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CAPTIVE IMPACT

Phillip Giles of MSL Captive Solutions discusses how the COVID-19 pandemic could potentially affect self-funded health plans and medical stop-loss captives

IRS Focus

Industry experts discuss the latest settlement offer made by the IRS and what its next move could be

Emerging Talent

Cheryl Baker, manager, risk management services at Blue Cross Blue Shield of Michigan

Isle of Man

How will new legislation, current trends and challenges impact the island's captive market?

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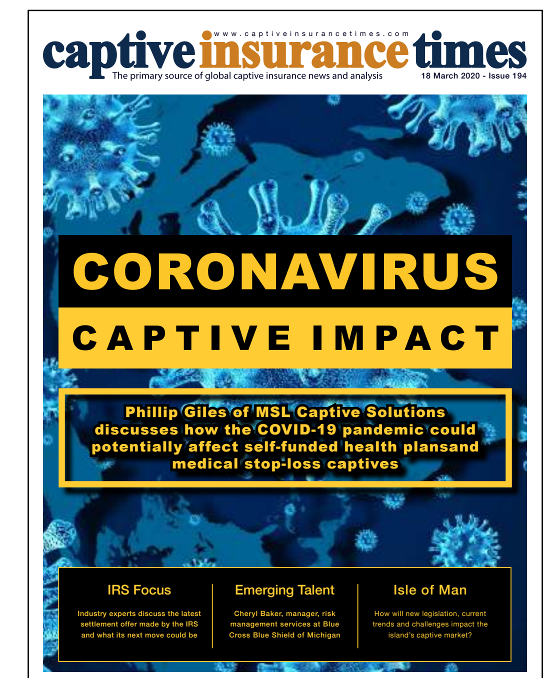

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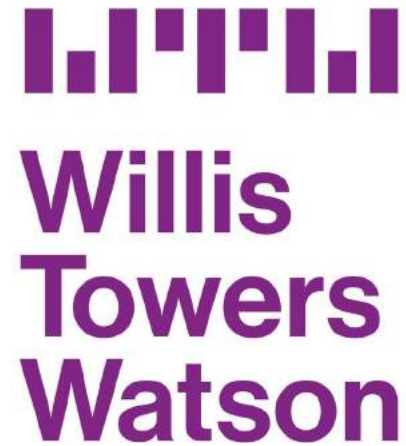

Aon to buy Willis Towers Watson

Aon is set to buy Willis Towers Watson in an all-stock transaction with an implied combined equity value of approximately $80 billion.

The deal will see the combination of two of the world's largest insurance brokers.

Willis Towers Watson CEO John Haley, described the combination of the two firms as "a natural step in our journey to better serve our clients in the areas of people, risk and capital".

Haley said: "This transaction accelerates that journey by providing our combined teams with the opportunity to drive innovation more quickly and deliver more value."

Aon CEO Greg Case added that the merger would create "a more innovative platform" that will create better outcomes for all stakeholders, including clients, colleagues, partners and investors.

Case stated: "Our world-class expertise across risk, retirement and health will accelerate the creation of new solutions that more efficiently match capital with unmet client needs in high-growth areas like cyber, delegated investments, intellectual property, climate risk and health solutions."

The combined company will be named Aon, maintaining its operating headquarters in London.

As part of the deal, Haley will take on the role of executive chairman with a focus on growth and innovation strategy.

The combined firm will be led by Case and Aon chief financial officer Christa Davies, along with a leadership team from both organisations.

The board of directors will comprise proportional members from Aon and Willis Towers Watson's current directors.

Both companies expect the transaction to close in H1 2021.

Upon completion of the combination, existing Aon shareholders will own approximately 63 percent, while Willis Towers Watson shareholders will own approximately 37 percent of the combined company on a fully diluted basis.

Aon anticipates that the transaction will provide annual pre-tax synergies and other cost reductions of $800 million by the third full year of combination, thereby allowing the firm to continue significant investment in innovation and growth.

Willis Towers Watson and Aon anticipate savings of $267 million in the first full year of the combination, reaching $600 million in the second full year, with the full $800 million achieved in the third full year.

Aon considered a bid for Willis Towers Watson last year, but in March released a statement stating that the company would not be pursuing an all-share business combination.

The deal comes a year after Marsh & McLennan Companies (MMC) completed the acquisition of Jardine Lloyd Thompson Group (JLT) for $5.6 billion in fully diluted equity value. ■

KeyState opens new Vermont office

KeyState Captive Management opened a new office in Burlington, Vermont on 1 March.

The new office builds on its existing presence in other states including Nevada, Delaware, Tennessee, District of Columbia, Alabama, Arkansas, Michigan, Missouri, Montana, and Oklahoma.

Over the last two years, KeyState has hired three captive professionals, Jeff Vigne, director of insurance services; Alicia Huskes, captive client services manager and most recently David Guerino, SVP and managing director of captive insurance.

The firm also received approval from the Vermont Division of Insurance to operate as a captive manager in the state.

KeyState CEO, Josh Miller stated: "We are excited to have David Guerino lead the KeyState captive team, and we are pleased to open our new office in Burlington."

"Vermont is one of the 'key states' for the US captive industry, and our new office in the heart of downtown Burlington represents our commitment to the growth of our captive management business into Vermont," he added.

Commenting on the new office, Guerino said: "KeyState has a very robust captive practice and strong relationships with its captive owners, business partners, and regulators. I look forward to building on this foundation, with a continued focus on business development and expanding our offerings to existing captive clients." ■

Risk Strategies acquires Atlas Insurance Management

Risk Strategies has acquired Atlas Insurance Management as part of its purchase of Atlas Group Limited and its affiliated entities.

Atlas Insurance Management focuses on the formation and management of captive insurance companies. It also forms and operates a number of its own insurers, including protected cell companies (PCC), making cells available to captive clients and acting as fronting insurers as well as pooling reinsurers.

The acquisition brings both onshore and offshore capabilities with a presence in multiple domiciles as well as licenses in 10 US jurisdictions, according to Risk Strategies.

It will also provide Risk Strategies with its first operating presence outside of the US.

John Mina, CEO of Risk Strategies, said: "As traditional insurers become more selective in their coverage and premiums rise, innovative alternatives such as captives are increasingly important in creating cost-effective ways to manage and mitigate client risk."

Martin Eveleigh, Atlas' founder and chairman, added: "Alternative approaches to managing the cost of risk are increasingly necessary in today's evolving world of business."

"We saw in Risk Strategies a firm with a truly consultative approach to risk management and the same dedication to using technical expertise and innovation in pursuit of the best solutions for clients."

Risk Strategies said that acquiring Atlas Insurance Management builds momentum behind the firm's efforts to build out captive management capabilities, adding to its recent acquisitions of Risk Management Advisors and Oxford Risk Management Group.

Terms of the deal were not made public. ■

Positive ratings for Nuclear Electric Insurance

A.M. Best has affirmed the financial strength rating of A (Excellent) and the long-term issuer credit rating of "a+" of Nuclear Electric Insurance Limited (NEIL). The outlook of these credit ratings remains stable.

The ratings reflect NEIL's balance sheet strength, which A.M. Best categorises as strongest, as well as its marginal operating performance, favourable business profile and appropriate enterprise risk management.

The ratings also acknowledge NEIL's management culture and its exclusive leadership position in the US nuclear power-generating industry.

NEIL underwrites the entire nuclear utility property insurance coverage in the US and continues with its mission of maintaining the financial strength to cover two full-limit nuclear losses, while promoting industry risk management and safety practices.

According to A.M. Best, partially offsetting these positive rating factors are the company's primary focus on property catastrophe risks and related business interruption claims, with the subsequent financial stress this could cause in the unlikely event of two full-limit losses.

Despite recent positive results, A.M. Best explained that the company remains exposed to volatility in underwriting results given the nature of the risks it insures and because of claims activity, which relates to the fact that it relies on one market and two principal product lines.

However, these factors are "inherent" to captive mutual insurers focused on a particular niche market supported by its members, A.M. Best noted.

NEIL designed its risk management programme to manage risks within the company's defined tolerance levels. The company also maintains a comprehensive loss prevention programme, with a specialised, effective loss prevention department closely working with insured members to control losses.

A.M. Best suggested the ratings also recognise NEIL's history of maintaining sufficient capital to support its ongoing obligations, which includes its financial flexibility to suspend policyholder distributions.

A key rating driver, according to A.M. Best, that could lead to positive rating action is profitability and reduced volatility in underwriting results over the long term.

However, key factors that could see a rating downgrade include increased leverage, substantial increases in losses and significant erosion of capital or loss of members. ■

Alabama's captive legislation passes unanimously

The Alabama Captive Association's bill to update the state's captive legislation was passed by a vote of 99-0 by the house of representatives on 25 February 2020.

The bill is sponsored by state representative David Faulkner, who also presented the previous amendment to the Alabama Captive Insurers Act in 2016.

Under the new bill, branch captive requirements will be revamped to more closely match those of pure captives.

Multi-state and multi-national organisations will also be able to better manage Alabama risks by making capital standards more reasonable expanding the use of branch captives to all lines of business.

Additionally, the bill will remove the requirement for coastal homeowners captives to be fronted.

The codification of a formal dormancy statute, that follows existing practice, to allow captives to cease writing business for up to five years to remain in existence.

Clarification on risks allowed in a foreign jurisdiction may now be insured in domestic captive.

Executive director of the Alabama Captive Association, Norman Chandler, said: "We are excited that captive legislation in Alabama continues to have unanimous support by the legislature. This shows the great commitment to captives. Alabama also continues its industry-first initiatives in-branch captives and in coastal homeowners captives." ■

Survey: Majority of UK and German firms exploring captive solutions

The majority of businesses in the UK and Germany are exploring captive insurance, according to surveys conducted by the UK risk and insurance management association, Airmic, and the German risk and insurance management association, GVNW in January and February 2020.

The survey concluded that 65 percent of UK and 53 percent of German firms are exploring alternative risk transfer solutions, including new and expanded use of captives, for their 2020 renewals.

Meanwhile, it found that over a third of businesses (33 percent UK, 46 percent Germany) plan to invest more in risk management solutions.

The survey stated that the impact of the hardening market goes beyond price, with reduced capacity, an increase in exclusions, and unavailability of cover for some, having a significant impact on 2019 renewals.

Directors and officers (D&O) rates have been hardest hit, the survey revealed with over 80 percent of respondents noting price rises in the UK and over 60 percent in Germany. In the UK, 13 percent have seen D&O rates more than double.

Julia Graham, deputy CEO and technical director at Airmic, commented: "Today's market conditions are notably different to previous hard markets which were cyclical and focused on price."

Graham added: "Today, by comparison, we are also seeing reduced capacity, an increase in exclusions and in some cases the complete withdrawal of cover. There are also early signs of changing claims behaviour which we are monitoring closely."

"This is a seismic shift. To stay relevant, the market must become more customer-centric, make better use of technology to improve service, and provide more innovative solutions."

According to the survey, there is a frustration at poor or late communication from insurance partners (43 percent UK, 62 percent, Germany) and over half of policyholders are only partially satisfied or not satisfied with service from brokers.

Joerg Henne, managing director of GVNW, said: "Communication and transparency need to improve and good risk management should be rewarded."

"Businesses understand their risks better than ever before and the fact that we are seeing risk professionals exploring alternative risk transfer solutions for 2020 renewals should be a wakeup call to the market," he explained. ■

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State Street's captive ratings affirmed

A.M. Best has assigned a financial strength rating of A- (Excellent) and a long-term issuer credit rating of "a-" to Federated Underwriting Company, located in Vermont. The outlook assigned to these credit ratings is stable.

A.M. Best categorises Federated's balance sheet strength as very strong, as well as its adequate operating performance, limited business profile, appropriate enterprise risk management and one notch of credit enhancement that it receives from its ultimate parent, State Street Corporation.

This single parent captive was formed and capitalised in 2019 as part of State Street's alternative risk financing strategy in the wake of significant price firming in the professional liability insurance market.

Federated's business profile is considered limited as it will operate as a single parent captive insurer whose sole purpose is to take on a specific layer of risk related to its parent's professional liability and bankers blanket bond insurance tower.

A.M. Best said it views the company's prospective operating performance considerations as "adequate" as this includes elements of stochastic modelling, average annual loss expectancies and tail risk probabilities.

However, the rating firms said these projections are subject to a high degree of variability due to external market factors.

The rating includes a level of credit enhancement from State Street.

According to A.M. Best, the rating enhancement considers an implied level of financial support to be provided if and when necessary as part of its legal obligation contained in its client agreements. ■

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PwC sees 2019 non-life insurance run-off figure increase

PwC's annual review of non-life run-off deals found an increase in publicly announced deals in 2019 compared to 2018, with deals jumping from 32 to 48.

Of the 48 deals, totalling $10.5 billion, nine were captives, 28 were (re)insurers, two were corporates and the other nine were Lloyd's.

In the report, PwC said that the market had seen "another busy year" with a number of new entrants completing deals and incumbent increasing activity levels to "new highs".

The UK and Ireland dominated deal activity in 2019 both by volume and values, driven in part by the Lloyd's run-off deals. In total the UK and Ireland saw 18 deals with an estimated gross liabilities totalling $4.6 billion with approximately $2.4 billion coming from Lloyd's.

Although Continental Europe did see an increase in activity, the region still remained low compared to the rest of the world at $0.6 billion. The review found that the Asia Pacific region outpaced Continental Europe in terms of deal values (though not volumes). North America saw a decrease in the volume of publicly announced deals from last year. According to the report, this is due to the lower number of deals being publicly reported rather than a lower number of deals being created. The region had 17 deals that totalled to $3.7 billion estimated gross liabilities.

The report also showed that there were four deals in the rest of the world, which totalled $1.6 billion of estimated gross liabilities.

Looking ahead to 2020, the report noted there would be a continued focus on the Lloyd's legacy market following syndicate run-off announcements and new entrants able to provide legacy solutions.

It also said to look out for the completion of the first US Insurance Business Transfers under Oklahoma legislation.

Finally, it also suggested an expansion of deals outside of the traditional US and European markets following a number of completed deals in Asia Pacific.■

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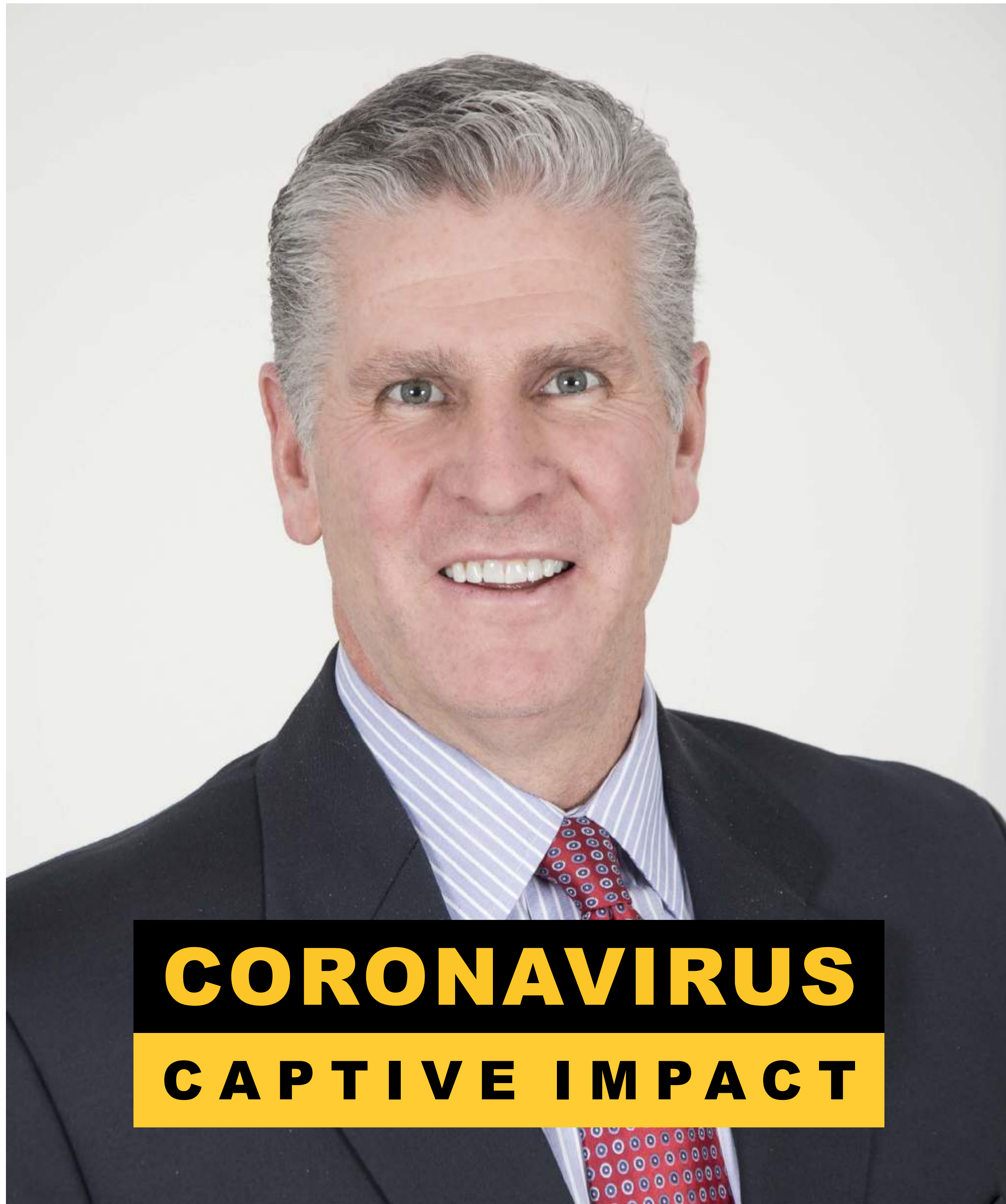

Phillip Giles of MSL Captive Solutions discusses how the COVID-19 pandemic could potentially affect self-funded health plans and medical stop-loss captives

It is still quite early to ascertain, with any degree of accuracy, the effects that the coronavirus pandemic will ultimately have on US health plans.

I can, however, offer some initial observations, from my perspective, as to how the pandemic could potentially affect self-funded health plans and medical stop-loss captives.

There is a significant variance in the levels of severity among those that have contracted the virus.

These range from symptoms of a cold or influenza, (requiring nothing more than home confinement), to intensive care hospitalisation for the more severe cases with advanced progression or individuals with compromised immune systems. The first scenario can be minimal in terms of cost while the latter can potentially be very expensive.

Self-funded "plans" themselves will experience a significant impact from COVID-19 as the employer (or plan sponsor) is directly responsible for all claims incurred by the plan. The degree to which the medical stop-loss coverage, including medical stop-loss risk held in a captive, is potentially impacted will be relative to the attachment level of the specific deductible covering the employer's primary plan risk. Traditional self-funded plans have two layers; the primary "plan" layer and the medical stop-loss layer.

The plan layer assumes responsibility for all claims incurred by the participants covered under the plan.

The employer pays the claims incurred by the plan and then seeks reimbursement for any larger claims, above a predefined (specific attachment) level from its medical stop-loss carrier or captive.

The industry-wide average specific stop-loss deductible (across all self-funded plans) is approximately $95,000. Most self-funded plans, including the smallest members participating in group medical stop-loss captives, have specific deductibles above $25,000.

From what we know at this stage, this should be well above the total treatment cost of most COVID-19 claims. Most large or complex claims (that would exceed the typical specific medical stop-loss deductible level of a self-funded employer plan) are more likely to come from elderly (retired) individuals, covered under Medicare, rather than from active employees covered by employee benefit healthcare plans.

Again, it is important to distinguish between the Plan layer, assumed directly by the employer, and the MSL layers, assumed by the captive and (re)insurers.

The plan will assume all claims so the effects from COVID-19 at primary coverage layer could be considerable while the impact to medical stop-loss layers (captive or (re)insurer) are likely to be much less significant.

A FEW ALTERNATIVE SCENARIOS

From an stop loss and captive perspective, claim frequency (i.e., aggregate), in addition to claim severity (i.e., specific), should also be considered, especially for smaller self-insureds, group captives and employers having large concentrations of employees in single locations.

The cascading effects of an infectious outbreak within a single employee population could have significant impact from an aggregate coverage perspective.

Group captives that provide captive aggregate coverage (as opposed to individual plan aggregate) could also see some increased potential to erode the aggregate attachment in the event of a widespread outbreak.

It may also be worth considering that the contraction of an infectious disease if it can be attributed to a work assignment (such as a healthcare worker infected by a patient), may compensable under workers compensation rather than the employer's self-funded health plan.

Again, it is still early, and there are enough variables to prevent us from fostering a consistent degree of certainty in terms of how much impact coronavirus will have on medical stop-loss captives and (re)insures. Employer exposure at the primary plan level is likely to experience a significant direct impact. While some medical stop-loss captives may have some increased aggregate exposure, my belief is that most specific attachments are probably set well above most coronavirus claim levels. In short, the primary plan will experience some financial duress while the typical captive excess layers are probably set high

Maintaining the regulatory roadmap

Located in the Irish sea, the Isle of Man is home to a big captive insurance market, with new insurance legislation on the cards, industry experts discuss how these as well as current trends and challenges are currently impacting its captive market

With a population of 83,000 people, the Isle of Man is a self-governing British crown dependency in the Irish Sea located between the north of England and Northern Ireland.

With a strong economy, the Isle of Man is backed by a Moody's rating of Aa2. Although it is located in the heart of the British Isles, it is not part of the EU or the European economic area and retains its internal self-government.

The Isle of Man is also home to 102 captive insurance companies, as of 31 December 2019. The captive market was first established in 1986 and offers a variety of structures including limited liability companies, protected cell companies, incorporated cell companies, insurance special purpose vehicles and limited liability partnerships.

In 2019, the island licensed two new captives and saw three closures. Industry participants discuss the new regulatory framework, current trends and what's to come in the future for the domicile's captive market.

Regulatory roadmap

The Isle of Man Financial Services Authority Regulatory Roadmap was first issued in June 2013 to provide an overview of a significant update to the Isle of Man's insurance regulatory framework which is consistent with the authority's aims of ensuring that the island has a proportionate and robust regime for the regulation and supervision of insurance business, consistent with the International Association of Insurance Supervisors' - Insurance Core Principles (published November 2019) to deliver a dual regulatory regime tailored to the needs of both captive and commercial insurers.

The authority has now issued the February 2020 Roadmap which provides regulated entities and other relevant stakeholders with information on progress over the past six months and looks ahead to significant workstreams over the next year.

The Isle of Man Financial Services Authority is due to launch a limited consultation in Q2 this year, in respect of capital requirements for protected cell companies (PCCs) and incorporated cell companies.

The new framework is anticipated to be in place for the captive insurance market on 31 December 2020.

Nick Gale, head of office, Marsh Management Services Isle of Man of Marsh Captive Solutions, reveals the key changes that will affect captive (re)insurers (Class 12 licence holders) include a new risk-based solvency capital regime based on an insurer's individual risk profile; and an updated Corporate Governance Code (CGC) of practice for insurers.

He notes that the CGC will include several possible exemptions for Class 12 (captive) insurers.

Ross Dennett, managing director at Thomas Miller Captive Management, adds: "Importantly in the process, the authority has not only undertaken extensive

consultation but it has also worked closely with Isle of Man Captive Association to ensure that the enhanced legislation is both relevant and appropriate."

Gale clarifies that Marsh has been working closely with the island's financial services authority over the last few years in order to address the needs of the captive sector and plan for the implementation of the new regulations.

As a result, Marsh doesn't expect any of its client companies that they manage to require additional capital or find the new governance requirements unduly difficult to comply with.

On regulation, Gale also noted that the Isle of Man income tax division has implemented new substance requirements for resident companies, including captive insurance companies.

Gale says: "While these requirements are new, they have been largely practised by the Isle of Man captive industry for decades and therefore are not expected to have much impact," he adds.

Hardening market

On the current trends, Dennett addresses the significance of the hardening of the conventional insurance and reinsurance market over the last year.

Dennett suggests that the hardening market has been a catalyst for a marked increase in business enquiries.

He explains that insurance purchasers are either faced with significant premium increases, reduced cover or in some cases are not able to source any cover at all from the insurance market.

"Capacity has reduced and insurers are clearly in a position where they can be a lot more selective over which risks and lines of business they choose to underwrite."

"Naturally, this scenario has focused minds on increased risk retention by purchasers and the logical home for such risk retention being a captive insurer," he continues.

Dennett points out that the general view is that this trend is long overdue as the pricing within the insurance market had reduced to sub-economic levels, meaning the island – along with the rest of the market – should expect a lot of interest and enquiries in the pipeline.

According to Gale, the captive insurance sector continues to be the bedrock of the island's non-life insurance sector.

Gale adds that Marsh is seeing an increase in enquiries and new insurance licence applications.

He says: "In addition, a number of existing captives are considering self-insuring more of their own risk, which is largely due to the challenges some insurance buyers are experiencing in the commercial market. Where cover is not available or is not cost-effective, companies are looking to utilise an existing captive or set-up a new captive vehicle to self-insure the risk."

Looking at it from a Marsh perspective, Gale adds they have seen increased interest in protected cell companies (PCC) over the last 12 months. Recently, Marsh's Mangrove Insurance Solutions PCC facility in the Isle of Man established two new cells and they expect to form another two shortly.

PCC legislation

A law governing PCC's was first enacted in 2004 on the island, which was known as the Isle of Man Protected Cell Companies Act (IOMPCCA), which was solely for their insurance industry. However, due to its potential to protect other industries, numerous business groups lobbied the government to expand the law. The act was amended in 2006 permitting a PCC to be used for any type of business. Additionally, the Protected Cell Companies (Eligibility) Regulations were created in 2010.

Dennett outlines that the Isle of Man "has always had a reputation as a 'can-do' captive domicile with a high sovereign rating and its standing as an internationally responsible country as acknowledged by the International Monetary Fund (IMF) and other regulatory bodies".

He explains that this is because a protected cell vehicle can allow a smaller company to isolate risk without incurring the expense of actually owning a captive.

A PCC can be designed to accommodate a quick entrance or exit. In addition to cost savings, a PCC can free up management time and offer both capital flexibility and acceptance. It can be thought of as being a standard limited company that has been separated into legally distinct portions or cells.

"The revenue streams, assets and liabilities of each cell are kept separate from all other cells. Each cell has its own separate portion of the PCC's overall share capital, allowing shareholders to maintain sole ownership of an entire cell while owning only a small proportion of the PCC as a whole", he continues.

He notes that a PCC can provide a means of entry into the captive insurance market to entities as it was previously uneconomic. The overheads of a PCC can be shared between the owners of each of the cells, making the captive cheaper to run from the point of view of the insured. The professional infrastructure on the island is well established, but according to Dennett, one of the attractions of the Isle of Man is that the finance sector is really quite broad.

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He comments: "Both the Isle of Man government and the Isle of Man Financial Services Authority recognise the importance of the captive sector and PCC's are an important tool."

Brexit impact

Although the Isle of Man is not part of the UK or the EU, it does have a close relationship with the UK.

Dennett states that with Brexit things will change and the scope of that change will take shape this year as the future relationship between the UK and EU is negotiated.

He explains: "For people and businesses in the Isle of Man the effects of these changes may be significant, or they may be minimal. The Isle of Man Government has, therefore, been preparing for the UK's withdrawal from the EU for some time. This has meant making sure that our laws have been changed to reflect the ending of our limited relationship with the EU, and also that government services can continue to be delivered."

He highlights that businesses and people have been provided with relevant information to ensure that they can also take the steps necessary to prepare for Brexit.

Island challenges

With ever-changing technological advances, comes the pressure to stay up-to-date with the latest innovations and trends.

Gale explains that the new insurance regulations and recent Moneyval plenary results are important steps in the right direction.

However, Gale adds that continued focus is required for the captive sector to adopt new and disruptive technologies that change the way the businesses operate and their client's needs for insurance.

He suggests that shifting social attitudes and political priorities are also likely to present new challenges and opportunities that must be understood and regulated appropriately.

"Sticking the right balance of timely and safe innovation and maintaining the island's strong reputation for reliability will be important to the island's ongoing success", he adds.

Looking at the competition, Gale points out that the number of potential captive domiciles grows almost every year so the Isle of Man "must continue to differentiate itself" to stay relevant".

Gale comments: "The Isle of Man Captive Association plans to actively promote the island's non-life sector in 2020 through various media channels to make sure its benefits and reputation don't just rely on word of mouth and the knowledge of key industry experts."

Planning ahead

For the rest of 2020, Gale believes that the outlook is "positive", due to the transitioning insurance market, which should lead to increased captive utilisation.

He adds that with the association actively promoting the island as a captive domicile and an alternative solution to commercial insurance, "the island will see its fair share of new formations and growth".

Although we are currently three months into 2020, Dennett reveals that this year has already been "very exciting" for the islands captive sector.

He notes that there have been "a lot of new captive enquiries coupled with existing captive owners looking to 'work' their existing captive more".

Dennett adds that he is also positive that the new regulatory framework will be finalised and formalised and the strong indications of the long-overdue hard market will all help grow the island's captive sector. ■

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The battle goes on

As the IRS' battle against micro-captives continues, industry experts discuss the latest settlement offer made by the IRS and what its next move could be

The Internal Revenue Service (IRS) has targeted micro captives for years, but in more recent times they have ramped up their efforts to do so, including them on its 'Dirty Dozen' list of tax scams since 2014, along with other actions.

In 2016, the Department of Treasury and IRS issued Notice 2016-66, which formally labelled micro captives as 'transactions of interest'. The IRS advised that these transactions have the potential for tax avoidance or evasion.

Under section 831(b) of the US tax code, captive insurers that qualify as small insurance companies can elect to exclude limited amounts of annual net premiums from income, so that the captive pays tax only on its investment income.

Named as a type of "abusive tax shelter", the IRS has previously suggested that some micro captives may be used by promoters, accountants or wealth planners to persuade owners of closely-held entities to participate in schemes that lack many of the attributes of genuine insurance.

Alan Fine, tax partner and insurance industry group leader, Brown Smith Wallace, notes that the IRS' aversion to captives dates back to the late 1970s and early 1980s when they attacked a large number of captive insurance companies.

Fine says: "Those early cases, like the cases of recent years, generally resulted in victories for the government."

He explains that the IRS currently operates under the assumption that most micro-captive transactions have been entered into and conducted improperly, without sufficient non-tax business purposes for doing so.

"There are some situations in which taxpayers try to reduce their overall tax liability by utilising the micro-captive strategy, rather than entering into it for risk management purposes," he adds.

Many major cases have made headlines as they went to US tax court against the IRS, the first case that involved a captive that made the election to be taxed solely on investment income under Section 831(b) was Avrahami v Commissioner of Internal Revenue (Avrahami).

In August 2017, the US Tax Court released its decision in the Avrahami case, backing the IRS.

Judge Mark Holmes ruled that payments made to the Avrahamis by their micro captive, Feedback, amounted to taxable dividends outside of the scope of certain tax elections.

Feedback insured the Avrahamis' Arizona jewellery stores and shopping centres against chemical and biological terrorist attacks.

But the IRS believed that the micro captive was organised to provide tax deductions under Section 831(b) of the Internal Revenue Code and lacked insurance risk, and that risk was not shifted to the captive.

Another example is Reserve Mechanical Corp v Commissioner of Internal Revenue and CIC Services LLC v. IRS, which is still ongoing in the court. CIC Services has petitioned the Supreme Court of the US to hear its lawsuit against the Internal Revenue Service (IRS) regarding IRS Notice 2016-66, while Reserve Mechanical Corp has filed the opening brief with the tenth circuit court of appeals.

Sean King, principal at CIC Services, explains that the IRS does not and has not identified all micro-captive transactions as 'abusive'. He says: "In fact, the IRS conceded in its original 'Dirty Dozen' publication that micro-captives, in general, are a "legitimate tax structure."

He adds that in Notice 2016-66, the IRS stated that it "lacks sufficient information to identify which 831(b) arrangements should be identified specifically as a tax avoidance transaction and may lack sufficient information to define the characteristics that distinguish the tax avoidance transactions from other 831(b) related-party transactions".

King says: "So, clearly, the IRS thinks that there are some, perhaps a lot, of non-abusive captive transactions."

Settle for less

In September last year, the IRS mailed a "time-limited settlement offer" for certain taxpayers under audit who participated in 'abusive' micro captive insurance transactions.

The settlement requires substantial concession of the income tax benefits claimed by the taxpayer together with appropriate penalties—unless the taxpayer can demonstrate good faith, reasonable reliance. The initiative is currently limited to taxpayers with at least one open year under exam.

Commenting on the IRS's latest move against micro-captives, Fine suggests that if the IRS were focused on pursuing taxpayers who entered into the captive transactions strictly to generate tax deductions, "I would not take exception to this move".

Fine explains that unfortunately, the IRS "is unlikely to be that focused on their new examination efforts"

He adds: "The additional issue is that there will still be a shortage of subject matter experts that understand the insurance-specific nuances of these transactions, resulting in longer, inefficient exams and increased professional fees for taxpayers defending the exams," he adds.

Phil Karter, attorney at Chamberlain Hrdlicka states he would not characterise the IRS' latest move as one "against" micro captives, but rather a recognition of the limitations on its own resources to effectively manage a large number of captive audits in the pipeline.

He explains: "In attempting to reduce the workload, the IRS has proposed a settlement that is arguably reasonable for bad captives or ones where the dollar amount at issue may not justify the expense of defending an audit, but much less so for well-organised, well-run captives that have been caught in the audited net simply because of the reporting requirement and consequent close scrutiny given to micro-captives generally."

Since the first announcement, in February, the IRS revealed that 80 percent of taxpayers who received offer letters elected to accept the settlement terms.

However, the Self-Insurance Institute of America (SIIA) has suggested that the settlement figures released by the IRS are "misleading".

SIIA stressed that the figure is misleading in that the 80 percent of the taxpayers have agreed to participate and consider a settlement, but did not actually settle.

According to SIIA, those taxpayers can indeed settle, but also have the option to go to court.

SIIA said it understands that, as of 19 February, not a single captive had engaged in a final settlement agreement, and making such an announcement is "premature".

In addition, SIIA suggested the audit teams will most likely be looking at other issues unrelated to the captive industry, not simply focusing on captives themselves.

SIIA revealed that while approximately 160 captive structures have agreed to consider settlements with the IRS, thousands of captives remain in place that are assisting America's small and medium-sized businesses to mitigate important and real risk factors.

Commenting on the benefits of accepting such offer, Fine says: "The benefit of accepting the settlement offer is it will allow affected taxpayers to move past the time and effort associated with the examinations. It provides certainty, particularly regarding the potential income inclusion at the captive level, and it reduces or potentially eliminates penalties."

At the time of announcing the settlement offer, the IRS also revealed it was establishing 12 new examination teams comprised of employees from the IRS large business/self-employed divisions that will be working to address abusive transactions and open additional exams.

Fine said he expects to see a significant number of these new examinations starting in the next 12 to 18 months.

He reveals: "Given the vast breadth of the information requests, the lack of captive insurance experts within the IRS (even within the new exam teams), and the IRS's steadfast refusal to look at these captives reasonably, the vast majority of the cases will then move to the appeals phase, followed by a large number of taxpayers moving to litigate in tax court."

The next move

Commenting on the IRS next move, King says that after decades of losing tax court case after-tax court case, the IRS has "finally managed" to win the last three in a row involving micro-captives of questionable status.

However, King states: "Knowing that they will eventually lose some important cases again and that such losses will embolden honest taxpayers to resist its attempts at extortion, the IRS is seeking to strike at its point of maximum leverage."

He adds: "The service hopes to intimidate as many taxpayers as possible in the coming months into settlements before adverse precedent undermines that leverage."

"My guess is that the Service will act quickly, or as quickly as governments do, to threaten more audits in hopes of scaring taxpayers into quick settlements."

A resolution

As the battle continues between the IRS and micro-captives, will there ever be a resolution or agreement between the IRS and its view on micro captives?

Karter discloses that many professionals who work on captive matters view the IRS' current aggressive captive audit initiatives as a "short-term pain" that will hopefully lead to a better long-term outcome in differentiating the many captives that are appropriately run to effectuate better risk management for their businesses from those that have no real business purpose but are set up principally to capitalise on tax benefits".

He adds: "When the dust finally settles, it is reasonable to expect that more clearly defined standards of what works and what doesn't will allow the many bonafide micro captive arrangements to successfully capitalise on the tax inducements congress intended in enacting section 831(b)."

However, King suggests that the IRS's hostility towards captives transcends decades, administrations and parties, and he doesn't believe this will change.

He states: "Ultimately the captive insurance industry will deal with the IRS just like they have for so long – by beating it in court. Court precedent will ultimately give the industry the guidance that the IRS refuses to. And in the meantime, the industry will continue to grow and prosper, just as it has."

Will the uncertainty remain?

As the IRS continues to focus on micro-captives, is there a possibility it will move the attention onto another form of a captive in the future?

Fine suggests that could be the case, "particularly if the Reserve Mechanical appeal is unsuccessful".

He notes that the issues the IRS is focusing on "aren't limited to micro captives".

"Concerns over the logic utilised by the tax court, such as the requirement to have a prior loss before there is a valid business purpose for purchasing insurance, 'cookie-cutter' insurance policies and what the court incorrectly referred to as "circular flow of funds" (the mechanism by which all risk-sharing pools operate) could potentially be issued for group captives, as well as the largest captives owned by fortune 500 companies."

King stresses that the IRS "loves uncertainty". He says: "Uncertainly allows it to raise revenue by arbitrarily coercing settlements from taxpayers who don't want to 'make a federal case of it.' And what qualifies as 'insurance' and what does not will probably always be somewhat uncertain."

"For that reason, I'm sure that the IRS will continue to scrutinise insurance arrangements in general, not just captives. That's just how the game is played", he adds. ■

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> "The insurance industry as a whole has always been fascinating to me – so what better way to start than providing banking solutions to the captive insurance industry"

Cheryl Baker

Manager, risk management services
Blue Cross Blue Shield of Michigan

Personal Bio: I grew up in southeast Michigan, where I remain today – give or take 30 to 40 miles. In my spare time, I enjoy travelling, cooking and trying out new restaurants. I'm also passionate about practising yoga and spending time with my friends and family.

Professional Profile: I graduated from the University of Michigan with a Bachelor of Arts in history, minoring in anthropology. From there, as a result of networking, I took a non-traditional path to captives. My first employer after college was a long-term customer at the establishment where I waited tables and tended bar throughout college. He overheard me speaking about graduating and offered me a position as an office manager at his management training company. After a couple of years, I was able to buy my first home, which led me to my next employer. My neighbour was looking for an employee within his risk management department. I was ultimately hired by Marsh to fill that position. There, I learned a lot about risk management and insurance, including captives. Over time, I engaged in significant formal education related to risk management and insurance, something that I continue to this day. After approximately 15 years, I moved to Blue Cross Blue Shield of Michigan; I have been with Blue Cross Blue Shield of Michigan for eight years.

How did you end up in the captive industry?

Although I was exposed to captives at Marsh, it wasn't until I moved to Blue Cross Blue Shield of Michigan that I was able to dive into the captive space. My manager and mentor, Frederick Driscoll, added me to the team that was standing-up Blue Cross Blue Shield of Michigan's single-parent captive. This enabled me to see how a captive is built, managed and run from the ground-up. Since the formation of the captive, I have been a member of the team responsible for its use and management.

What has been your highlight in the captive industry so far?

I have to say that meeting so many knowledgeable and creative individuals have been the highlight of my captive career, thus far.

What/who have been your influences in the captive industry?

My influences include my current leader, Fred Driscoll as well as several broker partners I've worked with over the years. Those individuals include Sean Rider (Willis Towers Watson), Anne Marie Towle (Hylant), Bruce Whitmore (Willis Towers Watson) and other captive owners such as Courtney Claflin and Karen Hsi (University of California), two of the most fearless captive owners I've met to date.

"Cheryl Baker has been instrumental in working with me and the BCBSM management team to fully develop our captive subsidiary, Woodward Straits, into a highly successful entity that contributes both financially and strategically to the company's mission and vision allowing the company to focus more on member care and satisfaction."

Frederick D Driscoll,
Director of risk financing and captive operations,
Blue Cross Blue Shield of Michigan

What is your impression of the industry?

In my view, the captive industry is so creative and nimble. People within the industry are truly interested in looking at emerging as well as traditional risks, risk mitigation and innovative risk financing via captive utilisation.

What are your aspirations for your career in the captive industry?

I really enjoy taking advantage of what the captive industry has to offer, enabling our team to mitigate and finance the enterprise's risks. I'd like to see continued innovation and look for additional strategic uses of our captive in order to help Blue Cross achieve its goals and mission.

What advice do you have for someone considering a role in the industry?

This is the industry for creative and new risk financing opportunities. I would advise anyone interested in the captive industry to reach out and meet as many people as possible (captive managers, owners, regulators, etc.). Look for mentors, advocates and inspirational colleagues in the captive space. You won't necessarily take all of the same steps but continue to have conversations with people involved at every stage of captive development, use and management. Look not only at risk financing options, but other strategic uses for your captive to expand the benefits to your enterprise. ■

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The latest moves in the captive industry

Robus, the independent insurance management, fiduciary and financial advisory group, has appointed Laura Boyd and Martin Bourgaize as it expands its Guernsey-based team.

Boyd joins from Rossborough as an insurance manager and will have responsibility for the underwriting and claims management across a portfolio of clients and will also be assisting with business development.

Bourgaize joins Robus as corporate services and insurance manager and will apply his experience in the corporate services arena to his new role.

According to Robus, both hires are the result of growth among the firm's client base over the past year and reflect its future ambition to win more business across the group.

Robus' Guernsey general manager, Jamie Polson, said: "We'd like to welcome [Laura] Boyd and [Martin] Bourgaize to the Guernsey team. These are two excellent hires who strengthen our resources and will enable us to grow even further in Guernsey and beyond."

"Boyd is an extremely enthusiastic professional with a relevant background in broking services which will certainly benefit our clients."

"Bourgaize's expertise in both insurance and company secretarial services will enable us to enhance the specialist, valuable elements of our comprehensive service proposition," he adds. ■

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A GUIDE TO TRAVERSING THE CAPTIVE TERRAIN

Arkansas insurance commissioner, Allen Kerr will step down from his role to pursue opportunities in the private sector, effective 27 March.

Kerr has been serving as the state's insurance commissioner since his appointment by Governor Asa Hutchinson in 2015.

As commissioner, Kerr recruited and welcomed 110 new insurance companies to do business in the state, increased annual revenue to the state by $84.25 million, increased licensures 67.6 percent and tripled the number of captive insurers in the state, according to the Arkansas Insurance Department.

Commenting on his departure, Kerr said: "It has been the greatest honour of my life to serve as state insurance commissioner under governor Hutchinson these last five years. Today, Arkansas is the destination for the insurance industry known as a place where a company can come and do honest business without being overregulated."

As of 31 December 2019, Arkansas had nine licensed captive insurance companies. ■

Guernsey Finance has named Rupert Pleasant as its new chief executive, replacing Dominic Wheatley, who in December announced he would be stepping down from his role on 30 June.

Huddleston has served in the department since 2014 and has previous experience in banking, public accounting, and most recently served as the division's director of receiverships.

Commenting on his promotion, Huddleston said: "My experience with the department and our stakeholders combined with my other professional experiences has helped me shape my management style as well as my insight into insurance policy."

"I am grateful for the opportunity to be appointed to this position, and I am looking forward to continuing to earn the trust of Tennesseans", he added.

TDCI assistant commissioner Rachel Jrade-Rice noted: "As the division's director, Bill Huddleston will help plan for the insurance division's future while helping further our mission of protecting Tennessee consumers."

She added: "His experience, leadership and knowledge will be beneficial in this role as he helps oversee day-to-day operations." ■