The earlier, the better

When deciding whether to form a captive, risk coverage should come first, financial benefits second, according to Steven Lonergan of Capstone Associated Services

Across industries and around the globe, mid-market businesses have been forming captive insurance companies because they serve as a powerful and practical risk mitigation and financing tool. Captive coverages: (i) plug the holes that commercial policies leave behind; (ii) are designed to customise the specific risks of the subject business more closely; (iii) cover deductibles and excess; and (iv) often can, more economically than conventional policies, cover risks otherwise not competitively priced in the marketplace.

Coverages from affiliated captives also eliminate the uncertainty of arbitrary denials of coverages and contentious claims adjustment often seen with commercial property and casualty carriers. The ancillary financial benefits—for example, retaining the ultimate rights and investment income on the capital used to fund losses—are an added bonus.

When implemented as part of a comprehensive risk management programme, alternative risk planning/captive planning improves a business's overall financial strength and integrity. For businesses with a robust risk profile, captives offer significant financial and strategic planning advantages. Given the significant advantages of utilising a captive for risk management, when, from a timing standpoint, should a captive be formed?

First, the obvious. The earlier the captive is formed, the earlier the benefits begin to accrue. While incurred but not reported (IBNR)-type losses can be insured with retroactive provisions or insurance (for example, 'claims made' provisions to the extent that the losses are unknown), nonetheless, as a general proposition, insurance coverage can start no earlier than the licensing of the captive. Also, the captive cannot be licensed until the application, financial pro formas, and business plan are submitted to a government insurance department and then reviewed and approved, followed by the formation and capitalisation of the corporate entity. All in, this is a several-month process.

This article makes the case for forming a captive earlier in the year, preferably in Q1 or Q2, rather than in the traditional end-of-year rush. For insureds and captive owners, timeliness in captive planning will provide a better vehicle for risk mitigation and overall success. There is little doubt that business owners who act earlier in the year may see a fuller realisation of their captive benefits.

More choice in where the captive is domiciled

Domicile selection is a critical component to captive planning. The domicile, or jurisdiction where the captive is incorporated and regulated, should have a positive regulatory track record and offer an appropriate regulatory environment for the particular type of captive being formed. For many businesses, forming a captive offshore makes sense. To be sure, historically, British Caribbean domiciles had a regulatory advantage—both as to expertise in regulating insurers, their legislative framework, strong service provider networks and the resulting large number of captives under formation—over the few US domiciles, especially pre-US Dodd-Frank (that is, pre-2010).

However, to qualify as a Section 501(c)(15) or Section 831(b) captive, forming a captive in the Caribbean calls for the captive electing under Internal Revenue Code Section 953(d) to be a domestic (US) insurer, waiving the benefit of all tax treaties in favour of the captive being treated as a US company for all US tax purposes. In fact, this is the only election that is available to a foreign insurance company, preventing it from being treated as a controlled foreign corporation (CFC).

As part of its revisionist application of its own rules during the Obama administration, the Internal Revenue Service (IRS) in 2014 began applying a new mechanical test under Revenue Procedure 2003-47 that effectively negated the ability of Section 501(c)(15) and 831(b) captives from domesticating in the US other than early in the year using the Section 953(d) election. The IRS began a policy to annualise the captive's income based on the days from the date of formation to the end of the tax year.

This is, if a captive were formed and licensed as of 1 December of a year reflecting $400,000 in premium, the IRS will annualise the captive's income to reflect $4,709,667 (365/31 X $400,000) as premiums for this first year. The captive would be required to have 10 percent of this annualised premium in US assets, which, in many cases with year-end formations, would exceed the captive's total assets. The result is that the captive is disqualified from making the Section 953(d) election.

Previously, for years, the IRS looked to the policy terms and other factors for annualising the income to determine whether the Section 953(d) criteria were met. The net effect of using a daily factor for annualising income is that many captives formed late in the year will be required to have more US assets than their total assets, which is an impossibility. This new ruling policy effectively negates the Section 953(d) election for non-US-domiciled captives formed late in the year. That is, captive owners that wait until later in the year to form a captive are restricted to an onshore jurisdiction, even if an offshore domicile is optimal.

More earned premiums to fund losses

Among the financial benefits of forming a captive to finance future losses (as opposed to reserving monies on the insureds' balance sheets to fund losses) is that premiums paid to a bona fide captive are tax deductible. In addition, on an operating basis, Section 831(b) captive owners pay income tax only on their investment income. Section 501(c) (15) captives, although subject to more severe restrictions overall, are wholly tax exempt on all income, both investment and underwriting.

Whether the property and casualty insurer is formed under Section 831(a), 831(b), or 501(c) (15), excess admissible assets can be invested in a wide variety of domicile-approved investments, as can the insurer's admissible assets, including (depending on the jurisdiction) secured corporate lending (for example, bonds and mortgages) under commercially reasonable terms. Still, these financial incentives should always come second to the insurance needs of the business. And as part of good insurance practice, the captive should meet the long-established criteria for being recognised as an insurer:

- The law of large numbers;
- Significant risk transfer; and
- The risks insureds should meet the commonly accepted notions of insurance.

In furtherance of the above, a captive usually underwrites many individual risks, which, practically speaking, means having a large number of non-correlated or negatively correlated risks. Arguments exist as well to have multiple policies covering different risks of multiple parties, although this analysis has little basis in insurance practice.

Despite the long-standing requirement for significant risk transfer and adequate distribution of risk, some 'captive managers' promote captive ownership as a tax-driven strategy while having no tax law or tax courting qualifications. Worse, some captive managers implicitly promote this strategy while taking no responsibility for the intricate and ongoing tax and legal structure of the captive. For them, the financial benefits act as a pure marketing tool to drum up business and expand their portfolio. This situation has fuelled the environment by which the IRS has increased its scrutiny of Section 831(b) and 501(c)(15) filers.

That said, when formed for the right reasons and operated properly, the financial benefits of a captive insurance company are first-rate. To this end, the benefits are more easily realised and more flexibly implemented early in the year.

In general, forming a captive insurance company requires reasonable risk transfer, distribution of risk, and solvency (capital supported by annual profits balanced against the net risk exposures). Operating captives earn premium throughout the exposure year. The earlier in the year the captive is established and funded, the more earned premium dollars exist to cover unexpected early losses.

Better strategic planning

For the captive insurance industry, October through December is very busy. Everyone involved in the planning process is hyper-focused on making sure captives are properly structured and funded before year's end.

There's certainly reason for there to be an uptick in captive activity when the autumn season begins. Typically, after the Q3 results are in, the annual budget gets fine-tuned. Business owners coordinate with their advisers to finalise year-end planning.

From an insurance, business and tax perspective, it's better to allow enough time for the captive to be properly structured and fully vetted rather than to do a rush job. Providing enough time for everyone involved to do their part makes for better strategic planning and execution. Of course, it is possible to form a captive in Q4, but there is no doubt that having more time to plan and execute helps ensure a positive outcome.

Turnkey captive insurance planning

Forming a captive, like any corporate formation, calls for a well-thought out plan and a team in place, preferably with an early-in-the-year start. It calls for partnering with a professional team led by tax or corporate lawyers well versed in the intricacies of captives, with the expertise to oversee the project. Captive management is the insurance and administrative part of the planning, which, while important, is only part of the equation.

Most captive insurance managers disclaim all legal and tax consequences of the planning, which leaves little chance of the captive 'getting it right' and 'covering the required bases'. The IRS has recognised this and has directed its attention to administrative and clerical, and insurance broker-type managers because their work has been found to have serious deficiencies not seen in lawyer or administered captives. For a successful implementation and operation, it is critical to have tax, corporate, regulatory and other legal representation that has substantive captive experience to avoid the many pitfalls of the planning. To be sure, the planning calls for a multidisciplinary team that also includes lawyers with assorted expertise, accountants, risk managers, underwriters, claims personnel, and actuaries.

In collaboration with The Feldman Law Firm, Capstone Associated Services administers property and casualty captive insurance companies, providing alternative risk financing services throughout the US. Now in its nineteenth year, Capstone provides captive services to mid-market organisations on a turnkey basis. We encourage beginning the discussion early in the year, focusing on the right reasons for forming a captive: risk coverage first, financial benefits second, followed by other benefits. **CIT**

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