Eating and Sleeping Better with a Captive Insurance Company*

By Tim Voorhees and Sunny Boren

Tim Voorhees and Sunny Boren discuss how Captive Insurance Companies (Captives) are one of the best tools for minimizing both transfer taxes and income taxes. The authors suggest that clients with successful companies consider how they can accumulate income from their businesses tax–efficiently in Captives that are owned by trusts outside their estates.

Practical estate planning requires sensitivity to all of the tax issues that concern clients. Many of the most effective transfer tax reduction tools require careful analysis of after-tax cash flows. Calculation of projected future cash inflows and outflows requires awareness of income tax deductions and liabilities. As income tax rates rise, clients increasingly ask for plans that reduce estate, gift, and generation skipping taxes while also minimizing income taxes.

One of the best tools for minimizing both transfer taxes and income taxes is the Captive Insurance Company (Captive). Clients with successful companies should consider how they can accumulate income from their businesses tax efficiently in Captives owned by trusts outside of their estates.

As when designing and drafting all estate planning instruments, the planners creating the Captive must always respect the public policy reasons allowing for formation of the entity. The Captive exists primarily to manage risks and help company owners sleep better at night. Nonetheless, Congress rewards Captive owners with substantial tax benefits that can help the owners and their beneficiaries eat better as well.

The first part of this article will suggest how a business owner should evaluate the feasibility of using a Captive to manage risks, protect assets from creditors, grow wealth tax efficiently, diversify assets, transfer wealth to beneficiaries, and transfer values to heirs. The second part of this article will review how a client designing and implementing a Captive should coordinate advisors managing the Captive, track next actions, and measure costs and benefits. The article concludes with a case study supported with exhibits that document a typical client situation.

Evaluating the Feasibility of a Captive

Clients with businesses producing more than $600,000 of taxable income annually should evaluate the feasibility of using a Captive to self-insure against risks. The Internal Revenue Code provides attractive tax incentives to encourage companies to set aside some of their taxable income in reserves that can cushion the business from risks that might cause disruptions of jobs or hurt the economic well-being of a community.

Captives can provide coverage when insurance is currently commercially unavailable or commercially overpriced. The Captive can reduce a company's risk

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of expenses related to 1) gaps in existing coverage, 2) large deductibles on existing coverage, 3) "excess" protection costs, or 4) remote risk expenses, such as those created by the loss of a key employee, litigation expense, or directors' and officers' liability.

The Captive reserves can grow with minimal creditor risk because the Captive is a C Corporation with the limited liability benefits afforded all such entities. Moreover, it is common to form the C Corporation inside of an asset protection trust that can shield assets from bankruptcies, lawsuits, divorces, and misguided caregivers.

The Captive is funded with money that would otherwise be lost to taxes. Businesses can deduct up to $1.2M of insurance premiums each year and grow these funds in a tax-efficient investment vehicle for retirement income or family wealth transfers. All premiums paid to the Captive are deductible as Code Sec. 162 business expenses. Moreover, when the Captive receives the premium payments, it does not have to pay taxes on the money because of provisions in Code Sec. 831(b).

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Captives perform best when reserves grow tax-efficiently with good risk-adjusted returns in a diversified portfolio. It is wise to document tax and investment issues in an Investment Policy Statement (IPS) because the Uniform Prudent Investor Act requires that portfolios managed for the benefit of others have prudent written standards. The Captive IPS should address your desired investment returns, tax constraints, liquidity needs, and risk tolerances. Because Captives operate in an environment impacted by income and transfer taxes, a seasoned Captive advisor should draft the IPS to examine likely returns after income, capital gain, estate and gift taxes.

Captives can allow for tax-efficient wealth transfer to heirs or even a surviving spouse. If an irrevocable trust owns the Captive, every premium dollar paid into the Captive may constitute a tax-free transfer from the taxable estate. Having a Captive gives the business owner flexibility regarding the portion of the wealth accumulated in the business for the benefit of heirs who will own the business. One child might receive equity and control of the family business while children not receiving ownership and control may inherit interests in a Captive funded with income from the business. The Captive may be owned by a trust designed to equalize the inheritance amounts for family members who do not receive equity in the business.

The trust owning the Captive can have dynasty trust stipulations, incentive clauses, and other provisions designed to pass values from generation to generation. Beneficiaries of the trust would need to honor the values that helped accumulate the value in the trust. Moreover, the Captive or life insurance funded with Captive reserves can provide for replacement of key managers who uphold and further the values of the family.

Just like a business needs a business succession plan, Captive managers should plan for an eventual exit strategy. A governance committee should execute a business plan, help the Captive pay claims wisely, employ professionals for the Captive's annual audit, monitor actuarial studies, and oversee filing of tax returns with an eye on the need to transition Captive assets to successor owners at the appropriate future time. This need to plan for the wise transfer of the Captive and/or assets in the Captive sets the stage for discussions about the integration of life insurance strategies with business succession plans involving Captives.

The Captive feasibility study should address all of the above risk management, asset protection, tax efficient growth, diversification, and wealth transfer issues. To initiate the feasibility study, experienced professionals should help gather and review copies of existing insurance policies, tax returns, and other corporate documents. The feasibility study should clarify current and potential costs related to current insurance coverage as well as the benefits of forming a new Captive. Assuming there is a clear value proposition related to funding a Captive, advisors should proceed with the design and implementation phase.

Designing and Implementing a Captive

The design of a Captive may involve consideration of myriad diverse income tax, estate tax, risk management, investment, wealth transfer, and legacy issues. Evaluating the benefits of a Captive requires a careful assessment of many interrelated variables. The planning team designing and implementing the Captive needs members who have demonstrated expertise in all of the following seven areas:

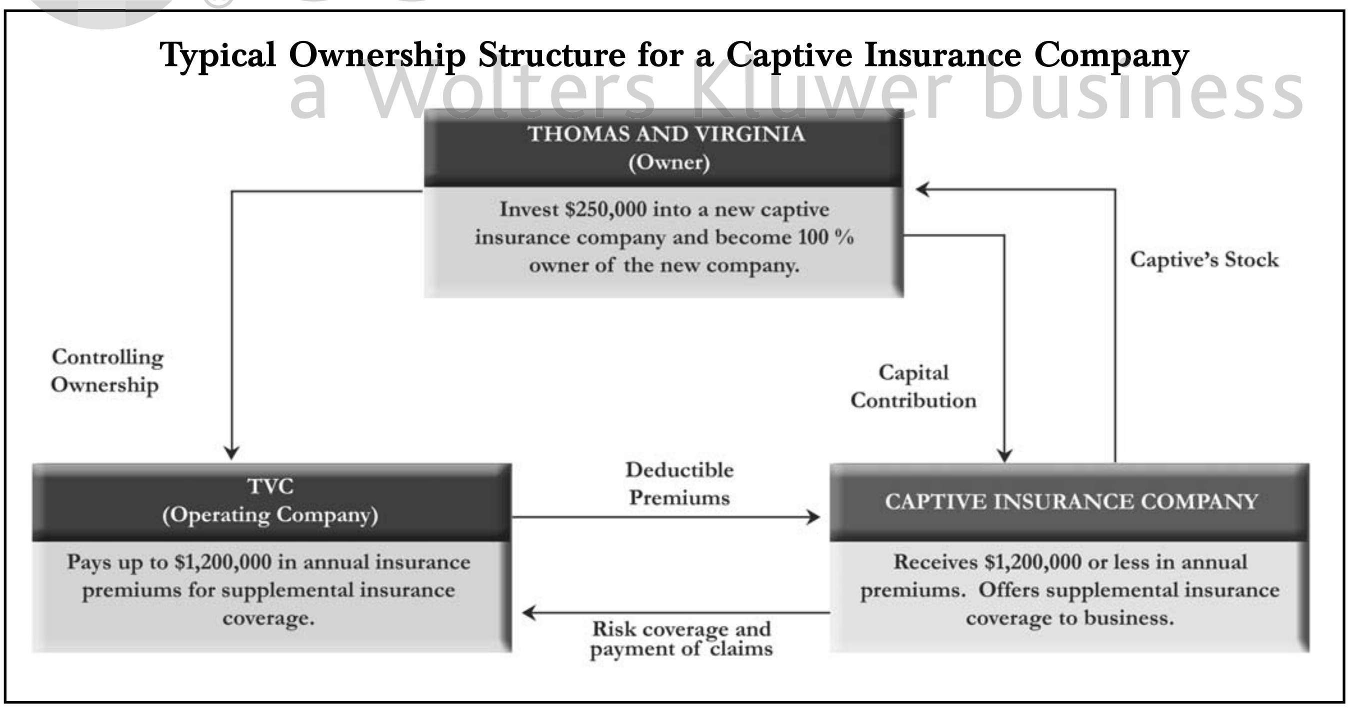
- **Plan design.** Ideally, the Captive illustration should include detailed cash flow projections for the CPAs, summaries of legal documents for the attorneys, and flow charts for the client.
- **Plan administration.** The Captive formation process requires focused attention to next action steps, ideally using Web-based project management systems.
- **Tax law expertise.** The formation and performance of a Captive requires knowledge of numerous tax issues.
- **Captive regulations.** Different jurisdictions have varying rules for managing Captives and operating the trusts that own the Captives. Advisors should understand clients well enough to know which structures best meet clients' needs.
- **Property/casualty insurance.** Advisors should know when to maintain commercial insurance and when to self-insure with a Captive.
- **Investments.** The IPS should clarify how captive funds are available for claims even if invested to fund buy-sell agreements, retirement planning programs, and wealth and estate planning strategies.
- **Life insurance.** Experienced agents can illustrate how life insurance policies may provide better tax, investment, and liquidity benefits than are available through non-insurance investments.

The Captive implementation process requires focused attention on next action steps. To keep planning team members communicating efficiently and effectively, all advisors should use a web-based project management program. Such a system allows for 24/7 updates regarding the status of each step in the formation, drafting, funding, and administration processes. As advisors from different disciplines "virtually look over the shoulder" of one another, they can help keep implementation on tight timelines while guarding against neglect of any important regulatory details.

Planning team members should draft a Captive business plan that addresses key governance, management and investment policies to guide the Captive managers. Once the business plan is ready, advisors should submit a formal application to the appropriate insurance regulators. After the regulators issue a license to operate the Captive, the advisor should fund the Captive with capital according to guidelines in the Captive's IPS. The investment manager may recommend life insurance as an asset class so that funds in the Captive can grow tax-efficiently to fund an exit strategy, while providing ample liquidity to pay claims.

During the implementation process, advisors can update the feasibility study with actual costs

Exhibit 1.



and benefits. Initial costs of the feasibility study normally credit toward Captive formation fees. Clients should see how the actual benefits of a Captive substantially outweigh the formation and administration fees.

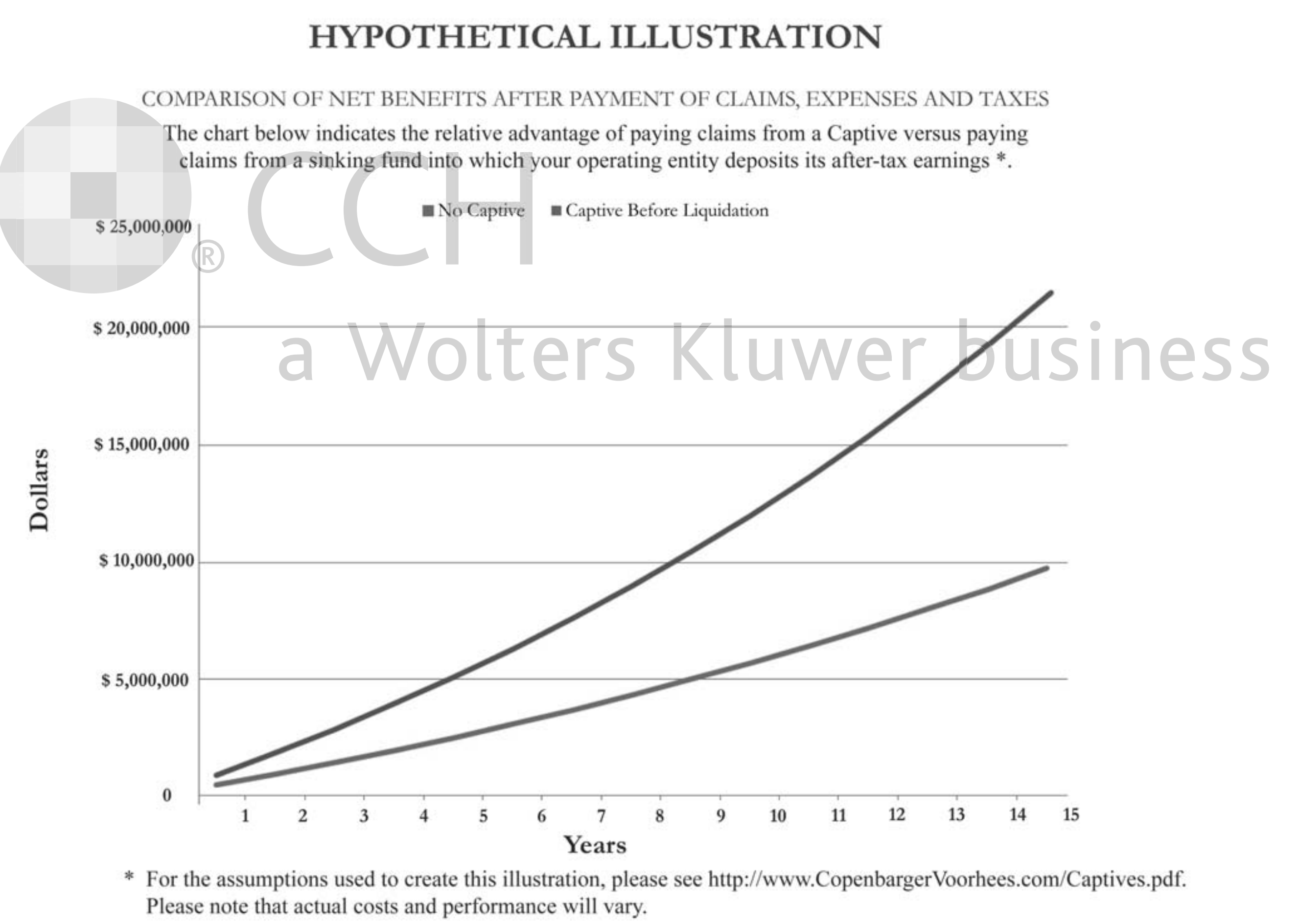
Case Study

Exhibit 1 is a flowchart of a typical Captive's ownership and operation structure. Thomas and Virginia contribute $250,000 of initial capital to the Captive during the formation process. Each year, the Captive manager performs an analysis regarding the types and amounts of insurance requested by TVC. When TVC pays premiums to the Captive, TVC takes an income tax deduction. The Captive, however, does not recognize taxable income upon receipt of the first $1.2M of premiums, but only upon receipt of any net investment income exceeding the annual addition to the reserve for losses.

For a visual comparison of the relative advantage of using a Captive versus simply reinvesting the after-tax earnings of your operating business into a sinking fund, see Exhibit 2. This graphic shows benefits that can vary significantly as claims change. Advisors should customize this graphic based on reasonable assumptions about each business considering a Captive.

Clients often pay significant fees for the formation of a Captive because creating a Captive requires specific expertise, years of experience, and a strong relationship with the Captive insurance regulator of the jurisdiction where the Captive will be domiciled. Nonetheless, advisory fees, even when combined with costs payable to third parties, normally total less than ten percent of tax savings.[1] More important, note the sub-

Exhibit 2.



stantial potential wealth accumulation using a Captive: A full $10M difference exists between the Captive's total assets and the total assets held by the sinking fund at the end of year 15, as shown in Exhibit 2.

Perhaps the greatest benefits of the Captive relate to the role of self-insurance in transferring a business to the next generation. A family can evaluate which management, legal, economic and/or technological issues might disrupt the business and then insure against them. For example, if the family patriarch has concerns about the proper succession of qualified managers, Captive funds can help maintain adequate key man life insurance. Such insurance may include high cash value to pay claims as well as ample death benefit to replace key managers. The owner or chief executive of a business can use much creativity in designing the Captive to insure against circumstances that might disrupt a multi-generational plan to help a family build wealth and influence.

Conclusion

A Captive can help clients sleep better by insuring against the risks that keep so many business people lying awake at night. Proper design of the Captive should also help clients eat better during retirement while transferring more wealth to family members and/or favorite charities. Guidelines in the above article can help clients address key issues while delegating Captive formation, drafting, funding, and administration issues to appropriate professionals.

Because the cost of a Captive feasibility study normally represents only a very small portion of the tax savings and other benefits, business owners should consider having a qualified expert evaluate the economic benefits of having the business fund a Captive Insurance Company. Moreover, business owners should work with seasoned advisors to integrate the Captive into legacy plans because of how the Captive can accumulate value across the generations while helping family members maintain the values that help it achieve business success.

Endnotes

* Readers of this article should consult with independent advisors regarding the tax, accounting and legal implications of the proposed strategies before any strategy is implemented. Nothing in this article is intended to offer securities or investment advice. Tax and regulatory rules affecting strategies in this article may change often and have varying interpretations. To the extent that this material concerns tax matters, it is not intended to be used and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed by law.

1 Fees and expenses are generally less than 10 percent of the income tax savings if the operating company purchases policies with premiums totaling the $1.2M maximum each year. If only $600,000 of premiums is funded per year, the total Captive fees and costs should be less than 25 percent of tax savings. All fees and expenses are typically fully deductable by the operating business.