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KEEPING CAPTIVES COMPLIANT

Michael A. DiMayo and Kevin E. Myers, principals at Oxford Risk Management Group, discuss the importance of ensuring compliance and other things to consider for enterprise risk captives making an 831(b) election

As with any business strategy, it is essential to conduct the appropriate due diligence to ensure compliant implementation, and captive insurance arrangements are no exception. Business owners interested in the eventual creation of a captive insurance company can benefit from a risk management analysis and comprehensive plan to more effectively manage enterprise risks and control costs.

Risk management

At the heart of every captive insurance implementation is risk management. A captive insurance company can provide protection against risks proving to be too costly to obtain via traditional insurers or may be unavailable in commercial markets. It may also be utilized to address the inability to obtain specialized types of coverage from commercial third-party insurers. For example, your company may be subject to economic loss due to governmental regulatory or legislative changes. While it would make a lot of sense for you to purchase coverage for protection from these risks, you may find that this type of policy is simply unavailable. Your captive insurance company is better equipped to offer specialized coverage, tailored specifically to your unique business needs.

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Kevin E. Myers is co-founder of Oxford Risk Management Group and Affiliates, and is the internal certified public accountant and tax advisor. Kevin has extensive experience in structuring captive insurance companies with respect to Internal Revenue Code Section 831(b) and related tax compliance.

If a captive insurance company is selected during the risk management process as the preferred way of addressing certain exposures, much of the information gathered in the risk identification process will be utilized in the preparation of the captive's feasibility study and business plan. It is important to understand that while a captive can be utilized to replace existing insurance coverage, this may not always be the case. Coverage issued by the captive such as deductible reimbursement does not have to take the place of existing coverage, especially when your existing policies provide coverage against the types of risks, which may result in catastrophic losses. The captive can provide a policy, engineered to the insurers unique specifications, to supplement these traditional lines of coverage. In most cases, to the extent existing property and casualty coverage is reasonably priced, the most attractive option may be to retain fully-guaranteed existing policies for traditional coverage, while supplementing it by addressing self-insured risks with a captive insurance company. Therefore policy features, coverage and limits can be drafted to meet your specific enterprise exposures.

Business purpose

The concept of valid business purpose is vitally important and the operating company should view management of risk as a process significantly more involved than merely purchasing traditional insurance. The risk management process generally begins with the identification and quantification of all exposures, perils and hazards existing in the organization. The risk manager and insurance broker play an important role in the identification of potential causes of loss, which may adversely impact the organization. The decision to transfer or retain risk is a financial decision. The risk manager must be knowledgeable about all aspects of the organization's operations, in addition to the business and regulatory environment within which they work.

Proper underwriting and pricing

One of the most important aspects of the captive implementation process is underwriting. Those individuals who understand the risk profile and business operations should be involved in the underwriting process. That will include the owners of the operating companies, and likely, upper-level management and any internal risk control employees. Underwriting is not a "set and forget it" matter. An underwriting plan must be reviewed annually to account for changes in its related operating company's business conditions and/or property and casualty pricing environment.

As part of the process, it is essential to obtain responsible pricing via independent, third-party credentialed actuaries. Whenever possible, pricing should reflect rigorous peer-review methodology, so the premiums paid by the insured to the captive are sensible and sound in every aspect.

Risk distribution

It is crucial that the captive insurance company conforms to Internal Revenue Code Section 7701(o) regarding economic substance, and be structured and managed as an insurance company, providing true risk for appropriate premium levels. The IRS has frequently stated in technical guidance that an insurance contract must fall within the "commonly accepted sense of insurance" based upon a number of factual determinations. A captive insurance company must be organized and operated for bona-fide business purposes and demonstrate both risk shifting and risk distribution in order for the arrangement to meet the requirements to qualify as insurance in the commonly accepted sense.

In light of increased IRS attention directed at 831(b) captives, it is crucial every effort is made to comply strictly with all available requirements and guidance. Fortunately, there is a long history of case law to guide the captive implementation and regulatory team throughout the process, enabling the experts to design a compliant captive insurance company for both risk shifting and risk distribution. Through a number of IRS "safe harbor", Revenue Rulings and tax court decisions, risk shifting and risk distribution for the captive insurance company can be designed with a clear path for compliance. It is equally important for the risk distribution structure and claims management to actually approve and pay appropriately filed claims, thus resulting in claims experience distribution among all of the risk distribution participants in a responsible manner.

Checks and balances

A number of professionals should be present to help develop, implement and administer a captive insurance company, which is generally retained to coordinate the activities of the other professionals, provide claims review services, and manage daily operations. It is ideal for the actuarial and legal professionals, as well as the captive management company service provider to be independent organizations. Accordingly, this involves providing independent checks and balances throughout the captive implementation, administration and ongoing management processes.

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Appropriate investment plan

The captive will submit an investment plan to the insurance regulators as part of the application process and can hold a variety of investments as approved by the insurance regulators in the domicile of choice. It is important for the captive investment plan to operate as a typical insurance company, with a focus on conservative investments which are liquid in nature to satisfy claims. The captive should maintain appropriate reserves to meet its potential claims liabilities, and its implementation process should include a review of the investment plan opportunities with the business owner's independent financial services team.

Choosing the right domicile

Domicile selection is one of the most vital factors to consider when forming a captive insurance company. Items to consider when selecting the most appropriate domicile will include:

- Captive statute
- Regulatory climate
- Taxation
- Infrastructure
- Compliance
- Investment objectives
- Overall perception of the structure

It is also important to analyze first year implementation and ongoing management costs to remain compliant in the jurisdiction you select for your captive insurance company. There are many excellent jurisdictions to consider and choosing the domicile closest geographically to your operating business may not be the best fit. That is why it is so important to hire independent, third-party professionals to analyze your long-term risk management goals and recommend the domicile that fits best with your goals. Without question, Tennessee is among the most attractive domestic domiciles and worthy of serious consideration.

In closing, the decision to implement a risk management plan and form a captive insurance company should closely resemble the decision making process reasonable for the establishment of any new business venture. In the case of a captive insurance company, the preparation of a business plan must also include an analysis of applicable insurance regulatory, tax and legal requirements specific to a business organization. As one of the nation's leading providers of captive insurance services, Oxford Risk Management Group and its best-in-class team of professionals will provide the expertise needed to help develop a long-term plan for the proper implementation, development and ongoing management of captive insurance companies.

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At Oxford Risk Management Group, we specialize in conducting captive feasibility analysis and coordination of turn-key captive insurance company arrangements. As an alternative risk and captive insurance research and consulting company, we're focused on coordinating design, implementation, regulatory approval and management of captive insurance companies.

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