company that is owned or controlled by a marketer or producer of service contracts and/or warranties, and that only insures or reinsures the contractual liability arising out of such service contracts or warranties sold through such marketer or producer.

c. For the purposes of this paragraph (2), "common ownership or control" shall mean ownership of 10 percent or more of the voting securities of a person or such other form of ownership or control as the Commissioner may approve.

(3) "Alien" means formed under the laws of any country or jurisdiction other than the United States of America or any of its states, districts, commonwealths and possessions.

(4) "Association" means any legal association of persons that has been in continuous existence for at least 1 year or such lesser period of time approved by the Commissioner, the association members of which, or which does itself, whether or not in conjunction with some or all of the association members:

a. Directly or indirectly, own, control or hold with power to vote all of the outstanding voting securities or other voting interests of, or have complete voting control over, an association captive insurance company; or

b. Constitute all of the subscribers of an association captive insurance company organized as a reciprocal insurer.

(5) "Association captive insurance company" means any captive insurance company that insures risks of the association members of the association and any of their affiliated companies.

(6) "Association member" means any person that belongs to an association.

(7) "Branch captive insurance company" has the meaning given such term in § 6972(c) of this title.

(8) "Capital and surplus" means the amount by which the value of all of the assets of the captive insurance company exceeds all of the liabilities of the captive insurance company, as determined under the method of accounting utilized by the captive insurance company in accordance with the applicable provisions of this chapter.

(9) "Captive insurance company" means any pure captive insurance company, association captive insurance company, agency captive insurance company, sponsored captive insurance company, industrial insured captive insurance company, special purpose captive insurance company, special purpose financial captive insurance company or risk retention group, whether domestic, foreign or alien, or branch captive insurance company, licensed under the provisions of this chapter.

(10) "Commissioner" means the Insurance Commissioner of this State.

(11) "Controlled unaffiliated business" means any person (other than a natural person in that natural person's individual capacity):

a. That is not in the corporate system of a parent and its affiliated companies;

b. That has an existing contractual relationship with such parent or any such affiliated company; and

c. Whose risks are managed by a pure captive insurance company in accordance with § 6919 of this title.

(12) "Department" has the meaning given such term in § 102(5) of this title.

(13) "Domestic" means formed under the laws of this State.

(14) "Excess workers' compensation insurance" means, in the case of an employer that has insured its workers' compensation risks in accordance with applicable law, insurance in excess of a specified per-incident or aggregate limit established by the Commissioner. Notwithstanding the foregoing, the per-incident and aggregate limit to be utilized by the Commissioner in establishing the excess workers compensation threshold for employers that are authorized under applicable law to self insure their workers compensation risks shall be $0.00.

(15) "Foreign" means formed under the laws of any state.

(16) "Industrial insured" means an insured:

a. Who procures the insurance of any risk or risks by use of the services of a full-time employee acting as an insurance manager or buyer;

b. Whose aggregate annual premiums for insurance on all risks total at least $25,000; and

c. Who has at least 25 full-time employees.

(17) "Industrial insured captive insurance company" means any captive insurance company that insures risks of the industrial insureds that comprise the industrial insured group and any of their affiliated companies.

(18) "Industrial insured group" means any group of industrial insureds that collectively:

a. Directly or indirectly, own, control, or hold with power to vote all of the outstanding voting securities or other voting interests of, or have complete voting control over, an industrial insured captive insurance company; or

b. Constitute all of the subscribers of an industrial insured captive insurance company organized as a reciprocal insurer.

(19) "Insurance" has the meaning given such term in § 102(2) of this title.

(20) "Insurer" has the meaning given such term in § 102(3) of this title.

(21) "Mutual insurer" has the meaning given such term in § 502 of this title.

(22) "Parent" means a person that directly or indirectly owns, controls, or holds with power to vote more than 50 percent of the outstanding voting securities or other voting interests of a pure captive insurance company.

(23) "Person" means a natural person, partnership (whether general or limited), trust, estate, association, corporation, limited liability company, statutory trust, business trust, custodian, nominee or any other individual or entity in its own or any representative capacity, in each case whether domestic, foreign, or alien.

(24) "Protected cell" has the meaning given such term in § 6932(3) of this title.

(25) "Pure captive insurance company" means any captive insurance company that insures risks of its parent and any of such parent's affiliated companies and any controlled unaffiliated business.

(26) "Reciprocal insurer" has the meaning given such term in § 503 of this title.

(27) "Risk retention group" means a risk retention group formed pursuant to the Liability Risk Retention Act of 1986, 15 U.S.C. § 3901 et seq., as amended.

(28) "Special purpose captive insurance company" means any person that is licensed under this chapter and designated as a special purpose captive insurance company by the Commissioner.

(29) "Special purpose financial captive insurance company" means a captive insurance company that is granted a certificate of authority under subchapter III of this chapter of this title.

(30) "Sponsored captive insurance company" has the meaning given such term in § 6932(5) of this title.

(31) "State" means the State of Delaware, and "state" means any other state, district, commonwealth or possession of the United States of America.

(32) "Transacting insurance" has the meaning given such term in § 103 of this title.

64 Del. Laws, c. 454, § 1; 70 Del. Laws, c. 186, § 1; 75 Del. Laws, c. 150, § 1; 76 Del. Laws, c. 161, § 1; 77 Del. Laws, c. 252, §§ 1-4.;

§ 6903. License application; certificate of authority.

(a) Any person complying with § 6906 of this title may apply to the Commissioner for a certificate of authority to do any and all insurance business comprised in §§ 902-905, 906(a)(1),(2), (4)-(15) and (b), 907 and 908 of this title and to issue annuities as defined in § 2902 of this title; provided, however, that:

(1) No pure captive insurance company may directly insure any risks other than those of its parent, any of such parent's affiliated companies, and any controlled unaffiliated business;

(2) No association captive insurance company:

a. Organized as a reciprocal insurer may insure any risks that a reciprocal insurer is not permitted to insure under Chapter 57 of this title; and

b. May insure any risks other than those of the association members of its association and their affiliated companies, provided that an association captive insurance company may insure risks of any other person if the insurance for such other persons satisfies each of the following requirements:

1. The insurance lines for such other persons must be the same as are authorized by the Commissioner to be written by the association captive insurance company for its association members;

2. Such other persons conduct the same or a related or similar business as that of the association members of the association captive insurance company; and

3. The maximum amount of premiums received in any year from all such other persons cannot without the express written consent of the Commissioner exceed 50% of the gross direct premiums received by the association captive insurance company from its association members in its preceding financial year;

(3) No industrial insured captive insurance company:

a. Organized as a reciprocal insurer may insure any risks that a reciprocal insurer is not permitted to insure under Chapter 57 of this title; and

b. May insure any risks other than those of the industrial insureds of its industrial insured group and their affiliated companies, provided that an industrial insured captive insurance company may insure risks of any other person (other than a natural person in his or her individual capacity) if the insurance for such other persons satisfies each of the following requirements:

1. The insurance lines for such other persons must be the same as are authorized by the Commissioner to be written by the industrial insured captive insurance company for its industrial insureds;

2. Such other persons conduct the same or a related or similar business as that of the industrial insureds of the industrial insured captive insurance company; and

3. The maximum amount of premiums received in any year from all such other persons cannot without the express written consent of the Commissioner exceed 50% of the gross direct premiums received by the industrial insured captive insurance company from its industrial insureds in its preceding financial year;

(4) No risk retention group may insure any risks other than risks that may be insured by a risk retention group under Chapter 80 of this title;

(5) A special purpose captive insurance company may, in addition to the authority set forth in this section for captive insurance companies, provide insurance or reinsurance, or both, for such other risks as approved by the Commissioner;

(6) No captive insurance company may provide personal motor vehicle or homeowner's insurance coverage or any component thereof;

(7) No captive insurance company may accept or cede reinsurance except as provided in § 6911 of this title; and

(8) Any captive insurance company may provide excess workers' compensation insurance to its parent and affiliated companies, unless prohibited by federal law or laws of this State or any other state having jurisdiction over the transaction, and any captive insurance company, unless prohibited by federal law, may reinsure workers' compensation of a qualified self-insured plan of its parent and affiliated companies.

(b) No captive insurance company shall do any insurance business in this State unless:

(1) It first obtains from the Commissioner a certificate of authority authorizing it to do insurance business in this State;

(2) Its board of directors, members, partners, managers, committee of managers or other governing body, or in the case of a reciprocal insurer, its subscribers' advisory committee, holds at least 1 meeting each year in this State, provided that this requirement shall not apply to: (i) a branch captive insurance company, or (ii) a captive insurance company that has 5 or more full-time employees each of whom has that employee's principal place of employment in this State;

(3) It maintains its principal place of business in this State or, in the case of a branch captive insurance company, it maintains in this State a principal place of business in accordance with the provisions of § 6972(c) of this title; and

(4) It identifies in its application for a certificate of authority its registered office in this State and its registered agent located at such office to accept service of process on its behalf and to otherwise act as its registered agent in this State, provided that whenever such registered agent cannot with reasonable diligence be found at the registered office of the captive insurance company, the Commissioner shall be an agent of such captive insurance company upon whom any process, notice or demand may be served.

(c)(1) Before receiving a certificate of authority, an applicant captive insurance company shall file with the Commissioner a certified copy of its organizational documents, a statement under oath of its president or other authorized person showing its financial condition, and any other statements or documents required by the Commissioner.

(2) Each applicant captive insurance company shall also file with the Commissioner evidence of the following:

a. The amount and liquidity of its assets relative to the risks to be assumed;

b. The adequacy of the expertise, experience, and character of the person or persons who will manage it;

c. The overall soundness of its plan of operation;

d. The adequacy of the loss prevention programs of its insureds; and

e. Such other factors deemed relevant by the Commissioner in ascertaining whether the proposed captive insurance company will be able to meet its policy obligations.

(d) Each applicant captive insurance company shall pay to the Commissioner a nonrefundable application fee of $200 for reviewing its application to determine its completeness, and a nonrefundable processing fee of $3,000 for examining, investigating and processing its application for a certificate of authority, and the Commissioner is authorized to retain legal, financial and examination services and other expert services from outside the Department, the reasonable cost of which may be charged against the applicant. The provisions of § 330 of this title shall apply to reviews, examinations, investigations, and processing conducted under the authority of this section. In addition, each captive insurance company shall pay a nonrefundable license fee for the year of registration and a nonrefundable renewal fee for each year thereafter of $300.

(e) Two or more captive insurance companies under common ownership and control shall pay the $200 application fee and the $300 renewal fee required by subsection (d) of this section as though they were a single captive insurance company; provided however, that each such captive insurance company shall be charged the reasonable cost of any legal, financial and examination services and other expert services from outside the Department retained by the Commissioner in connection with the examination, investigation and processing of its application for a certificate of authority. For purposes of this subsection, "common ownership and control" has the meaning set forth in § 6914(e) of this title.

(f) If the Commissioner is satisfied that the documents and statements that such captive insurance company has filed comply with the provisions of this chapter, the Commissioner may grant a certificate of authority authorizing it to do insurance business in this State until April 1 thereafter, which certificate of authority may be renewed.

64 Del. Laws, c. 454, § 1; 70 Del. Laws, c. 107, § 1; 70 Del. Laws, c. 186, § 1; 75 Del. Laws, c. 150, § 1; 76 Del. Laws, c. 161, §§ 2, 3; 77 Del. Laws, c. 252, § 5.;

§ 6904. Company name.

No captive insurance company shall adopt a name that is the same as, deceptively similar to, or likely to be confused with or mistaken for, any other existing business name registered in this State.

64 Del. Laws, c. 454, § 1; 75 Del. Laws, c. 150, § 1.;

§ 6905. Minimum capital and surplus; letter of credit.

(a) No captive insurance company shall be issued a certificate of authority unless it shall possess and thereafter maintain capital and surplus of:

(1) In the case of a pure captive insurance company, not less than $250,000;

(2) In the case of an association captive insurance company, not less than $750,000;

(3) In the case of an industrial insured captive insurance company, not less than $500,000;

(4) In the case of an agency captive insurance company, not less than $250,000;

(5) In the case of a risk retention group, not less than $1,000,000;

(6) In the case of a sponsored captive insurance company, not less than $500,000;

(7) In the case of a special purpose captive insurance company, not less than $250,000 or such other amount determined by the Commissioner;

(8) In the case of a branch captive insurance company, not less than $250,000 or such other amount determined by the Commissioner; and

(9) In the case of a special purpose financial captive insurance company that is also a sponsored captive insurance company, not less than $500,000, and in the case of a special purpose financial captive insurance company that is not also a sponsored captive insurance company, not less than $250,000.

(b) In connection with the issuance of a certificate of authority, the Commissioner may prescribe additional minimum capital and surplus based upon the type, volume, and nature of insurance business transacted.

(c) Minimum capital and surplus described in paragraphs (a)(1)-(9) of this section shall be maintained in this State and may be in the form of cash, an irrevocable letter of credit issued by a financial institution chartered by or licensed or otherwise authorized to do banking business in this State, or by any other financial institution approved by the Commissioner, or such other assets as may be approved by the Commissioner.

64 Del. Laws, c. 454, § 1; 75 Del. Laws, c. 150, § 1; 76 Del. Laws, c. 161, §§ 4, 5; 77 Del. Laws, c. 252, §§ 6, 7.;

§ 6906. Formation of captive insurance companies.

(a) A pure captive insurance company may be incorporated as a stock corporation or as a nonstock corporation, or may be formed as a limited liability company, partnership, limited partnership or statutory trust.

(b) An association captive insurance company or an industrial insured captive insurance company may be incorporated as a stock corporation or as a nonstock corporation, may be formed as a limited liability company, partnership, limited partnership or statutory trust, or may be organized as a reciprocal insurer.

(c) A special purpose captive insurance company or a special purpose financial captive insurance company or an agency captive insurance company or a branch captive insurance company may be incorporated as a stock corporation or as a nonstock corporation, may be formed as a limited liability company, partnership, limited partnership or statutory trust, or may be such other person, other than a natural person in that natural person's individual capacity, approved by the Commissioner.

(d) A sponsored captive insurance company, including a sponsored captive insurance company that is also a special purpose financial captive insurance company, may be incorporated as a stock corporation or as a nonstock corporation, or may be formed as a limited liability company, partnership, limited partnership, or statutory trust.

(e) A risk retention group may take any form permitted under the Liability Risk Retention Act of 1986, 15 U.S.C. § 3901 et seq., as amended.

(f) In the case of a captive insurance company other than a branch captive insurance company:

(1) Formed as a corporation, at least 1 of the members of the board of directors or other governing body shall be a resident of, or have that member's principal place of business in, this State;

(2) Formed as a reciprocal insurer, at least 1 of the members of the subscribers' advisory committee shall be a resident of, or have its principal place of business in, this State;

(3) Formed as a limited liability company, at least 1 member, manager or person in whom management of the limited liability company is vested or to whom rights and powers to manage and control the business and affairs of the limited liability company have been delegated shall be a resident of, or have its principal place of business in, this State;

(4) Formed as a partnership, at least 1 partner or person in whom management of the partnership is vested or to whom rights and powers to manage and control the business and affairs of the partnership have been delegated shall be a resident of, or have its principal place of business in, this State;

(5) Formed as a limited partnership, at least 1 general partner or person in whom management of the limited partnership is vested or to whom rights and powers to manage and control the business and affairs of the limited partnership have been delegated shall be a resident of, or have its principal place of business in, this State; and

(6) Formed as a statutory trust, at least 1 trustee or person in whom management of the statutory trust is vested or to whom rights and powers to manage and control the business and affairs of the statutory trust have been delegated shall be a resident of, or have its principal place of business in, this State.

(g) A captive insurance company incorporated, formed or organized under the laws of this State or under the laws of another jurisdiction that is licensed under the provisions of this chapter shall have the privileges and be subject to the provisions of the laws of this State or the laws of such other jurisdiction, as applicable, under which such captive insurance company is incorporated, formed or organized as well as the applicable provisions contained in this chapter. In the event of conflict between the provisions of the laws of this State or the laws of such other jurisdiction, as applicable, under which such captive insurance company is incorporated, formed or organized, and the provisions of this chapter, the latter shall control.

64 Del. Laws, c. 454, § 1; 66 Del. Laws, c. 223, § 1; 70 Del. Laws, c. 186, § 1; 75 Del. Laws, c. 150, § 1; 76 Del. Laws, c. 161, § 6; 77 Del. Laws, c. 252, §§ 8, 9.;

§ 6907. Annual reports.

(a) Captive insurance companies shall not be required to make any annual report to the Commissioner except as provided in this chapter.

(b) Prior to March 1 of each year, each captive insurance company other than a branch captive insurance company for which the Commissioner has waived any of the requirements of this section pursuant to § 6974 of this title, shall submit to the Commissioner a report of its financial condition, verified by oath of 2 of its executive officers or other authorized persons. Each captive insurance company shall report using generally accepted accounting principles, unless the Commissioner approves the use of statutory accounting principles or international accounting standards, with any appropriate or necessary modifications or adaptations thereof required or approved or accepted by the Commissioner for the type of insurance and kinds of insurers to be reported upon, and as supplemented by additional information required by the Commissioner. Any captive insurance company whose use of statutory accounting principles is approved by the Commissioner may make such modifications and adaptations thereof as are necessary:

(1) To record, as "admitted," the full value of all investments by such captive insurance company permitted under this chapter; and

(2) Subject to the Commissioner's approval, to make its reports under this section consistent with the purposes of this chapter.

The Commissioner shall by rule propose the forms in which captive insurance companies shall report.

(c) Any captive insurance company may make written application to the Commissioner for filing the required report on a fiscal year-end. If an alternative reporting date is granted by the Commissioner:

(1) The annual report is due 60 days after the fiscal year-end; and

(2) In order to provide sufficient detail to support the premium tax return, the captive insurance company shall file prior to March 1 of each year for each calendar year-end such form or information as the Commissioner shall by rule prescribe, verified by oath of 2 of its executive officers or other authorized persons.

64 Del. Laws, c. 454, § 1; 75 Del. Laws, c. 150, § 1; 77 Del. Laws, c. 252, § 10.;

§ 6908. Examinations and investigations.

(a) At least once in 3 years, and whenever the Commissioner determines it to be prudent, the Commissioner or the Commissioner's examiner shall personally visit each captive insurance company and thoroughly inspect and examine its affairs to ascertain its financial condition, its ability to fulfill its obligations and its compliance with the provisions of this chapter. The Commissioner may enlarge the aforesaid 3-year period to 5 years, provided said captive insurance company is subject to a comprehensive annual audit during such period of a scope satisfactory to the Commissioner by independent auditors approved by the Commissioner. The expenses and charges of the examination shall be paid to this State by the company or companies examined.

(b) The provisions of §§ 318-320, 321 (other than subsection (g)), 322 and 330 of this title shall apply to examinations conducted under this section.

64 Del. Laws, c. 454, § 1; 70 Del. Laws, c. 186, § 1; 75 Del. Laws, c. 150, § 1.;

§ 6909. Suspension or revocation of certificate of authority.

(a) A captive insurance company's certificate of authority to do an insurance business in this State may be suspended or revoked by the Commissioner for any of the following reasons:

(1) Insolvency;

(2) Failure to meet the requirements of § 6905 of this title;

(3) Refusal or failure to submit an annual report, as required by § 6907 of this title, or any other report or statement required by law or by lawful order of the Commissioner;

(4) Failure to comply with the provisions of its own organizational documents;

(5) Failure to pay any tax or fee, or to submit to or pay the cost of examination or any legal obligation relative thereto, as required by this

chapter;

(6) Use of methods that, although not otherwise specifically prohibited by law, nevertheless render its operation detrimental or its condition unsound with respect to the public or its policyholders; or

(7) Failure otherwise to comply with the laws of this State.

(b) If the Commissioner finds, upon examination, hearing or other evidence, that any captive insurance company has committed any of the acts specified in subsection (a) of this section, the Commissioner may suspend or revoke such company's certificate of authority if the Commissioner deems it in the best interest of the public and the policyholders of such captive insurance company, notwithstanding any other provision of this title.

(c) Although issued and delivered to the captive insurance company, the certificate of authority at all times shall be the property of this State. Upon any expiration, suspension or termination thereof, the captive insurance company shall promptly deliver the certificate of authority to the Commissioner.

(d) Suspension of a captive insurance company's certificate of authority shall be for such period as the Commissioner specifies in the order of suspension. During the suspension period the Commissioner may rescind or shorten the suspension by further order.

(e) During the suspension period the captive insurance company may not solicit or write any new business but must file annual statements, pay fees and taxes as required under this chapter, and, unless otherwise provided in the order of suspension, may service its business already in force as if the certificate of authority had continued in full force.

(f) If the certificate of authority has not terminated within the suspension period, then upon expiration of the suspension period, the captive insurance company's certificate of authority shall automatically be reinstated, unless the Commissioner finds that 1 or more causes of the suspension are continuing or that the captive insurance company is otherwise not in compliance with the requirements of this chapter, of which finding the Commissioner shall give the captive insurance company notice not less than 30 days in advance of expiration of the suspension period. If not automatically reinstated, and if not already terminated, the certificate of authority terminates at the end of the suspension period.

64 Del. Laws, c. 454, § 1; 70 Del. Laws, c. 186, § 1; 75 Del. Laws, c. 150, § 1; 76 Del. Laws, c. 161, § 7.;

§ 6910. Legal investments; management of assets.

(a) Association captive insurance companies, special purpose captive insurance companies and risk retention groups shall comply with:

(1) The investment requirements contained in Chapter 13 of this title, as applicable; or

(2) Such investment requirements as may be approved by the Commissioner upon application by any such captive insurance company.

(b) No pure captive insurance company, industrial insured captive insurance company, agency captive insurance company, special purpose financial captive insurance company or branch captive insurance company shall be subject to any restrictions on allowable investments whatsoever, including those limitations contained in this title; provided, however, that the Commissioner may prohibit or limit any investment that threatens the solvency or liquidity of any such captive insurance company.

(c) Loans of minimum capital and surplus funds required by § 6905 of this title are prohibited.

(d) Subject to subsections (a) and (b) of this section and § 6937 of this title, as applicable, a captive insurance company may own securities of or other interests in another captive insurance company, whether voting or nonvoting.

64 Del. Laws, c. 454, § 1; 75 Del. Laws, c. 150, § 1; 76 Del. Laws, c. 161, § 8; 77 Del. Laws, c. 252, § 11.;

§ 6911. Reinsurance.

(a) Any captive insurance company may provide reinsurance, on risks ceded by any other insurer, in accordance with § 910 of this title.

(b) With the exception of a risk retention group, any captive insurance company may take credit or a reduction from liability for the reinsurance of risks or portions of risks ceded to reinsurers in accordance with subchapter III of Chapter 9 of this title, or as otherwise approved by the Commissioner.

(c) A risk retention group may take credit or a reduction from liability for the reinsurance of risks or portions of risks ceded to reinsurers only in accordance with subchapter III of Chapter 9 of this title.

64 Del. Laws, c. 454, § 1; 75 Del. Laws, c. 150, § 1; 78 Del. Laws, c. 321, § 1.;

§ 6912. Rating organization membership.

No captive insurance company shall be required to join a rating organization.

64 Del. Laws, c. 454, § 1; *75 Del. Laws, c. 150, § 1.*;

§ 6913. Prohibited associations.

No captive insurance company shall be permitted to join or contribute financially to any plan, pool, association, or guaranty or insolvency fund in this State, nor shall any such captive insurance company, or any insured or affiliate thereof, receive any benefit from any such plan, pool, association or guaranty or insolvency fund for claims arising out of the operations of such captive insurance company.

64 Del. Laws, c. 454, § 1; *75 Del. Laws, c. 150, § 1.*;

§ 6914. Tax on premiums collected.

(a) Each captive insurance company, other than a sponsored captive insurance company (including a sponsored captive insurance company that is also a special purpose financial captive insurance company), and each protected cell of a sponsored captive insurance company shall pay to the Commissioner no later than March 1 of each year a tax at the rate of 2/10 of 1% on each dollar of direct premiums collected or contracted for, during the year ending December 31 next preceding, on policies or contracts of insurance written by the captive insurance company, after deducting from the direct premiums subject to the tax the amounts paid to policyholders as return premiums with respect to such preceding year only, which amounts shall include only dividends or distributions of unabsorbed premiums or premium deposits returned or credited to policyholders, up to a maximum tax for such year of $125,000; provided however, that no tax shall be due or payable as to consideration received for annuity contracts.

(b) Each captive insurance company, other than a sponsored captive insurance company (including a sponsored captive insurance company that is also a special purpose financial captive insurance company), and each protected cell of a sponsored captive insurance company shall pay to the Commissioner no later than March 1 of each year a tax at the rate of 1/10 of 1% on each dollar of assumed reinsurance premiums collected or contracted for, during the year ending December 31 next preceding, on policies or contracts of insurance written by the captive insurance company, up to a maximum tax for such year of $75,000; provided, however, that no such tax applies to premiums for risks or portions of risks which are subject to taxation on a direct basis pursuant to subsection (a) of this section, and no such tax shall be payable in connection with the receipt of assets in exchange for the assumption of loss reserves and other liabilities of another insurer under common ownership and control if such transaction is part of a plan to discontinue the operations of such other insurer and if the intent of the parties to such transaction is to renew or maintain such business with the captive insurance company.

(c) The annual minimum aggregate tax to be paid by a captive insurance company or a protected cell of a sponsored captive insurance company under subsections (a) and (b) of this section shall be $5,000 and the annual maximum aggregate tax to be paid by a captive insurance company or a protected cell of a sponsored captive insurance company under subsections (a) and (b) of this section shall be $200,000, provided, that the tax to be paid by a captive insurance company under subsections (a) and (b) of this section and this subsection is subject to subsections (d), (e) and (h) of this section.

(d) For all purposes of this section, 2 or more captive insurance companies under common ownership and control shall be taxed as though they were a single captive insurance company.

(e) For all purposes of this section, "common ownership and control" means the direct or indirect ownership of 80% or more of the outstanding voting securities or other voting interests of 2 or more captive insurance companies by the same person or persons.

(f) The tax provided for in this section shall constitute all taxes collectible under the laws of this State from any captive insurance company, and no other occupation tax or other taxes shall be levied on or collected from any captive insurance company by this State or any county, city or municipality within this State, except ad valorem taxes on real and personal property used in the production of income.

(g) The tax provided for in this section shall be calculated on an annual basis, notwithstanding that policies or contracts of insurance or contracts of reinsurance are issued on a multiyear basis. In the case of multiyear policies or contracts, the premium shall be prorated for purposes of determining the tax under this section.

(h) A captive insurance company that has 25 or more separate qualified individuals throughout a given tax year and that otherwise would be liable under this section for tax for such year in an amount exceeding $50,000 shall pay to the Commissioner under this section a tax for such year in the amount of $50,000. For purposes of this subsection, "qualified individual" means a natural person employed in this State on a regular basis of 35 or more hours per week either by such captive insurance company, or by a wholly-owned subsidiary of such captive insurance company that provides captive insurance company management, operating, investment or related services exclusively to such captive insurance company.

64 Del. Laws, c. 454, § 1; *67 Del. Laws, c. 155, § 1*; *75 Del. Laws, c. 150, § 1*; *76 Del. Laws, c. 161, § 9.*;

§ 6915. Rules and regulations; in general.

The Commissioner may establish and from time to time amend such rules and regulations relating to captive insurance companies as are necessary to enable the Commissioner to carry out the provisions of this chapter.

64 Del. Laws, c. 454, § 1; 70 Del. Laws, c. 186, § 1; 75 Del. Laws, c. 150, § 1.;

§ 6915A. Exemption from rules and regulations; special purpose captive insurance companies.

The Commissioner, on a case by case basis, may by order exempt a special purpose captive insurance company from the provisions of this chapter and any rule or regulation established by the Commissioner pursuant to § 6915 of this title that, as reasonably determined by the Commissioner based on such factors deemed relevant by the Commissioner consistent with the purposes of this chapter, are inappropriate to apply to such special purpose captive insurance company.

75 Del. Laws, c. 150, § 1.;

§ 6916. Applicable laws.

(a) No provisions of this title, other than those contained in this chapter or specifically referenced in this chapter, shall apply to captive insurance companies.

(b) Chapters 16, 18, and 50 and § 909 of this title shall apply to risk retention groups.

64 Del. Laws, c. 454, § 1; 75 Del. Laws, c. 150, § 1; 78 Del. Laws, c. 321, § 2[1].;

§ 6917. Captive insurance regulatory and supervision fund.

(a) There is hereby created a fund to be known as the captive insurance regulatory and supervision fund for the purpose of providing the financial means for the Commissioner to administer this chapter. All of the tax under § 6914 of this title and all other amounts received by the Department pursuant to this chapter shall be credited to this fund.

(b) At the end of each fiscal year, the balance in the captive insurance regulatory and supervision fund, in excess of such amount reasonably necessary to finance the Commissioner's administration of this chapter during the upcoming fiscal year, shall be transferred to the General Fund.

(c) Within 30 days after the end of each fiscal year, the Commissioner shall submit to the Secretary of Finance of this State a written report stating:

(1) The total amount of taxes and other amounts paid to the Department pursuant to this chapter during such fiscal year, and the total

amount of the Commissioner's costs and expenses to administer this chapter during such fiscal year; and

(2) The Commissioner's estimate of the total amount of the Commissioner's costs and expenses to administer this chapter during the current fiscal year.

75 Del. Laws, c. 150, § 1.;

§ 6918. Delinquency.

To the extent not inconsistent with this chapter, the provisions of Chapter 59 of this title shall apply to captive insurance companies licensed under this chapter (including for this purpose individual protected cells of sponsored captive insurance companies as set forth in § 6938 of this title).

75 Del. Laws, c. 150, § 1.;

§ 6919. Rules for controlled unaffiliated business.

The Commissioner may adopt rules establishing standards to ensure that a pure captive insurance company's parent or any of its affiliated companies is able to exercise control of the risk management function of any controlled unaffiliated business to be insured by the pure captive insurance company; provided, however, that, until such time as rules under this section are adopted, the Commissioner may approve the coverage of such risks by a pure captive insurance company, on a case by case basis.

75 Del. Laws, c. 150, § 1.;

§ 6920. Confidentiality.

All portions of license applications reasonably designated confidential by or on behalf of an applicant captive insurance company, all information and documents, and any copies of the foregoing, produced or obtained by or submitted or disclosed to the Commissioner pursuant to subchapter III of this chapter of this title that are reasonably designated confidential by or on behalf of a special purpose financial captive insurance company, and all examination reports, preliminary examination reports, working papers, recorded information, other documents, and any copies of any of the foregoing, produced or obtained by or submitted or disclosed to the Commissioner that are related to an examination pursuant to this chapter must, unless the prior written consent (which may be given on a case-by-case basis) of the captive insurance company to which it pertains has been obtained, be given confidential treatment, are not subject to subpoena, may not be made public by the Commissioner, and may not be provided or disclosed to any other person at any time except:

(1) To the insurance department of any state or of any country or

jurisdiction other than the United States of America; or

(2) To a law enforcement official or agency of this State, any other state or the United States of America so long as such official or agency agrees in writing to hold it confidential and in a manner consistent with this section.

75 Del. Laws, c. 150, § 1; *76 Del. Laws, c. 161, § 10.*;

§ 6921. Material changes in information; continued licensure.

In the event of any material change in the financial condition or management of a captive insurance company, the captive insurance company shall notify the Commissioner in writing promptly of any such change and in any event within 10 business days thereof.

75 Del. Laws, c. 150, § 1.;

§ 6922. Material transactions; prior notice.

No captive insurance company shall voluntarily take any of the following actions without providing the Commissioner at least 30 days prior written notice or receiving the Commissioner's approval of any such action within such 30 day period:

(1) The dissolution of the captive insurance company;

(2) Any sale, exchange, lease, mortgage, assignment, pledge or other transfer of or granting of a security interest in, all or substantially all of the assets of the captive insurance company;

(3) Any incurrence of material indebtedness by the captive insurance company;

(4) Any making of a material loan or other material extension of credit by the captive insurance company;

(5) Any material payment out of capital and surplus;

(6) Any merger or consolidation to which the captive insurance company is a constituent party;

(7) Any conversion of the captive insurance company to another business form;

(8) Any transfer to or domestication in any jurisdiction by the captive insurance company; or

(9) Any material amendment of the organizational documents of the captive insurance company.

75 Del. Laws, c. 150, § 1.;

§ 6923. Books and records.

(a) Unless otherwise approved by the Commissioner, a captive insurance company shall maintain its books, records, documents, accounts, vouchers and agreements in this State. A captive insurance company shall make its books, records, documents, accounts, vouchers and agreements available for inspection by the Commissioner at any time. A captive insurance company shall keep its books, records, documents, accounts, vouchers and agreements in such manner that its financial condition, affairs and operations can be readily ascertained and in such manner that the Commissioner may readily verify its financial statements and determine its compliance with this chapter.

(b) Unless otherwise approved by the Commissioner, all original books, records, documents, accounts, vouchers and agreements of a captive insurance company must be preserved and kept available in this State for the purpose of examination and inspection until the Commissioner approves the destruction or other disposition of the books, records, documents, accounts, vouchers and agreements. If the Commissioner approves the preservation and keeping of the foregoing outside this State, the captive insurance company shall maintain a complete and true copy of each such original in the State. Books, records, documents, accounts, vouchers and agreements may be photographed, reproduced on film or stored and reproduced electronically.

76 Del. Laws, c. 161, § 11.;

Publications

State Independently Procured Premium Taxes

9. Dow Chemical Company, Appellant v. Carole Keeton Rylander, Comptroller of Public Accounts of the State of Texas; and John Cornyn, Attorney General of the State of Texas, Appellees
   This case again declared Texas' independently procured premium tax unconstitutional.

   370 US 451 State Board of Insurance v. Todd Shipyards Corporation

Landmark U.S. Supreme Court case limiting a state's ability to tax a foreign domiciled insurer.

Captive Structuring

Humana, Inc. v. Commissioner 1 881 F.2d 247 (6th Cir. 1989) United States Court of Appeals for the Sixth Circuit Humana Inc., Petitioner-Appellant, v. Commissioner of Internal Revenue Respondent-Appellee
In this landmark case, the Service lost its "economic family" argument.
Gulf Oil Corp. v. Commissioner 914 F.2d 396, 66 A.F.T.R.2d 90-5552, 90-2 USTC P 50,496 (3rd Cir. 1990) United States Court of Appeals, Third Circuit.
Amerco, Inc. v. Commissioner 979 F.2d 162 (9th Cir. 1992) United States Court of Appeals, Ninth Circuit.
Sears, Roebuck & Co. v. Commissioner 972 F.2d 858 (7th Cir. 1992) United States Court of Appeals, Seventh Circuit.
Ocean Drilling & Exploration Co. v. 988 F.2d 1135 (Fed.Cir. 1993) United States Court of Appeals, Federal Circuit.
Malone & Hyde, Inc. v. Commissioner 62 F.3d 835 (6th Cir. 1995) United States Court of Appeals, Sixth Circuit.
Allgeyer v. Louisiana. No. 446. Supreme Court of the United States.
Connecticut General Life Insurance Co. v. Johnson, Treasurer of California. No. 316. Supreme Court of the United States.

- St. Louis Cotton Compress Company v. State of Arkansas. No. 120. Supreme Court of the United States.
- Susan Combs, Comptroller of Public Accounts of the State of Texas, and Greg Abbott, Attorney General of the State of Texas, Appellants v.STP Nuclear Operating Company, Appellee
- Kidde Industries, Inc. v. United States 40 Fed.Cl. 42 (Fed.Cl. 1997)
  Holds that Humana case applies to brother-sister subsidiaries and not divisions.
- United Parcel Service of America, Inc. v. Commissioner of Internal Revenue, 254 F.3d 1014 (11th Cir. 06/20/2001)
  In this significant case, the taxpayer's tax motivation for forming a captive was upheld in a $2 billion victory for the taxpayer.
- F. Income Tax Regulation 301.9100-1
  Relief under 301.9100-1 of the procedure and administrative regulations granting an extension of time to file election under 831 (b)2)(A)(ii).
- U. TREAS. REG. Section 1.337(d)-4 abd Exempt Organizations
  The IRS issued final regulations generally affecting a taxable corporation that transfers all or substantially all of its assets to a tax-exempt entity or converts from a taxable corporation to a tax-exempt entity in a transaction other than a liquidation.
- Rev. Rul. 2001-31, 2001-26 I.R.B. 1348 (6/25/2001)
  In this ruling, the IRS abandoned the "economic family" doctrine which the Service used to attack captive planning.
- Cumulative Bulletin Notice 2001-51, I.R.B. 2001-34, August 2, 2001
  On February 28, 2000, the Internal Revenue Service issued Notice 2000-15 , 2000-12 I.R.B. 826, identifying certain transactions as "listed transactions" for purposes of §1.6011-4T(b)(2) of the temporary Income Tax Regulations and §301.6111-2T(b)(2) of the temporary Procedure and Administration Regulations. This notice restates the list of transactions identified in Notice 2000-15 as "listed transactions" effective February 28, 2000, and updates the list by adding transactions identified in notices released subsequent to February 28, 2000.
- PLR 200242005
  Ruling on Risk Retention Groups.
- PLR 200242023
  Relief for late filed 953 (d) election granted under 301.9100-3(a).
- Tax Shelter Prop - TD 9017
  Tax Shelter Props. Regs.- The IRS has published temporary regulations (T.D. 9017)

that revise the categories of transactions that must be disclosed on returns under temporary reg. section 1.6011-4T.

- Part III - Administrative, Procedural, and Miscellaneous Certain Reinsurance Arrangements Notice 2002-70
  In this November 2002 pronouncement, the IRS announced that captive transactions utilizing certain reinsurance arrangements (so-called "PORCs") resulting in shifting of income will be "listed transactions" for purposes of Reg. Sec. 1.6011-4.
- Internal Revenue Bulletin: 2003-45 November 10, 2003
  In this publication, the IRS announced that it will now consider ruling requests on the tax treatment of captives.
- IRS Revenue Ruling 2002-89
  In this ruling, the IRS determined that where a captive derives 50% of its premiums from underwriting its parent's risks (with the other 50% of premium revenue from unrelated parties), there was sufficient risk distribution to constitute "insurance."
- IRS Revenue Ruling 2002-90
  In this pronouncement, the IRS ruled that a captive which insured 12 subsidiaries of a common parent, with no unrelated insurance underwriting, had sufficient risk distribution to constitute "insurance."
- IRS Revenue Ruling 2002-91
  In this ruling, the IRS determined that if within a group captive no one member's covered risks exceeded 15% of the group's total risks, then that captive possessed sufficient risk distribution to constitute "insurance."
- 2003 TNT 40-10
  Final Tax Shelter Regulations.
- Insurance Loophole Helps Rich
- Tiny Insurers Face Scrutiny As Tax Shields
- Notice 2003-34
  Notice 2003-34 – Insurance definition – offshore entities in hedge funds.
- Notice 2003-35
  Notice 2003-35- The purpose of this notice is to remind taxpayers that an entity must be an insurance company for federal income tax purposes in order to qualify as exempt from federal income tax as an organization described in 501 (c) (15).
- Internal Revenue Service (I.R.S.) Revenue Ruling Insurance, Federal Income Tax Purposes
  In this pronouncement, the IRS discusses the qualifications of certain arrangements as " insurance" for federal income tax purposes and specifically addresses the risk distribution requirement of a purported insurance contract under four fact scenarios listed in the ruling.
- Notice 2005-49 Qualification of Certain Arrangements as Insurance
  Notice 2005-49 comments on additional guidance concerning the standards for determining whether an arrangement constitutes insurance for federal income tax purposes.
- Section 23. Small Insurance Companies or Associations IRC 501(c)(15)
  IRS Manual on 501(c)(15) Insurance Companies.
- Determination of Gross Receipts for Purposes of Section 501(c)(15)
  Notice 2006-42 comments on The Determination of Gross Receipts for Purposes of Section 501(c)(15).
- Relief under 301.9100-3
  Relief under 301.9100-3 of the Procedure and Administrative Regulations granting an extension of time to file under election under section 831(b)(2))(A)(ii).”
- Rev. Rul 2007-47 was issued buy the US Internal Revenue Service on July 23, 2007
  This ruling holds that an arrangement that provides for the reimbursement of inevitable future costs does not involve the requisite insurance risk for purposes of determining (i) whether the amount paid for the arrangement is deductible as an insurance premium.
- IRS Issued Proposed Regulations
  IRS issued proposed regulations that provide guidance regarding the treatment of transactions involving obligations between members of a consolidated group and the treatment of transactions involving the provision of insurance between members of a

consolidated group.

- Internal Revenue Bulletin: 2008-5 February 4, 2008 Rev. Rul. 2008-8
  Revenue Rule 2008-8 explains how arrangements between an individual cell and its owner are analyzed for purposes of determining whether there is adequate risk shifting and risk distribution to constitute insurance.
- TAM 200816029 on Partnership Entities Counted For Risk Distribution Purposes
  TAM 200816029 on Partnership Entities Counted For Risk Distribution Purposes.

TAM 200827006

TAM 200827006 - Ruling discusses whether a manufacturer’s original product warranty risks covered by the Reimbursement Policies purchased by Taxpayer constitute insurable risks for federal tax purposes.

More Reading:

10. "Seeking Business, States Loosen Insurance Rules", *New York Times*, May 8, 2011
   "Own Your Own Insurance Company: Stewart A Feldman of Capstone Associated Services talks to Captive Review about why business owners should consider setting up a captive and how to go about it"Captive Review, Delaware Report 2011
   "Own Your Own Insurance Company: Physicians can control costs and increase profit potential via alternative risk management strategies"Plastic Surgery Practice
   "Managing the Middle Ground: Stewart A Feldman reveals the Fortune 1000 planning techniques now available for the middle market"Captive Review
   "The How and Why to Setting Up a Captive Insurance Company", InsuranceNewsNet Magazine,July 2010
   "Watch Your Assets", Barron's Cover,June 2010
   "Captivating Captives", Financial Planning,November 2009
   "Insurance Law", Texas Lawyer Roundtable Series,August 2009
   "Servicing the middle market", Captive Review,July 2009
   "Middle market captive growth", US Captive,April 2009

- "Captive Insurance Companies for Closely Led Businesses and Their Owners", Experience, Senior Lawyers Division American Bar Association, 2009
- "A Closer Look at Captive Insurance", The CPA Journal,June 2008
- "Captive insurance programs: Boon for middle-market companies", Houston Business Journal,February 1, 2008
- "Listed in Toronto, Based in Houston", Houston Chronicle,
  June 29, 2007
- "Capstone announces opening of trading of the largest Canadian
  IPO of 2007", Yahoo Finance, May 2007

"Insurance via 'Captives': Not as Sinister as It Sounds", The Wall Street Journal, March 27, 2007

THE CODE

IRC Section 831(b), allows a captive to be taxed as a small company (Small Insurance Company Tax Election). Under the 831(b) election, if the total gross premiums of the insurance company are less than the $1.2 million annually, then the company will only be taxed on its investment income. Since the 831(b) company does NOT pay tax on its premiums or underwriting profits, its reserves (for potential future risks) can grow tax efficiently.

IRC Section 162, is a basic customary and ordinary business expense code that allows insurance premium payments to be deducted as a business expense. Self Insured risks like business interruption, operating risks, litigation defense, credit default and natural disasters are an examples of deductions allowed under IRC 162.

IRC Section 953(d), allows a foreign domiciled captive reinsurance company (CRC) to receive the same US tax benefits and treatment as one formed in any of the US states that have captive legislation. Therefore, a captive reinsurance company that is formed, licensed, managed and operated outside the US can make an IRC section 953(d) election to be taxed as a domestic C corporation for US tax purposes. This election also allows foreign insurers to avoid exposure to branch profit taxes and the Section 4371 excise tax on premiums.

TITLE 26 > Subtitle A > CHAPTER 1 > Subchapter L > PART II > § 831
§ 831. Tax on insurance companies other than life insurance companies
(a) General rule
Taxes computed as provided in section 11 shall be imposed for each taxable year on the taxable income of every insurance company other than a life insurance company.
(b) Alternative tax for certain small companies (1) In general
In lieu of the tax otherwise applicable under subsection (a), there is hereby imposed for each taxable year on the income of every insurance company to which this subsection applies a tax computed by multiplying the taxable investment income of such company for such taxable year by the rates provided in section 11 (b).
(2) Companies to which this subsection applies (A) In general
This subsection shall apply to every insurance company other than life (including interinsurers and reciprocal underwriters) if—
(i) the net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed $1,200,000, and
(ii) such company elects the application of this subsection for such taxable year.
The election under clause (ii) shall apply to the taxable year for which made and for all subsequent taxable years for which the requirements of clause (i) are met. Such an election, once made, may be revoked only with the consent of the Secretary.
(B) Controlled group rules
(i) In general For purposes of subparagraph (A), in determining whether any company is described in clause (i) of subparagraph (A), such company shall be treated as receiving during the taxable year amounts described in such clause (i) which are received during such year by all other companies which are members of the same controlled group as the insurance company for which the determination is being made.
(ii) Controlled group For purposes of clause (i), the term "controlled group" means any controlled group of corporations(as defined in section 1563 (a)); except that—
(I) "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in section 1563 (a), and
(II) subsections (a)(4) and (b)(2)(D) of section 1563 shall not apply.
(3) Limitation on use of net operating losses
For purposes of this part, except as provided in section 844, a net operating loss (as defined in section 172) shall not be carried—
(A) to or from any taxable year for which the insurance company is not subject to the tax

imposed by subsection (a), or
(B) to any taxable year if, between the taxable year from which such loss is being carried and such taxable year, there is an intervening taxable year for which the insurance company was not subject to the tax imposed by subsection (a).
(c) Insurance company defined

IRC Section 953(d) Election by Foreign Insurance Company to be treated as domestic corporation

(d) **Election by foreign insurance company to be treated as domestic corporation** (1) **In general** If— (A) a foreign corporation is a controlled foreign corporation (as defined in section 957 (a) by substituting “25 percent or more” for “more than 50 percent” and by using the definition of United States shareholder under 953(c)(1)(A)),
(B) such foreign corporation would qualify under part I or II of subchapter L for the taxable year if it were a domestic corporation, (C) such foreign corporation meets such requirements as the Secretary shall prescribe to ensure that the taxes imposed by this chapter on such foreign corporation are paid, and
(D) such foreign corporation makes an election to have this paragraph apply and waives all benefits to such corporation granted by the United States under any treaty, for purposes of this title, such corporation shall be treated as a domestic corporation. (2) **Period during which election is in effect** (A) **In general** Except as provided in subparagraph (B), an election under paragraph (1) shall apply to the taxable year for which made and all subsequent taxable years unless revoked with the consent of the Secretary. (B) **Termination** If a corporation which made an election under paragraph (1) for any taxable year fails to meet the requirements of subparagraphs (A), (B), and (C), of paragraph (1) for any subsequent taxable year, such election shall not apply to any taxable year beginning after such subsequent
taxable year.
Except as provided in subparagraph (B), an election under paragraph (1) shall apply to the taxable year for which made and all subsequent taxable years unless revoked with the consent of the Secretary. (B) **Termination** If a corporation which made an election under paragraph (1) for any taxable year fails to meet the requirements of subparagraphs (A), (B), and (C), of paragraph (1) for any subsequent taxable year, such election shall not apply to any taxable year beginning after such subsequent taxable year. (3) **Treatment of losses** If any corporation treated as a domestic corporation under this subsection is treated as a member of an affiliated group for purposes of chapter 6 (relating to consolidated returns), any loss of such corporation shall be treated as a dual consolidated loss for purposes of section 1503 (d) without regard to paragraph (2)(B) thereof. (4) **Effect of election** (A) **In general** For purposes of section 367, any foreign corporation making an election under paragraph (1) shall be treated as transferring (as of the 1st day of the 1st taxable year to which such election applies) all of its assets to a domestic corporation in connection with an exchange to which section 354 applies. (B) **Exception for pre-1988 earnings and profit** (i) In general Earnings and profits of the foreign corporation accumulated in taxable years beginning before January 1, 1988, shall not be included in the gross income of the persons holding stock in such corporation by reason of subparagraph (A). (ii) Treatment of distributions For purposes of this title, any distribution made by a corporation to which an election under paragraph (1) applies out of earnings and profits accumulated in taxable years beginning before January 1, 1988, shall be treated as a distribution made by a foreign corporation. (iii) Certain rules to continue to apply to pre-1988 earnings The provisions specified in clause (iv) shall be applied without regard to paragraph (1), except that, in the case of a corporation to which an election under paragraph (1) applies, only earnings and profits accumulated in taxable years beginning before January 1, 1988, shall be taken into account. (iv) Specified provisions The provisions specified in this clause are: (I) Section 1248 (relating to gain from certain sales or exchanges of stock in certain foreign corporations). (II) Subpart F of part III of subchapter N to the extent such subpart relates to earnings invested in United States property or amounts referred to in clause (ii) or (iii) of section 951 (a)(1)(A). (III) Section 884 to the extent the foreign corporation reinvested 1987 earnings and profits in United

States assets. (5) **Effect of termination** For purposes of section 367, if— (A) an election is made by a corporation under paragraph (1) for any taxable year, and (B) such election ceases to apply for any subsequent taxable year, such corporation shall be treated as a domestic corporation transferring (as of the 1st day of such subsequent taxable year) all of its property to a foreign corporation in connection with an exchange to which section 354 applies. (6) **Additional tax on corporation making election** (A) **In general** If a corporation makes an election under paragraph (1), the amount of tax imposed by this chapter for the 1st taxable year to which such election applies shall be increased by the amount determined under subparagraph (B). (B) **Amount of tax** The amount of tax determined under this paragraph shall be equal to the lesser of— (i) 3/4 of 1 percent of the aggregate amount of capital and accumulated surplus of the corporation as of December 31, 1987, or (ii) $1,500,000.
(e) **Exempt insurance income** For purposes of this section— (1) **Exempt insurance income defined** (A) **In general** The term "exempt insurance income" means income derived by a qualifying insurance company which— (i) is attributable to the issuing (or reinsuring) of an exempt contract by such company or a qualifying insurance company branch of such company, and (ii) is treated as earned by such company or branch in its home country for purposes of such country's tax laws. (B) **Exception for certain arrangements** Such term shall not include income attributable to the issuing (or reinsuring) of an exempt contract as the result of any arrangement whereby another corporation receives a substantially equal amount of premiums or other consideration in respect of issuing (or reinsuring) a contract which is not an exempt contract. (C) **Determinations made separately** For purposes of this subsection and section 954 (i), the exempt insurance income and exempt contracts of a qualifying insurance company or any qualifying insurance company branch of such company shall be determined separately for such company and each such branch by taking into account— (i) in the case of the qualifying insurance company, only items of income, deduction, gain, or loss, and activities of such company not properly allocable or attributable to any qualifying insurance company branch of such company, and (ii) in the case of a qualifying insurance company branch, only items of income, deduction, gain, or loss and activities properly allocable or attributable to such branch. (2) **Exempt contract** (A) **In general** The term "exempt contract" means an insurance or annuity contract issued or reinsured by a qualifying insurance company or qualifying insurance company branch in connection with property in, liability arising out of activity in, or the lives or health of residents of, a country other than the United States. (B) **Minimum home country income required** (i) In general No contract of a qualifying insurance company or of a qualifying insurance company branch shall be treated as an exempt contract unless such company or branch derives more than 30 percent of its net written premiums from exempt contracts (determined without regard to this subparagraph)— (I) which cover applicable home country risks, and (II) with respect to which no policyholder, insured, annuitant, or beneficiary is a related person (as defined in section 954 (d)(3)). (ii) Applicable home country risks The term "applicable home country risks" means risks in connection with property in, liability arising out of activity in, or the lives or health of residents of, the home country of the qualifying insurance company or qualifying insurance company branch, as the case may be, issuing or reinsuring the contract covering the risks. (C) **Substantial activity requirements for cross border risks** A contract issued by a qualifying insurance company or qualifying insurance company branch which covers risks other than applicable home country risks (as defined in subparagraph (B)(ii)) shall not be treated as an exempt contract unless such company or branch, as the case may be— (i) conducts substantial activity with respect to an insurance business in its home country, and (ii) performs in its home country substantially all of the activities necessary to give rise to the income generated by such contract. (3) **Qualifying insurance company** The term "qualifying insurance company" means any controlled foreign corporation which— (A) is subject to regulation as an insurance (or reinsurance) company by its home country, and is licensed, authorized, or regulated by the applicable insurance regulatory body for its home
country to sell insurance, reinsurance, or annuity contracts to persons other than related persons (within the meaning of section 954 (d)(3)) in such home country, (B) derives more than 50 percent of its aggregate net written premiums from the issuance or reinsurance by such controlled foreign corporation and each of its qualifying insurance company branches of contracts— (i) covering applicable home country risks (as defined in paragraph (2)) of such corporation or branch, as the case may be, and (ii) with respect to which no policyholder, insured, annuitant, or beneficiary is a related person (as defined in section 954 (d)(3)), except that in the case of a branch, such premiums shall only be taken into account to the extent such premiums are treated as earned by such branch in its home country for purposes of such country's tax laws, and (C) is engaged in the insurance business and would be subject to tax under subchapter L if it were a domestic corporation. (4) **Qualifying insurance**

company branch The term “qualifying insurance company branch” means a qualified business unit (within the meaning of section 989(a)) of a controlled foreign corporation if— (A) such unit is licensed, authorized, or regulated by the applicable insurance regulatory body for its home country to sell insurance, reinsurance, or annuity contracts to persons other than related persons (within the meaning of section 954 (d)(3)) in such home country, and (B) such controlled foreign corporation is a qualifying insurance company, determined under paragraph (3) as if such unit were a qualifying insurance company branch. (5) **Life insurance or annuity contract** For purposes of this section and section 954, the determination of whether a contract issued by a controlled foreign corporation or a qualified business unit (within the meaning of section 989 (a)) is a life insurance contract or an annuity contract shall be made without regard to sections 72 (s), 101 (f), 817 (h), and 7702 if— (A) such contract is regulated as a life insurance or annuity contract by the corporation’s or unit’s home country, and (B) no policyholder, insured, annuitant, or beneficiary with respect to the contract is a United States person.
(6) **Home country** For purposes of this subsection, except as provided in regulations— (A) **Controlled foreign corporation** The term “home country” means, with respect to a controlled foreign corporation, the country in which such corporation is created or organized. (B) **Qualified business unit** The term “home country” means, with respect to a qualified business unit (as defined in section 989 (a)), the country in which the principal office of such unit is located and in which such unit is licensed, authorized, or regulated by the applicable insurance regulatory body to sell insurance, reinsurance, or annuity contracts to persons other than related persons (as defined in section 954 (d)(3)) in such country. (7) **Anti-abuse rules** For purposes of applying this subsection and section 954 (i)— (A) the rules of section 954 (h)(7) (other than subparagraph (B) thereof) shall apply, (B) there shall be disregarded any item of income, gain, loss, or deduction of, or derived from, an entity which is not engaged in regular and continuous transactions with persons which are not related persons, (C) there shall be disregarded any change in the method of computing reserves a principal purpose of which is the acceleration or deferral of any item in order to claim the benefits of this subsection or section 954 (i), (D) a contract of insurance or reinsurance shall not be treated as an exempt contract (and premiums from such contract shall not be taken into account for purposes of paragraph (2)(B) or (3)) if — (i) any policyholder, insured, annuitant, or beneficiary is a resident of the United States and such contract was marketed to such resident and was written to cover a risk outside the United States, or (ii) the contract covers risks located within and without the United States and the qualifying insurance company or qualifying insurance company branch does not maintain such contemporaneous records, and file such reports, with respect to such contract as the Secretary may require,
(E) the Secretary may prescribe rules for the allocation of contracts (and income from contracts) among 2 or more qualifying insurance company branches of a qualifying insurance company in order to clearly reflect the income of such branches, and (F) premiums from a contract shall not be taken into account for purposes of paragraph (2)(B) or (3) if such contract reinsures a contract issued or reinsured by a related person (as defined in section 954 (d)(3)).
For purposes of subparagraph (D), the determination of where risks are located shall be made under the principles of section 953. (8) **Coordination with subsection (c)** In determining insurance income for purposes of subsection (c), exempt insurance income shall not include income derived from exempt contracts which cover risks other than applicable home country risks.
(9) **Regulations** The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection and section 954 (i). (10) **Application** This subsection and section 954 (i) shall apply only to taxable years of a foreign corporation beginning after December 31, 1998, and before January 1, 2007, and to taxable years of United States shareholders with or within which any such taxable year of such foreign corporation ends. If this subsection does not apply to a taxable year of a foreign corporation beginning after December 31, 2006 (and taxable years of United States shareholders ending with or within such taxable year), then, notwithstanding the preceding sentence, subsection (a) shall be applied to such taxable years in the same manner as it would if the taxable year of the foreign corporation began in 1998. (11) **Cross reference** For income exempt from foreign personal holding company income, see section 954 (i).

DISCLAIMER

The information herein is general in nature, and may not be relied on for any specific use. The content herein (including graphics) does not purport to show all details and complexity in establishing a compliant captive or alternative risk transfer programs.

We are not engaged in rendering tax or legal services or advice. Please consult your attorney and tax professional.

Disclosure under IRS Circular 230: The information and services offered are not intended to and do not comply with the U.S. Treasury Department's technical requirements for a formal legal opinion, and cannot be used by a taxpayer to avoid any penalty that might be imposed on a taxpayer. Nothing herein may be used in promoting, marketing or recommending an investment plan or arrangement.