

Captive Insurance and Estate Planning

Jay Adkisson
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Background

- Partner in the law firm of Riser Adkisson LLP with offices in Orange County, Dallas, and Atlanta
- Co-owner of a captive insurance consulting firm (US) and licensed captive manager (BVI) from 1998 to 2004.
- Expert witness to the U.S. Senate Finance Committee and has presented to Heckerling and similar forums
- Author of several financial bestsellers in their area:
 - Asset Protection: Concepts and Strategies
 - Equity-Indexed Annuities: The Smart Consumer's Guide
 - Adkisson's Captive Insurance Companies

Important!

- The presumption for all the slides that follow is that the client has substantial non-tax insurance needs such that a captive insurance company is needed by the client without regard to any potential tax benefits.
- The slides that follow only demonstrate the potential ancillary benefits of a captive insurance company that has been formed for substantial non-tax casualty, loss and liability purposes.
- This presentation does not give any legal or tax advice or opinion whatsoever, and may not be relied on to avoid any penalties; it is for the education of planners only, and not to be given to prospective captive clients.

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Benefits: 5-Year Comparison

<u>NO CAPTIVE</u>	<u>WITH CAPTIVE</u>
\$6.0M (\$1.2M x 5)	\$6.0M (\$1.2M x 5)
< \$2.1M > Income Taxes	\$0 No Income Tax
=====	=====
\$3.9M Post-Tax	\$6.0M Post-Tax
< \$2.1M > Estate Taxes	\$0 No Estate Taxes
=====	=====
\$1.8M To Heirs	\$6.0M To Heirs
	\$0.4M Total 5-Year Cost
	=====
	\$5.6M To Heirs

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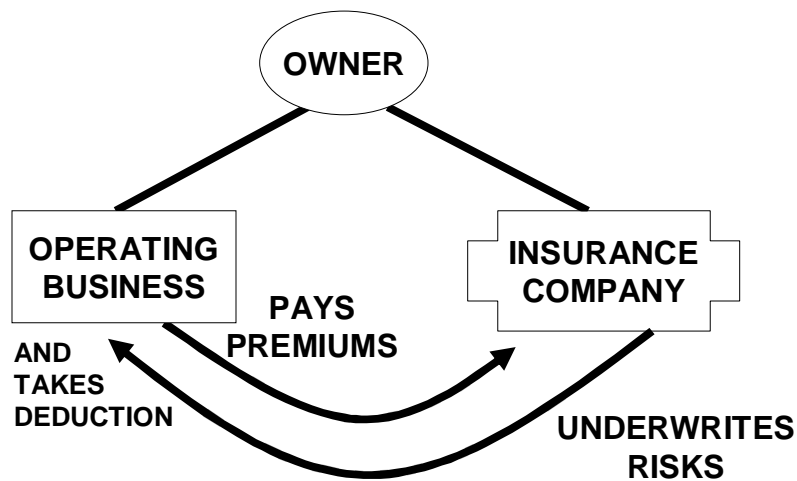
What is a Captive?

- A Captive is an insurance company that is formed by the parent company to underwrite the insurance needs of the parent's other subsidiaries
- Captives are attractive for clients with businesses with substantial insurance risks and consistent excess positive cash flow in excess of \$500,000 per year

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"Pure" Captive Insurance



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Captive Insurance

- Captive insurance arrangements have boomed in popularity the last five years
 - Vermont captives alone took in over \$11 billion in premiums in 2006
 - 90% of all S&P500 companies have captives
- Part of overall trend of alternative risk management
- Captive markets have become institutionalized and efficient
- Reinsurance markets now actively cater to small captives

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Onshore or Offshore?

- Historically, captives were formed offshore for tax and regulatory reasons
- Most captives are formed in US today
- Vermont, South Carolina, Hawaii, Utah, Arizona and others attract captives
- No need for offshore or “hide the ball” planning with captives – fully disclosed

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Captive Taxation

- Captive may accrue deductions for reserves
- But what is not spent on claims will be recaptured as income as policies expire
- Reserving allows the captive owner to “time the tax”

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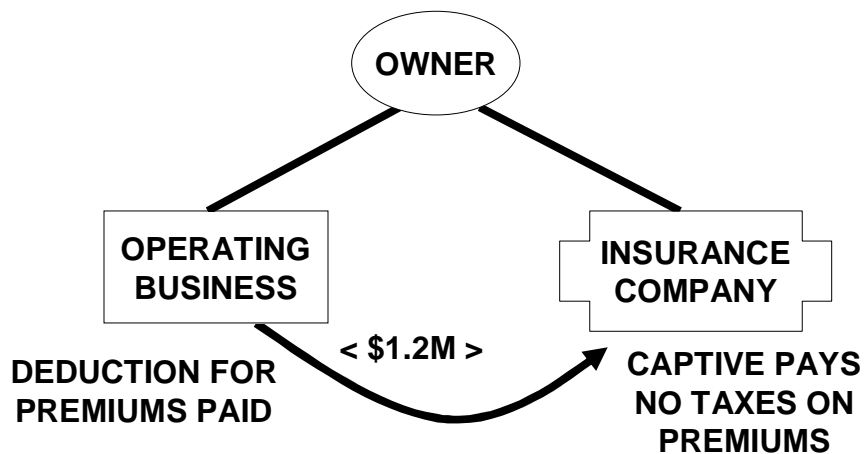
Captive Insurance

- 831(b) Election – Tax on investment income only
 - No tax on premium received
- No tax on up to \$1.2 million in total premiums *annually*
- Thus, the captive can receive up to \$1.2 million in premiums per year but pay no taxes on that money

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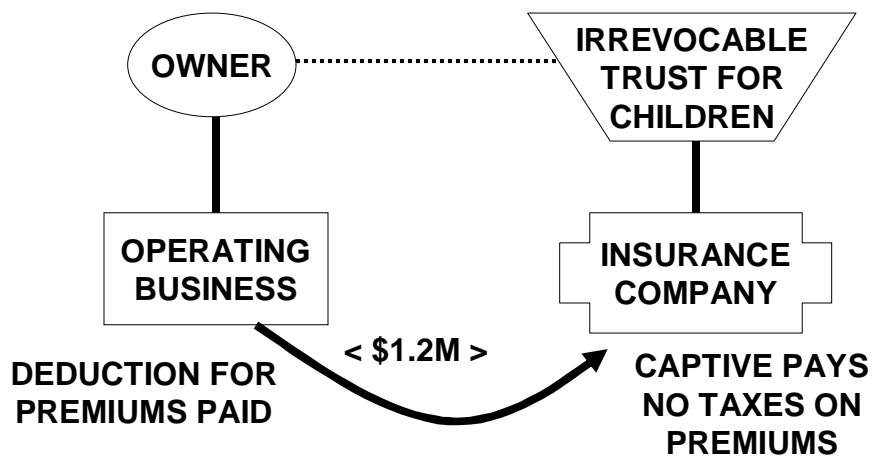
Captive Insurance



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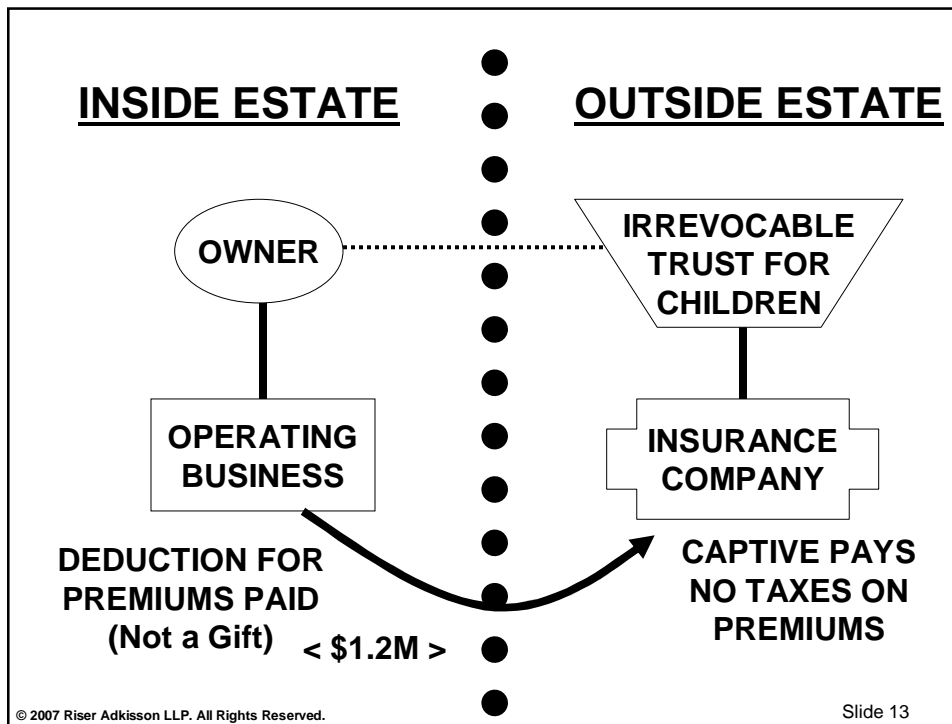
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Captive Insurance



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Captives and Income Taxes

- Generates a deduction to operating business for premiums paid
- No corresponding taxable income to insurance company if 831(b)
- Insurance company still deducts increases to reserves if not 831(b)

Captives and Estate Taxes

- Estate Tax Efficiency
- Payment of premiums not a gift
- No unified credit used
- Every premium dollar transferred is a tax-free transfer outside the estate

Captive Insurance

Combined Income & Estate Tax Efficiency

- Avoids federal and state income taxes
- Avoids federal gift and estate taxes and state death taxes
- *All in a legal and fully-transparent fashion*

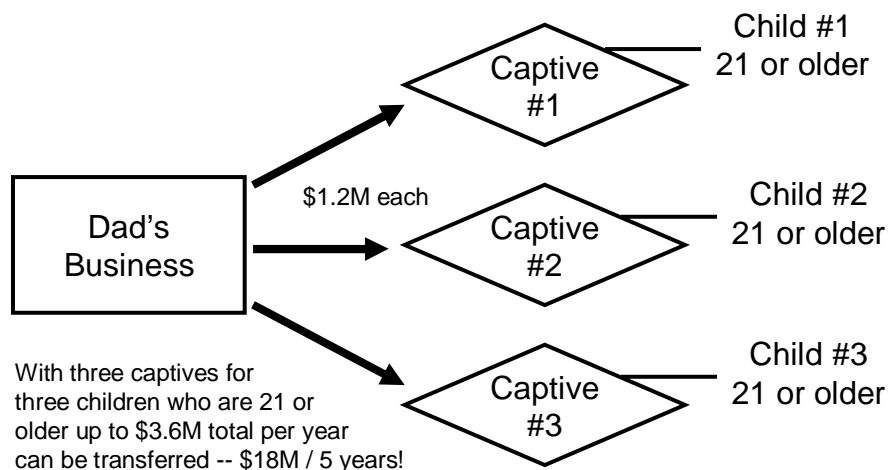
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Attribution Rule for Multiple Captives Children 21 or older are distinct



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Reserves – Limitations/Abilities

- Cannot loan money back to owner
- Cannot loan money back to insured operating business

- Can invest in new projects, even if closely held, both as an equity or debt investor
- Can invest in a wide range of investments subject to certain minimum limitations relating to liquidity and safety

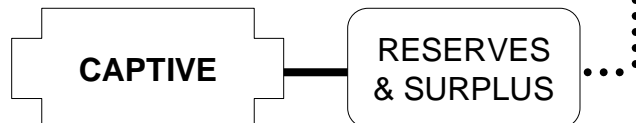
Surplus – Assets Not Reserves

- Represents captive's capacity to accept new risks
- Can be invested in anything without restriction
 - Real Estate, REITs, Raw Land, Strip Malls
 - Stocks, Bonds, Mutual Funds, Hedge Funds
 - Life Insurance

Investment Management

The reserves and surplus of captive insurance companies are typically managed by an investment advisor according to a detailed "Investment Policy Statement" (IPS).

Investment
Advisor



Because the assets of the captive will remain there for some years as reserves and surplus, captives are significant attractions for obtaining long-term and every-growing money under management for investment advisors.

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Life Insurance & Captives

CAPTIVES MAY INVEST IN LIFE INSURANCE

- Key Man Life Insurance
- Split-Dollar
- Buy-Sell Life Insurance
- 419(e) Welfare Benefit Plan

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Key Man and Captives

- A captive may purchase key man life insurance on its owner
- That key man is not deductible will not cause taxes to an 831(b) captive
- The cash value of the key man insurance builds up tax-free within the captive

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Buy-Sell Life and Captives

- A captive may purchase buy-sell life insurance
- Can fund multiple owners' buy-sell life insurance needs with pre-tax dollars
- Buy-sell life insurance builds up value within the captive tax-free

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Captives and Split-Dollar

- Captive may split-dollar life insurance policy
- If captive formed outside the estate, very efficient transaction
- Amounts to pre-tax split-dollar
- Incidental tax costs of split-dollar are insignificant compared to savings

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419(e) Welfare Benefit Trust

- Captive may establish a 419(e) Welfare Benefit Trust for its owner-employees
- Can discriminate within economic family if a DBO plan
- 831(b) captive does not need the deduction
- Death benefits payable to participant outside of company and outside of estate

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Suitability - Example

PROPERTY DEVELOPERS

- Construction Defects
- Environmental
- Flood, Wind and Earthquake

Suitability - Example

NURSING HOME OPERATORS

- Employee Liability
- HIPPA - Privacy
- Deductions and Exclusions
- Flood, Wind and Earthquake

Suitability for Captives

- Need to have \$250K for long-term liquid reserves
- Ability to pay more than \$500K in annual premiums to captive for at least five years
- Can satisfy risk spreading and risk shifting (or be structured to)
- Have adequate P/C insurance needs

Product Requirements

- None! (In some captive jurisdictions)
- Not true that only high cash value products are allowed
- Products with high initial cash values will be easier to work with
- Other products can work if client willing to contribute additional capital

Captive Process

- Feasibility Analysis – Meet with Insurance Commissioner
- Actuarial Study
- Licensing - Formation
- Capitalization
- Underwriting
- Typical “Turnkey” Cost ~ \$100,000
- Creation Time ~ 60 to 90 days

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Attorney-Formed Captives

- Attorney-client privilege allows more candid discussion of goals and objectives
- Non-attorney planners can be hired by attorneys as advisors under the privilege
- Assistance usually required with creation of investment policy statement or choice of suitable products

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Annual Maintenance

- Mostly Turnkey for Clients
- License Fees
- Premium or Franchise Taxes
- Actuarial
- Accounting
- Insurance Manager and Underwriting
- Typical Annual Fees ~ \$50,000

Exit Options

- Liquidate captive and pay long-term capital gains
- Quit writing insurance, make S election
- Sell insurance company to third-party and pay long-term capital gains
- Reinsure new captive held by next generation

Contact Information

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including captive insurance companies*