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SOLUTIONS BEYOND THE OBVIOUS

Captive Insurance

April 9, 2025

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Tool Bar Handouts

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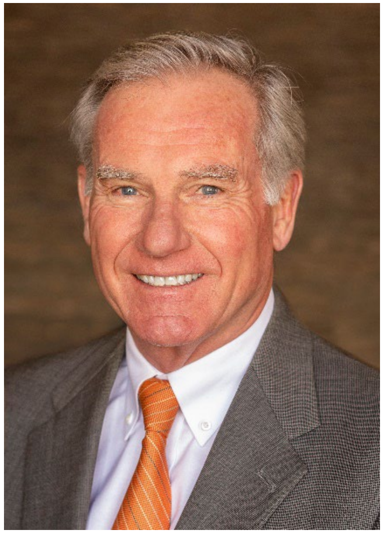
Today's Presenter



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Poll Question #1:

How many of you have seen significant increases in your insurance premiums both personal and business related in the past few years

Poll Question #2:

How many of you in managing your own auto, homeowners, or health insurance have opted for a high-deductible insurance plan?

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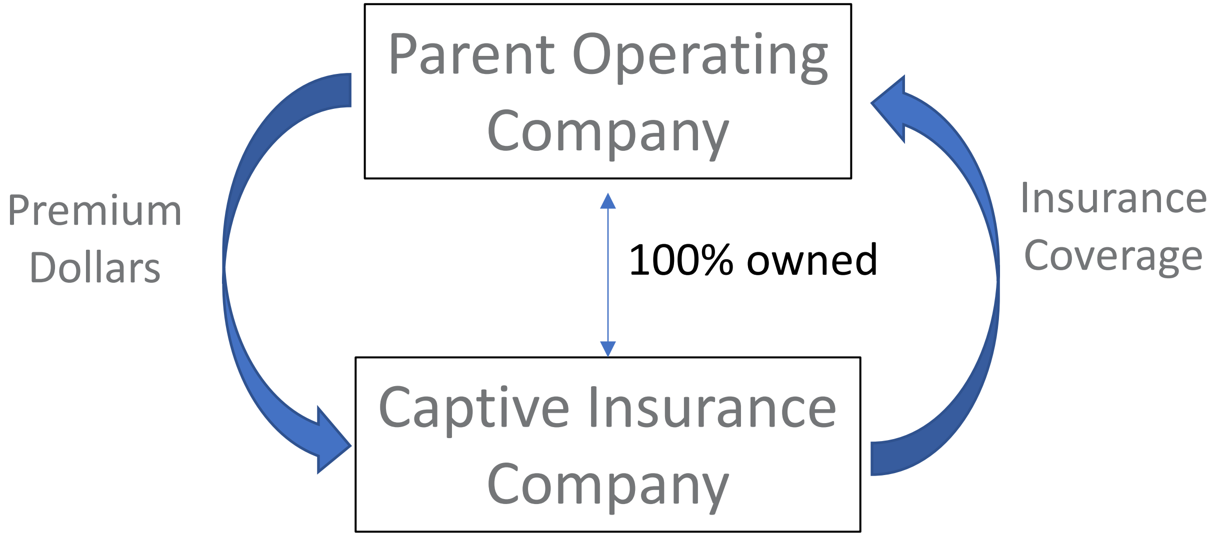
Agenda

- History of Captives
- Captives and The IRS
- Who Should Form a Captive
- Benefits of Forming a Captive
- Micro Captives 831(b)
- Steps to Forming and Running a Captive and Costs
- Case Studies
- Appendix: History of Captives from Inception to Present

History of Captives

- The concept is attributed to an Ohio insurance agent Fred Reiss who in the 1950's in response to skyrocketing commercial insurance policies figured out Youngstown Sheet and Tube could set up its own insurance company to insure its coke and iron mines
- The concept became very popular in many industries as a way to reduce insurance costs and to cover risks that were uninsurable in the traditional markets
- See Appendix at end for more details

Typical Captive Structure



Key Benefit: Captive can deduct reserves for losses, parent company can not

Captives and the IRS

- IRS fought captives for over 30 years.
- IRS used three arguments consistently.
  - Economic family-lack of risk shifting outside the group.
  - Nexus of contracts
  - Assignment of income-not a valid premium
- Although some of these were successful in lower court rulings ultimately none of the arguments succeeded
- IRS has been successful in abusive situations
  - Unrealistic risks and premiums
  - Failure to meet the definition of insurance

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The Harper Standards

- Whether the arrangement involves the existence of "insurance risk"
- Whether there was both risk shifting and risk distribution
- Whether the arrangement was for "insurance" in its commonly accepted sense
- Subjective-"Duck" test- does the company "walk and talk" like an insurance company

Safe Harbor Guidelines

- In the wake of all the litigation the IRS issued a number of rulings essentially waving the white flag and saying let's create some rules that everyone can follow and create some certainty of outcomes for taxpayers by codifying what they believed to be the acceptable standards as established in the courts
  - RR 2001-31 Abandoned the economic family theory
  - RR 2002-89 Established 50% unrelated risk as the standard
  - RR 2002-90 Established the 12 subsidiary test
  - RR 2002-91 Approval of homogenous unrelated group captive arrangements

Who Should Form a Captive

- A company that has an above-average risk profile
- A company or individual with the financial resources to contribute to a captive
- Company should have the right combination of income and risk
  - $3m in gross revenues
  - $300,000 in insurance premiums

What Types of Companies are Best Suited for a Captive

- Doctors and other professionals with malpractice exposure
- Manufacturers
- Auto dealers
  - Extended warranty policies.
- Exporters and Importers
- Real estate developers
  - Multiple legal entities provide risk distribution

What Types of Companies are Best Suited for a Captive (con't)

- Dry cleaning- environmental risks
- Construction related professions
  - Contractors
  - HVAC
  - Electrical
  - Plumbing
- Oil & Gas
- Hotels, Motels, Restaurants

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What Types of Companies are Best Suited for a Captive (con't)

- Transportation
  - Trucking
  - Bus
  - Rental
- Any company that provides some form of guarantee or warranty to its customers along with the goods or services it offers for sale

What are the Benefits of Forming a Captive

- Customize Insurance Policies
  - The Beech Aircraft case
  - Use individual loss experience to determine premium rates
- Insured gains negotiating leverage with third party insurers
  - Third party insurer insures standard risks-low volume high frequency risks – predictable premiums
  - The captive insures specialty risks-high volume low frequency risks – unpredictable premiums

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What are the Benefits of Forming a Captive (con’t)

- Can be used as a wealth transfer vehicle
  - Captive ownership to next generation
- Small Insurance Company Taxation-IRC Section 831 (b)
  - Less than $2.8m in premiums for 2024
  - Taxed on investment income only, not on underwriting income

Micro Captives 831 (b)

- The insured entity lowers its taxable income by the amount of premiums paid to its owned insurance company
- The premiums received by the insurance company are part of the company's underwriting income, which under 831(b) is not taxed
- After the non-taxed underwriting income and the taxable investment income have accumulated the captive shares can be sold or liquidated at capital gains rates
- This achieves both tax rate arbitrage and tax deferral

Recent IRS activity on “Abusive Microcaptive Strategies”

- Microcaptives added to IRS “Dirty Dozen” scams to watch out for
- IRS Notice 2016 – 66 requires disclosures by captives, owners and advisors
- Avriahami Case taxpayer defeat, however the arrangement was seriously flawed in its design

Recent IRS Activity on "Abusive Micro Captive Strategies" (con't)

- April 2023 IRS obsoleted Notice 2016-66 in response to mounting industry objections and court losses. And issued proposed regulations.
- January 2025, Treasury published the final regulations making substantial changes in response to industry comments.
- The regulations are an attempt to set forth standards that will identify potentially abusive situations and impose upon the participants significant tax shelter reporting requirements and the potential for significant fines in an effort to disincentivize participation.

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Summary of the Final Regulations

- Captive as Defined by the Regulations
  - Made the election under 831(b) to be taxed on investment income only
  - Issued insurance or reinsurance contracts
  - 20% common ownership with insured or related parties

Two types of captive arrangements that are subject to its requirements

- Listed Transactions: (The more serious abusive arrangement) 2 Requirements
  - Financing Arrangement

    Any arrangement such as a loan or a collateral agreement whereby the insured company or the active owner receives a direct or indirect benefit from the captive's investments, without incurring tax. AND,
  - Loss Ratio

    If the captive has paid less than 30% of its premiums out in losses over a 10-year period, this test is met. Cannot be met until it's been in existence for at least 10 years.

Two types of captive arrangements that are subject to its requirements (con’t)

- Transaction of Interest
  - Financing Arrangement

    Any arrangement such as a loan or a collateral agreement whereby the insured company or the active owner receives a direct or indirect benefit from the captive’s investments, without incurring tax. OR,

  - Loss Ratio

    If the captive has paid less than 60% of its premiums out in losses over a 10-year period, this test is met. Can be met before 10 years if it’s not been in existence for at least 10 years

By definition, a listed transaction will be a transaction of interest, but a transaction of interest will not necessarily be a listed transaction.

Exceptions to These Rules

- Homogeneous Industry Group Captives
  - By virtue of the nature of such groups and their ownership across a group of unrelated parties in the same industry, they would not meet the third requirement of the definition of a captive for purposes of the regulations

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Exceptions to These Rules (con't)

- Seller's Captive (Extended Warranties on Sold Products or Services)
  - 1. Captive is related to the "seller" through common ownership
  - 2. Captive insures risks of unrelated customers of seller
  - 3. 100% of the insurance business is related to risks associated with the products or services sold by seller
  - 4. 95% of the business is with customers unrelated to seller

Disclosure Requirements

- IRS form 8886 “Reportable Transaction Disclosure Statement”
- Filed by the captive, all captive owners, insureds, intermediaries, material advisors
- Captive must provide details on the types of policies written, contact information for actuaries and underwriters used, etc.
- Must be filed with tax returns for each year of participation and also filed with IRSs Office of Tax Shelter Analysis (OTSA)
- Can avoid filing 8886 by revoking the 831(b) election

Steps to Forming a Captive

- A feasibility study is performed by a captive advisor which has three objectives
  - Provide a blueprint for the captive program
  - Provides assurance that the program complies with relevant insurance and tax laws
  - Provides key decision makers with the tools needed to assess the plan

Steps to Forming a Captive (con't)

- A jurisdiction must be determined- US State or Foreign (Bermuda, Cayman Islands). The regulators in the selected jurisdiction will consider (Vermont, Utah, North Carolina, Hawaii) (Bermuda, Bahamas, Cayman Islands)
  - The character, reputation, financial standing and purposes of the incorporators
  - The character, reputation, financial responsibility, insurance experience, and business qualifications of the officers and directors
  - And such other aspects as the insurance regulators shall deem to be relevant

Steps to Forming a Captive (con’t)

- The applicant will need to make a formal application to establish an insurance company in the chosen jurisdiction. The applications vary from jurisdiction to jurisdiction but will generally include: (The use of outside professional managers generally serves to meet many of these requirement)
  - The amount and description of its assets relative to the risks to be assumed
  - The adequacy of the expertise, experience and character of the persons who will manage it
  - The overall soundness of its plan of operation

Steps to Forming a Captive (con’t)

- The adequacy of loss-prevention programs of its member parent, member organizations, or industrial insureds as applicable
- Other factors considered relevant by the regulators in ascertaining whether the proposed captive insurance company will be able to meet its policy obligations
- Capitalization will need to be determined based on premium volumes and expected risks to ensure a sound financial structure

Running the captive-Outside professionals needed

- Domicile manager
- Legal counsel
- Audit requirement
- Actuarial services
- Investment manager

Circumstances that will Lead to Shutting Down the Captive

- Insolvency or impairment of capital and surplus
- Failure to submit annual report on a timely basis
- Failure to comply with its own governing documents, articles, bylaws, etc.
- Failure to submit to an examination by the insurance commissioner
- Refusing to pay the cost of an examination
- Failure to comply with captive statutes in the jurisdiction

Fees

- Start-up $25,000- $50,000
- Ongoing annual fees $15,000- $20,000. (not including reinsurance, risk distribution, accounting and tax fees)

Case Study #1

- Profile: Specialty retailer offering product warranties to customers for an additional cost
  - Issue: Able to defer income recognition on warranty premiums received as "advanced payments", but carrying a substantial liability for "unrecognized advance payments". Company sought a way to reduce these liabilities and transfer the risk of future losses to another related entity for purposes of dealing with the users of its audited financial statements
  - Solution: Establish a captive insurance company to assume the risk on policies sold in prior years and remove the unrecognized revenue and cash from the balance sheet

Case Study #2

- Profile: Distribution company with large workforce vehicle fleet and substantial workers compensation, general liability and auto insurance premiums
  - Issue: Seeking ways to reduce third party insurance costs
  - Solution: Join a group captive that pools the risks of companies in a similar industry but that have better than average loss experience. The group captive is able to offer the same coverage at a substantially lower premium, because it only accepts companies into the group that have a superior loss experience track record. The company essentially captures some of the underwriting profits the third-party insurer was earning on their book of business

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Case Study #3

- Profile: Automobile dealer selling extended service warranty plans on the used cars that they sell
  - Issue: Company wishes to participate in the underwriting profits of this line of business which are significant and to also transfer wealth to the next generation
  - Solution: Establish multiple 831(b) companies with ownership spread across various members of the third generation. These companies assume a portion of the service warranty premiums along with the related risk and earn the resulting underwriting profits. Underwriting income is not subject to tax as a result of 831 (b) and so these profits accumulate tax free until such time as they are distributed as dividends, or the insurance company is dissolved or sold

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Questions

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