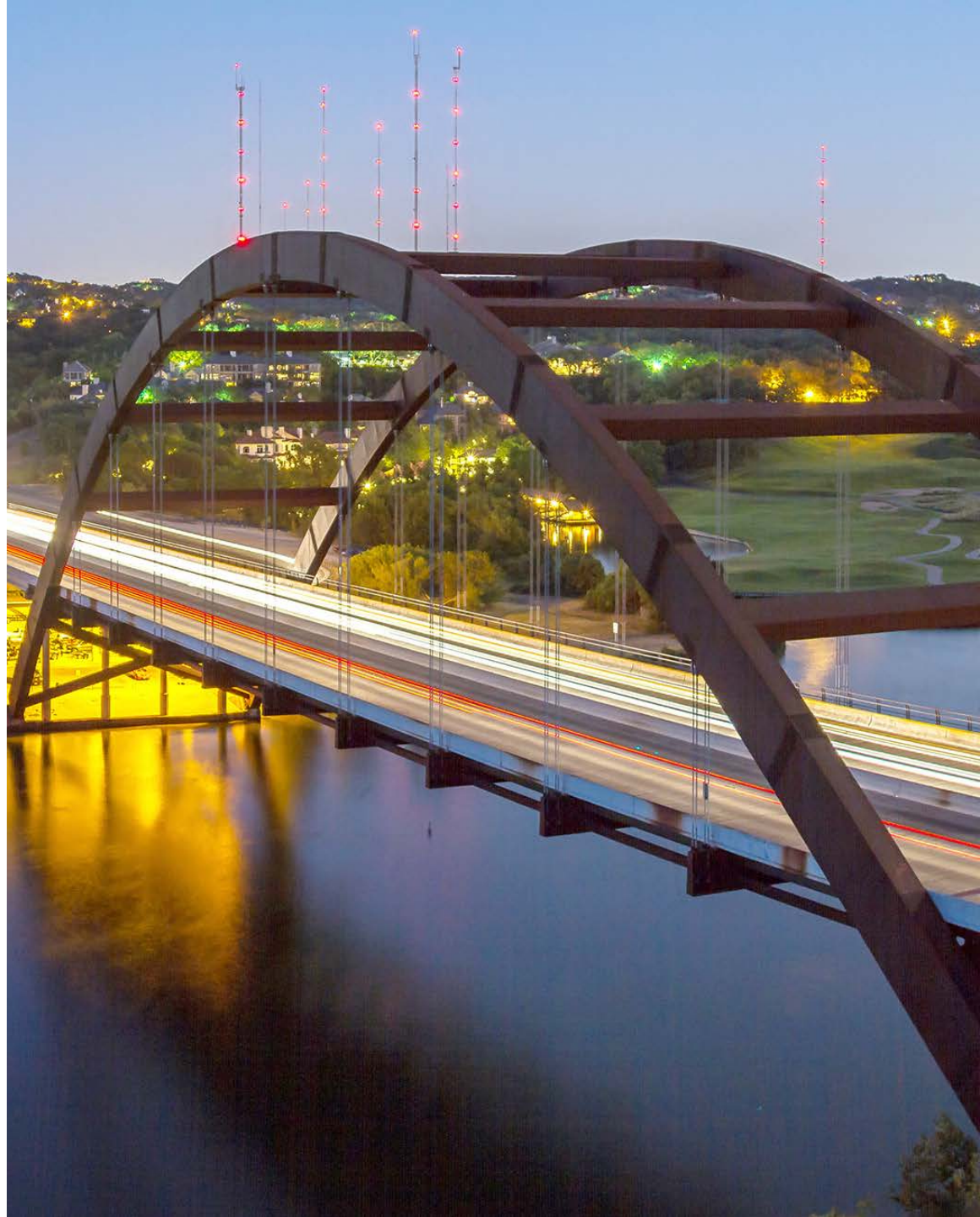




# 2016 Engineering & Construction Conference

June 15–17, 2016  
The Westin Austin Downtown  
Austin, Texas



# Should You Form a Captive Insurance Company?



**Daniel Leff**  
Specialist Leader  
Deloitte Consulting LLP



**Gregory Domareki**  
Lead Tax Managing Director  
Deloitte Tax LLP

9:45 – 10:45 a.m.

# Agenda

## Captive overview

### How are they used by Construction firms

- Contractor-controlled insurance programs (CCIPs)
- Create surety capacity
- Allocate profits to project owners

### Tax considerations: Recent developments

- Risk distribution: *Rent-a-Center* and *Securitas*
- Self-procurement premium taxes
- Modifications to 831(b) captives

Captive overview:

Current and common uses

# Captive overview

## What Is a Captive?

- Insurance subsidiary of a non-insurance parent
- Exists to serve the risk management needs of the parent and/or to support the core business goals of the parent, rather than for its own profitability
- Risk financing vehicle for retaining corporate insurance risks

### ➤ Risks Commonly Insured in Captives

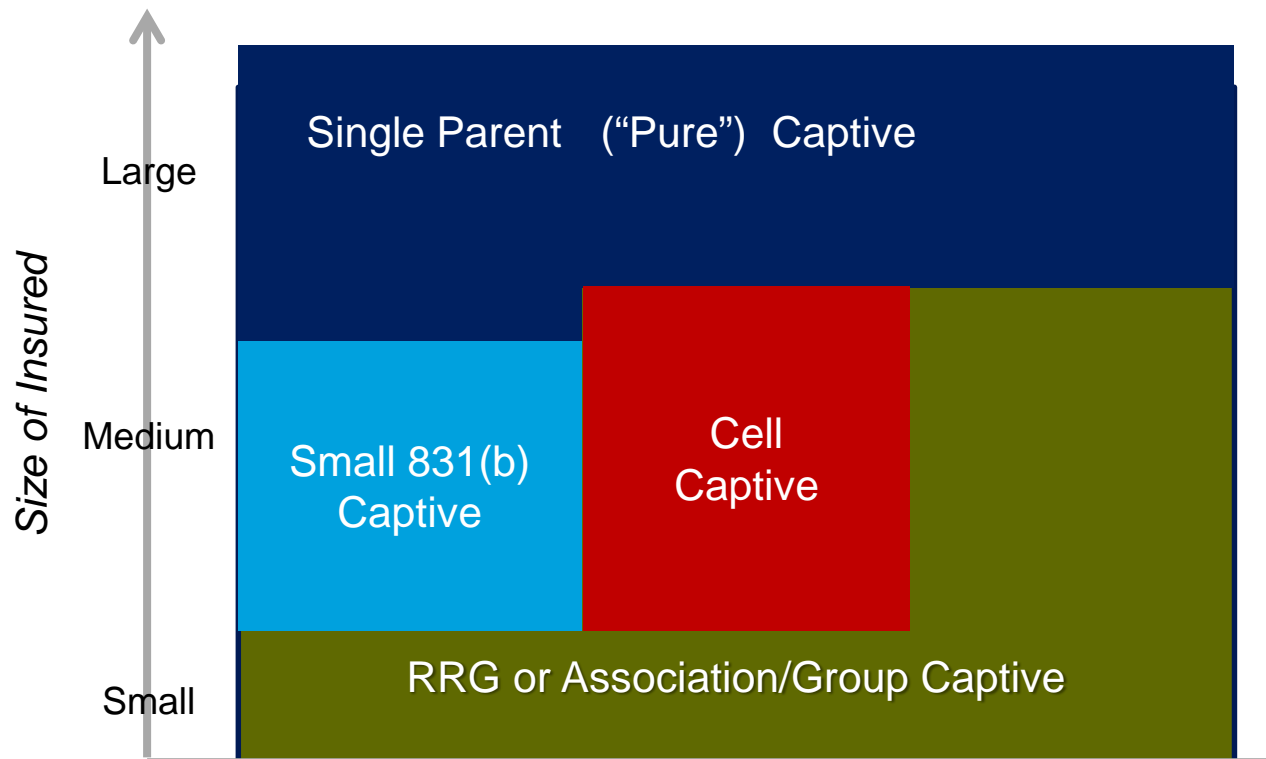
*Nearly any risk that is self-insured, carries large deductibles/retentions, is commercially unavailable, or cost prohibitive*

- Property and Business Interruption
- General Liability
- Automobile Liability
- Professional Liability
- Completed Operations Liability
- Terrorism
- Workers Compensation
- Employee Benefits
- Cyber Liability

# How do organizations use captives?

## And which types do they use?

- Development of Protected Cell/Incorporated Cell legislation, and now Series LLC cell captives
- Growth/emergence of Agency-owned captives
- Regulatory competition has led to increased domicile choice and innovation



# Identifying the differentiators:

Should you be in this business?

You potentially control a significant block of insurance business

Is it better than the average for its type?

How do you know?  
What attributes *make* it better?

Your Comparative Advantage

- Can you do consistently better at:
- Preventing loss occurrences?
  - Handling claims efficiently?

Is it currently profitable to insurers?

- What is the RoE?
- Is it preferred over alternative uses of capital?

What unique management tools do you possess that give you comparative advantage in this space?  
How do you maintain this advantage?

How would you attract and keep this business?

Coverage  
terms/conditions?

Premium pricing?

**Loss Leader**

Are there *other* strategic reasons why you would want to control this business?

Is your insurance facility a:

Sole provider?

Preferred provider?

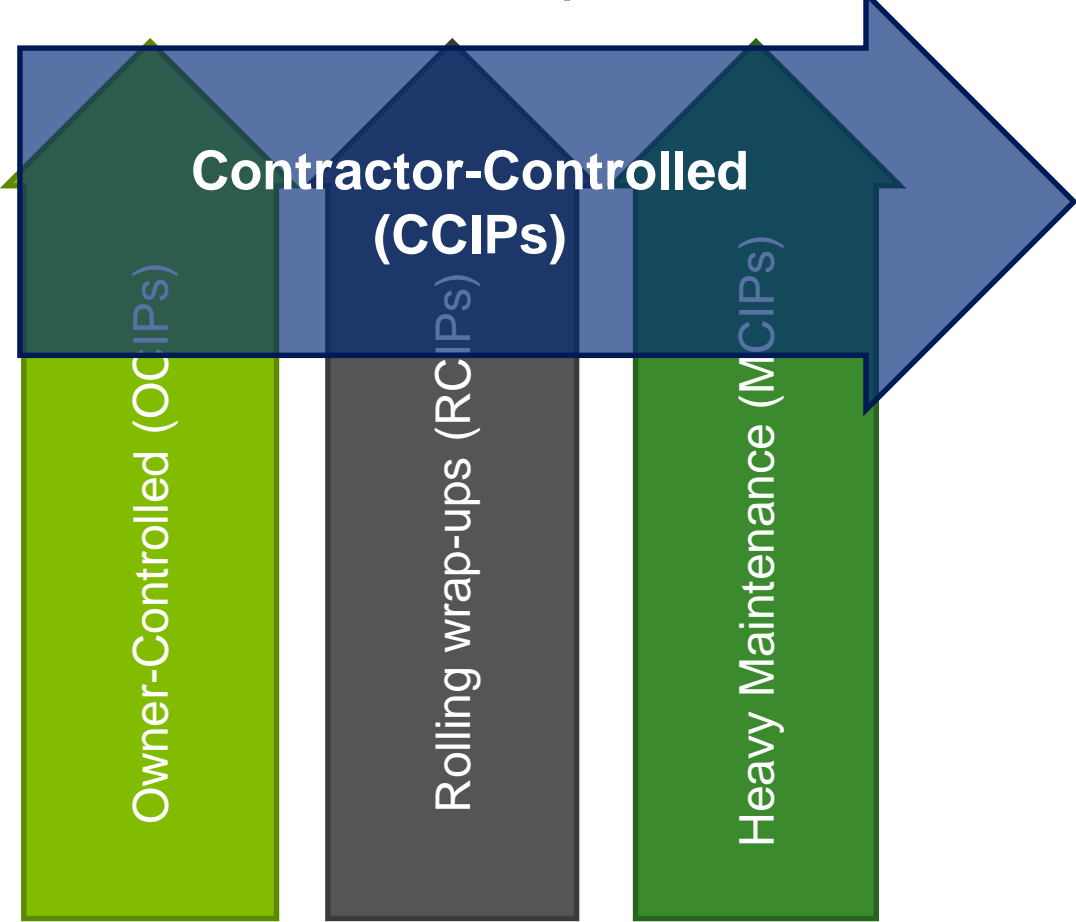
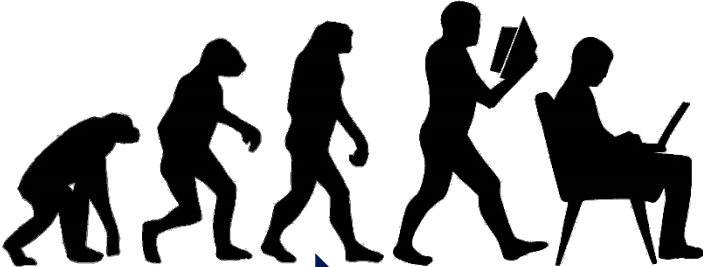
Provider of last resort?



# Captive overview: The rise of CCIPs



# Consolidated Insurance Programs – A brief history



**Contractor-Controlled  
(CCIPs)**

Owner-Controlled (OCIPs)

Rolling wrap-ups (RCIPs)

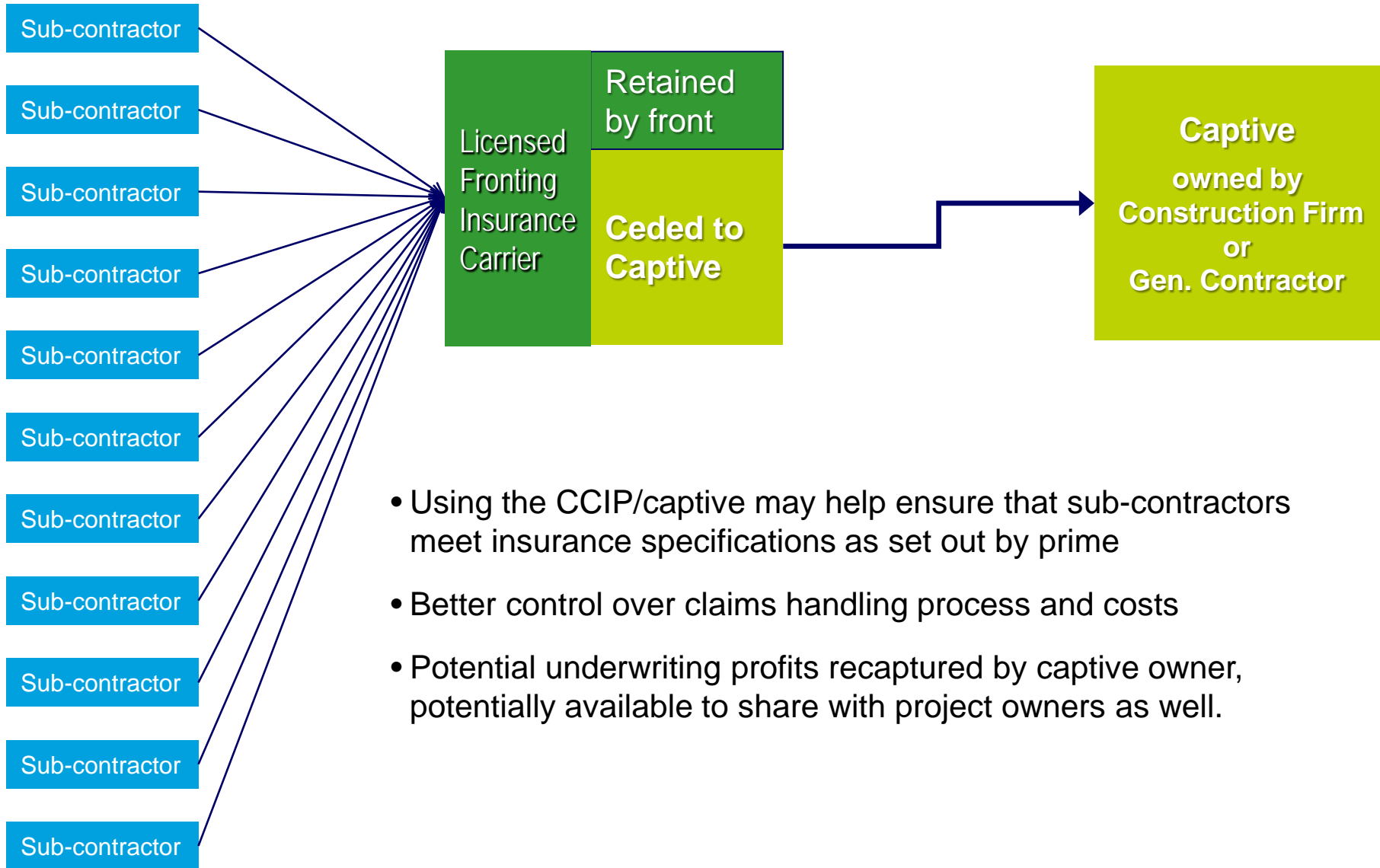
Heavy Maintenance (MCIPs)

Project Owners

## Coverages

- Workers' compensation and employers liability
- General liability
- Builders risk
- Excess liability
- Errors & Omissions/  
Professional liability
- Contractor default risk
- Environmental
- Construction defect liability

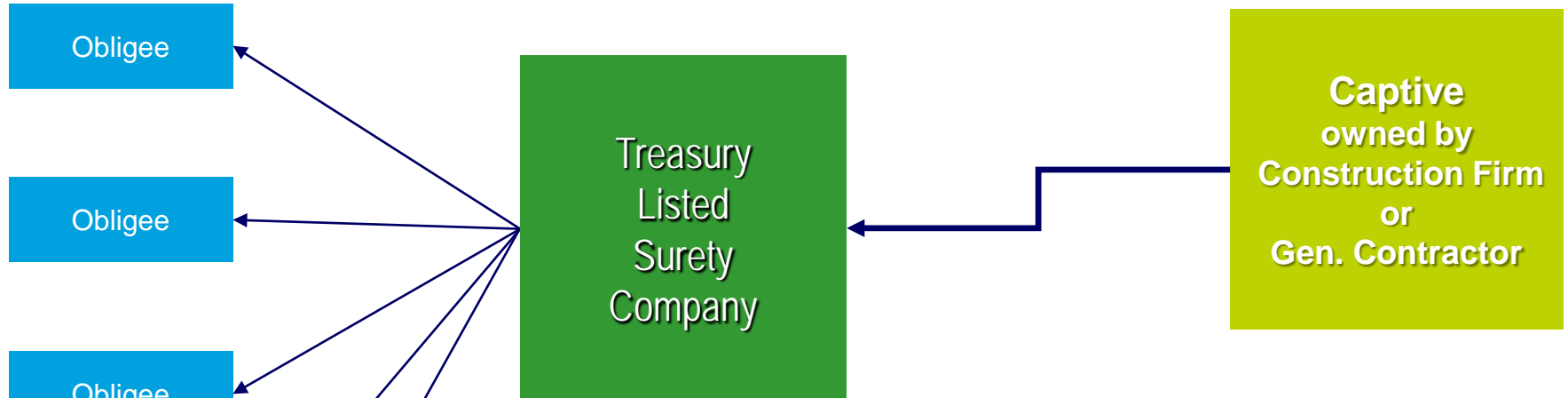
# CCIP sub-contractor captive programs



- Using the CCIP/captive may help ensure that sub-contractors meet insurance specifications as set out by prime
- Better control over claims handling process and costs
- Potential underwriting profits recaptured by captive owner, potentially available to share with project owners as well.

# Captives augmenting surety capacity

Putting your money where your mouth is



- Captive pledges capital as reinsurer of T-Listed surety company
- Capital is leveraged at varying ratios (depending on credit quality of parent)
- Expands surety capacity available in the marketplace
- Or, use insurance carrier program that offers protection against sub-contractor default

# CCIP management

Not necessarily a cash cow: Watch who you let in

## Qualification/ Enrollment

- Understanding information to be collected
- Avoiding adverse selection
  - *How can you tell who's a good risk?*
- *Are subs playing games with insurance deducts?*
  - Are subs getting the appropriate breadth of coverage?
  - Consider requiring subs to use CCIP
- Understand limitations
  - *Some groups/trades will never use CCIPs*
  - *You may want to exclude some contractor types or risk classes*

## Loss prevention/ safety monitoring

- Safety inspections and regular reporting
- Onsite healthcare and first aid
- Consider using external resources to inspect/report on safety compliance
- Data data data

# CCIP management

Not necessarily a black box – others are watching too

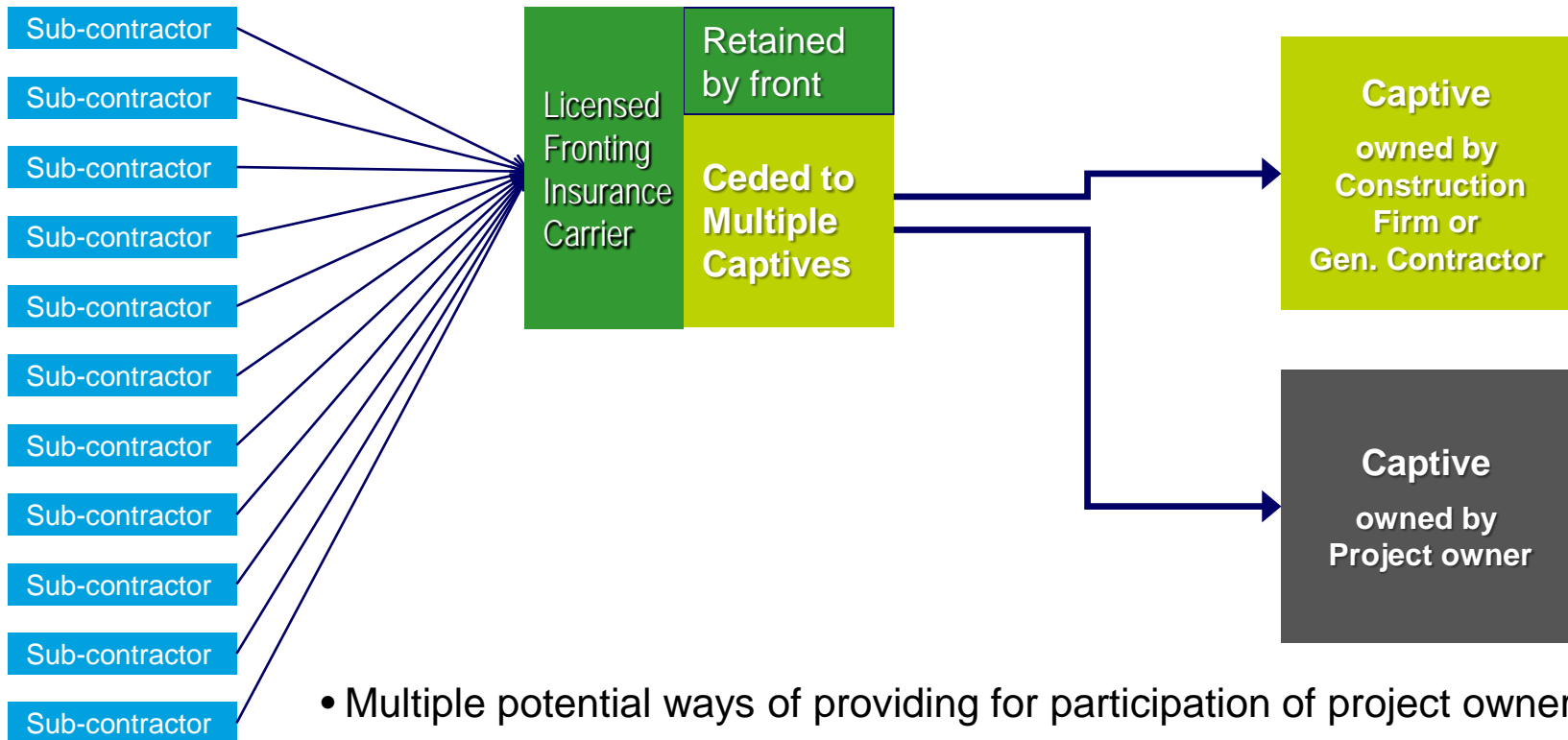
## Claims management

- Consider use of predictive analytics based on FNOL information
- Channel/triage claims response
  - *Get the right resources to the right claims at the right time*
- Consider profit sharing with subs
- If third party claims administrator is used, establish service level agreement and monitor adherence to SLA terms

## Financial management

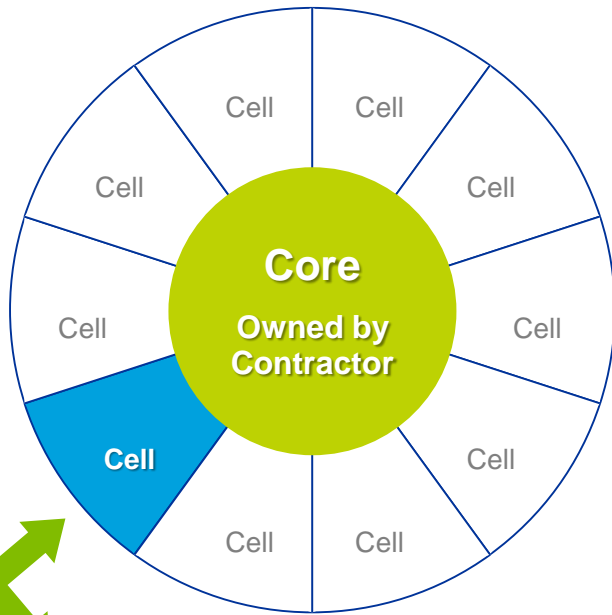
- There is no “loss budget”
  - *Project owners are auditing CCIPs*
- Use appropriate actuarial reserving techniques; think of the CCIP as an insurance company
- Allocations should not be performed haphazardly
- It takes multiple cooperating participants to make CCIPs profitable
  - Therefore, don't be surprised if those participants want to participate in the profits
- Owners and their construction auditors often misunderstand the details of CCIP

# CCIP captive program, with profit/loss sharing



- Multiple potential ways of providing for participation of project owners
  - Project owner can use its owned captive to receive a share of the risk (and potentially, profits)
  - Contractor can create a “protected cell” captive, in which project owner rents a cell that houses the underwriting results for a specific project
- Emphasizes the need for formalized financial management of programs, treating CIP as a miniature insurance company

# Protected Cell Captives - Overview



## Individual cells for project owners

- May reduce operating costs
- Faster exit strategy if desired
- May be able to operate under IRC Section 831(b) if annual premiums are < \$2.2 million

- Each cell is legally independent and separate from other cells and the core
- Assets of one cell are unaffected by the liabilities of another cell
- Therefore, assets of one cell cannot be drawn upon in the event of financial insecurity of another cell
- Each cell must have sufficient capital to cover its potential liabilities
- Cells may either rent capital from the core, or put up capital themselves – depending on the business plan of the sponsor
- Letters of Credit commonly used as capital
- In some, but not all, jurisdictions, if a cell becomes bankrupt, creditors can claim against the core;
- In others, assets of the cell are segregated from both other cells and the core

# Captive tax developments: Risk Distribution redefined



# Qualifying As Insurance for Federal Tax Purposes

Four main requirements must be met for a captive to be treated as an insurance company for federal tax purposes:

## *Meet the definition of an insurance company*

- *Primary and predominant business activity (> 50% ) during the taxable year is the issuing of insurance or annuity contracts, or the reinsuring of risks underwritten by insurance companies.*
- *Company must be adequately capitalized to insure the contemplated risks.*

## *Risk transfer must be present in the transaction*

- *Risk shifting requires the transfer of economic consequences of a loss away from the entity (the insured) claiming the deduction. In other words, the entity pays another (the insurer) to bear its risk.*

## *Risks insured by the captive must be sufficiently pooled and distributed*

- *Risk distribution requires the pooling of funds by the insurer in order to spread the economic consequences of the individual claims over a group that is sufficiently large to yield predictable losses.*

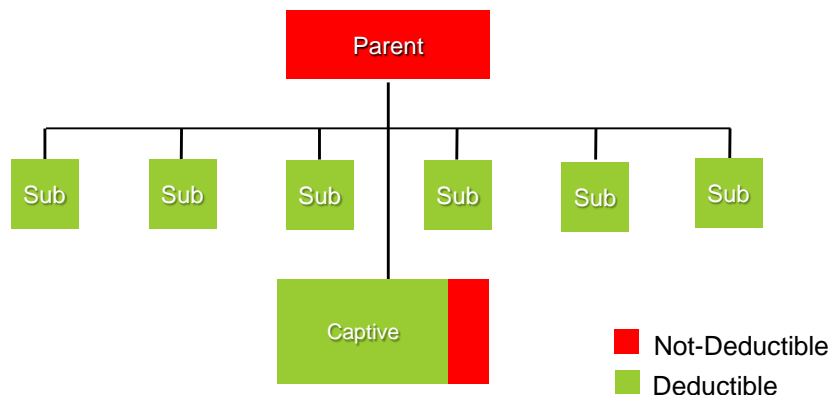
## *The captive and its transactions must exhibit “commonly accepted notions of insurance”*

- *While this is not well-defined by the Courts or the IRS, it is generally accepted to mean that the captive should engage in arm’s length contracts and transactions in premium determination, policy issuing, claims handling, and investment policy. That is, it should look and act as an insurance company.*

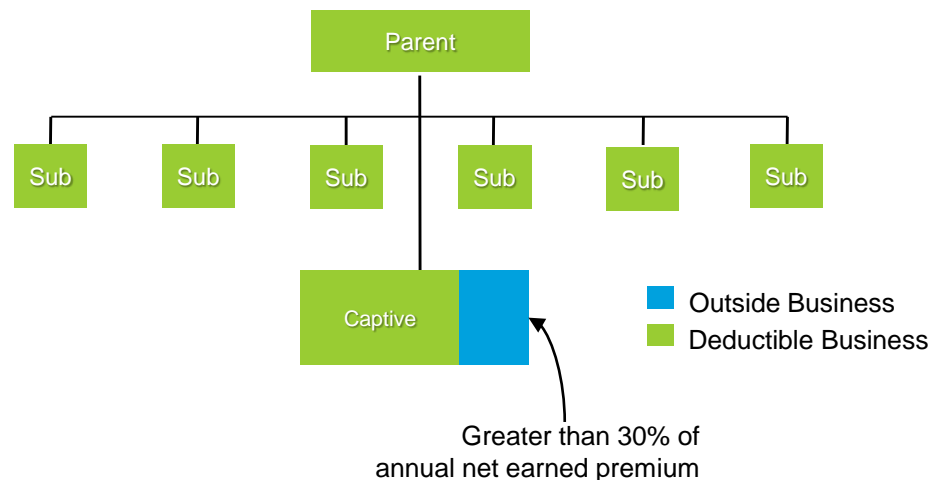
# Supporting Favorable Tax Treatment for Captive

## Two Approaches

*Brother-Sister Approach  
(The “Humana” Model)*



*Third Party Writings Approach  
(The “Harper Group” Model)*



- Brother-sister approach creates tax benefits when large proportion of risk resides with “sibling” subsidiaries to the captive. Parent company risks generally not deductible
- When majority of risk at the parent (or an insufficient number of subsidiaries) a significant volume of unrelated business needed for captive to be respected as an insurance company by the IRS. *Rent-a-Center* case (January 2014) changed the thinking on minimum requirements for risk distribution
- A substantial volume of unrelated business (*which could include risks of employees -- i.e., benefits*), can support deductibility of parent risk using the “Third Party Writings” approach

# Rent-a-Center Case, January 2014

## Changing the calculus on Risk Distribution

- *In Rent-A-Center, Inc. v. Commissioner (decided Jan. 2014), the Tax Court determined that sufficient risk distribution existed by looking solely to the number of risks insured.*
  - The Court did not appear to consider the number of insured entities, or the concentration of risk in each entity (one entity had over the 60% of the total risk), and accordingly did not follow the approach outlined by the IRS in Rev. Rul. 2002-90.
  - Safe Harbor Rule set forth by Rev. Rul. 2002-89 establishes a 50% threshold of unrelated risk to adequately pass the distribution test in a Parent-Subsidiary Arrangement.
  - Safe Harbor Rule set forth by Rev. Rul. 2002-90 established that no single member can account for more than 15% of the total risks/premiums in a Brother-Sister Agreement between the parent of the captive and its twelve operating subsidiaries.
- *Tax Court also noted that the captive in Rent-A-Center was adequately capitalized during the years in issue. The Court noted this as a key point in distinguishing it from some previous cases*

# Securitas Case, October 2014

## Adding momentum to *Rent-a-Center*

- *Decided by Tax Court on October 29, 2014 in favor of taxpayer; IRS did not appeal decision.*
- *Securitas AB is a public company located in Sweden; Securitas Holding Inc. (SHI) is the domestic parent of the U.S. affiliated group Securitas is a security company that provided guarding services, alarm systems, and cash handling services. During years in issue, Securitas had about 100,000 employees dispersed through its various business lines and spread geographically.*
- *Following Rent-a-Center, the Tax Court applied the risk distribution test by looking to the number of independent insured risks, as opposed to the number of legal entities; one entity had over 60% and 80% risk concentration respectively in the years under audit.*

# Captive Tax Benefits

## Federal:

- Acceleration of tax deduction: Captive takes tax deduction when loss reserve is set, rather than when loss is actually paid.
- Potential source of cash that monetizes deferred tax assets

## State and local:

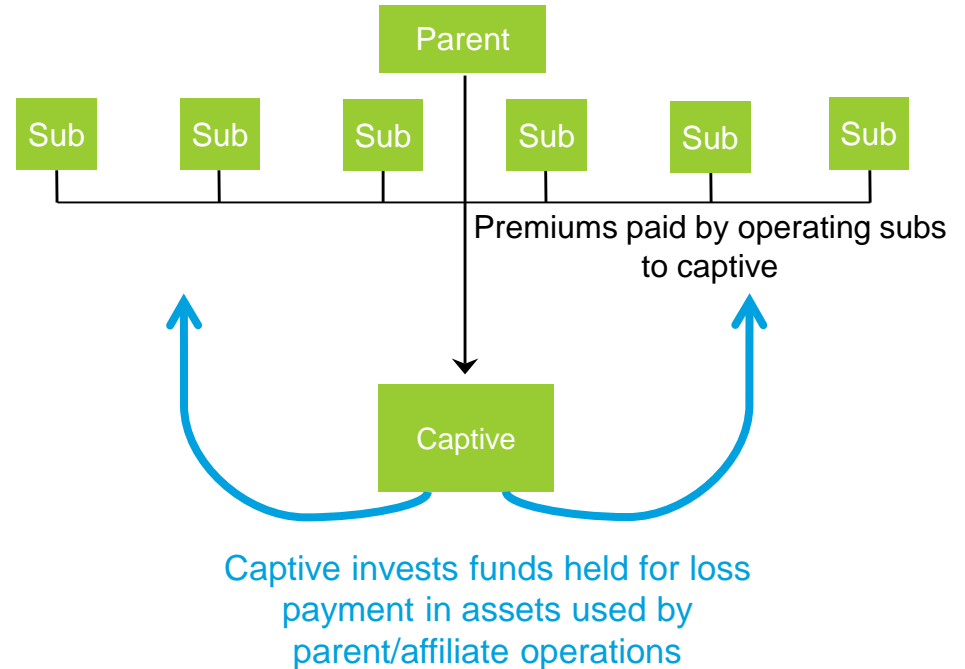
- Insurance companies are generally not required to file a unitary return in the U.S. and are subject to a premiums and/or self procurement tax in lieu of a state income tax.
- The premiums and self procurement taxes are based upon premiums written by the insurance entity; therefore, the underwriting and, more importantly, the investment income earned within the captive would not be subject to state income tax.

# Developing captive investment strategy:

## Avoiding a cash trap

Captive could act as an internal project financing vehicle. Eligible projects could include:

- Mortgage lending on real estate investments
- Secured lending on equipment (e.g., machinery, trucks)
- Inter-company loans from captive to subsidiaries, secured by receivables.
- Limited ability to extend unsecured loans to parent or affiliates



Deloitte experience is that when loanbacks and investments in affiliates exceed 50%, the IRS may raise issues of "circular flow of cash," calling into question the independence of the captive.

- However: no Revenue Rulings, Technical Advice Memoranda or cases that provide guidance on this subject

# State Self-Procurement Taxes

## The Non-admitted and Reinsurance Reform Act (“NRRA”)

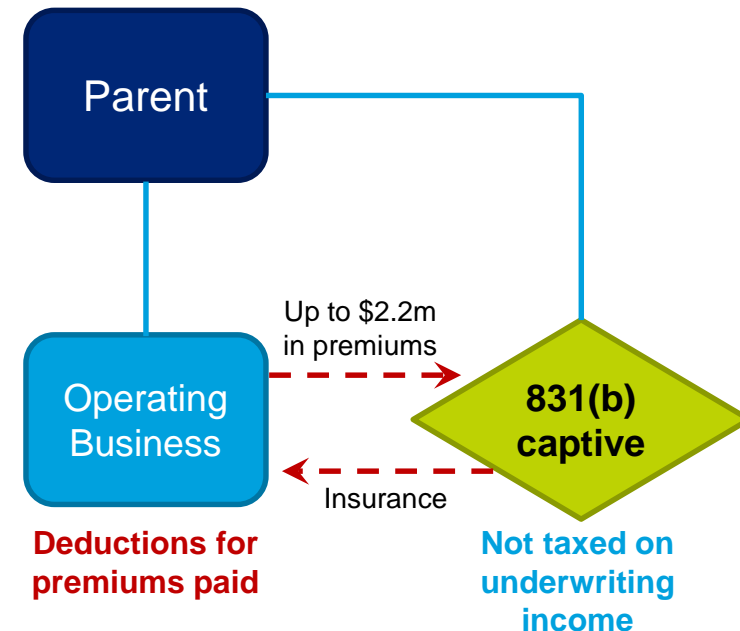
- Attached to the Dodd-Frank Act was the Non-admitted and Reinsurance Reform Act (“NRRA”), which determined that no State other than the primary State of business of the purchaser of an insurance policy is permitted to impose any premium tax on such insurance if the policy is considered non-admitted insurance.
- NAIC tried to establish an interstate compact to govern the distribution of premium tax revenue from the State of the principal place of business of the purchaser to the States where the insured is deemed to have risk.
- The Act went into effect in July of 2011. Presently there is no timeline for the establishment of an interstate compact by the NAIC, since an insufficient number of states have indicated an intent to join, and the largest states – CA, IL, NJ, NY, OH, PA and TX, which represent over 50% of the surplus lines premiums – remain holdouts.

- Advisable to domicile a wholly-owned captive in the same state as the “home office” state of the parent – assuming that there is a captive statute in that state.
- Number of states with captive statutes continues to climb: Currently over 30.

# “Micro” captives make the “Dirty Dozen”

February 2015: IRS decries “abuse involving a legitimate tax structure”

- Insurance company elects under IRC section 831(b) to be taxed on its investment income *only*
- The Protecting Americans from Tax Hikes (PATH) Act of 2015 will increase premiums allowed under IRC section 831(b) from \$1.2 million to \$2.2 million for tax years after 2016. Therefore, an insurance company must receive less than \$2.2 million in premium each year.
- Potentially allows a small insurance company to receive up to \$2.2 million per year in premiums, without paying any income taxes on those premiums, and
- Potentially creates up to \$2.2 million deduction in the operating business, so long as those premiums are otherwise deductible.



**831(b) companies still need to qualify as insurance companies for U.S. federal income tax purposes.**