How to Choose a Domicile

by Robert M. Horkovich & Phillip England

Choosing a domicile for a captive insurance company is a process of elimination. Often, the choice comes down to prior relationships with service providers or a captive owner's subjective impression about a jurisdiction. The choice narrows quickly, however, once one accounts for certain factors.

Income tax planning. Captive insurance income may be tax-favored, although in different ways depending on the jurisdiction and status of the owner. In general, tax objectives involve: deferring or excluding the captive's income from taxation; minimizing tax on the owner's receipt of dividends from the captive; utilizing the captive's tax losses, if any; and letting the owner take credit for any foreign tax that the captive pays.

For income tax treaty reasons, a Canadian parent might domicile its captive in Barbados and a German parent might favor a Luxembourg captive. The U.S./Ireland treaty may make Ireland a suitable home for a U.S.-owned captive that covers European risk.

Some offshore advisers tout opportunities for U.S. businesses to defer taxation of captive insurance profits by transferring them to an offshore captive that is not controlled by its American owners. This approach may run afoul of U.S. tax regulations, however. Many U.S.-owned offshore captives make a section 953(d) "domestic" election to treat the captive as a U.S. taxpayer. Alternatively, captives that insure U.S. risk often choose U.S. domiciles.

Under Revenue Ruling 2008-8, which treats a segregated cell company as if it were a standalone captive insurance company (provided tax definitional criteria are satisfied) it is feasible for a captive owner to own more than one captive without incurring major additional administrative expenses. Each of a "family" of captives may (with planning) qualify for certain tax exemptions. In such cases, the preferable domicile would accommodate segregated accounts companies.

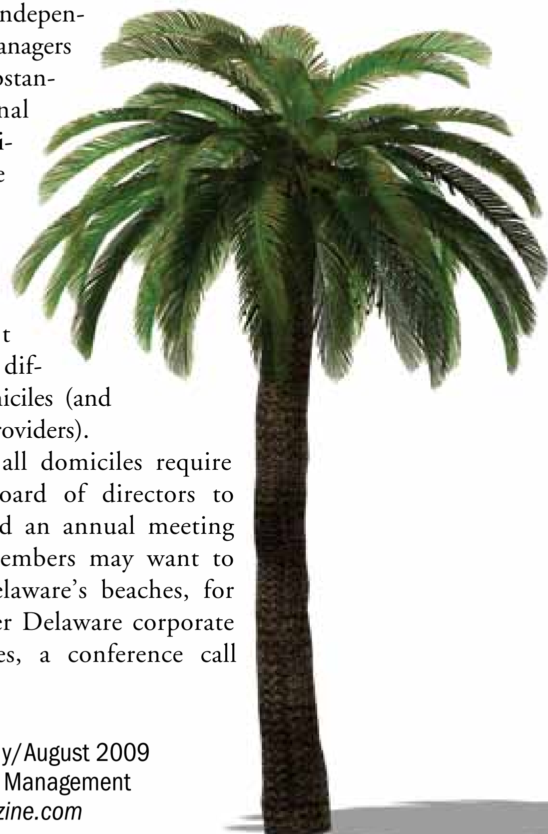
Premium tax planning. Arizona and many offshore domiciles assess no premium tax. A captive may be better served, however, to incur state premium tax (at a low rate) when it buys coverage from commercial reinsurers. Commercial insurance companies incur state premium tax (at a high rate, generally around 2%) on direct written premiums but not on reinsurance premiums if the assumed premiums have incurred state premium tax when written directly, even if written by a captive. Using a captive to buy commercial insurance coverage may reduce the overall state premium tax burden on such coverage. This may argue for domiciling a captive in a state that imposes a modest captive premium tax.

Many states impose a tax for obtaining coverage from an insurer that is not licensed for business in the insured's state. This tax, a self-procurement tax or direct placement tax, is essentially a tax on the coverage issued by a nonlicensed insurer. One solution is to domicile the captive in the state where the policyholder is located, if possible.

Insurance regulation. IRS examiners consider the rigor of captive insurance regulation as part of the test of whether the captive conforms with commonly accepted notions of an insurance company. Some domiciles are more rigorously regulated than others. Statutes in some domiciles arguably over-regulate a captive's investment portfolio. Typically, an owner wants its captive to invest in related-party investments. In Bermuda, absent special permission, 75% of a captive's liabilities must be backed by assets that are not related-party investments. In Utah, a captive cannot invest more than half its portfolio in related-party assets. Although opinions among tax advisers vary, some suggest a captive could invest more than half of its assets into related-party instruments.

Captive management. Some domiciles require locally based, independent captive managers to perform substantive operational roles; other domiciles allow the captive manager to reside elsewhere. The cost of captive management and auditing differs among domiciles (and among service providers).

Travel. Not all domiciles require the captive's board of directors to physically attend an annual meeting there. Board members may want to vacation on Delaware's beaches, for instance, but per Delaware corporate governance rules, a conference call will suffice. ■



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