

The Three Cs:

Conservations Easements,
Captive Insurance Companies &
Credits

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Tax Reduction Strategies

- Conservation easements
- Federal and state tax credits
- Captive Insurance Companies

Conservation Easements

- Voluntary restrictions on the use of land negotiated by the landowner and the organization chosen by the landowner to “hold” (enforce) the easement.
- Purpose: to eliminate most or all development potential in order to protect some conservation value(s) of the property that provides a significant public benefit.

Conservation Easements Benefits

- Property owner
 - Tax benefits vs. monetized benefits
 - Income tax deduction under §170 (h)
- Estate tax benefits
 - §2031 (c) and 2055 (f)

Captive vs. Small Companies

- “Captive” means the insureds of insurance company are affiliated with the owners of the insured company(ies)
- “Small” means the insurance company falls under IRC Sec. 831(b)

IRC Sec. 831(b)

- 831(b) Alternative tax for certain small companies
- (1) In general
 - In lieu of the tax otherwise applicable under subsection (a), there is hereby imposed for each taxable year on the income of every insurance company to which this subsection applies a tax computed by multiplying the taxable investment income of such company for such taxable year by the rates provided in section [11 \(b\)](#).
- (2) Companies to which this subsection applies
- (A) In general
 - This subsection shall apply to every insurance company other than life (including interinsurers and reciprocal underwriters) if—
 - (i) the net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed \$1,200,000, and
 - (ii) such company elects the application of this subsection for such taxable year.
 - The election under clause (ii) shall apply to the taxable year for which made and for all subsequent taxable years for which the requirements of clause (i) are met. Such an election, once made, may be revoked only with the consent of the Secretary.

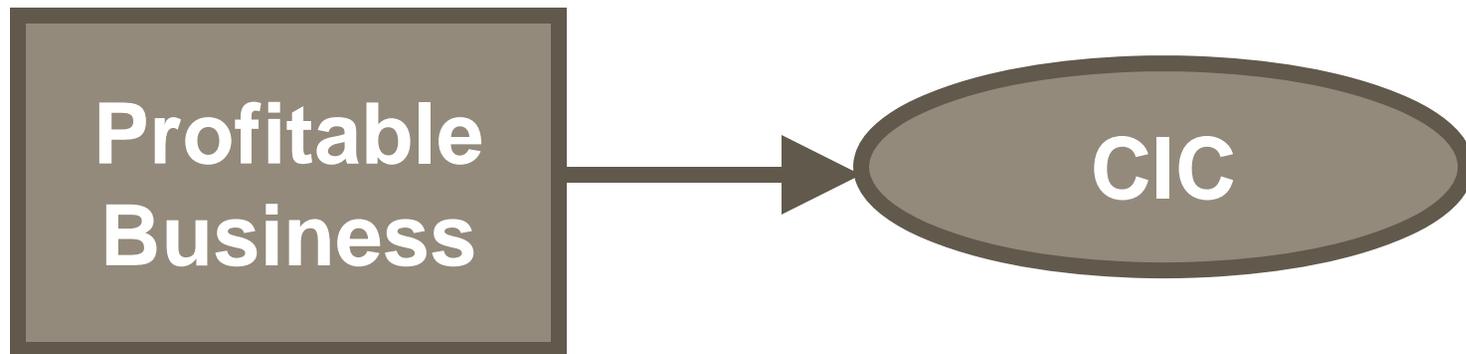
CIC Taxation

IRC 831(b) provides that:

- Insurance companies with less than \$1.2 million of annual premium pay \$0 income tax on insurance profits
- Investment income is taxed as income to C-corporation
- 831(b) must be timely elected and cannot be revoked without the permission of the Secretary

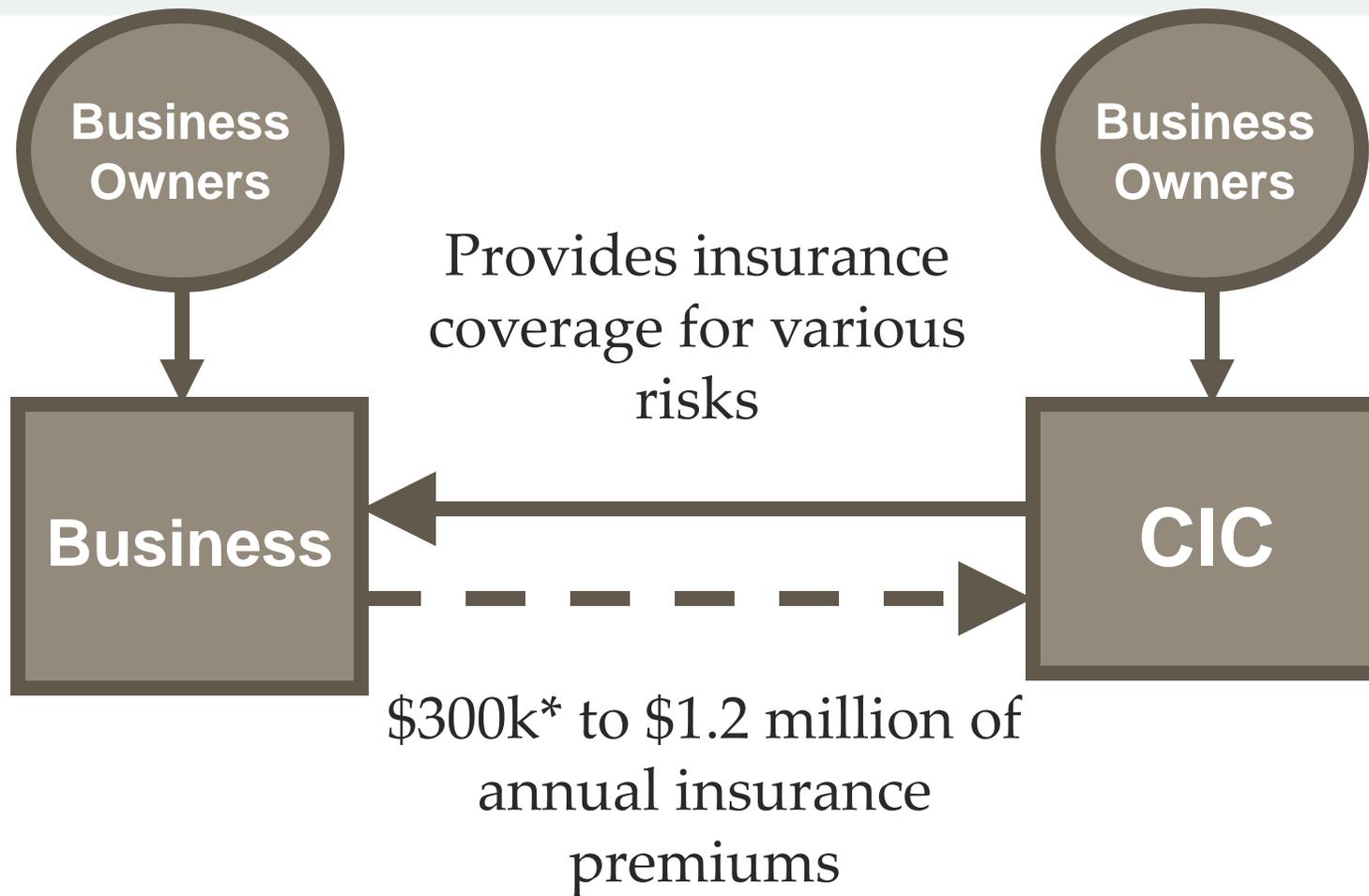
Tax Treatment of Premiums

- Profitable business pays up to \$1,200,000 in premiums each year



- Premiums may be deductible under sec. 162

Captive Insurance Company – 831(b)



* Practical not statutory

Economic Family Doctrine

- Adopted by the IRS in 1977 (Rev. Rul. 77-316)
- Parent corporations and their subsidiaries form an economic family
- If the ultimate burden of loss is retained in the family, there is no risk shifting or risk distribution (requirements to be considered insurance as set forth by the Supreme Court in Helvering v. LeGierse, 312 U.S. 531 (1941))
- Therefore, premium payments are treated as capital contributions or dividends and are not deductible under Sec. 162

Economic Family Doctrine

- IRS' economic family doctrine was not accepted by the courts (See Humana Inc., 881 F. 2d 247)
- IRS abandoned doctrine in Rev. Rul. 2001-31
- Adopted instead a facts and circumstances approach for determining if transactions constitute insurance (See Malone & Hyde, Inc., 62 F.3d 835, 76 AFTR2d 95-5962 (CA-6, 1995), rev'g TCM 1993-585)
- IRS continued to apply facts and circumstances test (See TAM 200149003, FSA 200202002, Notice 2002-70)

Risk Distribution

- Risk Distribution – does the insurance company distribute its risk to other insureds?
 - Rev. Ruls. 2002-89 (50%); 2002-90 (12 subs or no more than 15% of total premium); 2002-91 (Group Captive-7 unrelated insureds)
 - Harper Group and Includable Subsidiaries v. Commissioner, 96 T.C. 45 (1991): Because the CIC had at least 30% unrelated third party risk, the arrangement constituted insurance
 - Rev. Rul. 2005-40: risk distribution requirement is met if CIC has 12 or more insureds (10% risk distribution insufficient; single member LLCs and other disregarded entities are disregarded for risk distribution purposes)
 - Affiliated companies count, but not single-member LLCs
 - Compare to Humana, Inc. v. Commissioner, 881 F.2d 247 (6th Cir. 1989) in which sums paid to parent company's Captive Insurance subsidiary, on behalf of several dozen parent company subsidiaries was sufficient risk distribution to constitute insurance

Recent IRS Guidance

- December 31, 2004 - IRS releases rulings showing non-sham, bona fide captive insurance companies (TAMs 200453012 & 200453013)
- Rev. Rul. 2005-40, 2005-2 CB 4. A company that insures a single corporation cannot be an “insurance company”, even if the insurer is unrelated to the insured, premiums are arm’s length and the insurer is adequately capitalized, since there is no risk distribution

Recent IRS Guidance (cont)

- Ltr. Rul. 200644047. An insurance subsidiary insured the risks of its parent. Although various physicians performing work for the parent were also insured, the Service concluded that the risks insured were essentially that of the parent. (Rev. Rul. 2005-40)
- TAM 200816029. For purposes of applying Rev. Rul. 2005-40, the common General Partner of several Limited Partnerships is treated as one insured
- PLR 200907006. Service concluded that there was adequate risk distribution to warrant the company being treated as an insurance company. (Rev. Rul. 2002-91)

Recent IRS Guidance (cont)

- PLR's 200950016 & 200950017. Service finds reinsurance pools adequately satisfy risk distribution requirements as provided in Rev. Rul. 2002-90.
- PLR 201030014. Service finds that a Small Captive (831(b)) is recognized as a valid insurance company. "Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim."

Why Own a Small Insurance Company?

■ Estate Planning

- Best practice: CIC owned by dynastic trust for heirs
- Jurisdiction shopping for unlimited Rule Against Perpetuities: AK, DE, FL (360 yrs)
- Can structure to allow client shared access to investments

■ Buy-out Retirement Planning

- CIC can tie into a business buy-out/retirement plan/employee benefits
- More tax efficient than traditional methods

■ Tax Planning

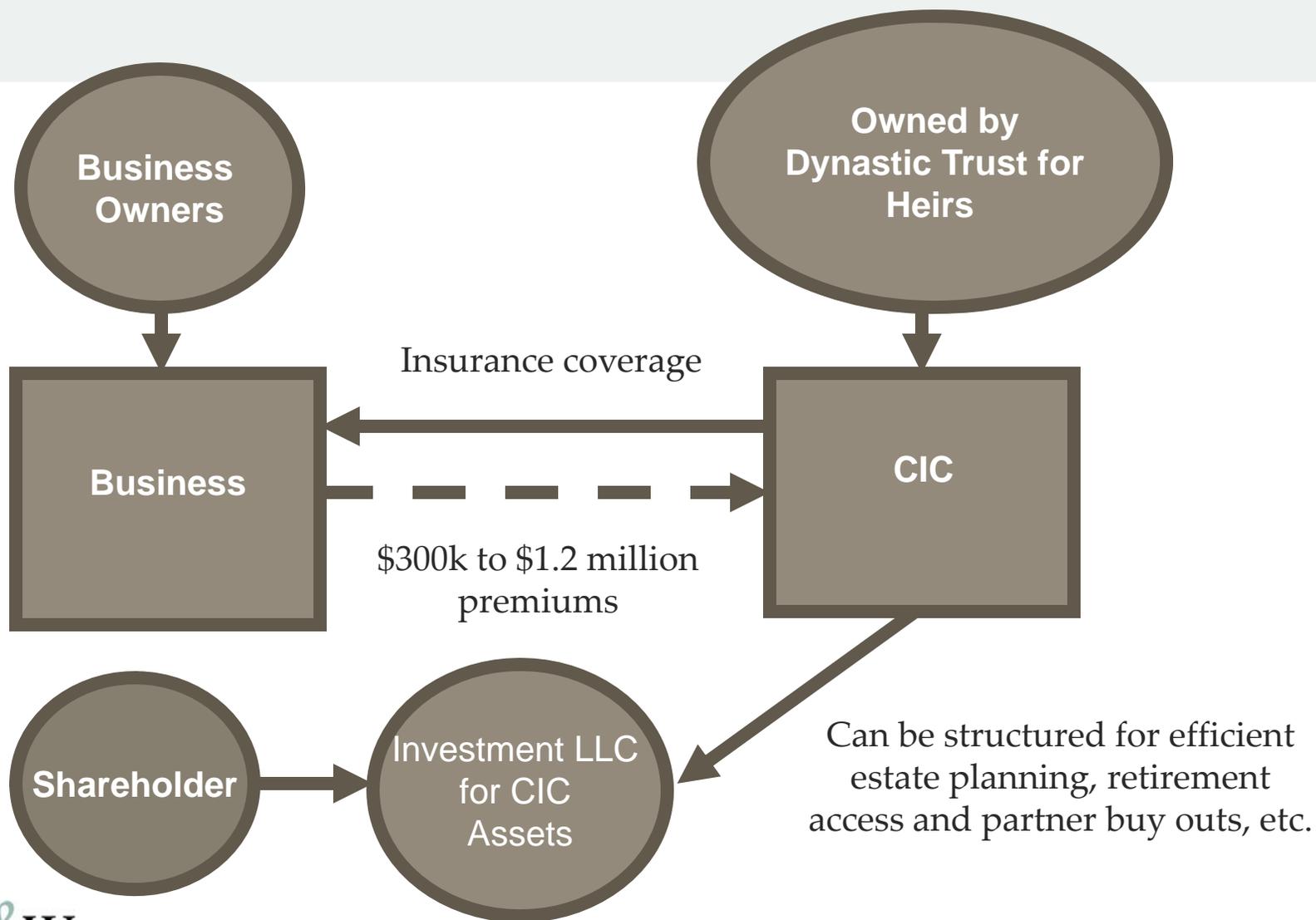
- Premiums can be tax deductible
- Benefit to family can be estate/gift tax free
- Profit can be accessed at lower tax rates

Risk Management Concept

Each business or practice has risks that it currently does not insure against, including:

- Deductibles & co-payments in existing policies:
 - Medical malpractice
 - Commercial general liability
 - Premises and products liability
 - E&O, D&O, and others
- Liability risks for which there is no coverage
 - Employee claims, partnership liability, government liability, etc.
- Economic risks for which there is no coverage
 - Loss of income, revenue cutbacks, loss of key person, loss of a key contract, etc.

CIC with Advanced Planning



Buy-Out and Retirement Concept

Business owners and employees are always looking for tax efficient ways to transfer wealth during buy-ins of younger partners and buy-outs of older ones.

- A business can create an internal buy-out plan using the CIC reserves.
- With particular structures, funds can be accessed by senior (retiring) partners during their lifetime in a tax-favored manner.
- The total retirement benefit from such arrangements can be significant.
- Operating business or practice will pay tax deductible premiums to the CIC owned by the senior partners so funds will accrue to older owners' for their retirement.

Tax Planning Benefits

1. Deductibility of premiums §162/§212
 - Assuming premiums are market comparable or can be valued by an actuary
2. Taxation of CIC's profits
 - 831(b) provides tax exemption from premium tax and from underwriting profit.
 - 831 (b) must be elected timely and cannot be revoked without permission of Secretary
 - Federal Tax on investment income only
3. Retirement
 - Certain investments and structures could allow client to access CIC invested funds tax efficiently.
4. Estate/Gift Taxes
 - Could transfer millions to heirs tax efficiently.

The Ground Rules

- Premiums and policies must be market-comparable
- Actuarial support needed
- Insurance formalities complied with
- Risk distribution must be present
- Initial Capitalization required
 - Letter of Credit accepted in several states
 - 4:1 (premiums to capital) with certain minimums
 - Gift tax return Form 709

Captive Insurance Company Policies

- Everything a business currently self-insures:
 - Deductibles
 - Excess losses above coverage limits
 - Construction defect
- Loss of income as a result of:
 - Losing key employee/salesperson
 - Loss of license/professional risks (professionals)
 - Loss of a key contract (Gov't. contractors)
 - Weather, terrorism, etc.
- Liability defense expenses:
 - Employee lawsuits – sexual harassment, wrongful termination, discrimination, etc.
 - Environmental issues
 - Professional claims
- Anything that might be considered a “Lloyd’s” risk

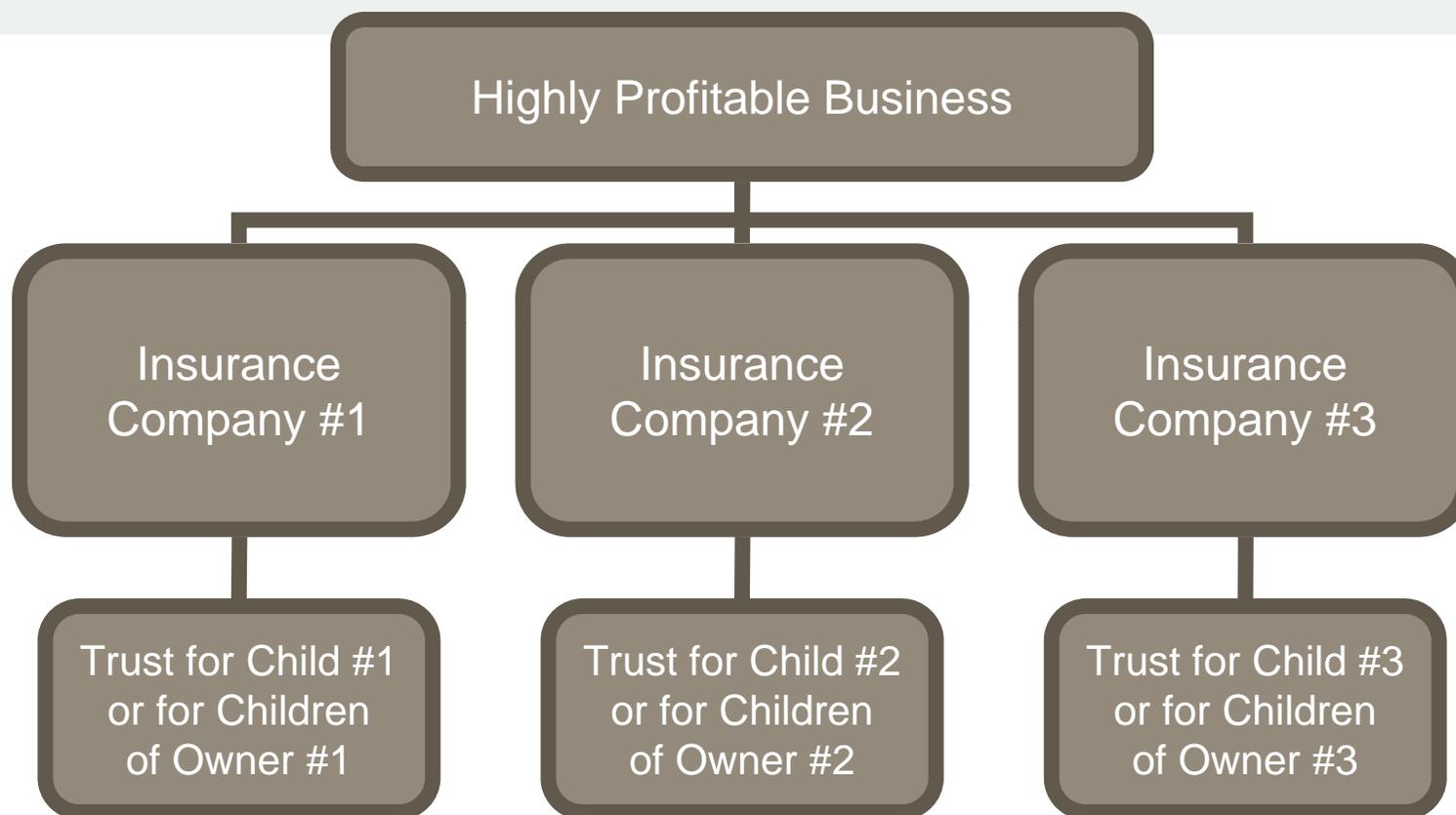
Examples of Captive Insurance Policies Written

- Professional Liability Gap Coverage
- HIPAA/Billing Audit Liability
- Contractual Liability
- General Liability Gap
- Cyber Liability
- Environmental Liability
- Excess Environmental Liability
- Labor Shortage/Strike Loss Reimbursement
- Employment Practices
- Employee Dishonesty
- Patent Infringement/Intellectual Property
- General Liability Gap
- General Liability Retention
- Property Management Professional
- Professional Misconduct
- Product Recall
- FDA Administrative Actions Liability
- Product Liability Gap
- Directors and Officers Liability
- Punitive Damages
- Loss of Key Employee
- Deductible Reimbursement (Property, Workers Comp, General Liability, Product Liability)

Greater Leverage for Larger Clients

- Clients' children (or trusts) can own CICs
- Each child (or trust) can own one CIC (children under age 21 are attributed to their parent)
- Client can still be the manager of the CIC and control the investments of CIC
- Effectively, this option saves current income taxes (35%-47%) to client and future estate taxes (35%) on net proceeds
- Children will only pay capital gains or dividend tax rates (currently 15% federal) in future

Multiple CIC Structure



Parent's Business could pay up to \$1.2 million per year into EACH child's CIC or into a CIC for each owner's children. §1563 attribution rules apply . Children under age 21 are attributed to the parent.

Thank you.

Please contact me if you have any questions.

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