

CAPTIVE INSURANCE COMPANY REPORTS

Documenting the Captive's Business Purpose

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Editor's Note: Andrew Rennick and Jeffrey Simpson, partners of the law firm of Gordon, Fournaris & Mammarella, in Pennsylvania, discuss the importance of documenting a captive's business purpose. Mr. Rennick can be reached at ARennick@gfmlaw.com.

It is axiomatic that a captive insurance company should be formed for risk management purposes, and that tax planning and asset protection should be ancillary motivations for entering into captive insurance arrangements. In a recent webinar sponsored by the American Bar Association Section of Taxation, the panelists, including a representative of the Internal Revenue Service (IRS) Office of Chief Counsel, discussed IRS challenges to captive insurance companies on the basis of a lack of a valid nontax business purpose. In light of potential challenges to the captive's business purpose, it is worth thinking about how a captive might provide evidence to auditors, and a reviewing court, of its nontax business purpose.

Certainly, the captive's conduct itself is of paramount importance in evaluating its business purpose. As the courts have repeatedly

emphasized, a captive should operate as "insurance in the commonly accepted sense." A captive should charge arm's length, actuarially determined premiums and be adequately capitalized; its investments should account for its liquidity needs; it should respect corporate formalities and not act as the alter ego for its parent or insureds. But, while a captive's actions may speak volumes, we should not diminish the evidentiary effect of a written record of the captive's business purpose.

Articulating the reasons for forming the company, the thinking behind its design, its goals, and its strategy for achieving those goals can provide powerful evidence of the captive's business purpose. Contemporaneous documentation (made while the key decisions are being made) can be particularly helpful in that it precludes the argument that the captive is manufacturing valid reasons for its existence in response to scrutiny (e.g., during audit). The closer to the decision-making process that business purpose is memorialized, the more likely that the factors considered by the captive's stakeholders and the analysis regarding the feasibility and details of the captive program will be accurate,

since memories fade, notes are lost, and e-mails are deleted.

Documenting business purpose should be a collective project involving all of the captive's stakeholders (e.g., the corporate parent or insured, the captive manager, and its counsel). The process starts with memorializing the factors that went into deciding that a captive arrangement is desirable. The first professional who meets with the insured regarding a captive program, whether a captive manager, a CPA, or counsel, should encourage the insured to document its insurance needs, so as to create a record of the problem(s) for which a captive might be a solution. If there is a triggering event, such as a change in the corporate parent or insured's risk profile that its commercial coverage is unable to address, or an incident that changes the parent's ability to obtain reasonably priced coverage, that event should be described.

Attempts to address the parent's risk management concerns through the commercial market should also be documented—including quotes from commercial insurers (or challenges obtaining coverage). This process not only provides evidence of the captive's business purpose but also serves as the foundation for the underwriting process. Ideally it will spark thoughts regarding the risks that the insured is currently self-insuring that may be appropriate for a captive.

Summarizing Memo

As the captive enters into the planning stage, the captive manager and the captive's counsel should document the key decision points, such as the risks to be insured, reinsurance arrangements, if any, the selection of service providers, the ownership structure for the captive, and the selection of the captive's domicile. An excellent form of documentation is a memorandum produced by the captive manager or counsel summarizing the program.

Such a memorandum can serve as an executive summary of the program for the various stakeholders' future reference and can provide valuable material for the captive's business plan and feasibility study.

Feasibility Study/Business Plan

The business plan and feasibility study are ideal places to document business purpose, as they respond to the fundamental questions regarding the captive—what are its goals and how will it work? Because these documents often call for a description of the captive in narrative form, they provide an excellent opportunity to weave a discussion of business purpose into the description of the captive's purpose, goals, and operations. For example, instead of simply listing the risks to be covered and the structure of a captive's reinsurance pool, the business plan can explain why obtaining coverage for those risks is important to the captive's parent, and how the reinsurance arrangements work to mitigate risk, manage cash flow, etc.

A robust discussion of business purpose in the business plan and feasibility study has additional benefits in that it can help the regulators understand the captive's intended purpose, leading to a smoother approval process, and that it can provide a touchstone for the captive's management and advisers as they evaluate the captive's performance on an ongoing basis.

Conduct Meetings

As a matter of good governance, the captive's management should meet regularly to review and discuss the captive's operations. One of the central roles of the captive's management is to measure the captive's operations and performance against its goals, so that it can give the captive's service providers strategic direction to help achieve those goals. In addition to having a robust discussion of business purpose at regular meetings, the captive's management and its counsel should document

that discussion, memorializing the captive's business purpose and strategies being considered and implemented to accomplish that purpose. The captive's governing body should also be meeting any time significant changes to the captive program are contemplated.

Captives often evolve alongside the businesses they insure. If a captive has positive claims experience, its growing surplus may also present opportunities to expand its operations. If the commercial insurance market or the operating company's business market undergoes a change that results in a reevaluation of the captive program, the changes should be documented along with a discussion of the captive's response.

Summary

When done properly, documenting the captive's business purpose should dovetail with living the business purpose—that is to say, if the captive is thoughtfully designed, with risk management at the forefront, and it observes best practices in corporate governance, then documenting business purpose should merely be a matter of recording the decisions that are made as they are being made. Taking the time to contemporaneously record business purpose will not only serve the captive well in the face of an IRS or court challenge, but will also make for a stronger and more effective captive insurance program.

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