Elements of a Captive Insurance Company

Lawrence Prudhomme, CPA, ACI

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Elements of Insurance

"involving a contract, whereby, for adequate consideration, one party agrees to indemnify another against loss arising from certain specified contingencies or peril … it is contractual security against possible anticipated loss."

To qualify as insurance, there must be:

- Risk transfer
- Risk distribution

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Elements of Insurance

<u>Risk Transfer</u>

- There must be the involvement of an insurance risk (two outcomes)
  1. Loss
  2. No loss
- The risk transferred must be a risk of economic loss
- The risk must contemplate the fortuitous occurrence of a stated contingency (the event will <u>not</u> inevitably occur)
- It <u>cannot</u> be merely an investment or business risk (three outcomes)
  1. Loss
  2. No loss
  3. Profit

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Elements of Insurance

<u>Risk Distribution</u>

- Risk distribution incorporates the statistical phenomenon known as the law of large numbers – "distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as a premium and set aside for the payment of such a claim."

- This can be achieved by risk pooling, which spreads the losses of one among many. It is the presence of risk pooling that distinguishes insurance from a gambling or betting venture.

Elements of Insurance

Is it insurance in its commonly accepted sense?

- Emphasis is on comparison with that of known insurance – are there policies issued, claims procedures, renewal provisions, etc.?
- Factors include adequacy of the insurer's capitalization and premiums priced at arm's length – preferably by a credentialed actuary
- Needs to walk and talk like an insurance company

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Elements of Insurance

- If you have risk transfer and risk distribution, you should have an insurance contract
- If at least 50% of your business is issuing insurance contracts, you will qualify for insurance company status
- If you qualify for insurance company status, in the United States you can take advantage of the benefits offered by Section 831(b) of the IRS Code

Domicile Selection

- Many jurisdictions to choose from around the world
- Selection affects the Captive's operating costs and requirements for cash, capital and investments
- Considerations include:
  - Taxes
  - Regulatory environment
  - Infrastructure
  - Perception

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Popular Domiciles

<u>Outside the U.S.</u>

Bermuda
Cayman Islands
Turks and Caicos Islands
British Virgin Islands
Guernsey
Isle of Man
British Columbia

<u>Within the U.S.</u>

Vermont
South Carolina
Hawaii
Utah
Arizona
Montana

831(b) “Small” Insurance Company

- Files federal taxes benefiting from section 831(b) of the IRS Code.
- Can make election if “net written premiums” for the taxable year do not exceed $1,200,000.
- Result: underwriting income is not taxable. Tax is assessed on net investment income.
- Election continues as long as company continues to meet the annual qualification test.
- Common ownership must be considered for “net written premium test”.

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Captive Red Flags

Insurance Risk vs. Business Risk

Risks being insured are not "insurable", the loss is not due to a fortuitous event or is putting the insured in a better position than before the loss

Inflated Premiums

Captive must rely on a competent actuary to establish reasonable and supportable insurance rates and not charge "what the insured wants to pay" in a given year

Inadequate Risk Distribution

There must be legitimate unrelated third party risk in the captive in a percentage sufficient qualify it as an insurance company

Bootstrapped Capital and Premium Payments

Payments and loan backs to the insured before funds become surplus will indicate a sham designed for tax evasion purposes

Questions

Lawrence Prudhomme, CPA, ACI
GPW and Associates, Inc.
2700 N. 3rd Street, Suite 3050
Phoenix, AZ 85004
602.200.6937
lprudhomme@gpwa.com

www.gpwa.com

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Consultants