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Tax Considerations for Owners of Captives Domiciled in Foreign Jurisdictions

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When starting a captive insurance company in a foreign jurisdiction such as the Cayman Islands or Bermuda, many prospective captive owners may get excited to learn about the potential tax benefits that come from utilizing a captive in their business structure. However, any potential tax benefits a captive may offer should never be a primary reason to form a captive.

Legitimate risk mitigation at a cost-effective price must always remain at the forefront of any prospective captive owner's reasoning when forming a captive insurance company. Likewise, legitimate business purposes must also be considered when determining the optimal jurisdiction to domicile your captive. Choosing a foreign jurisdiction such as the Cayman Islands can provide many benefits to enable your captive to thrive.

Why the Cayman Islands?

The Cayman Islands has been the choice of domicile for many captive owners since it passed the Insurance Law in 1979. The jurisdiction has since become a major hub for international insurance business and has enabled many companies' access to lower insurance costs, as well as insure against events the commercial market deems uninsurable. The Cayman Islands offers a vast breadth of professionals and all the necessary services providers with expertise in a wide range of captives.

The cost of operating a captive in the Cayman Islands is relatively low compared to other jurisdictions and offers a politically stable environment based on the British legal system. The Cayman Islands are tax neutral, meaning there are no capital gains, estate, property or income taxes, or other types of business taxes. Cayman has complied with all international regulatory initiatives designed to prevent tax evasion and money laundering. It also actively participates in the discussions around the development of these regulations and has become a standard setter for many offshore jurisdictions.

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Qualifying for Insurance Tax Treatment

Tax benefits, such as deductibility of premium, may only be recognized if the captive meets certain criteria which qualifies the captive for insurance tax treatment. While the Internal Revenue Code establishes the methods by which to calculate the taxable income of an insurance company, it does not define what insurance *is*. Practitioners must look to the relevant case law and guidance published by the Internal Revenue Service to determine whether a captive arrangement is more-likely-than-not to sustain an IRS challenge. If a captive insurance arrangement involves the existence of an "insurance risk", risk shifting and risk distribution, and the captive provides "insurance" in its commonly accepted sense, then it can be presumed that the IRS would uphold the arrangement in the event of an audit or challenge. Revenue Rulings 2002-89, 2002-90, and 2002-91 establish the safe harbor requirements the IRS deems necessary in order for a captive arrangement to be treated as legitimate insurance. Qualifying for insurance tax treatment is crucial regardless of whether the captive is domiciled in the United States or abroad.

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CFC Considerations

Additional layers of complexities arise for U.S. captive owners when participating in foreign captive insurance arrangements, most notably the subpart F taxing regime. When the captive is deemed a controlled foreign corporation (CFC), and the owner is deemed a controlling shareholder, the controlling shareholder is required to pick-up subpart F income on their tax return.

The subpart F regime is applied when the level of U.S. ownership in a foreign corporation reaches a threshold of 50%, and is applied to U.S. owners who hold a 10% interest in the foreign company. CFC reporting requirements may also be triggered through the related party insurance income (RPII) rules. The RPII rules effectively change the standard definition of a CFC by reducing the threshold of U.S. ownership in the foreign insurance company from 50% to 25% and deem any U.S. shareholder who is "related" to the insured as a controlling shareholder, regardless of their level of ownership. Controlling shareholders of CFCs are required to attach the Form 5471 *Information Return of U.S. Persons. With Respect To Certain Foreign Corporations* to their tax returns. In essence Form 5471 is an informational filing with the goal of providing the IRS a snapshot of the foreign corporation's operations and establishes the filer's relationship

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to it. The extent of information required to be reported is determined by the various categories of filers a filer may or may not fall into based on their relationship to the foreign corporation. Since the enactment of the Tax Cuts and Jobs Act of 2017, there have been substantial revisions to the Form 5471, including the addition of several reporting schedules, the reinstatement of the type 1 category filer, and new subcategories of filers on its latest December 2020 revision. As a result, determining who and what information is required to be reported has greatly increased in complexity.

Practitioners must take due care and understand the intricacies of the Form 5471 and filer requirements to ensure captive owners properly complete all the necessary information. Omissions of certain required schedules and information may result in an incomplete filing and could result in severe penalties for the filer and leave those tax years open to audit by the IRS indefinitely.

While the subpart F regime is probably the most important and complex tax issue facing owners of foreign captive insurance companies, it is just one of many. Given the recent changes in tax treatment of CFCs and other regulatory initiatives, it may make more sense for the captive to make an election under Internal Revenue Code Section 953(d) to be taxable as a domestic insurance company. This enables the owners of the captive to avoid CFC reporting headaches while still receiving the benefits of a favorable insurance regulatory environment that an offshore jurisdiction may offer.

Economic Substance Considerations

Foreign captives may also fall into the scope of other global taxing initiatives. For instance, the Organisation for Economic Co-operation and Development (OECD) released a global standards initiative widely known as “Economic Substance”, which has recently begun to take effect. The initiative applies to certain companies domiciled in ‘no or nominal tax’ jurisdictions, such as the Cayman Islands and Bermuda. The initiative requires who fall within its scope to perform ‘substantial activities’ in order to avoid being labeled as a shelter practice. The OECD’s objective is to prevent the transfer of profits from high tax jurisdictions to ‘no or nominal tax’ jurisdictions for the sole purpose of tax avoidance. The new standards compel entities based in these low tax jurisdictions to notify the local taxing authority of its existence and economic purpose. This information will then be available to the taxing authorities in the home country of the company’s beneficial owners.

Conclusion

Given the increasingly complex reporting requirements facing the owners of foreign captive insurance companies, it is imperative that owners seek out experienced professionals to navigate the process and offer solutions in a dynamic regulatory environment. Obtaining experienced service providers is key for owners who want to ensure their captive’s viability and success.

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