

**Captive Insurance Companies Provide Tax and Economic Advantages for Hedge Funds** By Gerald Nowotny<sup>1</sup>

*This article will outline the how a captive insurance company created by the hedge funds can serve as a highly effective risk management tool while achieving tax benefits for the hedge fund and its principals from both an income and estate tax planning perspective. The use of captive insurers has not been widely exploited by the hedge fund industry at this point in time for no apparent reason other than lack of familiarity. This article will provide examples of how a captive insurer can be used by hedge funds.*

Hedge funds and their principals have amassed great fortunes over the last fifteen years. Principals of hedge funds can no longer bask in the anonymity of the early days of hedge funds. A number of hedge fund managers have the profile of global titans of industry occupying solid positions in the Forbes 400 Wealthiest. This trend will likely continue as many hedge funds sitting on piles of cash are also becoming private equity<sup>1</sup> firms taking control of well known publicly traded companies.

The creation of hedge funds continues to proliferate at a rate of 25% to 30% per year. The hedge fund industry currently has over 5,000 funds and \$2.2 trillion of assets, but it is increasingly under attack from a number of regulatory fronts. The Securities Exchange Commission (SEC) is looking for greater investor disclosure while the Department of Treasury is looking for additional tax revenue. Treasury has identified several avenues of displeasure and additional revenue sources. Congress is unhappy with the current ability of hedge funds to defer performance fees in the offshore fund of hedge funds.

The New York Times referred to these arrangements as a Super Roth IRA for hedge fund managers.<sup>1</sup> Additionally, Congress is unhappy with the ability of tax-exempt investors to avoid unrelated business taxable income (UBTI) treatment by investing in the hedge fund's offshore fund. Lastly, Congress does not approve of the loan origination activity of hedge funds in domestic hedge funds avoiding UBTI treatment through sales of the loans to the offshore fund after a short seasoning period.

The likelihood of tax law changes in a presidential election year is not high. Any tax changes will most likely follow the election. However, it seems clear that notice has been given to the hedge fund industry and it is not business as usual. Congress views hedge funds and their principals as "fat cats" who are not paying their fair share in taxes. In a period of record deficits, Congress seems to have taken the view that it will be less controversial to raise taxes from this highly compensated esoteric industry than raising taxes in more controversial sectors. Virtually all hedge funds are structured as pass-through entities such as Limited Liability Companies or Limited Partnerships. Most hedge fund complexes operate their strategies with a domestic fund and an offshore fund

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for foreign investors and U.S. tax-exempt investors. The hedge fund investment management firm operates as the fund's general partner or managing member. The hedge fund's compensation is structured as an annual management fee of 1% to 2% per year and a performance fee equal to 20% to 30% of the fund's return. The performance fee is often subject to a performance fee known as the "high water" mark.

Hedge funds frequently operate with a small number of highly skilled and compensated employees and staff. As a result, these funds are exposed to large amounts of taxation at the individual rates of the principals (owners) of the hedge fund. In the New York tri-state area (where the majority of hedge funds are located), these rates can approach 40% to 48%. The after-tax business and investment income from the hedge fund will be reinvested in assets that are part of the hedge fund manager's taxable estate. Hedge funds also operate with a significant amount of business and market risk due investment strategies and the large amount of leverage used within the fund in volatile global markets.

### **What are Captive Insurance Companies?**

A captive insurance company is an insurance company that insures all or part of the risk of its parent company. The biggest catalyst in the development of captive insurers has been the expense or lack of availability of certain types of insurance in traditional commercial insurance markets. Association or group captives underwrite the risks of members of an industry or trade association. Agency captives formed by insurance brokers or agents allow agents to participate in the high-quality risks, which they control.

Captives have been used with the auto industry auto dealers as part of the dealership's warranty programs. Captives have also been created in response to disappearance of traditional insurance markets following devastating hurricanes or earthquakes.

Rent-a-captives are insurance companies that provide access to captive facilities without the business owner or user needing to capitalize his own stand-alone captive. The user pays a fee for the use of the captive facilities and will be required to provide some form of collateral so that the rent-a-captive is not at risk from any underwriting losses suffered by the user.

Captive insurers can be established as direct-writing companies that issue policies. However, the insurance industry is generally highly regulated in many jurisdictions allowing certain risks to be underwritten only by an admitted insurer. Generally in the case of smaller captives, it is simpler for the captive to operate as a reinsurer accepting the risks of its parent, which have been insured by a licensed direct-writing company (a 'fronting company') that is admitted in the jurisdiction and then ceded to the captive. The fronting company will charge a fee for its services and may require a letter of credit to guarantee the captive's ability to pay claims.

## **Traditional Reasons for Captive Insurers**

The following are eight traditional reasons for using captive insurers:

**Tax Minimization and Deferral.** Premiums paid by the captive are tax-deductible expenses to the operating company, the hedge fund. The premium income to the captive may also be income tax free depending upon the level of premium or alternatively taxed at a rate of 15% for federal tax purposes. The tax differential between the captive and the hedge fund manager's marginal tax bracket provides a favorable tax arbitrage. The captive can further defer taxation through the management of its reserves (liabilities).

**Lower Insurance Costs.** Commercial market insurance premiums must be adequate to meet the cost of claims. However, insurers are in business to make money and include in the premium a margin to provide for their acquisition costs, overheads and profit. This portion of the premium can represent as much as 35% or 40% of the premium. Through the creation of a captive, the parent seeks to retain the profit within the group rather than see it go to an outside party. A captive can help to reduce insurance costs by charging a premium that more accurately reflects the parent's loss experience instead of a certain industry as a whole.

**Cash Flow.** Aside from underwriting profits, insurers rely heavily on investment income. Premiums are typically paid in advance while claims are paid out over a longer period. Until claims become payable, the premium is available for investment with the captive. Through use of a captive, premiums and investment income are retained within the group.

**Risk Retention.** An operating company's willingness to retain more of its own risk, particularly by increasing deductible levels, may be frustrated by the inadequate discount offered by commercial insurers to take account of the increased deductible and by the fact that the company is unable to establish reserves to pay future claims on a tax-advantaged basis. Establishment of a captive can help address both these problems.

**Unavailability of Coverage.** A captive may offer coverage in a situation where the commercial market is unable or unwilling to provide coverage for certain risks. In other instances, a captive may provide a solution when the price quoted is seen to be unreasonable.

**Risk Management.** A captive can act as a focal point for risk management and risk financing activities of its parent organization. An effective risk management program will result in recognizable profits for the captive. Risk management can be viewed by a captive owner not as a cost center but as a potentially profitable part of the company's activities.

**Access to Reinsurance Market.** Reinsurers are the "wholesalers" of the insurance world. Reinsurers operate on a lower cost structure than direct insurers and are able to provide coverage at advantageous rates. As a result of using a captive to access the

reinsurance market, the buyer can more easily determine his own retention levels and structure its program with greater flexibility.

**Writing Unrelated Risks for Profit.** Apart from writing its parent's risks, a captive may operate as a separate profit center by insuring the risks of third parties. Underwriting unrelated risks may also be necessary to preserve the tax deductibility of premium payments.

### **Benefits of Hedge Fund Captives**

The hedge fund captive is unlike a traditional captive insurer. The focus of such a captive is not exclusively designed to reduce insurance costs. The additional planning objectives beyond risk management of a hedge fund captive are income tax reduction and deferral; asset protection; wealth transfer, and the reduction of future estate taxes. The hedge fund captive accomplishes these objectives.

A hedge fund captive is much more than a loss control vehicle. A captive should be seen as a vehicle for transferring wealth out of the operating business so that wealth is not trapped within the operating business, and thereby subject to higher taxation and the claims of the business' creditors. Premiums paid to the captive are tax deductible to the hedge fund. Premiums paid by the by the hedge fund are able to accrue reserves (read as liabilities of the captive) income tax-free and enjoy the other tax advantages of captive insurers at lower tax brackets than the hedge fund or its owners.

The captive can serve as an inter-generational wealth transfer tool. For the hedge fund manager, the shares of the captive can be transferred to an irrevocable family trust that removes the assets from the hedge fund manager's estate for federal estate tax purposes, at the time of the captive's formation. Over the period of time assuming favorable claims experience, the surplus of the captive will become significant.

Depending upon the laws of the jurisdiction, the captive will have considerable flexibility on permissible investments for the captive. The captive can potentially reinvest within the hedge fund manager's funds at a significantly lower rate than the manager's personal marginal income tax bracket.

The captive arrangement can also provide strong asset protection benefits to the hedge fund manager. The transfer of wealth from the hedge fund or investment management firm to the captive through premium payments provides a form of asset protection to the hedge fund manager. Ownership of the captive within a family trust (irrevocable) or an offshore asset protection trust (APT) provides another layer of asset protection for the hedge fund manager. The captive is an excellent wealth preservation vehicle. The captive is not a subsidiary of the hedge fund. The liabilities of the captive are limited to the exposure of the policies that it underwrites.

As a wealth accumulation vehicle, the captive arrangement is very powerful. The captive arrangement allows the operating business to take an income tax deduction for its premium payments. The captive is able to take a current deduction of the premium

payment as a contribution to its reserves. The ability to accrue reserves on a tax-free basis provides the captive with a unique ability to create deductions, defer taxes and time taxation for years when the captive is less profitable. These deductions can offset the captive's investment gains.

From a wealth accumulation standpoint, the captive can operate as a family bank in the sense that the captive can make an arms-length loan to a family member or business. These loans are treated for income tax purposes as tax-free distributions. The ability to make loans on an arms-length basis is a benefit of offshore jurisdictions.

### **Types of Captive Insurance Companies**

A closely held business owner should consider forming his own single captive insurer if premiums are at least \$500,000. In the event the closely held business does not have sufficient premiums to justify the creation of its own captive, the business owner may consider a rent-a-captive or a group (association) captive. These companies are also known as protected cell companies or segregated cell companies.

A rent-a-captive allows for the creation of segregated cell companies that provide for an internal separation of liability for each cell within the company, i.e., the liabilities of one client in a cell do not extend to another client.

A group or association captive is a third alternative for captive. The association captive may offer an array of coverage for a business owner. The group captive may also provide an experienced rate dividend to association members based upon claims experience for the group.

### **Tax Planning Considerations for Captives**

Micro-captives are able to make an election under Section 501(c) (15) to be treated as tax-exempt organizations. These captives have less than \$600,000 in gross receipts; 50% (not more than \$300,000) must be insurance premiums.<sup>2</sup> Due to tax abuse of these captives, Congress has created more stringent requirements to meet the requirements for tax-free status.

Mini-captives take in less than \$1.2 million of premiums annually. This captive may make an election under Section 831(b). Under that section, the Mini-captive is not taxed on premium income but only the captive's investment income.<sup>3</sup> This type of captive must have a minimum of at least \$350,000 in annual premiums to qualify for these tax benefits.

A captive may also be structured as a life insurance company under provisions in Sections 806 and 816 that provide a special tax deduction for "small life insurance" companies of 60%. The company's reserves related to life and health insurance must represent at least 51% of the captive's reserves. The company size cannot exceed \$500 million in assets.<sup>4</sup> The company's taxable income cannot exceed \$3 million. The special provisions provide the company with an effective rate of 15% for federal tax purposes.

The Internal Revenue Code does not provide a definition of insurance. From a tax compliance standpoint, the Service's primary challenge focuses on risk distribution. Risk distribution deals with the concept that the captive must issue enough policies to different insureds such that the "risk" is sufficiently spread across a number of policyholders to constitute "insurance" for tax purposes. This concept deals primarily with premium deductibility for the operating company.

Court cases have developed safe harbors to meet the risk distribution requirements. These court cases stipulate the minimum percentage of third-party risk that a captive must underwrite. Following the Gulf Oil case, the IRS unofficially maintained that a captive must underwrite at least 30% third-party risks.<sup>5</sup> The new safe harbor is at least 50% third-party risks. A captive can usually satisfy this risk by finding quality reinsurance risks to underwrite. The captive management firm assists the captive in identifying third party risks with low claims experience.

Rev. Rul. 2005-40 has introduced another safe harbor test that provides the captive must have at least eleven different insureds. This requirement can be met even if the insured is a related entity.<sup>6</sup> In Situation 4, the twelve subsidiaries were brother-sister companies were structured as LLCs, but were not disregarded entities for federal tax purposes. The Service ruled that the arrangements constituted valid insurance arrangements for tax purposes. In addition to these safe harbor guidelines, tax guidelines require the captive insurance arrangement to be similar to arm's-length commercial arrangements, i.e.:

1. Insured must face true hazard.
2. Premiums are based on commercial rates and actuarial experience.
3. Risks are shifted and distributed to the insurance company.
4. The arrangements must constitute insurance for federal income tax purposes.

Rev. Rul. 2008-8 provides guidance on whether a segregated cell captive or protected cell captive constitutes insurance for federal tax purposes. Protected cell or segregated cell captives are the separate entities of a rent-a-captive.<sup>7</sup>

**Protected Cell Company.** A protected cell company is a legal entity formed by a sponsor. The protected cell company establishes multiple accounts, or cells, each of which has its own name and is identified with a specific participant (business owner), but is not treated as a legal entity distinct from the protected cell company. Each cell is funded by its participant's capital contribution and by "premiums" collected with respect to contracts to which the cell is a party. Each cell is required to pay out claims with respect to contracts to which it is a party. The income, expense, assets, liabilities, and capital of each cell are accounted for separately from the income, expense, assets, liabilities, and capital of any other cell and of protected cell company generally. The assets of each cell are statutorily protected from the creditors of any other cell and from the creditors of Protected Cell Company.

A protected cell company maintains non-cellular assets and capital representing the

minimum amount of capital necessary to maintain its charter. Each cell may make distributions with respect to the class of stock that corresponds to that cell, regardless of whether distributions are made with respect to any other class of stock. In the event a participant ceases its participation in Protected Cell Company, the participant is entitled to a return of the assets of the cell in which it participated, subject to any outstanding obligations of that cell.

The holding of Rev. Rul. 2008-8 follows the methodology of Rev. Rul. 2005-40 and Rev. Rul. 2002-90.<sup>8</sup> In Situation 4 of the Rev. Rul. 2008-8, the captive insurer insures twelve subsidiary companies that were not treated as disregarded entities for tax purposes. The Service ruled that the arrangements constituted “insurance” for federal tax purposes and the captive is treated as an insurance company under Sections 831(c) and 816(a).

### **Differences in Jurisdictions for the Hedge Fund Captive**

A captive may be formed in a U.S. state or in an offshore jurisdiction such as Bermuda or the British Virgin Islands (BVI). Issues for “domicile” selection facing the captive include the following:

1. *Permitted Assets*. Different jurisdictions have different standards as to what types of investments may be used for reserves (liabilities). Some jurisdictions recognize 100% of the value of certain investment assets used for reserves while another jurisdiction will only recognize a lower percentage of the same asset class. A hedge fund manager thinking of investing in hedge funds should place significant value on this issue in determining the domicile of the captive. This issue is also a factor in capitalizing the asset with appreciated assets.
2. *Conservatism*. Newer jurisdictions are generally expected to be more flexible in regulation in order to attract captive insurance business. A more established jurisdiction may be more inflexible in regard to permitted assets and the type of coverage that the captive may underwrite.
3. *Records and Meetings*. Some domiciles require the captive to maintain records in the domicile. In the case of an offshore jurisdiction, this type of regulation may actually be favorable for the captive owner to protect the captive’s documents from disclosure and discovery. Some domiciles require annual meetings in the domicile while others do not.
4. *Licensing Fees and Premium Taxes*. All domiciles charge licensing fees, which vary from jurisdiction to jurisdiction as well as renewal fees. Some jurisdictions charge premium taxes. These costs are additional factors to consider.

As far as domestic jurisdictions are concerned, Vermont seems to be the domicile of choice. States as Utah, South Carolina, and Hawaii are competing aggressively for this business. The advantage of an offshore jurisdiction for the captive generally centers on the lower amount of bureaucracy and regulatory flexibility. Offshore captives can generally make an arm’s-length loan to the captive owner whereas most domestic captives prohibit this practice. Additionally, an offshore jurisdiction provides the captive owner with greater asset protection and greater investment flexibility within the captive.

## **How Does the Hedge Fund Captive Work?**

The hedge fund captive is an insurer domiciled in a domestic or offshore jurisdiction such as Bermuda or the British Virgin Islands (BVI). The offshore captive can make an election under Section 953(d) to be treated as a U.S. taxpayer for tax purposes.

Depending upon the level of expected premium, the captive will make a Section 831(b) election that will not tax the captive's premium income under \$1.2 million per year.

Alternatively, the captive may be structured as a small life insurer under Sections 806 and 816. At least 51% of the captive's reserves must be attributed to life and health related insurance risks. The captive is generally taxed in a 15% bracket for federal tax purposes creating a significant tax arbitrage for the hedge fund manager. The small life insurer that is an offshore insurer makes an Section 953(d) election to be treated as a U.S. taxpayer. This election avoids excise taxes under Section 4371 and also avoids taxation and withholding taxes on certain categories of income under Sections 871 and 1445.

## **Case Study**

**Facts.** Joe Smith, age 45, is a managing director of a hedge fund, First Philly Asset Management. Smith has a personal net worth of \$20 million. He has generated most of this wealth over the last ten years due to the success of his funds. Joe is married with two children. Each fund strategy features both a domestic and offshore version of the fund.

He created an irrevocable life insurance trust (ILIT) three years ago for estate planning purposes. The trust has a corpus of approximately \$1 million. Joe would like to maximize wealth accumulation and distribute as much of his wealth as tax efficiently as possible to his heirs.

First Philly manages four different strategies—a long-short equity fund, a convertible arbitrage fund, a distressed debt fund, and a multi-strategy fund-of-funds. The fund has a domestic and offshore fund that feed in to a master feeder-fund.

The fund has significant income due to management fees and performance fees. After bonuses to employees, First Philly has \$1.5 million of taxable income that is taxed at a 47% rate. Joe would like to minimize the income tax liability associated with his funds and accumulate funds on a more tax-advantaged basis beyond the reach of his personal and corporate creditors.

**Strategy.** Joe creates an offshore captive insurer in the BVI called Hedge Insurance Company ("Hedge"). The captive makes an election under Section 953(d) to be treated as a U.S. taxpayer. The insurer will not be treated as a controlled foreign corporation (CFC) and will not be subject to any premium excise taxes. The captive will not be subject to taxation in the BVI.

The shares of the captive will be owned by the Smith Family Irrevocable Trust. The shares will not be subject to the claims of Joe's personal creditors. Furthermore, the value of the shares will not be part of Joe's taxable estate for federal estate tax purposes.



Acme Captive Management established the captive and will administer the captive's administrative operations. Acme performed a feasibility study analyzing First Philly's current coverage to determine risks that are either self-insured or under-insured. Acme's feasibility study identified the risks below and designed coverage for the company's identified risks. The outline below details the coverage and premiums.

### **First Philly Risk Assessment and Coverage Proposal**

The description of new coverage is as follows.

***State or Federal Legislative Changes.*** First Philly must comply with all state and federal regulations in operating its business. First Philly operates in an investment business that some deem risky, and if for some reason First Philly were no longer allowed to sell its investment funds due to a change in state or federal legislation, First Philly would face serious financial risks.

The purchase of insurance covering state or federal legislative changes would be an appropriate manner to manage this risk.

***Directors and Officers Liability Insurance.*** First Philly exposes its directors and officers to litigation and possible liability by conducting business. If for some reason the directors and officers of First Philly were exposed to litigation, penalty or fines, First Philly faces risk.

The purchase of insurance covering director and officer's liability would be an appropriate manner to manage this risk.

***Market Volatility.*** First Philly operates in an unstable investment environment. First Philly takes considerable investment in achieving its target investment returns. The firm's revenue is derived from its investment performance and assets under management.

The purchase of insurance covering market volatility would be an appropriate manner to manage this risk.

***Inability of Insured Employee to Work.*** First Philly relies on key employees and traders to perform essential job functions. First Philly cannot operate at the same level of capacity, if one or more of these key employees were unable to work.

The purchase of insurance covering the inability of an insured trader's inability to work is an appropriate manner to manage this risk.

***Business Litigation Matters.*** First Philly operates on a in a litigious business environment. The expense and distraction of major litigation represents a significant business risk and obstacle. If First Philly were unable to focus on its core objectives because of litigation, First Philly would be in an unfavorable position.

The purchase of insurance covering business litigation risks is an appropriate method to manage this risk.

***Tax Audit Defense or Tax Controversy.*** Hedge fund tax strategies are under close scrutiny. First Philly may comply with all tax regulations set forth by its governing taxing agencies. An adverse tax ruling could expose First Philly to significant financial loss.

The purchase of insurance covering tax audit defense or tax controversy is an appropriate manner to manage this risk.

***Detrimental Code.*** First Philly trading strategies rely heavily on quantitative methods and technology. The firm relies on its operating and information systems to conduct business efficiently and effectively, including any financial algorithms or investment equations. First Philly's inability to effectively use its computer systems would expose the firm to adverse operating conditions that would adversely affect its investment performance and firm revenue stream.

The purchase of insurance covering computer system failure caused by detrimental code is an appropriate manner to manage this risk.

***Data Breach Liability.*** First Philly maintains client records that may contain identifying information of its clients that could potentially be compromised through a data breach. The exposure of the firm's records to a data breach is a concern that the firm needs to address. First Philly would incur significant operating and financial risks in the event of a data breach.

The purchase of insurance covering data breach liability is an appropriate manner to manage this risk.

***Changes in U.S. Tax Law.*** The tax environment for hedge fund managers and hedge funds is uncertain at best. Hedge fund managers face significant tax exposure for any adverse changes in tax law regarding offshore deferred compensation arrangements as well as other tax risks.

The purchase of insurance covering changes in U.S. tax law is an appropriate manner to manage this risk.

***Loss of a Significant Investor.*** First Philly derives all of its revenue through money management and performance fees related to its investment activities. The nature of the private placement investment offering that much of the firm's assets are concentrated in several large investors. The departure of a significant client would expose First Philly to financial loss.

The purchase of insurance covering loss of a significant client is an appropriate manner to manage this risk.

**Coverage Design Options.** The following design options can deal with the above-raised issues.

***State or Federal Legislative Changes.*** This Coverage will reimburse the First Philly for loss of business revenue and directly related expenses sustained by First Philly due to any state or federal legislative changes.

1. Coverage term: 12 months
2. Annual Premium: \$220,000
3. Coverage limit: \$1,250,000 Annually, \$2,000,000 Limit of Liability
4. Coverage territory: USA and Cayman Islands
5. Deductible: \$0
6. Coverage trigger: Claims made during coverage period
7. Named Insured: First Philly

***Directors and Officers Liability.*** This coverage will reimburse the First Philly for the loss of business revenue and expenses actually paid to defend any actions brought against First Philly, or the additional insured named below, for acting in his capacity as a Director or Officer.

1. Coverage term: 12 months
2. Annual Premium: \$150,000
3. Coverage limit: \$212,500 annually, \$250,000 limit of liability
4. Coverage territory: USA and Cayman Islands
5. Deductible: \$0
6. Coverage trigger: Claims made during coverage period
7. Named Insured: First Philly

***Market Volatility.*** This Coverage will reimburse the First Philly for the loss of business revenue and directly related expenses caused by stock market fluctuation and market forces beyond the control of First Philly.

1. Coverage term: 12 months
2. Annual Premium: \$150,000
3. Coverage limit: \$1,000,000 annually, \$2,000,000 limit of liability
4. Coverage territory: USA and Cayman Islands
5. Deductible: \$0
6. Coverage trigger: Claims made during coverage period
7. Named Insured: First Philly

***Inability of Insured Employee to Work.*** First Philly will be reimbursed for loss of business revenue and directly related expenses incurred by the First Philly due to the inability of the insured employee named below to work. Inability to work means the insured employee is, as a result of sickness or injury, unable to perform the material duties of their job.

1. Coverage term: 12 months
2. Annual Premium: \$100,000
3. Coverage limit: \$87,000 annually, \$435,000 limit of liability
4. Coverage territory: USA and Cayman Islands
5. Deductible: \$0
6. Coverage trigger: Claims made during coverage period
7. Named Insured: First Philly
8. Insured Employee: Chief trader

***Business Litigation Matters.*** First Philly will be reimbursed for direct expenses incurred in business litigation matters in which the First Philly is or may be a party, including any expenses of litigation counsel.

1. Coverage term: 12 months
2. Annual Premium: \$100,000
3. Coverage limit: \$200,000 annually, \$400,000 limit of liability
4. Coverage territory: USA and Cayman Islands
5. Deductible: \$0
6. Coverage trigger: Claims made during the coverage period
7. First Philly: First Philly

***Tax Audit Defense or Tax Controversy.*** First Philly will be reimbursed for direct expenses incurred in the defense of any audit, assessment, suit, action or allegation brought by the U.S. government or any State or local taxing authority for additional taxes, including any expenses of accountants, attorneys or other tax advisors.

1. Coverage term: 12 months
2. Annual Premium: \$14,000
3. Coverage limit: \$50,000 annually, \$100,000 limit of liability
4. Coverage territory: USA and Cayman Islands
5. Deductible: \$0
6. Coverage trigger: Claims made during coverage period
7. Named Insured: First Philly

***Computer System Failure Caused by Detrimental Code.*** First Philly will be reimbursed for loss of business revenue and directly related expenses caused by, or resulting from Detrimental Code.

1. Policy term: 12 months
2. Annual Premium: \$100,000
3. Coverage limit: \$150,000 Annually, \$500,000 Limit of Liability
4. Policy territory: USA and Cayman Islands
5. Deductible: \$0
6. Coverage trigger: Claims made during coverage period
7. Named Insured: First Philly

**Data Breach Liability.** First Philly will be reimbursed for damages awarded by a court of final determination based on negligence or other tort for causing a data security breach.

1. Coverage term: 12 months
2. Annual Premium: \$196,000
3. Coverage limit: \$290,000 annually, \$380,000 limit of liability
4. Coverage territory: USA and Cayman Islands
5. Deductible: \$0
6. Coverage trigger: Claims made during coverage period
7. Named Insured: First Philly

**Changes in U.S. Tax Laws.** First Philly will be reimbursed for loss of business revenue and directly related expenses sustained by the First Philly caused by any changes in U.S. Tax laws.

1. Coverage term: 12 months
2. Annual Premium: \$65,000
3. Coverage limit: \$100,000 annually, \$200,000 limit of liability
4. Coverage territory: USA and Cayman Islands
5. Deductible: \$0
6. Coverage trigger: Claims made during coverage period
7. Named Insured: First Philly

**Loss of a Significant Client.** This Coverage will reimburse the First Philly for loss of business revenue and directly related expenses sustained by the First Philly by reason of cancellation, termination, non-renewal or similar action which results in loss of the relationship or loss of an agreement, either in writing or oral by a Major Client of the First Philly for any reason other than cause.

1. Coverage term: 12 months
2. Annual Premium: \$55,000
3. Coverage limit: \$110,000 annually, \$225,000 limit of liability
4. Coverage territory: USA and Cayman Islands
5. Deductible: \$0
6. Coverage trigger: Claims made during coverage period
7. Named Insured: First Philly

### **Recommendations**

The following recommendations are made regarding captive risk financing for First Philly.

- State or Federal Legislative Changes: Premium \$220,000
- Directors and Officers Liability: Premium \$150,000
- Market Volatility: Premium \$150,000
- Inability of Insured Employee to Work: Premium \$100,000
- Business Litigation Matters: Premium \$ 100,000

- Tax Audit Defense or Tax Controversy: Premium \$14,000
- Computer System Failure Caused by Detrimental Code: Premium \$100,000
- Data Breach Liability: Premium \$196,000
- Changes in U.S. Tax Laws: Premium \$65,000
- Loss of a Significant Client: Premium \$55,000
- Total Premium \$1,150,000

The recommended premiums are determined by application of usual and customary insurance industry underwriting principles. The premiums are believed to be reasonable in relation to benefits provided without regard to any experience based premium refund or benefit.

### **Summary**

The hedge fund captive strategy delivers a combination of significant tax benefits. The premiums are fully deductible for income tax purposes. The captive will be not be taxed on premium income and only investment income in the event of an Section 831(b) election. A captive electing “small life insurance company” status under Section 806 may be taxed in a 15% bracket creating a large and favorable arbitrage for the hedge fund manager.

The captive’s surplus may be reinvested in the hedge fund manager’s funds at a lower tax rate than the hedge fund manager’s own tax bracket. The captive and its assets will not be subject to the claims of the hedge fund manager for asset protection purposes. The captive and all of its future growth can be arranged so that it will not be part of the hedge fund manager’s taxable estate.

In the information age in which we live, we are constantly bombarded with information and ideas. The plethora of information leaves us in information overload and fails to captivate and hold our attention. The captive insurance holds great promise as an integrated risk management and tax-planning tool that can hold the hedge fund manager and its advisors captive!

### **Footnotes:**

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<sup>1</sup> Jenny Anderson, “Managers Use Hedge Funds as Big IRAs”, New York Times, April 17, 2007.

<sup>2</sup> Section 501(c)(15). Tax-exempt captives were abused by taxpayers who capitalized the captive with appreciated assets to position a tax-free sale of the asset. Large corporate captives used these arrangements for commercial risks that had a long “tail” and invested on a tax-free basis.

<sup>3</sup> Section 831(b).

<sup>4</sup> Section 806(a).

<sup>5</sup> Gulf Oil Corp. v. C.I.R., 914 F.2d 396 (3rd Cir. 1990).

<sup>6</sup> Rev. Rul. 2005-40, 2005-27 IRB 4.

<sup>7</sup> Rev. Rul. 2008-8, 2008-5 IRB xx.

<sup>8</sup> Rev. Rul. 2002-90, 2002-2 CB 985.