

CAPTIVE INSURANCE: TAX CONSIDERATIONS FOR TAX- EXEMPT ENTITIES

Daniel J. Kusaila

Partner
Crowe LLP

Mikhail Raybshteyn

Senior Manager
Ernst & Young LLP



CAYMAN
CAPTIVE
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AGENDA

Captive planning for tax exempts and not-for-profit structures

- Overview and planning kick off

Structuring and Domicile selection

Type of captive

Programs and products

- What and why

Tax Considerations

- Insurance vs. Not Insurance
- Tax exempt entity considerations
- Domestic and Foreign taxation

Captive's filings and other obligations

LETS BEGIN... GETTING A CAPTIVE “OVERVIEW”

Your organization has made a decision to establish a captive.....now what?

Decisions that the management needs to make

- Picking appropriate advisor or advisors
- Having appropriate internal discussions to determine project leads and process steps
- Discuss approach, insurance needs, potential initial red-flags that may delay the process or introduce an impassable barrier for entry
- Conduct feasibility and discuss options
 - Structure / Products
 - Domiciles, incl. off-shore vs. on-shore
 - Status of the captive (qualified, non-qualified, other)
 - Funding
 - Administration
- Review feasibility and make final decisions
- Greenlight the application and have pre-application discussions with a domicile regulator
- Finish policies, complete tax and accounting memos
- Fund the captive

FEW MORE DETAILS ON CAPTIVES ...

There are approximately **6,800** captives globally writing over \$140b in gross premiums annually with \$408b in assets under management (AUM). Independent research firms estimate that there will be closer to **10,000** captives by year 2020.

Approximately **90%** of Fortune 500 companies have established captives

Eight major industry segments control **77%** of global captives by entity. These industry segments include financial services, health care, retail, manufacturing, power and utilities, construction, transportation and tech and telecom

Captive insurance companies have long been a major feature of global corporate risk management strategies.

The onset of a number of new major risks (e.g., cyber and fiduciary liabilities), and the need to address these risks via captives, have driven recent growth in both, # of entities and \$\$ premiums with continued **5%** annual growth expected over the next **5 to 7** year period

Regulatory and Tax authorities pressure is making the captive management landscape increasingly complex to operate within and driving the need for increased professional expertise outside of the mainstream insurance industry.



WHAT TYPE OF CAPTIVE TO CHOOSE?

Single parent / Pure captive

Greatest level of program flexibility and control

Generally available license in most jurisdictions

Longer market entry timeline

Slightly higher maintenance cost



Cell or Rent-a-Captive

Least flexible structure

A “room in an apartment” or an “apartment rental” concept

Quickest market entry

Lower maintenance cost

May be converted to a single parent in certain cases

Group or RRG

Slightly less flexible structure

Multi owner/participant concept

May require specific legislation depending on a domicile

Varying market entry timeline

Generally lower maintenance cost

WHY SHOULD A TAX-EXEMPT CREATE A CAPTIVE?

Improve Cash Flow

- Stabilize insurance costs
- Investment income remains in the captive

Reduced Insurance Costs

- Maintain underwriting profits
- Access to reinsurance markets - “insurance for insurance companies”
- Better risk management results in lower losses

Ability to customize insurance programs

- Insure any risk chosen – even coverage for risks not usually insurable
- Customize terms and conditions of policies
- Reduced need for commercial insurance

HOW, WHERE AND WHAT

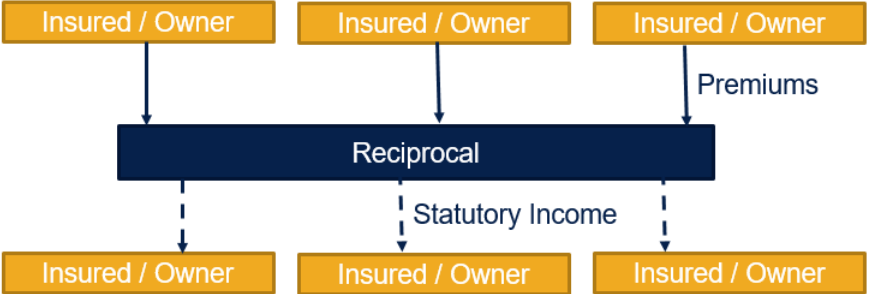
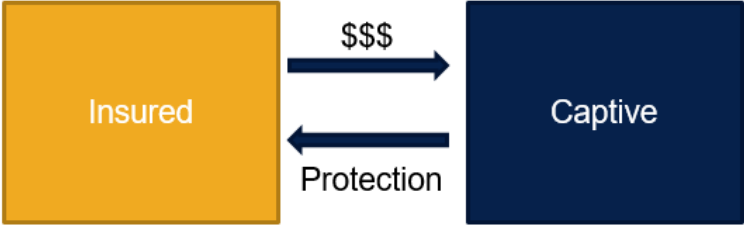
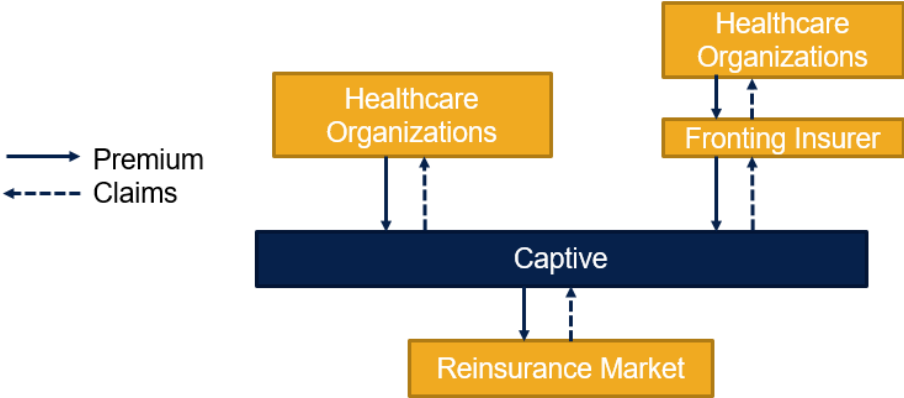
Let's connect the dots...

STRUCTURING..... HOW?

Variability will depend on a particular organization

Items to consider during the “How” stage:

- What am I trying to achieve?
- How big is my organization?
- Is there a specific type that is commonly used by peers?
- What are the costs / benefits?



STRUCTURING..... WHERE?

“Where” may be driven by a variety of considerations:

- Company’s policy
- Current footprint
- Experience with foreign entities and domiciles
- Prior experience with particular jurisdictions
- Capital and regulatory requirements
- Access to reinsurance market
- Concentration of “industry” captives

STRUCTURING..... WHAT?

Generally, the most popular coverages written by captives:

- Property
- General / Third Party Liability
- Employers' Liability / Worker's Compensation
- Professional Indemnity
- Automobile Liability

When it comes to tax-exempt and not-for-profit entities, additional coverages will typically deal with operations of the company or to augment/enhance certain coverages of the outside parties that provide services to or within the organizational structure (i.e. physicians in a hospital)



THE TAX OF IT ALL.....

What do tax-exempt and not-for-profit entities need to consider



INSURANCE VS. NOT-INSURANCE

Organizational, structuring and accounting considerations

Risk Shifting and Risk Distribution

- Indemnity vs. Deposit Accounting
- Guarantees and Retro-graded policies
- Parental vs. Affiliate vs. Unaffiliated Risk

Product considerations

Existence of insurance/insurable risk(s)

- Actuarial vs. Non-Actuarial pricing
- Loss pre-payment (i.e. MGM Grand fire coverage)
- Fortuity

Tax considerations

Tax-Exempt / Not-for-Profit / Mixed entities

Can you “split” the captive?

Offshore considerations for tax exempts

Other considerations

Insurance in a commonly accepted sense

- Fact vs. appearance

INSURANCE VS. NOT-INSURANCE

“Insurance Income” ??

For “insurance” treatment:

Risk Shifting must be to a separate legal entity

Risk Distribution connotes enough independent risks pooled to invoke the “actuarial law of large numbers”

Insurance risk must be present vs. “investment” risk

Common Notion of Insurance

Section 512(b)(17) – a tax-exempt entity must treat as UBI income attributable to insurance activities



INSURANCE VS. NOT-INSURANCE

If “insurance” - can an exclusion apply?

Section 512(b)(17) provides that a tax-exempt entity must treat as UBI an amount included in its gross income under Subpart F controlled foreign corporation rules...

EXCEPT:

Income attributable to its own insurance risks

Income attributable to insurance risks of tax-exempt affiliates

Income attributable to the insurance risks of an officer or director or an individual who directly or indirectly performs services for the tax-exempt organization or its affiliates

Special rule for universities and hospitals!!



TAX CONSIDERATIONS

Most of the captives of US tax-exempt entities are foreign entities.

Generally, a transaction with a foreign entity may fail insurance treatment for US federal tax purposes due to structure and/or contractual terms, and the premium paid may be treated as a deposit or a capital contribution.

A tax-exempt entity making premium payments to a foreign insurance company should consider the following items:

What is a tax-exempt entity's current position with respect to such premium payments?

Is there sufficient evidence that the premium paid should be treated as a deposit, a loan, or a capital contribution?

If there is not sufficient evidence – what should the entity do?

TAX CONSIDERATIONS- OFFSHORE CAPTIVES

- Cayman Islands has no corporate income taxes
- Offshore captives are not tax-exempt – so they can accommodate addition of non-employed physicians, but there may be relatively minor tax ramifications
 - Federal excise tax (FET) on premiums (inbound or outbound)
 - Unrelated business taxable income to captive’s U.S. shareholder – on *net* income from covering “voluntary attending physicians” or non-controlled entities
- Unlike onshore captives, covering third parties may generate some tax but it does **not** taint the entire captive – *principal reason most captives owned by tax exempt hospitals are domiciled offshore*
- Offshore captives can write up to 49% unrelated business without becoming fully taxable



TAX CONSIDERATIONS- OFFSHORE CAPTIVES

- **Premiums paid generally not subject to a federal excise tax (4% of the premium for direct insurance and 1% for reinsurance or life insurance)**
 - Except for premiums from unrelated voluntary physicians or entities
- **Can avoid attribution of any “unrelated business taxable income” to captive’s tax-exempt parent**
 - Except for insurance income from unrelated voluntary physicians or entities
- **State premium tax - known as (i) “direct placement” tax or (ii) “self-procurement” tax or (iii) “independently procured insurance” tax would apply (about 30 states impose this type of tax) with 3% rate typical**

TAX CONSIDERATIONS – US TRADE OF BUSINESS

Foreign insurance companies operating offshore generally not subject to direct U.S. taxation
Indirect U.S. taxation can occur if captive owned by U.S. shareholders (e.g., Subpart F, PFIC rules)

However, a foreign insurer may be subject to direct U.S. tax if it is considered to be engaged in a U.S. business (or has a U.S. “permanent establishment” where a tax treaty is involved)

Net income taxed at 21% (determined under U.S. income tax rules)

Additional branch profits tax on amount withdrawn from U.S.

Or makes an election under IRC §953(d) or 953(c)(3)(C)

Also potential state insurance regulatory problems if captive is conducting an unauthorized business of insurance onshore

TAX CONSIDERATIONS – US TRADE OF BUSINESS

To avoid being engaged in a U.S. trade or business, foreign insurer should (Not all encompassing list):

- Board meetings should be held outside U.S.
- Execute contracts outside of U.S.
- Approve asset allocation policy outside U.S.
- Use only independent agents in the U.S.
- Avoid having key risk management employees as officers or board members of foreign insurer; he/she should present claims report, etc. in capacity of consultant to the board
- Issue indemnity rather than “pay on behalf of” policies

Unfortunately the IRS will not issue a “Private Letter Ruling” on U.S. Trade or business

TAX CONSIDERATIONS – WITHHOLDING TAX

IRC 1441 requires all persons (individuals, partnerships, corporations, etc.) deduct and withhold from payment to a foreign individual or entity a tax equal to 30% on the following income:

- Interest
 - Dividends
 - Rents
 - Salaries
 - Wages
 - Premiums
 - Annuities
 - Compensation
 - Remunerations;
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- All other fixed or determinable annual or periodical gains, profit or income **(FDAP)**.

TAX CONSIDERATIONS – WITHHOLDING TAX

Common Exemptions:

- Insurance Premiums and Reinsurance Premiums subject to Excise Taxes
- Income Effectively Connected with U.S. Business
- Interest
 - Portfolio Interest
 - Bank Deposits
 - Tax exempt bonds and U.S. government bonds, notes
 - Original Issue Discount
- Certain Dividends from RIC
- U.S. source capital gains (long term or short term)

TAX CONSIDERATIONS – FILINGS: FOREIGN CAPTIVE

Reporting Requirement

Form 5471 – “Information Return of U.S. Persons With Respect To Certain Foreign Corporations”

Form 1120-F Protective return (as needed)

Form 926 - “Return by a U.S. Transferor of Property to a Foreign Corporation”

FinCEN Form 114 – “Report of Foreign Bank and Financial Accounts”

Form 8938- Foreign Financial Assets

Form 8621- Passive Foreign Investment Income

Form 8886 – Reportable transaction

Excise Tax – if “insurance” issued by a foreign insurer

4% excise tax on direct insurance premiums and 1% excise tax on reinsurance premiums

Form 720 – “Quarterly Federal Excise Tax Return”

Withholding and Premium Tax Considerations

Form W-8-BEN-E

Form 1042- Withholding Tax

Self-Procurement Tax - depending on the state, typically 3% tax rate



THANK YOU

Daniel J. Kusaila
daniel.kusaila@crowe.com

Mikhail Raybshteyn
mikhail.raybshteyn@ey.com

www.caymancaptive.ky