



Pulling power

Stewart Feldman of Capstone Associated anticipates a slow migration of US captives to their home states, if regulatory changes can be clarified in the future

There has been a lot of talk about captives moving back onshore. Traditionally, the trend has been the reverse. What are your thoughts on this?

There has been a big push onshore following enactment of the US Dodd-Frank Act, and even before with the Patriot Act's passage in 2002. The thrust has been to move captives onshore, and more generally, limit non-US planning. The Patriot Act, its successors and related acts have made it increasingly difficult to have non-US bank accounts. That's not to say that a captive has to have a non-US bank account, but certainly if it is desired, the Patriot Act and its related provisions have made it awkward, though not impossible, to obtain and maintain them. The reverse is also true—it has been increasingly difficult, but not impossible, to open US accounts for non-US captives.

Then along came Dodd-Frank in 2010. While there is an argument as to whether the Non-admitted and Reinsurance Reform Act (NRRA) provisions embodied in the overall legislation cover captives, one interpretation is that the captive, practically speaking, now needs to be based in its home state. The NRRA purports to delegate to the home state the ability to collect the totality of the independently procured premium (IPP) tax everywhere, not just

within the home state's borders. Very few recognised this issue when the NRRA was introduced.

The NRRA's IPP tax provisions are something that have been kicking around for more than 50 years and are considered valid by the states. The US Supreme Court struck this tax down in 1962 in the Todd Shipyard case to the extent that a state attempted to collect a tax beyond its borders, but nonetheless, in various forms, the IPP tax continues. Dodd-Frank would push the captive to its home state as a domicile and in turn allow the home state to be the exclusive collector of the IPP tax. When you put this all together, there is a strong push to have domestically-regulated captives.

On top of this, there is the Organisation for Economic Co-operation and Development (OECD) and other international organisations taking a look at offshore domiciles and the companies that are domiciled there. There has been an increase in the number of international audits by the OECD and similar organisations that evaluate offshore domiciles.

This offshore sensitivity is interesting because offshore domiciles in general, such as the Cayman Islands, Bermuda and Anguilla, have done a good job of regulation—some even say, much better

than their onshore counterparts. There is an opinion that offshore domiciles are much more involved in the regulation and ongoing activities of captives than US domiciles. In fact, offshore domiciles, in my experience, have at least as good and in many cases better regulators and expertise than US states.

There were previously very few US states that either had workable captive legislation or had the staff to oversee captives. Even today, most domestic jurisdictions are still staffing up. More of these jurisdictions now have statutes in place but few are in fact in the captive regulatory business.

An example is Florida, the fourth biggest state in the US. It recently formed its first captive in more than 25 years. At Capstone, we once contacted Florida about forming a captive and its response was that it didn't have the staff to approve it. The states looked upon captives as a new source of revenue. But only very few can make money from captive regulation, and then only after making a big capital investment. The result is that when states realise they can lose money, they do not to commit the resources.

My prediction is that there will be a slow migration of captives to their home states, measured in decades.

In summary, there are macro trends that are pushing the captives onshore—these are the Patriot Act, Dodd-Frank, concern with 'offshore planning' and the competitiveness of domestic domiciles. And some of the traditional offshore domiciles, for example, the British overseas territories, are no longer as good as they once were at captive regulation. Finally, there is no opposing force calling for offshore planning.

What are the pros and cons of onshore captives versus offshore?

On an historical basis, certain jurisdictions, primarily British, were more sophisticated than US domiciles in captive regulation. Those jurisdictions had staff employed that understood captives and regulated captives. While some US jurisdictions have caught up, some British jurisdictions have lost ground and other British jurisdictions, for example, the British Virgin Islands, have effectively abandoned captive regulation post-2008.

How is the US IRS playing a role in the onshore versus offshore debate?

In the US, most captives make the 953(d) election, however, the Internal Revenue Service (IRS), in furtherance of a general policy, is trying to encourage onshore formations. By way of example, the IRS has made 953(d) election very difficult or impractical to obtain, except early on in the year.

There have been efforts encouraging the domestication of captives. For example, if you form a non-US captive in December and you want it to be an 831(b) captive or 501(c)(15) captive, you're going to end up in tax court. The 953(d) election has been 're-interpreted' such that the IRS annualises revenue. So if you form a captive on 31 December and your premium is \$300,000, the IRS is going to multiply that by 365 and suggest that the captive has over a billion

dollars of premium on an effective basis and therefore is disqualified from 501(c)(15) status. The IRS has legislated in furtherance of its desire to push onshore regulation, so the playing field is certainly not level for onshore versus offshore.

Where are captives most commonly moving to from offshore jurisdictions?

The domiciles most commonly talked about are Delaware, Utah, Tennessee, South Carolina, Hawaii, and Vermont. Of these, Delaware is certainly the key domicile from a business standpoint. Texas is very new to the captive marketplace. While Texas may have around two dozen captives, these are generally very large companies, as the regulators are only beginning to focus on the mid-market. The gain of the US domiciles has stymied the growth of the traditional large British overseas territories. As to these domiciles specialising in mid-market captives, they are practically winding down, with few formations and ongoing liquidations or reincorporation elsewhere.

Is Europe catching up with the US captive market?

From the standpoint of the insurer, I think that ship has sailed. Overseas territories had the historical expertise in corporate formations and captive insurance to a lesser extent. That is now shifting to the US at least for captive regulation. I don't think Europe will catch up with the US. I think it's now a competition between the British overseas territories, which are a dwindling competitor, and US states.

From the standpoint of the insured, Europe has a different tax system to the US. The US has the 800 series of the Internal Revenue Code, which has been around for generations, promoting the off-loading of exposures of future losses to an affiliated insurer. If a company forms a property and casualty (P&C) company, that company can offload extraordinary warranty expenses, and other P&C liabilities, to the insurer through the use of a captive. That's a popular planning technique, and it's necessary because of the particular nature of our US tax system. In general, there is a different tax scheme in place in Europe that doesn't call for captives as a planning tool. **CIT**



Stewart Feldman
CEO and general counsel
Capstone Associated