

Chairperson's Report

This continues to be a year of change and initiative for IMAC and the Association is continuing to work on various endeavours including re-branding of IMAC, enhanced marketing of Cayman captives, research into new legislative avenues and consultation with Government on the draft Insurance Regulations. More information can be found in the various committee reports included in this edition of the IQ. A formal launch of some of these projects is forthcoming so watch this space!

RIMS Annual Conference and Exhibit - May 2 - 4, 2011

The RIMS Annual Conference and Exhibition was held in Vancouver, Canada from May 2-4, 2011. The Cayman Islands Government was an exhibitor for this conference and the Cayman Islands was represented by a large delegation of IMAC full and

local associate members from private sector companies, including banks, insurance managers and auditors. This year's conference and exhibition was well received. Indeed exhibiting there provided Cayman representatives with the opportunity to meet risk managers and other delegates from various market segments.

IMAC Annual General Meeting

IMAC's Annual General Meeting will be held on the morning of September 2nd, 2011. Registration for the Luncheon and Golf is now open and the agenda for the day is set out below:

- AGM Meeting (for full members only) at The Ritz Carlton – 9:00 am to 11:35 am.
- AGM Lunch at The Ritz Carlton Grand Ballroom – 11:45 am to 1:45 pm.
- AGM Golf Tournament at Blue Tip Golf Club sponsored by Munder Capital – 2:00 pm to 5:00 pm. Teams

are limited to 11 teams of 4 players so register early.

• AGM Evening Networking Function – 5:00 to 7:00 pm. All IMAC members welcome (with three complimentary beverages per attendee from member firms followed by a cash bar). Please contact Alanna Grace, Jennie Hope and William Forsythe AGrace@global.ky; jennie.hope@willis.com ; william.forsythe@candw.ky to indicate how many are expected from your firm.

Cayman-Canadian TIEA Now In Force

The Tax Information Exchange Agreement between the Government of Canada and the Cayman Islands was entered into force on June 1st, 2011. The TIEA was signed on June 24 2010 in George Town by the Canadian High Commissioner, H.E. Mr. Stephen C. Hallihan and Cayman Islands Premier the Honourable McKeever Bush, OBE, JP. The entry into force of this TIEA is significant for both countries, as it now allows for the exchange of information as outlined in the provisions of the Agreement, with relation to taxes.

The Cayman Islands has 23 agreements in place with the U.S., Denmark, Faroe Islands, Finland, Greenland, Iceland, Norway, Sweden, U.K., Ireland, the Netherlands, New Zealand, France, Netherland Antilles, Australia, Aruba, Portugal, Germany, Canada, Mexico, Japan, India and South Africa. Negotiations have also



Cayman Islands Financial Services - RIMS 2011, Vancouver, Canada

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been completed with a further seven jurisdictions.

Cayman Representatives to Attend Rims Canada

Gordon Rowell, Head of Insurance at CIMA, and other industry representatives will be attending RIMS Canada being held in Ottawa, Ontario this year, from September 18-21. Mr. Rowell plans to meet with key producers of captives to ensure the Cayman Islands is being favorably represented when it comes to feasibility studies on domicile selection, or even recommendations on domiciles. If you would like to set up a meeting with Mr. Rowell while he is in Ottawa, please contact him directly at g.rowell@cimoney.com.ky

Cayman Hosts 7th Global Forum Peer Review Group Meeting

The Ministry of Finance, Cayman Islands Government, hosted the seventh meeting of the Global Forum Peer Review Group from 18-22 July at the Westin Casuarina Resort. The event was expected to have more than 150 attendees, representing 40-plus jurisdictions. This meeting comprises presentations, discussions and approvals of peer review reports, and other matters involving the peer review process by member and non-member countries that relate to transparency and the exchange of information for tax purposes. The Minister of Finance, the Honourable McKeever Bush, OBE, JP, hosted the meeting.

"Through our longstanding relationship with the OECD, and having signed bilateral agreements with 23 countries, the Cayman Islands has maintained high standards in

tax transparency during the last 11 years," Mr. Bush said. "As members of the Peer Review Group and the Global Forum Steering Group, we are committed to participating in international cooperation matters relating to tax and policy matters of the OECD. "We look forward to sharing our Caymanian hospitality with the delegates, and I also thank the staff of the Financial Services Secretariat for organising this meeting on behalf of the Ministry," Mr. Bush added.

The Cayman Islands has actively participated in tax transparency initiatives since 2000, playing an integral role in the restructured Global Forum, Steering Group and the Peer Review Group. To date the Cayman Islands has provided assessors for five peer review evaluations. The Cayman Islands had a favourable assessment during Phase 1 of the Peer Review Process and is expected to undergo its Phase 2 in the second half of 2012

Risk Management & Solvency

The global turmoil in recent years has been said to have been caused by risk mismanagement and worldwide there has been an increased focus on addressing shortcomings in risk management practices. In the Cayman Islands, companies already had been considering their risk environments but given global events, CIMA then implemented the Rule on Risk Management where licensees were expected to adopt a Risk Management Framework ("RMF") appropriate to their size and complexity. The Rule was developed based on review of risk management issues identified in International Association of Insurance Supervisors Principle 18. The RMF

is then expected to document a company's processes in regards to Board Strategy, Risk Appetite, and Appropriate Controls. The objective was not necessarily reducing risk. Taking risk is acceptable as long as it's monitored and controlled. Risk management is an international issue and the Rule provides an opportunity to lead the way. Indeed, the Rule and risk management framework should be a useful tool for captive boards and management to assess and manage captive's risk. The Rule on Risk Management appears to have been well implemented by the industry based on the size and complexities of Cayman's captive population. While the items noted in the rule were most likely already being discussed by the various captive boards, the Rule did encourage further discussion as well as a more formal documentation program where warranted.

There has been historic criteria for promoting insurer solvency and inadequately addressed risks e.g., European Union's Solvency I framework (minimum capital requirements drawn from simple formula without adequate sensitivity to nature and scale of risk). Solvency assessment must work in partnership with Risk Management, not independent of it. Hence, Solvency II for insurance in Europe and Basel II for solvency globally. Solvency II has three pillars: Pillar 1 - Quantitative Requirements e.g. Solvency calculation, required capital, Pillar 2 - Qualitative Requirements e.g. risk management and Pillar 3 - Disclosure. The Cayman Islands has not committed to adopting Solvency II due to the uncertainty as to its current lack of proportionality, the treatment of beneficiaries and the use

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of standard calibration models. The lack of proportionality is a major issue in terms of captive companies given the significant differences between captive structures and commercial insurers. Indeed, back in 2006, the IAIS Issues Paper on the Regulation and Supervision of Captive Insurance Companies noted "in the light of a higher probability of accurate ultimate loss reserves in a captive it is unreasonable for solvency levels that would be applied to a commercial insurer to be applied to a captive."

Gordon Rowell, Head of Insurance Supervision of CIMA has advised that "Any attempt to strengthen supervision through the quantification of risk management and greater disclosure must be welcomed and Solvency II, from this perspective, is an excellent attempt at a total balance sheet approach to regulation. However, it is important that the model is fully tested and calibrated against all institutional models lest it fail to meet some of its laudable objectives. At present, EIOPA is still working on some of the calibrations and as such, it is very premature to make any cogitative analysis of the benefits until a final model is known and understood. I do however believe that captives, in general, should be either subject to some simplification rules or excluded altogether."

Caribbean Insurance Regulators Met In Cayman

The Cayman Islands Monetary Authority (CIMA) hosted insurance regulators from around the region for a training workshop, conference and meetings during the week of June 13-17th.

The Caribbean Association of Insurance Regulators (CAIR) and

the Caribbean Regional Technical Assistance Centre (CARTAC) staged the CAIR/CARTAC Insurance Supervision Workshop from Monday to Wednesday, June 13-15th. The workshop was geared towards insurance supervisors from regulatory agencies that are members of CAIR or from CARTAC member countries. Training focused on actuarial skills in order to orient participants to the roles of actuaries in insurance and expose them to basic actuarial concepts and tools.

Following the workshop, CARTAC sponsored the CAIR Conference on Thursday June 16th. The theme of the conference was: "Possibility to Probability: Exploring Regulatory Challenges in Risk Management". A range of topics relevant to the supervision of insurance companies were covered, including rating, solvency, capital, reinsurance issues, and Caribbean actuarial standards. Speakers and presenters included CAIR Chairman, Mr. Leon Anderson; CARTAC Program Coordinator, Mr. Arnold McIntyre; President of the Caribbean Actuarial Association, Ms. Cathy Lyn; CIMA executives, as well as other high level industry professionals. The week ended on Friday with separate meetings of CAIR, regional regulators, and the Caribbean Actuarial Association Advisory Committee.

CAIR was established in 1994 to address the need to create regulation appropriate for the Caribbean insurance industry. CARTAC is a regional training resource established by the CARICOM Council of Ministers of Finance and Planning (COFAP) and based in Barbados. Since the start of its operations in 2001, it has been used by member countries for

facilitating the development of skills in specialised industries, needed to meet the standards at both national and regional levels.

COMMITTEE REPORTS

Cayman Captive Forum Update

The Cayman Captive Forum 2011 will be at The Ritz-Carlton, Grand Cayman from Tuesday November 29th to Thursday December 1st, 2011. The Forum Committee has been very busy over the last couple of months discussing what, if anything needed to be changed to improve upon our very successful 2010 Cayman Captive Forum. I am happy to report that although a few minor tweaks will occur which primarily relate to the logistics of the event, the style, format and overall framework will remain the same as last year!

We are in the process of finalizing what appears to be another excellent slate of speakers for this year's forum and by the time of printing of this publication all submissions will be notified. Once again it was no easy task narrowing our choice down from record 114 submissions to the 34 final speaker topics and as always we very much appreciate everyone who takes the time to submit a potential topic. We are in the final stages of verifying our key note speaker for this year and will be able to make that announcement in our next quarterly report!

We continue to re-register existing sponsors and exhibitors and are proud to have KPMG as our main event sponsor for another year! We still have some sponsorship opportunities available and if you are interested we encourage you to contact our General Manager, Willie Forsythe at william.forsythe@caymancaptive.ky for more

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details. Without the support of our sponsors and exhibitors we would not be able to hold this event nor would we be able to provide funding to the IMAC scholarship fund, the main beneficiary of this event, which annually provides scholastic opportunities to Caymanian students. We look forward to seeing you in November!

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.

Research & Development Initiatives

Further to discussions between the IMAC Executive and local Cayman attorneys in regards to incorporated cell company provisions, interested stakeholders are examining and discussing the suitability of incorporated cell companies (and other substantially equivalent structures) for the captive insurance market

in Cayman. No formal legislative process has yet been initiated but the intention is to propose legislative amendments in due course.

IMAC 2011 Scholarship Awarded

The second half of the \$120,000 contributed in 2010 by HSBC, from SPV charitable donations, to the IMAC Scholarship Foundation has again been more than matched by the annual contribution from IMAC. This has enabled the Foundation to grant two scholarships this year instead of one, and we are sending Sheena Jackson to the University of Waterloo in Canada to gain a Bachelor's Degree

in Computer Science over the next four years, and Priscilla Brown to the University of South Florida to earn a Bachelors Degree in Management over the next four years. Details were published in the local press in July.

The recipient of the 2010 scholarship, Brittany Borden, has achieved excellent grades in her first year at Brock University in Canada and has been accepted at a University in Florida to complete her Bachelor's Degree in Business Administration.

Additional details about the scholarship program are available at www.imacky.com on the Education/Scholarship Program page.



L-R: Merta Day, Sheena Jackson, John Pitcairn, Priscilla Brown and Mike Bowerman

Industry News

Beecher Carlson Cayman, Ltd.

Since becoming Beecher Carlson, the organization has undergone significant growth. Through key acquisitions and strong organic growth, Beecher Carlson has grown from a rank of 66th on Business Insurance Top 100 list in 2006 to a rank of 21st in 2010. One of the key acquisitions was that of

RiskCap Cayman, Ltd in 2004 which continued to do business under the same name. The decision was made this year to officially change the name of RiskCap Cayman, Ltd to Beecher Carlson Cayman, Ltd to better represent the global resources and expertise of the Company.



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Industry News

RSM Cayman

RSM Launches in the Cayman Islands

RSM Cayman Ltd, approved by the Cayman Islands Monetary Authority in June 2011 is the newest full member firm within RSM International (RSMI), the world's 6th largest global network of accountants and consultants.

The partners of McGladrey and Pullen, Cayman recently announced the formation of the new firm, RSM Cayman Ltd., trading as RSM Cayman and the successor firm to McGladrey & Pullen, Cayman

The formation of RSM Cayman has been driven by the continued growth of the firm and is effected to support the expansion of the practice in full service audit and advisory, alongside its successful local review and fund sign-off services.

The firm maintains an extremely strong relationship with McGladrey, the US member firm of RSMI, and the 5th largest US public accounting firm, formalised by its membership of The McGladrey Alliance. This highly regarded membership, alongside over 100 independent accounting firms in the US, and only the 2nd internationally, facilitates continued and strengthened access to McGladrey resources including training, IT, marketing and practice management.

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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.

Five To Do's for Audit Committees in 2011

When considering and carrying out their 2011 agendas, audit committees should...

1. Keep the audit committee's eye on the ball: financial reporting and related internal control risk. Ensuring that the audit committee agenda appropriately focuses on the issues that require the committee's attention will be a significant undertaking in 2011. The challenges of a continuing slow growth economy coupled with the impact of major public policy and regulatory initiatives – Dodd-Frank, IFRS and accounting standards convergence, financial services regulation, etc. – on the company's compliance, risk, and governance processes will require the attention of every audit committee. To meet this workload challenge, develop more-focused (yet flexible) agendas, with an eye on the company's key financial reporting and related internal control risks. Streamline committee meetings by insisting on quality pre-meeting materials, spending less time on low-value or "checklist" activities, and engaging in more discussion (versus presentations).

2. Understand how the raft of accounting changes on the horizon will impact the company and its resources. While the SEC determines what role IFRS will play in US financial reporting, significant change to US accounting is on the way. The FASB and the IASB are working on a number of joint projects, and final accounting standards in several areas- fair value measurements and insurance contracts – are scheduled to be issued by June of 2011. Understand how these projects will impact your company, including implementation / resource requirements, and stay close to where the projects are headed and the timeline.

3. Understand the company's significant tax risks. Tax authorities in the US and globally are ratcheting-up their enforcement efforts – and are more aggressively sharing information to increase the effectiveness of their tax audit of multinationals. In September, the IRS announced that it will require companies to report uncertain tax positions on their tax returns – providing important information to the IRS for use in tax audit. Given this tax risk environment, understand management's process for determining the company's tax risk appetite. Who is involved? What are management's processes for determining whether a tax position is uncertain? What about the related controls?

4. Reassess the quality of business controls around the company's key operational risks – and consider possible lessons learned from the business crises of the past 18 months. Understand the company's key operational risks – including low probability, high impact risks – and assess the adequacy of the business controls management has put in place around those risks. What's changed in the operating environment? Have we had any failures – or near misses? What are the risks posed by the extended organization – service providers? How good are our disaster recovery plans? Are emerging risks – whether slow-moving or fast-hitting – getting sufficient agenda time? Does the audit committee have a good sense of the company's risk culture –beyond the boardroom and senior management level? Is the company's risk appetite clearly articulated and understood?

5. Consider whether the company's financial statements and disclosures provide users with a good, plain-English understanding of the state of the business. Given the importance of transparency to the key decision makers and shareholders, consider how disclosures can be improved – perhaps going beyond what's "required" – to better address expectations. Enlist management in this effort. At the end of the day, do the financial statements and disclosures tell the company's story?

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Scholarship Report

My name is Brittany Borden, I am 19 years old and I am currently completing the first year of my business degree at Brock University in Ontario, Canada.

Coming to university was the best decision I have ever made and I am extremely grateful for being given this amazing opportunity. The knowledge I have gained and the experiences I have encountered have made my first year of university unforgettable.

Brock University is a wonderful school. It has a beautiful campus, lots of extracurricular activities, a great introduction program for international students and is constantly making improvements to the University. Brock also has a very diverse student population and this year I met many new people from all over the world.

The university is located in St. Catharines, Ontario. St. Catharines is a relatively small city with extremely friendly people, which has made my transition into a new country easier



than I expected. Another great benefit of living in St. Catharines is that everything is very convenient and targeted towards university students.

The freedom and independence of living away from home made me both nervous and excited. I was excited to see how well I could take care of myself on my own but I was also very nervous to leave all of my family and friends behind. It was difficult to adapt to taking over all of the responsibilities my parents once had, like paying the bills and cooking every

day. But over the course of this year, I have grown to love all of the responsibilities I have taken on and as a result I feel I have truly transformed into a mature young adult.

The main thing that caught me by surprise was how cold it gets. I didn't realize that the temperature stayed close to 0°C for 7 out of the 8 months I am in Canada. The drastic climate change has been very hard to adapt to, however, being able to experience snow for the first time has made it worth it.

Each of my first year classes have been interesting and enjoyable. The teachers are always enthusiastic and being able to make my own class schedule is amazing.

I have absolutely enjoyed my first year of university and I am extremely grateful to everyone at IMAC who has made this amazing opportunity available for me. I will never forget how much you all have done for me. Thank you.

ICCIE held its first-ever online auction



The International Center for Captive Insurance Education (ICCIE) held its first-ever online auction in June. Nearly 30 gifts were donated to support the home of the captive insurance industry's only professional designation -- the Associate in Captive Insurance (ACI). IMAC participated with a contribution of a \$150 Best Buy Gift Card, which was auctioned off at nearly full price.

The auction comes as ICCIE prepares to mark its seventh anniversary. With nearly 200 ACI graduates and more than 700 registrations in the designation program or individual courses, ICCIE has attracted students and faculty from many different domiciles and corners of the world. For additional information about ICCIE, go to www.iccie.org.

Upcoming Events

ASHRM

October 16-19, 2011
Phoenix Convention Center
www.ashrm.org

Cayman Captive Forum

November 29 - December 1, 2011
The Ritz Carlton, Grand Cayman
www.caymancaptive.ky

The 3rd Annual BDO/IMAC Quiz Night

The third annual BDO/IMAC Quiz night was held on Thursday evening, May 26th at Hard Rock Café.

A record fifteen teams took part in this year's contest eclipsing the mark of 10 teams that participated in each of the previous two years. This year's event

trivia), we were faced with a three-way tie between the two Crusader teams and CIMA, so we had to devise a tie-breaking "speed round" idea to help break the deadlock. After some deliberation and consultation of the quiz book that also acted as our last

Paul Fordham, Simon Kilpatrick and Ismay Johnson) proved themselves to have the quicker pen in the tie breaker and walked away with the first place prize of a North Sound jetski safari trip. CIMA had to be content with second place for the second year in a row and were rewarded with gift certificates to Ortanique. The third place team from Crusader earned themselves a few laps at the Cayman Karting track.

When asked for a few words to describe the feeling of winning such a prestigious title, Jessop replied, "It's all about the winning, oops, no sorry – the taking part, I mean. Great night, lots of fun and a full year for everyone to polish up their general knowledge, roll on next year." That may have been the team's celebratory Appleton and soda drink from the trophy talking, however.

Of course, we did award prizes again for the last place team, which the "What You Talkin' Bout" team from Willis took home this year, and for most creative/humorous name, won this year by "Quiz Team Aguilera" from Marsh.

BDO would like to thank everyone for making this year's event such a great success and a lot of fun. Already looking forward to next year!



Team "All or Nothing" with Ed Weber, Tiffany Petyt, Wayne Morgan and Lisa Johnson - missing Terry Petyt who was behind the viewfinder

included two teams from each of Crusader, Global, Kensington and Marsh as well as teams from Aon, Caledonian (last year's champs), CSI, Sagicor, SRS, Willis and, of course, the team from CIMA, the 2009 winners and 2010 runners-up.

The quiz consisted of eight challenging rounds full of questions which had been prepared and focus group-tested (with first-graders, albeit) by BDO staffers over the prior few months (OK, days), all designed to test the skill of the participants. This year's quiz also saw a new twist of strategic play, with the addition of a joker card for each team to play at the beginning of a chosen round of questions which would double that team's score for that round.

At the end of the eight rounds of questions and as a direct result of a successful answer challenge by Michelle "Bulldog" Lockwood of Crusader (that girl knows her Chilean miners

place consolation prize for the evening, it was decided that the three teams would be challenged to write down as many Caribbean countries as they could in one minute.

While CIMA and the aptly-named "In First Place" Crusader team put up a good fight, "The Caped Crusaders" (Stuart Jessop, Michelle Lockwood,



Team "Caped Crusaders" with Stuart Jessop, Simon Kilpatrick, Ismay Johnson, Michelle Lockwood and Paul Fordham

US Taxation of Captives: Part II - Tax Exempt Owners

In contrast to their taxable counterparts, tax exempt owners generally seek to avoid their captive being classified as an “insurance company.” Special federal tax issues arise when one or more tax-exempt organizations (such as hospitals and healthcare systems, colleges and universities, YMCAs, etc.) form and operate a captive insurance company. Although tax deductibility of premiums paid by tax-exempt insureds is unimportant, ascertaining the proper tax characterization of the risk funding arrangement as qualifying or failing to qualify as “insurance” for tax purposes always is important. To facilitate analysis, we will consider:

- Single-owner onshore captives
- Multi-owner onshore captives
- Single-owner offshore captives
- Multi-owner offshore captives

For lack of any commonly used name for captives with exempt organization owners, we will refer to these arrangements as “EO captives” and their parent as an “EO.”

Tax Considerations for Onshore EO Captives

Corporations formed under the laws of a state or the District of Columbia are generally taxed on their worldwide income. However, a special Internal Revenue Code (IRC) provision permits risk pools covering only exposures of state political subdivisions and governmental instrumentalities to operate on a tax-exempt basis. School districts and similar public or municipal units typically use this narrow exception to run tax-free their workers compensation and liability pools.

The Unrelated Business Taxable Income (UBTI) Conundrum

But why form an EO captive at all? Couldn't the EO simply set up an internal bank account to fund its exposures and those of unrelated parties? The answer, unfortunately, is “No.” A specific IRC provision states that if an EO conducts a “commercial-type insurance” business which constitutes an insubstantial portion of its activities (measured by gross revenues), then the net insurance profit will be taxable to the EO as “unrelated business taxable income” (UBIT). Worse, if these insurance activities become substantial (a gray area, somewhere around 10 percent of its gross revenues), then the EO will lose its tax exemption. As we will see, an EO captive often will allow no or low-tax risk funding for its parent and unrelated parties that would be unattainable by the EO itself.

Single-Owner Onshore EO Captives

An EO captive that does not write enough unrelated business to qualify as an “insurance company” will generate only investment, but no insurance underwriting, income. Whether it takes the form of a trust or a subsidiary, it can obtain its own tax-exempt status if it covers only the EO parent that created it and/or exempt affiliates controlled by the parent, and their respective employees. A number of hospitals operate tax-exempt captives in Vermont and Hawaii in this manner to fund institutional, employee and controlled affiliate risks. However, a simpler trust format typically is used by EO hospitals to self-fund medical malpractice risks (trusts require no capitalization, regulatory filings or domicile managers). The Internal Revenue Service (IRS) has officially recognized

that such trusts, whether securing a separate IRS “determination letter” or operating as an “integral part” of the founding EO, are nontaxable.

If a single-parent captive writes enough unrelated business to become ineligible for exempt status, the bad news is that it will then become a fully taxable property and casualty insurer. Although the good news is that it would be eligible for the benefits of “insurance company” taxation, few, if any, EOs would choose this approach because the entire risk pool (including parent coverage) would then be taxed. A fine point here is that the threshold for taxing the risk pool in the EO world is the more stringent “insubstantial” versus “substantial” gray line mentioned above, rather than the unofficial, more lenient 30 percent unrelated net retained premium “rule of thumb” applicable in the taxable owner world.

Multi-Owner Onshore EO Captives

Surprising to non tax practitioners is the fact that a trust, captive, or other risk-bearing entity covering exposures of two or more unrelated EOs is considered engaged in a true “insurance” business under the IRC's strict “commercial-type insurance” rules and therefore is a taxable entity. An example of this reality is three domestic EO (hospital and charity) risk pool taxpayers, which logically, but erroneously, believed their pools would inherit the participants' EO status. All three lost court decisions on this point.

Tax Exemptions. Four narrow exceptions exist to automatic federal income taxation of onshore EO captives.

- Domestic captives formed by

US Taxation of Captives: Part II - Tax Exempt Owners

churches and associations of churches are eligible to obtain exempt status if certain IRC requirements are satisfied. In one well publicized instance, a Vermont group captive formed exclusively by Catholic hospitals achieved such status.

- A particular IRC section grants tax exempt status to non-life insurance companies if annual gross receipts do not exceed \$ 600,000 and more than 50 percent of those receipts consist of premiums. Mutual insurance companies may qualify as tax-exempt under the same IRC section if their gross receipts do not exceed \$150,000 and if premiums make up more than 35 percent of those receipts.

- Another obscure IRC section allows a charitable risk pool formed as a nonprofit organization under an authorizing state law exempting it from state tax, and which obtains at least \$1 million in startup capital from an unrelated charitable organization, to qualify for tax exemption.

- Lastly, a single member domestic limited liability company (LLC) captive, so long as it is not classified as an insurance company for tax purposes (usually because it covers no unrelated policy holders), is treated as a “disregarded entity” for taxes and thus is simply a part of its tax-exempt parent hospital.

Given the virtual certainty of full taxation onshore (at least where unrelated risks are or may in the future be included), forming an EO captive offshore historically has been preferable from a tax standpoint. As will be discussed below, however, unless an exception applies, a 1996 change in the IRC makes some

taxation more likely for EOs owning offshore EO captives.

Tax Considerations for Offshore EO Captives

In 1996, the IRC was amended retroactively to the beginning of that year to clarify the law on taxation of EOs owning offshore captives. The change was sufficiently fundamental that it is worthwhile to provide the citation to this provision (IRC § 512(b) (17)) and to discuss briefly both pre-1996 and post-1995 situations.

Note that this entire offshore EO captive discussion assumes that no voluntary onshore tax election has been made (to our knowledge, never done by EO captives) and that the offshore EO captive has successfully avoided engaging in a U.S. trade or business. Although captive domiciles impose no corporate income taxes, captives (EO or otherwise, formed outside United States) are ineligible for U.S. EO status. Thus, if they do business in the United States, they will become subject to direct federal income taxation, including the possibility of a second tier “branch profits tax.” Finally, offshore EO captives face the same Federal Excise Tax and 30 percent withholding tax rules on U.S. source passive income as any other captive. Please see Part 1 (CICR November 2010 for a brief discussion of all these topics).

Single-Owner Offshore EO Captives Pre-1996

A long line of IRS private letter rulings starting in the early 1980s consistently concluded that, in a single-parent context, owning an offshore captive does not adversely affect the exempt status of an EO. These rulings also concluded that investment income generated by the EO captive, taxable currently to the EO parent as a deemed

distribution under the controlled foreign corporation “Subpart F” rules is in the nature of a dividend, which by statute is excludable from UBTI. (Note: This exclusion is inapplicable if the EOs investment in the shares of the offshore captive was “debt financed” -that is, acquired with funds borrowed by the EO.) Further, in a 1990 ruling, the IRS allowed an offshore hospital captive, without changing the favorable tax result, to cover professional and general liability of taxable subsidiaries and controlled tax-exempt affiliates of the hospital, employees of any of these entities, and professional liability of voluntary (non-employed) medical staff of the hospital.

Single-Owner Offshore EO Captives Post-1996

The 1996 IRC amendment now makes the relevant inquiry whether the EO owner of an offshore EO captive would generate UBTI if it were itself conducting the business of the captive. The mechanism for accomplishing this is a “look-through” approach treating any “insurance income” of the captive as being taxable as if it were generated by the EO parent itself. Therefore, the rules above describing an EO conducting a “commercial-type insurance” business, including UBTI or potential loss of EO status, will determine the outcome. But recall that a single-owner captive covering only parent and controlled affiliate risk, under caselaw and IRS interpretations, does not create “insurance income,” but rather only investment income. Thus, this IRC amendment should not change the favorable tax results previously obtained by EO captives where risks of only members of the same economic family (and their employees) are being funded.

A single-owner offshore captive that

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covers not only the EO, as above, but also other entities may avoid the “look through” rule by taking advantage of the amendment’s specific definition excluding from UBTI coverage of “affiliates.” In one respect, the amendment narrows the prior interpretation of “affiliate.” Only EOs can be “affiliates,” so coverage of, for example, a for-profit, noncontrolled (i.e., a taxable 50/50 owned joint venture) will generate UBTI. In another respect, however, the amendment liberalized the commonly accepted existing rule: The amendment allows coverage without UBTI of any tax-exempt “affiliate” of the EO that has “significant common purposes and substantial common membership, or directly or indirectly substantial common direction or control” with the EO.

This is broader than under the pre-1996 law, where, for two tax-exempt parties to be considered related, they must have had a relationship similar to that of parent-subsidiary. That is, previously one must have possessed the capability of electing a majority of the board of directors of the other. Further, coverage of directors, officers, or individuals who perform services for the EO or its “affiliate,” primarily with respect to risks associated with those services, will not generate UBTI.

Multi-Owner Offshore EO Captives-Pre 1996

A few additional favorable private letter rulings were in a multi-shareholder rather than single-parent offshore EO captive context. Nonetheless, concern existed that under longstanding IRS pronouncements, offshore EO captives involving sufficient risk sharing and risk distribution among unrelated parties to constitute “insurance” were more vulnerable than single-parent

EO captives to causing UBTI in the hands of EO shareholders. This was particularly so because these captives insure mostly risks of their EO shareholders or other related parties and thus were subject to stringent “Subpart F” rules targeting offshore related party insurance income (RPII).

Multi-Owner Offshore EO Captives Post-1996

As mentioned, the 1996 IRC amendment mandates the “look through” approach with the result that, unless an exception applies, virtually all multi-owner, risk-sharing offshore EO captives writing coverage for at least a few unrelated EO owners will generate UBTI in the hands of these owners.

Tax Exceptions. There are two exceptions:

The amendment contains a special rule applicable to colleges and universities and hospitals that “participate in an insurance arrangement that provides for any profits from such arrangement to be returned to the policyholders in their capacity as such.” Although no regulations have been issued interpreting this provision, it appears that offshore EO captives formed as mutual insurance companies or as stock companies that cannot return profits through share ownership, but only via the policies it issues, will qualify for the benefits of this exception.

Where the EO participants in the offshore multi-owner EO captive establish “cells” or “separate-accounts” such that no risk sharing or risk distribution can occur (short of the insolvency of the captive), no “insurance income” would exist, so favorable single-parent EO captive treatment would seem to

be warranted. Consistent with this observation, the IRS in 2008 guidance and proposed Treasury regulations issued in 2010 continues to move in the direction of each cell being treated as a stand alone taxpayer.

State Taxation of EO Captive Transactions

Although the situation varies dramatically from state to state, often state premium taxes supplant the state income tax applied to insurance companies, including both onshore and offshore captives. Although all states have premium taxes, they may not apply if only a “private procurement” of coverage is occurring, or if only “industrial insureds” are being covered, because such taxes are levied in exchange for the privilege of transacting an insurance business in the state. Most states impose an often weakly enforced “self-procurement tax” on premiums paid to an onshore or offshore captive, in some cases even if the coverage is actually not “insurance” under federal law, and even if no insurance producer or broker is involved. Status as an EO policyholder or owner usually is not relevant to applicability of this tax.

Reciprocal RRG-A Better Structure for Multi-Owner EO Captives?

As we have seen, the 1996 IRC amendment substantially reduced the tax advantage of offshore domiciles for EO captives and therefore renewed EO interest in onshore captives generally and risk retention groups (RRGs) specifically. RRGs can be viewed as special purpose onshore group liability captives, which are fully taxable entities qualifying as “insurance companies” eligible to deduct reserves for future losses. From a regulatory standpoint, under the

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federal Risk Retention Act, they have the ability to write liability coverage nationally on an “unfronted” basis from a “captive friendly” state (such as Vermont or Hawaii) and to solicit new business elsewhere without violating state insurance laws.

A reciprocal is unique in that it can take advantage of the EO status of its participants notwithstanding its domestic charter. A specific IRC provision permits a reciprocal to deduct, up to the amount of statutory income, profits allocated to each participant’s “subscriber savings account.” No cash changes hands; these accounts are merely bookkeeping entries standing in the name of each insured. If the insureds are EOs, there is no correlative income inclusion when the allocations are made. Thus, the surplus of the reciprocal is maintained for regulatory purposes at the same time the reciprocal’s tax burden is greatly reduced by effectively shifting it to EO policyholders.

IRS Form 990-Return of Organization Exempt from Income Tax

Beginning in 2009, IRS Form 990, the annual tax return for organizations exempt from federal income tax, includes questions applicable to their ownership and operation of captives. Because this recently revised Form 990 is complex and extensive, we mention only three items here. First, exempt organizations with foreign financial accounts (presumably other than “commingled funds”) must report them in Core Form, Part V, Lines 4a and 4b. Second, exempt organizations with captives (wherever domiciled) will need to report the existence of, and certain transactions (such as capital contributions) with, the captive

on Schedule R (Related Organizations and Unrelated Partnerships) to Form 990. Third, exempt organizations with offshore captives will likely need to complete Schedule F (Statement of Activities Outside the United States).

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IRS guidance on the Schedule F indicates, for example, that an exempt organization must report expenses if it sends directors to board meetings outside the United States and the expenses exceed a \$10,000 threshold.

Key Tax Points To Remember

Single-owner onshore EO captives generally strive to avoid -insurance company- tax status. by limiting their risk funding to related members and their employees. in order to avoid tainting the entire pool by causing it to forfeit its tax-exempt status.

Single-owner offshore EO captives generally strive to avoid -insurance company- status. by limiting their risk funding to related members and their employees. in order to escape paying Federal Excise Tax and to prevent throwing off -unrelated business taxable income- taxable in the hands of the EO owner.

Multi-owner onshore EO captives are rare. unless formed as controlled -fronting- vehicles rather than risk bearers. since they are fully taxable except as noted above.

Multi-owner offshore EO captives typically use one or more of the special rules or definitions in the 1996 IRC amendment or other means to prevent generating UBTI taxable in the hands of the EO owners.

A popular multi-owner group structure for liability exposures only of EOs is an onshore -risk re tention group- formed as a -reciprocal exchange allowing favorable onshore regulatory access combined with the equivalent of offshore tax benefits.

I hope that you have found our quarterly newsletter interesting and informative. Please feel free to contact our General Manager, William Forsythe (william.forsythe@caymancaptive.ky) with ideas for articles or press releases. Submissions are welcome!

Monique MacDonald, IMAC Chairperson