

Captive Insurance 101

September 25, 2018

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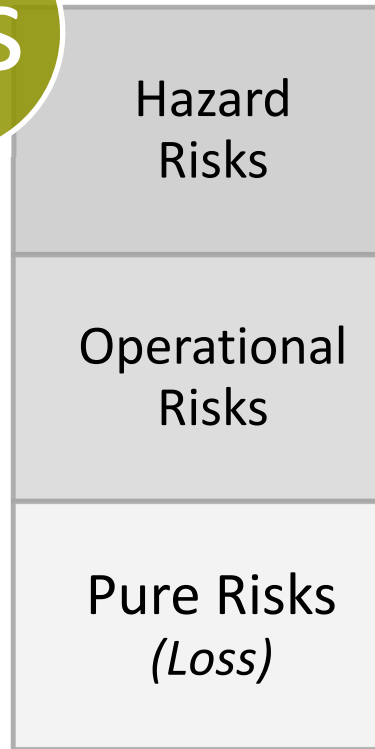
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Insurable Risk

Yes



No

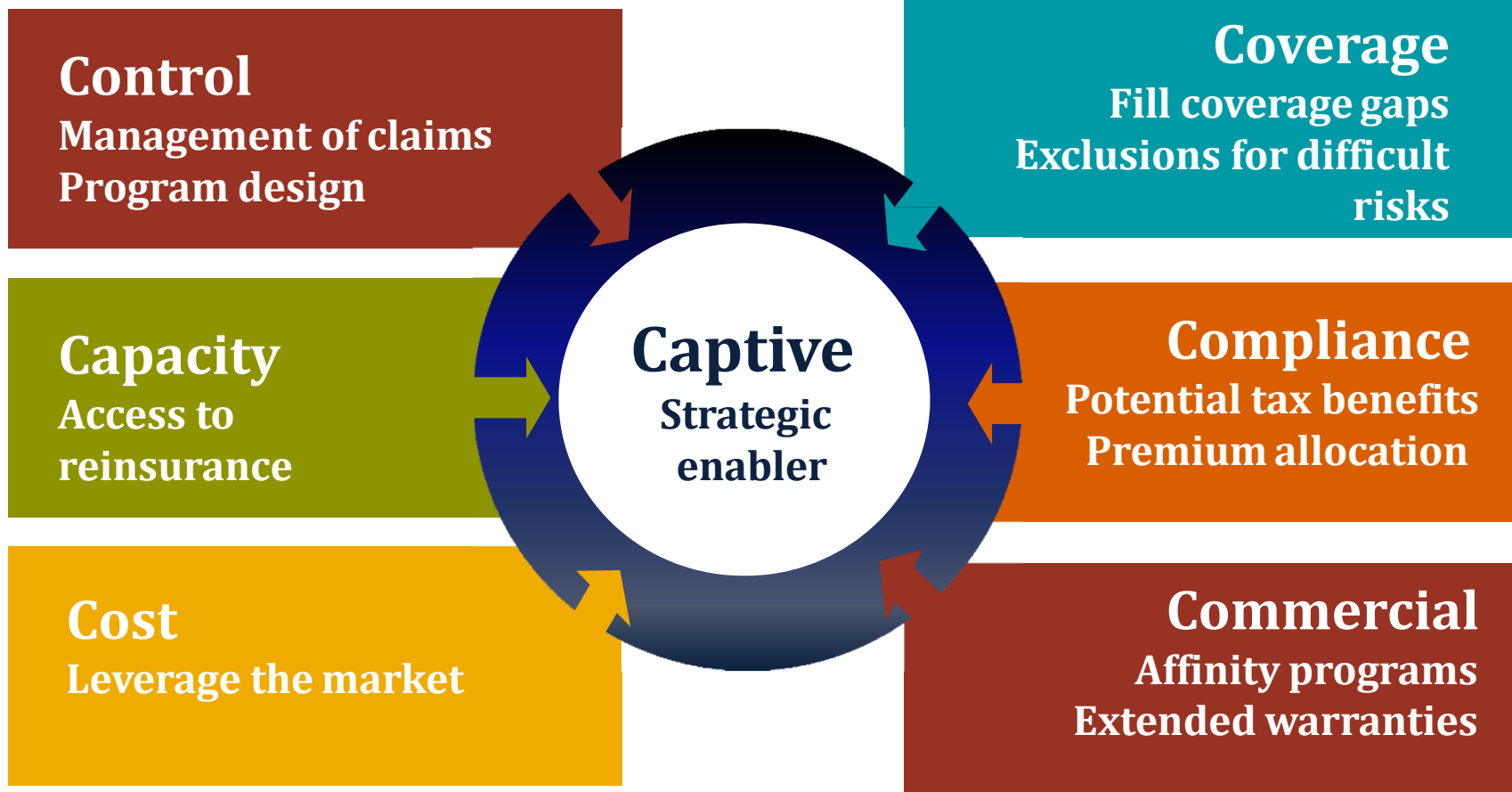


What is a Captive?

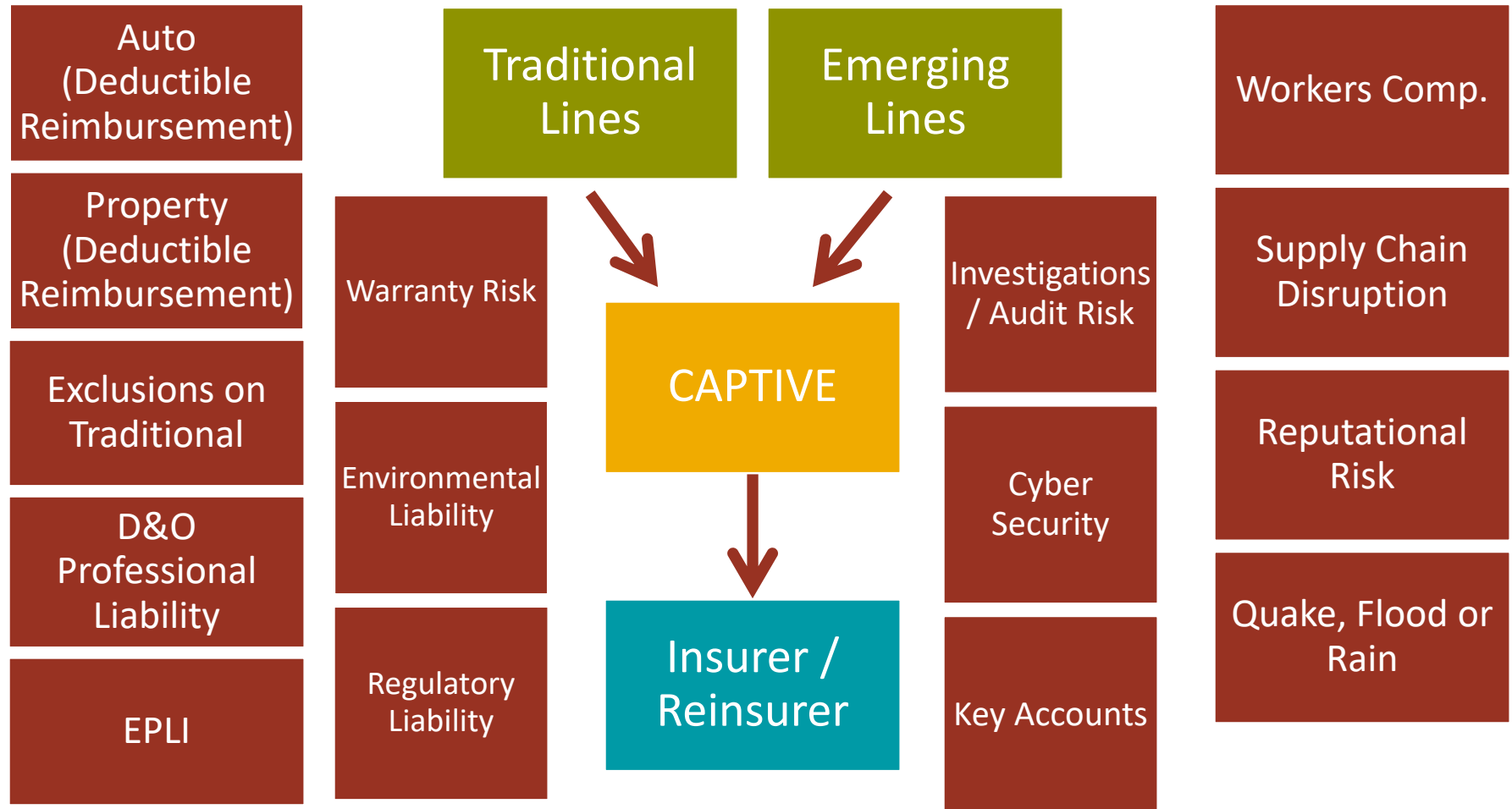
- An Insurance or Reinsurance company
- Specifically established to insure or reinsure
- The risks of the parent or associated third parties/entities



Why are Captives Formed?



Types of Risk



Types of Captives

	Single Parent	Sponsored Cell Captive	Association / Group Captive	Risk Retention Group
Scale	>\$1M in premium	Any minimum premium level	Typically a min. of \$250k in premium, no maximum	Any premium volume
Features	<ul style="list-style-type: none"> • Medium to Larger account solutions • Unilateral control of captive (subject to regulator) • No risk sharing, unless pooling arrangement is deployed 	<ul style="list-style-type: none"> • Typically established by a 3rd party sponsor • Insured can “rent” the captive space • Typically lower operating costs • Could be a protected cell or incorporated cell structure • No risk sharing 	<ul style="list-style-type: none"> • Sharing risk is required • Access to profitability of insurance program • Considerably greater control as compared to guaranteed cost insurance • Lack of unilateral control of services and risk • Communal risk management 	<ul style="list-style-type: none"> • Sharing risk is required • Policy holders are share holders • Formed in a state/domicile and ability to write in all 50 states • Liability insurance only • Typical Industries: Healthcare, transportation, governments and professional services

Benefits

- Opportunity for favorable risk management business outcomes
- Recapture leakage in traditional risk transfer solutions
- Opportunity to take risk and profit positions in affiliate business
- Control frictional and non-loss costs
- Global consistency of coverage
- New capacity for certain risks
- Ability to provide stable insurance protection year-to-year
- Enhanced claims service with focus on loss prevention and reasonable claim resolution

Considerations

- Incurring unexpectedly large losses
- Compliance issues
- Meeting and maintaining capital requirements
- Competing uses for available capital
- Accessing capital for competing needs
- Distributing profits
- Winding down program
- Restrictions on selling or transferring ownership
- Focus and commitment must be long term
- Overcoming the learning curve

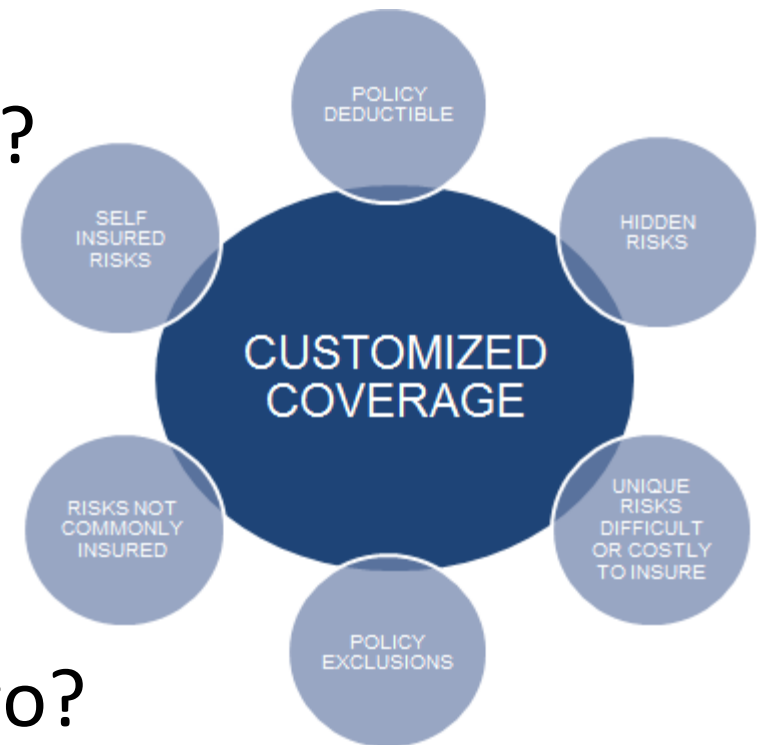
What is a Captive for?

- A captive is a vehicle for financing risk that is retained by the insured(s).
- Business owners and managers should ask themselves, “What risk do I want to retain?” and “What risk do I want to transfer?”
- The answer will depend on various factors, particularly on the availability and cost of insurance in the commercial market.
- The questions cannot properly be answered without first identifying risks within the business.

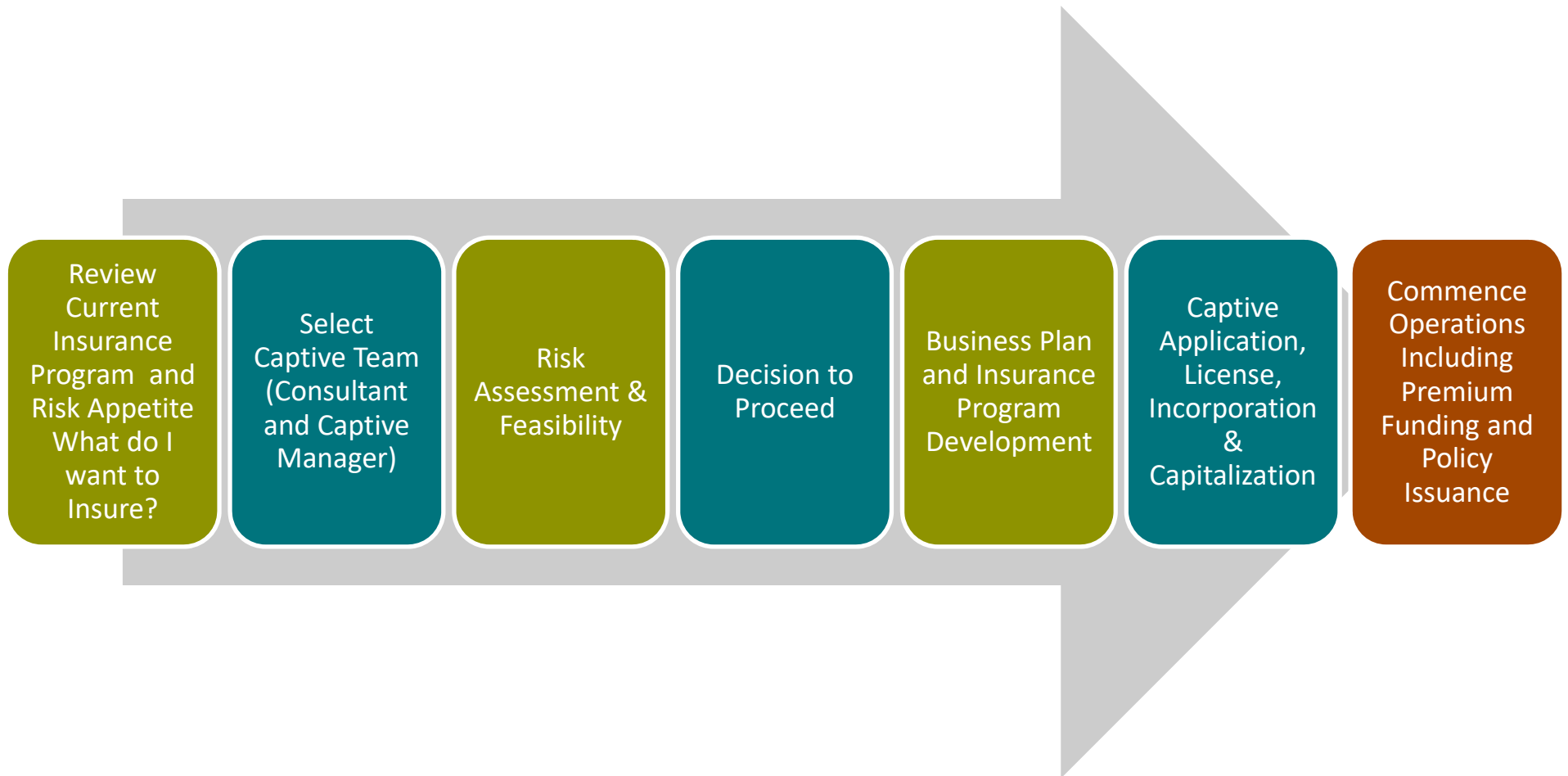
Identifying Retained Risk

Questions to ask:

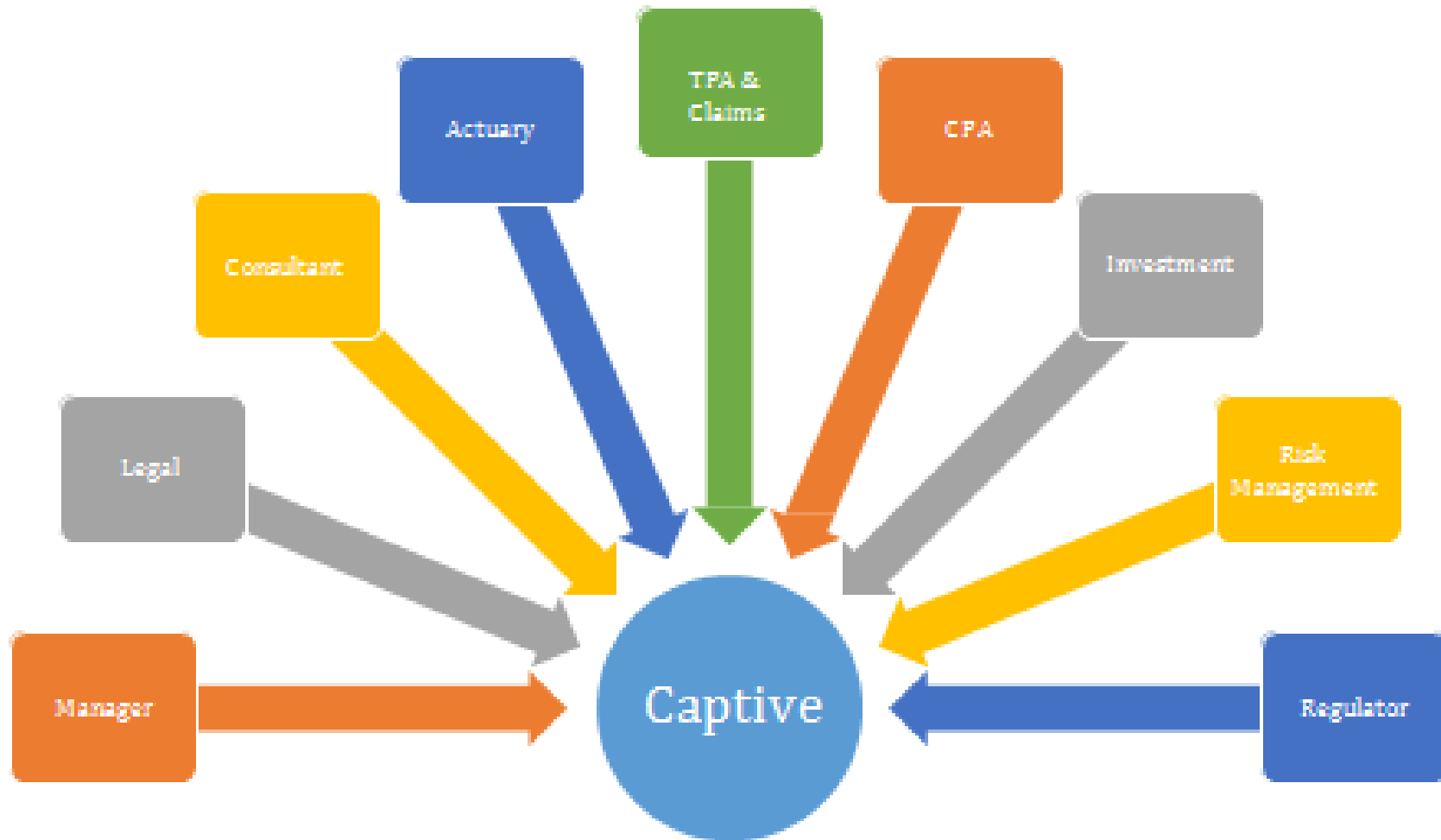
- What does the business do?
- How does it do it?
- What environments exist ?
- Regulatory, supply chain, distribution channels?
- What makes the business go?
- What keeps you up at night?



Captive Formation Process



Captive Professionals



Captive Manager Selection

Criteria

- Ethical behavior
- Implements best practices
- Professional competence
- Strong communication skills
- Transparency
- Evidence of success

Criteria

- Expertise in type of captive
- Domicile options
- Depth of resources
- Access/relationship with other providers
- Functions being preformed
- Compensation
- Integrity of pooling structures

Domicile Selection

Criteria

- Statutory Capitalization and surplus requirements and solvency ratios
- Receptiveness of regulatory environment
- Quality of local infrastructure
- Availability of expertise
- Stability of regulatory environment

Criteria

- Flexibility as respects investment portfolio
- Ease of doing business – in a suitably regulated environment
- Expertise in business under consideration
- Efficient financial outcomes: tax, wealth, investment, etc.

Actuarial Risk Pricing

Third party actuaries should NOT price loss exposures that do NOT represent real insurance risk. Rigorous methods and assumptions develop expected loss estimates for each coverage.

Insurance Must...

- Reflect a shift of both economic loss and timing of payments
- Represent a material risk (probability) of a material loss

Actuarial Methods Utilize...

- Pricing from public information
- Rate filings for similar coverage
- Past claims history
- Reinsurance techniques when little public data exists

Actuarial Reports Must...

- Comply with the highest actuarial standards and be easily reviewable by other actuaries and regulators

Taxation of Captives



- **Tax planning with captives**
 - Timing difference: deduct premiums versus losses
 - Permanent tax reduction
 - Sec. 831(b): no tax on underwriting income of certain small insurance companies (“micro-captives”)
 - Section 501(c)(15): tax exemption for small insurance companies (limited application after 2003)
 - Shift income: captive owned by employees, family trusts, etc.

Taxation of Captives

- **Tax requirements for true insurance**
 - Risk shifting: risk of loss is shifted from the insured to a financially viable and bona fide insurer for an arm's length premium
 - Risk distribution: numerous, independent risks, and the associated premiums, are “pooled”
 - Insurance risk: risk of a “fortuitous event”; not business or investment risk
 - Insurance in the commonly accepted sense: customary insurance formalities observed

Taxation of Captives



- **The shysters move in**
 - Insurance for implausible risks
 - Failure to match genuine business needs/risks
 - Duplication of commercial coverages
 - Premiums unsupported by underwriting or actuarial analysis, and set at a target deduction
 - Premiums significantly higher than premiums for comparable commercial coverage
 - Formalities not observed (licensing, premium payments, policy documentation, claims, etc.)
 - Limited pooling of risk and premiums

Taxation of Captives



- **Congress takes action**

- Micro-captive diversification requirements:

- Shareholder diversification: descendants of insured's owners can't have more than a 2% greater ownership interest in the captive than in the insured; or
- Policyholder diversification: no more than 20% of premiums attributable to any one policyholder

- Micro-captive can receive up to \$2.2MM in annual new written premiums (up from \$1.2MM)

- Limit is also indexed for inflation (\$2.3MM in 2018)

- Passed 2015, effective 2017

Taxation of Captives



- **IRS takes action**

- Notice 2016-66 (Nov. 1, 2016): specified micro-captive transactions designated a “transaction of interest,” triggering extensive reporting to IRS by captive and its material advisors
 - Reporting required if 20% ownership overlap and either (a) less than 70% loss ratio or (b) “producer” loans, etc.
- Litigation:
 - *Avrahami* (2017)
 - *Reserve Mechanical* (2018)

Taxation of Captives



- **Where are we now?**

- Prudently structured and maintained captives are as viable as ever, but more IRS scrutiny
- Many micro-captives are using 80% risk pools after 2016 to permit captive ownership diversification
- Other tax advantaged captive structures may be available
- ***Manager and advisor selection is critical!***
- Remember that taxes are only one potential benefit of a captive insurance program

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