

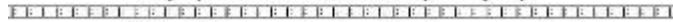
RMaP™

Risk Management Plan Services

Designed By:

DRDA

a professional limited liability company



certified public accountants and business consultants

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Topics

Definition	3
The Basics	3
Benefits	4
Businesses Insured, Risks Insured	6
General Guidelines	7
The Types of Captives	7
The 831(b) Small Captive	8
Setting up a 831(b) Small Captive with DRDA	8
Feasibility Study or Assessment	8
Underwriting	9
Selecting a Domicile	9
Company Creation and Preparation and Submission of License Application	9
Capitalization and Tax Elections	10
Cost Comparison of Captives by Jurisdiction	10
Taxation Issues	11
In General	11
At the Cell Level	13
Summary	14

Definition

DRDA's Captive Risk Management Plan, or RMaP™, is a tool for managing business risk in a more cost effective, tax efficient and protected manner.

The Basics

The underlying concept of the RMaP™ is fairly straight-forward, but because of the complexity of business, the tax code and insurance regulations, the implementation details can be somewhat confusing at first. The purpose of this paper is to provide an overview on RMaP™ services, and to provide some details relating to types, benefits, and taxation.

All businesses have risks. Some of those risks are managed by how you do business (i.e. safety and training programs, requiring letters of credit for overseas shipments, etc.). Other risks are covered by traditional insurance from 3rd party licensed insurance company's (i.e. Travelers, Aetna, John Hancock, etc.) Other risks are retained by the operating company and paid for with savings from after tax profits. The RMaP™ analysis looks at these various aspects of your business and determines the optimum way to manage risks and protect what you have.

DRDA's RMaP™ analysis focuses on the last two elements mentioned above:

- i. Those risks that are insured through 3rd party carriers, and
- ii. Those that are retained.

One tool often overlooked by small and middle market businesses is the use of a captive insurance company to manage their risks. A captive insurance company is a sister company formed by a business owner to insure in part the risks of the operating business. The operating business pays premiums to the captive, and the captive insures the risks of the operating business. If structured properly the premiums paid by the operating company are deductible by the operating company, and the premiums received by the captive are not taxable if within the limits prescribed by the Internal Revenue Code as discussed below.

In the last 30 years the captive industry has grown substantially. From an estimated 1,000 captives in 1980 to over 6,000 in 2009. Captives now account for more than 10% of all commercial insurance premiums collected worldwide. In the U.S. alone, captives were responsible for over \$9 billion in premiums in 2009.

In the 1970's and 1980's the IRS and the courts issued several rulings that started to define situations in which captive arrangements would be respected by each. Many major U.S. corporations started forming captives to help manage their risks. By 1981, Vermont passed captive legislation and the domestic captive sector began to

grow. As expected these activities led to more court cases, more challenges by the IRS, and a clearer definition of the tax treatment of captives and the tax-deductibility of premiums paid to them.

By the mid 1990's the tax laws relating to captives had matured to the point that tax and financial/risk planners and managers could be comfortable knowing that premium payments to the captive would be deductible in appropriate instances. The number of captives has grown rapidly as has the number of jurisdictions licensing captives. Today, more than half the US states now have captive enabling legislation.

Captives are a great planning tool and there is now an entire industry that supports them. Yet, captives are poorly understood by both business owners and business planners. Those who know the most about captives are doing planning for large multi-national corporations. Unfortunately, the planners that are advising the smaller businesses and their owners are largely unaware captives exist or know very little if anything about them.

The use of a captive offers significant benefits and potential savings for business owners, and we'll go into the specifics in the next section. An ordinary business insurance policy provides insurance that protects the business and its owners from various types of business losses and liability. But a captive has a number of advantages.

Benefits

There are quite a number of potential benefits in using a captive. We'll provide a brief discussion of many of these in this section.

Benefit #1. Stabilize Insurance Budgets. Captives can charge premiums based on the risk or claims of your business alone, rather than having to make significant adjustments each year based on the performance of a number of businesses (many of which may be causing your premiums to be artificially high).

Benefit #2. Reduce Insurance Administrative Costs. Premiums to commercial insurance companies cover both the cost of insurance and the insurance company's administrative costs. Captives have relatively low administrative costs.

Benefit #3. Negotiation Tool for Lower Insurance Costs. Captives offer a business the potential for insuring some risks internally. Thus, if the commercial insurance firm knows you have the option to insure in the captive, then captives can be a tool for negotiating lower commercial insurance costs.

Benefit #4. Utilize Own Experience In Reducing Insurance Costs. Insurance premiums are greatly influenced by the amount of perceived exposure or risk. If you know

your exposure or risk is less than what the insurance companies perceive them to be, then there is the potential for reducing insurance costs.

Benefit #5. Premium Flexibility. The captive can be more flexible with how premiums are paid, whereas most commercial firms are not.

Benefit #6. Increased Claims Control. Commercial insurance firms offer almost no control over how claims are paid. Control over claims is a big benefit of a captive. This would include even questions of litigation and hiring of attorneys. In addition, a captive is generally more supportive about coverage of claims.

Benefit #7. Recapture Underwriter Profits. Instead of the commercial carrier earning profits from your premiums, the captive earns the profits.

Benefit #8. Accept Greater Deductibles. The captive can be used to insure the deductibles of a commercial policy.

Benefit #9. Access to Reinsurance Markets. Because captives are licensed insurance companies, they have access to the reinsurance markets.

Benefit #10. Customized Coverage. Coverage with the captive can be customized, closer to exactly what a business might need. Commercial insurance firms rarely offer highly customizable plans.

Benefit #11. Underwrite Exposed Risk. Some risks are nearly impossible to commercially underwrite at low volumes, or to do so would be unaffordable. Using a captive may be one means for insuring these exposed risks.

Benefit #12. Enhance Loss Prevention. A captive offers the business owner another means for insuring non-standard business risks. Ordinarily these uninsured expenses are paid out of current year's cash flow or after tax savings. A captive allows for these non-standard risks to be budgeted in a tax efficient manner.

Benefit #13. Profit Center. Like commercial insurance firms, captives have the potential for being profit centers particularly when the captive has the potential to insure third party risks. The captive itself could turn into a valuable asset for the owners.

Benefit #14. Liability and Wealth Transfer. Captives can be used to shift liabilities out of the business, or to transfer wealth out of the business. This offers some potentially great advantages to the business owner, financial planner or estate planner.

Businesses Insured, Risks Insured

Any active business can benefit from a captive and almost all risks can be written by a captive. An example of the types of businesses insured by captives are:

Contractors	Financial Services	Manufacturing	Restaurants
Developers	Franchises	Physicians	Retail
Distribution	Healthcare	Professional Services	Transport
Energy	Industrial Services		

Risks Insured

Administrative Action	Computers: Dissemination of Data	General Liability	Product Launches
Advertising and Marketing Failure	Computers: Loss of Data	Insurance Failure & Bad-Faith	Product Recall/Liability
Antitrust and Unfair Competition	Computers: Software Liability	Judicial Administrative Delay	Product Tampering
Auto	Computers: Virus Losses	Knock-Off Lost Profit	Production Benchmarks
Benefits - Employees	Confiscation and Expropriation	Lawsuit Interruption	Property Damage
Business Credit Cover	Contract Frustration	Labor Costs	Receivables
Business Dirty Tricks	Copyright Infringement - By Another	Legal Expenses	Regulatory Risk
Business Document Forgery & Counterfeiting	Currency Risks	Lender Failure	Revelation of Trade Secrets
Business Extortion	Delay Start-Up	Loss of Key Customer	Strike and Labor Unrest Insurance
Business Interruption	Eminent Domain	Loss of Talent	Supply Chain
Business Reputation	Employee HIV Contamination	Machinery Breakdown	Terrorism
Cargo Consequential Loss	Employment	Market Flooding	Theft
Cash in Transit	Extended Warranty	Market Risks	Trade Credit
Commercial Crime	Financial Crime	Medical Malpractice	Trade Good Will
Communications Breakdown or Interruption	Force Majeure	Mold	Transit Risk
	Foreign Operations	Patent & Trademark Infringement - Claims Against	Unfair Calling of Guarantees
		Political Risk	Weather Risks
			Windstorm
			Workers Compensation

General Guidelines

There are several basic points to consider when looking at participating in DRDA's RMaP™ analysis. Your DRDA point of contact can help review any of these points should you have questions.

- i. When you purchase stock of a company, you become part-owner of that company. Likewise, participating in DRDA's RMaP™ may involve the setting up and operating of a captive insurance company, so participating in RMaP™ could mean owning or being part-owner of an insurance company.
- ii. There must be a business involved, and risk must be transferred and the risks of the captive must be distributed.
- iii. The RMaP™ Plan can be used to insure business loss and liability (i.e. business risk), of which there are *many* types (see the Businesses Insured, Risks Covered section above).
- iv. The legal structure and setup of the captive is critical in order to be able to take full advantage of both insurance cost savings and wealth management.
- v. A captive is not necessarily a good tool for insuring high severity risks.
- vi. If needed, the captive can be structured such that it is owned by the business owner's children or grandchildren, or held in trust.

The Types of Captives

There are six major types of captives and it is helpful to review the differences and uses for the various types.

The Pure (or Single Parent) Captive. Most captives can be classified as pure captives. These are captives that insure the risks of the businesses owned by the owner within the normal risk shifting and risk distribution guidelines.

Agency Captive. An Agency Captive is typically a reinsurance company owned by an insurance agent or group of insurance agents. The primary objectives of forming agency captives are (a) to participate in underwriting profit and so increase agency revenue, (b) to ensure long-term availability of coverage and (c) to demonstrate to insurers that the agent has confidence in the insurance program and is ready to share in the risk.

Rent-A-Captive. A Rent-a-Captive insures the risks of its renters and returns underwriting profit and investment income participation to the insured's. Certain insurance companies rent their surplus to other entities wishing to establish a self-insurance program but do not want to or are not able to capitalize their own captive.

Protected Cell Companies. A Protected Cell Company (PCC) also referred to as Segregated Accounts Companies (SAC), Segregated Portfolio Companies (SPC), and Statutory Fund Companies (SFC), are essentially a more cost effective and better

protected rent-a-captive with special differences. Rent-a-captives allow renters to shield their capital and surplus from other renters in the captive as long as the rent-a-captive's owner remains solvent. If the owner's liquidity becomes deficient, renters may be exposed because their assets may have to pay claims of others. PCC's on the other hand, guarantee each "cell" within the company will be shielded not only from sharing capital and surplus with other cell owners, but also from any legal action against the PCC as well. A PCC provides better asset protection than a rent-a-captive.

Group Captives. These are captives that are set up by groups of otherwise unrelated businesses or associations. For example, a group of electrical contractors could form a group captive for insuring risks of their individual businesses.

Risk Retention Groups (RRGs). RRGs are similar to group captives, but they are formed under the Federal Liability Risk Retention Act (LRRRA). The original intent of this act was to provide a means for groups to insure against product liability, but other member-owned organizations (such as physicians groups) have adopted the use of RRGs as well in recent years.

The 831(b) Small Captive

Any of the captives listed above, could qualify under IRC §831(b). This category of smaller-sized captives was created by Congress as a means for providing competition in the insurance industry.

To qualify under IRC §831(b) a captive can take in a maximum of \$1,200,000 in premiums annually. The captive pays no income tax on the premiums it receives, but investment income made by the captive is taxable. When properly structured, premium payments paid to the captive are tax-deductible to the insured business.

Setting up a 831(b) Small Captive with DRDA

Establishing a captive is an involved process that involves input from and consultation with a number of professionals and the business owner/manager.

Feasibility Study or Assessment

The first step is to conduct a feasibility study or assessment to determine if a captive is appropriate. This assessment would consider:

- i. A thorough understanding of the business operations, activities, market, and goals.
- ii. A thorough understanding of the business needs and objectives to be addressed with the captive. A captive will generally provide coverage for economic risks that are either difficult to insure or are uninsurable in the traditional market.

- iii. Is the business owner committed to integrating risk management and the use of a captive in their overall business plan? Forming a captive requires a commitment of time, capital and an approach to managing risks. This type of commitment should not be undertaken lightly but rather with an intention of integration with your overall business strategy going forward.

Underwriting

The next phase of formation is to determine the appropriate premium to be charged for the risks being covered. Underwriting of the insurance policies must be conducted according to sound actuarial principles. An underwriting report is needed for prudent management of the covered risks and may form part of the license application discussed below. Throughout the life of the captive, policy premiums and limits will be subject to regular underwriting or actuarial review.

Selecting a Domicile

There are a number of jurisdictions around the world and within the United States that have enacted captive enabling legislation. The Captive Manager will assist you in selecting the right jurisdiction based on a number of criteria such as:

- i. What types of risks will be underwritten by the captive?
- ii. What are the capital costs and requirements for the intended coverage's to be written?
- iii. How flexible, stable and friendly is the regulatory environment?
- iv. Taxation
- v. Operating costs within the domicile
- vi. Investment restrictions
- vii. Reserve requirements
- viii. Reporting requirements, etc.

Company Creation and Preparation and Submission of License Application

The next phase of formation is the creation of the company and the preparation and submission of the application for insurance license. The creation of the company involves selection of officers, directors, managers and determining who will own the company (i.e. entrepreneur, children, grandchildren, trust, FLP, etc.). These decisions will be governed by the business owner's objectives and the technical skills needed to appropriately manage the captive.

The application for insurance license will be prepared and submitted to the Insurance Commissioner in the jurisdiction in which the captive will be domiciled.

The application is an all encompassing work that touches on each aspect of ownership and operation of the company and will include the following:

Ownership – Information about the company’s shareholders, officers and directors so as to document their reputation, trustworthiness, experience and credibility. This information generally entails financial information, residency, citizenship and perhaps criminal background checks. Most jurisdictions also require a letter of reference from a bank and two professionals (attorney, CPA, CFP, etc.). The regulators want to make certain a licensed insurance company in their jurisdiction is owned and operated by persons of good standing.

Business to be conducted – The application will require the development of a business plan describing how the company will operate, the types of risk it will insure, how it will market its policies and to whom, professionals providing services to the company, capital to be raised, investment policies, sample insurance policies with coverage limits, pooling and reinsurance arrangements, and pro forma financial statements of the anticipated operating results of the company. This information is usually physically taken to the Insurance Commissioner by the Insurance Manager and a face to face interview is undertaken to walk the Commissioner’s representative through the application and all of its attachments.

Capitalization and Tax Elections

The capital required to establish the captive can vary significantly based on:

1. The jurisdiction
2. Risk to be covered
3. Premiums to be received
4. And a host of other issues

Capitalization can range from as low as \$50K for a cell captive offshore to hundreds of thousands or millions of dollars onshore depending on the factors listed above. DRDA will work with you and your insurance manager to determine the appropriate amount of capital to insure your anticipated risks. Once the application is approved company bank accounts are opened, capital transferred, policies issued and tax elections made. From this point forward the captive operates like any other insurance company by investing premiums received and processing claims received.

Cost Comparison of Captives by Jurisdiction

The cost to set up a captive can vary significantly. Costs to set up a captive in the U.S., for example, often run quite a bit higher than what they cost in other countries. Through economies of scale and efficiencies in operations we have been able to operate captives at a cost level to the client of 15% to as low as 7% of annual premium. These levels not only cover the cost of managing operating and reporting

for the company but also pooling costs and stop loss reinsurance. The exact cost for you can be determined prior to your commitment to establish the captive.

Taxation Issues

In General

An insurance company is any company wherein more than half the business during the taxable year is the issuing of insurance or annuity contracts or the underwriting of risks underwritten by insurance companies.¹ Although its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code.² A taxpayer that qualifies as an insurance company is treated as a corporation under § 7701(a)(3), even if it would not otherwise be classified as a corporation for state law purposes or under other provisions of the Code. For example, a non-corporate business entity was held to be an insurance company, and therefore a “corporation” within the meaning of § 7701 (a)(3), because its primary and predominant business activity was underwriting insurance risks.³ The determination of whether a captive’s primary and predominant business is the issuance of insurance contracts is important to the policyholder. If the captive is deemed to be in the insurance business the premium payments made pursuant to the insurance contract are deductible by the policyholder/payer as ordinary and necessary business expenses under IRC § 162.

Insurance is not defined under the Internal Revenue Code. The U.S. Supreme Court provides the authority for what constitutes insurance. The courts written opinion stated that “historically and commonly insurance involves risk-shifting and risk-distribution.”⁴ In other words, in order to be insurance there must be:

- i. A shifting of risk from one party (the insured) to another (the insurance company); and
- ii. A distribution of risk in that the insurance company is not solely carrying the risk of one party but distributing its risk over many insured’s.

¹ IRC § 816(a) and 831(c).

² Treas. Reg. § 1.801-3(a)(1)

³ Rev. Rul. 83-132, 1983-2 C.B. 270.

⁴ *Helvering v. Le Gierse*, 312 U.S. 531, 61 S.Ct 646 (1941).

The element of risk shifting is easily accomplished by an insurance policy/contract shifting the liability to a licensed insurance company. The issue at question is how much third party risk must be held by the captive to meet the test of risk distribution. In the Harper Group Case the Tax Court held that risk shifting and risk distribution were present where the captive received 29 to 32 percent of its premiums from unrelated parties. This decision was affirmed by the 9th Circuit Court of Appeals. In this case the captive policy was found to constitute insurance for federal income tax purposes and premium payments that were made to the captive were deductible under IRC § 162.⁵ There have been no other rulings by the courts to indicate what percentage of premiums must be received from third parties to constitute risk distribution. Almost 10 years later the IRS issued a Revenue Ruling⁶ indicating the risk distribution threshold was met where 50% or more of the captive's premium income and risk exposure is received from unrelated third party policyholders. In 2003 the IRS issued a Notice that a captive may not qualify as an insurance company if:

- i. The risks assumed by the captive are not "insurance risks";
- ii. The captive generates excess investment income relative to the premiums it earns; or
- iii. The terms of the purported insurance contracts significantly limit the risks assumed by the captive.

These are areas that will ultimately be determined by the courts but the notice gives insights into areas of concern for Treasury.⁷

Later in 2003 the IRS issued a Revenue Procedure revising the procedural requirements for a foreign insurance company to elect to be treated as a domestic corporation under IRC § 953(d). By electing under IRC § 953(d) a U.S. taxpayer can own a foreign chartered and licensed insurance company and avoid the controlled foreign corporation reporting rules that would otherwise be required. In essence, the foreign corporation is treated as if it was incorporated here in the United States and taxed like any other U.S. Corporation.

An insurance company is subject to tax under either Part I or Part II of Subchapter L, as applicable, and is eligible to make a number of elections. For example, § 831(b) permits certain small insurance companies other than life insurance companies to elect to be taxed only on taxable investment income (and not on underwriting income); § 846(e) permits an insurance company to compute discounted unpaid losses using the company's historical payment patterns, rather than the historical

⁵ Harper Group v. Com'r, 96 T.C. 45 (1991), aff'd, 979 F.2d 1341 (9th Cir. 1992).

⁶ Revenue Ruling 2002-90, 2002-2 C.B. 985.

⁷ Notice 2003-34, 2003-1 C.B.990.

payment patterns determined by the secretary under § 846(d); and § 953(d) generally permits a controlled foreign insurance company to elect to be treated as a domestic corporation if it would otherwise qualify to be taxed as an insurance company).⁸

At the Cell Level

A number of jurisdictions have statutes that provide for the chartering of a legal entity commonly known as a protected cell company, segregated account company, segregated portfolio company or statutory fund company (“Protected Cell Company”). Rev. Rul. 2008-8, sets forth facts that are typical of arrangements involving Protected Cell Companies and provides guidance on how to determine whether such an arrangement qualifies as insurance for federal income tax purposes. In Notice 2008-19 the IRS proposes that a Protected Cell Company would be treated as an insurance company separate from any other entity if:

- i. The assets and liabilities of the cell are segregated from the assets and liabilities of any other cell and from the assets and liabilities of the Protected Cell Company such that no creditor of any other cell or the Protected Cell Company may look to the assets of the cell for the satisfaction of any liabilities, including insurance claims (except to the extent that any other cell or the Protected Cell Company has a direct creditor claim against such cell); and
- ii. Based on all the facts and circumstances, the arrangements and other activities of the cell, if conducted by a corporation, would result in its being classified as an insurance company within the meaning of § 816(a) or 831(c).

The effect of this position on the insurance company at the cell level is that:

- i. Any tax elections that are available by reason of a cell’s status as an insurance company would be made by the cell and not by the Protected Cell Company of which it is a part;
- ii. The cell would be required to apply for and receive an employer identification number (EIN) if it is subject to U.S. tax;
- iii. The activities of the cell would be disregarded for purposes of determining the status of the Protected Cell Company as an Insurance company for federal income tax purposes;

⁸ Rev. Proc. 2003-47, 2003-2C.B.55.

- iv. The cell would be required to file all applicable federal income tax returns and pay all required taxes with respect to its income; and
- v. The Protected Cell Company would not take into account any items of income, deduction, reserve or credit with respect to any cell that is treated as an insurance company within the Protected Cell Company.

An IRS Notice is not law but it does give insight into the current thoughts and position of Treasury on dealing with these issues. If officially adopted it may take the form of a regulation, revenue ruling, or revenue procedure. The proposed guidance would be effective for the first taxable year beginning more than 12 months after the date the guidance is published in final form.

Summary

In Summary, risks must be managed for any business to succeed long term. The RMaP™ process in conjunction with a captive allows for a more cost effective, efficient and protected manner for managing business risks. Additionally, premium payments made to a captive insurance company are deductible under § 162 if:

- i. Risk shifting has occurred at the policyholder level.
- ii. Risk distribution occurs at the captive level.
- iii. More than half the business of the captive is insurance business.
- iv. The risks assumed by the captive are insurance risks.
- v. The captive does not generate excess investment income relative to the premiums it earns, and
- vi. The captive accepts risks within reasonable underwriting standards.