



# A Brief History of Captives

This Brief History of Captives, prepared by Hugh Rosenbaum, includes excerpts from a much more complete [history available at no cost on Captive.com](#).

## 1953—First “Captive”

**Frederic M. Reiss** (1924–1993), often called the “great white father” (because of his shock of white hair) of the captive movement, founded Steel Insurance Company of America, a captive developed for an Ohio steel company, from which the term “captive” was borrowed from “captive” mines sending ore to the company’s mills.

## 1960s—Captive Count: 100+

### 1970—Bedpan Mutuals Formed

Medical malpractice (medmal) mutuals began to command 60 percent of the medmal liability market. Many were created for insureds in single states.

### 1972—Captive Insurance Companies Association (CICA) Began

The organization met in **Grant Whitney’s** living room. Only 12–15 large single-parent captives were represented.

### 1976—Controlled Risk Insurance Company, Ltd. (CRICO) Formed

This was the start of Cayman as a healthcare captive center. The Harvard medical centers’ captive met with “resistance” to licensing in Bermuda because of its need to cover individual physicians, so it moved to Cayman.

This induced many other healthcare captives to follow it there. Today, Cayman is the largest offshore domicile for healthcare organizations based in the United States.

### 1978—Revenue Ruling 78–338

It designated the number of group captive members needed to achieve tax deductibility of premiums. This ruling applied to oil at the time (31); other rulings and cases went on to refine it down to about 12. With the right number of owner/insureds and no one representing a big percentage of the total, deductibility for all was ensured.

### 1978—Carnation Tax Case

In *Carnation Co. v. Commissioner*, 71 T.C. 400 (1978), *aff’d*, 640 F.2d 1010 (9th Cir. 1981), the taxpayer lost, and the Internal Revenue Service (IRS) economic family “doctrine” was strengthened. Closeness of the captive to its parent and subs was a factor but also faulty capitalization. Taxpayers lost seven of eight US cases in 1978–1985.

### 1981—Captive Count: 1,251

### 1981—Risk Retention Act Passed

Under this Act, which was improved in 1986, a group captive could obtain a state license under federally chartered insurance law to directly write all casualty coverages

(except direct workers compensation). It gave a boost to the number of group captives, although by the time risk retention groups (RRGs) became more common (more than 200 are operating today), the liability crisis had passed. While RRGs only have to meet licensing requirements in one state, eliminating the need for fronting, several state insurance commissioners tried to block applications and submissions, and some still do. RRGs are not subject to state guarantee fund assessments.

### **1981—Vermont Passed Captive Legislation**

Vermont was part of the new wave of domestic domiciles. Thanks to the support of RIMS, Ed Meehan's foundation building, and Len Crouse's tireless promotional efforts, Vermont went on to become the number one US domestic domicile by numbers, growth, and influence. In 1986–88, some 150 captives were licensed. They were quick to change when change was called for. For example, initially they had a minimum premium threshold of \$2 million. They soon eliminated that. There are now about 570 captives in Vermont.

### **1982—Victor Rod Appointed Luxembourg Supervisor**

He became the longest-serving insurance regulator in any domicile from 1982–2014. Under Rod, the new captive legislation was enacted, although Electrolux and other Scandinavians had established captives there earlier. Rod took part in defending captives in international supervisors' meetings and pronouncements, and did his best to resist Solvency II in its original manifestation.

### **1985—Hardening Insurance Market (1985–1986)**

Property and then liability capacity crises occurred. Absence of capacity or outra-

geously high rates were the drivers for many captive formations.

### **1985—ACE and XL (1985–1986)**

They initially were group captives. XL wrote the \$50 million to \$100 million excess liability insurance layer, and ACE wrote \$100 million excess of \$100 million. They were launched in response to a lack of liability capacity. Three years later, they both had become commercial insurers, no longer captives, because they were owned by public shareholders, not insureds.

### **1986—Tax Reform Act (TRA) Passed**

This Act seemed to remove almost all previous tax advantages of offshore captives. The definition of controlled foreign corporation (CFC) changed. Owners of group captives were obliged to declare their share of captive income, and loss reserves had to be discounted. Election by offshore captive owners to have their captives taxed as if in the United States (953(d)), an improvement over the more restrictive election (953(c)), was at first resisted. Nowadays, the election is made by a majority of large captives. Related Person Insurance Income (RPII) rules reduce attractiveness of offshore domiciles for group-owned captives.

### **1986—831(b) Tax Exemption Enacted**

This tax exemption for underwriting income of insurance companies with premiums of less than \$1.2 million was created to help Midwest farm mutuals, but it would later stimulate the formation of microcaptives or 831(b) captives.

### **1987—Spike in Captive Formation**

There were 210-plus captives formed in the top 4 domiciles: Bermuda, Cayman, Vermont, and Barbados. This is a high water-

mark for captive formations following an insurance crisis, with about 350 formed that year worldwide.

### 1989—*Humana Tax Case*

A taxpayer won deductibility based on a “brother-sister” structure. Parent premiums are not deductible; subsidiary premiums are deductible. This is a big breakthrough for captive owners.

### 1991—*Self-Procurement Tax*

A 3.6 percent tax increase passed in New York, one of many state increases. Most states now require self-regulation and payment of this kind of tax for premiums paid to nonadmitted captives. Until 2014, many owners just ignored the requirement—not anymore, though.

### 1997—*First Protected Cell Legislation*

Steve Butterworth passed this legislation in Guernsey. Although rent-a-captive structures had been used long before that, their cells were segregated by contract or by private act. In the new protected cells, they were protected by statute. Bermuda’s similar enabling legislation followed in 2000.

### 1997—*Vermont Passed HB529*

“Controlled unaffiliated business” was permitted in captives. While this was important for onshore domiciles, for offshore domiciles, unrelated business had never been restricted.

### 2002—*Captive Count: 4,300*

### 2002—*Vermont Reached 500 Captives*

The state became third in importance behind Bermuda and Cayman with 500 licensed captives in the state.

### 2002—*IRS Rulings 2002–89, 90, 91*

These rulings set a 50 percent unrelated business threshold, the number of entities for a captive’s income to be considered “insurance,” and clarified risk distribution (for a while). They also set 12 as the minimum number of brother-sister related entities. For group captives, they established that seven is the sufficient number. The 50 percent unrelated business test spurred interest in employee benefits (deemed unrelated business) in captives. The number of entities was confirmed by Rev. Ruling 2005–40.

### 2004—*Puerto Rico Passed Captive-Favorable Regulations*

Puerto Rico is onshore for regulatory purposes but offshore for tax purposes. The effective tax rate on underwriting and investment income of captives domiciled there is 4 percent or 0, depending on the structure, but premiums are still subject to federal excise tax until the IRS implements a proposed relief. It took another 5 years before Puerto Rico “took off” as a domicile. In 2016, there were about 350 captives and cells, most of them microcaptives, domiciled there.

### 2005—*Delaware’s Captive Insurance Industry Grew*

In 2005, Delaware modernized its insurance law more favorably for captives. In 2010, Delaware became the first domicile to begin licensing series captive insurance companies, whose business units have some attributes like cells but are licensed as self-standing captive insurers. By the end of 2015, there were 1,060 licensed entities in Delaware, of which 242 were pure captives, 740 were series captive insurers, 50 were special purpose vehicles, and 8 were others.

## 2007—Captive Count: 5,120

### 2007—Cell Captive Estimate

A first estimate of the number of cells to be made indicated 1,700. This is a very low number that only counted those considered microcaptives. As we learned later, there were many more cells, which actually numbered in the thousands.

### 2008—Reciprocal RRGs

Used for nonprofits, notably medmal captives, they offer advantages over classic RRGs, plus offshore reinsurer models. Medmal captives owned by nonprofit hospital systems began to use reciprocals more.

## 2013—Captive Count: 6,560

### 2013—National Association of Insurance Commissioners (NAIC) Accreditation Standards

The NAIC started an accreditation standards for multistate reinsurer initiative. Originally intended for life-insurance-owned “captives,” the danger of captives getting caught up in NAIC restrictive regulation became real. The initiative was dampened following objections from captive-friendly state regulators. Many predict it will reemerge.

### 2014—Favorable Tax Cases

In *Rent-A-Center, Inc. & Affiliated Subsidiaries v. Commissioner*, 142 T.C. 1 (2014), and *Securitas Holdings, Inc. & Subsidiaries v. Commissioner*, T.C. Memo. 2014–225 (2014), the uncorrelated risk entities argument was finally upheld. The ratio of premium to capital and surplus are considered irrelevant to captives, and parental guarantees are acceptable if not required by the frontier.

## 2015—Captive Count: 6,939

### 2015—Microcaptives (831(b)s) Included in IRS “Dirty Dozen” List

Captives, specifically microcaptives, were included in the IRS “Dirty Dozen” scams to watch out for. Tax shelters were always on the list, and this year, abusive 831(b) captives were included as scam tax shelters. The IRS repeated the warning in its 2016 list. The IRS has always had it in for captives in general, but this listing of 831(b) captives specifically showed how tax-planning abuse of captive insurance does not go unnoticed for long. Worse than inclusion on this “Dirty Dozen” list were listed transactions. In 2002, agent-owned captives (or producer-owned reinsurance companies, nicknamed PORCs) were included as listed transactions but removed again in 2004.

## 2016—Captive Count: 6,700

### 2016—Solvency II Implemented

It affected captives domiciled inside the European Union. Europe’s biggest domicile, Guernsey, is not inside the European Union, but fronting was affected for reinsuring EU risks to captives located outside the European Union.

## 2017—Captive Count: 6,647

### 2017—Avrahami v. Commissioner Decision

The case, *Avrahami v. Commissioner and Feedback Ins. Co., Ltd. v. Commissioner*, 149 T.C. 7 (2017), won hands down by the Internal Revenue Service, involved a micro-captive (831(b) captive) in an offshore domicile, whose facts, circumstances, and pooling mechanism were so irregular that the outcome was no surprise.

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