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
Elements of Insurance

Risk Transfer

- 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 not inevitably occur)

- It cannot be merely an investment or business risk (three outcomes)
  1. Loss
  2. No loss
  3. Profit
Elements of Insurance

Risk Distribution

- 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
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
Popular Domiciles

Outside the U.S.

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

Within the U.S.

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”.
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.
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