

Captive insurance

Why The Bahamas?

Jurisdiction has commitment, resources to become “Gold Standard” in global niche market

By Peter J Strauss

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A little understood risk management tool, captive insurance has many aspects that, upon acquiring a practical and working understanding of the concept, make it a very valuable and

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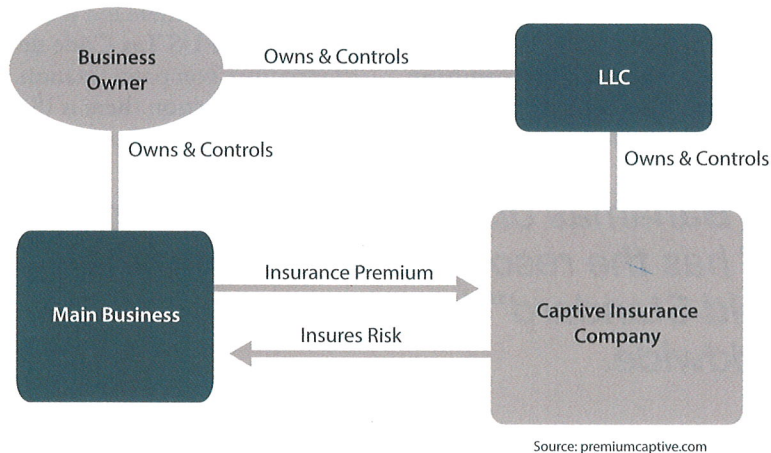
viable strategy for most successful business owners and entrepreneurs to implement. The Bahamas has been a home to captive insurance companies for more than 60 years and still remains a premier choice when considering where such an entity could be domiciled.

Captive market

There are many facets of a well-designed captive insurance programme that address very real and potentially large risks that every business is exposed to. In the truest of senses, it is a risk management tool. Additionally, upon proper implementation, there are potentially significant tax advantages that become available to the business owner.

So, let's begin with what a captive insurance company is. As its name implies, it is an insurance company that has been organized and recognized by a relevant jurisdictional body and is empowered to issue insurance policies. This company functions just as any other licensed

A captive insurance company



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insurance company: it employs actuaries to calculate probabilities; engages underwriters to assess risks; retains managers to administer its affairs and pays claims; engages auditors and tax professionals; and hires investment professionals to manage the investment portfolio.

The other term having a major bearing on the operation of a captive insurance programme is the word "captive." As this implies, its operations are restrained or, more appropriately, limited. A captive insurance company will only provide insurance products and services to its owner, hence the term "captive."

For many people this may be a new concept. With the recent coverage in business periodicals and the news media, captive insurance may seem like the latest fad. The truth could not be more divergent. Captive insurance has been in place

for more than 70 years.

One of the most famous captive insurance companies of all time is Allstate Insurance, which has its origins as being a subsidiary of Sears Roebuck & Co. Over time, the vast majority of the Fortune 500 companies have come to own their own insurance company. Moreover, The Bahamas has for a long time had a stake in the business. As far back as 1962, one of the first captive management companies was International Risk Management Ltd, which was domiciled in The Bahamas.

Managing risk

Every business has risks of varying types and sizes. Some risks, of the more traditional variety, are insured through commercial insurance carriers—insurance companies offering coverage in the open market.

ICCIE scholarships

In the fall of last year, the Bahamas Financial Services Board (BFSB) and the Insurance Commission of The Bahamas (ICB) selected the recipients for two scholarships being provided for the Associates in Captive Insurance (ACI) designation: Sanchez Brooks and Anastasia Campbell.

The BFSB is partnering with the ICB on the scholarships for the International Center for Captive Insurance Education (ICCIE) Course. BFSB chief executive officer Aliya Allen says: "ICCIE is the first and only comprehensive captive insurance education programme in North America, and its courses are relevant to any domicile around the world. The ACI designation is recognized and respected globally."

Campbell is an associate in the Corporate & Financial Services Group (including the insurance sector) at Graham Thompson and Brooks, ACII, is an underwriter at Summit Insurance Co Ltd.

The scholarship initiative was launched last year, in collaboration with the Bahamas Insurance Association and the Insurance Institute of The Bahamas, both of which appointed representatives to the planning and scholarship committees.

Examples of these risks and coverage would be automobile liability, property coverage (fire, wind and flood) for structures, and workers' compensation.

For all those risks and exposures that exist and for which commercial coverage has not been procured, they are by default (and definition) self retained and therefore self insured.

Captives at a glance

- Captives have been prevalent in the US for over half of a century.
- More than 30 states and 30 countries currently serve as domiciles for captive insurance companies.
- Over 90 per cent of Fortune 1,000 companies utilize a captive insurance company.
- The IRS provides specific Internal Revenue Code Sections and Revenue Rulings that support the utilization of captive insurance companies.
- The captive insurance market exceeds \$200 billion in annual insurance premiums.
- There are approximately 28 million small businesses in the US, of which only roughly 2,000 have a captive insurance company.

These are risks that we may not think of often, but they nonetheless exist and represent an opportunity to employ a captive insurance company for managing this risk and providing a financial mechanism to “back stop” the adverse financial impact of unforeseen events.

With regard to these self-insured risks, a business owner might be inclined to set aside funds in a reserve for the day an event occurs and a loss is sustained. While this is financially prudent, it is not efficient from an income tax perspective. Only licensed insurance companies are allowed under the US Tax Code to claim a deduction for the

establishment of reserves for future economic losses. So, an operating business that establishes a reserve for a future event must disregard this expense when calculating its taxable income.

However, if the operating company were to establish a captive insurance company, which has been properly

insurance companies bring this componentization to the property and casualty lines of insurance for smaller sized businesses.

Furthermore, there is a whole section of the US Tax Code devoted to insurance company taxation. Within this section there is IRC section 831(b), which is often referred

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formed, licensed and operating, it would then be allowed to deduct as insurance expense the calculated premium necessary to insure the varied risks by paying these premiums to this separate entity, of which they are the owner.

Business benefits

As was noted earlier, most of the Fortune 500 companies have discovered the benefits of establishing their own insurance companies. There are many business practices whose formulation and implementation starts with the largest of entities and over time, mechanisms and service providers appear that bring these benefits to smaller enterprises.

An example many medium size business owners have probably seen is medical reimbursement insurance. Thirty years ago, only the largest of companies could self insure their employee medical cost. Now, through third party administrators, businesses of all sizes (even those with as few as 50 employees) have been able to componentize the process. They hire third party administrators to process and pay claims, rent health care provider networks for discounts, and purchase stop-loss coverage for exposure capitation. Just as transpired in the medical insurance arena, captive

to as the “small insurance exclusion.” This particular section stipulates that the first \$1.2 million premium income for a captive insurance company is exempt current income taxation. This is an exemption that is available year after year. So, now we see an additional benefit of captive insurance, the ability to operate a business in a manner that is not only financially prudent, but also very tax efficient.

Due diligence

How does a business owner go about creating a captive insurance company, and where should it be domiciled?

A law firm needs to employ a very methodical, deliberate and thorough due diligence process, which will result in the formation of a captive insurance company for a business owner.

Please note the phrase “result in the formation” of a captive insurance company. There are many people in the marketplace who will “sell” anything, and that is because they are in the business of selling. At a good law firm an evaluation and investigation process is undertaken to see if a captive insurance company is a good “fit” for a business and its ownership. What is being contemplated is the creation of a

legal structure, the registration with regulatory bodies, and formation of long lasting business relationships. These things are most often best left to a team of legal professionals, as opposed to commission driven insurance agents.

At the conclusion of this due diligence process, a business owner is given an underwriting report, and at that point can decide to proceed with the formation of a captive.

Destination Bahamas

One of the most critical choices for a business owner, after deciding to proceed, is where they should domicile their captive insurance company. Because this is the creation of a long lasting entity and its functionality will be a major component of its business structure, it is not to be decided casually. The domicile choices are numerous. Currently, there are more than 30 US states and territories that allow for the domicile of captive insurance companies [section (b) small insurance] within their jurisdictions and close to 35 international jurisdictions allowing for captive insurance company formation.

So, why choose to organize captives in The Bahamas?

Each client has unique needs and special demands that arise from their business. One size does not fit all. Each captive's formation is different. The Bahamas has a business friendly environment in which to domicile these entities. As was noted earlier, the Bahamian involvement with captives goes back more than 60 years. There is an understanding within The Insurance Commission of The Bahamas of how captive insurance companies function and the needs of this specialized entity.

The jurisdiction also has highly skilled human resources. Within the Bahamian business community there are accountants, bankers, and other legal advisors who are receptive and accommodative of the needs of this industry. The combination of skilled

professionals and legislative infrastructure means that The Bahamas displays the commitment and has the resources to become the "Gold Standard" for captive insurance worldwide. @



Peter J Strauss, JD, LLM, is the managing member of The Strauss Law Firm, LLC, located in South Carolina.

His firm focuses on estate and tax planning, asset protection and captive insurance solutions. Strauss has authored three books on captive insurance, and regularly speaks at national conferences on the subject. The Strauss Law Firm recommends its clients to base their captive insurance companies in The Bahamas and has been instrumental in the formation of Bahamas-based service providers.



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