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Choice of Domicile in Captive Insurance Planning

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A captive insurance company in its most typical form is essentially a new subsidiary that is created by a parent company to underwrite the insurance needs of its operating subsidiaries. The basic idea of a captive is to bring in-house the purchasing of insurance that was previously done from unrelated commercial insurance companies, and retain the underwriting profits for the benefit of shareholders. But even beyond that, captive insurance companies fulfill a large role in making the entire enterprise focus on the management of its various risks of loss and incurring liabilities.

The factors that go into the decision to form a captive insurance company, and the steps to do so, are beyond the scope of this article and are well-treated elsewhere. This article will focus upon a critical inquiry that is inherent in the captive creation process, which is the choice of the jurisdiction where the captive will be formed and domiciled.

Captive insurance companies were originally formed outside the United States, usually in well-known debtors' havens such as Bermuda, the Cayman Islands, and the British Virgin Islands. This is because of a perception that there were certain potential local tax benefits to being formed in those domiciles, but much more importantly, because the U.S. states did not have captive legislation, and instead treated captives like normal commercial carriers. Doing so made little practical sense, insofar as normal commercial carriers are subject to a wide swath of laws designed to protect the general public, such as requiring large amounts of capital and reserves, public filing of policies, and making premium rate requests. These requirements were, of course, nonsensical in the captive context where there is little need to protect the operating subsidiaries from the captive insurance company ultimately owned by the same parent.

Vermont cracked open the door to captives in 1981, and through sheer persistence and aggressively changing its laws to match or exceed those of the offshore havens in favorability, was able to hold its own and grow its captive business against the likes of Bermuda. The IRS kicked the door wide open in 2002, following its landmark loss in *United Parcel Service v. C.I.R.*, 254 F.3d 1014 (11th Cir. 2001), by issuing Revenue Rulings 2002-89, 2002-90, and 2002-91, that not only recognized the fundamental legitimacy of a properly structured and operated captive insurance arrangement, but also created safe-harbors in the confused area of risk distribution. Numerous states then flooded the captive marketplace – 37 states as of this writing – by passing captive insurance enabling legislation.

It should be noted that for most tax purposes, there is little difference between an offshore captive (one formed outside the United States) or a domestic one, since the vast bulk of captives make the election under Tax Code § 953(d) to be treated as a domestic company. These days, the reasons for a captive to "go offshore" most often relate to those relatively few captives that for tax reasons do not make the § 953(d) election (captives owned by charitable organizations, for instance, have tax reasons for wanting to be taxed as a controlled foreign corporation instead), or captives where financial privacy or practical immunity to the enforcement of a domestic judgment is at a premium.

The analysis and planning that goes into the formation of a captive insurance arrangement may be likened to the solving of a Rubic's cube, where decisions must be made that will affect several or all sides, and some key issues must be resolved at once as if some juridical algebra problem. Most often, the question of where the captive should be domiciled is one of the last

– not first – issues to be resolved. This is because the resolution of other issues, such as availability of capital, specialty lines of insurance to be written, and particular needs for flexibility in the investment of the captive's assets, quite often lead to the choice of a particular domicile. There is rarely a need for prospective captive owner to choose the domicile as a first step, and indeed to do so can lead to missed opportunities if the captive arrangement could have been more efficient if formed elsewhere.

But even beyond that, the issue of state taxation of premiums now most often resolves the issue – particularly if the captive owner is headquartered in one of the ever-increasing number of captive-friendly states. In the past, states paid little attention to their fiscal losses occasioned by captive insurance, mainly for the reasons that the very concept of captive insurance was little known to the state tax authorities, and payments to captives (as opposed to ordinary commercial insurance carriers) are inherently difficult for state field auditors to pick up. While some states have long been aggressive in taxing the premiums paid to captives (Texas is probably the best example of this), it has only been recently that other states have taken note of their own fiscal losses and have grown more aggressive in taxing the premiums paid to captives. Yet, at the same time, when a state passes new captive insurance legislation, in order to make that state's laws more attractive to new captive formations, the state will usually exempt or substantially limit the taxes on premiums paid to its in-state captives. This creates a very powerful incentive for new captive owners to choose their own state (if it is friendly to captives) to form their captive, and puts pressure on existing captive owners to bring their captives back home.

So, the default rule might be well be – if it isn't already – the best domicile to form your captive is the one you are in. This disregards, however, that some states such as California and Washington do not yet have captive enabling legislation, while other states have either done little or nothing to implement their legislation, or have implemented it very poorly. The upshot of this is that many prospective captive owners will have to look beyond their state's borders for a place to land their new insurance company. It is for these owners and their advisers that the factors discussed below will be of the most importance.

It would be easy enough at this point to dive into a discussion of the technical nuances of the laws of various jurisdictions. That would not do the subject proper justice. Long experience has shown that the single most important factor in choice of domicile for a captive is not any specific statute or regulation, but that of the amenability of the insurance regulators in the domicile to working with captive owners to make the arrangement a success. Laws and regulations are only so good, or bad, as they are interpreted by their regulators, and in the case of captives this typically means the insurance commissioner's office or equivalent.

Very simply, a bad insurance commissioner's office can make hash out of the best captive laws and regulations with the result that the captive owner becomes quite miserable. A good insurance commissioner's office can, by contrast, work through mediocre laws and regulations to make captives in the state a happy success. Of course, no chart could adequately spell out the differences in how these regulators treat captives, and any such chart would be obsolete as quickly as the personnel changes occurred in the insurance commissioner's office, which they do with some regularity. Suffice it to say that the best information about regulators must be obtained anecdotally from captive managers and other captive professionals who have done business in the state, while noting that the regulators of some states have a long and consistent history of favorable treatment of captives, while other states have undergone uncomfortable fluctuations dependent upon whomever is in charge at a given time.

With that caveat firmly in mind, we turn to an examination of the statutory and regulatory factors that go into domicile selection for captives. What we will see is that the specific requirements of each jurisdiction are very similar. There is a good reason for that, which may be accurately expressed in a single word: competition. To vie for business, the various domiciles must offer regulations that are as, or more, favorable than that of competing jurisdictions. One may attribute Vermont's long run of success to the fact that its state legislature, mindful that the captive sector is its second largest industry, has demonstrated a willingness to quickly consider and pass cutting-edge legislation so as to keep Vermont's captive laws competitive with those of other jurisdictions.

Minimum capitalization, i.e., how much cash the captive will need to qualify and stay qualified for its insurance license, is a significant factor of consideration in choosing a domicile. Obviously, the less money that a captive owner has to tie up in the captive, which moneys may be deployed to greater returns elsewhere, the more efficient the captive arrangement will be. Thus, captive domiciles compete for business by lowering their capital requirements to certain minimum amounts.

It is here that our Rubic's cube reappears, where we have to solve more than just one side of the puzzle at once. Although captive owners naturally desire to place as little capital as possible in their captive, the requirements of tax law must be taken into consideration. For tax purposes, one of the elements to establish the existence of an insurance contract is the requirement of "risk shifting," which posits that the captive must have more risk of loss than simply the premium that it takes in from its insured. The captive must have, the slang goes, enough of its "own skin in the game" such that it can satisfy claims against a policy over and above the premium received.

Thus, there are both actuarial and tax variables in the minimum capitalization equation. From the actuarial side, the limits on the maximum potential losses that the captive may underwrite – and thus policy limits – are limited by some combination of the total premiums to be received by the captive, loss expectancy, existing reserves, and capitalization. Plus, while the IRS has provided painfully little guidance on what constitutes minimum capital for tax purposes, it seems (largely anecdotally) that the captive's capital should not be less than one-third of the premiums received in any given year, i.e., as it is usually articulated, premiums should not exceed capital by a ratio of greater than 3:1.

There seems to be an accepted exception to this ratio for the first year of a captive's existence, when the ratio of premiums to capitalization should not exceed 5:1, and which takes into consideration that relatively few claims are likely to have matured to where they will require payment in the first year. It is this 5:1 ratio that has worked to set the standard for minimum capitalization in most captive domiciles. The vast majority of captives start out as companies that make the Tax Code § 831(b) election, which means that the captive will not be taxed on its premium income so long as its premiums received do not exceed $1.2 million during the year. Applying the 5:1 ratio to $1.2 million results in a minimum capitalization requirement for tax purposes of $240,000 (which has been rounded up for statutory purposes to $250,000), which represents by far the most common minimum capitalization requirement of domestic domiciles. The states that have higher statutory minimum capital requirements are usually avoided by captive owners.

However, not all new captives will take in the maximum amount of $1.2 million in premiums the first year, and this is where regulatory flexibility to lower the minimum capital for the first year only can be a very significant advantage for a captive domicile. These exceptions are created by the very practical recognition that by the second year, the premiums paid in the first year for the first year's policies which have not expired, will be available to apply toward the statutory minimum.

Offshore domiciles often have much lower minimum capital requirements (Nevis only requires $10,000 in capital for a single-owner captive) in consideration that many of the captives they form will not be subject to the minimum capitalization requirements for U.S. tax purposes, as their owners will often have little or no connection to the United States. But again, the statutory minimum capital requirements are but one side of the captive Rubic's cube for U.S. taxpayers.

Investment flexibility, i.e., the particular domicile's rules about how the captive's assets may be deployed, is a very significant factor in choosing a captive domicile – some might suggest the single most important factor. Non-captive commercial insurance companies are usually subject to "permitted asset" rules, which are an exhaustive list of the things that such insurance companies may invest in, so as to help protect the financial health of those companies from speculative investments (and also the state insurance fund from having to take over the liabilities of an insolvent carrier). The investment rules relating to captives can be much more flexible, and it is here that the domiciles have an opportunity to really compete against each other.

Prior to the 2008 crash, which resulted in the liquidation of not just a few captives whose investments had failed, the investment rules relating to captives were typically very lax. The typical statement was that an investment was appropriate, "so long as it does not threaten the minimum liquidity of the company." In application, this had an "almost anything goes" air, and led to captives making all sorts of creative, speculative, but often ill-advised investments, of their assets.

After the 2008 market crash, many regulators started to the take back the reins over captive investments. This has been most commonly seen in how regulators view a large, single investment that comprises a large percentage of the captive's overall assets, say over 30 percent – regulators now often cringe when so many of the captive's eggs are be placed in one basket, and may either refuse to approve the investment or require additional capital to be infused into the company. But it is also seen in regulators occasionally requiring that certain captives abide by the very regimented investment restrictions for non-captive commercial carriers.

As with so many things in the captive sector, the best information regarding a domicile's investment flexibility is not necessarily found in its laws or regulations, so much as learned anecdotally from conversations with captive managers and owners of existing captives in that state. It should also be noted that investment flexibility in a particular domicile has the potential to change literally overnight as personnel changes in the insurance commissioner's office bring different attitudes about how captives should be safely investing their assets. This issue can be a moving target, and more than a few captives have left particular domiciles and migrated elsewhere when they felt that investment restrictions had become too strict.

Infrastructure support, i.e., the ability of the insurance commissioner's office to effectively handle captives, is also a very important consideration. Newer domiciles in particular are often unwilling to extend adequate funding to the captive division within the insurance commissioner's office until the economic benefits of captives within the state have been established. Indeed, while 37 states have passed captive enabling legislation, probably a third or so of these states could be said to have adequately funded their insurance commissioners to allocate resources for separate captive regulators; this is why captive development is stillborn in those states.

On the other hand, the legislatures of the handful of states that lead the sector in the number of captives domiciled have seen the economic benefits of captives and have well-funded their insurance commissioners' offices to properly administer them. These states have independent "captive deputy commissioners," full time staffs, and quality financial analysts and examiners who are highly experienced with captives and their peculiar needs.

But infrastructure support is not just limited to the insurance commissioner's office. The best domiciles will have many quality captive managers who have been at least minimally vetted by the commissioner, and a cadre of other professionals such as accountants and attorneys who are likewise familiar with captives in that state. The availability of numerous of these captive service providers and professionals gives captive owners both the ability to choose between numerous competent providers and professionals, and the benefits of competition between them to drive down the pricing of their services.

In summary, there is quite a bit of analysis that goes into the selection of the domicile for a captive insurance company, and much of that analysis will be based on anecdotal information obtained from others who have practical experience in particular domiciles. The resolution of other considerations in the planning of the captive will quite often require the elimination from consideration of certain (if not many) domiciles, and make the choice of domicile in the end that much easier. But even if the grass appears greener on the other side of the fence, strong consideration to forming the captive in the state where the operating business is located now should always be made, even if that state's captive laws and regulations are not the best.

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