HOW TO START A CAPTIVE

From the publishers of CAPTIVE REVIEW

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Introduction

The global captive industry is growing and emerging domiciles are working hard to catch up with their more established counterparts. In the United States captives are no longer exclusive to the Fortune 500 firms and the majority of new formations now come from the middle market which is rapidly embracing self-insurance and alternative risk transfer.

This in turn is forcing captive managers and service providers, not to mention regulators, to adapt quickly in order to keep up with the new demographic. At the same time the Internal Revenue Service is scrambling to clamp down on the perceived abuse of captive structures and maintain credibility as a risk management tool first and foremost and a method of tax optimisation after.

Offshore jurisdictions are also benefitting from increased interest from the US middle market, although the rise of US onshore is putting pressure on some established offshore options.

This *Captive Review Start-Up Report 2015* seeks to provide a comprehensive guide for prospective captive owners on aspects of tax and general compliance, as well as domicile and captive structure choices.

Captive Review questions established industry experts from offshore and onshore domiciles in both the public and private sectors to discuss the essential aspects prospective captive owners must consider before starting the formation process.

Captive Review also analyses the different captive structures that are available, necessary steps involved in the decision making process and common pitfalls that can plague captive formations.

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CAPTIVES GO MAINSTREAM

Middle market form captive risk management toolbox

Lance McNeel, CPCU, ARM, vice-president of business development at Capstone Associated Services, Ltd., explains how the middle market is embracing captive solutions

Written by **Lance McNeel**

Lance McNeel CPCU, ARM is vice president of business development for Capstone Associated Services, Ltd. McNeel brings over 30 years of experience in all areas of the insurance industry, including property and casualty insurance, life and health insurance, and reinsurance.

To Take Arms Against a Sea of Troubles

Middle market companies are silent heroes of the US economy, representing a third of private sector GDP and jobs. These companies operate without the raw political power of their larger peers or the assistance provided to small businesses by the SBA and other federal and state programs. The middle market suffers the slings and arrows of fortune seeking relief from the many risks faced. However, companies are now finding refuge from the rough seas of uncertainty in enterprise risk management and one of its very effective tools – captive insurance.

Defining captive insurance companies

A captive insurance company, for purposes of this article, is a single parent captive whereby the insurer and the insured are both are owned by related parties. That definition in the context of middle market companies can be further restricted to insurers that meet the definition of Internal Revenue Code §831(b) with annual net written premiums of less than $1.2m.

Captive insurers that fit within this definition provide middle market companies with the ability to reduce risk financing costs associated with the purchase of commercial insurance, a degree of asset protection, and the ability to cover risks whose coverages are unavailable or economically unattractive in the commercial markets. Secondary benefits include the ability to reward key employees or family members in the ownership structure, to create tax-efficient claims reserves, and to make commercially-reasonable loans.

Description of enterprise risk management

Descriptions of enterprise risk management (ERM) often include a brief statement of how it combines all areas of organisational risks, and then dive into a lengthy statement describing the need for high-level commitment to the process, which in turn is described in great detail. For purposes of this article, ERM is best described as the business strategy of managing all organisational risks as an interconnected portfolio. These risks go much further than the traditional risk management focus on pure losses to include financial, operational, compliance, and strategic losses.

By focusing on the high-level description, we can see immediately how captive insurance planning can help achieve the goals of ERM. Policies can be structured to meet specific needs of the enterprise dealing with a wider variety of risks than are available in the commercial insurance market. However, there are limitations to the ability of captives to meet all of the risks associated with ERM. Generally, those risks that are determined to be 'business risks,' such as cost fluctuations or changes in consumer preferences, are not recognised as insurable risks.

What enterprise risks can captives manage?

A captive can cover all of the risks traditionally covered by commercial insurance companies, although generally not at the same limits, and rarely for regulated policies such as workers' compensation or on the road vehicles. Large deductible programs offer attractive options for captive insurance. Supply chain coverage is also frequently covered by captives, which can provide some of the operational risk management that is a goal of ERM. Reputational risk and compliance risk can also be included in a well-conceived captive strategy.

"A risk that is considered uninsurable can be covered if it is melded with an insurable risk"

Business or speculative risks are typically not included in a captive insurance portfolio. Any insurance policy that is a 'derivative' or 'financial hedge' is not insurance for federal income tax purposes and is usually excluded from captive coverages. Other risk exposures that may fail as insurable risks are wear and tear, normal inventory shortage, intentional acts, and generally catastrophic events such as flood and earthquake except at some finite level of coverage. In some of these cases, a risk that is considered uninsurable can be covered if it is melded with an insurable risk. This structure is often referred to as a dual trigger policy. An example would be coverage for an increase in energy costs caused by a hurricane among other triggers.

Example 1 – traditional insurance layering

Consider an industrial company with operations in nine states and total revenues in excess of $100m. The company currently has a large deductible insurance program with a $360,000 deductible on workers' compensation and a $250,000 deductible on general liability and auto liability. Commercial insurance premiums for the program are approximately $2m, and the developed deductible losses are projected to be $1.2m. The traditional risk management approach would argue that this is an excellent use of commercial insurance to protect the company from catastrophic losses while reducing its premiums through the use of deductibles well within its level of risk tolerance.

Enterprise risk management would suggest that the deductible, even though it may be reserved in a loss fund, is being funded by after-tax dollars which dilutes the efficiency of the plan. A better approach would be to use a captive to insure the deductible with pre-tax dollars. This would increase the efficiency of the funding mechanism, provide some asset protection to the reserves, and as long as the premium level that is less than $1.2m, provide a tax preferred profits on the portfolio.

Example 2 – dual trigger coverage

I mentioned earlier that dual trigger coverage may be able to help a company protect itself from risks that would usually be considered business risks. An example would be a policy that covers an integrated energy company from increases in the level of workers' compensation deductible losses if the price of oil drops below a specified level. This type of dual trigger (increased deductible losses and oil price decreases) provides protection from oil price fluctuation, which is generally thought to be a derivative type transaction when it is combined with traditional workers' compensation losses above a threshold. This type of coverage protects the company from the double effects of a business downturn and an increase in deductible claims.

Conclusion

Enterprise risk management is being taken very seriously by large corporations because it makes sense to assess and manage all risks as an interconnected portfolio. Captive insurance planning provides sophisticated tools to help with the process. This is one of the reasons why the interest in captives has exploded for middle market companies throughout the United States. We see this as a trend that will continue as these companies become more adept in the use of the ERM toolbox.

Domicile choices and trends

Logan R. Gremillion, tax attorney with The Feldman Law Firm, explains the process of choosing a captive domicile

Written by
Logan R. Gremillion

Logan R. Gremillion is a respected tax attorney with the Feldman Law Firm and a graduate of New York University's renowned Graduate Tax Program. From 2009 through 2010, Gremillion practiced tax law at Hrbacek & Associates, where he advised small to mid-sized businesses and partnerships in federal tax planning and controversy issues.

The number of domiciles authorising the formation of captive insurance companies has been on the rise in the past few years. The increased growth has prompted several states to join traditional domiciles Vermont and South Carolina in offering middle market businesses the opportunity to form a captive insurance company to cover their risks and take advantage of secondary captive insurance benefits. Texas, New Jersey and Tennessee are among the latest states to authorise or reform captive insurance legislation. With so many jurisdictions to choose from, how does one select the right domicile?

What is in a domicile?

All insurance companies are subject to the oversight of their licensing domicile. A domicile's captive insurance regulations are far reaching and affect many different levels of the captive's operations. The regulations govern what types of insurance coverages the captive can offer and to whom, how much starting capital is required for licensure, capital surplus levels that must be maintained, and the types of investments the captive can make.

From the point of formation to liquidation, a captive insurance company is effectively in partnership with its domicile. Once a business has decided to form a captive, the next step is choosing where the captive should be formed. Certain domiciles, due to minimum capital requirements or other difficult to satisfy requirements, have been traditionally seen as the domicile of choice for large public companies in which to form their captive. Large minimum capital requirements can exclude all but the largest of privately held businesses from forming a captive.

"Texas, New Jersey and Tennessee are among the latest states to authorise or reform captive insurance legislation"

The complexity of the application process is another area of concern. Once a company has been formed the next step is to file an application for an insurance license from the domicile's regulatory agency. While differing from domicile to domicile, this usually includes a voluminous formal filing, including multiple financial studies, financial pro formas, identification of coverages and forms of policies, letters of reference from banks, explanation of the professional team responsible for the captive's operations, and background checks. The complexity of the application does not always mean that the examination and approval process is longer. Some of the more established domiciles have developed a thorough but quick application process that can evaluate and issue an insurance license much quicker than some of the newer, less experienced domiciles.

Once an application has been filed, the application examined and issues resolved, the insurance license is issued, and the captive insurer is subject to the ongoing oversight of its domicile. Some domiciles, Tennessee for example, will require custody of minimum capital requirements to remain within the state. Other domi-

ciles will only require the funds to remain in a certain types of secure or low-risk, non-volatile investments. Captives, just as all licensed insurance companies, are subject to solvency requirements. Each jurisdiction has its own methods and approved asset classes of investments to calculate the required solvency and surplus levels.

Annual filing and examination requirements are another area of concern. Some domiciles require a simple annual statement, while other may require an annual audit conducted by designated, independent auditors. Choosing which domicile in which to form your captive has significant and long-lasting effects. It is not a decision to be made lightly.

What are the trends in domicile selection?

The latest trend in domicile selection has been moving not just onshore, but to the same jurisdiction as the insureds. That is, for businesses based in the United States, the businesses have been choosing to form their captive in the state in which they are head-quartered. We see this as not only a result of the expansion in viable captive domiciles, but due to the expanded awareness of captives and the attempt to tax the premiums written by them.

In 2010, as part of the voluminous Dodd-Frank Act, the United States Congress passed the Nonadmitted and Reinsurance Reform Act or NRRA. This act was a result of the lobbying of the surplus lines industry. Before the act, surplus lines brokers would typically have to report and collect taxes to many different states on the large multi-state insurance coverages they brokered. The NRRA gave authority of one state, the home state, to collect tax on these multi-state insurance coverages. The loose language in the NRRA led many states to attempt to tax not only the surplus lines coverages but also the more simple insurance coverages issued by out of state captives.

This home-state regime led to the possible exposure of captive insurance premiums to double-taxation. That is, not only are the insurance policies issued by the captive taxed by the captive domicile, they are also taxed by the insured's home state. While it was the intent of Congress for the NRRA to only apply to surplus lines coverage, and for states to cooperate and share the tax proceeds based upon risk exposures in each state, the states saw this as an opportunity to collect revenue on the entire premiums.

This led many businesses that would otherwise form a captive in an established captive domicile to lobby their home state to authorise the formation of captive insurance companies. This has in turn led to many new states getting into the captive insurance licensing business.

> "The latest trend in domicile selection has been moving not just onshore, but to the same jurisdiction as the insureds"

Which domicile should you choose?

Due to the significant and far-reaching implications making such a decision has, it is impossible to name any one jurisdiction. We are sceptical that many of the newly authorised jurisdictions are the correct ones to choose. Captive insurance regulation is complex and needs to be implemented by experience regulators with the requisite expertise which takes years to develop. The new domiciles cannot compete in terms of expertise and efficiency.

Even though the trend is to move to onshore jurisdictions, offshore should not be ruled out. Many offshore jurisdictions have a robust regulatory structure and knowledgeable regulators. Several have the experience developed over a decade or more in dealing with captives that is required for the successful operation of captive insurance planning.

Asset portfolios: Not "A whole new ball game"

Megan Brooks, Capstone's financial risk manager, discusses captive asset management

Written by
Megan Brooks

Megan M. Brooks is the financial risk manager for Capstone Associated Services, Ltd; she joined Capstone in 2006. Prior to joining the firm, she worked in real estate development and the manufacturing industry.

Take a page from the play book of some of the insurance industry's heavy hitters. Captive owners and advisors don't need to reinvent the wheel when designing an asset portfolio model for captive insurance. Captives are very similar to the insurance industry's major players such as Zurich Insurance Group or Travelers. They must maintain compliance within their selected domicile's regulatory body, the Internal Revenue Service (IRS) and best practices of the insurance industry while maintaining a responsible investment strategy.

Traditionally, insurance companies, and more specifically property & casualty, tend to be relatively conservative, investing heavily in fixed income products and allocating a small component to riskier assets to increase yield. According to the NAIC Capital Markets Bureau Special Report, the majority of an insurer's asset allocation is comprised of bonds; throughout recent years corporate bonds tend to be the largest bond type held by insurers at 53% of total bond exposure for the entire industry.

This does not necessarily limit the captive's investment portfolio options. However, it creates a template for owners and advisors on how to manage their investments. Current trends in asset classes among the larger insurers' reflect an inclination to further diversify their portfolio by investing in common stocks, loan products, and master limited partnerships. While these alternatives can satisfy an insurer's stronger risk appetite, boost earnings and provide added diversification, they require greater sophistication in the management of the company and careful monitoring of compliance with the companies' multiple regulatory bodies.

Assets – capital/reserves

Inherent to any insurance company is the tendency to accumulate substantial amounts of cash that can be used to purchase investments which ultimately are available to satisfy claims. The basic investment strategy primarily revolves around the liabilities of the company. Assets accumulated by insurers consist of both funds associated with the company's policyholders' surplus and capital and funds appropriated for the insurance company's policy reserves, the latter being funds set aside to meet policyholder obligations as they come due. The nature and size of an insurer's invested assets vary significantly based on the specifics of the insurer (e.g. types of coverages, premium levels, deductibles, limits and policy reserves). In the case of a captive insurance company that has elected to be treated as an Internal Revenue Code Section 831(b), premium revenues accumulated annually are capped at $1.2m and the taxable investment income has no limitation.

Because the liabilities drive the investment strategy, fixed income and, more specifically government and corporate bonds, are the most popular type of investment used by insurance companies, mainly because of their liquidity. For the portion of the portfolio allocated for capital and policy reserves, the return is typically low; however, insurers can potentially enhance yield and investment income through changes in credit quality, liquidity, and maturity. One of the more recent and significant shifts in bond allocations has been the migration toward lower-rated NAIC-2 category assets (BBB rated credits). Most domiciles allow for these lower-grade investments; however diversification restrictions may be imposed on specific ratings.

Assets – surplus/retained earnings

As time passes, the captive will accumulate assets beyond the required capital and reserves. Under this condition, a more robust asset allocation plan may be implemented to satisfy a wider range of risk/return scenarios. While many jurisdictions discourage investment in low-grade or privately-held investments (e.g., private equity funds or limited partnerships), other suitable options (or 'other assets') include but are not limited to common stocks, loan products, master limited partnerships and trusts or funds traded on a public exchange such as REITS or ETFs. Valuation of other assets is an important factor in calculating solvency of the company and the satisfying reporting requirements of the insurance domicile, hence the regulators' avoidance of certain private or secondary market transactions whose value cannot be obtained using observable measures such as market price.

Another element to consider in the design of the captive's investment portfolio is tax efficiency. Although it is not the main driver, it should be considered. The midmarket captive is always a US C corporation and usually based on the IRS code section 831(b), with the result that premium revenue is tax-exempt and the investment income is taxed at regular C corporate rates. For example, long-term capital gains are taxed at ordinary income tax rates. Communication between your tax and financial advisors prior to investing is needed to ensure that not only is the risk appetite met but also that the planning is as tax efficient as possible.

Compliance

As discussed above, captive insurance companies, like all insurance companies, must remain solvent (such being the ability to meet insurance liabilities) and maintain compliance with all applicable rules and regulations. The role of ensuring that the company complies should be assumed by lawyers and tax personnel acting as the captive manager and not by a financial or administrative services organisation. Selection of a captive manager with the requisite skills is imperative to the success and growth of the company.

While the captive manager should have no control or signing rights to the accounts and it is not their duty to select the specific investments, it is important to involve the captive manager during the setup and ongoing operations of the captive. The captive manager should have a thorough and current knowledge of the domicile's regulations and requirements, a good working relationship with the domicile, and insight into a captive's best operating practices.

Conclusion

Taking advantage of captive insurance has many attractive benefits and by nature, the planning is usually complex and multi-faceted. The up-front decision making will affect the captive's ongoing operations and its viability. It needs to be done right up-front with the right team in place.

STRONG FOUNDATIONS IN TENNESSEE

Captive Review speaks to Michael Corbett, Ben Whitehouse and Kevin Walters of the Tennessee Department of Commerce & Insurance, and Kevin Doherty of the Tennessee Captive Insurance Association, about the formula behind Tennessee's booming captive industry

Captive Review (CR): What is the current state of the captive environment in Tennessee?

Michael Corbett (MC): Since the renewal of Tennessee's captive insurance law in 2011 we have been pleasantly surprised with the tremendous response by the public. We now have 278 risk-bearing entities (RBEs) comprised of 75 captive insurance companies and another 203 cell companies associated with some of those captives. The service community has been especially supportive, not to mention the numerous captive managers that have settled here in the past four years.

Kevin Doherty (KD): In terms of overall growth it's been an enormous success story largely because of the executive branch who proposed the legislation and the legislators themselves who enacted it. Roughly half of new captive formations are by out-of-state businesses, which we consider to be quite an endorsement that our style is working.

Our success is based on the principle of the tripod, being the most effective structural framework. The three legs of our tripod are the executive branch, the legislative branch and the private sector. These three sectors working together is the key to our success.

Written by
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Michael Corbett is the director of the captive section at Tennessee Department of Commerce & Insurance.

Written by
Ben Whitehouse

Ben Whitehouse is the attorney for the captive section at Tennessee Department of Commerce & Insurance

Written by
Kevin Doherty

Kevin Doherty is the president of the Tennessee Captive Insurance Association

We have seen dramatic growth in the private sector since 2011. The Tennessee Captive Insurance Association (TCIA) conducts regular meetings and the attendance at these has more than doubled since we started. Our service provider community has also grown, which is essential because it takes a whole range of specialties to grow a captive industry. We believe we have the ideal environment to continue to make Tennessee one of the most competitive domiciles in the country, or the world.

CR: Tell us about the recent legislative session. What changes have been made to the statute?

Ben Whitehouse (BW): The legislation we ran this year had wide bipartisan support and is the latest step in a continuous improvement of Tennessee's legislative regime. As we grow, we learn and we continue to look to our neighbours to see if there are aspects we can adopt ourselves. When changes need to be made we aren't afraid to get them done.

This year we found we could offer captives greater flexibility in managing their asset portfolio and we allowed them to invest their minimum capital in cash equivalents as well as cash. We also modified the rules surrounding captive investment policy. Under the new law the captive's governing board must establish an investment

> "We believe we have the ideal environment to continue to make Tennessee one of the most competitive domiciles in the country"

policy and, with the regulator, ensure the captive abides by it.

The largest growth area we have seen is in the protected cell sector. What makes Tennessee unique is its full embrace of protected cell captives through the series limited liability structure. A lot of captives have come here specifically because we allow protected cell formations. This year we upgraded our statute to ensure captive owners can take full advantage of what the series LLC structure can offer.

The final feature of this year's legislative package was necessary changes to help make workers' compensation captives a viable option for Tennessee employers.

KD: What's significant about this year's legislation is that it shows the willingness of both the legislative and executive branches to make regular changes to the law in order to ensure it is the very best it can be for both the business and the state of Tennessee. The captive industry is still evolving and regulators have to be ready and willing to adapt in order to ensure their domicile remains competitive. I believe Tennessee's lawmakers respect that fact.

"The captive industry is still evolving and regulators have to be ready and willing to adapt in order to ensure their domicile remains competitive. I believe Tennessee's lawmakers respect that fact"

CR: As the US captive marketplace becomes more crowded, will domiciles have to specialise in order to ensure a continued inflow of captives?

MC: So far the only state that has come close to specialising is Utah. They have taken on a niche in the 831 (b) captive sector. We believe a domicile's speciality is only dictated by the restrictive nature of its statutes. Tennessee's statutes are in no way restrictive and allow for risk-retention groups, protected cell captives (both series and unincorporated) as well as group and association captives.

BW: Although we accept all captive types, by virtue of having the LLC law we are one of only two states able to offer that structure to captive owners, so we have inadvertently specialised in series limited liability companies and protected cell captives.

MC: In addition, one of our focuses at the captive section has been making Tennessee the healthcare domicile of choice due to our historic strength in that area. We have seen a significant number of healthcare captive formations and that blends well with the national issue of reforming healthcare.

CR: How does Tennessee compete against the established offshore domiciles?

KD: Ultimately, many offshore captives were created because there was no domestic alternative; this is no longer the case. There are still great captive domiciles offshore, but they are very far from home for a lot of companies. Tennessee on the other hand is ideally located in the centre of the US and has fantastic transport links with every surrounding state and beyond.

CR: What would you say to a prospective captive owner about Tennessee as a domicile?

MC: In short, all the pieces you need are here. The actuaries, accountants, captive managers and the legal and financial expertise; all are critical and all here within a one-day trip.

CR: Do you have a roadmap for where you would like Tennessee to be in a year's time?

MC: We believe there is a critical mass of captive formations that must be reached in order to make sure the industry has a very solid foundation. Our critical mass number is around 500 risk-bearing entities. We are about to break 300 and hope to surpass 400-450 before the New Year. We will reach the point soon where, regardless of any changes in the executive, legislative or private sector, our tripod framework will be sound.

READY FOR EU, LATAM AND AFRICAN CAPTIVES

Steve Kinion explains why Delaware's captive industry is well placed to be *the* global captive domicile

Written by
Steve Kinion

Steve Kinion became director of the Bureau of Captive and Financial Insurance Products in July 2009. Prior to his appointment, he was the senior advisor for regulatory policy for Insurance Commissioner Karen Weldin Stewart.

Captive Review (CR): Why are you targeting European firms to form captives in Delaware?

Steve Kinion (SK): Many European firms have US operations. That means they have insurance exposure in the US. Delaware is already the domicile of choice for large European insurers such as SCOR SE, so we understand global insurance regulation. We can be the choice domicile for European, Latin American, or African firms seeking to form captives to cover their US-based as well as international risks.

CR: Are European firms your main target?

SK: We are also targeting Latin America and Africa. Firms in the Pacific Rim have sought out Delaware and we seek them as well.

CR: How is Delaware positioning itself in attracting foreign start-up captives?

SK: Delaware has the most multi-lingual captive staff in the United States. Our staff includes French, German, Lithuanian, Polish, Russian and Spanish speakers. Our ability to be multi-lingual means that we can easily communicate in a global environment. Delaware also allows captive insurers to present their financial statements on an International Financial Reporting Standards (IFRS) basis.

CR: Why is it important for Delaware to allow captives to report on an IFRS basis?

SK: Approximately 120 nations and reporting jurisdictions permit or require IFRS for domestic-listed companies. When a foreign, ie, non-US, firm creates a captive in Delaware, it can use IFRS as its accounting standard. This allows the firm to accomplish two very important tasks. First, it can present the captive's financial statements using the same accounting standard as the home country parent and affiliated companies. Second, it allows a captive's parent to use a single company-wide accounting language. This avoids the expense of converting the Delaware domiciled captive's financial statements from a US accounting standard to IFRS.

CR: How will Solvency II regulations in the EU affect United States captive domiciles?

SK: There has not been an exodus of captives away from EU domiciles to the US as a result of the upcoming Solvency II standards scheduled to come into force in 2016. However, the existence of Solvency II may affect future choices for where to domicile a captive.

CR: Are differences in minimum capitalisation driving decisions for start-ups in choosing one domicile over another?

SK: Yes, because like water and electricity, capital will typically follow the path of least resistance. Delaware's capital requirements provide the right balance. They are not too onerous so that Delaware is avoided as a domicile, but they are not too lax to make a captive insurer thinly capitalised.

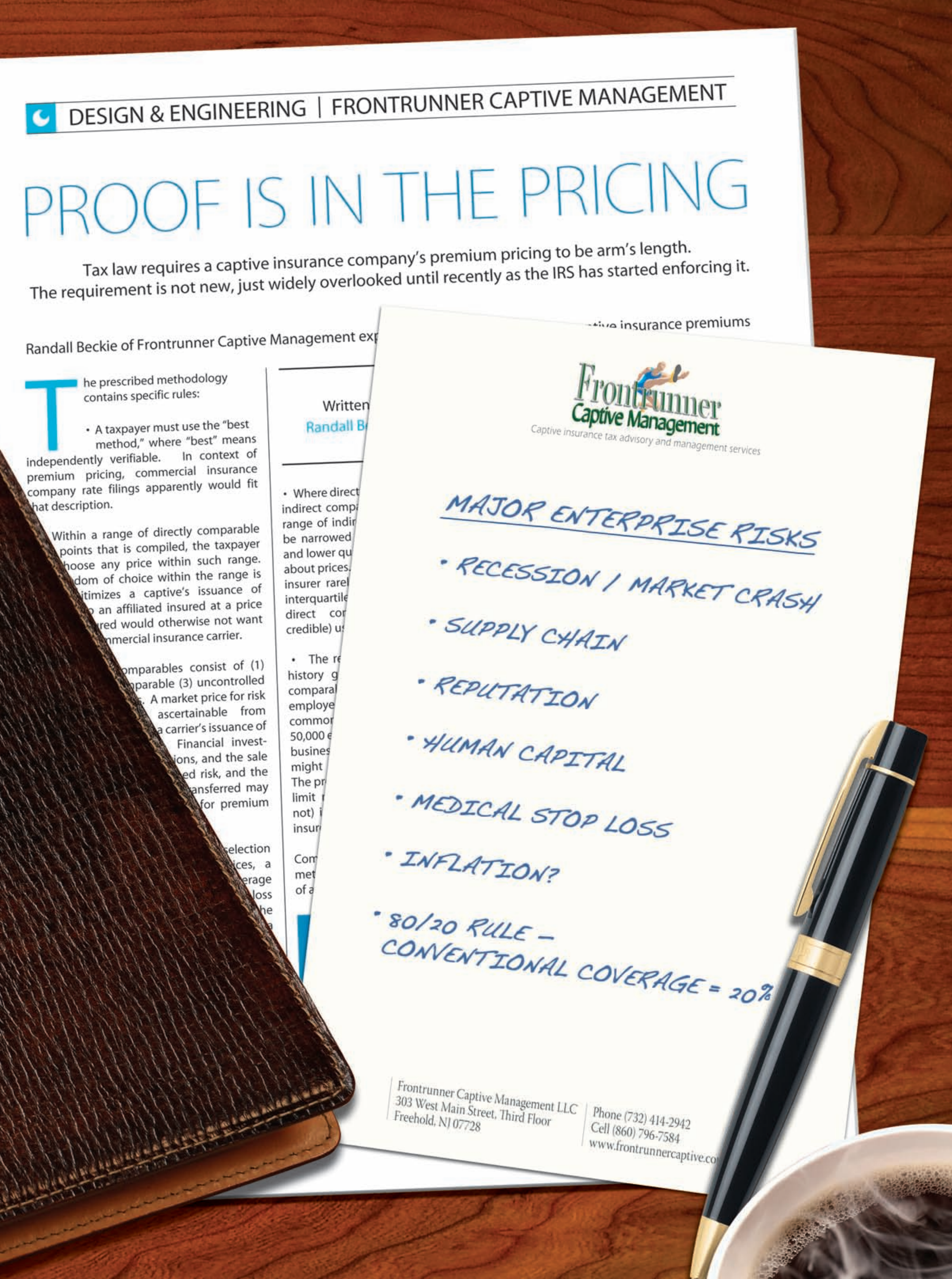
CR: What has been the impact of the IRS' increased scrutiny on 831-B election for start-up captives in Delaware?

SK: Delaware has experienced little if any impact due to increased IRS scrutiny. Delaware actively works to prevent what the IRS refers to as "unscrupulous promoters" from forming captives in Delaware. Our proactive regulatory approach dissuades these marginal promoters from selecting Delaware as a domicile.

CR: Why and how is Delaware unique for a potential captive start-up as a captive domicile?

SK: Delaware offers a firm but fair regulatory environment administered by an experienced staff. Delaware is a premier domicile ranking as the third largest captive domicile in the US and the sixth largest worldwide.

In terms of annual premium volume, Delaware ranks as the third largest US domicile with $6.6bn in annual premium for 2013.


DESIGN & ENGINEERING | FRONTRUNNER CAPTIVE MANAGEMENT
PROOF IS IN THE PRICING
Tax law requires a captive insurance company's premium pricing to be arm's length.
The requirement is not new, just widely overlooked until recently as the IRS has started enforcing it.
Randall Beckie of Frontrunner Captive Management ex
The prescribed methodology contains specific rules:
• A taxpayer must use the "best method," where "best" means independently verifiable. In context of premium pricing, commercial insurance company rate filings apparently would fit
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LOOK UNDER THE HOOD OF YOUR CAPTIVE

Randall Beckie and Mike Smith of Frontrunner Captive Management outline examples of how to avoid running afoul of the IRS and tax examiner

For the price of a car, you can run a captive insurance company for a year. How can you know whether you get what you pay for? Quality and performance can be evaluated in several aspects:

- Design
- Engineering
- Sales & service
- Production scale

Whereas you can test drive a car, a captive's performance benchmarking and safety features are not pasted to the window.

Aside from group captives and risk pools (the purpose of which is to spread risk), a captive's horsepower is measurable by the tax savings it creates. The tax savings depend on the type and scope of risks that the captive underwrites. Achieving high performance usually means dealing with trade-offs in design and engineering. A stock model captive that has been implemented a thousand times before surely is not tuned. Top performance comes from custom fitting a variety of specialty components. We describe a few of our winning designs below.

Design

Not every available tax angle can fit into one captive. A captive that makes a §831(b) election derives no advantage from favourable accounting methods for insurance companies. Fortune 500 companies form captives partly because captives can deduct unpaid loss reserves. Such deductibility is wasted on an §831(b) insurer's tax return. If a business can transfer both underwriting income and insurance reserves to a captive, the best of both worlds may involve forming two or more captives of different kinds.

Written by
Randall Beckie

Randall Beckie CPA, has provided tax consulting support to Anderson Kill's tax and captive insurance group practice and leads Frontrunner Captive Management.

Written by
Mike Smith

Mike Smith, CPA, PFS, is the San Diego, California-based business developer for Frontrunner Captive Management. Smith's career of 30 years has focused on providing high-net-worth clients with tax planning and wealth preservation solutions.

Managing multiple captives under the same roof necessitates operating them as efficiently as one standalone. Meanwhile, each among several such captives should operate with independence of purpose. With planning, captives can underwrite not just property/casualty but also health, life and annuity risks. The coverage types and premium volume influence the kind of insurance company that a captive may be.

Example A: A Fortune 500 captive that was taxable under §831(a) increased the insurance reserves 10-fold by underwriting off-balance-sheet liabilities of its operating affiliates. The new approach proceeded from the observation that GAAP-based reserve valuations in the parent's financial statements may understate potential ultimate liabilities. A captive can insure against the possibility that conventional actuarial methodology leaves downside volatility off the books.

Example B: A captive with a net underwriting loss for the year would have wasted the tax net operating loss because underwriting income was non-taxable under §831(b). Before year-end, the captive began writing group term life insurance on the lives of business owners and employees, the consequence of which was to characterise the captive as a life insurance company. This salvaged the tax net operating loss for utilisation going forward. Meanwhile, the owners took dividend distributions from the captive at half the tax rates as if they had taken bonuses as wage compensation.

Example C: A family-owned venture capital enterprise enabled minority shareholders (including the owner's children) to obtain tax exemption on investment income as well as underwriting income by structuring some of their captives as co-insurers that qualified for §501(c)(15). Under that provision, subject to various restrictions, up to $600,000 of an insurer's annual gross receipts can be tax-exempt.

Example D: 250 employees participate in their employer's health benefits plan. The employer's owners formed two captives: (1) an §831(b) property/casualty captive and (2) a captive with life insurance company tax status that insured long-term medical inflation risk. For that risk, the insurance reserves for that are greater than the premi-

ums, owing to conservative rules of actuarial methodology. Investment income restored the life insurance captive to profitability. Next, the small life insurance company deduction under §806 offset 60% of such income (limited to a deduction of $1.8m).

To know whether your captive insurance design is optimally advantageous for your circumstances, you would need to know whether the dealer could have given you a turbocharged package for around the same price as the base model. You should also want to know what makes the performance mods street legal, which is a matter of engineering.

Engineering

The detailed engineering of a captive insurance strategy balances ambitiousness of design against tax defensibility. Tax defensibility starts with showing how the captive serves risk management purposes. The ambition to expand a captive insurance arrangement leads to:

1. Pricing the insurance premiums as high as possible
2. Underwriting coverage types for which commercial insurance is not readily available. Novel coverage types may raise the question of what is insurance? We are active in requesting private letter rulings that probe the boundaries.

Arm's length premium pricing is a basic safety feature of a captive's tax defence. As the IRS knows better than many consulting actuaries do, captive insurance premium pricing is constrained by transfer pricing principles under tax code §482 and the regulations thereunder.

A transfer pricing methodology must conform to the 'best method'. In the context of insurance premiums, the best method boils down to evidencing a reasonably comparable uncontrolled transaction price. The tax regulations allow the taxpayer to choose the highest price within a range of reasonably comparable uncontrolled transaction prices. For safety's sake, the captive manager's job should include demonstrating the arm's length prices, which can be gathered from publicly available rate filing databases, insurance brokers, and commentaries.

Without this seatbelt on, an actuary can cook up premium prices that fatally expose the captive in case of collision with a tax examiner. Here is how it is done wrongly (true story, and all too common): The policyholder can afford to pay $400,000 of premium and $100,000 of contributed capital to his captive year one, hence the captive would be able to issue coverage limits of $500,000. The actuary selects three coverage types to fit the bill, including, say, cyber risk. Looking at industry-wide loss data, the actuary notes that the mean loss occurrence is $240,000 with an average frequency of six years, so the average annual expected loss is $40,000. It is presumed that this expected loss reflects a 50% actuarial confidence level. If the actuary increases the confidence level to 90%, the premium price would increase $40,000 to $133,333. Recycle similar assumptions for three coverage types, and you get a 75-page actuarial feasibility study report that justifies $400,000 of premiums.

The flawed result is that the premium is priced at 30% of coverage limit for a policyholder with a history of no such losses, whereas commercial insurers' rate filings indicate premiums priced at 3% of coverage limit. The actuary's selected price fails the arm's length test. The IRS is in the midst of investigating certain captive managers on grounds of abusive promoter practices. What the IRS may find is that the premium pricing by the independent consulting actuaries ran loose from the tax transfer pricing principles.

In our shop, selecting coverage types and premium prices is the underwriter's job. The actuary's job is to determine the confidence level of the captive's overall financial adequacy to carry the selected policies. We don't let premium pricing develop abstractly, we shine light on comparable prices that independent insurers actually charge. This way, the actuarial feasibility report serves as a tax transfer pricing study.

Some coverage types (e.g., financial guaranty risks) can be priced by reference to market prices for risk transfer in transactions that are not in the form of an insurance policy. The transfer pricing regulations accommodate this approach to benchmarking.

Sales & service

Part of what you pay for may include the labour to bring a captive solution to you. The tax savings from the captive is given to you by the tax law, which is a free public good. If a promoter asks you to pay for the tax value added, is that because the promoter is not in the primary business of providing professional consulting services? Professional services should follow an ethic of continually justifying the cost of the effort versus the benefit of the service.

The captive manager's team serving your captive should include a professional with underwriting or risk management experience who can enhance the non-tax advantages of having a captive. Accounting and administration come with the territory. Best practices call for the manager to field other multi-disciplinary talents.

Production scale

Efficient, cost-competitive captive management becomes possible after somebody else already paid for R&D, road testing, and the first time through. Ideally the design would have been proven in a highly scrutinised Fortune 500/Big 4 CPA firm environment before being implemented down market. This is how we have grown to be a leader in applied innovation for captives.

ACTUARIES KEY TO CAPTIVE FORMATION SUCCESS

Peter Johnson of Bartlett Actuarial Group explains the role of an actuary in captive formations

Written by
Peter Johnson

Peter Johnson is a consulting actuary for Bartlett Actuarial Group, Ltd., an independent property and casualty actuarial consulting firm providing services to clients in the alternative risk transfer market. The firm specialises in captive feasibility studies, captive programme formation, self-insurance programmes and actuarial certification of insurance reserves.

Captive Review (CR): When forming a captive, how does an actuary's responsibilities differ from that of a captive manager?

Peter Johnson (PJ): The captive manager is involved with managing the prospective insured's captive formation, from the beginning stages of selecting service providers and organising documents to the later stages of submitting the application and licensing requirements for the selected domicile.

Actuaries are service providers who are generally responsible for completing the feasibility study (included with the captive application). The feasibility study includes premium projections, the expected loss scenario, the adverse case loss scenario, limit/deductible/retention, confidence levels, and capitalisation requirements. Actuaries can also provide advice on various other aspects such as pooling/reinsurance arrangements, risk diversification, exposure and capital requirements.

CR: What are the key attributes for prospective captive owners to consider in order to operate a successful captive?

PJ: 1) Programmes with good loss experience and loss control prevention do better;

2) Ensure risks are diversified and appetite for risk is satisfied (i.e., is parent(s) comfortable with the retained level of risk);

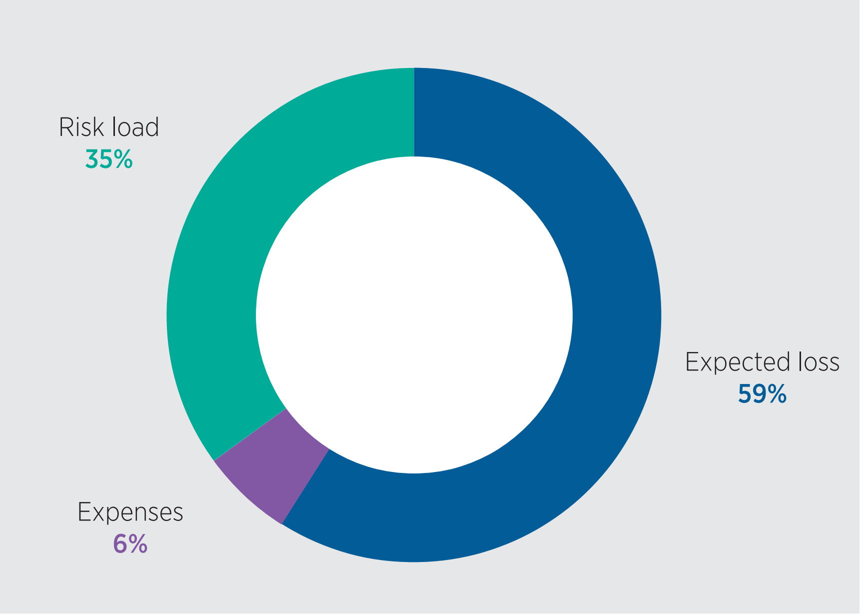
3) Fronting and reinsurance is used as needed;

4) Parent(s) is financially stable; and

5) Supported by knowledgeable and skilled service providers.

CR: What factors decide the recommendation of a special purpose captive or a pure captive structure?

PJ: One benefit of a special purpose captive is operating expenses are shared between the series business units (SBU). This allows multiple mid-sized parent companies to diversify their risk by each forming an SBU and sharing that risk under one captive. In addition to the potential operating cost savings for each parent, the parent's management team develops a better understanding of their risks and how to protect against unfavourable future loss outcomes.



A pure captive structure may be appropriate if a company is large enough and has appropriate diversification of risk. A key benefit is pure captives generally only assume risk from one insured thereby giving that insured more control over the captive's loss experience. A disadvantage of pure captives is operational expenses are typically higher than special purpose captives.

CR: Have your clients' questions regarding captives changed in the past year? Are you finding they are more educated about captive solutions?

PJ: Yes. Recently there has been more concern of premium excessiveness and questions around the adequacy of premiums for captives. Actuaries monitor the appropriateness of the level of premiums and respond to the actual experience of the captive as needed with increases or decreases in each captive's premium level. Increases may come with unfavourable loss experience or positive economic trends in the insurance market place. Premium decreases may come with positive loss experience and downtrends in the loss experience or premiums in the commercial market.

> "Actuaries monitor the appropriateness of the level of premiums and respond to the actual experience of the captive as needed with increases or decreases in each captive's premium level"

CR: Which lines of insurance are most commonly put through captives when they are first formed?

PJ: Standard property and casualty risks such as general liability, product liability, auto liability, workers' compensation, and professional liability are very common lines of insurance to include in a captive. Workers' compensation is typically included as a deductible reimbursement policy. We've also seen growing concern over the years for other risks now commonly underwritten into captives such as terrorism, warranty, cyber liability and other enterprise risk management risks.

CR: In general, what are an actuary's key considerations when establishing the appropriate premium for a captive's coverage?

PJ: In estimating premiums, an actuary must consider all the various costs associated with the coverage the captive provides. This is an expected value of future costs and includes all costs associated with the transfer of risk. These costs are comprised of the captive's expected loss associated with a fortuitous event, a risk load, and other expenses associated with running a captive (e.g., taxes, licences, management fees, actuarial fees, etc.). Note the risk load should be included in situations where a margin of protection is warranted (*see graph above*).

CR: How much is the rate of captive formations affected by a soft insurance market?

PJ: Premium excessiveness, narrow coverage and lack of insurance availability are three key reasons to form a captive. In a soft market when commercial market premiums are lower and greater availability of coverage exists, it may be less appealing for a parent company to pursue the formation of a captive.

HOW TO AVOID UNCERTAINTIES AND SURPRISES

Director of financial examination at DC's department of insurance, Sean O'Donnell, explains why an understanding of the long-term regulatory environment is vital for start-up owners and managers

When setting up a captive and choosing a domicile, many factors need to be considered. What are the capital requirements and flexibility of the captive laws? What about the experience of the captive regulators? What are the annual meeting requirements and how convenient is travel to the domicile? These factors are fairly easy to evaluate and while they are all important, it's also important for captive owners and organisers to look beyond these short-term domicile-selection factors and also focus on longer-term factors such as the processes for financial examinations, business plan changes and financial reporting. To avoid surprises after the initial 'licensing honeymoon', these long-term factors should be evaluated just as carefully as other factors to determine the long-term impact on operations and costs.

Written by
Sean O'Donnell

Sean O'Donnell is the director of financial examination in the Risk Finance Bureau at the District of Columbia Department of Insurance, Securities and Banking. O'Donnell's duties include reviewing licensing applications and business plan changes for DC captives, and overseeing the financial analysis and examinations of DC captives.

The financial exam varies by domicile

The financial examination process should not be overlooked when evaluating a domicile. To avoid surprises and frustrations after licensing, prospective captive owners and organisers should understand the financial exam process, including the frequency and estimated cost of exams. They should ask: when can the captive expect the first exam? How often are subsequent exams performed? Are there provisions for extensions or waivers for inactive companies or other types of companies? Will the captive unit or will another unit within the insurance department be performing the exam? Are contract examiners used? If yes, what is the process for selecting the contractors and determining the costs to be charged? To what extent does the domicile oversee and supervise the contractors? Does the domicile add additional fees above the contract examiner fees? What are the overall anticipated costs of exams and what controls are in place to ensure exams do not exceed estimates? All of these questions should be addressed up front, prior to licensing.

Some domiciles may conduct the first exam within the first few years and then every five years following the first exam. Some domiciles may have flexibility to waive exams or extend the exam period for certain types of captives. In cases where a domicile does not perform exams of certain captives at all, captive owners need to decide if this is desirable or not. But overall, captive owners should be aware of when to expect exams.

The District of Columbia process

The District of Columbia (DC) Department of Insurance, Securities and Banking (DISB) has licensed over 200 captives since 2001 and currently has 126 active captives representing all types including association (10), agency (5), branch (3), cell (32), RRG (37), pure (35) and rental (4). DC DISB outlines the financial exam process prior to licensing to ensure there are no surprises down the road. The DC captive law requires that exams be performed at least once every five years but for non-RRG captives this requirement can be extended if the captive is not writing any business or meets certain other requirements. And there may be limited situations where a captive may be examined prior to the five-year mark. All of these provisions are discussed up front with prospective captive owners.

DC recently amended its captive law to permit the commissioner to extend the five-year examination cycle if the captive has: (1) continuously filed unqualified audits; (2) sufficient surplus; and (3) it is in compliance with its business plan. The initial five-year exam will not be waived, and exams will not be permanently waived. Finally, all types of captives, except RRGs, are candidates for extensions.

Significant differences in efficiency and cost in financial exams can occur depending on how a domicile conducts financial exams. Direct supervision of the exams by employees of the captive unit results in efficiencies and the ability to best control costs. Less efficient and more costly exams can result when the exam function is largely delegated to persons that are not involved in the licensing and on-going regulation of the captives.

All DC captive financial exams are administered and directly supervised by employees of the Risk Finance Bureau (RFB), the unit within DC DISB that licenses and regulates captives. This process provides for maximum efficiency and control over the exam as the RFB employees are the same employees who participated in the licensing of the captive and who regulate it on a day to day basis.

While the RFB currently augments its examination staff with contract examiners, a process has been developed that results in efficient and cost-effective financial exams. Under this process, prospective contract examiners experienced in examining captives are invited to propose hourly budgets and maximum 'not-to-exceed' total costs to conduct exams in accordance with required exam procedures. Some domiciles tack on additional costs above the cost of the contract examiners but the RFB does not do this.

The captives are notified of the cost in advance of the exam and if no unusual or unexpected circumstances arise during the exam, the not-to-exceed cost proposed by the contract examiners is the maximum that may be billed to the captive. While not a frequent occurrence, if circumstances beyond the control of the contract examiners arise, the amount to be billed may be increased but only after careful review and approval by the RFB. Examples of where costs could be increased are situations where a lack of available documentation from the captive or from the captive's auditor results in the contract examiners having to do more work than initially contemplated.

This process enables the RFB to closely control the exam process and related costs, which are more difficult to predict and control if the contract examiners are not closely supervised or are able to charge the captives hourly fees rather than a capped total fee. The RFB further increases efficiency and controls costs by examining affiliated captives and cell structures at the same time using the same examination team. In addition, when possible, examinations are grouped together if the captives are managed by the same captive manager and the contract examiners are asked to propose on these groups of exams and to factor in a discount that is spread among all of the captives in the group.

Differences in the examination process can result in vastly different future costs to the captive. Captive owners and organizers need to ensure they are familiar with the process and the potential impact on the captive. Under the RFB's process, exam costs for DC captives in recent years have ranged from below $5,000 per cell for cell structures, as low as $8,000 for pure captives, and from $28,000 up to $45,000 for risk retention groups (RRGs), which can vary widely in cost due to size and complexity. A few risk retention groups with unique or unusual issues have exceeded $60,000 but this is not typical for most RRGs.

Business plan changes and reporting

Another factor to consider is the domicile's process for business plan changes. While not having the same potential direct cost impact on a captive as exam fees, vague information and guidelines regarding the business plan change process and requirements can lead to inefficiencies and delays in the review and approval process, and can lead to inconsistent treatment of otherwise similar business plan change requests. In addition, the domicile's review and approval process can be delayed if the changes are subject to a second level of review and approval outside of the captive unit, such as by the domicile's legal office.

To help DC captives navigate the business plan change process, the RFB has developed detailed guidelines outlining the most common types of business plan changes and when notification only, prior approval, revised financial projections, or other information is required. Furthermore, all requests for business plan changes are reviewed entirely within the RFB, which is separate from other units within the DC DISB. Requests are reviewed by the persons who helped license the captive and who regulate it on a day-to-day basis. Review and approval by persons outside of the RFB is not required. Many business plan changes, including requests for dividends, are reviewed and approved the same day received.

> "A lack of clear guidelines could lead to uncertainty and inefficiencies… For example, are separate stand-alone financial statements and audits required from cells, or are combined statements and audits allowed?"

Similar to the business plan change process, the financial reporting process, especially for cell captives and other types of companies such as branches should be clearly outlined by the domicile. A lack of clear guidelines could lead to uncertainty and inefficiencies when a captive must first file its financial reports. For example, are separate stand-alone financial statements and audits required from cells, or are combined statements and audits allowed? In DC, the RFB annually distributes detailed reporting guidelines, including requirements for cell and branch reporting.

Conclusion

By obtaining information up front about financial examinations, business plan changes and financial reporting, these factors will be better understood and more predictable, allowing prospective captive owners and organisers to better evaluate the potential long-term impacts on the captive. The RFB understands the importance of these factors.

FINDING YOUR PERFECT MATCH

Wesley Deaton of The Deaton Law Firm, PLLC, outlines the difference between pure and protected cell captives, and what factors should influence your choice

Written by
Wesley Deaton

Wesley Deaton is the member and manager of The Deaton Law Firm, PLLC, a boutique business law firm in North Carolina, United States. He is licensed to practice in North Carolina and New York. A large portion of his practice involves the formation of captive insurers, including pure and protected cell captives.

Captive Review (CR): What is the difference between cell or pure in terms of the regulatory requirements?
Wesley Deaton (WD): A pure captive insurance company is a standalone insurer, which individually must meet all of the statutory requirements of its formative jurisdiction. A cell, however, is part of a larger structure called a protected cell company. Often, the regulatory requirements of a protected cell are lesser than for a pure captive insurer, because the cell is part of a larger collective vehicle that is regulated.

CR: Could you explain the structure of a protected cell company?
WD: Picture a wheel that has a hub and spokes. The protected cell company is the hub, and the cells lie between the spokes. Each cell is a separate risk-holding vehicle, whereas the protected cell company itself handles much of the day to day regulatory requirements (and possibly management) of each cell.

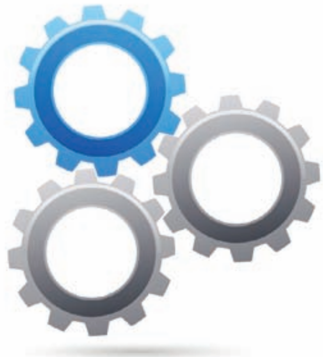
In jurisdictions which allow protected cell companies, two different types of cells are often created: simple protected cells, and also incorporated cells. A simple protected cell is usually not viewed as a standalone entity, though sometimes jurisdictions will give a protected cell limited rights to contract and even to disassociate from the protected cell company. By contrast, incorporated cells are separate and distinct legal entities, and in many jurisdictions must meet the standard requirements of a pure captive. Typically, an incorporated cell has more rights to act independently of the protected cell company, but also has to meet higher regulatory requirements than a protected cell.

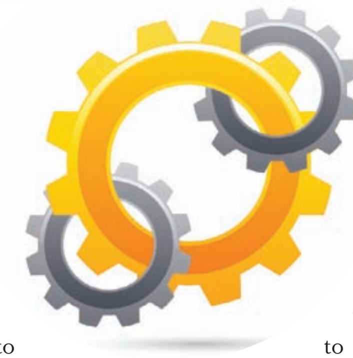
CR: What factors would make a cell more appealing than a pure captive?
WD: Let me first state that each client's situation is different, and so what makes the best captive for any particular client will depend on the given circumstances. That said, there are a few *potential* benefits to using a protected cell or incorporated cell rather than a pure captive, but the main benefits boil down to ease of use, and potentially lower costs.

When the client utilises a protected or incorporated cell, the cell is part of a larger structure that is called the protected cell company. The client may be termed a 'participant' in the protected cell company in some jurisdictions. With a pure captive insurer, the client will incur all of the costs of the captive: legal, actuarial, management, etc. With a protected cell company, the cell usually shares some of these costs with other cells within the protected cell company.

Therefore, there are some cost efficiencies that may be gained by use of a cell versus a pure captive insurer. Similarly, in some circumstances (and depending upon the jurisdiction), the capital requirements

"Each client's situation is different, and so what makes the best captive for any particular client will depend on the given circumstances… there are a few *potential* benefits to using a protected cell rather than a pure captive"





for cells may be lower than the capital requirements for pure captives.

CR: **The PCC market has exploded in the past 12 months. Why is that and will it continue?**

WD: The captive managers and investment advisors with whom I work like the efficiencies offered and the ease of use of protected cell companies. A client with captive insurance needs can often create and maintain a cell at a lower price point than if it were incorporating a pure captive. Therefore, when performing a cost-benefit analysis of whether a captive is worth creating, there are times when a client could justify creating a cell in which it would not yet be worth creating a full-blown pure captive.

CR: **How difficult is it to turn a cell into a pure captive and when would be the right time to do so?**

WD: That answer depends in part upon the type of cell created, and of course is subject to the jurisdiction's laws. In general, an incorporated cell will be easier to convert into a pure captive than a protected cell because it is already closer in structure to a pure captive insurer. To use North Carolina as an example, because the incorporated cell already must meet the legal requirements of a pure captive insurer, the cell would only need to disassociate from the protected cell company and obtain approval from the Department of Insurance to then operate as a pure captive.

However, in North Carolina, legislation is being considered that would also give the holder of a protected cell the right, upon regulatory approval, to disassociate from its protected cell company and to convert into a fully-incorporated pure captive insurer. In general, though, a cell can be seen as a nice middle ground for a new captive client. It may be all the client ever needs, but if the client ever needs a pure captive, the conversion process will usually be simpler than incorporating a pure captive from the ground up. The "right time" to convert depends on the needs of a specific client. In simplest terms, it would be when the client believes that the benefit of having more direct control of running the pure captive outweighs the potential cost savings and efficiencies of remaining part of a protected cell company.

CR: **Some jurisdictions don't cover cell captives. Are they limiting themselves by not doing so?**

WD: Definitely. Protected cell companies give captive clients a vehicle by which they can enter into captive business at potentially lower cost and less administrative overhead. Protected cell captive statutes create additional vehicles for potential captive clients and offer enormous flexibility.

"In general, an incorporated cell will be easier to convert into a pure captive than a protected cell because it is already closer in structure to a pure captive insurer"

CAPTIVES TAXATION LANDSCAPE TO CONTINUE SHIFTING

Paul Phillips, Stephen Baker and Abbie Foreman of EY outline the pitfalls and challenges currently facing captive managers

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Paul H. Phillips III is a tax partner, financial services (US), focused on US Federal income tax matters. Phillips has over 20 years of experience serving the captive market as a business tax advisor and oversees EY's Captive Services team.

Written by
Stephen Baker

Stephen Baker is a senior manager, financial services (US), focusing on the international and federal income taxation of insurance transactions and restructuring. Baker has 18 years of experience in the insurance industry (both in-house and consulting) and is an active member of EY Captive Services team.

Written by
Abbie Foreman

Abbie Foreman is a tax manager, Financial Services (US), specialising in state and local tax issues for insurance companies. Foreman has over eight years of experience and serves as a state and local tax subject matter advisor to EY's Captive Services team.

When starting a new captive, or even evaluating an existing structure, it is critical to recognise the shifting landscape with regard to tax matters. While taxation should not drive the decision to form a captive, recognition of the potential pitfalls and successfully navigating the rules and regulations are essential in properly structuring any arrangement in an efficient manner.

With regard to US Federal taxation and qualification as an insurance company under the Internal Revenue Code, 2014 was a good year, as the industry obtained clarification through the US Tax Court and a favourable revenue ruling from the Internal Revenue Service (Service or IRS). However, the IRS has also stated they will examine possible abuses in areas of the captive market, thus it is best to proceed with caution.

Also, while various US states have made it easier to obtain licences and operate within their state, they have also taken a hard look at indirect tax matters, with certain states passing laws intended to clamp down on procurement of insurance through unlicensed carriers. Accordingly, someone exploring captives must be aware of the possible traps with regard to indirect taxes, as they could completely offset any efficiencies gained on the Income Tax front.

As stated, 2014 found taxpayers receiving both favourable rulings and increased guidance. In Rent-A-Center, Inc. v. Commissioner, 142 TC 1 (2014) and Securitas v. Commissioner, TC Memo 2014-225, the Tax Court upheld the deduction for premiums paid in a brother—sister insurance arrangement.

While each case had various determinations made in the taxpayers' favour, the most critical determination involved the concept of risk distribution. In both cases, the Tax Court did not follow the Service's view as articulated in prior Revenue Rulings regarding risk shifting and risk distribution; however, in neither case did the US Government file an appeal.

Specifically, the Tax Court emphasised that risk distribution is viewed from the insurer's perspective and that as a result of the pooling of a large number of statistically independent risk exposures, risk distribution is achieved. These two cases challenge the IRS' interpretation of risk distribution as published in Revenue Rulings 2002-90 and 2005-40. This is an interesting and important shift, as for many years, the captive market has been focused on the safe harbour provisions of Revenue Rulings 2002-89, 2002-90 and 2002-91.

Risk distribution was also the highlighted discussion of the taxpayer favourable Revenue Ruling 2014-15 (May 8, 2014), wherein the IRS has addressed the long-standing question of whether the entity or the individuals are the insured risk. In this situation, a domestic corporation provided benefits to retired employees and their families through a Voluntary Employee Beneficiary Association (VEBA).

The VEBA insured those risks to an unrelated insurance company that then reinsured those same liabilities to a captive of the domestic corporation. In this ruling, the Service noted that the risks from the VEBA are distributed among a large number of covered individuals and did not focus on there being a single VEBA plan. In two taxpayer-favourable private letter rulings (201428006 and 201419007), the service discussed the nature of risk-shifting and risk-distribution.

The service concluded that where a retailer obtained product service contract insurance from an insurance company and the insurance company further ceded a portion of that risk to a captive of the retailer, the transaction qualified as insurance and the captive qualified as an insurance company. 2014 also found a push for increased scrutiny as well as increased guidance.

Senate Finance Committee Chair Ron Wyden urged, and continues to urge, the Service to challenge hedge fund backed insurance companies. In 2003, the service also indicated potential scrutiny of hedge fund backed insurers and again the environment is one of scrutiny.

Opponents of the structure argue that it allows investors to defer taxable income build-up until the sale of an investment at long-term capital gain tax rates.

So far, 2015 has seen indications of increased focus on the captive insurance industry. On 3 February, 2015, the Service issued IR 2015-19 identifying the 'Dirty Dozen' tax scams and abusive tax schemes on its radar. Compiled annually, the 'Dirty Dozen' lists a variety of common scams that taxpayers may encounter at any time, but many of which peak during filing season as people prepare their returns or hire people to help with their taxes.

The list included the use of small or micro captive insurance companies, wherein the insured claims deductions for premiums paid to a captive owned by either the insured, the same owners of the insured or family members of the insured. The captive then elects under Internal Revenue Code Section 831(b) to only be taxed on investment income. This election is currently only available for insurance companies with net written premiums (or direct written premiums, if greater) that do not exceed $1.2m per year; accordingly, a captive insuring low frequency catastrophic risk and no claims experience may effectively shelter taxable income up to $1.2m per year.

Determination of abuse will depend highly on facts and circumstances. The Service noted a focus on the promoters of these captives, and not just the captives themselves. The Service released its Priority Guidance Plan on 30 January, 2015, including guidance relating to captive insurance companies within the priority list.

In shifting the focus to possible pitfalls in the indirect tax space, the journey to the 'recent' developments actually started in 2010. As part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), the Non-admitted and Reinsurance Reform (NRRA) provisions were passed into law in July 2010 (effective 21 July, 2011) as an attempt to simplify compliance for insureds by limiting the taxation and regulatory authority over non-admitted insurance to the 'home state' of the insured.

> "Despite the backlash Illinois received for its self-procurement tax bill, there is great concern within the industry about whether more states will jump on this bandwagon"

This allowed the home state to collect premium tax on surplus lines policies. While arguably it was never the intent of the legislation to apply to captive insurance companies, certain states, most notably Texas and Illinois, have used the NRRA as a foundation to pass laws as a means of generating additional revenues by imposing a premium tax on insureds that purchase insurance from captive companies.

Despite the backlash Illinois received for its self-procurement tax bill, which was effective 1 January, 2015, there is great concern within the industry about whether more states will jump on this bandwagon. It is also noted that Illinois now has two proposed bills to be introduced that would repeal the self-procurement tax.

Another issue that has been emerging over the past few years stems from the movement of a number of states that require combined/consolidated unitary groups to include captive affiliates in the state tax filing group.

As captive insurance companies are often not subject to a tax on premiums written, the question of whether or not the captive is exempt from corporate income tax through the 'in lieu' provisions in some states comes into play. Many states have begun to challenge this theory and it is anticipated that this will continue to be a hot topic as captive taxation continues to be scrutinised as states search for other avenues to raise revenue.

Last, but not least, multinational operations should note the developments stemming from the Organisation for Economic Co-operation and Development (OECD) and their Base Erosion and Profit Shifting (Beps) project. In December, the OECD released Beps Action Four, which focuses on limiting base erosion via interest deductions and other financial payments.

Action Four could result in the adoption by various jurisdictions of domestic law provisions extending beyond conventional debt servicing costs to include reinsurance generally and captive insurance payments in particular. The OECD has also issued actions around transfer pricing, with other actions still pending, thus, as this is often an area of focus with regard to IRS examinations and other audits performed by foreign taxing authorities, taxpayers exploring multinational captives need to consider the contemporaneous documentation requirements of transfer pricing.

In summary, things are constantly changing and when sorting through the details, it may seem like impossible terrain to travel down. However, despite the new pitfalls, the path to qualification as an insurance company is actually clearer than before, with better clarity for traditional captives (i.e., the captive arrangements involving the centralisation of property and casualty type risk into an entity expecting qualification as an insurance company taxable under Subchapter L, Part II, Section 831(a) of the Internal Revenue Code).

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TAX CLINIC FOR OFFSHORE CAPTIVE INSURANCE FIRMS

Tim Min of BDO Advisors SEZC explains the implications of various tax elections for offshore and onshore captives

Twenty-fifteen is shaping up to be quite a year. From the implementation of Fatca to seeing an increased scrutiny of Sec. 953(d) elections, the captive insurance industry has been inundated with increased tax compliance burden in recent months. One example of this increased burden is Fatca compliance for specified insurance companies or requests to produce a Form W-8BEN-E, only to be explained later that it is either a non-financial foreign entity or a so-called Internal Revenue Code Sec. 953(d) company.

To help navigate the challenges ahead, BDO would like highlight certain tax issues to prepare for any challenges that might be encountered by captive owners and service providers.

Internal Revenue Code Section 953(d) Election

Recently, we have noticed a significant increase in IRS scrutiny of new and existing Sec. 953(d) elections. We believe the IRS is making a general effort, rather than focusing on a specific jurisdiction or size of captive. If you are selected for review, it would seem that it is just a random 'luck of the draw'. Those of you who make your own luck may want to focus on this area and tidy up any potential loose ends.

In general, when offshore insurance companies desire to be treated as a US taxpayer, the Internal Revenue Code Sec. 953(d) election allows such companies to elect to file US tax returns and pay US income taxes. However, the IRS requires a certain asset as security for taxes in the form of either a Letter of Credit (LOC) or pledging US assets and declaring US office.

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We have observed that the majority of captives opted for the LOC option when making the Sec. 953(d) election two to three years ago, whereas the majority of captives are now opting for the US assets and office option when filing. Further, we have observed a number of captives amending their elections from being LOC-backed to applying the US assets and office test.

The increased IRS scrutiny is likely to be a response to the number of captives wanting to use US assets and office on the original or amended Sec.953(d) election. The risk appears to be greater for those opting for the US asset and office test.

Prospective new Sec. 953(d) elections should be prepared with greater care than in previous years. Some of the IRS notices and scrutiny came about because the LOC or US asset and office test computations used erroneous annualizing factors. We have seen that certain captives have been denied because the annualisation factor used understated the required US assets held.

Special care should be taken by those captives intending to elect the Internal Revenue Code Sec. 831(b) election. The Sec. 831(b) election is available for certain smaller insurance companies who want to be taxed on investment income only, rather than the traditional net income which includes underwriting, investment Income, and other forms of income. In cases where the captive intends to elect the Sec. 831(b), the annualisation of premiums written for the purposes of the LOC or US asset and office test must still be done correctly.

Captives should also consider their options in terms of when to make the election. Sec. 953(d) may be elected anytime from incorporation to the extended due date of the initial US federal income tax return filing. When making an election using estimated or projected figures, it is important to ensure that the actual amounts do not materially differ from the election disclosure. Should the actual figures be materially different, the captive may underestimate the amount of the US assets to be held.

Most importantly, captives should only use assets to the extent of any potential claim by the US government with respect to the assets, which may arise from the failure of the corporation to pay any tax imposed

by the Internal Revenue code. Any such claim by the US government is not subordinated to the claims of any other creditor.

We have observed many instances where the IRS have requested verification of the US assets and office addresses. Usually, such notices are for new applicants but we would not be surprised if the IRS begins to extend this type of inquiry for those requesting amended Sec. 953(d) elections from LOC to US assets and office test basis.

Captives should also ensure that the stipulated conditions reported under the Sec. 953(d) election are met on at least an annual basis. Generally, if the captive's gross income is more than 120% of the gross income of its initial year of operation, the captive must re-compute the required new LOC or US assets needed to satisfy the increased level of gross income. Such year would then become the new 'base year' for all subsequent years' requirements.

Continuing with the issue for those captives which elect to use a US affiliate's assets, we also recommend that the captive be vigilant to make sure the change in gross income also corresponds with the increased US assets available to meet the Sec. 953(d) election.

Finally, there are compulsory requirements that are not just a matter of making sure there are enough assets to support the Sec. 953(d). Revenue Ruling 2003-47 provides guidance in making the Sec. 953(d) election. Within the Revenue Ruling, the IRS specifically states that the captive must make timely filing of the US income tax returns and must pay any US taxes due, including estimated taxes, by the required deadlines. This might seem quite basic and obvious but failure to meet any of the stated requirements could risk denial of the Sec. 953(d) election.

Miscellaneous Issue of the Day

We have been asked on many occasions for tax advice in relation to handling passive foreign investment company (PFIC) investments by certain captives. A PFIC is defined to be any foreign corporation that meets the so-called income test or the asset test with respect to the investor. Pursuant to IRC Sec. 1297(a), a foreign corporation is a PFIC if: (1) '75% or more of the gross income of such corporation for the taxable year is passive income, or (2) the average percentage of assets (…) held by such corporation during the taxable year which produce passive income or which are held for the production of passive income is at least 50%'.

US federal tax law generally taxes income from PFICs either on an annual income inclusion basis, or a deferral basis, subject to certain 'deemed tax and interest methodology'. We believe US taxpayers will find current inclusion the annual income inclusion basis to be more tax advantageous. To use the annual income inclusion, the investor must either obtain Sec. 1295 PFIC Annual Statement or make sure the investor is able to make the Sec. 1296 election to mark-to-market the PFIC. Otherwise, the investor may only be left with the deferral basis, which may impose onerous deemed tax and interest charges.

Care should be therefore taken when investing in a PFIC as there are increased tax compliance costs.

The discussion above has briefly touched on a few of the potential US tax issues which are faced by both existing and new, start-up captive insurance companies.

It is highly advisable to examine these (and several other) potential issues during the planning stage of any new captive's existence and not to take the position that any errors made during these early stages can just be corrected at a later date, as this is often not the case – at least not without substantial cost and effort. Your trusted tax advisor should be equipped to walk you through each of these matters and to lay out the various options for you.

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CAPTIVE FORMATION: THE ROAD TO SUCCESSFUL RISK MANAGEMENT

Hartley Hartman, of Johnson Lambert, talks to *Captive Review* about where to start in the captive formation process

After a plethora of brain storming sessions you decide that the most efficient and cost effective way to insure your select business risks is to form a captive. Now what?

The first step towards captive formation will be to choose various knowledgeable providers such as captive managers, actuaries, legal counsel and tax advisors to help you on the road to a successful formation. This process can essentially be broken down into four distinct phases: conducting a feasibility study, choosing a domicile that best suits your needs, completing a captive application and implementation. For the purposes of this analysis we will take an in-depth look at the formation steps of a 'pure captive', where the captive insures the risks of one group of related entities. There will, however, be slight differences in this process depending on the type of captive to be established.

Captive law in most domiciles requires that the applicant submit a captive feasibility study as a component of their application. The goal of a feasibility study is to determine whether or not the risk financing and risk management program of your organisation is, in fact, a viable option with a legitimate business purpose. The scope of a captive feasibility study can take many different shapes, however, for the purpose of forming a captive this study should contain at a bare minimum an actuarial analysis and

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an operational and financial evaluation of the captive. These are the two areas that regulators of each captive domicile will analyse when determining whether or not to accept a captive application.

The actuarial analysis portion of the study usually include loss projections at three scenarios: projected, optimistic and pessimistic. The base of the projections may be different depending on the availability of your historical data. You may not have sufficient loss data or are unable to obtain this information from your past insurance carriers. In these instances the actuary may mix historical data with industry data or just rely on industry data. The actuary can also assist you in determining the premium pricing for the proposed insurance risks to be covered under the captive.

The second component of this feasibility study will focus on an evaluation of the proposed financial projections and operations of the pending captive. Regulators will pay close attention to this part of the feasibility study. This portion of the study will most likely be conducted by a captive manager, as they are in the business of administering captives on a day-to-day basis and are highly qualified to assist with this type of report. This evaluation will help determine how a captive can best manage its potential risk, however, it is imperative during this process that 'real' insurance risks are identified as being insured by the captive as there could be potential tax implications if the captive does not qualify as an insurance company.

The end result of the financial and operational evaluation of the feasibility study would produce an initial captive business plan, which would include a schedule of the anticipated insureds and type of coverage to be provided, program philosophy and pro-forma financial statements. A well-executed feasibility study will provide the framework for a successful captive business plan and will validate the benefits of foregoing the commercial insurance market to assume business risks within a self-funded captive.

The selection of a domicile for your captive should be conducted concurrently with your feasibility study, as there may be particular sections of the study that may need to be fine-tuned for the domicile of your choosing. In determining the domicile that best fits your captive you must first establish the overarching goal of your captive and then determine which domicile will help

you best meet that goal. There are five focal points that most owners consider when choosing between domiciles: regulation, infrastructure, reputation, logistics and tax.

Regulation

The regulations of the chosen domicile should be recognised and understood by all parties involved with the captive (parent, insurers, and reinsurers). There are differences in capitalisation, premium taxes, investment restrictions, annual compliance and reporting requirements amongst various domiciles which will play a role in determining which domicile is more suited for your particular captive.

Infrastructure

It is crucial to select a domicile that has a well-established infrastructure that will support the functionality of a captive. This includes an abundance of qualified service providers and a regulatory body that is adequately trained in captive management. Choosing a domicile with proven infrastructure can lead to a shorter response time when submitting business plan changes and various other submissions as there is less of a need to educate regulators on the specifics of your captive.

Reputation

The reputation of your potential domicile is another important factor to consider. There are some domiciles that have established a reputation for being particularly attractive to certain types of captives or industries and others that shy away from certain types of captives. Choosing a domicile that specialises in the type of captive seeking to be formed is highly beneficial for its growth and success. One distinct advantage that a reputable domicile can provide is the tendency to obtain more favourable rates from reinsurers.

Logistics

Most captive regulation require an annual meeting to be held within the selected domicile. Ease of travel plays a crucial role in selecting the proper domicile. There tends be greater interaction with senior management of the captive when the domicile is in closer proximity to the parent company. Although logistics is an important factor to consider, the overall infrastructure and knowledge of regulators and service providers should be of a higher concern as those factors will contribute to the success of the captive, whereas, logistics is more-or-less a commodity.

Tax

Tax compliance is a general concern when choosing a captive domicile. The choice of onshore or offshore domicile is heavily dependent on the physical location of the business risk the captive will be insuring.

For example, a US captive may be subject to various federal excise and local taxes on premium paid to non-US insurance companies. As such, captives that insure both US and international risk who are domiciled outside of the United States will often file a 953(d) election, which will allow them to be taxed as a US company for federal income tax purposes; minimising the perception that the offshore domicile was chosen as a form of tax evasion.

Premium taxes typically vary from domicile to domicile and are taxed at a much lower rate than premiums paid to traditional insurers.

Now that the most sensible domicile has been selected to meet the needs of your captive and the feasibility study has been completed, the captive application is ready to be submitted to the regulators of the selected domicile. Application requirements also vary from domicile to domicile, but will typically include:

- Application for admission (Certificate of Authority)
- Business plan outline
- Biographical affidavits for all directors and officers
- Listing of all authorised service providers
- Corporate documents (draft)
- Articles of Incorporation
- Bylaws
- Organisational chart
- Minimum capital and surplus guidelines
- Proforma financial projections
- Actuarial feasibility study
- Financial statements of parent company
- Insurance policies to be written and process documentation

The planning and formation phases of captive development can be involved and surrounding yourself with knowledge service providers will ease the process. As the industry advances the number of captive domiciles continues to grow as the captive marketplace is becoming more and more commonplace.

The creation of a captive insurance company is not always a reality, as evidenced by a pre-formation feasibility study, but can provide substantial risk management and tax benefits to those who are successfully able to obtain licensure.

FEDERAL HOME LOAN BANKS

Maria Sheffield gives context to the concept of the insurance market and explains how captive insurance companies are a product of their past

Before the Great Depression of the 1930s, housing finance was exclusively the realm of the private sector, which generally consisted of short-term renewable loans. The features of these loans, including high down payments (roughly 60% of the home's purchase price), short maturities (10 years or less), and large balloon payments, presented significant challenges to widespread home ownership. The primary source of mortgage funding came from life insurers, commercial banks and thrifts. In the absence of a nationwide housing finance market, availability and pricing for mortgage loans varied widely across the country.

When the Great Depression hit, it devastated the entire US economy including the housing market. By 1932, the unemployment rate had risen to nearly 34% and the federal government began its response to the housing crisis this same year when the government estimated that 20%-25% of the nation's home mortgage debt was in default. This was the year congress enacted the Federal Home Loan Bank Act (the Bank Act).

The Bank Act created the FHLBank System, which is a government sponsored enterprise (GSE) and the Federal Home Loan Bank Board (FHLBank Board) as its regulator. The intention was to provide a reserve system to support housing finance that would bring relief to troubled homeowners and lending institutions. It established 12 regional Federal Home Loan Banks (FHLBs) supervised by the FHLBank Board. It also provided authority to borrow up to $215m from the US Treasury and for the newly created FHLBs to issue tax-free bonds as a source of loan funds (known as "advances") for the benefit of member institutions. Since conception, the capital stock of the regional banks was to be owned by member institutions, each of which was required to purchase stock. While 12 regional banks

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were authorised, only five regional banks were organised before the end of 1932.

The 12 FHLBs that exist today borrow funds in debt markets and provide their members low-cost, long- and short-term advances, which members use to fund mortgage loans and maintain liquidity for their operations. Advances are primarily collateralised by residential mortgage loans and government and agency securities. Advances are priced at a small spread over comparable Treasury obligations. Each regional FHLB is federally chartered but privately capitalised and independently managed within the framework of the Federal Housing Finance Agency (FHFA). Each FHLB has its own elected board of directors, comprised of member and independent (non-member) directors. Each FHLB is capitalised by the capital-stock investments of its members and its retained earnings. Members buy stock in proportion to their borrowings from the FHLB, their holdings of mortgages and mortgage securities, and their assets.

Institutions eligible for FHLB membership include savings banks, savings and loan associations, cooperative banks, commercial banks, credit unions, and insurance companies that are active in housing finance. The 12 FHLBs have more than 7,500 member financial institutions. The FHLBs aim to serve as a reliable source of liquidity for their member institutions in support of members' residential-mortgage and economic-development lending activities. Funds provided by the FHLBs offer a stable source of support for mortgages and community lending. Without the FHLBs, most member institutions would not have access to medium- and long-term sources of funding. By supporting financial related institutions, the FHLBs strive to strengthen communities and benefit consumers by helping to ensure competition in the housing-finance market.

Captive insurance company moratorium

In June 2014 the FHLBs jointly agreed to a three-month moratorium on admitting captive insurers, which are being used by mortgage investors to access the government-chartered system. This was a surprising move as the Bank Act has permitted all insurance companies – without qualification – to be eligible for membership in the FHLBs for over 84 years. In fact, US insurance firms were one of the original eligible members of the FHLB system in the 1930s when the statute was passed, which has no doubt served to compound the captive industry's feeling of persecution following the announcement of the moratorium.

To be clear the Bank Act reads: 'Any… insurance company…shall be eligible to become a member of an FHLB if certain requirements are satisfied, including that the firm 'is subject to inspection and regulation under the banking laws, or under similar laws, of the State…' (emphasis added.) While neither the Bank Act nor its legislative history defines the term 'insurance company,' the term is defined elsewhere in federal law – in language that is not limiting.

The 1940 Investment Company Act defines an insurance company generally as a firm which is organised as an insurance company, writing insurance or reinsuring risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a state. That definition reads the same as the definition of the term in the Securities Act of 1933 – a law enacted just a year after the Bank Act became law. Consequently, at the time Congress decided to permit insurance companies to be members of the banks, the term 'insurance company' was familiar to the legislators, and there is no indication Congress wanted to limit the meaning of the term.

The Department of the Treasury defines 'insurance company' as 'any person engaged within the United States as a business in the issuing or underwriting of any covered product' (various types of insurance and annuity contracts). And *Black's Law Dictionary* defines an insurance company as 'a corporation or association that issues insurance policies'.

There is nothing in the Bank Act or any interpretations that give the FHFA authority to define insurance company to mean anything other than the meaning that was generally accepted when the FHFA became law: a firm that engages in the business of insuring or reinsuring risk. Clearly a captive insurance company meets the definition of an insurance company. Since 1994, financial institutions such as Wells Fargo and JP Morgan Chase have gained access to the federal home banks through the use of captives.

In September 2014, three months after the initial moratorium, the FHFA issued a membership proposal for a 60-day comment period. The proposal would require many banks, thrifts, credit unions and insurance companies to hold 10% of their assets in the form of mortgages in order to maintain their FHLB membership. Smaller institutions with less than $1bn of assets would have to maintain at least 1% of their assets in mortgages. Captive insurers would no longer be granted membership, although those that are currently members could stay for five years – with restrictions on borrowing. Following issuance, the FHFA extended the public comment period on its far-reaching proposal to tighten the FHLB membership rules until 12 January 2015. By the close of the comment period in January, more than 1,300 comments had been received.

Real estate investment trusts (REITs) responded to the proposal by saying their firms match the FHLBs' mission of supporting real estate and they don't present unusual risks, partly because their borrowing is backed by collateral.

For their part, a majority of the FHLBs tend to support the membership of captive insurance companies. David Jeffers, executive vice president of policy and public affairs at the Council of Federal Home Loan Banks, has indicated the proposed standards will do more harm than good. Jeffers has been quoted as saying: "For 25 years Congress has made clear the purpose of FHLBs and our purpose is to maintain a safe and secure model and to provide liquidity to a broad spectrum of business for broad use. This goes much further; we see this as an anti-liquidity and anti-housing regulation, and a threat to the fundamental purpose of home loan banks."

The president and CEO of the Chicago FHLB has publicly stated: "These actions will likely lead to smaller FHLBs with fewer assets, reduced profits, lower retained earnings, and a decreased market value of equity and capital stock. As a result, less money will be available to support the FHLB's economic development programmes."

An uncertain future

The FHFA has provided no indication as to whether or not it will continue its quest to change the current membership requirements of the FHLBs. While the FHLBs supported the three-month moratorium, given the continued lack of guidance from the FHFA and the overwhelming negative response to the proposed rules, many of the banks have started to once again process membership applications of captive insurance companies. And while the moratorium certainly dampened the receipt of applications from companies wishing to access the FHLB, momentum is once again increasing.

One key difference in the FHLB membership applications being processed is the inclusion of an acknowledgement regarding the pending FHFA membership rules related to captives. While current captive insurer members could retain membership for five years if the FHFA's proposal is enacted, those admitted since it was released would be kicked out if the rule is 'adopted as proposed', according to the FHFA's plan. Therefore, any new member is being made fully aware of the potential impact of the rule, and as I understand it, is being asked to sign a form acknowledging the same.

A majority of the parents of captives ultimately seeking membership in a FHLB are REITs but this is certainly not always the case. Captives formed by REITs or any other company that wishes to access a FHLB, function similarly to any other licensed captive and often have a variety of lines of coverage in their captive. Generally, property and liability coverages are included, as well as TRIPPA coverage. The most common liability coverages are errors and omissions and directors and officers. Like all other captives, the captives accessing the FHLBs range in size with some captives writing more than $10m of premium.

Regardless of the FHFA's intent to exclude captives, the fact remains: captive insurance companies are insurance companies. They are subject to the same regulatory bodies and oversight as other insurance companies including regulatory requirements for supervision, conservation, rehabilitation, receivership and liquidation. Additionally, the ability of a captive to either lend money or pay dividends to affiliated organisations is tightly regulated and generally requires prior review and written approval from the state insurance commissioner. In short, captive insurance companies, regardless of whether or not they are members of an FHLB, are regulated consistently. On the part of the FHLBs, all FHLB exposures are well collateralised and the insurance members, including captives, just like depository members, are subject to overall credit limits and periodic financial reviews.

The importance of captives, and REITs, in promoting the FHLB's housing finance mission has been recently highlighted by the US Treasury Department. Michael Stegman, an adviser to Treasury Secretary Jack Lew, has pointed out that while advances made to captive members pose "potential incremental risks to the FHLB System", the activities of REITs in providing an important source of private capital for the housing market appear to be aligned with the housing finance mission of the FHLBs.

It seems that the FHLBs tend to agree that the FHFA proposal is unnecessary and is not in line with Congress's preference toward an expansive view of the FHLB's reach and mission. The disruptive and unintended consequences to FHLB members, the FHLBs and the US financial system far outweigh any perceived benefits that might be achieved. Captives accessing the FHLB system can actually help expand mortgage credit to individuals and businesses and further serve a vital purpose, supporting home mortgage lending at a time when the home-loan financing model is facing difficulties. We hope the FHFA recognises the value that membership of captive insurance companies brings to the FHLB system.

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Missouri's business friendly climate and prime location as the most centrally located captive domicile in the U.S. have driven our rapid rise to a $6.5 billion-dollar industry. Our law allows for most popular formation types without the need for extended travel and wasted time. Our dedicated team ensures the licensing and ongoing regulatory process is efficient and effective. We approach each captive individually to allow for innovation and success.

www.captive.tn.gov

CAPTIVE SECTION - TENNESSEE DEPARTMENT OF COMMERCE & INSURANCE
Michael A. Corbett – Director, Tel: 615 741 3805, email: michael.corbett@tn.gov Benjamin A. Whitehouse – Captive Counsel, Tel: 615 741 2616, email: ben.whitehouse@tn.gov
Having passed captive legislation in 1978, Tennessee takes pride in being the second oldest US captive domicile. With the passage of state-of-the- art legislation in 2011, Tennessee is quickly becoming one of the very few "domiciles of choice" in the United States. With the unwavering support of Governor Bill Haslam and Commerce & Insurance Commissioner Julie Mix McPeak, Tennessee looks forward to significant growth in 2015 and beyond.


Missouri
Stability. Innovation. Your Gateway to Captive Success.
To learn more about starting your Missouri captive insurance company, please contact Captive Program Manager Maria Sheffield:
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