THE PROS IN NORTH CAROLINA

Phillip England, of Anderson Kill, and Randall Beckie explain the differences in the regulatory regimes of US domiciles to *Captive Review*

When choosing a captive insurance domicile, no factor is more essential than whether the regulatory regime accommodates your captive's business plan. The more complex the plan, the more expert regulatory oversight matters. A high-volume captive domicile becomes that way when the service providers who operate there start mass-producing captives. Our captive insurance clients want custom tailoring at off-the-rack pricing. Following are some observations regarding some new captives domiciled in North Carolina.

Three new planning ideas

Here are three captive insurance solutions that work in North Carolina and not just anywhere:

1. Co-insurance cell captives:

Co-owners of a business might well prefer to create a separate captive for each stakeholder. Example: senior owns 80% of the business, junior owns 20%. To preserve fairness, for every $100 of captive insurance premiums that the business pays, $80 should go to the senior's captive while $20 should go to the junior's captive. The challenge is: operating two captives could cost twice as much as one. Unless they are co-insurance cell captives.

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In some domiciles, each cell captive is subject to triennial regulatory examination, which mainly consists of an audit. However, we have seen triennial exam fees exceed what a captive manager gets paid! On the other hand, in North Carolina, a triennial examination would be conducted at the regulators' discretion, not just for the sake of doing it. Therefore, provided that the captive management service team maintains a captive's compliance with reporting requirements (regulation involves (A) relying on the annual independent audit of the captive, which can be relatively inexpensive, and (B) requiring and carefully reviewing business plan amendments), it will be spared the cost of triennial regulatory examinations. This can make the difference between whether it is cost-effective to set up multiple co-insurance cell captives in the first place or not.

Giving each stakeholder his own co-insurance cell captive is important for exit planning. A captive can make a non-taxable liquidating distribution into a parent company, including an S corporation parent that holds investments. This redeployment of a captive's accumulated earnings and profits into a holding company's asset portfolio works where the holding company owns 100% of the captive prior to liquidation (even if only moments before). In contrast, where one captive has multiple owners, as a practical matter, their exit from the captive would involve recognising taxable income in the form of dividends or capital gains.

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2. Guaranteed renewable accident & health insurance programs:

Many employers subsidise employee health benefits. Health claims volatility is manageable via commercially available group health insurance or stop loss insurance. What is not commercially insurable is the risk of medical cost inflation, which has long outpaced consumer price inflation.

A guaranteed renewable A&H captive insurance programme lets an employer level its funding for projected inflation of health benefit costs. The employer's premiums that pre-fund projected inflation are (with planning) tax-deductible. Meanwhile, the captive may (with planning) recognise contract reserves that more than offset its underwriting profits. For many businesses, a guaranteed renewable A&H policy would generate more captive insurance premiums than any other coverage type. Guaranteed renewable A&H facilitates the employer's budgeting, steers clear of ERISA complications, improves the affordability of providing healthcare subsidies by the employer, and saves on taxes in several different ways. Why don't more employers do this with their captives?

One impediment has been that a couple of leading US captive domiciles take the view that guaranteed renewable A&H should be regulated as if it were a type of stop loss insurance. Stop loss insurance regulation, if it were to apply, provides that coverage cannot attach at less than $20,000 per capita or less than 110% of expected group claims costs. Those restrictions collide with the economics of a level premium guaranteed renewable A&H policy.

The North Carolina regulators take an arguably more enlightened view. In North Carolina, captive insurance of guaranteed renewable A&H is what it purports to be, without being recast as stop loss insurance. Moreover, for a captive A&H policy that really is simply stop loss insurance, that too may be allowable in North Carolina, provided (generally) that the captive insurance coverage runs to the employer and not directly to the employees.

The difference with regulation in North Carolina stems from the regulators' understanding of the intent of the captive insurance statutes. Read literally, the captive insurance statute says no captive can directly provide health insurance. Understood contextually, the statute was arguably intended to allow a captive to insure an affiliated employer's healthcare funding risks without having to participate in a state guaranty fund, as commercial health insurance companies would.

3. Captive life insurance programmes: Subject to careful planning and thoughtful regulatory review, a special purpose captive in North Carolina would seem to be able to issue certain types of life insurance to an affiliated business, such as key man life insurance, that the business needs in order to fund a stock redemption by an owner/manager when he dies. Captive life insurance may be the lifeline for business succession planning.


North Carolina State Capital building, Raleigh

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In some domiciles, issuance of a life insurance policy by a captive is strictly forbidden. On its surface, the North Carolina captive statute says no captive may directly provide life insurance. But once again, in North Carolina the regulators understand the captive statute to be intended to spare captives from participating in a life insurance guaranty fund of the sort that is mandatory for commercial life insurance carriers.

Enabling a captive to issue life insurance and guaranteed renewable A&H insurance allows a captive to become a life insurance company for tax purposes. A life insurance company can avail itself of the small life insurance company deduction under tax code §806. That special deduction (which can approach $1.8m) can offset investment income that is earned in connection with the life insurance or guaranteed renewable A&H insurance business.

Some US captive insurance promoters are in a gold rush to tout §831(b), sometimes unfortunately with more enthusiasm for sales than with support for arm's length premium pricing. Sometimes the use of §831(b)s can be a trap for the unwary. On the other hand, hardly anyone talks about letting life insurance captives earn investment income in a tax-efficient way. Letting captives earn low-taxed investment income is important because business owners can create related-party investments that their captives can invest in at yields that surpass the financial markets.

In North Carolina, a captive can invest its assets in cash value life insurance products, an opportunity for life insurance salesmen. But to us, the opportunity that interests our clientele is that North Carolina can let a captive issue life insurance, which is the opposite of letting a captive invest in someone else's life insurance product.

New impression, old neighbourhood

Among US captive insurance domiciles, North Carolina is a new kid on the block, which gives it the advantage of learning from others' mistakes. Historically, captive regulators elsewhere have seen it as none of their concern if a captive over-prices its premiums. Presently, as the IRS scrutinises captive managers' underwriting practices, we may all soon see there is no safety in erring on the high side. Always remember the IRS can spot the difference between fast and loose vs careful, substance-oriented planning. North Carolina has a good support system for fostering a quality, expert regulatory environment.