

# BUSINESS LAW TODAY

## A Growing Multidisciplinary Practice: Captive Insurance and Wealth Planning

By [Edmond M. Ianni](#)

A multidisciplinary practice in the United States has been growing in the converging space of captive insurance and wealth planning. Risk management and capital preservation/growth have been the bridge connecting these traditionally unintegrated spaces. Recognizing this evolving practice, the American Bar Association (through its Real Property, Trust and Estate Law Section) held its first webinar on this multidisciplinary topic in 2009. This practice is robust across the United States – and has been accelerated by increasing client demand for risk management and tax-advantaged wealth management strategies, especially in this weak economy and post-American Taxpayer Relief Act of 2012 environment. This article will provide a summary overview of this practice, describing captive insurance in the United States and how it is being integrated with wealth planning.

### The Business Context

Privately held businesses and high-net-worth families in the United States have been particularly active in establishing their own captive insurance companies as part of a comprehensive risk and wealth management program. In a study by McKinsey & Company, “wealth management”

was one of five attributes identified for a successful family business, and an integrated “strong risk-management culture” was noted as a principal driver. Considering some statistics, this should not be a surprising observation. Over 80 percent of U.S. businesses are family firms (i.e., a business owned and/or controlled by a family). Most of individual wealth in the United States is concentrated in family businesses. Family businesses are a main driver of the U.S. economy, accounting for approximately 60 percent of the country’s employment and approximately 50 percent of U.S. GDP. In the United States, more than \$40 trillion of assets – much of which are business assets – are expected to transfer intergenerationally in the next four decades. Risk management and wealth management understandably have become integral needs in this context.

Privately held businesses and their owners increasingly have turned to captive insurance companies (or simply “captives”) as a combined risk/wealth management strategy. While the precursor to the modern captive traces its history to 16th century London, the term “captive” was coined in the 1950s to name a self-insurance arrangement for mining operations in the United

States. Today, there are over 5,000 captives worldwide, of which more than 1,000 are domiciled in the United States. Many Fortune 1000 businesses, for example, have established their own captives. The growth of captives in the United States continues, particularly in the converging risk and wealth management space.

### Nature of a Captive

Captive insurance is a form of private risk transfer and coverage. Captive insurance essentially involves the transfer of specified business risks from an enterprise to a separate, typically private legal entity (the captive insurer), which economically assumes those risks and is financially responsible for any losses resulting from the realization of those risks. The captive insurer, not the captively-insured enterprise, therefore is responsible for payment of claims on those losses. Depending on the applicable jurisdiction’s laws, a captive may be formed as a corporation, limited liability company, statutory trust, partnership, association, or some other legal form.

A captive generally is regulated by the state of its domicile. In the United States, the majority of states and the District of Columbia currently have captive insurance

laws on their books. State laws are not uniform in this area and, therefore, differ across the country with respect to permissible captive structures, capitalization requirements, licensing and other regulatory issues.

### **Business Purpose: Risk Management**

A captive must have a business purpose in order to be a proper captive insurance company. The underlying business purpose of a captive is risk management: it is designed to cover specified risks facing a business. Those risks may be ones for which commercial insurance coverage is unavailable or prohibitively expensive, such as terrorism risk or environmental liability risk. They may be risks for which commercial insurance does not typically cover, such as employee benefit risk (e.g., healthcare benefits), credit risk, business interruption risk, and equipment warranty liability. The vast majority of existing captives have been established to insure mainstream property and casualty (or “P&C”) risks, including general liability, workers’ compensation, directors and officers liability, product liability, errors and omissions liability, automobile liability, builder’s risk, marine risk, employment practices liability, and professional liability (e.g., medical malpractice).

Building on a risk management purpose, captives are formed for different strategic reasons. They may include, for example: providing insurance coverage for a tranche of business risks that a commercial carrier is unwilling to insure; reducing the costs of the business’ insurance program; captively insuring self-retained risks, such as the deductibles under existing commercial insurance coverage; replacing variable, more expensive commercial premiums with a steadier, less expensive captive premium cashflow; qualifying for direct access to the reinsurance market and its wholesale rates; or simply enhancing the efficiency and effectiveness of a business’ insurance and risk management program.

By replacing a layer of commercial coverage with captive insurance, for example, the business owner typically will achieve cost savings – avoiding the added costs built into the commercial insurer’s premium (such as

administration and overhead for the commercial insurance company). Furthermore, by captively insuring certain business risks (for example, employer-provided healthcare benefits), the business owner presumably will be incentivized to establish better risk controls (such as an employee wellness program to reduce the risks of healthcare benefits claims).

### **Practical Considerations**

The business lawyer in this multidisciplinary practice often guides the client from exploration of the possibility of creating a captive for the client’s business through establishment and ongoing governance of the captive. These services may include providing counsel on, and often partnering with, a banker or other co-adviser on any or all of the following:

- Captive suitability analysis
- Strategy development
- Coordination of an actuarial feasibility analysis
- Legal entity selection and customization
- Choice of state domicile for the prospective captive
- Related wealth management advice (i.e., the integrated wealth planning discussed below)
- Development of captive’s proposed business plan
- Balance sheet architecture
- Financial structuring and capitalization (including issuance of a letter of credit, if needed)
- Possible affiliation or serialization
- Tax advice
- Rendering a legal opinion, if needed
- Reinsurance matters
- Pre-application (for captive licensure) dialogue with the state regulator
- Preparation and submission of license application
- Possible “negotiation” of administrative order, if needed
- Arrangement for, or coordination with, outside professional services (e.g., bankers, accountants, auditors, captive managers, investment managers and custodians)
- Implementation of approved captive

- Ongoing compliance and corporate governance (e.g., conducting annual and special meetings and preparing regulatory reports)

While it is beyond the scope of this article to discuss in detail all of the practical considerations involved here, several of them will be briefly highlighted – taxation, capitalization and costs.

### **Taxation**

Federal and state taxation of captives are always carefully considered for the client. At the federal level, both income tax and transfer tax considerations are made. (As federal transfer taxes – namely, estate tax, gift tax, and generation-skipping transfer (GST) tax – pertain to wealth planning, they will be discussed below.) For many family businesses, they may be able to structure their captive to qualify for favorable federal income tax treatment. One of the most actively used qualifications is Section 831(b) of the Internal Revenue Code, designed for small and middle market captives which do not expect to write annually more than \$1.2 million of captive insurance premium. If the captive qualifies as an 831(b) captive insurer, its premium income is not subject to federal income tax, and only its investment income is so subject. Assuming an otherwise applicable 35 percent federal corporate income tax rate, that benefit could mean up to an annual federal tax savings of \$420,000 – a significant annual preservation of capital for the client. In addition, the payment of the (actuarially designed) captive insurance premium by the insured entity is a deductible ordinary and necessary business expense.

Moreover, if the client desires to captively insure different buckets of risk (e.g., healthcare benefits, product liability, business interruption, and employment practices) which, in the aggregate, would be expected to garner more than \$1.2 million in annual captive premium, the client – with your professional counsel – possibly may be able to legally structure the captive to still qualify for 831(b) treatment, provided the other legal requirements, such as risk transfer and

distribution, are met. That structuring possibly may involve, for example, segmenting each bucket of risk into a separate series business unit captive, which itself is separately expected to write less than \$1.2 million of annual premium and to qualify for favorable 831(b) tax treatment.

State taxation of a captive also is a consideration in advising the client. This varies among the states. Typically, though, domiciliary states impose a modest premium tax (often less than one percent) on the captive's written premium. Some states do not impose any ordinary business income tax (other than a modest premium tax) on a captive licensed in its state. And some states impose a direct placement "procurement" tax on premiums written by a captive which is not licensed in its state (ranging from less than one percent to five percent across the country).

#### **Capitalization and Costs**

Capitalization of the captive is a uniform regulatory requirement among the states which have captive licensing laws. The amount of required minimum capitalization, however, varies among the states and is usually set forth in state statutes. It is important to note that these statutory minimums are just that – minimums. The domiciliary regulator (typically, the state's insurance commissioner) usually has the authority to require a higher level of capitalization depending on the nature of the business to be insured, the actuarial analysis, and other regulatory considerations.

The costs of establishing a captive vary according to its nature, size, and complexity. For example, it is not uncommon for start-up costs, including professional fees, to range from approximately \$25,000 to over \$90,000. After the captive has been established and capitalized, there will be administrative costs going forward. These will include the costs of managing the captive's operations, complying with regulatory requirements, and otherwise administering the captive's business. Middle market captives, for example, often budget approximately \$30,000 to \$75,000 per year for these administrative costs.

#### **Integrated Wealth Planning**

As noted above, the multidisciplinary business counselor today is often guiding the client in the converging captive insurance and wealth planning space. A captive insurance company has not only risk management implications but also wealth management implications. The creation of a captive is the creation of a business asset – and therefore creates a wealth planning need and opportunity. How this business asset is owned and transferred must be considered for the client.

Generally, if the captive is owned by the *individual* business owner or owners who created the captive, the captive will be included in that business owner's or owners' taxable estate(s), assuming they have a taxable estate upon their death. The top federal estate tax rate is 40 percent. However, the business owner has options for removing this asset from his or her taxable estate.

#### **Planning with a Family Trust**

One such option is to place the captive (let's assume it is an 831(b) captive) in an irrevocable family dynasty trust; that is, the family trust will own the captive. The beneficiaries of the trust (per the client's wishes) are the business owner's children, grandchildren, future great-grandchildren, and succeeding generations (hence, the "dynasty" name). This wealth planning strategy has several benefits.

First, the captive asset is removed from the business owner's eventual taxable estate, thereby excluding the value of that asset from estate taxation. Second, as a properly constituted dynasty trust, the trust asset transfers would not be subject to GST tax (the GST tax rate is 40 percent). Third, if the captive itself is structured as a limited liability company (LLC), for example, the transfers of the LLC interests into the family dynasty trust should enjoy valuation discounting for federal gift tax purposes. This would substantially reduce gift tax liability for those transfers, if any, after taking into account any applicable annual gift tax exclusions (\$14,000 per donee for individual donors) and any applicable lifetime gift tax exemptions (in 2014, \$5.34

million for individuals). Fourth, the payment of premium to the captive would not constitute a taxable gift; rather, it would be, as noted above, a deductible ordinary and necessary business expense. Fifth, if the family dynasty trust is established in a jurisdiction, such as Delaware, which does not impose state income or capital gains tax on an irrevocable nongrantor trust whose beneficiaries are residents outside that jurisdiction (and assuming that is true for this business owner's family trust), then that family trust's accumulated income and realized capital gains will not be subject to state income taxation. In short, the federally untaxed underwriting profit in the 831(b) captive combined with the anticipated surplus that the well-managed captive expects to build over the years will be able to be kept in the family without being subject to hefty transfer taxes.

#### **Integrated Charitable Planning**

It should be noted that there are other wealth planning strategies in the captive space which can achieve similar client benefits. One other strategy will be noted here: it is one which integrates the client's charitable objectives with its wealth and captive risk management goals. For the client who wishes to benefit a charity but desires to keep the underlying asset in the family, a customized charitable lead trust (CLT) has been used. This is how it works.

The client business owner establishes a CLT and funds it with certain assets. In this case, one of those assets will be the captive insurance company itself. A portion of the income from those trust assets, designated by the client (called the "grantor"), is typically paid annually to one or more qualified charities of the client's choosing (called the "charitable beneficiary" or "income beneficiary" of the trust). The assets remaining in the CLT at the end of its term either revert to the client or are transferred to the client's designated "remainder" beneficiaries, such as his or her family.

The CLT may have a duration, designated by the client, of a specified number of years, the lifetime of the client (or of more than one individual), or a combination of

the two. A CLT may be structured for tax purposes as either a grantor type (where the grantor, as taxpayer, assumes all the income tax benefits and responsibilities of the trust assets) or nongrantor type (where the trust itself, as taxpayer, assumes them).

The CLT may take one of two forms based on the way in which the amount of income is determined for the charitable beneficiary – the charitable lead annuity trust (CLAT) or the charitable lead unitrust (CLUT). In a CLAT, the annual income payable to the charity is a fixed sum, which can be either a specified dollar amount or an amount equal to a fixed percentage of the assets initially transferred into trust. In a CLUT, the annual income payable to the charitable beneficiary is equal to a fixed percentage of the annually-recalculated value of the trust's assets. The client's lawyer or other adviser, such as the client's banker, typically advises the client on the optimal structuring and form of this CLT for the client's situation.

The benefits of incorporating a CLT into the client's wealth and risk management planning are several. First, it is a plan which helps the client achieve his or her charitable gifting objective. This method of charitable giving also provides special tax and other benefits to the client. Second, although the client's gift to charity will be spread over time, a CLT allows the client to take a current income tax deduction for that gift. The amount of that deduction is the present val-

ue, determined by federal formula, of the CLT's payouts to the charity. Furthermore, to the extent that the client cannot utilize all of that deduction in the current tax year, the client generally may carry forward the unused amount of the deduction for the next five years, thereby further reducing the client's income tax liability. Third, the deemed gift to the client's noncharitable, remainder beneficiaries (usually, his or her family) of the assets remaining in the CLT at the end of its term will be discounted for gift tax purposes. This can be a substantial benefit with respect to highly-appreciated trust assets (such as, presumably, the captive business asset).

Fourth, the assets placed in the CLT are effectively removed from the client's taxable estate. The appreciated value of the assets placed in the CLT therefore would pass to the client's family beneficiaries free of estate tax. Fifth, the CLT allows the client to preserve assets for his or her family (or others of the client's choosing) in a tax-advantaged way. It allows the client to share the fruits of the client's success with his or her chosen charity(ies) without the client's family having to part with the assets that the client had placed in trust. Sixth, the CLT also is an effective way of controlling the timing of the client's transfer of assets to family members, especially where the client is concerned that it would be premature to do so now, such as when the client's family beneficiaries are too young or not

yet prepared to handle the responsibilities of ownership.

### Conclusion

The comprehensive planning needs of family business clients, especially those in the middle market, are driving the growth of this multidisciplinary practice across the United States. Risk management and wealth management, as the McKinsey study notes, are critical disciplines to be seriously embraced by private businesses and their owners in order for them to succeed. Captive insurance, as an efficient and effective risk management tool, can be customized as an integral part of the client's comprehensive wealth planning. Many family businesses have benefited from this interdisciplinary convergence, and many more are expected to do so with good counsel across the country.

*Edmond M. Ianni is Managing Director of EMI Strategic Capital. Mr. Ianni, a past Chair of the Delaware State Bar Association Corporate Counsel Section and International Law Section, has served as Chief Strategy Officer of Millennium Wealth Management and Director of Strategic Development for the State of Delaware's Bureau of Captive and Financial Insurance Products. Mr. Ianni may be reached at (302) 690-7766. © 2014 Edmond M. Ianni.*