Captive Insurance Companies: A Growing Alternative Method of Risk Financing

PHILLIP ENGLAND, ISAAC E. DRUKER, AND R. MARK KEENAN

The authors explain how a captive insurer can serve as a funding or financing vehicle for insuring the losses of its parent company and other affiliates.

Growing numbers of publicly traded companies, large and mid-sized privately held corporations, tax exempt organizations, and other business entities are relying on captive insurance companies to provide insurance and lower the costs associated with paying claims owed to third parties. Captives insure risks like those covered by general insurers, plus provide specialized coverage for, e.g., terrorism risks, all tailored to the risk/potential loss profile of an affiliated group of insureds. In essence, a captive insurance company is an entity formed in a particular jurisdiction or domicile primarily to insure or reinsure the risks of the corporate parent and/or one or more other related entities, or even unrelated...

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entities. So long as all of a captive’s actions are deemed prudent and within the scope of the law and usual insurance company practice, it can write almost any type of insurance coverage for related or unrelated entities and charge a premium that the company and its regulators find acceptable.

A captive can be owned by a corporation or by non-corporate entities, and can be domiciled on-shore or off-shore. Today, there are over 4,000 captive insurance companies around the world, nearly 1,500 of which are domiciled in Bermuda. Vermont, the largest U.S. domicile, has nearly 400 captives. A number of U.S. states are considering changes in their laws to encourage captives to be formed there and some U.S. states seek to specialize their captive legislation around certain types of coverage (e.g., medical malpractice).

All decisions regarding the operations of a captive are made by its board of directors, designated by the parent company. This ensures that the captive’s parent company maintains a level of control of the captive’s operations and permits the parent company to be as aggressive or conservative in risk underwriting as it desires, although it must be kept in mind that a captive, as an insurer, is fully subject to the laws and regulations of its domicile.

THE ADVANTAGES OF FORMING A CAPTIVE

Companies form captive insurers for many reasons. Although there are tax advantages that can exist with respect to a captive, the premise for a captive must be non-tax; stated another way, the tax benefits must come second to a basic business purpose and the genesis of captive planning must be a legitimate business need confirmed by a feasibility study relating to the role of a captive within the context of an affiliated group’s insurance program.

The primary goal of any captive is to reduce the company’s long term cost of risk. Captive expenses are normally lower than conventional insurance markets.
CAPTIVE INSURANCE COMPANIES: A GROWING ALTERNATIVE METHOD OF RISK FINANCING

A FEW POINTS ABOUT CAPTIVES

- The very existence of a captive can give a parent company negotiation leverage with the commercial insurance market—an important financial benefit of captives in and of itself, since it shows to such market that the parent (and affiliates) have some expertise in the operation of an insurance company and the way coverage can be expanded, altered or developed to fit into an insured group’s overall insurance needs.

- In addition, a captive insurance policy can use market-based premium quotes to set rates on an “arm’s length” basis for its owner-insureds. This means, as a general rule, that a captive can accrue for loss expectancy for uncertain or unknown liabilities on a similar basis as an independent insurance company even though a wholly-owned subsidiary might actually be able ultimately to provide insurance services to a parent at lower cost. The additional surplus can be invested or otherwise put to use consistent with insurance company practice.

- Captives also allow their parent companies to respond quickly to changes in the commercial insurance market, whether the market firms up or softens. A parent company with a captive can respond to market conditions by having the capability to fund higher retention levels.

- There may be certain types of coverage desired by a parent or affiliated group that are either quite costly or unattainable in the commercial insurance market and in such cases a captive can fill a void.

- A captive by its existence can create heightened loss potential awareness throughout an organization and can help create a more efficient loss prevention program among members of the captive’s insured group.

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Finally, it is well known that captives offer a superb management tool for high-frequency, low severity risks.

SELECTING A DOMICILE

On-shore and off-shore domiciles each have different benefits and drawbacks, which can affect the domicile a parent company chooses for its captive. The decision of where to domicile a captive largely depends upon an organization’s analysis of a given domicile’s specific advantages and disadvantages. A decision should be based on the parent company’s overall risk management objectives and the ultimate direction it wishes the captive to take and also how “comfortable” a parent feels with respect to the overall regulatory approach of a particular domicile.

The factors to be considered for choice of domicile are varied and numerous. These include:

- The regulatory environment, including sophistication and reputation of the regulators;
- Organization / operation costs of captive creation;
- Investment restrictions on the captive’s surplus;
- Capitalization requirements;
- Taxes (local premium tax, federal excise tax); and
- Types of coverage to be offered (whether a particular domicile offers unique advantages regarding a particular type of coverage).

THE REGULATORY ENVIRONMENT

The most important reason to form a captive in a non-U.S. domicile is the jurisdiction’s flexible regulatory environment. Captives formed off-shore, as a very general rule, have more flexibility.
with respect to the type of business they can write.

For example, on-shore captives in Vermont—the leading U.S. domicile for captives—are regulated more closely than their off-shore counterparts and must generally operate entirely within the confines of a filed business plan. It should be noted, however, that these required business plans may be altered rather easily with the approval of the appropriate regulators. As a very general rule, all domiciles require a business plan for regulatory approval, but a somewhat softer approach to changes in such plans is taken in offshore domiciles.

Whether on-shore or off-shore, an early meeting with regulators (to discuss general planning ideas) in a potential domicile is usually a very good idea.

**INCORPORATION AND OPERATING COSTS**

The formation and operation of a captive entails various expenses, including the following:

- Feasibility study costs;
- Organizational costs;
- Actuarial fees;
- Business plan costs;
- Management fees;
- Legal fees;
- Audit fees; and
- Premium taxes.

Overall organizational plus first year of operation fees and costs (including a formal feasibility study) can range from about $50,000 to over $125,000, depending on the complexity of a captive’s
program.

Regulatory requirements and the locally sitused management (usually through a third-party management firm) of captive insurance companies create an ongoing expense which may vary somewhat depending on jurisdiction.

FEASIBILITY STUDY

One of the most important steps in evaluating the potential value of a captive is a feasibility study which examines the benefits of a captive to a particular insured group and in general takes into account types of risks to be transferred to a captive and the costs, loss and claims history associated with such risks. Such a study provides a roadmap for how a captive can be specifically used to meet the insurance needs of its owners and related party insureds.

INVESTMENT RESTRICTIONS AND CAPITALIZATION REQUIREMENTS

In all jurisdictions, there are restrictions on permissible investments by a captive. Because they can vary, each jurisdiction’s rules must be examined.

Similarly, capital requirements for a newly formed captive can vary widely from jurisdiction to jurisdiction, from less than $150,000 to well over $1 million. The variation depends on a number of factors, including the proposed coverage offered by a captive and whether the insureds are related to the captive or unrelated.

RESTRICTIONS ON THE USE OF SURPLUS

Surplus is the amount of premiums or income that is retained by an insurance company but that is not needed currently for payment of claims. By increasing surplus, captives can increase their ability to retain risk (e.g., to write additional coverage).
Captives have some significant latitude to invest surplus so long as basic fundamental requirements are maintained and the capital base is not impaired. Importantly, intra-group loans are permitted in certain jurisdictions and for certain purposes.

Minimum solvency requirements (ratio of surplus to written premium, loss reserves, etc.) are regulated by each state and country, and must be maintained by all insurance companies, including captives.

**PREMIUMS PAID TO THE CAPTIVE**

One of the benefits to the parent or group having a captive is the tax deductibility of premiums paid to the captive. This is different from the usual straight self-insured arrangement, where an insured recognizes a tax deduction as losses are paid out over time, when losses are actually sustained. For example, take the instance of workers’ compensation losses that are triggered by an event in one underwriting period, but are paid out over a period of years. Only as such losses are paid out, is the tax deduction recognized and only in the financial period the payment is made.

Under a captive arrangement, premiums are calculated pursuant to insurance accounting principles (taking into account prospective loss exposures), since the captive is, as noted, intended to be a true insurance company. With proper planning, such premiums are currently deductible so long as the U.S. Internal Revenue Service (IRS) recognizes the captive coverage as a true insurance arrangement (as opposed to simply being in substance a self-insurance reserve). Also of equal importance from a group or consolidated cash flow perspective, it should be noted that a captive structured as (and in fact operating as) a true insurer can establish deductible insurance loss reserves in the current period for layers of assumed risk previously retained and reserved for by the insured, as well as risks now covered by the captive and relating to subsequent events. The bottom line results of the foregoing are...
enhanced cash flow and deferral and possible reduction of overall taxable income for the consolidated corporate group.

As an example, see the Tax Deductions and Cash Flow chart herein, which posits that (i) cash in the amount of the cumulative loss reserve carried on the books of the parent company ($50 million) will be transferred by it to the captive, and treated as a premium payment, in the year the captive begins operations and (ii) an annual premium ($10 million) will also be paid to the captive in that year, as well as in each of four subsequent years. Thus, over five years, in the example, the hypothetical 80 percent loss reserve established by the captive (against $100 million aggregate premium income) gives rise to consolidated tax deductions of $80 million, yielding tax savings/deferrals (at an effective tax rate of 40 percent) of perhaps as much as $32 million during the period (assuming little or no tax on the captive’s net income).

### TAX DEDUCTIONS AND CASH FLOW (AMOUNTS IN MILLIONS)

<table>
<thead>
<tr>
<th>USE OF CAPTIVE</th>
<th>INSURED</th>
<th>CAPTIVE</th>
<th>GROUP</th>
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<tbody>
<tr>
<td>Transfer of Accumulated Loss Portfolio Reserve by Insured as Premium paid to Captive (Year 1)</td>
<td>($50)</td>
<td>($50)</td>
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<tr>
<td>Annual Premium Deduction by Insured (Five years)</td>
<td>($50)</td>
<td>($50)</td>
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<tr>
<td>Total Premium Income of Captive</td>
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<tr>
<td>Loss Reserve Deduction by Captive (80 percent of Premium)</td>
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<td>($80)</td>
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<tr>
<td>Net Income (Captive)</td>
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<tr>
<td>Net Consolidated Deduction</td>
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<td></td>
<td>($80)</td>
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<tr>
<td>Tax Deferral @ 40 percent</td>
<td></td>
<td></td>
<td>$32</td>
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TAXES

Analyzing the tax issues involving a captive insurance company requires, of course, examining the rules in the domicile in which the captive is to be located, as well as U.S. tax provisions. Thus, for example, a captive domiciled in Bermuda is a foreign insurer for purposes of U.S. tax and the U.S. imposes a U.S. federal excise tax of one percent on gross ceded reinsurance premiums and four percent on direct property and casualty premiums placed with such captive. If the premiums paid by the insured to its captive are not treated as insurance premiums for IRS purposes, they are exempt from this U.S. federal excise tax, but there would be a loss of U.S. tax deductions associated with the payment since it would not be payment for “an insurance premium”.

A way to avoid federal excise tax is for the offshore captive to take the Section 953(d) election contained in the U.S. Internal Revenue Code. This election allows foreign insurers to be treated as U.S. taxpayers. However, if such election is made:

- The captive would be subject to U.S. tax at the captive level; its losses could not offset gains from other operations under the parent’s umbrella, although losses could be carried forward and could be used to offset future captive income;
- This election is irrevocable unless IRS consents;
- Either a security bond or U.S. situs assets of the captive must be provided; and
- The elector must waive any otherwise applicable tax treaty benefits.

There are potentially significant benefits in taking the Section 953(d) election. For one thing, because the captive would be treated as a U.S. taxpayer, the interest on intercompany loans between the offshore captive and a U.S. parent would not be subject to the withholding tax of 30 percent. Also, the election can eliminate
certain “Subpart F” concerns as discussed below.

**SUBPART F**

U.S. shareholders in an off-shore insurance company that is a “controlled foreign corporation” (CFC) also are subject to the U.S. Subpart F anti-deferral rules. An off-shore insurance company that has at least 25 percent of its stock owned by U.S. shareholders would qualify as a CFC and its shareholders would be required to include in income each year their pro rata share of the company’s income. The off-shore company’s income would be calculated based on U.S. insurance tax accounting rules and only the portion attributable to its U.S. shareholders would be included (i.e., portions attributable to non-U.S. shareholders would not be taxable). Upon an actual distribution of dividends from the off-shore company, the shareholder would be permitted to exclude such dividends from income and thus they would not be taxed a second time on the off-shore company’s income.

These rules are a fundamental part of tax planning for a foreign captive controlled by U.S. persons and, in the absence of a Section 953(d) election as described above, present a formidable gauntlet that must be the subject of careful examination.

Now, consider a domestic domicile-based captive: For example, one cost of a Vermont captive, not incurred with a Bermuda captive, is the state premium tax that is due regardless of the IRS treatment of premiums paid to the captive. Vermont imposes a state premium tax of 0.4 percent on the first $20 million of direct insurance premiums (and on a declining scale thereafter) and a 0.225 percent tax on the first $20 million of reinsurance premiums written (and on a declining scale thereafter).

**DIRECT PLACEMENT TAX**

The obligation of the insured parent or affiliate to pay direct
placement tax to a state may be incurred as a result of a state’s regulations pertaining to an insured directly procuring coverage from a non-admitted insurer. Since a captive domiciled in one state is usually treated as a non-admitted insurer in another state, an insured may be potentially liable for paying a direct placement tax based on the net written premium paid by as to the captive.

Direct placement tax generally is payable based on rates, which vary by state, applicable to the amount of premium allocated to each state. Some states do not impose any direct placement tax.

THE FEDERAL TAX LAW OF INSURANCE PREMIUMS

The fundamental issue in IRS audit litigation involving captive insurance companies is whether payments to a captive insurer should be classified as “insurance premiums,” i.e., whether “risk shifting” and “risk distribution” are present. For tax purposes, for a contract to be treated by the IRS as an “insurance contract” (eligible for a premium deduction), both shifting of the risk of economic loss and risk distribution among a number of insureds must be present.

These concepts are the subject of many IRS rulings and cases. In very general terms, risk transfer means that an insured is insulated from the economic impact of a loss occurrence. Also, generally speaking, risk distribution means that an insurer is pooling potential claims for which it may be liable, so as to hedge the amount of its potential claims payouts occurring at any one point in time.

In addition to the foregoing, the IRS will examine any captive arrangement to assure that it is not an economic sham and that it operates in a traditional insurance business manner. The following factors are usually considered by the IRS in determining the viability and independence of a captive.
ECONOMIC SUBSTANCE REQUIREMENTS

- No parental guarantees of any kind or similar financial arrangement are made in favor of the captive.
- The captive does not loan substantial funds to its owner-insured or any other policyholder (however, some planning opportunities exist here, but in effect no premium rebates).
- Capitalization is adequate and the captive has economic viability.
- A valid non-tax purpose motivates the formation of captive.
- The captive’s business operations and assets are kept separate from the business operations and assets of its owner(s).

CONFORMITY WITH COMMONLY ACCEPTED NOTIONS OF INSURANCE

- Premiums are priced at arm’s length and are established according to usual or customary insurance industry rating formulas (retroactive arrangements are quite suspect).
- The conduct of insurance business between the captive and policyholders occurs in a manner that is consistent with the standards applicable to an insurance arrangement between unrelated parties.
- The captive has, in fact, a process to consider claims and establishes the validity of claims before paying claims.
- The captive either performs all necessary administrative tasks using its own personnel or it outsources those tasks at prevailing commercial market rates.
- The insureds truly face insurable risks and hazards.
The transaction is of a type that is insurance in the commonly accepted sense.

The captive is validly formed and holds on a current basis all required licenses to conduct insurance business in the jurisdictions in which it operates.

The captive’s governing board actually functions in a fiduciary capacity.

RISK DISTRIBUTION CHARACTERISTICS

• In a brother-sister insurance arrangement, there must be at least 12 affiliated corporate policyholders that pool their risk. In an association captive arrangement, there must be at least seven policyholders.

• Where there is no brother-sister relationship (i.e., parent of captive is an insured), the writing of substantial business with unrelated insureds becomes extremely important for purposes of premium deductibility. Basically there must be “substantial” unrelated business by the captive in such a situation (30 percent of premium income of captive coming from unrelated insureds—non-affiliated entities—generally thought of as sufficient for premium payment deductibility).

• No single policyholder’s risk accounts for more than 15 percent of the captive’s aggregate maximum exposure to loss.

• The volume of potential loss events is significant. Presumably, “significant” volume means volume that is significant in a statistical context, in the sense that data are sufficient to enable an actuary to assign probabilities to the insurer’s potential underwriting losses.

• Pooled risks are homogeneous in character and there are in fact a volume of such risks.
A net underwriting loss generated by one policyholder is borne in substantial part by premiums paid by other policyholders (i.e., true insurance is at work).

There is a real possibility that a policyholder will sustain a covered loss in excess of the premium it pays.

A policyholder is not obligated to pay additional premiums if its actual losses exceed its premium during any period of coverage, nor will a policyholder be entitled to a refund if its premium exceeds its actual losses during any period of coverage.

CONCLUSION

A captive can provide the solution to many problems, but a couple of basic issues must be kept in mind. First, companies should realize that they are forming an insurance company that will operate as an insurance company and that will be regulated as one. Second, the point of a captive is to finance risks and to do so at what one would hope is a reduced cost. Tax savings should not be the reason for creating a captive, but certainly can be an important incidental benefit of doing so.

The foregoing was an overview of certain points relating to the establishment of a captive and tax planning involving captives. Both the regulatory rules of a particular jurisdiction, and IRS thinking regarding captives, continue to evolve. Prior to the implementation of a captive program, contact should be made with the regulators in the proposed domicile. Further, a captive program must be sensitive to the possibility of changing IRS trends. Finally, it is essential that a detailed feasibility study and business plan specifically tailored to the particular captive arrangement be prepared, in order to insure that a captive proposal makes basic business sense for a corporate parent or group.