Maximising value

Neil B. Glassman and Trisha W. Hall of Bayard Law discuss how Delaware captives can be used to maximise the value of closely held enterprises

As captive insurance companies gain ground with middle market companies, many business owners are seeking ways to maximise the value of the captive vehicle, by enhancing the worth of family enterprises. An often overlooked strategy is to use a captive for personal wealth accumulation, a form of 'estate planning' that makes sense incrementally, if the captive makes business sense in the first place. For smaller captives, the United States income tax advantages often will exceed the cost of operations, the savings from which can be invested for growth over the long-term. For those business owners who are subject to US taxation upon death, the wealth that accumulates in the captive will then pass tax free to the next generation. The benefits of this strategy are amplified by utilising the laws of Delaware.

Traditionally the playground of the Fortune 500, captive insurance companies are becoming increasingly popular with the middle market, largely as a result of economies of scale and favourable US tax decisions in the early 2000s. Due to the fact that many businesses in the middle market are closely held family-owned entities, advisors and captive managers have recognised opportunities to grow and shift wealth to the family through the ownership structure of the captive. Before taking advantage of these opportunities, however, the captive has to make sense for the business in the first place: risk transfer and risk distribution must be present, the business must insure actual risks, and actual claims must be processed. Where the insurance arrangement makes sense, the benefits of the captive extend beyond insurance and risk management.

The United States incentivises companies to insure risk by offering certain advantages to them through its tax code. A business may take a current year income tax deduction for premiums paid for insurance whereas no such deduction exists for money set aside in reserve to cover future losses. A "micro-insurance company," meeting the definition of section 501(c)(15) of the US tax code, does not pay income tax on either its underwriting or investment income, if the total income for the company is less than $600,000, no more than half of which is from its investments. A 'small insurance company', meeting the definition of section 831(b) of the US tax code, does not pay income tax on its underwriting income, but will pay tax on income from its investments.

In contrast to the tax treatment of insurance, the US penalises individuals who die with significant wealth, also through the tax code. US gift, estate and generation skipping transfer laws impose taxes on intra-family transfers of wealth. After the imposition of these taxes, approximately one-half of the property transferred may actually be enjoyed by the intended recipients, with the government taking the other half. However, because these taxes apply only to gratuitous or below-market transfers, and premiums paid to a captive are actuarially determined payments for insurance policies, transfer taxes will not apply. Therefore, by structuring a captive insurance company so that it is owned by the business owner's family, directly or, preferably, indirectly through a trust or other entity, the business owner can maximise the family enterprise value.

> "Domiciling a captive insurance company in Delaware, with its efficient, experienced and flexible regulatory scheme, is an excellent strategy"

A series offering

Domiciling a captive insurance company in Delaware, with its efficient, experienced and flexible regulatory scheme and environment, and its historically friendly and welcoming business and

trust climate, is an excellent strategy to facilitate wealth accumulation and wealth transfer. Delaware offers by statute serialised legal entities in the form of a series LLC or a series statutory trust (here, referred to collectively as a series organisation). A series organisation is similar to a protected cell captive in that the assets of each series within the organisation are isolated from the liabilities of the other series and possibly the series organisation itself. Each series will also be treated as a separate taxpayer for federal income tax purposes. Unlike a protected cell captive, each series may have members and managers distinct from those of the series organisation or other series, with specified rights, duties and powers, and each series may have a discrete business purpose or investment objective. A serialised captive may qualify as a special purpose captive in Delaware and as such will pay Delaware's premium tax only at the organisational level and not for each series unit. This feature reduces the operational cost of forming multiple, related captives.

Delaware offers a myriad of trust and estate planning vehicles and benefits. Notably among them are the self-settled asset protection trust (APT) which allows the person establishing or contributing property to the trust to protect trust assets from his or her creditors, while retaining some control over and enjoyment of them. Delaware also allows for certain trusts, so called dynasty trusts, to last in perpetuity. In addition, Delaware does not impose an income tax on beneficiaries of Delaware trusts who reside out of the state, which results in savings of up to 11%. Delaware also provides, by statute, the ability to sever the functions of the trustee into separate roles for administration, investments, and distributions, while protecting the ability of management to safely make decisions and implement necessary strategies.

Of course, Delaware's renowned and respected Court of Chancery decides all matters related to both business entities and trusts.

A case study

The following case study illustrates how these various benefits can operate together to benefit a business owner and his family:

Propco, a closely-held real estate development company structured with a subsidiary for each of its projects, was founded by John Smith. Propco has experienced inconsistent swings in the cost of its liability insurance policies over the years, and routinely sets aside money in reserve to pay for losses not covered by those policies. Based on a feasibility study, Propco has decided to implement a captive insurance programme. The captive will insure Propco's more manageable risks, for example, employment practices, water damage, mould, and deductible reimbursement; risks it had previously been paying from reserves without a policy of insurance to cover them. Propco will continue to purchase insurance for third-party risks from the traditional insurance market. Propco will take a deduction on its US income tax return for the premiums it pays to the captive.

John Smith previously formed Smith Family LLC to consolidate the management of his various investments, to protect those investments from his future creditors, and to facilitate the transfer of the investments to his three adult children. John has retained a 1% ownership interest in Smith Family LLC. A Delaware dynasty trust for the benefit of John's children and their families owns the other 99%. John also establishes a Delaware APT with himself as a discretionary beneficiary along with his wife and children, which will continue for his children's benefit after his death. Smith Family LLC will provide the initial funding of capital into the captive. The captive will be formed as a Delaware Special Purpose Series LLC with Smith Family LLC as the member of series A and John Smith's Delaware APT as the member of series B. Each series will qualify under section 831(b) of the US tax code as a small captive and will receive $1m of premium annually.

Neither series A nor series B will pay US income tax on the premiums they receive. Delaware will not tax either the premium income or the investment income. The surplus of each series will be invested in a diversified portfolio. Even after the captive pays claims, expenses and taxes on its investment income, the growth on the assets in the captive will exceed the growth that would have been earned outside of the captive because of the tax savings. The tax savings in the captive will compound over time. As this is a legitimate business arrangement that happens to benefit the business owner's family, it escapes gift, estate, and generation skipping transfer tax liability upon John Smith's death.

When establishing and managing captive insurance companies, do not overlook the ownership structure of the captive. By doing so, you may be only solving half of the equation.

Neil B. Glassman practices insolvency, insurance and entity law. He advises financial institutions and public and privately held businesses and investors on insolvency and bankruptcy matters and has developed a specialty in counselling insurance companies in regulatory matters in Delaware, including the formation and operation of captive insurance companies.

Trisha W Hall focuses her practice in the areas of estate planning, estate and trust administration, and the representation of fiduciaries and beneficiaries. She advises clients on all aspects of estates and trusts, including wills, powers of attorney, probate and estate administration, and irrevocable trusts.

Delaware Captives

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Clients seeking advice related to the formation & operation of captive insurance companies receive comprehensive legal counsel from Bayard's insurance and tax attorneys.

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222 Delaware Avenue, Suite 900
Wilmington, DE 19801
+1 (302) 655-5000 • www.bayardlaw.com