Cayman Captive Forum – 2008

Strong Planning, Operational and Tax Strategies for Group Captives

Wednesday, December 3, 2008
Track C, Group Captives – 3:20 p.m. to 4:15 p.m.

Moderator: Monte D. Jahnke, Member
Kerr, Russell and Weber PLC, Detroit, MI USA

Panelists:

- Cayman Counsel: Alan Craig
  Turner & Roulstone

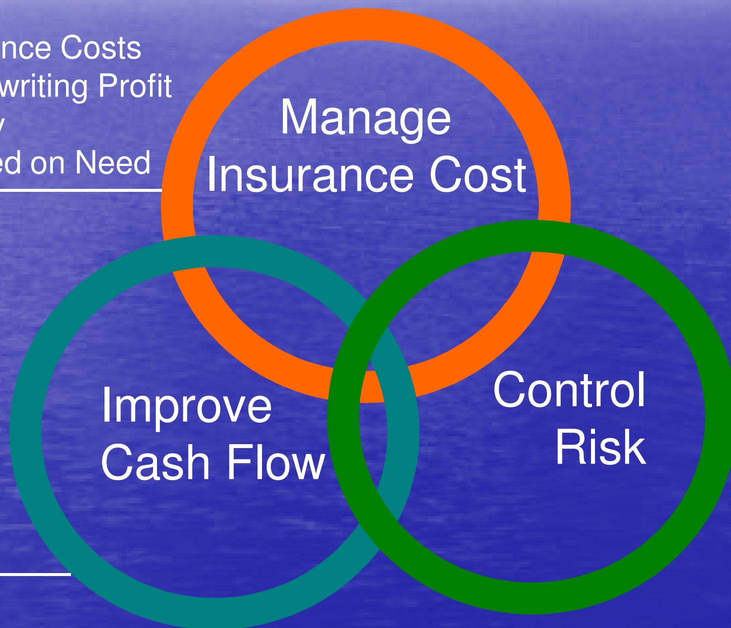
- Tax Counsel: John D. Gatti
  Kerr, Russell and Weber PLC, Detroit, MI USA

- Captive Owner/Managers: TanCayman Insurance Co. SPC, Ltd./California McDonald's Restaurant Owners Program

  - James Abbate, Alia Corporation, Merced, CA
  - Seth B. Madnick, Edgewood Partners Insurance Center, San Ramon, CA

Goals of Captive Participation

Manage Insurance Costs
Capture Underwriting Profit
Pricing Stability
Purchase Based on Need



Greater Control over Claims
Increase Coverage
Increase Capacity
Underwriting Flexibility
Access to Reinsurance Market
Incentives for Loss Control

Retain Premium Dollars
Investment Income
Additional Profit Center

Discussion Objectives

- Seeking best practices to maintain solid formation, operation, board composition, oversight, and communications
- Avoiding and successfully managing shareholder and stakeholder relations
- Getting “in” and “out” with confidence
- Critical U.S. tax decisions for non-CFC off shore group captives

Sensitive Group Captive Characteristics

Monte D. Jahnke, Kerr, Russell and Weber, PLC

- Absent proper attention, potentially fertile ground for internal disputes
- Especially so with captives formed at the behest of a sponsoring agency or broker who retains captive risk with its clients.

Sensitive Group Captive Characteristics Continued

- Owners often have little or no previous affiliation; no common corporate culture from which to govern together.
- Such owners (even in the same industry) are sometimes scattered geographically and are unfamiliar with one another initially.

Sensitive Group Captive Characteristics Continued

- Owners from trade associations are, despite their captive program interests, independent *competitors*, often in the same area or region (potential divided loyalties).
- Group captives by definition promote a sharing of financial exposure as both owners and insureds (different hats/same heads).
- Favorable US tax treatment of certain groups (non-CFCs) requires ongoing diligence.
- How to structure, oversee, manage, and discipline appropriately to assure success?

Problematic Situations

- Sudden shareholder insolvencies
- Sudden aberrant risks of one or a few shareholders
- Non-cooperative, “alpha dog”, or loose cannon shareholder(s)
- The shareholder member with no long term view; the fickle insured
- Jousting managers or brokers influencing shareholder dissent

Problematic Situations Continued

- Managers or brokers with duel agendas or loyalties
- Board members who should have “noses in but fingers out” vs. unreasonably demanding approaches to governance
- Ownership changes that can trap the unwary in unforeseen tax exposure.

Comments by Cayman Counsel

Alan Craig – Turner & Roulstone

- Formation
  - Division of the operational mechanics between insurance documentation, the Memorandum & Articles (Issuer Charter/By-laws) and Shareholder Agreements
  - Use of split Voting and Participating Shares
  - Use of Segregated Portfolio Companies

Comments by Cayman Counsel

- Operation
  - Role of the Broker/Sponsor
    - Possible conflicts of interests arising
  - Board Representation
    - Balancing representation with operational efficiency
    - Legal responsibilities of Board members

Comments by Cayman Counsel

- The effect of unforeseen eventualities
  - Insufficiency of reinsurance coverage
  - Insolvency of a counterparty
  - Need for special assessments/additional capital
  - Dealing with members in breach

Comments by Cayman Counsel

- Termination
  - Withdrawal of Members
    - Ability to reach a settlement when relevant policy years have not been closed
    - Removal of members with adverse loss history
    - Removal of liquidated/untraceable members
  - Effects of Liquidation/Winding-Up of the Company

Owner/Manager Perspectives

TanCayman Insurance Co, SPC, Ltd

James Abbate – Alia Corporation

Seth Madnick - Edgewood Partners Insurance Center

- Structure of Group Captive
  - How is ownership participation established?
  - How are voting rights determined?
  - How are directors and officers elected and how often?
  - How do the directors and officers sustain captive knowledge in long term management planning?

Comments by Owner/Manager

- Structure of Group Captive (continued)
  - Distribution of funds/profits – Determine Goals
    - Return of capital
    - Return of underwriting profit
    - Return of investment income
    - Retain funds to reduce insurance costs
  - Withdrawal of Members
    - Voluntary
    - Involuntary
    - How long to retain funds for future claims development

Comments by Owner/Manager

- Structure of Group Captive (continued)
  - Understanding business risks of captives.
    - Potential loss of underwriting profits and investment income
    - Potential loss of investment/collateral funding
    - Sharing risk with other business owners
    - Long term commitment

Comments by Owner/Manager

- Day-To-Day Issues
  - How does the group educate its members on the “business of insurance?”
  - Understand your program cost components and how may they change over time
    - Operating Expenses
    - Collateral
    - Loss funding
  - What risk management support does the group offer its members?
  - How does the group address poor performing members?

Comments by Owner/Manager

- Day-To-Day Issues (continued)
  - Active Member Participation is key to success
    - Risk Management/Loss Control
    - Finance
    - Underwriting
  - Transparency to Members
    - Provide useful information to captive members frequently
    - Encourage attendance at membership meetings
    - Share operating and financial reports

Comments by Tax Counsel

John Gatti – Kerr, Russell and Weber, PLC

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Deferral

- Normally, foreign corporations are not subject to taxation in the United States on their foreign operations.
- Dividends of foreign corporations are subject to United States taxation when paid.
- Even though dividends will eventually be taxed, it is still preferable to defer repatriation.

Deferral Example

	Deferred	Currently Paid
Income	$ 100,000	$100,000
Less Current Tax	$ -	$ (34,000)
After Tax Proceeds	$ 100,000	$ 66,000
Annual Income	$ 8,000	$ 5,280
Less Annual Tax	$ -	$ (1,795)
After-Tax Income	$ 8,000	$ 3,485
Number of Years	10	10
Total Income	$ 80,000	$ 34,848
Amount Distributed	$ 180,000	N/A
Tax on Distribution	$ (61,200)	N/A
After Tax Distribution	$ 118,800	
Net After Tax Proceeds	$ 118,800	$100,848
Benefit of Deferral	$ 17,952	

Exception to Deferral – Controlled Foreign Corporations

- The Internal Revenue Service requires Controlled Foreign Corporations to currently include Subpart F Income and certain other income.

Controlled Foreign Corporations

- A CFC is "any foreign corporation if more than 50 percent of (1) the total voting power of all classes of stock . . . Entitled to vote, or (2) the total value of the stock is owned by *United States Shareholders* on any day during the taxable year of such corporation.
- However, for captive insurance companies, ownership is reduced to 25%.

Definition of *US Shareholder*

- A *United States Shareholder* is defined as a United States person who owns 10% or more of the total combined voting power of all classes of stock entitled to vote.

Subpart F Income

- Foreign Insurance Income
- Foreign Personal Holding Company Income
- Foreign Base Company Sales Income
- Foreign Base Company Services Income
- Foreign Base Oil Related Income

Deemed Dividends - Investment in US Property

Earnings of a CFC invested in U.S. property (with certain exceptions) pursuant to Section 956 are taxed to the U.S. shareholders.

- Loans to U.S. Persons
- Indirect Loans to U.S Persons
  - Pledge of greater than 66 2/3% of CFC Stock
  - Guarantee by the CFC of the US Shareholder's debt
- Receivables from U.S. outstanding more than industry average
- Exception for U.S. bank deposits of foreign subsidiary

Re-Characterization of Gain

- When a *US Shareholder* sells stock in a CFC, pursuant to sec. 1248, the gain is re-characterized as a dividend to the extent of the *US Shareholder's* share of the CFC's earnings & profits.

Avoiding CFC Treatment

- No one person or entity owns 10% or more of the CFC stock.
- The *US Shareholders* own less than 25% of the CFC stock.

Mitigating CFC Treatment

- Carefully analyze and monitor transactions between the *US Shareholders* and the CFC.
  - Analyze transactions so that they do not result in a deemed dividend.
- Carefully monitor and control "*earnings & profits.*"

Questions and Answers

Concluding Comments