



180°

A guide to what's hot in the world of captives and ART



Strategic Risk Solutions

Issue 14, Q4 2007

Inside This Issue

Derick White to Join SRS

Re-domestication: To Move or Not to Move

IRS Proposed Regulation

SRS News

Derick White to Join SRS

In November, SRS announced that Derick White will be joining the company effective February 1, 2008. Mr. White is currently Director of Captive Insurance for the Vermont Department of Banking, Insurance, Securities & Health Care Administration.



At SRS, Mr. White will be President of the company's Vermont operations. He will be responsible for the management and development of SRS's captive management business in the State. He will also oversee SRS' activities in other eastern US domiciles including South Carolina, Washington DC and Kentucky.

Derick White has served the captive division of the Vermont Department of Banking, Insurance, Securities & Health Care Administration since 1992 first as Chief Examiner, then Acting Deputy Commissioner and finally as Director of Captive Insurance.

Re-domestication: To Move or Not to Move

The growth in captive domiciles has led to competition among domiciles for not only new captives but existing captives. Should captive owners be considering re-domestication? In this newsletter we review reasons to consider re-domestication and how to re-domicile. This article draws on information presented by P. Bruce Wright of Dewey & Lebeouf and Brady Young of SRS in our October webinar.

The reasons to re-domesticate are similar to those driving the original domicile decision (Regulatory, Tax, Infrastructure, Logistics and Perception). As captives mature and the domicile landscape changes, it may be necessary or advantageous to re-domicile an existing captive or form a new captive. Like the domicile choice, the re-domestication decision will be unique to each captive and based on its particular circumstances.

Regulation - there are two situations which might be a reason to re-domesticate on regulatory grounds: a change in the domicile's regulatory position relative to other domiciles and a change in the captive's business plan.

- Change in regulatory position: periodically domiciles may

become concerned about classes of business written in captives and restrict activities in those areas, for example warranty business. Captives underwriting these classes may consider re-domesticating to more favorable domiciles. The emergence of new domiciles and the expansion of captive regulations also alter the relative regulatory landscape. For example, several domiciles have passed legislation allowing LLC captives and not for profit captives. A captive looking for a "pass through" structure now has a greater choice of domiciles and structures. This may change the location of its most favorable domicile. Other examples include rent a captives and agency captives which have historically only been acceptable in offshore domiciles. Several US domiciles have recently included legislation including rent a captive (or sponsored captives) and agency captives.

- Change in Business Plan: certain coverages can only be written onshore. The Department of Labor requires that captives writing ERISA benefits be subject to onshore domestic regulation. Similarly only licensed domestic insurers, including captives, can access TRIA. Changes in business plans to include these coverages will require an offshore captive to re-domesticate onshore or form a branch.. Conversely a domestic captive which increases the amount of third party business it is writing may need to re-domesticate offshore. US domestic captive regulations typically restrict the amount of unrelated third party business underwritten. Offshore domiciles provide more flexibility in writing third party business.

Tax – changes in the tax regulations can cause a captive to consider re-domesticating. The recently announced proposed regulation, discussed later in this newsletter, is an example of this and if passed may cause some captives to look at re-domestication offshore. Other situations which may merit re-domestication from tax purposes include:

- Trapped losses: the dual consolidated loss rule means that losses in an offshore captive can not be taken in a consolidated return. If an offshore captive anticipates that there will be continued losses, moving onshore would allow its results to be consolidated into the group, offsetting income elsewhere.
- Direct placement taxes: these taxes are imposed in approximately 40 states on transactions with non-admitted insurers. They are typically equivalent to the surplus lines rate. Some captive domiciles, such as New York, do not apply the tax on risks located in that state. At 3-4% of premium this can be a significant saving if a captive owner has a large portion of its risk located in the captive's domicile state.

Other Reasons – Infrastructure, logistics and perception can all be reasons to re-domesticate

- **Changing Infrastructures:** increasing costs may prompt a captive to look at other domiciles purely for economic reasons. Turnover of staff among service providers can impact service levels. Temporary work permits and temporary assignments in offshore domiciles increase turnover and have led some captives to consider re-domesticating onshore.
- **Meeting Logistics:** given the activity level of most captives and the requirement and tax reasons to have one or more meetings in the domicile each year, the ease of reaching and communicating with the domicile is a factor in domicile selection. With the increase in the number of domiciles and the narrowing of the differences there may be sound logistical reasons to re-domesticate to a domicile closer to the parent's home.
- **Perception:** increased scrutiny by the captive owner's management may make it inappropriate for a captive to continue to be located in certain domiciles. With more onshore alternatives, internal questions about the location of offshore insurance subsidiaries in some domiciles that are considered tax havens have increased.

How to Re-domesticate - for those captives that conclude that it is beneficial to re-domesticate, how do you do it? There are three main options available.

1. **Merger** – this is the easiest way to re-domesticate. The captive moves its capital and its business and continues operations in the new domicile. If the domicile has a re-domestication statute then the transfer is quite seamless. Corporate and insurance filings are required and there are tax issues to consider. The captive may want the transaction to be treated as a reorganization for tax purposes, so the expenses of the merger are deductible.
2. **Assumption Reinsurance:** in situations where a merger is not feasible, the next best option is assumption reinsurance. This requires all insureds of the captive to agree to look to the assuming reinsurer for coverage and release the captive of its obligations. With no residual business, the captive can then be liquidated. This structure is treated as reorganization for tax purposes. The drawback is being able to access all insureds of the captive, including any additional insureds under the policy. For example, a Directors & Officers liability policy would require a release from all individual directors and officers of the company. Obtaining releases is further complicated if any of the insureds or fronting insurers are insolvent.
3. **Run off of old captive:** this is the least efficient option as capital is trapped in the old captive. With new capital required for the new captive, there will be a short term increase in capital requirements. There will also be increased costs of operating both captives. One option to accelerate the run-off is to commute the captive's coverage, although this may trigger a taxable event if the captive claimed a tax deduction on the original premiums.

Partial Re-domestication – the regulatory benefits of being onshore can be achieved without fully re-domesticating. Several

single parent captives have established onshore branches to establish an US regulatory presence. This structure has been mostly used to write ERISA benefits under the Department of Labor requirements but some US domiciles allow other risks to be underwritten by branch captives. Offshore group captives have created greater flexibility by forming an onshore Risk Retention Groups. This can be done by forming a domestic subsidiary or affiliate where there isn't an exact match between owners and insureds of the captive.

Conclusion - the question of domicile should be periodically reviewed as circumstances change. Captive owners should ask themselves "if we were starting over where would we domicile". If the answer is not the current domicile, then is there enough justification to move. Moving a captive is not a simple exercise. There are regulatory, tax and operational issues to be addressed. It costs money to move and it takes time to move. Re-domestication, while a valid option to consider, should be viewed as a five year or longer decision.

A recording of the original webinar may be viewed at <https://strategicrisks.webex.com> under Event Recordings in the Event Center.

IRS Proposed Regulation on Consolidated Returns; Intercompany Obligations

On September 28, the IRS published a proposed regulation on the treatment of insurance between members of a consolidated group. Under the proposed regulation a captive would no longer be able to take a tax deduction on loss reserves on business from insureds whose tax returns are consolidated with those of the captive. The deduction would not be taken until the loss is actually paid.

The proposed regulation has caused considerable concern among the captive community. For affected captives it would remove a potential benefit of the captive over self-insurance, if passed. While there has been a lot of noise, captive owners need to consider their own particular circumstances and the impact the proposed regulation may have before making any hasty decisions.

It is far from certain that this proposed regulation will be put into effect. If it is implemented as written, it will affect policies written in tax years following the finalization of the regulation. That would most likely not be until the 2009 tax year. We recommend that captive owners not over-react, but monitor the situation and start developing some contingency plans should the proposed regulations be implemented.

Affected Captives – If implemented, the proposed regulation would apply to domestic captives which are part of the same consolidated tax group as their insured(s) as well as offshore captives making a 953d election.

Unaffected Captives – Many captives would be largely unaffected by the proposed regulation, including:

- Group Captives, including Risk Retention Groups
- Foreign captives not making a 953(d) election

- Captives writing third party business. Loss reserves on unaffiliated business would still be deductible under the proposed regulation.
- Captives writing short-tail business such as property and TRIA coverage.

Current Status - the proposed regulations are in a comment period until December 27, 2007. CICA and VCIA have convened a task force of leading captive experts to respond to the proposed regulations. Extensive lobbying efforts are also under way principally from representatives of US captive domicile states. From the discussions to date, it is clear that there are a number of strong grounds for countering the proposed regulations, including:

- They would over-ride existing court decisions and IRS Revenue Rulings
- There has been no alleged abuse of the existing consolidated tax return rules
- It would encourage captives to move offshore, a move which is counter to recent policy aimed at leveling the playing field for the US insurance industry in competing with offshore insurers.

If passed we believe most affected captive owners will have ample time to consider alternative strategies. We will provide updates on the proposed regulation as they develop. Updates on the activities of the captive task force responding to the proposed regulations can be found at the VCIA (www.vcia.com) and CICA (www.captiveassociation.com) web-sites.

SRS News

SRS to Expand South Carolina Office

In August SRS announced that it has expanded its operations in South Carolina through the hiring of Laura Roemer. Laura will be based in Charleston. She will serve as the local compliance officer and oversee the management of SRS's clients in the domicile.

South Carolina continues to grow as a captive domicile and is poised to become the second largest US captive domicile SRS has been managing captives in South Carolina since 2003. The establishment of a local presence allows us to better serve our clients in this increasingly important onshore domicile.

Client News – SRS is pleased to welcome the following new captive clients:

- **Bluegrass Indemnity Insurance Company, Ltd.** SRS has been appointed as captive manager of this recently licensed Cayman captive. The company provides home owner's warranty deductible coverage.
- **Developers Reliance Insurance Company.** SRS was appointed as manager of this group captive licensed in Arizona on September 21, 2007. The captive is owned by LVMJ Private Client Group and serves the building industry.
- **South Insurance Company, Ltd.** SRS has been appointed as manager of this recently licensed Cayman group for its insureds.
- **Southeastern Casualty, Ltd.** SRS has been appointed as manager of this recently licensed Cayman captive. The company provides reinsurance for commercial general liability, auto liability, workers compensation and property insurance.
- **Susquehanna Health System Insurance Network, Ltd.** SRS was appointed as manager of this Cayman single parent captive effective November 1, 2007. The company provides reinsurance for professional and general liability coverages.
- **Tapestry Insurance Corporation.** SRS was appointed as manager of this Arizona domicile single parent captive effective August 1, 2007. The captive is owned by Bayeux Holding Company.

Our People – SRS is pleased to welcome the following new hires:

Laura Roemer has joined SRS as Account Manager in the Charleston, SC office. Laura was previously with the Crusader International Group where she managed captives for both Meeting Street Management Company in South Carolina and Potomac Captive Managers in the District of Columbia. She has experience managing pure captives, risk retention groups and segregated cell captives. She is a graduate of Elon University with a double major in Accounting and Business Administration.

Lurelyn Oliverios will be joining SRS Cayman as an Client Accountant effective January 1, 2008. Lurelyn was formerly with Chevron. The addition of Lurelyn is in response to our sustained growth in the domicile and will allow us to maintain our high level of customer service.

SRS Webinar Series - SRS hosts periodic webinars on topical issues affecting the captive insurance industry. To ensure you are included on the distribution list for webinar announcements, contact us at info@strategicrisks.com.

Strategic Risk Solutions (SRS) is an independently owned captive management and consulting firm. The company is an approved manager of captive insurance companies in most leading onshore and offshore domiciles. SRS is committed to being the premier provider of captive management and advisory services in the territories in which we operate.

For more information on SRS, visit us at www.strategicrisks.com.

Contact: info@strategicrisks.com, Tel: 781 487 9800