

Navigating your way Offshore

SOLOMON HARRIS  
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# Corporate Governance and Tax Issues Facing Captives

a webinar presented by

SOLOMON HARRIS  
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&

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Will & Emery



## Our presenters...



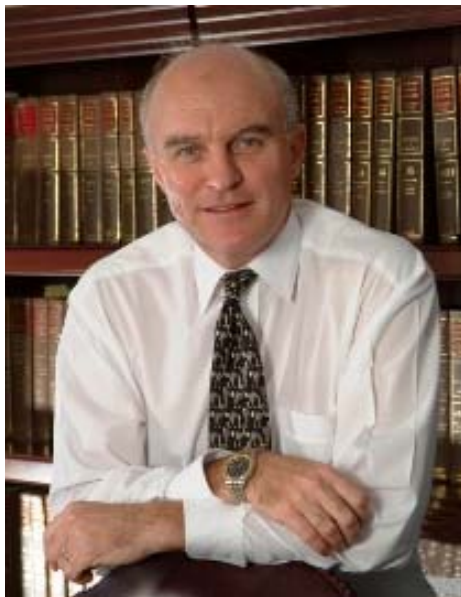
Sophia Harris  
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## Our presenters...



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Kay Carter

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# Corporate Governance and Procedures for Captives

Paul Scrivener and Kay Carter



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## Introduction

- Legal Structure of the Captive
- Directors
- Shareholders
- Officers
- Registered Office
- Share Capital
- Directors' Meetings
- Shareholders' Meetings



## LEGAL STRUCTURE OF THE CAPTIVE

- Separate legal entity
- Limited liability
- Memorandum of Association
- Articles of Association (your roadmap!)
- Shareholders Agreement (another roadmap!)
- Subscription Agreement/Participation Agreement



## THE DIRECTORS

- Appointment of directors (CIMA and ROC)
- Resignation/removal of directors (CIMA and ROC)
- Rotation of directors
- Committees



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## DIRECTORS' COMMON LAW DUTIES

- Agent for Company
- Fiduciary
  - To act in good faith and in the best interests of the company;
  - Not to exercise powers for an improper purpose;
  - Not to misapply the assets of the company;
  - To avoid any conflict of interest; and
  - Not to make a secret profit from his or her position.
- Duty to exercise care and skill
- Owed to company (shareholders as a group).



## DIRECTORS' STATUTORY DUTIES (All Companies)

- Meetings sufficient to fulfill obligations to Company
- Keep proper minutes
- Maintain registers (members, directors and officers, mortgages and charges)
- Keep proper books of account (audits not required)
- ROC filings (changes, amendments, special resolutions)
- Annual returns (exempted companies only)



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## STATUTORY DUTIES (Segregated Portfolio Companies)

- Segregation of cell assets
  - Physical, not merely accounting
  - Co-mingling likely fatal to integrity
- No transfer of assets between cells except for full value
  - Not dealing at arm's length
- Proper execution of documents for a cell
  - Personal liability of director (document execution)



## STANDARD OF CARE FOR DIRECTORS

- Applies to duty to exercise care and skill
- Subjective (tailored to director, company, circumstances)
  - No hindsight
- Objective (reasonable person test)
- Duty to participate and not abdicate responsibility
- Delegation of authority



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## BREACH OF DUTY

- Duty owed to company; not to cell, individual shareholders or policy holders
- If questionable solvency, must consider creditors, policy holders
- Directors must bring action against offending director
- Breach of Directors' duties may result in personal liability
- If insolvent, liquidators obligated to act for company
- Shareholders' right to bring action very limited



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## INDEMNITY

- Articles contain indemnity (must exclude dishonesty, willful default or willful neglect)
- Can indemnify for negligence, provided not willful neglect
- “Gross negligence” (not a defined legal concept)
- If the company does not indemnify for any negligence, must specify in detail what is to be considered to be negligence
- Directors and officers insurance should mirror Articles



## THE CAPTIVE'S SHAREHOLDERS

- Role
- Powers (majority rule)
- Duties
- Different classes
- Protection of the minority



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## THE CAPTIVE'S SHAREHOLDERS (cont'd)

- Trustee shareholders
- Death of shareholder
- Joint shareholders
- Corporate shareholders
- Register of Members



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## THE CAPTIVE'S OFFICERS

- Chairman
- President
- Secretary
- Assistant Secretary
- Treasurer



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## THE REGISTERED OFFICE

- Role
- Reputational risk
- Names to be displayed
- Registers
- Seal



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## SHARE CAPITAL

- Authorised and issued
- Nature of a share
- Nil paid/part paid/fully paid
- Different classes of shares
- Capital maintenance rule
- Increase of share capital



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## SHARE CAPITAL (cont'd)

- Reduction of share capital
- Share premium account
- Issuing shares
- Transferring shares
- Redeemable shares
- Repurchase of shares



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## SHARE CAPITAL (cont'd)

- Fractional shares
- Dividends



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## DIRECTORS' MEETINGS

- Calling a directors' meeting
- Notices
- Location
- Proxies/alternates
- Quorum



## DIRECTORS' MEETINGS (cont'd)

- Voting
- Minutes/written resolutions



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## SHAREHOLDERS' MEETINGS

- AGMs and EGMs
- Calling a shareholders' meeting
- Notices
- Location
- Proxies



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## SHAREHOLDERS' MEETINGS (cont'd)

- Special resolutions/ordinary resolutions
- Minutes/written resolutions
- Class meetings

# Taxes & Captives – The Basics

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## Offshore Captives with Taxable U.S. Parents

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## Captives Not Formed for Tax Reasons

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- Tax benefits are not typically a reason for forming a captive
- Non-tax reasons drive captive formation
  - Reduce cost of coverage
  - Direct access to reinsurance markets
  - Mitigate market swings in commercial market
  - Customized coverage; fund commercial policy gaps
  - Improved risk retention capability

***Stabilizing Losses or Strengthening Earnings Often More Important Than Tax Deductions***

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## Key Captive Issues if Parent is Taxable

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- Most important tax issue is to make sure that captive is treated as “insurance company” for federal tax purposes
- Insurance companies taxed more favorably than other entities
  - Allowed a deduction for loss reserves (must be discounted)
  - Unearned premiums generally taxed as earned over policy term
- Compare to self insurance where losses and associated expenses are deductible only when actually paid

***Most Important Tax Benefit is Cash from Tax Deferral***

## Achieving “Insurance Company” Tax Status

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- Must be operated as bona fide insurance company; separate and distinct entity from affiliated companies
- Avoid “sham” characterization
  - Appropriate capitalization in relation to loss exposures
  - Comply with local insurance regulations and corporate formalities
  - Transact business at arm’s length using actuarially determined pricing
  - Maintain books and records comparable to other insurers
  - Avoid parent guarantees
  - Avoid substantial loans of captive assets to related parties

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## Deduction of Premiums

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- Premium payments are generally deductible if contract qualifies as “insurance”
- Highly contentious with IRS for many years
- Current status
  - In many cases, premiums paid by brother/sister corporations to captive are deductible
  - Premiums paid by parent company to captive are not deductible (absent presence of significant third party insurance risk – at least 30%)

***Insurance Status Usually Important for Taxable Parents of Both Offshore and Onshore Captives***

## Offshore Insurers: Why Avoid U.S. Business?

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- Foreign insurance companies operating offshore generally not subject to direct U.S. taxation
  - Indirect U.S. taxation can occur if captive owned by U.S. shareholders (e.g., Subpart F, PFIC rules)
- However, a foreign insurer may be subject to direct U.S. tax if it is considered to be engaged in a U.S. business (or has a U.S. “permanent establishment” where a tax treaty is involved)
  - Net income taxed at 35% (determined under U.S. insurance tax rules)
  - Additional 30% branch profits tax on amount withdrawn from U.S.
- Also potential state insurance regulatory problems if captive is conducting an unauthorized business of insurance onshore

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## Offshore Insurers: Avoiding U.S. Business

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- To avoid being engaged in a U.S. trade or business, foreign insurer should:
  - Hold board meetings outside U.S.
  - Execute contracts (including issuance of policies, investment management agreements) outside U.S.
  - Approve asset allocation policy outside U.S.
  - Use only independent agents in the U.S.
  - Avoid having risk management employees as officers or board members of foreign insurer
  - Issue indemnity rather than “pay on behalf of” policies

***U.S. Tax Nexus Avoidable if Offshore Captive Properly Structured & Operated***

## Offshore Insurers: Federal Excise Tax

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- Federal excise tax (“FET”) applies to premiums paid to foreign insurer/reinsurer covering U.S. risks
- 4% FET on direct property and casualty policies
- 1% FET on reinsurance of U.S. risks
- Withheld and remitted quarterly by U.S. premium payer
- IRS “cascading” theory for applying FET
- Not applicable if captive makes an IRC § 953(d) onshore tax election

# Taxes & Captives – The Basics

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## Offshore Captives with Tax Exempt U.S. Parents

## Onshore Hospital Captives – Tax Status

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- If captive funds risk of only its tax exempt parent and employees, then domestic captive can obtain an IRS “determination letter” granting tax exempt status
- Easier to obtain if captive formed as a non-profit membership company with no shares issued (VT, HI, DC permit this form)
- Must file IRS Form 1023 with a description of intended activities – cannot cover non-employed physicians or third parties if “substantial” portion of business (5%-10%)
- Thus limited scope of captive activities if onshore – covering >10% ineligible parties can cause **all income of the domestic captive to become fully taxable**

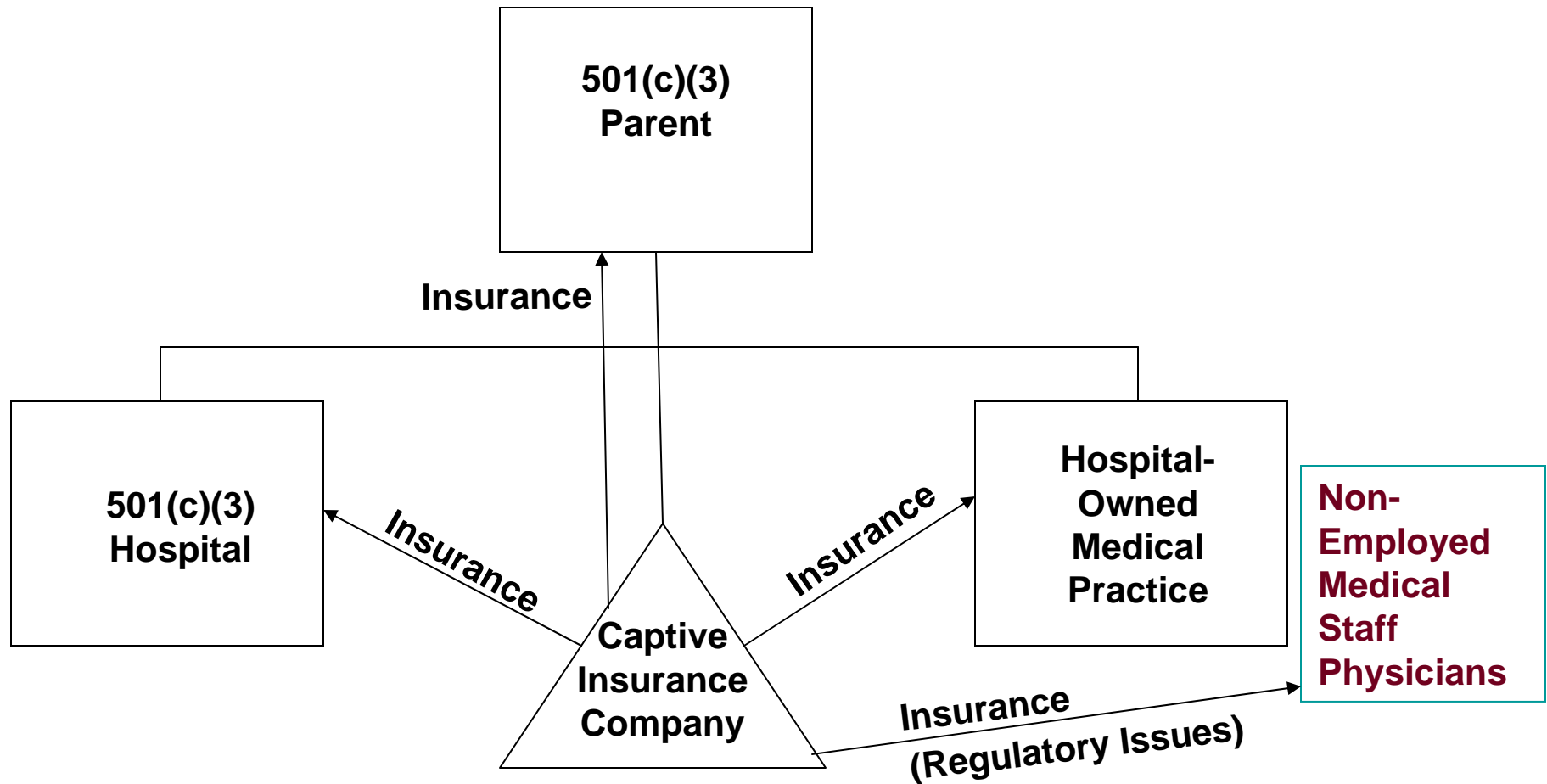
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## Offshore Hospital Captives - Tax Issues

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- No corporate income taxes in Cayman
- Offshore captives are not tax-exempt – so they can accommodate the addition of non-employed physicians, but there may be tax ramifications
  - Federal excise tax on premiums
  - Unrelated business taxable income to captive's U.S. shareholder – on *net* income from covering “voluntary” (non-employed) physicians or non-controlled entities
- But unlike onshore captives, covering third parties may generate some tax but it does **not** taint the entire captive – *this is the principal reason most captives owned by tax exempt hospitals are domiciled offshore*

## Captive Insurance Company - Sole Owner Tax Exempt Organization with Non-Employed Physician Coverage



## Recent Tax Developments

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- Cascading FET (Rev. Rul. 2008-15)
- Cell Companies (Rev. Rul. 2008-8 and Notice 2008-19)
- Testing Tax Status of Reinsurers (Rev. Rul. 2009-26)

# Questions & Answers

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Do you have any questions?



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Thank you for your kind attention!

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