

Chairperson's Report

2011 will be a busy year for IMAC given the number of continuing developments in our industry including the draft Insurance Law and Regulations (industry consultation will follow shortly). In addition, IMAC are currently upgrading our existing processes and formulating additional strategies in order to preserve the position of the Cayman Islands as the domicile of choice for captive insurance companies. This includes legislative developments, various marketing programs, research and development initiatives and educational events. And of course, planning for the 2011 Cayman Captive Forum is moving ahead at full steam. See the Committee Reports for further details in this regard.

RIMS Annual Conference & Exhibit 2nd - 4th May, 2011

The RIMS Annual Conference and Exhibit will be held at the Vancouver Convention Centre West, Vancouver, Canada from May 2-4, 2011. The Cayman Islands Government is an exhibitor for this conference, at which a large delegation of IMAC full and local associate members attend to provide support. The Cayman Islands Government booth is number #1011 so if you are in attendance at this conference, please ensure you stop by and visit. In addition, the Cayman Islands are hosting a reception during the conference on Monday, May 2nd from 5:30-8:30 PM at Aqua Riva, located at 200 Granville Street, Vancouver, BC. See the directions below:

New Rule on Regulatory Reporting Standards Issued

The Cayman Islands Monetary Authority (CIMA) has issued a new rule called the Rule on Regulatory Reporting Standards (the 'Rule'). In issuing the Rule, CIMA is observing a recommendation made by the International Monetary Fund ('IMF') in its Country Report No. 05/92 'Cayman Islands: Assessment of the Supervision and Regulation of the Financial Sector', where the IMF noted that the regulatory reports formed a key component of CIMA's ability to monitor regulated entities in their compliance with regulatory requirements and their financial position and performance. The IMF report concluded that as accurate and timely reports are essential to CIMA performing its functions, CIMA should impose administrative fines for late or erroneous filing. Through this Rule, CIMA continues to meet international standards by meeting the suggestions of Essential Criteria 8 of the Basel Core Principle 21, Essential Criteria 12(c) of the International Association Insurance Supervisors Core Principle 12 and principle 9 of the International Organization of Securities Commissions. The effective date of the Rule is 1st August 2011. Therefore, the Rule will only apply to reports due from the 1st August 2011 onwards. Where a report was due before the 1st August 2011 but a firm receives an extension to the deadline resulting in the extended deadline



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falling after 1st August 2011, the Rule will also apply. This should provide firms with a reasonable period to prepare for the implementation of the Rule. CIMA views this Rule as a key addition to the Authority's powers in providing an efficient administrative option to the Authority where it seeks to ensure its provisions and standards are being complied with.

New-look Banknotes Set for Release

The Cayman Islands Monetary Authority (CIMA) has introduced a new series of banknotes, the D series, beginning the week of 4 April. The new series represents the first complete redesign of Cayman Islands banknotes since local currency was introduced

in 1972, and incorporates innovative features to significantly increase protection against counterfeiting and to make the notes more durable.

All six denominations – the \$1, \$5, \$10, \$25, \$50, and \$100 banknotes – have been redesigned, carrying new images, patterns and, in the case of one denomination, a new colour. At the same time, many of the familiar elements of the previous notes have been kept for continuity. Visually, the D series places heavy emphasis on the Cayman Islands' environmental heritage, with most of the notes featuring indigenous fauna and flora from the three Islands. The jurisdiction's expansion from its seafaring tradition into a modern financial services centre is also depicted. Each note bears an updated portrait of Her

Majesty Queen Elizabeth II, along with the Cayman Islands crest, and all the notes now carry an outline of Grand Cayman, Cayman Brac and Little Cayman. (Formerly, only the \$25 had an image of the Islands.)

The new family of notes has been in development since 2007. CIMA's Chairman, Mr. George McCarthy, OBE, JP, said: "The Board felt that it was timely to carry out a complete update of the banknotes, first, to modernise a design that had not changed substantially since the initial 1972 design, and, second, to take advantage of the latest security features available. Both the previous and current Cabinet agreed to this initiative. The length of the process, from conception to issuing, reflects how extensive the redesign has been and the many components of such a project."

Premier and Minister of Finance, Hon. McKeeva Bush, OBE, JP, has welcomed the new issue: "I am pleased with the design of these new banknotes, which are a stunning reminder of our Islands' natural treasures. I am happy too that the new series is being issued under the auspices of the Ministry of Finance. This serves as a marker of our recently updated constitution while the Queen's portrait acknowledges our continued British Overseas Territory status." As with all CI currency, CIMA will issue the new D series through the local retail banks. The issuing will be done on a phased basis. Managing Director, Mrs. Cindy Scotland, explained: "The public can expect to see the \$5 and \$25 notes first. The other denominations will follow as the notes that are now in circulation are gradually withdrawn from circulation. All previously-issued banknotes continue to be legal tender."



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Companies Law Amendment Boosts Cayman's Competitiveness

Legislative efficiencies have, once again, placed the Cayman Islands financial services industry at the forefront of an increasingly competitive market. The Companies Law (Amendment) Bill, 2011, makes necessary provisions to enhance the jurisdiction's offerings in the areas of company registrations and securities investment. Cayman Islands Premier and Minister of Finance, the Hon. McKeeva Bush, OBE, JP, tabled the bill in the Legislative Assembly on the 11 April 2011. He noted, "The process by which these amendments were prepared reflects Government's renewed partnership with the private sector, which has been instrumental in soliciting the views of industry and providing input into the drafting process. All departments involved, along with the Financial Services Legislative Committee, which is comprised mainly of private sector members, should be commended for their tireless efforts to ensure that the Cayman Islands remains a key player in the global financial services market."

The provisions of the Bill include:

- Amendment of merger provisions
- Treasury Shares
- Paperless share transfer
- Share redemption and repurchases
- Execution of documents
- Update of foreign company provisions
- Special resolutions: permit different thresholds for different matters
- Permitting company names in a foreign script
- Segregated Portfolio Companies portfolio names, director's liability, segregation of

assets and termination of SPC's. "These amendments are the end result of an extensive consultation process, aimed at addressing client and market-driven issues that have arisen in practice. It is expected to increase the attractiveness of the Cayman Islands as a domicile for corporate entities and maintain our competitive edge. Therefore, our local industry will benefit ten-fold from these new amendments, creating new opportunities for growth in this key sector of our economy," Bush continued.

Charles Jennings, Chairman of the Financial Services Legislative Committee added, "The adoption of these amendments has shown that the purpose of the Committee, namely to propose and draft new laws and amendments that will enhance the jurisdiction's reputation as a leading financial services centre, has been achieved. The Committee looks forward to being able to continue its work in partnership with the Government, the Companies Law amendments being the first of several proposals that the Committee is currently working on."

New CIMA MOU

The Cayman Islands Monetary Authority (CIMA) has formally established bilateral ties with the Dubai Financial Services Authority (DFSA) through a memorandum of understanding. The MOU, signed earlier by CIMA's Managing Director, Mrs. Cindy Scotland, received endorsement by the Premier of the Cayman Islands, the Hon. McKeeva Bush, OBE, JP, who was in Dubai for a State visit and was present for the signing by the DFSA on Wednesday,

30 March. Also in attendance were the Dubai International Financial Centre (DIFC) Governor, H.E. Ahmed Humaid Al Tayer, and other officials from both jurisdictions. The MOU with DFSA reinforces the regulator-to-regulator cooperation which the government of the Cayman Islands fully supports," said the Premier. "As I have previously stated, there are many synergies between our jurisdictions and I am proud to have been able to be a part of this solidification in our ongoing relationship with Dubai." This agreement - which boosts the number of MOUs and similar accords which CIMA has with international counterparts to 21 - will govern cooperation and the exchange of information between the organisations; something that had already been taking place on an informal basis.

Signing on behalf of the DFSA, Chief Executive, Mr. Paul Koster, said: "The DFSA is pleased to have entered into this formal arrangement with the Cayman Islands Monetary Authority. Both authorities are integrated regulators striving to embrace best practice and seeking to reflect the resolutions of the international standard-setters." The DFSA is the independent regulator of all financial and ancillary services conducted through DIFC. The DFSA's regulatory mandate covers asset management, banking and credit services, securities, collective investment funds, custody and trust services, commodities futures trading, Islamic finance, insurance, an international equities exchange and an international commodities derivatives exchange. In addition, DFSA, like CIMA, complies with the Basel Core Principles for Effective Banking Supervision and

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is a member of the International Association of Insurance Supervisors (IAIS).

COMMITTEE REPORTS

Cayman Captive Forum Update

Planning for the 2011 Cayman Captive Forum is progressing well and we are happy to report that the Main Sponsor, KPMG, plus many of our existing co-sponsors have agreed to remain sponsors for 2011. The deadline for speaker submissions was extended till Mar 31st and the Committee is currently evaluating approximately 100 speaker submissions. The negotiated Ritz room pricing at for this year's conference is as follows: Resort view rooms for US\$269 and Ocean view rooms at US\$399. Room registration is set to open in the Summer. Further details will be advised.

Legislative Developments

An ad-hoc group from the IMAC Executive and its Legislative & Regulatory Committee continue to perform a high level review of the draft Insurance Regulations. The draft regulations will be issued for consultation with the insurance industry in the near term.

Marketing Program

The latest news is that we have recently appointed local Cayman marketing consultancy firm, Fresh Image, to help us with our many and varied marketing activities. Some of the immediate projects they will help us with include: the reformatting of the IMAC website to

make it more informative and user-friendly; changing our logo (farewell to the palm tree); redesigning the IQ so that it's more web-based, and highlighting all the excellent work that the IMAC Education, Scholarship, Forum, Legislative and Strategic Committees do.

Research & Development Initiatives

IMAC's Research & Development Committee has been working on a number of initiatives including: production of a Domicile comparison chart that is being finalized and will soon be posted on IMAC's website. They have also been working with the IMAC Executive and US/Cayman attorneys in reviewing other domiciles cell legislation with a view to proposing some form of registered or incorporated cell provisions in current SPC legislation. In addition, they are developing a proposal to consider active marketing to Canadian captives that the Cayman Islands should be a preferred domicile.

Educational Events planned for 2011

1. Captive Basics 2011 Course at UCCI in April-June timeframe.
2. Presentation on 2010 Insurance Law and Regulations, TBD when Regulations are finalized.
3. Presentation on USA Health Care Reforms, in May or June, to be followed by an IMAC Social Event.
4. Scholarship Foundation Fundraising Dinner and Auction in September.

Technical Update

For the benefit of IMAC members and associate members, KPMG presents a quarterly summary of the key industry and technical accounting issues that are impacting captives and their boards of directors this year.

Federal Excise Tax ("FET") Filing Requirements

The instructions for Form 720, Quarterly Federal Excise Tax Return, specify that a taxpayer who pays premiums to a foreign insurer (or to any nonresident person such as a foreign broker) must pay federal excise tax under IRC §4371 and file a quarterly Form 720.

The taxpayer who pays the premiums may be exempt from the tax under IRC §4371 if the policy is issued by a foreign insurer that is a resident of a country that has a current treaty with the United States. However, the exemption from the excise tax liability does not necessarily provide an exemption from the filing requirement. IRC §6114 requires each taxpayer that takes a position that a treaty of the United States overrules an internal revenue law must disclose that position.

Specifically for Form 720, the taxpayer must make this disclosure once a year on its 1st quarter Form 720, which is due before May 1 of each year. The disclosure must be made on a statement reporting the payments of premiums that are exempt from the excise tax on policies issued by foreign insurers for the previous calendar year. For example, a taxpayer that reinsures solely with United Kingdom based reinsurers in tax year 2011, must file a first quarter Form 720 by May 1, 2012 to disclose the treaty-based excise tax exemption. That taxpayer is not required to file Form 720 for any subsequent quarters in 2012. Its next reporting requirement will be a Form 720 by May 1, 2013, assuming it maintains the same reinsurance practices in 2012.

The taxpayer may be able to use Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b), as a disclosure statement.

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U.S. Medicare Program Eliminates Investment Restrictions for Offshore Captive Insurers

Hospitals and other health care providers participating in the U.S. federal Medicare program ("Providers") will be pleased to learn that the Centers for Medicare & Medicaid Services ("CMS") has eliminated the investment restrictions that had applied to Cayman and other offshore captives. Previously, Providers that wanted to receive "cost based" reimbursement from the Medicare program (or similar programs, such as some state Medicaid programs) for premiums paid to related captives could do so only if the captive met specific Medicare guidelines, including the investment guidelines, which were contained in Section 2162.2.A.4 of the Medicare Provider Reimbursement Manual ("PRM"). Generally, under the investment guidelines, a captive's investment portfolio was limited to 10% investment in equities, with further limitations on the types and

amounts of equity investments, and the grades of fixed income investments.

CMS eliminated the investment restrictions (leaving intact other guidelines for captives) in a transmittal dated March 1, 2011, effective as of November 11, 2010, by deleting Section 2162.2.A.4 of the PRM in its entirety. It appears that CMS did so as a result of the August 13, 2010 decision of the United States Court of Appeals for the District of Columbia in *Catholic Health Initiatives v. Sebelius* (Case No. 09-5377). In that case (involving premiums paid to a Cayman Islands captive), the Court invalidated PRM Section 2162.2.A.4 on procedural grounds, stating that CMS failed to promulgate the investment restrictions as a regulation in accordance with the Administrative Procedure Act. The PRM is not a

regulation, and it is not published with notice and comment.

As a result of CMS' action, Provider sponsored captives that have been following the Medicare investment guidelines now have an opportunity to reconsider their investment policies, particularly as they relate to asset allocations. In addition, Providers that have been foregoing cost based reimbursement treatment of premiums paid to captives that did not follow the Medicare investment guidelines will have an opportunity to do so in the future, and may for some past premiums as well.

Julie Robertson is a partner of Honigman Miller Schwartz and Cohn, LLP, a firm which has provided legal services to captive insurance companies and their owners for over thirty years.

Crusader appoints new President

Mrs. Fiona Moseley has been named President of Crusader International Management (Cayman) Ltd. Mrs. Moseley has over 20 years experience in international insurance and finance operations and possesses extensive knowledge and experience of offshore variable life and annuity and captive management programs. *She has held the position of Managing Director of CIMCL since 2003 and has been instrumental in building the company to be one of the most respected captive managers in the Cayman Islands.*

According to company founder, Mr. Ian Kilpatrick "Fiona has successfully lead the company through the difficult economic times experienced over the last two years and managed to not only maintain business but grow it

substantially. She has introduced new financial products that have not only benefitted the company but more importantly its clients. Fiona joined the company when it was founded in 1992 and has steadily worked her way up the corporate ladder. The position of President has been vacant since October 2009 when my Partner relinquished the position on his departure from the group.

Fiona's appointment to this position acknowledges her hard work and dedication not only for the company but the industry and community as well. She is currently President elect of Rotary Central having devoted many hours to helping the community through being actively involved in their service; particularly their Junior Achievement Program

and has spearheaded Crusader's active participation in training and sponsoring young students to acquire an understanding of running a business.

I am certain in her new role Fiona will continue helping the company develop and continue its active participation in community affairs."

(CIMCL) is a member of the Crusader International Group which designs, organizes, and implements alternative risk transfer solutions in a number of jurisdictions around the world. Crusader works closely with its clients to develop unique programs for their clients who are high net worth Individuals, companies, groups, and associations that seek alternatives to the standard insurance marketplace.

Scholarship Fund Report

We are pleased to report that we are receiving a steady flow of donations to the fund including from our regular fund contributors Royal Bank of Canada and Wells Fargo Insurance Trust Services as seen below. You will see the names of these and other contributors listed on our website.

This year the Fund will again be offering a scholarship for a maximum of four years to a Caymanian High School graduate. Preference will be given to those candidates who intend to pursue a career in the financial ser-

VICES industry upon graduation from university, however applications from all disciplines will be accepted. Candidates should be prepared to begin their university degree programme in the 2011 school year. The choice of university must be approved by the Foundation.

Applicants should possess a minimum of five good CXC passes or equivalent. Evidence of educational achievements and, if appropriate, university acceptance should accompany the application. In addition, a

brief narrative as to the reason for the choice of University/Course should be included. Further details and application forms can be obtained by clicking the Education tab at www.caymancaptive.ky

Applications should be submitted no later than 20th of May 2010 to:

Insurance Managers
Association of Cayman
Educational Scholarship Foundation
P. O. Box 10552, Grand Cayman,
KY1-1005, Cayman Islands
Attention: Mr. William J.N. Forsythe,
FCA or email to william.forsythe@caymancaptive.ky or by delivery to the IMAC office located on the 2nd floor (beside Marsh's offices) at Governors Square, West Bay Road.



John Pitcairn accepts a US\$10,000 donation from Saad Hafiz of Royal Bank of Canada



John Pitcairn accepts Wells Fargo's US\$5,000 donation to the Scholarship Fund

CIMA Update

Articles of interest from CIMA's
"The Navigator - January 2011"
www.cimoney.com.ky

- CIMALicence/Registration Numbers
- International Students Gain New Perspective on Cayman Regulator
- Staff Assists the Community
- Promotions

Caribbean Association of Insurance Regulators (CAIR) - The CAIR/CARTAC Insurance Supervision Workshop and the CAIR Conference and Annual General Meeting will be hosted by the Cayman Islands Monetary Authority. This event will be held at the Grand Cayman Marriott Beach Resort, Grand Cayman, from June 13 - 17, 2011. The Workshop is scheduled for June 13-15, 2010 and will cover Actuarial Skills. The workshop will be conducted by Mr. Michael Hafeman, actuary and independent consultant.

Update from a Scholarship Recipient

Kia Ora (hello) from sunny New Zealand! Samantha Dorman here, recipient of the 2006 Mary-Lou Gallegos scholarship, award, by the Insurance Managers Association of Cayman (IMAC). I am presently pursuing a Bachelors of Veterinary Science (BVSc) at Massey University in Palmerston North, which is in the lower North Island of New Zealand.

This past week I commenced my 4th year lectures and labs, which have been really captivating and hands on. This year focuses on the health and management of specific animal species, (namely Cattle, Horses, Deer, Sheep, Goats, Dogs and Cats), with each species being allocated its own paper/course. This is in contrast to third year, which I like to refer to as 'the year of -ologies', as papers studied included Parasitology, Immunology, Microbiology, Pathology, Pharmacology, and the list goes on.



At work with Ernie the Goat Kid who broke his leg Feb 2011

The third and fourth years of Veterinary School are known to be the most difficult ones, due to the sheer volume of information that is thrown at you. To add to the stress of my third year, I unexpectedly had to take two weeks off at the start of second semester to visit my mom in Ft. Lauderdale, Florida, who suddenly fell ill as a result of Guillian Barre

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With classmates at the opening dinner of the 2011 Australasian Veterinary Students' Conference - January 2011

Syndrome. This is a neuromuscular disease that causes an ascending paralysis, i.e. you get paralysed from the feet and hands upwards. In her case, her respiratory muscles became paralysed and so she was placed on a ventilator. Her tongue muscles were also paralysed, and as a result she has been unable to speak since.

Although my mother is still in hospital overseas (some 8 months after becoming ill), she has experienced tremendous improvement and her physicians expect she will be able to return to the Cayman Islands within the next month if things continue to go well. She should make a complete recovery; however, the healing process will continue to be a slow one. I was happy that I could spend two weeks with her when she first became ill, and due to my Veterinary knowledge, I was able to communicate with the doctors easily and explain the various tests, procedures, and results to my family members more clearly, as there are so many similarities between Veterinary and human medicine. I was particularly grateful to be able to spend my 25th birthday with her in November, as well as Christmas and New Years.

Despite this traumatic emotional experience for my family and myself, I managed to complete all my third year exams with higher-level passes.

With just under two years to go until I complete my degree, I am looking toward the future with excitement and zeal. As my focus/interest is in large (farm) animal medicine, I plan to return to my beloved isle and gain employment as a large animal Veterinarian at the Cayman Islands Department of Agriculture, where I have been engaged in work experience annually on return to the island during Christmas breaks. I hope to enrich the Agricultural industry of the island and further educate farmers on proper farming practices that will not only enable them to have healthy animals, but will make their farming efforts more profitable and sustainable. I am fortunate that I have been able to study Veterinary Science in a country that places so much emphasis on farming and agriculture and am most appreciative of the ongoing support received from IMAC throughout my tertiary studies. I encourage any individual or business interested in making a strong contribution to The Cayman Islands and to the education of its young people to donate to/invest in the IMAC Educational Scholarship Fund. You can be assured that your financial contribution will be money well spent. Without this scholarship supplementing my Cayman Islands Government Scholarship, I would not have been this close to fulfilling my dream of becoming a Veterinarian. Thank you IMAC!

Kane to acquire HSBC's Insurance Management operations

Acquisition will create world's largest independent insurance manager.

Kane, a leading provider of specialist risk and insurance management services, has today (11 March 2011) announced that it has signed an agreement to acquire the insurance management operations of HSBC. Under the agreement, which has been signed with HSBC Bank Bermuda Ltd, HSBC Bank Cayman Ltd and HSBC Insurance Agency (USA) Inc, Kane will acquire HSBC Insurance Holdings (Bermuda) Ltd, HSBC Insurance SPC Ltd, the insurance management business and assets of HSBC Bank (Cayman) Ltd, and HSBC Insurance Agency (USA) Inc for a total amount of USD27.5m. The acquisition will be backed by private equity firm CBPE Capital.

HSBC Insurance Management (HIM)* is the world's fourth largest insurance manager and a recognised leader in the field of Insurance Linked Securities (ILS). HIM has an extensive and diverse customer base, which it serves from a global network of offices in Bermuda, Cayman, Guernsey, Malta, New York, South Carolina, Washington DC and Vermont, in addition to being approved to provide insurance management services in six other US States. The Company provides management, administration and structuring support services for: Captives; Cell Companies; Insurance Linked Securities; Insurance and Reinsurance Companies; and Life, Pensions and Investment (LPI) Companies.

Stephen May, CEO of Kane, said: "This agreement is a major step forward in the overall growth strategy for Kane. The acquisition will position us as the world's largest independent insurance manager and

clearly supports our aim of creating a global, domicile-neutral platform from which to offer our independent, expert advice. We welcome the new employees and customers of HIM into our Group and look forward to building and developing long term successful relationships."

HSBC will work closely with Kane to ensure a smooth integration of HIM into the Group. As part of the acquisition, Kane has offered employment to all HIM staff.

Roy Fellowes, CEO of HIM, said: "We are excited about becoming a part of the Kane Group and delighted they have embraced, and are committed to supporting and growing all current HIM business lines. Kane and HIM have a number of synergies, not only in relation to the products and services we provide, but also in terms of the culture and approach of the two organisations. These synergies will enable a successful transition and ensure that we maintain the high levels of service which our customers expect."

Clive James, a Director of Kane, said: "The acquisition of HIM provides a strong fit for Kane. We have established an excellent reputation in the provision of alternative risk transfer services, and are keen to bolster our activities in all of the sectors in which HIM presently operates. The Company provides a large and secure base in a number of key insurance territories coupled with a significant presence in traditional captives, and the specialist ILS and LPI markets"

Completion of the acquisition is expected to take place on 30 April 2011, subject to regulatory approvals. For further information please contact Linda Haddleton at linda.haddleton@ky.hsbc.com

Upcoming Events

RIMS Annual Conference and Exhibition
2nd - 4th May, 2011

Captive Basics Course
Early May.
Registration details TBA

BDO Quiz Night
26th May, 2011
Hard Rock Café details TBA

Shaun and Owen at Chamber of Commerce Job Fair



Many students visited the IMAC booth at the Chamber of Commerce Job Fair in February. IMAC is grateful to our willing volunteers from HSBC and Crusader.

US Taxation of Captives: Part I – Taxable Owners

By Tom Jones

This is the first of two articles summarizing current U.S. taxation of captives and their owners. This article focuses on captives owned by taxable entities and individuals. The second article will consider captives wholly or partially owned by tax-exempt organizations. We chose to bifurcate the two topics because of the fundamental differences in tax implications between the two types of owners. For instance, taxable owners generally strive to achieve “insurance company” status for their captives. Tax-exempt owners, in contrast, generally try to avoid having their captives being classified as “insurance companies.” Their reasons should be explained separately. Our ambitious objective is to describe in plain English the basics of how captives and their owners are taxed by the United States and its political subdivisions. You may be relieved that no Internal Revenue Code (IRC) provisions or Internal Revenue Service (IRS) rulings are cited by number, and only a few key cases are mentioned by name. Be aware, however, that generalizations have numerous exceptions, and the ideal use of this information is to enhance your ability to ask more targeted questions of your tax adviser. Although taxation of “cell” captives, “rent-a-captives,” and other “exotic” structures are not discussed in detail, the general principles described in this article also are applicable in determining how they are taxed.

Presence or Absence of “Insurance” Matters

When forming or participating in a risk financing mechanism, the threshold

tax issue is always the same: Is it really “insurance” for federal and state tax purposes? Although economists and insurance academics long ago reached a general consensus on the meaning of the term “insurance,” the tax law definition continues to evolve. Prior to discussing this definition, it is useful to understand why the presence of “insurance” for tax purposes matters.

Benefits of “Insurance” to Taxpayers: Deductibility of Premium Payments

The most obvious advantage of “insurance” status to taxpayers is the ability to deduct the payment to the insurer. To achieve tax deductibility, insurance premium payments must be deemed to be an ordinary and necessary business expense. In contrast, setting money aside in a self-funding reserve earmarked for future contingent losses is not tax deductible because, in effect, the taxpayer is merely moving the funds “from its left to its right pocket.” That is, payments into a reserve fund are generally not deductible until the fund actually pays out money for a loss or for loss adjustment expenses. Although this difference is only one of timing, a taxpayer that is able to accelerate deductions actually benefits from what amounts to an interest-free loan by the government.

A corollary benefit from “insurance” inures to the risk-funding vehicle (e.g., an insurance company) itself. As stated, a regular taxpayer cannot deduct internal loss reserves. However, the IRC affords insurance companies

a special statutory advantage. (Note: all references to insurance companies include reinsurance companies as well.) Insurers alone are eligible to take a current tax deduction for a “reasonable and fair” estimate of future contingent losses and loss adjustments expenses (reduced by an IRS-prescribed or experience-derived discount factor to account for the time value of money). So, if a funding vehicle is subject to tax, and if it can be classified as an insurance company, its tax burden will be substantially reduced. This is most pronounced in the case of “long-tail” exposures, where years pass between the premium payment and the claim payout. This loss reserve deduction is beneficial to both onshore and offshore captives. A 2004 IRC amendment confirmed that the same definition of “insurance company” applies to property and casualty (P&C) as to life insurers; namely, that over 50 percent of its business is issuing insurance or annuity contracts, or reinsuring risks of insurance companies.

Offshore captive insurers, furthermore, have two more tax advantages. First, they may voluntarily elect to be taxed in the United States. Sometimes, an offshore insurer decides that it prefers to be treated as a domestic taxpayer for tax minimization or compliance simplification reasons. It can do this by making an essentially irrevocable election to this effect. But only true insurance companies are permitted to so elect. Second, by statute, an offshore insurance company is automatically

US Taxation of Captives

exempted from an onerous tax regime applicable to a passive foreign investment company (PFIC).

Disadvantage of “Insurance” to Taxpayers: Other Taxes.

A disadvantage of falling within the definition of “insurance” is that premiums paid to offshore insurers with respect to U.S. risks are subject to a Federal Excise Tax (FET) (unless a tax treaty applies). The tax is 4 percent of the premium for direct (unfronted) insurance and 1 percent of premium for reinsurance or life business. In addition, the IRS takes the position that the FET applies on a so-called cascading basis, i.e., to multiple insurance and reinsurance transactions covering the same risk. So, for example, under the IRS view, an insured may bear the FET cost of 4 percent of the premium paid to a Bermuda insurer and may then bear an additional FET cost of 1 percent of the premium paid by the Bermuda insurer to reinsure the risk with another Bermuda insurance company. No FET treaty relief exists for the most common offshore captive domiciles—Bermuda or the Cayman Islands. Other countries do enjoy FET relief in treaties, such as the one between the United States and Ireland. Further, many states impose a special type of premium tax, often called a “direct placement” or “self-procurement” tax, applicable to insurance premiums paid to both onshore and offshore captives that are not licensed in the taxing state. In many (but not all) cases, this tax is not applicable if no “insurance” exists such that the payment, at least arguably, is not really a “premium.”

The Evolving Tax Definition of “Insurance”

The Need for Risk Shifting and Risk Distribution

Surprisingly, neither the IRC nor other official pronouncements actually define the term “insurance.” To find “insurance,” both the IRS and numerous courts have required the presence of both risk shifting and risk distribution. Risk shifting connotes the transfer of risk to a separate party, e.g., the financial consequences of the potential loss are shifted from the insured to the insurer. Risk Distribution mandates that enough independent risks of unrelated parties be pooled to invoke the actuarial law of large numbers, e.g., each insured’s risk exposures are spread among premiums paid by other insureds so that a particular insured is not funding its own losses. In 1977, the seminal IRS revenue ruling on risk shifting was released in which the “economic family” doctrine was enunciated, denying premium and loss reserve deductibility to a single-parent captive covering risks of only the captive’s parent and its subsidiaries. (The IRS has since abandoned the “economic family” doctrine—discussed below—but continues to apply the principles outlined in that ruling to challenge arrangements where the captive covers only its parent’s risk or where the facts and circumstances otherwise indicate that the purported insured has not in fact transferred risk.) A year later, the IRS conceded that if a sufficient number of unrelated parties pool their loss exposures (31 in the ruling), then sufficient risk distribution exists to create “insurance.” In 2002, the

IRS released a group captive ruling indicating that as few as 7 equal owners should suffice to create a bona fide insurance company.

Unrelated Risk

In practice, courts have concluded that insurance is present if a single parent captive writes significant unrelated business. That is, the courts have determined that if a captive covers a sufficiently large percentage of “unrelated risks,” then the entire risk pool should be treated as an insurance company. This judicial rule derives from three appellate cases decided contemporaneously against the IRS and for the taxpayer in 1992. In the first case, the IRS alleged that Allstate was not an “insurance company” relative to its then parent, Sears, notwithstanding that well over 99 percent of Allstate’s insureds were completely unrelated parties. In a companion case involving the Harper Group, only 29 percent of the retained premiums were (in one of the years under audit) attributable to unrelated parties. In both cases, the taxpayer prevailed. IRS guidance issued in 2002 provides that where only 10 percent of the premiums are attributable to unrelated parties, the arrangement lacks the requisite risk shifting and risk distribution to constitute insurance for tax purposes. However, where 50 percent or more of the premiums are attributable to unrelated risks, the requisite risk shifting and risk distribution are present. From these cases and administrative guidance—and with a considerable degree of trepidation—the unofficial rule of thumb for finding enough risk transfer and risk distribution to support a finding of “insurance” is

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at least 30 percent (the closer to 50 percent the better!) unrelated (third-party) retained premium.

Brother-Sister Risk

While the battle over unrelated risk was underway, an ingenious lawyer for Humana Corporation in 1986 presented to the court a then novel theory that a captive's coverage of brother-sister corporations, although under common ownership by the parent, could result in a finding of "insurance." Building on a longstanding tax principle that separate corporations should be treated separately in spite of their common ownership, the argument was that risk indeed had been distributed among the numerous sister subsidiaries of the captive even though they belonged to the same economic family. Although the Tax Court initially rejected this approach, the Sixth Circuit Court of Appeals accepted it, and other circuit courts subsequently have cited this case with approval. In addition, the U.S. Court of Federal Claims in Washington concurred and, in so doing, gave the theory national viability. The IRS, recognizing that the courts had rejected the economic family doctrine, announced in 2001 that it would no longer invoke the theory with respect to captive insurance transactions. Shortly after that announcement, the IRS released additional guidance in the form of a revenue ruling which concluded that an arrangement in which a captive insurance company provided professional liability coverage to 12 brother-sister subsidiaries constituted "insurance" where none of the subsidiaries accounted for liability coverage of

less than 5 percent, nor more than 15 percent, of the total risk insured by the captive insurance company. Recent guidance, however, cautions that the 12 brother-sister subsidiaries must be "regarded" entities-as contrasted with entities that are treated as a division of their parent entity, often referred to as a "tax transparent" or "disregarded entity." A Federal Claims Court decision rejected the notion that divisions of a corporation should be treated as if they were separate corporations for this purpose. So, siblings of even a single-parent captive-if there are enough of them, the risk spread among them is adequate, and they are regarded entities--can deduct premiums paid to the captive (although the parent itself cannot) and, further, the captive can deduct loss reserves attributable to the siblings.

Partnerships and S Corporations

As discussed above, at least according to the IRS, disregarded or tax transparent entities (such as limited liability companies with only one member) are treated as branches of a parent entity and are not treated as separate entities for purposes of assessing risk shifting and risk distribution. What about partnerships and S corporations? These types of entities are similar to disregarded entities from a tax perspective, e.g., partnership income flows through to its partners, and S corporation income flows through to its shareholders. In the partnership area, the determination of whether the entity or the owner is the insured may depend on the state law form of legal entity. For example, a partnership that is organized under a state limited

partnership law is not necessarily the insured. In that instance, the IRS may view the general partner as the insured because under state law, the general partner is ultimately liable for the partnership's obligations. As a result, in the insurance arrangement, it is the general partner whose risk is shifted. In contrast, a partnership that is organized under a state law limited liability company act may itself be viewed as the insured because, under state law, no liability attaches to anyone other than the limited liability company itself. A similar result would arise with regard to corporation that has elected special tax treatment under Subchapter S of the IRC-while the owners, rather than the corporation, are taxed on corporate earnings, no liability attaches to anyone other than the corporation itself. As a result, the insured would be the corporate entity and not the shareholders.

Onshore versus Offshore

For a tax planner, the basic dichotomy in captive domicile selection is onshore versus offshore. Nontax business factors often rightly predominate in making the "proper" choice. In fact, the United Parcel Service (UPS) tax case underscores the critical importance of documenting the business reasons motivating the decision to form a captive. Moreover, in recent years, the courts and the IRS have focused on the "economic substance" of transactions, i.e., does the transaction have a substantial nontax purpose, and does it meaningfully affect the parties' economic positions. Very recently, the "economic substance" doctrine was codified in the IRC thus highlighting the continued emphasis on the taxpayer's business motivation.

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The conventional wisdom has been that offshore insurance regulation, for example in Bermuda and the Cayman Islands, generally is more flexible and reporting requirements are less stringent than onshore. Given that over 30 captive-friendly states now compete for captive business, however, great strides have been made by American domiciles in accommodating the ever-changing uses and objectives of captives and their owners. A few fundamental tax principles will assist in analyzing domiciles for the optimal tax outcome:

1. Any risk pool sharing sufficient exposures to constitute “insurance”-whether in the legal form of a trust, partnership, or limited liability company-is taxed as a corporation.
2. Corporations formed under the law of any U.S. state generally are subject to federal income tax on worldwide income.
3. An offshore corporation is itself taxable in the United States only if it conducts business in the United States. A narrow exception, mentioned above, is that if the offshore corporation is an “insurance company,” it can voluntarily elect to be taxed as a domestic corporation. But most offshore captives diligently avoid engaging in a U.S. business (see below), both to escape federal income tax at the captive level and to stay out of state insurance regulatory trouble. (As “alien” insurers without a certificate of authority from any state, they are prohibited from conducting an insurance business onshore.)

Taxation of Offshore Captives

Despite misperceptions among the general public, offshore captive insurance programs generally are subject to annual federal income taxation, even though taxation by the host domicile may be light or nil. Five major tax areas include:

- Imputed federal income tax imposed on the shareholders of a controlled foreign corporation (CFC)
- Related person insurance income (RPII) CFC Rules
- Branch profits tax
- Federal withholding tax
- Federal Excise Tax (discussed above)

CFCs and “Subpart F” Provisions

An offshore captive, if controlled by U.S. persons or if writing a significant amount of risks of its U.S. owners, is subject to a complex imputed federal income tax regime imposed on CFCs under the “subpart F” provisions of the IRC. In general, subpart F provides that each U.S. shareholder owning 10 percent or more of the voting power of a CFC (after taking into account complex attribution rules) will be taxed annually on its pro-rata share of the undistributed insurance income attributable to risks outside its country of incorporation. An insurance company is a “regular” CFC if such U.S. shareholders collectively own 25 percent or more of the voting power or value of the foreign captive. The purpose of imputing the foreign captive’s income to its U.S. owners is to prevent U.S. shareholders (or policyholders in the case of a mutual company) from deferring U.S. tax by accumulating such income offshore in a no-tax or low-tax jurisdiction. Double

taxation of this income is avoided by allowing the foreign captive to pay actual cash dividends subsequently without additional tax. If the foreign captive is an “insurance company,” subpart F income will be computed in essentially the same basic way in which a domestic insurance company computes its taxable income. That is, the U.S. shareholder will be taxed currently on net underwriting and investment income, calculated using U.S. tax accounting rules, earned by the foreign captive after deduction of “fair and reasonable” discounted loss reserves. If the foreign captive does not qualify as an “insurance company,” then it generates only investment income, and it may be subject to the PFIC provisions mentioned above. Some offshore insurance company captives avoid the CFC subpart F provisions by making the voluntary onshore tax election previously described. They thereby become eligible (subject to restrictions on use of tax losses) to join in the parent’s federal consolidated income tax return. These offshore captives are usually controlled affiliates of multinational corporations. Why would they choose this election? To avoid having to pay the Federal Excise Tax on premiums, a possible 30 percent “branch profits” tax, and a 30 percent withholding tax (the latter two to be described below).

RPII CFC Rules

In addition to the “regular” CFC definition, special provisions apply to certain offshore insurance companies, mainly group-owned captives. The effect is to tax all U.S. shareholders (regardless of captive ownership percentage) annually on their share of the captive’s undistributed income

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attributable to insuring parties related to the captive's owners. These related RPII CFC rules, which vastly expand the net of subpart F where captive owners and insureds overlap, apply whenever the following three criteria are satisfied:

- RPII represents 20 percent or more of the captive's insurance income;
- Twenty percent or more of the voting power or value of the captive's shares is directly or indirectly owned by its insureds or their affiliates; and
- U.S. shareholders (without regard to the 10 percent minimum ownership requirement for "regular" CFCs) own 25 percent or more of the voting power or value of the captive's shares for at least 30 consecutive days in a taxable year.

Branch Profits Tax

Offshore captive income "effectively connected" with its U.S. trade or business may be subject not only to "mainstream" corporate tax (currently at a 35 percent statutory rate), but also to a second layer of tax. The branch profits tax is imposed at a rate of 30 percent on net earnings attributable to the captive's U.S. trade or business which are not retained in that business. "Effectively connected" income is that income effectively derived from doing business in the United States (whether purposeful or inadvertent).

Federal Withholding Tax

Finally, offshore captives should not lose sight of the 30 percent federal "withholding" tax (a misnomer as it is non recoverable) on passive income such as interest and dividends emanating from a U.S. source.

This tax makes "loanbacks" from offshore captives to U.S. parents more expensive because it applies to the actual or imputed interest on such related party loans. This tax usually is avoidable on fixed income securities owned by the foreign captive, under the "portfolio interest" exemption, but it applies to dividends on equities of U.S. issuers, although not to American Depositary Receipts (ADRs) of foreign issuers. More complex rules apply to mutual funds (including bond funds) that usually are treated as generating dividends. For this reason, many offshore captives invest in offshore "clone" funds that escape withholding tax under the tax treaty between the United States and their country of formation (often Ireland or Luxembourg).

How to Avoid U.S. Business.

Most offshore captives strive to avoid being found to be "engaging in a U.S. trade or business" because the captive itself (rather than its U.S. shareholders) then will become subject to U.S. corporate tax on income "effectively connected" with its U.S. business. Many steps can be taken to avoid engaging in a U.S. trade or business. Common techniques include the following:

- Carrying on as many activities as possible outside the United States
- Not qualifying to do business under the corporate laws of any state
- Conducting daily operations through offshore management personnel (usually by contract with a captive management organization) located outside the United States
- Holding all board of directors

meetings (including committees) and executing all contracts outside the United States

- Drafting the captive policies in an "indemnity" rather than "pay on behalf of" format with a clause shifting duty to adjust and settle claims to the indemnified Party
- Having a deductible or self-insured retention such that the onshore party has the first-dollar loss exposure

If there is an income tax treaty in force between the United States and the captive's domicile, as is the case with Bermuda, then the issue becomes whether the insurance company has income "attributable to" a U.S. "permanent establishment." In general, the treaty rules allow a somewhat broader range of activity before sufficient nexus for direct U.S. income taxation exists. A frequently overlooked safeguard is to cause the offshore captive to file an annual protective IRS Form 1120-F to eliminate the possibility (as permitted in the IRC) that it might be taxed on gross income (without benefit of deductions or credits). This return need not disclose information other than the name, address, and Federal Employer Identification Number of the captive.

Taxation of Onshore Captives

Because a domestic captive is itself subject to tax on worldwide income, no imputation system like the subpart F provisions is necessary. Domestic "insurance company" captives can deduct discounted loss (and unearned premium) reserves when calculating their taxable underwriting and investment income. As with an eligible

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offshore captive electing onshore tax treatment, a domestic captive at least 80 percent owned (measured by voting power and value) by another domestic corporation can be included in the federal consolidated income tax return of its parent. Although this inclusion causes the premium deduction and taxable premium income to “wash out” in the consolidation, the discounted loss reserve deduction survives to reduce consolidated taxable income of the group.

Miscellaneous Tax Considerations

Other factors can militate against a captive’s status as a true insurance company. A few of the most prominent include the following:

- Undercapitalization or promise of additional capitalization (sometimes called “accordion” capitalization) of the captive
- Parental guarantees or comfort letters in favor of the captive or its “fronting” insurer
- Excessive use of “loanbacks” of captive assets to its parent
- Captive policies that do not transfer risk, for example, because policy limits are certain to be exceeded (i.e., policies that are more like banking or deposit transactions than insurance contracts)
- Cell or “Chinese Wall” sub-account structures (whether by statute or contractual) designed to prevent risk sharing. (Definitive guidance in this area is expected. In the interim, in 2008, the IRS published a ruling considering the deductibility of premiums paid to a cell company. The guidance

applied the risk shifting and risk distribution principles outlined in this article to a single cell of the cell company as if it were a separate taxpayer and not a division of a cell company. Proposed Treasury Regulations issued in September 2010 provide additional guidance. The Proposed Regulations generally treat each cell as a separate taxpayer--applicable to U.S. cells and to non-U.S. cells that conduct an insurance business. Thus, the Proposed Regulations are consistent with the IRS guidance and support application of the risk shifting and risk distribution principles to the cell as a separate taxpayer. The Proposed Regulations also provide transition rules that generally permit a cell to be treated together with the other cells in the cell organization and with the cell organization itself as a single entity until a change in ownership of 50 percent or more of the cell organization (or the cell.)

Key Tax Points to Remember

To reinforce your recall of captive tax basics, here are a few key tax principles in condensed form:

- “Insurance” is not specifically defined in the tax law and, therefore, its meaning is derived (and will continue to evolve) mainly from case law and IRS pronouncements.
- The touchstone of “insurance” is risk shifting and risk distribution.
- Existence of “insurance” is important, not just to accelerate a tax deduction to the time the premium is paid from the time

the claim is paid, but to allow the risk pool to deduct reserves for estimated losses and unearned premiums.

- Any risk pool constituting “insurance,” regardless of form (trust, limited liability company, unincorporated association, etc.) is taxable as a corporation.
- A longstanding tax maxim is that, absent extraordinary circumstances, each legal person (individual or entity) has an independent and separate identity, irrespective of who owns it or whom it owns.
- Notwithstanding the above maxim, a legal entity that is disregarded or tax transparent, such as a single member limited liability company, will be treated by the IRS simply as a division of its parent and will not be treated as having an independent and separate identity.
- By writing as little as 30 percent or, better, at least 50 percent (measured by net retained premiums) unrelated business, the entire captive can be a true “insurance company.”
- Alternatively, a captive covering a significant number of brother-sister affiliates can be an “insurance company” vis-à-vis those affiliates (but not the parent).

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