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INTRODUCTION

“Captive Overview” is an informative publication of CICA, designed as an introductory guide on the structure and usage of captive insurance arrangements. This guide will explain why captives have become a significant alternative to traditional insurance and how firms should proceed when considering formation of a captive. It covers the practical, legal, and governmental considerations of implementing captive programs.

A captive insurance company, commonly referred to as a “captive”, is an alternative risk transfer entity and an alternative to the traditional commercial insurance and reinsurance markets. Whereas a commercial insurer is owned by a broad base of stockholders, known as a “stock” company and/or policyholders, in the case of a “mutual” company, a captive is owned by a finite group of owners who share common interests. The captive owner may be a single-parent company, or commonly called a “pure” captive; but sometimes owners may be from an industry group or trade association, typically called a “group” or “association” captive.

The single-parent captive writes business only for that parent or its related entities, while the group captive underwrites risks for multiple groups or members. In some cases, the captives are owned by a party unrelated to the insured, who “rents” the captive's surplus to a firm wishing to set up a funded self-insurance program. The services provided by a captive can also vary depending on the needs of the insureds. Some captives engage in active underwriting through risk classification and pooling, while others may serve simply as a conduit through which the assumed risks are transferred to the reinsurance markets.

Captives were once considered to be outside the standard of risk management practices, however, within the past decade or so, most if not all major corporations have either utilized captives or actively considered the feasibility of captives. Captives are now truly considered a mainstream risk management alternative. The reasons for this widespread acceptance include:

- Cost savings when compared to traditional insurance
- Lack of predictability of insurance market cycles, and the protracted “hard” market within certain sectors (e.g. medical malpractice insurance)
- Favorable IRS tax rulings
- Growing number of domiciles enacting attractive captives legislation
- The need of risk managers to insure uninsured, underinsured or inefficiently-insured risk exposures; e.g. terrorism, cyber-risk, various employee benefit programs.

The advantages offered by a captive insurer can be significant including control and potential tax benefits. The ownership control the captive affords to the parent company can be useful in permitting customized insurance products and underwriting standards to fit the specific circumstances of the insured, particularly in cases where coverage might otherwise be unavailable or prohibitively expensive. Ownership also permits determination of appropriate litigation and claims settlement strategies. In other settings, the captive’s direct access to reinsurance markets may reduce the cost of transferring risks and allows the parent to benefit from favorable loss experience enjoyed by the captive.

Captive insurance may provide a tax benefit to the parent firm since contributions to a self-insurance pool are not recognized by the IRS to be tax deductible business expenses, although
actual losses are deductible as they are paid. In addition, premium payments to an insurer, including a captive, are permissible business expenses that may be used as an offset to taxable corporate profits. This particular benefit of captives has received a substantial amount of scrutiny by the tax authorities, resulting in the Harper Group appellate court decisions in the early 1990s and a series of revenue rulings in 2002. The rule of thumb flowing from the Harper cases is that premium payments to a wholly-owned captive should be tax deductible if the captive writes a substantial amount of business (i.e., 30% of the premium volume) that is unrelated to the parent company. Note: while the case law guideline is 30%, the IRS’s “bright line” test in the revenue rulings for unrelated risk in a pure captive is 50%. Further, as discussed below, in 2001 the IRS conceded that in certain circumstance premiums attributable to “brother-sister” risk (in contrast to “parent-subsidiary” risk) placed in a captive can be deducted. In 2002, the IRS issued several revenue rulings creating a safe harbor program for captives. The Department of Labor (“DOL”) approved Columbia Energy and others creating a fast track approval process for employers to fund benefit programs through their pure captives. With the prospect that employee benefits could now join property/casualty insurance as possible lines of insurance placed into the captive, the captive vehicle has become mainstream for all aspects of corporate risk funding.

A captive insurer, structured to respect the current state of the tax laws, can provide significant tax and risk financing benefits to a company, either as a stand-alone business or as a complement to traditional insurance mechanisms. Potential tax benefits should never be the primary driver of a captive feasibility study but, if the prospective captive can be shown to be tax neutral or better, then the risk financing benefits can be strong drivers of the captive implementation strategy. Once used as a hedge against hard markets, the captive is today used for its flexibility and the control that it provides its owner(s). Today there are more than 5,000 captive insurers worldwide and the growth of this risk financing tool is very strong.

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1 Estimated as of year-end 2007
**WHAT IS A CAPTIVE?**

A captive insurance company insures the risk of its owner(s) and/or related or affiliated parties and returns underwriting profit and investment income. Captives are insurers owned by the insureds and organized for the main purpose of funding the owners' risks while allowing owners to actively participate in decisions influencing underwriting, operations and investments.

**Single Parent Captives**

Single Parent Captives are often described as 'pure' captives. These are companies with a single owner, for whom they provide insurance coverage. They are usually monitored by a risk manager or financial officer at the parent company and managed by a domiciled insurance management company. A common example is a manufacturing company that forms a wholly-owned captive to insure the deductible portion of the parent’s Workers’ Compensation, General Liability and Auto Liability policies.

**Association Captives**

An Association Captive is formed by a pre-existing association to provide insurance coverage for members. Ownership rests with the association or individual members. The association typically has a financial expert at the association level with primary responsibility for the captive. Where an association does not have an insurance specialist on its payroll, primary responsibility is then given to the management company, brokers, and other consultants. An example of an association captive is an association of mental health workers that provides its members with medical malpractice liability coverage through an association–owned captive.

**Industry Captives**

An Industry Captive is owned by a group of companies within the same industry that joined to solve a common insurance coverage problem. The stockholders of the Industry Captive elect a Board of Directors to whom the management company reports. Industry Captives are usually work-intensive due to the need for detailed and regular reporting to individual policyholders. An example would include mental health workers getting together to form their own captive insurance company not through an association affiliation to insure their medical malpractice liability coverage.

**Agency Captives**

An Agency Captive is typically a reinsurance company owned by an agent or group of agents. These are formed by brokers or intermediaries for their clients. An agency captive is sometimes used as a strong marketing tool with regard to reinsurers as it demonstrates the agent is prepared to join in the risk. An example is an insurance agency forming a captive to insure a portion of its small book that it was placing in the market. The agency can now derive additional benefit by participating in the risk.
Rent-A-Captive
A Rent-a-Captive insures the risks of it renters and returns underwriting profit and investment income participation to the insureds. Certain companies rent their surplus to other entities wishing to establish a self-insurance program but do not want to capitalize their own captive.

Protected Cell Companies
Protected Cell Companies (PCC) also referred to as Segregated Accounts Companies (SAC) and Segregated Portfolio Companies (SPC), are essentially rent-a-captives with a special difference. Rent-a-captives allow renters to shield their capital and surplus from other renters in the captive as long as the rent-a-captive's owner remains solvent. If the owner's liquidity becomes deficient, renters may be exposed because their assets may have to pay claims of others. PCCs, on the other hand, guarantee each "cell" within the company will be shielded not only from sharing capital and surplus with other cell owners, but also from any legal action against the cell's assets. This protection is known as "walls of brick," since even in the case of cell liquidation, it has no legal recourse against any other cell in the company.

Special Purpose Financial Captives
Special Purpose Financial Captives (SPFC) are created for the limited purpose of entering into a SPFC contract and to date has been focused on insurance securitization transactions and into related agreements to facilitate the accomplishment and execution of those transactions. The creation of SPFCs is intended to achieve greater efficiencies in structuring and executing insurance securitizations to diversify and broaden insurers' access to sources of capital and to facilitate access for many insurers to insurance securitization and capital markets financing technology.

Special Purpose Captive Insurance Company
SPCs are captive insurance companies that are formed or licensed under the laws of a domicile like South Carolina that does not meet the definition of any other type of captive insurance company defined in this section. Typically, special purpose financial captive insurance companies are specialized captive insurers designed to act as special reinsurance vehicles for life or property and casualty insurers whereby insurance business transferred to such special purpose captive insurance companies can be funded through capital markets offerings.

Risk Retention Group
Risk Retention Groups (RRG) are corporations or limited liability associations formed under the Federal Liability Risk Retention Act of 1986 (LRRA). RRGs are formed for the purpose of assuming the liability exposure of their members and allow members who engage in similar or related business or activities to write liability insurance for all or any portion of the exposures of group members. First party coverages, such as property, worker’s compensation and personal lines, are excluded. As RRGs are authorized under a federal statute, a group becomes licensed in
one state and is able to engage in the business of insurance in all states subject to limited regulatory requirements.

An RRG is a pool of individual insureds that are homogeneous and have agreed to share the third-party liability risk among them in accordance with the 1986 Risk Retention Act passed by Congress. For the most part, a RRG is not subject to state insurance laws and regulations, but is subject to various state statutes where it is domiciled. It is important to note that the vast majority of state insurance regulations do not apply to RRGs.

In order for a RRG to be domiciled, the regulator must review and approve a feasibility study, business plan, and the capital requirement to support the underwriting risk. In some cases, the RRG is only subject to the minimum capital requirement of the state. Capital can be provided in cash, letters of credit or a combination of both to meet the requirement.

In order to conduct business in various states, a RRG must fill out the appropriate form to register in that state. There are no requirements to use licensed agents or brokers for the solicitation of business. In addition, RRGs are not subject to rate and coverage filings.

The owners and insureds of RRGs are the same. Capital must be provided by the insureds in order to comply with the ownership provisions of the Risk Retention Act.
HISTORY

The establishment of captive insurance as a popular alternative risk transfer vehicle extends from the failure of traditional insurance providers to meet distinct needs of individuals and businesses. Entities that have difficulty finding needed coverage at affordable premiums have designed and implemented their own solutions through this tool. The first captive dates back to the 1800s, when New England textile manufacturers created a group captive (in the form of a mutual company) in response to high fire insurance rates of that period.

The first pure captive, as it is defined today, may have been the Mahoning Insurance Company, established by the Youngstown Sheet & Tube Company in 1935. It was used to write a single, all-lines policy with Lloyd’s of London when rigid insurance laws prohibited Youngstown from obtaining such a policy from the conventional market.

In the early 1960s there were approximately one hundred captive insurance companies in existence. In the 1970s captives began to popularize in response to a hardening insurance market. The insurance industry progressed through a cycle of hard and soft markets in which pricing and coverage policies are alternately made more rigid or more lax based on insurers’ financial standings at any given period. The 1970s saw restrictive underwriting in lines such as product liability and medical malpractice causing workers’ compensation and liability rates to skyrocket.2 Hundreds of captives were formed during this period, including some by the world’s large corporations.3 The number of captives worldwide increased to 1,000 by 1980.4

During the growth of the captive industry, Bermuda emerged as the top domicile, with the Cayman Islands and the British Virgin Islands vying for business, as well. Offshore domiciles attracted US companies for their (potential) tax advantages and because companies encountered less bureaucracy than what was found in the US. To compete, states began granting captive insurance companies the same benefits they could derive offshore. Colorado came first in 1972, but Vermont, Hawaii, and South Carolina now lead the way.5

During the 1980s, as competition for business intensified, the IRS challenged the legitimacy of captives as insurance companies and the deductibility of insurance premiums. Under the “economic family theory,” it was argued that no insurance relationship existed with a group of affiliated companies. The commonly accepted definition for “insurance” required: (1) risk shifting, where a company transferred risk to an unrelated party; and (2) risk distribution, where the insurer could spread its risk across a sufficient number of exposures.6 Risk shifting did not exist in a captive, as liability remained within the same economic family.

Through various court cases, US tax law came to allow the deductibility of premiums paid to a captive under circumstances where it is organized to cover affiliated companies other than a parent, and/or where the captive’s third-party business makes up at least 30% of its total, with some exceptions.7 A soft market during the 1990s slowed the growth of captives, but it picked up

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7 Harper Case, Generally held to be an industry rule of thumb.

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again in the new millennium. Insurers tightened underwriting practices once more and after the September 11, 2001 attacks, one-third of property & casualty carriers lost significant value. Today, interest in captives is at an all-time high. Captives are responsible for over $300 billion in 2004 premiums. As of 2007, there are over 5,000 captive insurance companies around the globe. Bermuda remains the number one domicile, housing almost 1,000 captives. With over 750 captives, Vermont ranks first in the US. Lines of coverage are extending beyond traditional products – product liability, workers’ compensation, professional liability (medical malpractice) – and into non-traditional areas such as employee benefits. Growth in funding employee benefits in a captive would mean more business in the US. Benefits regulated by ERISA are required to be domiciled onshore.

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**REASONS TO FORM A CAPTIVE**

There are several reasons to form a captive:

- **Reduced Reliance on Commercial Insurance**
  
  As the captive matures, its surplus grows, giving it greater capacity to retain risk. Increased surplus also creates new opportunities for accessing reinsurers and entering pooling arrangements, which further increase available capacity.

- **Reduced Cost of Risk**
  
  The price of insurance coverage purchased in the conventional market typically reflects a significant markup to pay for the insurers’ acquisition costs (including marketing and broker commissions), administration, and overhead as well as profit to the insurer. The fact that premiums are paid in advance represents a lost opportunity to earn investment income. Establishment of a captive cannot eliminate these costs, but it can reduce them. The extent of the reductions will depend on the captive's loss experience, the claims handling costs and the degree to which the captive promotes cost consciousness and efficiency in the parent.

- **Stabilization of Pricing**
  
  Where the insured enjoys a stable and reasonable loss experience from year to year, a captive affords the ability to price insurance coverage accordingly. By contrast, the conventional insurance market will often set prices in relation to broad industry classifications, and thereby fail to reflect key differences in loss experience among individual insureds. The result is price volatility based on general market conditions and the actions of other insureds. In addition to the stabilization of pricing over time, there are also advantages to be realized in terms of the organization's financial planning and control functions.

- **Provision of Cover Where Otherwise Unavailable**
  
  From time to time, the conventional market is unwilling or unable to provide cover for certain risks, especially for volatile liability and casualty risks. The establishment of a captive to write such lines or to provide additional capacity can be an answer to these market problems. Coverage, which have at times been unavailable or difficult to obtain on satisfactory terms, include product liability, professional liability, oil pollution, hazardous waste and labor strike insurance. Whenever insurance cover is unavailable or overpriced, the feasibility of a captive is enhanced.

- **Access to Reinsurance Markets**
  
  Because reinsurers generally deal with insurance companies, a captive affords direct access to the international reinsurance markets. In bypassing conventional insurers, the insured is spared markup costs. The savings associated with eliminating these costs will frequently outweigh the incorporation and other startup costs of a captive.

- **Improved Cash Flow Benefits**
  
  The ability of a captive to generate investment income from unearned premiums received is often a critical advantage in forming a captive. This is especially true where premiums are paid in advance and losses are paid out over a lengthy period of time (which, in turn, depends on the kinds of risks insured). To the extent investment income can accumulate in a tax-free domicile, there will be additional funds available to pay losses and a corresponding reduction for further funding of the captive.

- **Reduction of Government Regulations and Interference**

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In contrast to the rigorous insurance regulation in most industrialized countries, a domicile can provide a less onerous, yet responsible, regulatory framework. This has been described as a system of shared regulation, whereby the regulated cooperate with a view to achieving the most appropriate level of policyholder protection while at the same time permitting the captive to grow and prosper.

- **Ability to Customize Insurance Programs**
  A captive has complete freedom to insure any risk it chooses and to customize the terms and conditions of its policies. This can lead to improved loss control efficiency and promote greater awareness of the factors that commonly give rise to losses.

- **Formal Allocation of Deductibles for Self-Insurance Retention within a Corporation**
  A medical facility may want to allocate costs to locations by loss ratios while a real estate partnership may need to bill each partner its respective cost (rather than an arbitrary allocation). With a captive, it is easier for the smaller entities to justify these expenses.

- **Underwriting Advantages Inherent in Captives**
  A key advantage of a captive is its ability to provide management information across a spectrum of underwriting disciplines respective historical claims information. When feasibility studies are undertaken, it is not uncommon to find that pre-captive loss experience is unreliable.

  Depending on the risk involved, a wide range of sophisticated, analytical tools can be employed to help calculate incurred but not reported (IBNR) losses. On a day-to-day basis, simple spreadsheets can be maintained and used.

  These tables can be enhanced to show numbers of claims and differentiate between paid and outstanding amounts so that the cash flow effect may be monitored. It’s simple and effective when its limitations are understood:

  The composition of the portfolio may have changed over the years
  The method of reserving may have altered over time, especially because it is often based on human, not scientific, judgment
  Deductibles may vary year to year, distorting the information
  A yearly security loading variable that tries to track judicial inflation, currency movements, and the unexpected may have been added
  A significant advantage in maintaining this type of record is its appeal in explaining to non-insurance people the method of determining IBNR levels.

  Because of the uncertainty associated with long tail business and risk of a catastrophe, it may be appropriate for a captive to purchase aggregate excess of loss or stop-loss protection. In some cases, it may be necessary to engage the professional services of a qualified actuary. In any event, it is advisable to be aware of and monitor what is happening to the captive in order to maximize its value to the parent and to support a prudent assessment of future premium requirements.
• **Opportunities for Improved Claims Handling and Control**
  A captive owner is also free to establish their own claims handling policies and procedures. This has obvious advantages such as the reduction of the time taken to process and pay claims.

• **Creation of a Profit Center**
  To the extent a captive might offer insurance coverage to unrelated customers (sometimes in response to tax planning objectives of the captive), it will have diversified into open market operations similar to conventional insurers. Although there are special risks and capital requirements associated with engaging in such business, doing so will have the potential to generate additional profits.

• **Tax Advantages**
  While professional tax advice should be sought before making the decision to form a captive, there may be certain tax advantages associated with such a decision. These might include the tax-favored accumulation of reserves and respective investment income (which may depend on, among other factors, the domicile of the captive, the residence or citizenship of the captive’s owners or the source of its income). Another advantage may be the deductibility of premiums paid for by the insured for tax purposes (as premium expense of the insured). Also, if a captive qualifies as a true insurance company for tax purposes, then unlike other corporations, it can deduct currently a “reasonable and fair” loss reserve for unpaid actual losses incurred. Finally, state premium taxes otherwise payable in a commercial insurance program may be reduced. Although tax advantages may be of significance in the decision to form a captive, they should never be the prime-motivating factor.

• **Enterprise Risk Management & Strategic Risk Financing:**
  Consistent strategic risk financing and assumption of risk approach for all hazard risks across your organization; property & casualty and employee benefits insurable risks alike. In line with enterprise risk management thinking and first steps in achieving a holistic view and approach towards hazard risk.

• **Ability to Direct Investment Options**
  Generally when you purchase commercial insurance you do not control the investment of the unearned premiums and loss reserves. A captive can afford the opportunity to direct these investment choices.
SOME POSSIBLE DRAWBACKS

While the drawbacks to setting up a captive are few, they typically include the following:

Administration

- Increased Administration Burden: The captive owner(s) will be ultimately responsible for claim administration, loss control and underwriting. Additional time; money; and personnel and management commitment is required for these services. Such costs may be offset by contracting out administration to captive management companies. However, these costs will reduce the premium savings expected.

- Delegation: Where a captive management company is engaged, a high degree of delegation and partnership is required. A significant management time commitment is involved, but if the parent company already employs a risk manager, this time commitment should be within the normal arena of such a manager's duties.

- Acquisition of Expertise: A parent company must acquire relevant expertise for all the insurance related disciplines. This could be offset by the engagement of captive management services, although it would be prudent to have at least some expertise residing in the parent company.

- Merger or Acquisition: A captive’s existence may complicate merger or acquisition activity and may involve the unwinding or combining of multiple captives.

Financial

- Volatility of Reinsurance Market: Generally speaking, the reinsurance market acts more swiftly than the primary insurance market in the event of adverse experience. Since the reinsurance market tends to be experience rated (premiums closely reflect the loss history of the insured) a reinsured risk of a captive might face premium increases sooner than a commercially insured risk.

- Capital Commitment: At least during the initial stages of a captive formation there will be a burden on the parent's financial resources to fund the initial set-up costs and the capitalization required by the domicile's regulatory body.

- Run-Off: A change in the parent company’s business plan or a merger might result in the captive being placed in a run-off mode. Expenses of a run-off produce no current economic benefit.
WHEN RENTING INSTEAD OF OWNING MAKES SENSE

A rent-a-captive helps companies sidestep the legal and administrative costs and complexities of startup. For a set fee, companies “rent” a portion of the rent-a-captive’s underwriting capacity, while drawing on the facility’s technical expertise. Unlike a pooled insurance arrangement, a company renting a captive is judged by its unique book of business and loss record, while earning investment income from its individual investments. Companies considering using a rent-a-captive as part of a risk management and insurance program need to be aware of three basic truths.

First, the account must self-balance. In most instances, the reinsurer company connected with the rent-a-captive is not a risk carrier, but purely a service provider. “Own” assets must match “own” liabilities.

Second, make sure your rent-a-captive risk is not mixed with other risk pools. Each individual client should be serviced through contractual limit restrictions and an individual bank account, not from the general bank account of the reinsurer.

Third, the reinsurer should be set up in such a way that one bad rent-a-captive program does not have an impact on total operations.

Strict underwriting principals; contractually limited restrictions; and individual bank accounts can help address this issue. Legislation, created to address this situation can also help. Consider bringing your accounting and tax advisors on board early so you eliminate conflicting advice between advisors.

Sharing Your Risk

While rent-a-captive cells do not usually share risks with each other, they should take measures to help ensure solvency. One important way is to find the proper reinsurance partner, one who understands this particular way of insuring risk. Another is to partner with a risk sharing (fronting) company. Because of the complexities of this arrangement, a risk sharing company will request tight procedures, controls, warranties, and sometimes substantial fronting commissions.

Alternative risk transfer will continue to evolve as the popularity of rent-a-captives grow. Accessible to companies of modest size, a rent-a-captive can also serve as an intermediate step prior to setting up an individual captive insurance company. The latter scenario may appeal to a company that has accumulated reserves substantial enough to be transferred into a fully owned captive company.

Sponsored Programs

Sponsored programs are sponsored by an insurer and offer some of the benefits of a captive. The insurer sponsor typically provides reinsurance underwriting and overall program management.
WHO SHOULD CONSIDER A CAPTIVE

There are no set criteria to identify companies that could benefit from a captive, however, there are rules of thumb that can be followed. These include:

- Premium should be sufficient to achieve savings and cover expenses (i.e., $750,000 to $1,000,000.) The organization must be able to capitalize the entity with an adequate premium to capital/surplus ratio generally of 3:1 to 5:1
- The loss ratios for the coverages should be low enough to generate surplus and offer some cushion so the captive can sustain any adverse losses
- An initial investment of capital is needed to fund the company. The parent should have sufficient resources to exceed the minimum surplus ratio without a drain on corporate cash. The minimum is about $100,000, but depends on the domicile selected and business written

There are also a number of internal questions that should be asked and answered. These include:

What needs will the captive address?
The captive should provide coverage for lines of business that are either difficult to insure in the conventional market or that provide significant cost savings by retaining the risk. A properly designed captive provides its insured with the ability to create a risk-financing program that offers flexibility, stability and control.

Is the parent organization willing to make the necessary commitments?
Forming a captive requires commitments of time and initial funding by the parent. The degree of these commitments depends on the size of the organization and the extent of the captive's role in providing alternative risk financing services for the organization.

Are the goals of the captive and the organization focused?
It is important the goals of the captive be well defined and appropriately managed in its infancy if it is to be successful over the long term.

Does the concept of a captive mesh with the overall corporate strategy?
The ideal organization to form a captive is one that is willing to forego transferring some risks to the conventional markets and wants to operate conservatively by funding for them. Moreover, a long-term commitment to captive funding must be present to take advantage of all the benefits offered by captives.

Is there a strong leader?
A successful captive must have a strong leader to see the program through its many phases. The more influential the leader, and the more fervently he or she believes in the merits of a captive, the greater the chances of success.

Who will own the captive?
This is frequently the most important consideration. Will it be the holding company, an existing entity, and/or a new organization and one or more owners?
**SETTING UP A CAPTIVE**

The first step is to conduct a feasibility study and submit an application to the domicile regulatory authority. Most jurisdictions, both onshore and offshore, require a single-parent captive to be initially capitalized at $250,000. Fees involved in establishing a single-parent captive range from $50,000 to $100,000. Given these start-up costs, only well-capitalized companies with substantial property and casualty or benefits insurance premiums and minimum claims can afford to take advantage of a single-parent captive.

Smaller companies are forming group captives, which normally are formed by an association or group of entities with similar risks. A group captive can provide many of the benefits found in a single-parent captive, while reducing the start-up costs and capitalization requirements for each participant.

Many small and mid-sized companies are participating in rent-a-captives since the participants do not have to pay all of the start-up costs or capitalize the entity.

**Feasibility Study**

A company considering any type of captive insurance arrangement must perform a feasibility study. Such a study involves an analysis of the owner/insured’s risk profile and financial condition and includes financial analysis, legal research, actuarial projections, accounting, tax projections, domiciling options, comparisons, and an insurance issues analysis. Among other things, it should include a five-year pro forma that predicts the financial impact of establishing a single-parent captive or participating in a group captive or rent-a-captive arrangement. The feasibility study should also provide the company with an estimate of what the actual costs will be for each approach.
SELECTING A DOMICILE

With over 60 jurisdictions worldwide now having specific provision for captives, the choice of selecting a domicile may be daunting. Answering these questions will help you narrow your selection:

- How might political instability affect the captive's ability to function
- Would the time spent traveling to and from the location be difficult to manage
- Can capable employees or management companies be found at a reasonable cost
- How friendly and sophisticated is the regulatory body of the considered domicile
- Do they have employee benefits legislation

More broadly your considerations should be concerned with these additional issues:

- Stable and predictable business environment
- Regulatory environment
  - Flexible captive insurance legislation
  - No specific solvency ratios
  - No policy form or rate requirements
  - Easy access to reinsurance markets
  - Considerable latitude in the scope of allowable investments
- Reasonable capitalization requirements
- Availability of high quality professional services
- Quick and efficient procedures for organizing and activating the captive
- Taxation
- Lower operating costs relative to other domiciles
- Compatibility of local language, currency and customs
- Economic, political and social stability
- Time zone convenience for Pacific Rim, North America and Europe
- Strategic location
- Infrastructure
  - Supervisory jurisdiction
  - Tax treaty with US
  - Registration and incorporation expenses
  - Investment restrictions
  - Capitalization local taxes
WHERE TO DOMICILE A CAPTIVE

Unlike traditional insurance companies, which may be licensed to write business in multiple US states and/or foreign countries, a captive insurance company is licensed in only one jurisdiction, commonly referred to as its domicile. The most common domicile has been Bermuda, with almost 1000 captives as of year-end 2006.\(^9\) In recent years numerous onshore and offshore domiciles have experienced rapid growth. There are now dozens of choices for locales in which to domicile your captive.

While a captive owner’s decision on where to locate is far less important than it may once have been due to competition among the domiciles, there are a few general questions you must ask of yourself to help you make this decision:

1. Do we want to be on-shore or off-shore?
2. If on-shore, do we prefer east coast or west coast?
3. Do our industry and/or lines of business contemplated for the captive dictate a preferred domicile? Health care companies typically prefer the Cayman Islands.
4. Where will meetings, (e.g., Board Meetings) be held?

One key factor in determining on-shore vs. off-shore may be whether or not you intend to utilize the captive to fund employee benefits for a US employer, where such employer is subject to ERISA laws and the oversight of the US Department of Labor (DOL.) The DOL typically requires that a US domicile be used. For example, some companies that already had an off-shore domicile have created a US based “branch” of the off-shore captive. Given the relative importance of the on-shore versus off-shore distinction, listed below are the top six domiciles with number of captives by the end of 2006.

**Off-shore domiciles\(^{10}\)**

<table>
<thead>
<tr>
<th>Domicile</th>
<th>Number of Captives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bermuda</td>
<td>989</td>
</tr>
<tr>
<td>Cayman Islands</td>
<td>740</td>
</tr>
<tr>
<td>British Virgin Islands</td>
<td>383</td>
</tr>
<tr>
<td>Guernsey</td>
<td>381</td>
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<tr>
<td>Barbados</td>
<td>235</td>
</tr>
<tr>
<td>Luxembourg</td>
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</tr>
</tbody>
</table>

\(^9\) Captives and Other Risk-Financing Options, Insurance Information Institute, [http://www.iii.org/media/hottopics/insurance/test3/](http://www.iii.org/media/hottopics/insurance/test3/) (December 2007)

\(^{10}\) Captives and Other Risk-Financing, [http://www.iii.org/media/hottopics/insurance/test3/](http://www.iii.org/media/hottopics/insurance/test3/)
On Shore Domiciles¹¹

Vermont 563
Hawaii 160
South Carolina 146
Nevada 97
Arizona 74
District of Columbia 70

Southwestern US domiciles witnessed a surge in business in 2006 as regulators, often modeling their laws after Vermont, attracted new captives. Arizona, Nevada, and Utah saw 50% increases in their number of captives. The number of captives frequently changes. A summary is available at www.CICAWorld.com. In addition, under the “Resources” tab, you may select two domiciles to compare. The side-by-side comparison chart provides capitalization requirements, incorporation expenses, tax issues, etc.

Once the domicile of the captive has been decided, a line of communication should be established with regulators on the most appropriate captive structure and detailed regulatory financial requirements should be discussed. If a foreign country is selected, currency deposit requirements should be determined. All information on the licensing and incorporation process should be confirmed with regulators or attorneys.

Captive Application and Required Documents

A number of documents are required to be submitted with an application for a license. These will differ by domicile but generally include:

- Proposed Memorandum and Articles of Association (by-laws) for the company
- Bank references on the promoters and proposed owners of the company, together with the evidence the insurance expertise is available to the company
- Evidence that none of the shareholders, directors or officers of the company has a criminal record
- A business plan stating the proposed business activity of the company; the make-up of ownership and management; the type and expected volume of business to be written; details of any re-insurance agreements to be entered into; as well as financial projections. The business plan provides a yard-stick for the annual certificate of compliance, which is a statement, usually by the auditors of the company that the activities of the company have been carried out in accordance with the submitted business plan. The Superintendent can approve subsequent amendments. The business plan will also include, as an appendix, an analysis of the past loss history of the type of business to be written, demonstrating that the proposed business is financially viable
- Evidence that capitalization is available

¹¹ Captives and Other Risk-Financing, http://www.iii.org/media/hottopics/insurance/test3/
• Confirmation from the company's auditors and from its local representative that they are willing to accept the appointment

• Appropriate government fees

• Biographical information

• Financial reports of the parent

**RUNNING THE CAPTIVE**

The operation of a captive is very similar to that of an insurance company. It must underwrite and rate risk; issue and service policies; handle claims; manage the investment portfolio; employ an information technology system to manage and generate reports; and perform accounting and financial reporting. In addition, it may provide risk management services and promote and market its products.

There is also a need to engage consulting, actuarial, banking, legal, and management services. In order to protect the captive from catastrophic losses, the vast majority will purchase reinsurance from the marketplace in order to protect the captive’s capital. Captives have a governance responsibility to its insureds/owners. This is done primarily through a Board of Directors, which is responsible for the governance and monitoring of the operation of the captive. Many captives have various committees, such as underwriting, claims, finance/investments, etc. In most domiciliary states there is a requirement to have one director who is a resident of that state.

All captives must file GAAP audited financial statements to their domiciliary state. Some RRGs also file NAIC statutory statements on a quarterly and annual basis. The regulator also requires a yearly loss reserve opinion from an actuary that is approved by the domiciliary state.

Captives have the option to outsource various services to providers or to hire staff to provide service. A captive is required to have a captive manager that is approved by the domiciliary state to ensure statutory compliance and report to the regulators. Typically, captive managers will provide the accounting service for the captive.

**Benefits**

• In order to do business, captives are required to have less capital than a traditional insurance company

• A captive can start writing business much faster than a traditional insurance company due to a simplified process to license the captive in a domiciliary state and register in various states

• There is no requirement for approval from state regulators on rating plans and policy forms

• There is no requirement to engage licensed agents and brokers to solicit business

• The reporting requirements to regulators is less demanding than a traditional insurance company

• With the exception of domicile premium taxes, there are often no other fee and assessment requirements

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Captive insurance companies have a tailor-made risk management program that is more effective in controlling and reducing risk.

A captive is formed and run by a team including internal members from the parent, association or other related entity and various external service providers. It is a stand-alone legal entity complete with its own board of directors and slate of officers. The board of directors empowers the officers to make management decisions that fall within the board’s guidelines.

**Internal Team Members**

Internal team members are the drivers of the captive solution from inside the parent, association or other related entity and typically maintain a role in the day-to-day management of the captive post formation. The internal team members who fulfill this role differ by type of captive.

**Pure Captive**

Parent companies form captive insurance companies for a variety of reasons. Those reasons typically indicate who within the parent organization drove the initiative. As an example, if the captive is being formed for risk management purposes, the risk manager is usually the driver of that captive solution. Alternatively, if employee benefits are to be written in the captive, personnel from human resources and legal are often driving the initiative. The Chief Financial Officer (CFO) of the parent organization is invariably involved as an internal team member due to the financial impact and potential federal income tax ramifications surrounding the captive formation.

**Group Captives, Risk Retention Groups**

Group captives are often formed by members of an association or by members of an industry. They may also be formed by consultants, insurance brokers and other third parties that have expertise in the area of need but are not insureds of the captive. Typically, group captives are developed to address an unmet coverage need or to correct an imperfect insurance solution involving price and/or availability. Founding members of a group captive are usually involved in the day-to-day operations of the captive and are elected officers and/or directors of the captive. In some instances, group captives form a dedicated unit from group members or from association staff.

**Directors and Officers of the Captive**

In a typical captive entity, the majority of the directors and officers of the captive are employees of the parent (in the case of a single parent captive), members of the insured group or association (in the case of group and association captives), or agency employees (in the case of agency captives). These individuals make strategy decisions that guide the operations of the captive. External team members act on the guidance of the directors and officers and have only as much authority as is granted them by the directors and officers through the execution of the service agreements.

**External Team Members**

The internal team members driving the captive solution may not experts in all disciplines necessary to successfully form and operate a captive. They therefore look to outside industry service providers to supply captive expertise, typically in the areas of regulation and compliance, financial statement preparation, consulting, actuarial science, risk management, claims.
management and corporate, captive and tax law. The areas of expertise supplied by the captive’s external team members are all crucial to the successful operation of a captive insurance company. As noted below, some of the external team member roles can be fulfilled by the same parties while others cannot.

**Captive Manager**

Most captive domiciles require a captive entity to be managed by a captive manager approved by that domicile. Many also require the manager to reside in the domicile. Across all domiciles, regulators prefer to establish close working relationships with captive managers to help ensure that only quality captive insurance programs are proposed.

The captive manager’s role is broad and begins prior to the formation of the captive. Arranging and attending the initial meetings between the individuals forming the captive and the domicile regulators to discuss the proposed captive is typical.

It is important to note that the captive manager has multiple roles within the captive formation and operation process. The manager clearly has a contractual obligation to fulfill the requirements set out in the Management Agreement with the captive (as discussed below). However, the manager also has a responsibility to provide assurance to the regulators that the captive is in compliance with the local laws and requirements as well its filed business plan. Generally, deviations from the filed business plan must be approved by the regulators in advance of changes and issues of non-compliance must be notified to the regulators.

A captive manager’s responsibilities will vary with each individual captive managed and may work with other vendors such as consulting and actuarial firms but generally include the following (although not all management firms perform all these functions):

- **Pre-Incorporation/Licensing or Set-Up Services:**
  - Development of a captive feasibility study with assistance from consultants and outside actuaries as needed
  - Assistance with developing the insurance program, including arranging any fronting facilities and specific and aggregate reinsurance directly or with a broker
  - Assistance with the selection of lawyers, bankers, auditors, investment managers and other service providers required by the captive
  - Assistance with the captive’s Business Plan for inclusion in the license application
  - Coordinating the process of registering and incorporating the captive through the regulators in the domicile of choice

- **Post-Incorporation/Licensing or Set-Up Services:**
  - acting as principal representatives and providing the principal office as required by the domicile of choice
  - Arranging and attending directors’ and shareholders’ meetings
  - Maintaining the accounts of the captive: establishing the general ledger of the company in a form consistent with normal accepted accounting practices in the domicile of choice with refinements based on the nature of the business or to satisfy the Board of Directors’ specific requests
- Preparing financial statements (income and balance sheet plus attendant notes) typically no less frequently than quarterly, and distributed according to instructions
- Preparing full financial statements at the end of the captive’s fiscal year for audit purposes
- Working with the auditor to assist the efficient completion of the audit
- Monitoring investment returns and/or making investments as directed
- Performing statistical analyses (e.g. loss triangulations) and reports (e.g. budget comparisons or projections) as requested
- Communicating with the regulators in the domicile of choice and completing all obligatory filings (e.g. changes in shareholders, directors, or officers or amendments to the business plan of the captive and the Statutory Financial Statements)
- Attending to the day-to-day activities of the captive from arranging accommodation for attendees of the company’s meetings to liaising with other parties associated with the company’s affairs (e.g. lawyers, brokers, investment advisers, claims assessors etc.)
- Issuing cover notes, policies, reinsurance agreements and associated documentation, collecting premiums and reporting business
- Arranging and supervising the underwriting programs of captives as directed by the Board of Directors, including placement of the appropriate reinsurance protections required
- Maintaining and monitoring complete claims files; developing loss reserves as appropriate; issuing claims drafts; and filing claims with insurers and reinsurers and press subrogation where applicable

Types of Management Companies

Contracting with an outside captive manager is the most common form of captive management. Management companies are owned by a variety of different companies including large insurance brokers, independent firms (not affiliated with insurance brokers), reinsurance companies, and, less often, law firms.

Large Insurance Broker Management Companies

- Large insurance brokerage firms provide captive management services in all of the major captive domiciles to offer clients continuity of services if they form a captive

Independent Management Companies

- Independent management companies have no affiliation with the large insurance brokers (but some do have insurance brokerage capabilities) or insurance carriers. Some captive owners elect to use an independent firm because they want to decouple their traditional insurance program from their captive program. This offers captive owners the advantage of preserving continuity of service if they decide to change their insurance broker

Reinsurance Company-owned Management Companies

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• Management companies are owned by insurance and reinsurance companies offering clients the option of utilizing their reinsurance services

Law Firms

• Captives are managed by law firms. Law firms typically manage start–up captives that are waiting to appoint the on-going captive manager, captives that are dormant with little or no activity or captives in run-off. Law firms do not have the same full service capabilities that brokerage owned, independent and reinsurance company owned management firms offer

Self Management

• Few captives are self-managed. Captives are self-managed when the captive is very large and can support full-time dedicated staff. Most captive domiciles require that the books and records be maintained in that domicile, the self-management team typically lives and works in the domicile

The Captive Management Contract

The captive management company and the owner(s) of the captive will execute a management contract. Typically, a management contract will address the following issues:

• How and when the management company will be compensated (options include a flat annual fee, hourly rates, or percentage of premium written)

• Who will provide the management company with instructions and approvals

• What services are to be performed and when they are to be performed

• What are the retention of records requirements, who will maintain ownership of records, and who will have access to management company files

• Confidentiality wording

• Termination procedures

Regulators

The domicile regulators are an integral part of the captive team. They approve the original business plan, the initial capital and surplus requirements, and all subsequent changes. They have a unique interest in the solvency of the captive and take an active position in ensuring its financial health to protect the insureds, the shareholders, the domicile’s reputation and the reputation of the captive insurance industry as a whole.

The regulators will perform periodic regulatory examinations to ensure the financial health of the captive as well as to ensure compliance with local laws and the filed business plan. Finally, they are a valuable resource for evaluating potential business scenarios based on their broad experience in the captive field.

Consultants

Many potential captive owners/organizers engage a consultant with a specialization in risk management, employee benefits or other areas to assist with the feasibility process of a captive. Quite often a captive is a component part of an overall plan. The consultant will prepare or assist
in the preparation of the contents of the application to forma captive with the domicile of choice. The consultant may already be a trusted advisor to the parent, association or other related party or they may simply be engaged for the limited purpose of the captive. Captive managers, insurance brokers, actuaries or attorneys may also offer this service.

**Actuaries**

The actuary is a critical part of the formation and operation of the captive. Actuaries provide the analysis based on historical and industry loss information relevant to the risk(s) to be insured in the captive entity. These numbers form the basis for the premium to be charged the insured and the capital and surplus needed to fund the company. The actuary is involved in the feasibility and application process as well as providing periodic (at least annual) analysis of the loss reserves in the captive and the annual actuarial certification of loss reserves (if required by the domicile). The broker, consultant or captive manager may also offer these services.

**Insurance and Reinsurance Broker**

The firm’s insurance broker may be involved either because it places the parent’s or association’s insurance program (of which the captive is a part) or they are charged with the marketing of the program to enlist insureds/members. If the captive is part of an overall insurance program for its parent, the insurance broker ensures there are no coverage gaps or duplications, that policy wording and policies are issued and that fronting carriers and reinsurance for the captive are in place. For a group captive the broker is responsible for the marketing of the program, enlisting insureds/members, drafting of insurance policies and policy servicing. The broker may also offer captive management, consulting, actuarial and third party administration services.

**Auditors**

A captive is required to have an annual audit of its financial statement performed by an independent, approved audit firm. In a pure captive situation, the captive often uses the same audit firm as the parent company. No other service provider can perform the audit function.

**Attorneys**

A captive typically selects an attorney in the selected domicile who has an expert knowledge of the local captive law. A qualified attorney should be consulted prior to captive formation to determine the optimal legal structure of the captive in relation to other affiliated companies and the parent. The captive attorney will typically consult with the parent company’s legal department or external attorneys familiar with the parent company’s structure. Consultants or the captive manager may be able to fulfill this role in limited circumstances.

The captive attorney will also handle the captive’s day-to-day legal and compliance issues. The local attorney will often work with the parent company’s legal department on such matters.

**Tax Counsel**

It is imperative that tax counsel is consulted regarding the country or federal income and state tax status of the captive insurance company to avoid unintended consequences and to create the most advantageous structure for tax purposes. Commonly, an attorney or accountant with specific expertise in this area will be engaged to evaluate the proposed structure. Internal personnel also assist with this process.
**Third Party Administrators**

The Third Party Administrators (TPA) provides loss control and claims handling services. These services may be provided by a TPA, consultant, insurance broker, fronting carrier or reinsurance company. Sometime the parent company provides these services.

A highly qualified and dedicated team is essential to the successful operation of a captive insurance company. Each team member, from the captive manager to the domicile regulator, is critical to the captive’s performance. All services providers should be providing excellent service and advice and communicate well with the captive and other service providers at a reasonable cost. The captive should review service providers on a periodic basis.

**Governance**

A critical component of corporate governance is accountability. This is accomplished through various committees that report to the board and through board leadership. The major areas of responsibility include financial oversight and reporting through an audit committee or the board; management and director compensation; and the selection of directors to the board through the screening and nominating process. In addition, the board has to deal with management succession, developing board policies on governance, training, investments, and other various policies as it relates to the operation of a captive.

Other key responsibilities include evaluation of board performance as it relates to its fiduciary obligations; accountability; transparency; and disclosure. A critical component of captive governance also includes legal and compliance obligations and long-term strategic planning and execution.

**Fiduciary Duties of Corporate Directors**

Corporate directors and officers owe certain duties to a captive and its owners/insureds. These include:

- Duty of loyalty to the captive by exercising independence and eliminating or disclosing conflicts of interest;
- Duty of care in the administration of the affairs of the captive; and
- Duty of candor, which requires that information provided to owners/insureds, regulators, and others be materially complete and not contain misstatements of fact.

**Ethics**

The issue of ethics is typically expressed in a written policy that outlines a code of conduct for directors and officers. The purpose of this policy is to ensure that strong ethical principles and standards are used to guide board decisions. In doing so it ensures a strong tone from the top of the organization that will manifest itself throughout the organization, service providers, and others. A policy on business conduct/ethics typically includes:

- Statements on conflicts of interest
- Corporate opportunities
- Confidentiality
- Fair dealing
• Protection and proper use of assets
• Compliance with all applicable laws, rules, and regulations; and
• Reporting of any illegal or unethical behavior that affects the operation of the captive

**WHAT ABOUT TAXES**

The foremost federal income tax issue associated with the formation and operation of a captive is whether it will be treated as an insurance company for purposes of federal taxation -- that is, whether its primary and predominant business activity is the issuance of insurance contracts. Insurance companies generally are taxed more favorably than other entities. The Internal Revenue Code (IRC) affords them several federal income tax benefits, primarily the ability to defer recognition of a portion of the company’s unearned premiums and also to deduct a discounted reserve for unpaid losses, including IBNR losses and case development.

The determination of whether a captive’s primary and predominant business activity is the issuance of insurance contracts is significant to the policyholders since the deductibility of payments to the captive generally depends on whether such payments are made pursuant to an insurance contract. In general, if the payments are made pursuant to an insurance contract, then they should be characterized as ordinary and necessary business expenses currently deductible under IRC §162. In contrast, if the payments are made pursuant to a risk financing arrangement that does not constitute insurance, then they would not be currently deductible. Rather, the deduction is deferred until payments are made to claimants with respect to a covered loss.

**Characterization of Captive Insurance Arrangements as Insurance**

Although neither the IRC nor the Treasury regulations hereunder provides a definition of the terms insurance contract or insurance, the Supreme Court has established that insurance status generally requires the presence of two elements - risk shifting and risk distribution. In 2004, Congress amended the IRC to clarify that to qualify as a property and casualty insurance company over half of an entity’s activities must consist of issuance of insurance or reinsurance contracts.

Prior to the issuance of Rev. Rul. 2001-31, the IRS, applying its economic family theory, asserted that risk shifting and risk distribution are absent when only the risks of the parent corporation or its controlled operating subsidiaries are funded in a wholly-owned captive. The IRS therefore consistently challenged single parent captives, claiming that payments made pursuant to such arrangements did not constitute deductible premium payments and that such captives failed to qualify as insurance companies for federal income tax purposes.

The courts generally agreed with the IRS that risk is not shifted or distributed when a parent corporation makes premium payments on its own behalf to a wholly owned insurance subsidiary. But the courts also established two alternative approaches for finding risk shifting and risk distribution in the context of captive structures. These approaches are: (a) including a substantial level of risk exposures (measured by net premiums) of parties legally unrelated to the insurance subsidiary and its parent in the risk pool (the unrelated party risk approach), or (b) including the risk exposures of numerous corporate affiliates of the insurance subsidiary in the risk pool (the brother-sister approach.) If the captive arrangement satisfies either approach, then
payments to the captive may constitute deductible insurance premiums and the captive may qualify as an insurance company under the IRC.

In June 2001, the IRS announced in Rev. Rul. 2001-31 that it no longer would invoke the economic family theory to challenge captive insurance arrangements. Although, initially, a measure of uncertainty existed regarding the impact of the IRS’s abandonment of the economic family theory on the brother-sister approach and the unrelated party risk approach, in December 2002, the IRS issued two rulings which confirm the validity of both approaches. The rulings, Rev. Rul. 2002-89 and Rev. Rul. 2002-90, should provide taxpayers with increased confidence regarding the viability of captive insurance arrangements that are properly structured. It should be noted, however, that the IRS may continue to challenge insurance treatment for transactions between a parent and its captive where less than 50% of the premiums transferred to the captive derive from unrelated policyholders or in a brother-sister context one of the sibling’s accounts for the majority of the pooled premiums. Further, no insurance tax treatment will be available if, based on all the facts and circumstances, the captive’s structure or operations are a sham.

Avoiding Sham Status

Both the brother-sister and unrelated party risk approaches depend, in large part, on treatment of the captive as a separate and distinct entity. A captive generally will not be respected as an entity separate and distinct from its affiliates if the facts and circumstances indicate that it is a sham. The following is a list of steps, gleaned from case law, which should help captives avoid sham status:

- Establish and document non-tax business objectives and purpose
- Avoid parental guarantees or other agreements under which the parent may be obligated to contribute additional capital to the captive
- Ensure that the captive is adequately capitalized in relation to the loss exposures it bears but not so overly capitalized as to become an investment company
- Avoid substantial loans between the captive and related parties
- Engage professional captive managerial expertise to operate the captive
- Comply with local insurance regulations and corporate formalities
- Follow conventional investment strategies
- Use risk-transferring insurance contracts
- Assure sufficient risk distribution among separate policyholders
- Transact business at arm’s length using actuarially determined pricing
- Maintain the captive’s business operations and assets separately from the operations and assets of the parent
- Coordinate the captive’s books and records in a manner comparable to other insurers
- Implement loss prevention programs, including safety and quality control programs
US Tax Consequences of Incorporating Offshore

The taxation of an offshore captive depends on whether it is engaged in a US trade or business. If a captive is found to be carrying on a trade or business within the US, income attributable to such US business generally is subject to US federal corporate income taxes. The maximum US corporate income tax rate on such income is 35%. In addition, a branch profits tax may apply to any earnings attributable to a foreign corporation’s US business that are withdrawn from the US business. The branch profits tax rate is 30%.

If, however, an off-shore captive is not engaged in a US trade or business, then the captive should not be subject to direct US taxation of its underwriting profits. Off-shore captives not engaged in US trade or businesses are, however, generally subject to indirect US taxation under subpart F of the IRC, which imposes a tax on US persons owning stock in certain off-shore captives. Prior to 1986, the tax applied only to captives if US persons owning 10% or more of the voting power of the captive’s stock (10% Shareholders) owned, in the aggregate, more than 50% of the outstanding voting power or value of the captive. In such circumstances, the 10% Shareholders were required to recognize as ordinary income their pro rata share of the captive’s so-called “subpart F income”. This generally included income from the captive’s insurance of risks located outside its country of incorporation and passive investment income in the nature of dividends, rent, royalties, interest and annuities.

The Tax Reform Act of 1986, however, substantially broadened the foregoing rule and, in so doing, diminished the tax deferral advantages of offshore captives. Under current rules, a tax is imposed on U.S. persons owning any stock in an offshore captive if (a) more than 25% of the voting stock or value of the corporation is owned by 10% Shareholders or (b) a significant overlap (generally 20% or more) exists between U.S. owners of the captive and its policyholders. Owners of both mutual and stock insurance companies are subject to current tax on certain portions of this attributed income, called related party insurance income (RPII). RPII generally includes investment income as well as underwriting income.

In addition to the indirect tax imposed by subpart F, if an offshore captive does not carry on a U.S. trade or business, investment income from sources within the U.S. (i.e., dividends, interest and other fixed or determinable, annual or periodic income) generally will be subject to a 30% non-recoverable U.S. withholding tax. Interest received from U.S. banks and interest received on most portfolio debt, however, generally is exempt from withholding tax.

Finally, offshore captives may be subject to federal excise tax (“FET”) of 1% or 4% of their gross premiums. FET, which is imposed on policies of insurance and reinsurance issued by non-U.S. insurers and reinsurers with respect to U.S. risks, is generally withheld and remitted at the source of the premiums. The rate at which FET is imposed is 4% on casualty insurance or indemnity bonds, 1% on life insurance, sickness and accident insurance policies and annuity contracts, and 1% on any reinsurance contract.

Captives with Tax Exempt Owners

The tax treatment of captives owned by colleges, universities, charitable hospitals and other tax-exempt organizations is beyond the scope of this overview. Suffice it to say that, in general, such organizations strive to avoid “insurance” status. Onshore captives, if not writing insurance, may under certain circumstances achieve tax-exempt status themselves. Offshore captives try to avoid insurance status in order to avoid FET and the creation of “unrelated business taxable income” in the hands of the tax-exempt parent and because tax deductions are irrelevant to them.
Notable Tax Decisions

Tax laws are complex and uncertain, but some of the highlights include:

Helvering v. LeGierse, 312 U.S. 531 (1941). Established the principle that both risk shifting and risk distribution are requirements for a contract to be treated as insurance.

Carnation Co. v. Com’r., 71 T.C. 400 (1978), aff’d, 640 F.2d 1010 (9th Cir. 1981), cert. denied, 454 U.S. 965 (1981). Denied a deduction for premiums paid by a parent corporation to an unrelated U.S. insurer to the extent the premiums were ceded (pursuant to a reinsurance arrangement) by the insurer to the parent’s wholly owned Bermuda captive. The court’s decision hinged on its determination that the captive wrote no unrelated risk, was inadequately capitalized and entered into an agreement under which the parent could be compelled to contribute additional capital to the captive.

Stearns-Roger Corp. v. Com’r; 577 F. Supp. 833 (D. Colo. 1984), aff’d, 774 F.2d 414 (10th Cir. 1985). The U.S. District Court held that premium payments by a parent to its wholly-owned captive subsidiary were not deductible based on the “economic family” doctrine. The 10th Circuit Court of Appeals supported the denial, but rejected the economic family argument.

Clougherty Packing Co. v. Com’r., 84 T.C. 948 (1985), aff’d, 811 F.2d 1297 (9th Cir. 1987). This complex Tax Court decision, disallowing captive premium deductions, touched on many controversial issues and resulted in wide differences of opinions among the 19 judges.

Crawford Fitting Co. v. U.S., 606 F. Supp. 136 (N.D. Ohio 1985). The court held that insurance premiums paid to a captive by a group of separate corporations that were owned and controlled by a group of related individuals were deductible because the shareholder/policyholders of the captive were not so economically related that their separate financial transactions had to be aggregated and treated as the transactions of a single taxpayer.

Humana, Inc. v. Com’r, 881 F.2d 247 (6th Cir. 1989). (Controlling case Brother-Sister) The 6th Circuit Court of Appeals held that the brother-sister captive arrangement constituted insurance for federal income tax purposes and, as such, premium payments attributable to the risk exposures of the captive’s brother-sister entities (but not its parent) were deductible. The Court’s decision was based on the so-called “balance sheet” approach, under which risk shifting depends on the effect of the arrangement on the policyholder’s net assets.

Kidde Industries, Inc. v. U.S., 40 Fed. Cl. 42 (Cl. Ct. 1997). Applying the balance sheet approach articulated in Humana, the Court held that premium payments made by brother-sister entities to the captive were currently deductible. In contrast, payments made by divisions of the parent corporation did not constitute insurance premiums deductible under IRC §162.

The Harper Group v. Com’r, 96 T.C. 45 (1991), aff’d, 979 F.2d 1341 (9th Cir. 1992). (Controlling third party risk) The Tax Court held, and the 9th Circuit Court of Appeals affirmed, that risk shifting and risk distribution were present where the captive received 29 to 32 percent of its premiums from unrelated parties. As such, the captive arrangement was found to constitute insurance for federal income tax purposes and payments made to the captive were deductible under IRC §162.

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12 Represents Landmark Case

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Transacting offshore company’s business through a U.S. office found to constitute engaging in a
U.S. business for federal income tax purposes.

United Parcel Service vs. Com’r, T.C. Memo 1999-268 (1999), rev’d, 254 F.3d 1014 (11th Cir.
2001). The 11th Circuit found that the Tax Court had improperly determined that a restructured
program in which a shipping corporation transferred its “excess value charge” income and
obligations to a Bermuda insurance company was a tax sham. The Tax Court opinion describes
the economic-substance doctrine as follows:

“This economic-substance doctrine, also called the sham-transaction doctrine, provides that a
transaction ceases to merit tax respect when it has no ‘economic effects other than the creation of
tax benefits.’ [Citations omitted]. Even if the transaction has economic effects, it must be
disregarded if it has no business purpose and its motive is tax avoidance. [Citations omitted].”

Revenue Rulings

Premiums paid to the captive were not deductible because there was no transfer of risk outside
the “economic family.”

applicable to payments made to captive if they are not made pursuant to an insurance transaction.
Had the captive assumed outside risks, however, the outcome could change.

modified by Rev. Rul. 2002-91. Premiums paid to association captive are deductible if there is a
true sharing of risk between participants in, or owners of, an association captive. Facts indicated
31 unrelated participants, no one of which accounted for over 5% of aggregate premiums.

Rev. Rul. 79-138, 1979-1 C.B. 359. The computation of federal excise tax is based on gross
premiums and applies to portion of risk assumed by foreign reinsurers.

Rev. Rul. 80-191, 1980-2 C.B. 168. The IRS will not follow the Crescent Wharf and Warehouse
Company and Wien Consolidated Airlines, Inc. decisions, which hold that an employer’s
liability for workmen’s compensation is deductible in the year of an employee’s death or injury
even if the amount of the liability is contingent upon the occurrence of future events. The IRS
continues to disallow deductions for expenses not based on a fixed liability.

Rev. Rul. 80-222, 1980-2 C.B. 211. Federal excise tax is payable on insurance premiums paid to
alien insurers. Such payments should not, however, be subject to withholding tax of 30%.

Rev. Rul. 80-225, 1980-2 C.B. 318. Alien insurer is doing business in U. S. and is therefore
subject to U. S. income tax if it has an agent in the state.

corporation may deduct the premiums paid to its wholly-owned captive subsidiary with respect
to group-term life insurance of its employees.

argument for denying “insurance” status (and therefore premium/loss reserve deductions) for
single parent and brother-sister captive insurance arrangements.

13 Represents Landmark Case

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Rev. Rul. 2002-89, 2002-2 C.B. 984. IRS concluded that an arrangement whereby a captive insurance company provided professional liability coverage to 12 brother-sister entities, each accounting for between 5% and 15% of the total premiums, constituted “insurance” for federal income tax purposes. The IRS’s conclusion was based on the application of the brother-sister approach to creating risk shifting and risk distribution.

Rev. Rul. 2002-90, 2002-2 C.B. 985. IRS applied the unrelated party risk approach to conclude that a parent’s premium payments to its captive insurance subsidiary were deductible where over one-half of the captive’s premium income and risk exposures derived from unrelated policyholders.

Rev. Rul. 2002-91, 2002-2 C.B. 991. IRS ruled that an association captive formed by fewer than 31 unrelated policyholders qualified as an insurance company where no member owned more than 15% of the captive and no member had more than 15% of the vote on any corporate governance issues.

Rev. Proc. 2002-75, 2002-2 C.B. 997. IRS announced the removal of captive insurance transactions from the list of transactions for which rulings and determination letters will not ordinarily be issued.

Notice 2003-34, 2003-1 C.B. 990. IRS announced that it would scrutinize offshore captives to determine whether they qualify as insurance companies for federal income tax purposes and, therefore, are exempt from the onerous passive foreign investment company rules. The Notice indicated that a captive may not qualify as an insurance company if the risks assumed by the captive are not “insurance risks,” the captive generates excess investment income relative to earned premiums or the terms of the purported insurance contracts significantly limit the risks assumed by the captive.

Notice 2003-35, 2003-1 C.B. 992. IRS reminded taxpayers that, in order to qualify as an organization exempt from federal income tax under IRC § 501(c)(15), the organization must qualify as an insurance company for federal income tax purposes. In general, that means that the captive’s primary and predominant business activity must be the issuance of insurance contracts. The IRS also announced that it would scrutinize the tax-exempt status of entities claiming to be described in IRC § 501(c)(15) and challenge the exemption of any entity that does not qualify as an insurance company.


Rev. Rul. 2005-40, 2005-2 C.B. 4. IRS introduced concept that one policyholder (or two if one accounts for 90% and the other 10% of premiums) cannot constitute an insurance arrangement even if the “insurer” and “policyholder” are completely unrelated; also held that a single member LLC (limited liability company), if disregarded for tax purposes, cannot count as a sibling in a purported brother-sister structure.

Notice 2005-49, 2005-2 C.B. 14. IRS sought taxpayer input prior to issuing tax guidance on four topics related to captives: (i) taxation of cell captives and their tax elections; (ii) tax effect of “loan backs” by captives to related parties; (iii) impact on risk distribution requirement of homogeneity and heterogeneity of risk exposures; and (iv) proper taxation of finite risk contracts. CICA submitted comments on each of these topics.

14 Represents Landmark Case
Rev. Rul. 2007-47, 2007-30 I.R.B. In the context of environmental remediation funding via a commercial insurance policy, essentially requires “event” risk for insurance tax treatment, holding that timing and severity risk alone are insufficient and denying the policyholder a premium deduction and the commercial insurer a loss reserve deduction.

**INSURING EMPLOYEE BENEFITS**

Although captives have been historically used to provide property and casualty coverage, recent legislative developments, rising employee benefits costs and captive owners’ need for unrelated business have fueled the growth of employee benefits placed in captives. Captive owners’ interest in employee benefits was further fueled by the US DOL approval of prohibited transaction exemptions for Columbia Energy Corporation in 2000 and Archer Daniels Midland Company (ADM) in 2003. Today, captive owners are funding a broad spectrum of employee benefits, ranging from active and retiree medical, life and disability benefits to supplemental executive retirement plans (SERP) and deferred compensation plans.

When thinking about putting employee benefit plan risks in a captive, the captive owner first needs to determine whether there are laws and regulations regulating the plan that need to be followed. Generally in the US ERISA governs welfare benefits such as group life, health, disability, etc. Benefits that are not governed by ERISA, such as SERPs, deferred compensation and foreign employee benefits can be funded through an employer’s pure captive with less regulatory hurdles.

**Benefits of insuring employee benefit plan risks through a captive**

Some of the benefits of reinsuring employee benefit plan risks through a captive include reduced costs, centralized risk management, and better coverage. Adding employee benefits plan risks to a captive's book of business could also help diversify the risks because many employee benefit risks tend to be less volatile than property and casualty risks. Finally, there is a potential tax benefit of reinsuring employee benefit plan risks with a captive. This is because the IRS has taken the position that certain employee benefits constitute unrelated business because the risk of loss being insured does not actually belong to the employer. Rev. Ruling 1992-93. Therefore, reinsuring certain employee benefits through a captive may help the captive reach the necessary level of unrelated business for the tax deductibility of the parent company's property and casualty premiums. Tax issues related to a captive is dealt with more in another section of this manual.

**Managing risk and costs of companies’ defined benefit (DB) obligations – pensions and retiree medical**

An aging workforce over the next two decades raises an issue about future benefits for employees. Employers seem to struggle with funding employee benefits for current and future retirees. Cost of retirement plans continue to increase year after year.

There are a variety of financial strategies that can be used to address the risks and costs of DB plans. One of the innovations to finance an ongoing cost and future risk increases is captive insurance. With a proper implementation and maintenance, a captive solution may provide the
answer to the problem that most companies with defined benefits face. A few of the captive insurance advantages are; improved pension security, lower pension costs and enhanced risk management.

For pensions there are three main reasons why captive insurance should be taken unit consideration; cash flow, cost savings, overall control in general. Let’s explore how each would improve a company’s financial position and from a risk standpoint:

- Trustees and the IRS make it very difficult for the company to avoid stranded pension surplus. As an example, assume that a pension liability is discounted at 5.0%. If the captive earns 6%, there is an excess of 100 basis points over what is owed the pensioners. This would emerge as captive profit and a potential return on capital for the captive’s parent in return for assuming the pension risk. This would not be possible for a company to do in the absence of a captive.

- Use of a captive may reduce the long-term cost of financing a pension plan to the extent that it enables the company to carry out desired financial risk management actions that might not otherwise be undertaken by trustees and/or fiduciary risk. In measuring the potential cost savings of a captive, it is important to reflect the risk-adjusted cost of the captive’s expected investment mix in the estimated net cost savings. Additional cost savings would be derived from the lower loads charged by a captive when compared to a commercial insurer.

- US based companies have better control over the nature of investments as well as investment volatility and interest-rate risk due to relatively good friction of the financial market. Companies, however, cannot directly access without tax penalties any excess of assets over the plan’s liabilities.

The use of captive for pension financing is subject to regulatory hurdles. Use of a captive would be prohibited transaction by ERISA because the owner of the captive is a party-in-interest with respect to the plan. To use a captive, the plan sponsor must obtain a Prohibited Transaction Exemption from the DOL, which administers ERISA. This is one of the reasons why captives are not commonly used to finance pensions. Reviews of regulations as well as extensive discussions with some pension authorities indicate that captive use is desirable. The main reason that regulators could find captives attractive is that the pension would be fully funded and secured by the fronting issuing the pension annuity.

The captive can assume the mortality risk of the pension as well as the investment and interest rate risks. The risks can be assumed entirely or in partnership with the fronting insurer, depending on the contract between two parties. The quantity of risk taking will determine the company’s cost savings, long-term profits, and control.

**ERISA prohibited transactions**

Anyone who is thinking about insuring or reinsuring employee benefit plan risks through a captive needs to be aware of the provisions of the ERISA (29 U.S.C. 1001, et. seq.). ERISA prohibits certain transactions between employee benefit plans and parties in interest. 29 U.S.C. § 1106. Employers who sponsor employee benefit plans are considered parties in interest. 29 U.S.C. § 1002(C). Any entity that the employer owns more than 50 percent of is also considered
a party in interest under ERISA. 29 U.S.C. § 1002(14)(G). Therefore, a captive that is owned by an employer would be a party in interest under ERISA and prohibited from engaging in certain transactions with the plan.

If a party in interest engages in a prohibited transaction it can be penalized an amount equal to five percent of the "amount involved." 29 U.S.C. § 1123(i). In the case of insuring or reinsuring employee benefit plan risks with a captive, the "amount involved" would most likely be the premium paid to the captive for the year.

The two prohibited transaction provisions that relate most directly to the use of a captive to insure or reinsure employee benefit plan risks are 29 U.S.C. § 1106(a)(1)(D) and § 1106(b). § 1106(a)(1)(D) prohibits the "transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan." Under § 1106(a)(1)(D), the payment of premiums to a captive for insurance or reinsurance could constitute the transfer of assets of the plan to a party in interest. § 1106(b) prohibits self-dealing transactions. Specifically, subsection (b)(1) states that a fiduciary shall not "deal with the assets of the plan in his own interest or for his own account"; subsection (b)(2) states that a fiduciary shall not "in his individual or any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or its participants or beneficiaries"; and subsection (b)(3) states that a fiduciary shall not "receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan." Under this section it could be argued that the employer, who is also a plan fiduciary, is self-dealing by arranging a transaction where it's captive insurers or reinsures the plan risks. This is because the employer is the entity that ultimately benefits by using its captive to insure the plan risks.

**ERISA Exemptions**

Although ERISA prohibits certain transaction, it also gives the DOL the authority to grant exemptions as long as the exemption does not relieve a fiduciary from other ERISA provisions. 29 U.S.C. § 1108(a). The Secretary must also find that the exemption is "administratively feasible," in the "interests of the plan and of its participants and beneficiaries," and "protective of the rights of participants and beneficiaries of such plan." 29 U.S.C. § 1108(a). Before granting an exemption, the Secretary must publish notice in the Federal Register that the DOL is considering granting an exemption and must allow for a comment period of between 30 and 60 days.

Under § 1108(a) there are two types of exemptions that the Secretary can grant. The first type is a "class exemption," which covers broad classes of transactions. Once the DOL grants a "class exemption," anyone who meets the requirement of the exemption can proceed with the transaction without seeking DOL approval. The second type of exemption is an "individual exemption." An individual exemption is only applicable to the party to whom it is granted. Seeking a regular individual exemption can be a costly and time-consuming process. In some cases, seeking an individual exemption can take up to a year.

**ERISA Class Exemptions**
In 1979, the DOL published a prohibited transaction class exemption that allows an employer to place its employee benefit plan risk with a captive on a direct basis. 44 Fed. Reg. 46365. This class exemption, though, had several conditions, including that:

- The captive is a licensed insurer in the US
- Within the prior 18 months preceding the proposed transaction the captive has obtained a Certificate of Compliance from the insurance department of its state of domicile
- Within the prior five years the captive has undergone a financial examination by the insurance department of its state of domicile, or has had its last fiscal year's books examined by an independent certified public accountant
- No commissions are paid by the plan in connection with the placement of the insurance
- The plan pays no more than "adequate consideration" for the coverage
- That no more than 50 percent of the captive's business is "related" to the employer

The last condition, known as the "50 percent test," has created problems for most employers and captives trying to utilize the exemption. According to the DOL, the "50 percent test" is applied by taking the premiums applicable to any of the employer's risk, and dividing it by the total premium the captive has received. If the result is less than 50 percent, then the test has been satisfied. As one can see, the "50 percent test" eliminates most captives from being able to utilize this class exemption.

To make the class exemption even less useful for true captives, the DOL also takes the position that reinsuring employee benefit plan risks with a captive that doesn't meet the "50 percent test" would also be a prohibited transaction where there is a prior understanding that the premiums will be ceded to the captive. Specifically, the DOL stated:

[I]t is the Department's view that if a plan purchases an insurance contract from a company that is unrelated to the employer pursuant to an agreement, arrangement or understanding, written or oral, under which it is expected that the unrelated company will subsequently reinsure all or part of the risk related to such insurance with an insurance company which is a party in interest of the plan, the purchase of the insurance contract would be a prohibited transaction.

**ERISA Individual Exemption (Columbia Energy)**

In 2000, the DOL issued a notice of proposed exemption for Columbia Energy Group to reinsure its employee long-term disability risks in its captive. (65 Fed. Reg. 50223.) The DOL did not require Columbia Energy meet the "50 percent test" as long as each of the following conditions were satisfied:

- The captive was a party in interest with respect to the plan by reason of a stock or partnership affiliation with the employer
- The captive was licensed to sell insurance or conduct reinsurance operations in at least one U.S. state
- The captive had obtained a Certificate of Authority from the Insurance Commissioner of its domiciliary state which has neither been revoked nor suspended
• The captive had undergone an examination by an independent certified public accountant for its last completed taxable year immediately prior to the taxable year of the reinsurance transaction; or had undergone a financial examination by the Insurance Commissioner of its state of domicile five years prior to the end of the year preceding the year in which the reinsurance transaction occurred
• The captive was licensed to conduct reinsurance transactions by a State whose law requires that an actuarial review of reserves be conducted annually by an independent firm of actuaries and reported to the appropriate regulatory authority
• The Plan paid no more than adequate consideration for the insurance contracts
• The Plan paid no commissions with respect to the direct sale of such contracts or the reinsurance thereof
• That in the initial year of the contract involving the captive there was an immediate and objectively determined benefit to the Plan's participants and beneficiaries in the form of increased benefits
• That in subsequent years the formula used to calculate premiums paid by the plan was similar to formulae used by other insurers providing comparable coverage under similar programs
• The premium charge calculated in accordance with the formula was reasonable and was comparable to the premium charged by other insurers with the same or a better rating providing the same coverage under comparable programs
• The plan only contract with fronting insurers with a rating of A or better from A.M. Best
• The reinsurance arrangement between the fronting insurer and the captive was indemnity insurance only and the fronting insurer was not relieved of liability to the Plan should the captive be unable or unwilling to cover any liability arising from the reinsurance arrangement
• The captive retain an independent fiduciary, at the employer's expense, to analyze the transaction and render an opinion that the requirements set forth above had been complied with

ERISA ExPro Exemptions

To address the long time frame it takes to seek an individual exemption, the DOL developed an expedited procedure, known as "ExPro," in 1996. 61 Fed. Reg. 39988. Under the ExPro process, an applicant only has to inform the DOL of its intent to enter into a transaction that is "substantially similar" to at least two prior individual exemptions granted within the previous five years. Once the DOL receives an ExPro application, the applicant will receive an acknowledgement from the DOL. The receipt of this acknowledgement provides the applicant "tentative authorization" and starts a 45-day period in which the DOL may withdraw the authorization. At the end of the 45-day period, the applicant must give notice to all interested parties. Three days after the applicant mails the notices, a 25-day comment period begins. Five days after the comment period expires, the authorization becomes "final." Therefore, the time from submission to final authorization under ExPro can be as short as 78 days.

In 2003, ADM was approved by the DOL to use its captive to reinsure employee group life insurance benefits. 68 Fed. Reg. 23764. ADM's application request followed the Columbia Energy exemption. Since ADM's exemption was approved, other companies can now utilize the ExPro process described above to seek exemptions for reinsuring employee benefit plan risks
with their captives. There are now over 10 ExPro exemptions for captive reinsurance listed on the DOL’s website: http://www.dol.gov/ebsa/regs/expro_exemptions.html.
International Employee Benefits financing through a Captive

While the US has only recently discovered the possibilities of reinsuring employee benefit risks to a parent-owned captive, some forward thinking multinationals have been utilizing this opportunity for their non-US benefit programs since the mid-1970s.

This process is less onerous since ERISA and the DOL do not have jurisdiction over foreign benefit programs. More importantly, an ideal platform to consolidate many different countries employee benefit programs into one global financing arrangement has existed since the 1950’s. Multinational pooling as this arrangement is known naturally evolved to include some parent companies taking on more risk and expanding the use of their general Insurance captives to include employee benefits. This helped them to create a broader spread of risk with increased degrees of predictability and add “unrelated risk” at the same time. Pooling is sold and administered in countries around the globe by a handful of global insurers or networks such as AIG, Generali, Insurope, John Hancock/IGP, Swiss Life, Allianz and ING. It combines all local contracts placed within the insurer’s network for the purpose of experience rating, achieving economies of scale and risk diversification savings.

Sperry Rand and IKEA were some of the pioneers back in the 1970s as one of the global pooling networks; Swiss Life actively marketed the concept at that time. These early experiences paved the way, so that today it has been estimated that between 36-50 major Multinational companies reinsure some element of their foreign benefit insurance to their captive, and that the total reinsured premium is in excess of $350 million.

Types of Benefit Programs

Typically this includes group life, accident, long and short-term disability, and medical insurance. In the past it has not included retirement plans, with the exception of spousal and/or orphan’s risks associated with some of them. Recently there has been some movement to change this as more and more legacy defined benefit plans are being frozen and these “stranded assets” represent a huge opportunity to involve the captive in taking on some portion of longevity or investment risk as well as manage the underlying assets using a “buy-out “ annuity as the fronting mechanism.

Process

Although there are numerous instances of one-country retrocessions, captive reinsurance of foreign benefits typically starts with the establishment of a multinational pool. The captive can then participate in three distinct ways, moving from “casual” to highly involved:

1. The captive becomes the “contract holder” of the pooling agreement and as such receives the annual accounting reconciliation of all plans that are pooled and receives any dividends that are due to favorable loss experience.

2. The captive participates in some form of risk transfer by agreeing to accept losses over a specified level, again on an annual accounting basis. It can also include the removal of the IBNR with the captive’s agreement to pay any “run-off” claims upon the termination of any local participating contract or release of disability reserves where permitted.

3. The captive accepts all risk and moves its foreign benefit plans to pay annual premium in advance so that it is collected at one central source by the pooling network and then immediately retroceded to the parent’s captive in order to maximize investment income.
Quarterly bordereaus track the entire plan experience for settlement and provide an excellent risk management tool for corrective action, if necessary, in real time when compared to the annual accounting methods noted above.

In this last scenario, the captive is the ultimate guarantor of risk, and can also custom tailor its reinsurance protection as it wishes by retaining the opportunity to access these markets directly or use their fronting carrier’s treaty capacity. This includes individual stop loss for high-sums insured for life and disability as well as aggregate stop loss and catastrophic protection against multiple losses due to any one incident. This format is the “highest and best” use of the captive for reinsuring foreign benefits and it estimated that approximately no more than 25 multinationals are at this stage of development but the future is promising for significant growth and expansion. Indeed, most major market searches today now include questions about utilizing a captive with more movement towards implementation, provided the economics make sense and the internal decision makers from International Management, Risk Management, Treasury and Human Resources all work together with common purpose.

**Domicile**

There are many domiciles that have experience with multinational pooling. Bermuda and Ireland seem to be most popular situses with Guernsey, Gibraltar, or Zug, Switzerland sometimes in the mix.

By adding US benefits, most of the well – established captives already reinsuring foreign benefits will merely need to create a branch captive onshore in the US, which is not a difficult process.

**Collateral**

Security to underlie and support reinsured premium to the captive can be in the form of a Letter of Credit, a Security Trust Agreement, or a Parental Guarantee. Which type of collateral is most optimal is largely dependent upon the financial health of the parent, its captive, and the risk being reinsured. In addition, each insurance network may have its own regulations on permitted security as well as how it’s calculated.

**The Future**

Ernst and Young published an overview of the multinational pooling business in 2005 and estimated total multinational pooled premium in excess of $5 billion. With approximately $ 350 million of that or less being reinsured to a captive, there seems to be substantial room for growth.

Recent factors that may fuel this growth include greater need for more timely information due to Sarbanes-Oxley and corporate governance, wider acceptance of enterprise-wide risk management and more emphasis on global purchasing that may bind internal teams from both Risk Management and Human Resources together to achieve significant cost economies.

While not meant to be the best solution for all, certainly the more sophisticated buyers of global insurance with a committed captive strategy should or will be looking at this now or in the future. If the market opens up for reinsuring defined benefit plans, the increase in reinsured premium could be ten-fold or more.

In summary, the future is very bright.
CONVINCING MANAGEMENT
Enterprise Risk Management Rational

Enterprise Risk Management (ERM) is a structured approach to identify and assess risks that threaten achievement of strategic objectives or represent opportunities to exploit for competitive advantage and allows the optimal allocation of capital and human resources. ERM is a decision support tool that highlights trade-off between expected risks and rewards. All companies face a wide range of risks in the normal course of business. But all risks are not created equal. ERM helps managers focus on the risks that have the biggest influence both as a threat and opportunity, in their ability to achieve strategic goals and to add shareholder value.

One argument is a captive can be used as a risk management financing tool to strategically and formally determine the level of hazard risk the company is willing to assume, the company’s “risk appetite”. Once this important first step is achieved, the company is on the road to apply the same principles that were learned to identify and assess hazard risks in the organization for other enterprise-wide risks such as; financial, strategic and operational risks of the business. A captive can be viewed as a strategic risk financing tool to help a risk manager contribute to the ERM process in his/her organization.

In addition, there has been much talk in the press over the last few years about ERM and how it should be or is being applied by various types of organizations in vastly different industries, using SOX guidelines or custom approaches with some degree of success, and oftentimes with limited progress. However, ERM is an area where Risk and Benefits Managers can work together with respect to hazard risks or insurable risks, which can be commonly managed and financed using a captive. A pure captive can be used by many large employers to strategically and consistently fund these risks and control these risks. This can be an important step in the ERM process for your organization to help breakdown some of the risk silos and particularly in the hazard risk area of enterprise risk.

Implementation of a Captive

Establishing a captive requires a long-term commitment by the parent organization. The reasons for forming a captive are set out in the “Reasons to Form a Captive” section of this manual and must be weighed carefully in light of the parent’s goals and objective. Getting the parent organization’s management to buy into the benefits of a captive is imperative before the next steps are taken.

It is vitally important that the captive be well planned, for it involves the creation of a facility that must meet risk-financing needs now and in the future. If you have decided that the formation of a captive might be right for your organization:

- Discuss the subject with your current insurance broker or consultant
- If your broker or consultant does not have captive management capability, talk with either another broker who has or an independent consultant who specializes captives
- Talk with other risk managers whose organizations already have a captive
- Members of the CICA are a good initial source of information. Current information is posted at CICA’s web site (www.CICAworld.com)
- Meet with regulatory authorities

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• Have a captive manager or independent consultant perform a feasibility study. This can range from a brief analysis to a full-length study. Included in the study should be an actuarially determined loss projection, a domicile comparison and a financial analysis. As part of the study, identify the legal, tax and accounting issues that need to be addressed by appropriate advisers
• Analyze the study and resolve any outstanding issues
• Prepare a business plan for the captive
• Incorporate the company and prepare the necessary captive application forms
• Market any insurance or reinsurance for the captive

Once you have formed a captive, it is imperative that you continue to have the parent company’s management involved in the captive. Some ways to do this are:
• Have them on the captive’s board of directors
• Have regular presentations to management and parent’s board of directors about the captive results and programs in the captive
• Have management involved in decisions regarding limits and retentions

Make sure you talk to management in their terms.

**In Summary**

Captives are unique vehicles that can provide effective solutions for organizational risks. Owners should consult appropriate captive advisors to make sure the captive structure is appropriately established to avoid any future complications.
Appendix A

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Appendix B

CAPTIVE TERMS

There are many terms used in the captive and alternative risk financing industry. This appendix contains a listing of the more common terms, but because different interpretations can apply, use care in applying these terms to different situations.
Glossary of Captive Terms

A

Admitted Reinsurance - Reinsurance provided by a reinsurer licensed or authorized in the jurisdiction in question. A company is “admitted” when it has been licensed and accepted by appropriate insurance governmental authorities of a state or country.

Arbitration Clause - A clause within a reinsurance agreement providing that if the ceding company and the reinsurer fail to agree, then they select neutral arbitrators with the authority to bind both parties to a solution. Resolving differences without litigation.

Association Captive Insurance Company - A captive insurance company established by members of an association to underwrite their own collective risks. An association captive usually only insures members of the sponsoring association.

B

Bordereau - A report providing premium or loss data with respect to identified specific risks, which is furnished the reinsurer by the reinsured. This report typically includes the insured’s name, premium basis, premium and the amount of coverage.

Burning Cost - The premium needed to cover losses based on historical experience for a proposed reinsurance agreement.

C

Cancellation - Run-off basis means that the liability of the reinsurer under policies, which became effective under the treaty prior to the cancellation date of such treaty, shall continue until the expiration date of each policy; Cut-off basis means that the liability of the reinsurer under policies, which became effective under the treaty prior to the cancellation date of such treaty, shall cease with respect to losses resulting from accidents taking place on and after said cancellation date. Usually the reinsurer will return to the company the unearned premium portfolio, unless the treaty is written on an earned premium basis.

Capacity - The largest amount of insurance an insurer or a reinsurer is willing and able to underwrite, including the amount they retain and the amounts for which they automatically bind their reinsurer.

Captive Insurance Company - A risk-financing method or form of self-insurance involving the establishment of a subsidiary corporation or association organized to write insurance. Captive insurance companies are formed to serve the insurance needs of the parent organization and to escape uncertainties of commercial insurance availability and cost. The insureds have a direct involvement and influence over the company’s major operations, including underwriting, claims, management policy, and investments.

Catastrophe Reinsurance - A form of reinsurance that provides coverage for losses resulting from a catastrophic event such as conflagration, earthquake or windstorm. Catastrophe loss generally refers to the total loss of an insurance company arising out of a single catastrophic event. These losses typically must exceed a specified amount and number of insurers and locations.

Cede - When a company transfers risk to another company.
Ceding Commission - An amount paid by a reinsurer to the ceding company to cover the ceding company’s acquisition and other expenses. The cedant’s acquisition costs and overhead expenses, taxes, licenses and fees, plus a fee representing a share of expected profits - sometimes expressed as a percentage of the gross reinsurance premium.

Ceding Company - The original or primary insurer; the insurance company that transfers its risk to a reinsurer.

Claims-Made Basis - A form of reinsurance under which the date of the claim report is deemed to be the date of the loss event. Claims reported during the term of the reinsurance agreement are therefore covered, regardless of when they occurred.

Commission - The primary insurance company usually pays the reinsurer its proportion of the gross premium it receives on a risk. The reinsurer then allows the company a ceding or direct commission allowance on such gross premium received, large enough to reimburse the company for the commission paid to its agents, plus taxes and its overhead. The amount of such allowance frequently determines profit or loss to the reinsurer.

Commutation - In the result of the termination of this contract, the Reinsurer shall be free from all further liability to the company for all loss and allocated loss expense not finally settled by the company as of the date of termination. In consideration of that release, the Reinsurer shall pay to the Company all amounts of loss and allocated loss expense due for losses finally settled.

Commutation Clause - A clause in a reinsurance agreement, which provides for estimation, payment and complete discharge of all future obligations for reinsurance losses incurred regardless of the continuing nature of certain losses.

Contingent Commissions - A payment to the ceding company in addition to the normal ceding commission allowance. It is a fixed percentage of the reinsurer’s net profits after a charge for the reinsurer’s overhead, derived from the subject treaty.

Contributing Excess - Where there is more than one reinsurer sharing a line of insurance on a risk in excess of a specified retention, each such reinsurer shall contribute towards any excess loss in proportion to his original participation in such risk.

Earned Premium - That part of the reinsurance premium calculated on a monthly, quarterly or annual basis, which is to be retained by the reinsurer, should there cession be canceled.

Errors and Omissions Clause - A provision in reinsurance agreements which is intended to neutralize any change in liability or benefits as a result of an inadvertent error by either party. To the extent possible the parties are placed in the position they would have been if the error had not occurred.

Ex Gratia Payment - A payment made for which the company is not liable under the terms of its policy. Usually made in lieu of incurring greater legal expenses in defending a claim.

Excess of Loss - Recoveries are available when a given loss exceeds the cedant’s retention defined in the agreement.

Expense Ratio - The percentage of premium used to pay all the costs of acquiring, writing and servicing insurance and reinsurance.

Experience - The loss record of an insured or of a class of coverage. Classified statistics of events connected with insurance, of outgo, or of income, actual or estimated. What figures show to have happened in the past.

Extra Contractual Obligations (ECO) - When used in reinsurance agreements, refers to damages awarded by a court against an insurer which go beyond the coverages of the insurance
policy, typically due to the insurer’s bad faith, fraud, or gross negligence in the handling of a claim.

F

**Facultative** - Facultative reinsurance means reinsurance of individual risks by offer and acceptance wherein the reinsurer retains the “faculty” to accept or reject each risk offered. The reinsurer may specify its own ratings or terms for the reinsurance.

**Federal Risk Retention Act** - This act does not allow a state insurance regulator to prohibit risk retention groups domiciled in other states from operating within the regulator's state, thus eliminating the need for a fronting company.

**Financial Reinsurance** - A form of reinsurance which considers the time value of money and has loss containment provisions, and is transacted primarily to achieve financial goals, such as capital management, tax planning, or the financing of acquisitions.

**Flat Rate** - A percentage rate applied to a ceding company’s premium writings for the classes of business reinsured to determine the reinsurance premiums to be paid the reinsurer.

**Following the Fortunes** - The clause stipulating that once a risk has been ceded by the reinsured, the reinsurer is bound by the same fate thereon as experienced by the ceding company.

**Fronting** - Most commonly refers to the practice of a non-admitted insurer (or an insured with a captive insurance company) contracting with a licensed insurer to issue an insurance policy for regulatory or certification purposes. This fronting insurer assumes little or no loss exposure; instead, financial arrangements are made to guarantee claims administration and payments. The fronting insurer is usually paid a percent of the premium.

I

**Incurred Loss Ratio** - The percentage of losses incurred to premiums earned.

**Industrial Insured** - An insured which procures the insurance of any risk or risks by use of the services of a full-time employee acting as an insurance manager or buyer and whose aggregate annual premiums for insurance on all risks total at least $25,000 and who has at least 25 full-time employees.

**Industrial Insured Captive Insurance Company** - Any company that insures risks of the industrial insureds that comprise the industrial insured group, and their affiliated companies.

**Inflation Factor** - A loading to provide for increased medical costs and loss payments in the future due to inflation.

**Intermediary** - A third party in the design, negotiation, and administration of a reinsurance agreement. Intermediaries recommend to ceding companies the type and amount of reinsurance to be purchased and negotiate the placement of coverage with reinsurers.

**Intermediary Clause** - A provision in reinsurance agreements, which identifies the intermediary negotiating the agreement. Most intermediary clauses shift all credit risk to reinsurers by providing that: the cedant’s payments to the intermediary are deemed payments to the reinsurer; and the reinsurer’s payments to the intermediary are not payments to the cedant until actually received by the cedant.

L

**Layer** - A horizontal segment of the liability insured.

**Lead Reinsurer** - The reinsurer who negotiates the terms, conditions, and premium rates and first signs on to the slip; reinsurers who subsequently sign on to the slip under those terms and conditions are considered following reinsurers.
**Letter of Credit** - A financial guaranty issued by a bank that permits the party to which it is issued to draw funds from the bank in the event of a valid unpaid claim against the other party.

**Loss Adjustment Expense** - All expenditures of an insurer associated with its adjustment, recording, and settlement of claims, other than the claim payment itself.

**Loss Development** - The difference between the original loss as originally reported to the reinsurer and its subsequent evaluation at a later date or at the time of its final disposal.

**Loss Event** - The total losses to the ceding company or to the reinsurer resulting from a single cause.

**Loss Portfolio Transfer** - The transfer of incurred losses to a third party. The assuming party hopes to profit by investing the sale price it has received over the length of time it requires to settle the claims it has assumed.

**Loss Ratio** - Proportionate relationship of incurred losses to earned premiums expressed as a percentage.

**Non-Admitted Insurers** - Insurance companies not licensed in a state may engage in business in the state if an admitted, properly filed company issues the policy and reinsures losses to the non-admitted reinsurer.

**Non-Admitted Reinsurance** - Reinsurance is non-admitted when placed in a non-admitted company and therefore may not be treated as an asset against reinsured losses or unearned premium reserves for insurance company accounting and statement purposes.

**Non-Subscriber Workers' Compensation Plan** - A non-subscriber is an employee who elects, by filing appropriate notices required by state insurance authorities, to pay work-related injury loss through some method other than statutory workers' compensation.

**Occurrence** - An adverse contingent accident or event neither expected nor intended from the point of view of the insured. With regard to limits on occurrences, property catastrophe reinsurance agreements frequently define adverse events having a common cause and sometimes within a specified time frame.

**Offset Clause** - A condition in reinsurance agreements which allows each party to net amounts due against those payable before making payment.

**Participating or Pro Rata Reinsurance** - Includes Quota Share, First Surplus, Second Surplus, and all other sharing forms of reinsurance where under the reinsurer participates pro rata in all losses and in all premiums.

**Per Risk Excess Reinsurance** - Retention and amount of reinsurance apply “per risk” rather than on a per accident or event or aggregate basis.

**Peril** - The causes of possible loss in the property field - for example: Fire, Windstorm, Collision, Hail, etc.

**Policy Year** - The year commencing with the effective date of the policy or with an anniversary of that date.

**Pool** - A group of insurers or reinsurers through which particular types of risks are underwritten with premiums, losses, and expenses shared in agreed ratios. A method of allocating reinsurance among several reinsurers.
Pool - A joint underwriting operation of insurance or reinsurance in which the participants assume a fixed interest in all business written.

Portfolio Reinsurance - In transactions of reinsurance, it refers to all the risks of the reinsurance transaction.

Portfolio Run-off - Permitting premiums and losses in respect of in-force business to run to their normal expiration upon termination of a reinsurance treaty.

Premium (Written/Unearned/Earned) - Written premium is premium registered to an insurer or reinsurer at the time a policy is issued and paid for. Premium for a future exposure period is said to be unearned premium for an individual policy, written premium minus unearned premium equals earned premium.

Premium, Deposit - When the terms of a policy provide that the final earned premium be determined at some time after the policy itself has been written, companies may require tentative or deposit premiums at the beginning which are readjusted when the actual earned charge has been later determined.

Premium, Pure - The portion of the premium calculated to enable the insurer to pay losses and, allocated claim expenses or the premium arrived at by dividing losses by exposure and in which no loading has been added for commission, taxes, and expenses.

Professional Reinsurer - Reinsurers that offer reinsurance to other than affiliate companies. The majority of professional reinsurers provide complete reinsurance and service at one source directly to the ceding company.

Profit Commission - A provision found in some reinsurance agreements which provides for profit sharing. Parties agree to a formula for calculating profit, an allowance for the reinsurer’s expenses, and the cedant’s share of such profit after expenses.

Pure Captive Insurance Company - Any company that insures risks of its parent and affiliated companies.

Pure Premium - That portion of the premium which covers losses and related expenses, i.e. includes no loading for commissions, taxes, or other expenses.

Q

Quota Share - The basic form of participating treaty whereby the reinsurer accepts a stated percentage of each and every risk within a defined category of business on a pro rata basis.

R

Reciprocal or Reciprocal Risk Retention Group - An unincorporated association; reciprocal insurance is that which results from an interchange among subscribers of reciprocal agreements of indemnity, the interchange being effectuated through an attorney-in-fact common to all subscribers.

Reinstatement Clause - When the amount of reinsurance coverage provided under a treaty is reduced by the payment of a reinsurance loss as the result of one catastrophe, the reinsurance cover is automatically reinstated usually by the payment of a reinstatement premium.

Reinstatement Premium - An additional premium paid to replenish the limit consumed in the event of a loss.

Reinsurance - The transfer of some or all of an insurance risk to another insurer. The company transferring the risk is the ceding company, and the company receiving the risk is the reinsurer.

Reinsurer - An insurance company that accepts the risk transferred from another insurance company in a reinsurance transaction.
**Rent-a-Captive** - Rent-a-Captives offer the benefits of a captive insurance company without the capitalization requirements, administrative costs and legal ramifications associated with establishing and operating an insurance subsidiary, and can return underwriting profits and investment income to a participant.

**Retention** - The net amount of risk which the ceding company or the reinsurer keeps for its own account.

**Retrocession** - A reinsurance of reinsurance. The transaction whereby a reinsurer cedes to another reinsurer all or part of the reinsurance it has previously assumed.

**Retrospective Rating** - A method which allows adjustment of the final reinsurance ceding commission or premium on the basis of the actual loss experience under the subject reinsurance treaty.

**Retrospective Rating Plan** - A method of establishing a premium on large commercial accounts. One in which the final premium is based on the insured's actual loss experience during the policy term, subject to a minimum and maximum premium, with the final premium determined by a formula.

**Risk Retention Group** - A group self-insured program or group captive insurance company formed under provisions of the Liability Risk Retention Act of 1986, by or on behalf of businesses joined to insure their liability exposures. Such a group is exempt from most state laws, rules or regulations, except for the state in which it is domiciled.

**Risks** - A term used to denote the physical units of property at risk or the object of insurance protection and not Perils or Hazard. The word is also defined as chance of loss or uncertainty of loss.

**S**

**Salvage and Subrogation** - Those rights of the insured that, under the terms of the policy, automatically transfer to the insurer upon settlement of a loss. Salvage applies to any proceeds from the repaired, recovered, or scrapped property. Subrogation refers to the proceeds of negotiations or legal actions against negligent third parties and may apply to either property or casualty coverages.

**Self-Insurance** - Insuring yourself by setting aside money to cover possible losses rather than by purchasing an insurance policy.

**Self-Insurance** - The planned assumption of risk.

**Sliding Scale Commission** - A ceding commission, which varies inversely with the loss ratio under the reinsurance agreement.

**Slip** - A binder often including more than one reinsurer.

**Special Acceptance** - The facultative extension of a reinsurance treaty to embrace a risk not automatically included within its terms.

**Sponsored Captive** - A captive insurance company in which the minimum capital and surplus required by applicable law is provided by one or more sponsors, insures the risks of separate participants through the contract, and segregates each participant’s liability through one or more protected cells.

**Spread Loss** - A form of reinsurance under which premiums are paid during good years to build up a fund from which losses are recovered in bad years.

**Stop Loss** - A form of reinsurance under which the reinsurer pays some or all of a cedant’s aggregate retained losses in excess of a predetermined dollar amount or in excess of a percentage of premium.
**Subject Premium** - A cedant’s premiums to which the reinsurance premium rate is applied to calculate the reinsurance premium.

**Surplus** - The excess of assets over liabilities. Surplus determines an insurer’s or reinsurer’s ability to write business.

**Surplus Share** - A form of proportional reinsurance where the reinsurer assumes pro rata responsibility for only that portion of any risk, which exceeds the company’s traditional retentions.

**T**

**Tax Reform Act of 1984** - One section of this act redefined income related to the insurance of US-based risks as US-source income instead of foreign-source income. Another section made income from the insurance of related risks in foreign countries taxable in the current year. The net effect of these two changes was to eliminate most tax advantages for an offshore single parent captive.

**Tax Reform Act of 1988** - The major change imposed by this act affected offshore group captives in that the definition of a U.S. shareholder was changed from an ownership interest of 10 percent or more to any shareholding interest.

**Treaty** - The written contract defining the reinsurance agreement. The treaty contains provisions defining the terms of the agreement including specific risk definition, data on limits and retention, and provisions for premium payment and duration.

**U**

**Ultimate Net Loss** - The total sum which the assured, or any company as his insurer, or both, become obligated to pay either through adjudication or compromise, and usually includes hospital, medical and funeral charges and all sums paid as salaries, wages, compensation, fees, charges and law costs, premiums on attachment or appeal bonds, interest, expenses for doctors, lawyers, nurses, and investigators and other persons, and for litigation, settlement, adjustment and investigation of claims and suits which are paid as a consequence of the insured loss, excluding only the salaries of the assured’s or of any underlying insurer’s permanent employees.

**Unearned Premium** - That portion of the original premium that applies to the unexpired portion of risk.

**WXYZ**

**Working Layer** - The first layer above the cedant’s retention wherein moderate to heavy loss activity is expected by the cedant and reinsurer.
The attached information represents CICA members active in the noted areas. This information was provided by the members shown and may or may not reflect their current activity. CICA does not endorse, verify or monitor the business practices of its members. Individuals are encouraged to follow standard business practices before retaining services.
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Appendix D

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“CAPTIVES: AN OVERVIEW”

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