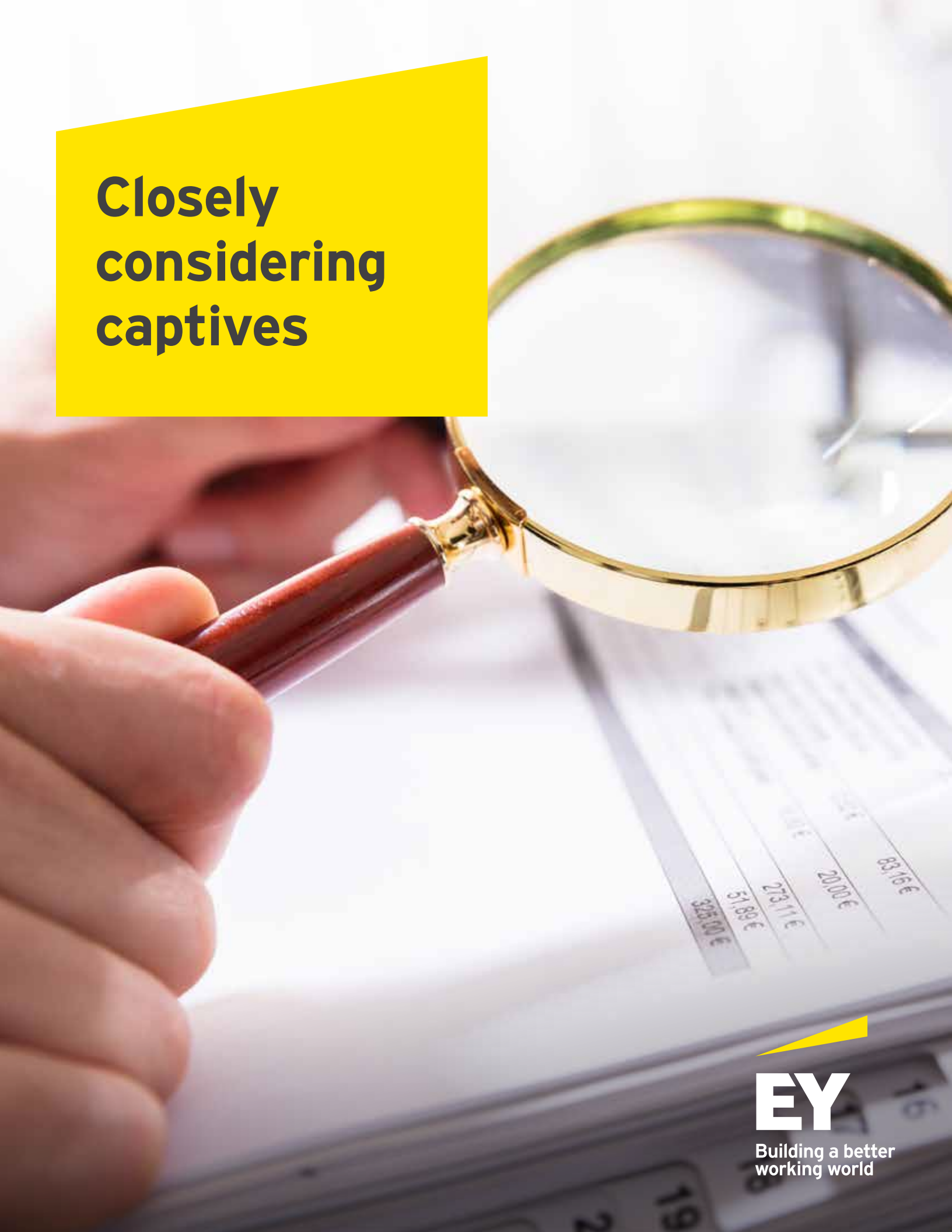
Closely considering captives



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Building a better working world

You've been thinking about forming a captive for a number of years, as you saw how well it worked at your previous company. Premium expense reduction, budget smoothing, tax efficiencies, etc., you know the benefits and disadvantages. Now, it's time to move forward and take a closer look with a feasibility study, which should be easy as nothing has changed in the captive marketplace, or has it? Let's take a look at some recent developments within the risk, actuarial and tax aspects of a captive structure.

Risk

While the latest tax changes and their impact in the captive space may make the headlines, risk opportunities and considerations are equally important. Highlights here include global application, new risks and revenue generators.

Think globally, act locally, as they say. US-based corporates have often not written, or reinsured, their risks from non-US countries. Local fronting costs may have been too high, and bringing income from a low tax jurisdiction back to the US' traditionally high tax rate was impractical. Enter the Tax Cuts and Jobs Act of 2017. While consolidating global risk has always made sense, it now also has the potential for tax efficiencies. Identifying local risks, liabilities, employee benefits, property, etc., written locally by a front insurance carrier, with reinsuring into a US captive provides local insurance coverage and the potential for lower taxes in the US consolidated captive. Risk consolidation may have similar benefits for non-US corporations; however, a captive writing UK risks from a non-UK domicile may have issues in that the EU passporting rights will go away after Brexit is finalized. This could increase fronting costs and make risk consolidation costly.

Insuring casualty (US workers' compensation, global general, product and auto liability), as well as property, is the core for most new captives; however, there may be a bigger "bang for the buck" in looking at corporate risks that have not traditionally been insured. Start with a 10-K filing and look at "Risk Factors," where you will find C-suite concerns to the financial wherewithal of the company: inventory shrinkage for retailers, asset retirement obligations for miners and oil and gas companies, self-insured health benefits for most all companies, a business stoppage due to a non-covered peril (non-damage-related business interruptions), traditionally unavailable CAT exposure, etc., etc., etc. The ability to use a captive to write these risks for regulatory, liquidity or contractual reasons while solving business concerns generates CEO-level awareness and sound risk management practices.

Modern-day captives are designed not only for traditional self-insurance (as well as the risks mentioned above), but also as a more strategic tool to generate revenue and help with customer and supplier issues. The key is to identify areas where the captive could write affiliated business profitably and solve business issues — examples include contractors needing insurance to operate on your job site, forced placed floor insurance with retailers for their holding of your products, enhanced benefits offered to employees, including life, auto, homeowners, pet, and personal umbrella, warranty and extended warranty, medical malpractice for hospital groups, tenant insurance, handset coverage … the list goes on. These are risks current to your operations and those with whom you do business with, so identifying the potential in your industry may make the new captive not just an expense reduction and an additional capital management tool, but a core part of the company's diversified revenue stream.

Actuarial

It's not a secret that a captive insurance company is typically utilized when subject insureds have difficulty obtaining insurance coverages in the commercial market for the risks they are trying to manage or when they desire to be prudent with their insurance spend. Difficulties in purchasing insurance can stem from economic reasons, based on the price of available insurance coverage, or simply from a lack of availability of needed coverage due to the uniqueness of the underlying risk. This means that you need to consider the adequacy of rates and the coverages the captive will provide. There are other relevant considerations, such as qualifying the coverage as insurance risk, capital and regulatory requirement differences between jurisdictions, and relevant accounting standards. Ok, since we've cleared this hurdle and you still want a captive, let's continue…

A new captive owner should be aware of the process in establishing rates for insurance coverages, including the data on which the rates will be based. Typically, historical loss experience is a major factor in determining rates. However, depending on the types of risk or coverages the captive is intended to provide, the historical loss experience may lack full credibility. In such cases, the historical loss experience should be weighted with industry experience. Industry benchmarks can include major insurance company rates, advisory organization loss costs or rates, rates for risks with a comparable level of risk from a different industry, etc. Determining a level of expense associated with providing the coverage is a relevant and significant process in developing the final rates, as the rates should provide for all costs associated with an individual risk transfer. Similar to the loss data, the expense provision can be based on the actual cost or industry benchmarks.

The definition of insurance risk differs under different accounting standards, but it generally involves paying a premium for future insured events that have not occurred or the extent of the exposure is not determined. However, there are coverages that are unique in nature, or cover losses that have already occurred, or may provide a limit of insurance that is not a large multiple of the premium. These coverages will require cash flow testing based on accounting guidance to determine if there is enough risk transfer to comply with insurance accounting standards. Cash flow testing will often look at probabilistic loss scenarios to assess the likelihood and magnitude of losses from insured events. Common tests include the 10-10 Rule (10% probability of a 10% loss) or the Expected Reinsurance Deficit (ERD).

While the capital requirement for a captive insurance company may be less significant than for a traditional insurance company, one must be aware that the capital, or at least some of it, may be tied up for a number of years for the coverage that it writes today. The premium written turns into loss reserves that may not be paid out for many years. For example, workers' compensation insurance provides, among other benefits, lifetime medical expenses to permanently injured workers.

In the US, the business of insurance is regulated at a state level. Therefore, the state of domicile, for domestic captives, reviews the premiums determined for the new captive coverages. The state regulator will often review initial rates that are proposed to be put in effect and may request additional information supporting the rates. The auditor of the captive and the captive's owner should also review rates and loss reserves recorded by the captive under the appropriate insurance accounting standards. Last but not least, intercompany transactions should be assessed from the transfer pricing perspective. Transfer pricing professionals follow a given set of rules to avoid potential issues with local regulatory and tax authorities. Therefore, it is prudent to involve them at the onset, as they may provide a good review of an actuarial study and the overall plan.

Tax

Yep, just like you thought, we saved the best for last. We do want to reiterate the importance of sound risk and actuarial studies and practices, as those are at the backbone of setting up your captive. With that said, Uncle Sam, in general, and the Internal Revenue Service, specifically, do have a say as to the captive's qualification as an insurance company for tax purposes. As new captive owners continue to wrestle with the four pillars of insurance company qualifications, the Tax Cuts and Jobs Act of 2017 (TCJA) layered additional complexity to the process, albeit thankfully not to the process of qualification itself.

So, what are the key takeaways from the TCJA? Let's all agree, the TCJA did not result in a recodification of the Internal Revenue Code; accordingly, the structure of the code sections remains, with a few additional sections added. The key headline on the corporate front: a reduction in the corporate tax rate from 35% to 21%, followed by the move to a territorial tax system for corporations and some base broadeners or revenue raisers needed to keep the total cost of the TCJA within the $1.5 trillion cost as authorized by the previously passed budget.

Focusing on the insurance industry and the captive market, let's explore the impact along domestic and international considerations. On the domestic side, the first critical point is what didn't change. As mentioned above, the TCJA did not modify or codify the definition of insurance; accordingly, the existing case law and four pillars of qualification, presence of insurance risk, risk shifting, risk distribution and common notions of insurance remain the criteria for analyzing if a structure would qualify as an insurance company. Additionally, the election for a controlled foreign insurance company to be treated as a US domestic insurance company and for certain small insurance companies to be taxed on investment income only (the 953(d) and 831(b) elections) remains as well. Nevertheless, certain base broadeners did result in a larger book to tax difference in the government's favor as it relates to the deduction for unpaid losses and exclusion of tax-favored investment from income. For life insurance companies, the small life deduction was also eliminated and their net operating loss rules modified, unlike P&C companies — the only entities that retained the old net operating loss rules. Looking broadly, it appears that the domestic captive market, including 953(d) companies, faired reasonably well in the aftermath of the TCJA.

Looking at the international arena, the TCJA definitely spiced up the playing field through the introduction of the base erosion and anti-abuse tax provisions, as well as modifications to controlled foreign corporation and passive foreign investment company rules, which are among the most notable ones. Although a detailed dive into each of these is outside the scope of this article, it is important to mention that new captive owners should be well aware of these, and other, new or modified provisions (resulting from the TCJA) and should consult a reputable tax advisor as plans on how, where and when to establish a captive are being drawn up. Depending on the overall corporate structure, some of the new provisions may simply not apply, while in other situations, these provisions and their impact may dictate whether to place the new captive onshore or offshore, especially for multinational structures looking for possible risk management centralization.

The views expressed are those of the authors and do not necessarily reflect the views of Ernst & Young LLP or any other member firm of the global EY organization.

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