EXECUTIVE SUMMARY

Partially Exempt Non-Life Insurance Companies

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INTRODUCTION

Under the Internal Revenue Code, small insurance companies meeting certain requirements are given special benefits. A non-life insurance company that earns less than $1.2 million annually in premiums may in some circumstances avoid taxation on those premiums. However, the company will be taxed on all investment income. See IRC § 831(b).

A larger type of life insurance company, with premiums up to $3 million a year, is taxable at a favorable 13% rate on all its income. From $3 million to $15 million in premiums, the rate increases gradually until there is no reduction from ordinary rates. Sec IRC Sec. 806.

THE TAX BENEFITS

It may be possible in some circumstances to accomplish the following:

Underwrite Client's Own Business. Set up a "captive" insurance relationship, and cause the client's business to purchase premiums of up to $1.2 million annually from the insurance company. This gives the business a deduction for the premiums paid, but the insurance company does not pay corresponding income tax because of its quasi-exempt status -- so long as sufficient "third party insurance" is underwritten by the company.

Estate Tax Planning. Form a "captive" insurance company for the client's children over 21, and have the client's existing business purchase insurance coverage from the children's insurance company. This gives the client's existing business a deduction for the premiums paid, while also moving these moneys out of the parent's estate and to the children's insurance company.

ADVANTAGES ONLY TO *BONA FIDE* INSURANCE COMPANIES

These exemptions <u>only</u> apply to *bona fide* insurance companies that actually shift risk in the economic sense, and that have as their principal activity the business of insurance. These companies are closely scrutinized by the IRS, and the rules defining abuses of the tax benefits are still evolving. At a minimum, the insurance company must do the following:

Be adequately capitalized. The IRS has often challenged and won against thinly-capitalized insurance companies. An insurance company must be adequately capitalized for the purpose for which it is being formed, and the risks that it is underwriting.

License. A *bona fide* insurance company will have an insurance license issued to it by a jurisdiction having a respected regulatory regime.

Have insurance managers, actuaries, underwriters, and accountants. A company which does not have competent professional advisors may not be respected as *bona fide* for tax purposes.

Underwrite insurance risks. A small insurance company which fails to underwrite insurance risks commensurate with its capitalization and business plan runs the risk of being declared a sham for tax purposes.

Underwrite third-party risks. A small insurance company which does not write a minimum percentage of third-party insurance may be held not to distribute significant economic risk, and thus may be declared not to be an insurance company for tax purposes. Third-party risks are those risks that do not involve the insurance company's parent corporation, and are outside the control group that includes the insurance company. If a client's insurance company only underwrites the insurance needs of the client's business ("related party insurance"), there would be no third-party insurance. Although case law allows related party insurance, combined with a significant portion of third party insurance, it must be written on commercially reasonable terms in order to substantiate a deduction for premiums.

Resolution of Claims. The insurance company must resolve claims made against its policies.

HISTORICAL USES OF SMALL INSURANCE COMPANIES

Corporations, individuals and planners have successfully utilized insurance companies since the early 1900's to:

Manage Risks

Minimize federal and state income taxes, and

Diversify and increase portfolios.

The following individuals or companies are prime candidates for the utilization of insurance companies:

Owners of Profitable Businesses

Self-Insured & Partially Self-Insured Companies

Congress has given insurance companies special tax benefits not available to other businesses. You can take advantage of these tax benefits by owning your own insurance company.

SUMMARY OF NON-TAX BENEFITS

Insurance Business - An insurance company will generate revenues from underwriting risks, including risks which are now self-insured, as well as certain third-party risks.

Asset Protection - An insurance company will typically provide valuable additional asset protection benefits.

Control - The insurance company owners and participants retain substantial control over investments, and flexibility in how those investments are managed. An advantage of an insurance company over other accumulation vehicles, such as trusts, is that it is proper for the owner to control and manage the insurance company's assets.

Reinsurance Market Access - An insurance company can negotiate with reinsurers for coverage of excess risk. In general, reinsurance rates decline when small captives combine to form a risk retention group (e.g., for medical malpractice insurance).

Independent Investment - An insurance company has the potential to become a business of great value.

COMPLIANCE AND DISCLOSURE

Each aspect of insurance company formation and management in which this office participates is conducted in strict compliance with current rules and regulations under the Internal Revenue Code, with complete disclosure and reporting to the Internal Revenue Service.

Insurance company owners and participants are not asked to sign a confidentiality agreement relating to the matters discussed in this summary.