# CAPTIVE INSURANCE BASICS

## *Have You Heard About Captives?*

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# Overview

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**Professional Affiliations**

- American Institute of Certified Public Accountants (AICPA) – Committee Member
- North Carolina Association of Certified Public Accountants (NCACPA) – Committee Member
- North Carolina Captive Insurance Association (NCCIA) – Committee Chairman
- South Carolina Captives Insurance Association (SCCIA)

**Firm activities**

- Captive Insurance Co-Line Leader
- D&I Steering Committee
- Audit Efficiency Team member

# Today's Agenda

- What is a Captive?
- Common Types of Captives
- How Captives Work
- Considerations
- Recent Developments

# What is a Captive?

# Definitions

- **Risk** – Everything.  Seriously.
- **Coverage** – The risk to be transferred.
- **Deductible** – Risk of loss retained by an insured.
- **Premium** – Cost charged by an insurance company to write coverages.
- **Reinsurance** – When an insurance company "cedes" risk on coverages to another insurance company.
- **Underwriting** – The process of writing coverages.
- **Risk transfer** – The process of moving risk of loss from one risk-bearing entity to another.
- **Risk distribution** – The process of pooling together numerous and similar risks of loss to reduce the overall risk of the coverages being written (i.e. to prevent single losses from creating solvency issues for insurers).

# What is a Captive?

- Small insurance company
- Risk management vehicle for owner(s)
- Regulated as an insurance company
- Typically managed by a captive manager (third-party)

# How Did We Get Here?

- 1600s – Lloyds Teahouse in London (now, Lloyds of London)
- 1958 – The term “captive” was first used by Fred Reiss in 1958. The US Government took notice.
- 1962 – First modern captive in Bermuda
- 1980s – Over 1,000 captives, primarily offshore
- 2010 – Over 6,000 captives worldwide, with over 30 states with captive legislation

# Why Captives?

- Glad you asked:
  - **Reduction or stabilization of insurance costs** over time
  - **More control** over underwriting and claims management
  - **Financial benefit** for more favorable claims experience
  - **Coverage that might otherwise be unavailable or unaffordable or otherwise uninsurable risks**
  - Direct access to the **reinsurance** market
  - Possible **income tax benefits** over traditional self-insurance

# Common Types of Captives

# Types of Captives

Typically captives can be *broadly* placed into a few types:

– Pure captive (single-parent)

– Group/Association Captive

– Sponsored Captive (Rent-A-Captive)

# Pure Captive

- Insures only the risk of its parent and/or affiliated companies
- One of the most common forms of captives
- Also called “single parent” captives
- Offer the highest level of control and flexibility
- Offer highest retention of underwriting profit

# Group/Association Captive

- Usually consists of entities within same industry or similar characteristics joining together to self-insure.
- This process often takes the form of an Association Captive.
- Association Captives can only insure the risk of the association members.
- This is an effective method for sharing costs and pooling risks for similar groups or associations.
- There is less control over the operations and finances than other captive types.

# Sponsored Captives

- Sponsored captives, also referred to as:
  - Incorporated Cell Captive
  - Protected Cell Captive
  - Series LLC
  - Segregated Cell Captive
  - Rent-A-Captive

# Sponsored Captives (continued)

- Sponsored captives typically consist of a “core” and multiple cells or series.
- This type of captive insures the risks of separate, unrelated participants or risks in each cell or series through separate agreements.
- The core serves as a “general account” that manages the operations of the cells for a fee.
- The cells conduct insurance activity.

# Sponsored Captives (continued)

- This type will typically requires less capital and start-up costs.
- It is sometimes referred to as a “rent-a-captive.” Cells may be referred to as protected, segregated, or incorporated.
- Incorporated cells seem to offer the most protection.
- Each cell is a separate taxable entity.

# How Captives Work

# Captive Operations

- The process for creating a captive involves several steps:
  - Selecting a captive manager
  - Completing a feasibility study
  - Choosing a domicile
  - Process of approval

# Captive Manager

- Underwriting
- Claims administration
- Administrative
- Quarterly and annual reporting
- Third-party service providers

# Feasibility Study

- Establishes the viability of the captive.
- A feasibility study identifies
  - **The risk to be insured** by the captive as well as the projected amount of risk.
  - **The capacity** to build surplus for increasing retentions or access to capital.
  - **The cost** of operating the captive.
- Domicile selection.

# Approval Process

- The approval process varies by domicile, but typically must provide the following:
  - Application
  - Feasibility study
  - List of service providers
  - Business plan
  - By-laws or articles of incorporation
- Once approved, a certificate of approval (or "certificate of authority") is issued.

# Considerations

# Accounting Considerations

- File **quarterly** and **annual statements** within their domicile requirements.
- **Audited financial statements** are required in most domiciles.
- They are subject to **examination** by domicile regulators on a rotating basis.
- Most regulators require an **investment policy** and business plan (strongly recommended).

# Accounting Considerations (continued)

- **Risk transfer:**
  – Must review all related contracts in order to determine that the captive actually bears risk of loss
  – Typically considered from tax standpoint
- **Risk distribution** – Required by both regulators and the IRS, as the distribution of risk to prevent solvency issues.
- Captives will engage in various related party transactions:
  – Surplus notes, or loans to/from shareholders
  – Investing in commonly owned subsidiaries
  – LOC where assets of parent secure the LOC
- Consolidation considerations

# Tax Considerations

- State income tax – typically a premium tax
- Federal taxation varies based on election of 831(a) or 831(b) status.
  - It is critical that the captive meets the definition of an insurance company, especially for those making the 831(b) election.

# Recent Developments

# PATH Act - 2015

- The PATH Act has had a significant effect on the captive industry.
  - The 831(b) premium limit has been increased to \$2.2 million from \$1.2 million and indexed for inflation (\$2.35 million in 2020).
  - Diversification requirements and two tests:
    - 20% of net written premium test
    - Ownership test – limitation for specific holders

# Revenue Rulings

- **Revenue Rulings 2002-89, 2002-90,** and **2002-91** – Clarifies the risk shifting/distribution for captives.
- **Revenue Ruling 2004-65** – The IRS recommended 831(b) captives no longer be identified as "listed transactions." This did not last.
- **Revenue Ruling 2005-40** – The IRS attempted to clarify requirements to qualify as an insurance company for federal income tax purposes, reiterating the need for risk distribution.
- **Revenue Rulings 2008-8** – Clarification on arrangements between cells in a cell captive and the owners for appropriate risk shifting and distribution.

# IRS Notice 2016-66

- http://www.cricpa.com/notice-2016-66/
- 831(b) captives were identified as **"transactions of interest."** which requires disclosure of certain information to the IRS.
- Disclosures are made on Form 8886, which is due May 1.
- In dispute with the Supreme Court at the moment (oral arguments in December 2020).

# Significant Case Law

- Rent-a-Center v Commissioner – Petitioner win
- Avrahami v Commissioner – Commissioner win
- Reserve Mechanical v Commissioner – Commissioner win
- Syzygy v Commissioner – Commissioner win
- CIC Services, LLC v Commissioner – with Supreme Court

# Closing Remarks

- Captives make excellent risk management vehicles.
- There are so many different structures with varying benefits and drawbacks.
- Although there are tax benefits are available, risk management must be the focus.
- Due care is critical – it's important to know your captive and know your manager.

# Questions?

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