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Structuring Captive Insurance Programs: Key Provisions, Regulatory Requirements, Risk-Pooling Arrangements

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Today's faculty features:

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STRUCTURING CAPTIVE INSURANCE PROGRAMS: KEY PROVISIONS, REGULATORY REQUIREMENTS, AND RISK-POOLING ARRANGEMENTS

Strafford Webinar

Michael Domanski, Gregory Nowakowski, Ryan Peruski

HONIGMAN®

Introduction

- Honigman is a full service corporate law firm with offices in Detroit, Washington D.C. and Chicago; over 275 lawyers
- Captive insurance practice since 1979
- Ten lawyers dedicated to the captive practice, including two tax lawyers and one who addresses coverage/reinsurance disputes
- Represent over 200 captive insurance programs owned by U.S. businesses, which are domiciled onshore (*e.g.,* Vermont and Arizona) and offshore (*e.g.,* Cayman Islands and Bermuda)
- Serve as U.S. counsel/general counsel for captives
  - Provide advice regarding corporate, regulatory, contractual, insurance and tax matters; keep captive boards apprised of legal issue

Introduction (Continued)

- Michael Domanski – Partner, leader of the firm's insurance tax practice
- Gregory Nowakowski – Partner, specialist in corporate, regulatory and transactional matters
- Ryan Peruski – Partner, specialist in compliance and controversy matters

Agenda

- Overview of Captive Insurance
  - Characteristics
  - Common structure / alternative structure
  - Common uses
- Benefits of Captive Insurance Programs
  - Non-tax
  - Tax
- Regulatory Considerations
  - State
  - Federal
  - International
- Structuring Key Provisions
- Avoiding Pitfalls

Overview of Captive Insurance

- What is a captive:
  - "A captive insurance company insures the risk of its owner(s) and/or related or affiliated parties and returns underwriting profits and investment income. Captives are insurers owned by the insureds and organized for the main purpose of funding the owners' risk while allowing owners to actively participate in decisions influencing underwriting, operations and investments."
    - *Captives An Overview,* Captive Insurance Companies Association, 2008
  - "An insurance company that has as its primary purpose the financing of the risks of its owners or participants. Typically licensed under special purpose insurer laws and operated under a different regulatory system than commercial insurers. . . ."
    - Westover, Kathryn, CPCU, *Captive Practices and Procedures,* Appendix A, International Risk Management Institute, Inc., 2006.

Characteristics

- Usually a separate legal entity
- Shareholder(s)
  - With reserved powers
- Board of Directors
  - Possibly with committees
  - Specified powers
  - Duties of care and loyalty to the Company

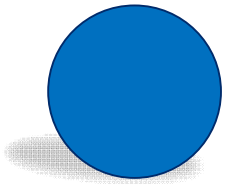
Characteristics (Continued)

- Officers
  - Positions determined as required by the captive's domicile or as otherwise desired
  - But impacted by:
    - Regulatory environments
    - Tax considerations
      - US trade or business issues
      - Nexus aspects
- Onshore and offshore models

Characteristics: Domicile

- Bermuda and the Cayman Islands are the largest and oldest domiciles
- Vermont was among the first U.S. states to adopt captive legislation in 1981
- It's widely acknowledged to be the premier U.S. domicile and is the third largest worldwide (after Bermuda and the Cayman Islands)
- Through the 1980s and 1990s, a few other states adopted captive legislation, but most did not host many captives
- Since 2000, many states have passed their own captive statutes

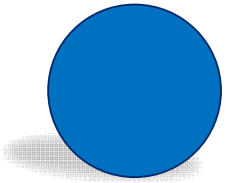
Common Structure



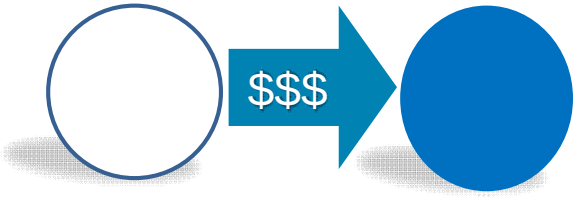
Single Parent Captive

A captive insurance company with one (corporate) owner, insuring only the risks of the parent organization or its subsidiaries

Alternative Structure: Rent-A-Captive



Single Parent Captive



Rent-A-Captive

A captive owner funds the formation expenses, capital and surplus

An arrangement in which a captive participant “rents” the facilities of an outside organization; provides the benefits that captives offer without the start-up costs

Common Uses

- **Placement** of controllable frequency layer of risk
- **Deductible** buy down
- **Fill** coverage gaps in insurance program
- **Financing** risks that cannot be placed in the traditional insurance market
- **Creating** tax efficient structures
- **Optimizing** capital deployment for risk financing

Benefits of Captive Insurance Programs

- Many non-tax advantages, including:
  - Allowing access to a broader group of insurance companies for layers of coverage insured in the commercial market
  - Helping to organize focus on the causes for losses and target efforts to prevent them
  - Allowing organizations to have control over their own claims / coverage
  - Fill coverage gaps
  - Resulting in savings in an organization's overall insurance costs by reducing dependency on commercial carriers, whose pricing is often volatile and cyclical

Benefits of Captive Insurance Programs (Continued)

- Reducing costs of overhead expenses over time
- Accessing reinsurance
- Assist with cash on hand issues if necessary

Example: Healthcare Industry

- One of the leading users of captive insurance companies is the healthcare industry
- The Harvard hospitals formed one of the first captives (in the Cayman Islands) in the late 1970s
- It has been estimated that over half of the hospitals in the country participate in a captive program or self-insurance program
- Hospitals typically use captives to self-insure their general and professional liability risks
- There are few, if any, commercial carriers willing to sell insurance to provide hospitals, particularly, large systems, with “first dollar” coverage
- Currently, medical malpractice markets may be hardening
- Nuclear verdicts

Tax Benefits of a Captive

- Taxable insureds generally want the transactions with their captives to be treated as “insurance” from a U.S. federal tax perspective for purposes of providing a tax deduction for premiums paid to their captives
- Tax-exempt insureds generally do <u>not</u> want the transactions with their captives to be treated as “insurance” for U.S. tax purposes
  - Deductions for insurance premiums are not important
  - If the transactions are “insurance,” premium taxes can apply
  - Most captives owned by tax-exempt organizations structure their programs and take the position that they do <u>not</u> qualify as “insurance” for federal tax purposes

Regulatory Considerations

- State
  - Unauthorized insurance
  - Captive regulation
  - Sale, negotiation, solicitation
- Federal
- International

State Aspects (Continued)

- In general, insurance transactions are regulated by individual states and not on a federal level.
- Each state has an insurance law defining or describing the activities that give rise to regulation in that particular state, with some of these laws also including a description of activities that may not give rise to regulation, but instead allow the state to exercise personal jurisdiction over the insurer.
- Insurers that are not licensed in or regulated by the state are sometimes referred to as “alien,” “foreign” or “unauthorized” insurers.

State Aspects (Continued)

- It should be noted that state regulation of insurance also is subject to the due process clause of the U.S. Constitution, which requires some minimum contact with a state in order to justify state regulation.
- *See State Bd. of Ins. v. Todd Shipyards Corp.*, 370 U.S. 451 (1962). The due process constraints, as applied in this context, however, typically do not prohibit the state from regulating or taxing transactions between unauthorized insurers when the risks insured are located exclusively within the state and the insureds' headquarters are within the state.
- *See Haisten v. Grass Valley Medical Reimbursement Fund, Ltd.,* 784 F.2d 1392 (9th Cir 1986) (holding adequate minimum contacts existed necessary for personal jurisdiction to apply California regulations against Cayman Islands domiciled captive insurance company where the insurance company purposefully directed its commercial efforts toward California residents, despite the insurance company activities, which occurred outside California).

State Aspects (Continued)

- State approaches – case law definitions of transacting insurance (*e.g.,* Michigan) versus statutory definitions (*e.g.,* Illinois).
  - It is unlawful for companies to "enter into a contract of insurance as an insurer or . . . transact insurance business" in Illinois without a certificate of authority.
    - Maintaining an agency or office in Illinois where insurance contracts are executed;
    - Maintaining files or records of contracts of insurance;
    - Receiving payment of premiums for contracts of insurance;
    - Making or proposing to make, as an insurer, an insurance contract;

State Aspects (Continued)

- Making or proposing to make, as guarantor or surety, any contract of guaranty or suretyship as a vocation and not merely incidental to any other legitimate business or activity of the guarantor or surety; and
- Taking or receiving any application for insurance.
- 215 Il. Comp. Stat. 5/121-123.

- Also look for industrial insured exemptions and/or other state law uniqueness

State Tax Overview

- Insurer level tax
- Insured level tax
- Captive insurance company statutes – create licensing of limited lines companies
- Washington State – Captive registration for insuring risks therein
- Economic nexus considerations

Domicile Taxes

- Many offshore domiciles do not have an income tax or a premium tax (*e.g.,* the Cayman Islands)
- Captives may obtain a guarantee from the foreign government
  - For example, in the Cayman Islands, a captive can receive an exemption for a period of time (typically 20 years) starting with its formation as protection in the event that an income tax system is later adopted
- No premium taxes imposed by most, if not all, offshore domiciles
- Onshore domiciles generally impose a premium tax or a fee (in lieu of a premium tax)

State Premium Taxes

- Most states impose a **direct procurement tax** (DPT) on premiums paid by a resident of the state (or with respect to risks located in the state) to unauthorized insurers
- Some states do not have a DPT
- Absent direction in state, most insureds follow the principles of federal law and apply this tax only to “insurance” premiums
- The tax is imposed on the insured, not the insurer
- These taxes have been receiving more attention in recent years, due to federal law addressing the allocation of certain premium taxes, the desire to increase state revenues and the proliferation of U.S. domiciles

Federal Tax Overview

- In the absence of a statutory definition, federal tax cases and Internal Revenue Service rulings have indicated that a “facts and circumstances” and “substance over form” approach is applicable to determining whether an arrangement qualifies as insurance from a federal tax perspective
  - This means that a transaction can be characterized differently for tax, accounting and regulatory purposes

Federal Tax Criteria For Insurance

- Consistent with these principles, a captive arrangement must satisfy the following elements for purposes of qualifying as insurance for federal tax purposes:
  - Existence of an insurance risk (traditional coverages, “risk transfer” from an actuarial perspective)
  - Insurance in the commonly accepted sense (arm’s-length / commercial-like transactions, sound governance practices)
  - Risk shifting (lack of parental guarantees/parent-subsidiary relationships, adequate capitalization)
  - Risk distribution (many insured parties, substantial “exposure units”)
- The seminal case supplying the definition of insurance is *Helvering v. Le Gierse*. 312 U.S. 531 (1941).

International Tax Aspects

What is a captive from a U.S. tax perspective?

- Captives formed outside of the U.S. are not subject to U.S. federal income taxation unless “conducting a U.S. trade or business”
  - Facts and circumstances test
  - Mind and management outside of the U.S.
  - No U.S. presence, office, address
  - No U.S. agents
- If a single parent captive, owned by a U.S. person, captive is treated under the Internal Revenue Code as a **controlled foreign corporation** (CFC)

International Tax Aspects: From the Shareholder's Perspective

- A CFC's income is deemed to be distributed annually to its U.S. shareholders, regardless of whether a distribution actually occurs
- That deemed distribution is treated as dividend income when received by the U.S. shareholder
- If a tax-exempt organization, the dividend income is not taxable to it
  - *Exception*: **unrelated business taxable income** (UBTI) in the event parent has insurance income attributable to coverage provided to taxable affiliates, non-controlled entities and certain individuals (such as non-employed medical staff members)

International Tax Aspects: Federal Premium Taxes

- **Federal excise tax** (FET) applies on "insurance" premiums paid to non-U.S. insurers (with exceptions under treaties with some foreign countries)
  - 4% on direct insurance premiums
  - 1% on reinsurance premiums
- IRS Rulings/Case Law:
  - No FET if the premiums/funding do <u>not</u> relate to transactions that are "insurance" for federal tax purposes
  - FET does apply to transactions that are insurance for federal tax purposes

International Tax Aspects: Withholding Taxes

- If a captive is a CFC, certain of its U.S. source income will be subject to a 30% withholding tax
  - Generally, the withholding tax applies on dividends (not interest or capital gains), and also applies to income on certain mutual funds
- This tax should be taken into account in determining the advisability of investment and the return
- A CFC also shouldn't invest in some vehicles which may cause it to be engaged in a U.S. trade or business (which it does not intend)
  - *Example*: Certain partnerships

Key Provisions

- Governance
- Financial
- Regulatory
- Entry and exit
- Tax
- Controversy

Key Provisions (Continued)

- Factors contributing to captive closures:
  - Increased IRS/regulator scrutiny of insurance transactions
  - Parent mergers and affiliations (especially in the healthcare sector)
  - Changing market conditions
  - Desire to free up cash/investments
  - Undercapitalization
  - Ownership issues

Key Provisions (Continued)

- Goals in a successful unwind/exit:
  - Honoring valid policyholder obligations
  - Adjusting liabilities fairly and correctly
  - Preserving assets and capital
  - Controlling and reducing expenses
  - Executing a well thought-out plan
  - Maintaining control over open claims

Avoiding Pitfalls

- How can counsel incorporate captive programs into client's overall risk mitigation / management scheme?
  - Measured approach and detailed feasibility
  - Consultant / team effort
  - Common pitfalls
- Risk of adverse experience
- Discipline of a regulated entity
- Difficult to unwind
- Commitment of owners' administrative resources
- Insurance is not the owners' core business and the operation of an insurance company requires adherence to unique sets of rules

Avoiding Pitfalls (Continued)

- Factors that will promote a successful captive operation include:
  - Senior management support of concept; participation in governance
  - Long term commitment to insurance program
  - Willingness to bear risk
  - Financial resources to support captive
  - Reliable processes to maximize efficiency
  - Experienced service providers
  - Stable domicile

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