DENTONS

Captive Basics for the Commercial Real Estate Industry

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Grow | Protect | Operate | Finance

Today's Agenda

- Questions – what do you want to talk about?
- What is captive insurance?
- Evolution of captives
- Why do companies form captives?
- Considerations for commercial real estate landlords and tenants
- Considerations for developers and contractors
- Starting a Captive
- Tax Considerations

What is captive insurance?

- Captive insurance is a form of alternative risk transfer
- A captive insurance company is a closely-held insurance company, owned and operated by its insured(s) or their affiliates
- The captive is financed, owned, and controlled by its owner(s)
- Regulated by the state in which the captive is domiciled
- Captive insurance vs. self insurance

Evolution of captives

- Captives initially covered only related-party risk
- Captives now may cover unrelated risk (controlled unaffiliated)
- Originally, captives were “single-parent”
- Group captives are owned by numerous unrelated insureds
- Originally, captives were corporations, but LLCs, nonprofits, cell companies, and series LLCs are now in use as well

Why do companies form captives?

- Insure unaffordable or uninsurable risks
- Fill in gaps of coverage/deductibles
- Avoid volatility of commercial premiums
- Greater control over claims process
- Increased ownership over risk management processes and data
- Capture profits of commercial insurance industry
- Access to the reinsurance market

Considerations for Commercial Landlords & Tenants

- Landlord/Tenant
  - The tenant establishes a captive insurance company that insures the liability or property coverages of the tenant and the tenant's affiliates
  - Lenders, landlords and others may require insurance certificates. Will they accept insurance issued by the captive? Will they only be accepted if a commercial insurance company issues the policy, and the risks are reinsured by the captive ? [Such a fronting arrangement is more expensive.]
  - A landlord owns a captive requires its tenants to purchase insurance from its captive (called "forced placement"); for instance, an apartment building owner may require the apartment dwellers to purchase insurance from the landlord's captive. Some considerations: (1) what is the scope of coverage; (2) does it overlap, supplant or enhance commercial coverage already in place; (3) does it create gaps; (4) cost compared to commercial coverage or self-insurance; (5) claims processing by captive; and (6) financial stability of the captive

Considerations for Developers and Contractors

- Owner Controlled Insurance Program (OCIP) and Contractor Controlled Insurance Program (CCIP)
  - OCIP: A Developer (owner) requires the contractors and subcontractors to purchase insurance from the Developer's captive
  - CCIP: the General Contractor requires the contractors and subcontractors to purchase insurance from the General Contractor's captive
  - Possible coverages could include liability, Subcontractor Default Insurance (SDI), etc.
  - Developer's (and General Contractor's) Perspective: is that the program eliminates disputes over which subcontractor was at fault, and it control costs
  - Contractor's Perspective: OCIP or CCIP coverage may be less or different from the contractor's normal coverage (overlaps and gaps); it may not cover unique coverages needed by a particular subcontractor; it may be less economical than the contractor's normal coverage

Captives Owning Real Estate

- Captive Insurance Companies have only one “job”: to pay claims as, and when, they come due; accordingly:
  - Each domicile provides a minimum amount of liquid assets that is required
  - Each domicile provides a minimum amount of capital that must be maintained
  - Each captive must adopt an investment policy
  - Because real estate is not liquid, most captives will not hold real estate
  - In addition, the IRS is very skeptical of related party loans and investments, so there is more sensitivity to a captive purchasing the headquarters building of it affiliates
  - However, if there is sufficient net worth and liquidity, it may be possible for a captive to purchase real estate

Forming a captive

- Forming and operating a captive involves several legal aspects:
  - Regulatory
  - Corporate
  - Commercial
  - Securities
  - Tax
  - Specialized industry

- It also involves several service providers, etc.
  - Captive manager
  - Regulator
  - Accountant
  - Legal
  - Actuary
  - Investment Manager
  - Claims processor

Tax Considerations

- Tax Consequences:
  - Deduction of premium by the Insured
  - Income to the Captive
  - Insurance Reserves (discounted present value) are deductible by the captive, not by self-insured
- Tax Tests (not intuitive, and small changes in facts can produce very different results)
  - Insurance Risks (traditional coverages vs. newer coverages [loss of key supplier, reputation, etc.]
  - Risk Shifting and Risk Distribution – depends on structure
    - If the insured owns the captive, there must be substantial unrelated business (50%? 30%)
    - If the insureds own none of the captive (common parent is OK), the IRS wants 12 insureds, with premiums between 5 and 15% of the total. Courts have found insurance with enough “exposure units”
  - Organized, operated and regulated like an insurer; capital; policies; claims; pricing; and investments

Tax Considerations Cont’d

- IRS believes most “micro-captives” that elect to be taxed under section 831(b) are abusive
  - A captive can elect to be taxed only on its investment income (not taxed on insurance income) if premiums don’t exceed $2,800,000 in 2024 (indexed)
  - The IRS has won 7 of 7 cases
  - Previously required those involved to report to the Office of Tax Shelter Analysis, the Treasury has proposed to reinstitute this requirement by naming certain captive transactions as “listed transactions” and “transactions of interest”

Questions?

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