FEATURE

Captive Growth Restrained in 2018

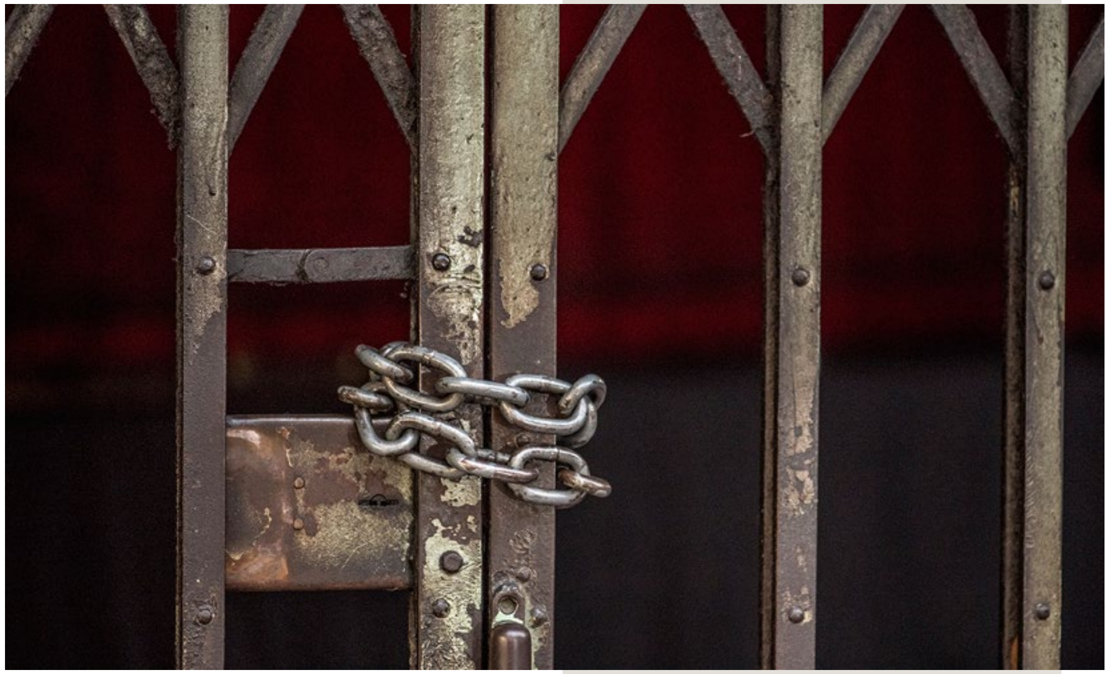
WRITTEN BY KARRIE HYATT

In 2018, the captive industry saw slower growth than it had in recent years. While active captive domiciles still added new captives to their books, for most domiciles, there were not as many new formations as in 2017.

The lackluster increase in captives likely had several causes. The continued soft insurance market being one. Another being the continued scrutiny by the IRS into small captives electing the 831(b) tax designation. In fact, the IRS again named these captives to its annual "Dirty Dozen" list of potential tax scams this year. Captives redomiciling and mergers also played a part in the near flat numbers in 2018.

However, despite what the static figures seems to indicate, the captive sector is thriving. Captive owners are insuring more types of coverages through their captives and captives are bringing in more money to their domiciles. In 2018 in Tennessee, written premium rose by 20% over the previous year. North Carolina, one of the newest and most aggressive of captive domiciles, released a statement last year claiming that captives had a $30 million dollar impact on state finances in 2017, and over $70 million since 2013. When its 2018 numbers are released it will likely be much higher due to its rapid addition of captives.

STATE-OF-THE-CAPTIVE BY DOMICILE



Of the state captive domiciles that have released their numbers from 2018, only four show an increase in formations over the previous year. For Vermont and Arkansas, the increase was only by one captive, bringing the total number of captives up to 558 for Vermont and six for Arkansas. While Vermont remains the largest onshore captive domicile, Arkansas is working on building its captive industry. Vermont has already updated its captive law in 2019—as it does every year—with several minor changes and clarifications, including allowing captives to undergo examination every five years instead of three. Arkansas is also looking to update its own law this year as well. The southern state originally passed captive law in 2001, but it wasn't until 2017, when the state legislature updated the law, that the domicile really began courting new captives. The bill introduced into the state legislature in February provides clarifications on types of captives; on capital, surplus, and reporting requirements; on sponsored and cell captives; and on risk retention groups. By seeking to further update its legislation in 2019, Arkansas is indicating its seriousness as a captive domicile.

The other two jurisdictions that had an increase in formations were Kentucky, with seven new captives, an increase from four in 2017, and the District of Columbia, which had the largest number of new formations, with 17 new captives over the previous year's three. In fact, this was the domicile's largest net gain of captives since 2015.

Arizona, Delaware, Georgia, Hawaii, Montana, South Carolina, Tennessee, Texas, and Utah all reported fewer captives licensed in 2018 than in 2017. Many of these licensing 40% to 50% fewer captives.

Delaware licensed only 46 captives last year, in contrast with the 117 licensed in 2017. Of the newly licensed captives, 30 were taking advantage of Delaware's latest addition to its captive law—conditional licensing. Signed into law in October, H.B. 334 amends the state's law to allow captive applicants to be granted a six-month provisional license to operate while the application is processed by regulators. The idea proved popular. In the last ten weeks of 2018, Delaware granted 30 conditional licenses, indicating that previous nine months, the domicile had only licensed 16 new captives. In a statement, Insurance Commissioner Trinidad Navarro said,

"Captive insurance formations faced a number of challenges in 2018, due to recent changes in tax law. Despite the headwinds, Delaware's having knowledgeable captive regulators continues to attract quality applicants."

In Vermont, one of its newest captives is the first of its kind—an affiliated reinsurance company. Affiliated reinsurance captives were enabled by Vermont through legislation in 2018 in reaction to the *Base Erosion and Anti-Abuse Tax* (BEAT) that was included in the *Tax Cuts and Jobs Act of 2017*, which subjects some companies that reinsure offshore to additional taxation. Vermont's law offers a viable onshore option for these companies.

In addition to Vermont and Arkansas updating their captive laws this year, so far Georgia and North Carolina are also considering updates. Georgia has been updating its captive law with regularity over the last few years to keep it competitive. The 2019 changes considered are clarifying technicalities and streamlining the tax reporting and the licensing processes.

H.B. 220 was introduced into the North Carolina legislature in March. This would be the captive law's fourth update since it was originally passed in 2013. The latest update clarifies some technical issues and makes some changes to the premium tax charges. At the time of writing, only Vermont had signed the updated legislation into law.

REASONS CAPTIVE NUMBERS ARE STATIC

The soft market, new taxation rules, tax court decisions, and an economy in flux work against forming captives. The effects of the *Tax Cuts and Jobs Act of 2017* made forming a captive less beneficial due to decreased tax benefits. When the law was signed in December of 2017, industry experts forecasted a reduction in new captive formations, which certainly played out in 2018.

The small growth in captives in 2018 might also be a reflection of the decision of the U.S. tax court in *Avrahami v. Commissioner*—the 2017 court decision that said the 831(b) captive owned by the Avrahami family was being used as a tax dodge. This decision and other similar court decisions have slowed down the rapid growth of small captives that would be eligible for the 831(b) tax option.

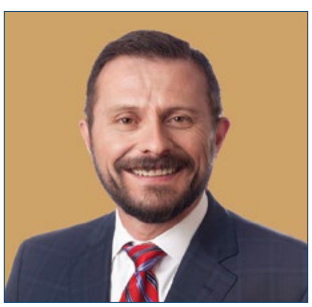
There was a significant rise in mergers and acquisitions (M&A) activity in the global insurance sector in 2018, according to the *Sidley Global Insurance Review 2019*, released by Sidley Austin, LLP. On the captive side, M&A activity may stem from the recent tax court decisions regarding small captives, which has led to some brokers leaving the captive space.

Captives redomiciling has led to fewer captives in some domiciles, and more in others. There has been a movement over the last few years of U.S. companies

Delaware

Advantage

- Delaware takes captive insurance company licensing to a new level that Speeds to Market the licensing process.
- Delaware is the first in the nation to electronically offer a conditional certificate of authority as part of the general application.
- Delaware's conditional certificate of authority means receiving a license to conduct insurance business the same day of submitting the application to do business.



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with offshore captives redomiciling them onshore. There has also been a trend for captives to redomicile to the home state of their parent company. This trend might increase following last year's high-profile captive tax cases—*Washington Insurance Commissioner vs. Cypress Insurance Co.* and *Johnson & Johnson vs. New Jersey*. These cases stemmed from different circumstances, but both saw a captive sued by their parent company's home state for not paying certain kinds of taxes.

Some captive domiciles are actively seeking to bring in redomiciling captives. In North Carolina's 2019 captive legislation update, the domicile wants to offer a "premium tax holiday" to foreign captive's who consider redomiciling to the state by the end of 2020.

While captives did not grow in huge numbers in 2018, captives were still being formed. There were some significant changes in the marketplace—mostly regarding taxation—that put a damper on companies developing a captive for their insurance needs. There are at least three more cases relating to captives waiting for decision from the U.S. Tax Court that are expected this year. As the conditions that saw smaller growth in the captive sector in 2018 have not changed, the growth of captives in the U.S. in 2019 is likely to again be flat. ■

Karrie Hyatt is a freelance writer who has been involved in the captive industry for more than ten years. More information about her work can be found at: www.karriehyatt.com.