

OFFSHORE (CAYMAN) CAPTIVES IN THE MODERN ERA

Alan Craig
Partner
Campbells
acraig@campbellslegal.com

Eric Lark
Partner
Kerr Russell
elark@kerr-russell.com

Damian Pentney
Partner
PwC
damian.pentney@ky.pwc.com



CAYMAN
CAPTIVE
FORUM
2018

INTRODUCTION

A. A brief history of captives, captive jurisdictions and the success of the Cayman Islands as a domicile

- The Birth of an Industry
- Early Captive Legislation and Cayman
- Segregated Portfolio (Protected Cell) Company Legislation and Cayman

B. In the modern era, does it still make sense to domicile a captive in Cayman?

[Hint: The panel would unanimously and emphatically state “yes”!]

- The Statistics
- The Reality
- Other Offshore Domiciles

THE CONTINUING COMPELLING CASE FOR DOMICILING OFFSHORE (IN CAYMAN)

A. The Advantages of Cayman as a Jurisdiction

- A long history of innovation and being ahead of the curve
- Cayman is a major worldwide financial center
- Importance of captive insurance to the island
 - Government support
 - Public/private partnership
- Approachable regulator and correct mix of flexibility and legitimacy

THE CONTINUING COMPELLING CASE FOR DOMICILING OFFSHORE (IN CAYMAN)

A. The Advantages of Cayman as a Jurisdiction (cont.)

- Excellent, stable and deep infrastructure of professionals supporting the industry
 - Unlike many onshore jurisdictions where captive insurance is a start-up industry, captive insurance is a mature industry in the Cayman Islands
 - Proven model – “been there, done that”
 - Captive managers, accountants, auditors, attorneys, local banks, investment managers, independent directors
 - Know each other and roles, how to interact with each other, with regulators
- Regulatory framework/environment
 - Mentioned previously innovativeness and being ahead of the curve
 - Many new initiatives we’ll get into later

THE CONTINUING COMPELLING CASE FOR DOMICILING OFFSHORE (IN CAYMAN)

A. The Advantages of Cayman as a Jurisdiction (cont.)

- Reasonable capital/surplus requirements
- Reasonable costs to set up and operate a captive in Cayman
- Favorable local tax regime
 - No premium tax, income tax
 - Reasonable annual fee
- Familiarity and political and economic stability
- “Go to” jurisdiction for healthcare, group captives
- Other advantages
 - No requirement to meet in Cayman every year, unlike many states
 - No requirement for local directors, unlike many states
 - Local attorneys tend to be more reasonable, less omnipresent
 - Discourages claims, lawsuits against captive
 - Shareholder, captive liquidation examples
 - Discourages contingent fee litigation
 - Ease of access – sunshine, beaches, golf, restaurants, etc.



THE CONTINUING COMPELLING CASE FOR DOMICILING OFFSHORE (IN CAYMAN)

B. The Disadvantages of Jurisdiction Offshore

- There is still a stigma attached to Offshore Jurisdictions
 - In the “old days” less global regulation, less transparency, the world was a larger place, and tax loopholes existed and were utilized
 - “The Firm” and other movies perpetuate the stigma
 - Money laundering, tax havens and no transparency
 - U.S. politicians perpetuate myths for political advantage
 - “Panama Papers” and similar exposés that people don’t understand
 - IMAC marketing campaigns to counter the negative (and inaccurate) perceptions
 - More transparency, international cooperation, IRS scrutiny than ever
 - Perception = reality!
 - Some companies simply cannot overcome the perception
 - Need to continue to work on changing the perception

THE CONTINUING COMPELLING CASE FOR DOMICILING OFFSHORE (IN CAYMAN)

B. The Disadvantages of Jurisdiction Offshore (cont.)

- FET & Other U.S. federal tax issues
- State self-procurement taxes (premium taxes)
- Compliance with U.S. reporting obligations
 - FATCA – Foreign Account Tax Compliance Act
 - FBAR – FinCen Form 114 – Foreign bank account report regardless of captive tax election
- Impact of EU initiatives on Cayman and other offshore jurisdictions
 - Example: Bermuda and Solvency II equivalency
 - BEPS
 - Pressure regarding physical presence
- Other disadvantages

THE CONTINUING COMPELLING CASE FOR DOMICILING OFFSHORE (IN CAYMAN)

C. Cayman vs. Other Offshore Jurisdictions

- Cayman versus Bermuda
 - More similarities than differences
 - Direct access to reinsurance markets
 - Regulator comparison and communication
 - Cost comparison
 - Our experience/perception

THE CONTINUING COMPELLING CASE FOR DOMICILING OFFSHORE (IN CAYMAN)

C. Cayman vs. Other Offshore Jurisdictions (cont.)

- Cayman versus Barbados
 - Many similarities but some key distinctions
 - Barbados and Canada
 - Regulators and regulation
 - Infrastructure and professional depth
 - Other issues
- Other offshore jurisdictions
 - Others in Caribbean - not typically comparable
 - European-centered jurisdictions

THE CONTINUING COMPELLING CASE FOR DOMICILING OFFSHORE (IN CAYMAN)

D. Cayman vs. Onshore (U.S.) Jurisdictions

- Vermont, Hawaii, D.C., South Carolina, Delaware some of the more established U.S. jurisdictions
- Proliferation of U.S. jurisdictions over past 10 years
- Some lines of business require U.S. only providers (ex: TRIA coverage, employee benefit risk)
- Ease of access – depends, but typically easier + not international
- Is the U.S. jurisdiction's captive insurance department a state priority?
 - Is it properly staffed, funded, politically popular?
 - How does the captive insurance department interact with rest of insurance department?
 - How experienced is the regulator?
 - How stable is the department – does it change when a different political party is in power?
- Little history and experience
- How strong is the professional infrastructure?

THE CONTINUING COMPELLING CASE FOR DOMICILING OFFSHORE (IN CAYMAN)

D. Cayman vs. Onshore (U.S.) Jurisdictions (cont.)

- Is the regulatory framework proactive or reactive?
- Costs to set up and operate a captive
 - Sometimes have to pay for professional review of application
 - Premium taxes in lieu of state income taxes in most jurisdictions
 - Capital/surplus requirements – can be substantially more than Cayman
- State protection provisions
 - Local directors
 - Local meetings annually
 - Local service provider directives
 - Mandatory regulator meetings

THE CONTINUING COMPELLING CASE FOR DOMICILING OFFSHORE (IN CAYMAN)

D. Cayman vs. Onshore (U.S.) Jurisdictions (cont.)

- Federal taxes
 - Little difference if IRC 953(d) election is made
 - If IRC 953(d) election is not made by offshore captive, many differences
- Generally, no stigma, but the reputations of some U.S. jurisdictions are less than stellar

THE CONTINUING COMPELLING CASE FOR DOMICILING OFFSHORE (IN CAYMAN)

E. The Impact of Recent U.S. Federal Tax Reform on Offshore Captives

- Preliminary disclaimers and assumptions
- Recall a foreign captive that qualifies as an “insurance company” and is a CFC can elect to be taxed (from a U.S. federal tax standpoint) at the shareholder level (Form 5471’s) or the entity level (IRC 953(d) election)
- On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act (TCJA) which impacted captives as follows:
 - Largest impact was lowering of lowest U.S. federal income tax rate from 35% to 21%
 - The impact of this is to essentially take away any remaining tax advantage of being offshore + not taking 953(d) election
 - Complicated analysis – have to determine if getting shareholder dividends or policyholder distributions
 - If shareholder is an individual or flow through entity, can probably get qualified dividend treatment, but taxed first at captive level
 - If shareholder is a corporation, dividends may be eligible for a dividends received deduction, but taxed first at captive level and dividends received deduction is reduced under the TCJA
 - Policyholder distributions taxed as ordinary income but also deemed an expense of the captive
 - Lastly – how should assessments be treated – as premium or capital contributions

THE CONTINUING COMPELLING CASE FOR DOMICILING OFFSHORE (IN CAYMAN)

E. The Impact of Recent U.S. Federal Tax Reform on Offshore Captives (cont.)

- Other major impacts of the TCJA:
 - CFC rules
 - Prior: a shareholder was a “U.S. shareholder” (for purposes of determining U.S. shareholder ownership of a foreign entity for CFC purposes) if such shareholder owned 10% of the voting shares of the stock of the foreign corporation
 - Now: a shareholder is a “U.S. shareholder” if it owns 10% of the vote or value of the shares of stock of the foreign corporation
 - Impact: captive can no longer issue non-voting shares to avoid CFC status
 - Result: it will be harder to avoid CFC status and thus harder to avoid IRS jurisdiction
 - BEAT – Base Erosion Anti-Abuse Tax
 - Generally, imposes a minimum level of tax (similar to an alternative minimum tax) on certain deductible payments made to a foreign affiliate
 - Limited application to captives
 - Applies to single parent captives of large C Corp parents
 - Parents must have at least \$500M of annual domestic gross receipts
- Conclusion: Tax advantages for U.S. based captive participants have essentially been eliminated, but...

THE CONTINUING COMPELLING CASE FOR DOMICILING OFFSHORE (IN CAYMAN)

F. The Impact of EU Initiatives on Offshore Captives

- If most Cayman captives have North American participants, why do we care what the EU is doing?
- Solvency II equivalency – established in Bermuda
 - Stricter capital and solvency requirements
 - More robust disclosure requirements
 - Risk management framework
- Solvency II equivalency not established in Cayman, but influential nonetheless
- Increased governance and reporting is generally a good thing, but over-regulation is a concern
- Common reporting standards (CRS) – similar to FATCA
- General Data Protection Regulation (GDPR) (EU-5/25/18)
 - Impact on Cayman discussed below
 - Likely will have similar impacts in the U.S.

THE CONTINUING COMPELLING CASE FOR DOMICILING OFFSHORE (IN CAYMAN)

G. Recent Cayman Regulatory Initiatives

- Past 10 years have seen a significant increase in Cayman regulatory activity
 - Already mentioned the recent portfolio insurance company (PIC) regulation
 - Incorporated cell company regulation
 - Insurance law amended in 2010 to establish new classes of Cayman insurance companies – recognizes differences in types of insurance companies, their financial capabilities/resources + sophistication
 - Competitive updates to the Insurance Law
 - Insurance manager regulation also enacted
 - Requires licensure of insurance managers
 - More robust requirements on keeping books and records
 - Establishes the captive manager as the point of contact with CIMA
 - Whistleblowing requirements if concerns about clients
 - Rule on Risk Management for Insurers (2015)
 - Requires written framework be established, documented and maintained

THE CONTINUING COMPELLING CASE FOR DOMICILING OFFSHORE (IN CAYMAN)

G. Recent Cayman Regulatory Initiatives (cont.)

- Rule and Statement of Guidance (SOG) on Corporate Governance for Insurers - 2016
 - Requires a written Corporate Governance Framework be adopted and approved annually
 - Proportional
 - Requirements apply to governing body (typically Board) and its structure and governance
 - Checks and balances on governance of risk management, compliance, actuarial matters, internal audit
 - Requires regular review of internal controls (see also, Rule and SOG on Internal Controls, 2007)
 - Requires adoption of a Conflict of Interest Policy and directors must submit a Conflict of Interest Statement annually
 - Requires Policy on Outsourcing be reviewed annually (see also, SOG on Outsourcing (2015))
- Monetary Authority Law (2016 revision)
 - Includes CIMA's Enforcement Handbook provisions
- Overall impact of plethora of regulations is good, but...
 - Clearly influenced by Solvency II
 - Other outside pressures (OECD, NAIC, etc.)
 - Creeping ever closer to over-regulation and stifling the entrepreneurial spirit so crucial to the industry
 - Do the changes make Cayman more or less competitive?

THE CONTINUING COMPELLING CASE FOR DOMICILING OFFSHORE (IN CAYMAN)

H. Potential/Future Cayman Regulatory Initiatives

- Regulations on administrative fines
- Data Protection Law 2017 – effective 1/1/19
 - Seeks to comply with GDPR “adequacy standard”
 - General Data Protection Regulation (GDPR) (EU – 5/25/18)
- Other regulations in the pipeline and issues expected to be addressed
- Impact on Cayman’s competitiveness as a domicile

Best Practices for Maintaining a Captive's Offshore Status

- A. In an increasingly connected world, why is it necessary to take precautions to preserve a captive's offshore status?
- The IRS and "U.S. trade or business" concerns
 - The 953(d) election eliminates the IRS U.S. trade or business concerns, but...
 - Still have state (insurance) regulatory concerns
 - Captive is not licensed in any of the states and is deemed a non-admitted insurer
 - Would not want to be deemed to be conducting insurance business in any state without proper licensure

Best Practices for Maintaining a Captive's Offshore Status (cont.)

- B. Safeguards against inadvertent presence in the U.S. (or a particular state)
- Generally, make sure “mind and management” of the captive remain offshore and that the captive is not “conducting insurance business” in the U.S. or engaging in a “U.S. trade or business”
 - Want to avoid continuity, regularity, substantiality of the captive’s U.S. activities
 - Remember, the captive is licensed as an insurance company in Cayman and is regulated by Cayman’s insurance laws – so adhere to them

Best Practices for Maintaining a Captive's Offshore Status (cont.)

- B. Safeguards against inadvertent presence in the U.S. (or a particular state) (cont.)
- The captive insurance manager's role is to facilitate the conduct of the captive's business offshore
 - Few captives have employees or own property, but if they do the employees or property should not be onshore
 - Offshore captives can contract arm's length with independent third parties (independent contractors) onshore
 - All typical functions of an insurance company (such as underwriting) should be concluded offshore
 - Direct write policies should always be signed and delivered offshore, for instance

Best Practices for Maintaining a Captive's Offshore Status (cont.)

- B. Safeguards against inadvertent presence in the U.S. (or a particular state) (cont.)
- All material (and definitely major) decisions of the captive should be made offshore
 - All shareholder, board and board committee meetings should occur offshore and any actions (decisions) of such groups should be made offshore
 - Document meetings with minutes and include resolutions of the actions taken
 - Avoid participation by decision makers by remote means
 - Utilize proxy meetings when shareholders, directors cannot meet offshore

Best Practices for Maintaining a Captive's Offshore Status (cont.)

- B. Safeguards against inadvertent presence in the U.S. (or a particular state) (cont.)
- All material contracts to which the captive is a party should be executed offshore on behalf of the captive
 - In a direct-write situation, even more important to maintain the offshore nature of the captive because there is no licensed fronting insurance company and likely no licensed broker involved
 - Again, policies should be issued and delivered offshore
 - Direct write policies should indemnify/reimburse the insured to minimize the captive's direct onshore involvement in a claim/loss
 - Remember, whether a captive is conducting business onshore is a factual determination and it should avoid continuous, systemic, regular and substantial trade, business, and mind and management onshore

Best Practices for Maintaining a Captive's Offshore Status (cont.)

C . Regulatory Consequences of Ignoring Best Practices for Maintaining Offshore Status

- As President Trump might simply state, ignoring best practices could be “very, very bad”
- On the tax (IRS) side, filing a protective 1120F informational return could provide some protections
- In general, however, unless the 953(d) election has been made the captive has not been paying any income taxes on the federal level
- On the insurance regulatory side, the captive could be deemed to be conducting insurance business in a given state without a license

Conclusion

- As discussed, many advantages of Cayman (and other offshore jurisdictions) still exist, even in the modern era
- Tax advantages of going offshore have largely been eliminated
- Important to do your homework and analyze all factors
- Choosing Cayman (and certain other offshore jurisdictions) can still be a fine choice, just make sure you respect and maintain the offshore nature of your captive to avoid inadvertent tax and insurance jurisdiction onshore
- Q&A's

Alan Craig
acraig@campbellslegal.com

Eric Lark
elark@kerr-russell.com

Damian Pentney
damian.pentney@ky.pwc.com

www.caymancaptive.ky

THANK YOU!

