FORMING A MICRO CAPTIVE

David Kirkup and Mark Sims, of Captive Alternatives, outlay some of the key considerations when establishing a micro captive

Captive Review (CR): Why do risk pools require a closer look in the aftermath of the recent Avrahami and Reserve Mechanical tax court decisions?
David Kirkup (DK): Both cases hinge on a 'bad' pool with limited or no real risk and the appearance of circular funds. The cases do highlight what the courts consider to be bad facts on risk distribution.

Mark Sims (MS): Risk distribution is key in demonstrating that a captive is operating like a real insurance company. This is something the IRS is looking closely at in an attempt to invalidate whole portfolios of captives. Revenue Ruling 2002-89 states that a captive that receives 50% of its premiums from unrelated entities will achieve adequate risk distribution.

CR: In light of those decisions, what are considered 'best practices' for risk pools?
MS: Pool arrangement should be benchmarked against an industry standard Quota Share Reinsurance arrangement with genuine risk of loss, i.e. no backdoor guarantees against loss; there should be significant third-party risk; insurance policies should be at least based on industry standards; premium pricing should be actuarially determined and arm's-length to the client; there should be a history of legitimate claims; the pool should be adequately capitalised and adequate funds should be withheld until the end of the claims year; finally, exposure should be from the first dollar – matching the original policy.

Written by
Mark Sims

Mark Sims is vice president of business development for Captive Alternatives, LLC. He is a graduate of Indiana University and has more than 25 years of experience in risk management and insurance consulting. Sims educates trusted advisors and prospective clients on the use of private insurance companies for insuring catastrophic business risks and employee benefits programmes.

Written by
David Kirkup

In his capacity as chief operating officer and CFO, **David Kirkup** manages all operations and oversees the financial performance for Captive Alternatives. With more than 20 years in the insurance industry and over 30 years of professional business experience, Kirkup is using his expertise to help make Captive Alternatives the premier risk management consulting and captive management enterprise.

CR: What are the key elements of a properly structured captive?
DK: Quota-share arrangements are common risk distribution structures employed in innumerable commercial insurance contexts. Typically, they involve a licensed insurance company issuing policies to an insured business and then ceding quota-share treaty reinsurance to a captive reinsurer. The pool should consist of similar risks with diverse coverages. Pools that rely totally on terrorism risk, like Avrahami, are not considered valid. Owners and managers should ensure that a fixed percentage of the total risk is transferred, the risk transferred is unchanged from the originally priced risk, and the percentage of premium transferred exactly corresponds to the percentage of risk transferred. Common underwriting methodology by a professional actuary who has the ability to view the entire portfolio of risk, and exclude atypical or unusual risks, is paramount.

MS: There should be reasonable potential for loss, either through direct losses or third-party claims, without artificial recourse to the insured or other exclusions. The pool should regularly and consistently pay claims, and ceding payments from the pool to the captive should be reduced by these pool claims.

DK: Also, the claim adjudication process should ideally be managed by a third-party administrator to ensure arm's-length disposition of submitted claims. Keep in mind that, when the flow of money is simply designed from the outset to ensure a circular flow of funds with no regard for claims or the size of the underlying risk, it's hard to argue that this is really insurance.

CR: What should a business owner consider when selecting a domicile for their captive?

MS: There are many jurisdictions out there with various pros and cons. Bermuda is the oldest and largest, but tends to be expensive and favoured by large corporations. Vermont is obviously onshore and was the first state to develop captive legislation. It's also a favourite among Fortune 500 and larger corporations. These days, most captives elect to be taxed as US corporations. Many US states have since enacted captive legislation and, in general, capital requirements are higher than offshore, while regulation may be more rigorous. At the other extreme, there are a number of offshore locations including BVI, Cayman, Anguilla, and others. While regulation may be less intensive and capital requirements lower, this may be considered a con in the future as more 'Panama Papers-style' revelations potentially tarnish reputations.

DK: Puerto Rico is an interesting choice because it has the best of all worlds – it is highly regulated by an insurance department overseen by the NAIC, follows US federal law, and has one of the highest capital requirements of all jurisdictions. At the same time, it is also a very flexible and creative domicile, willing to work with international insurers to help grow and diversify the new international insurance sector. Puerto Rico also has a separate tax department, independent of the IRS, which may allow captives to enjoy significantly lower corporation taxes compared to Bermuda or Vermont.

> "Risk distribution is key in demonstrating that a captive is operating like a real insurance company"

CR: When should a captive be considered by a business?

DK: The ideal candidate for a captive is a profitable, growth-oriented business enterprise with complex operations and diverse risks. There should be a desire to develop a professional risk management programme utilising various strategies to transfer or finance internally. Of course, we always look for an ability to provide detailed risk management data on exiting coverages, size, markets, employees, suppliers and customers as well as historic financials.

MS: We typically suggest the guideline of revenue in excess of $5m annually with strong and consistent profit margins. We want to work with business owners who are willing to undertake the obligations of an insurance company owner, albeit delegated to a captive manager. However, the owner needs to stay involved, have an understanding of their coverages and limits, and maintain open communication with insurance company staff. We find that once we introduce business owners to corporate risk management concepts, their appreciation for the danger of their existential risks and the value of a captive programme grows rapidly.