Focus INSURANCE

Consider the offshore captive structure

Canadian businesses are looking at self-insurance to manage risk in emerging markets

Kim Willey

JAZZIRT / ISTOCKPHOTO.COM

Canadian businesses looking to manage risks associated with international operations should strongly consider self-insurance through an offshore "captive" structure. The concept, used successfully for decades primarily by U.S. corporates, is gaining traction with Canadian businesses as a viable option to manage risk, particularly related to emerging markets.

In its most basic form, the concept calls for a parent company to place capital in a wholly-owned offshore vehicle, which is then licensed and regulated in the offshore jurisdiction as an insurance company. The captive insures the risks associated with the business of the parent. The parent pays premiums to the captive calculated only on the risks insured (and not at the rate the risk is priced in market as a whole) and such capital is available for investment subject to the liquidity requirements of the local insurance regulator. The capital is also available to meet claims made by the parent and the structure is administered by the parent and a professional insurance manager.

Of recent, Canadian companies have been reluctant to self-insure, arguably because commercial insurance premium rates have been soft. An abundance of capital in the markets and few major events over the last few years has kept rates low. Nonetheless, pricing volatility is a reality and a captive offers a practical and flexible solution to manage such fluctuations while retaining income otherwise lost in expenditure to a third-party insurance provider.

The captive structure also allows organizations to insure against risks associated with operating in emerging markets. Canadian businesses, particularly in the resource sector, are continually expanding into the lucrative emerging market space which brings a level of substantial risk, including protracted payment customer defaults, governmental intervention, bankruptcies and supply chain disruptions. It may be costly if not impossible to insure against these risks in the commercial markets. Familiarity with the business also allows a captive to effectively price premiums for insurance (often at reduced rates to the commercial market). As observed by Stephen White, business development director for the Kane Group in Toronto, "Our clients frequently use their captives to provide coverage for emerging risks where the traditional market cannot provide either the terms required or the limits needed. Captive structures are providing our clients an effective platform to manage enterprise risk beyond what coverage is generally available in the insurance market and represents an important element in most corporations' risk management framework."

> Our clients frequently use their captives to provide coverage for emerging risks where the traditional market cannot provide either the terms required or the limits needed.
>
> **Stephen White**
> Kane Group

A captive has the added benefit of facilitating direct access to the reinsurance market, allowing it to purchase reinsurance for emerging market and other risks at wholesale rates and thereby offset a large portion of potential losses.

Many jurisdictions, including British Columbia, offer a captive product. However, no jurisdiction has the depth of experience and insurance and reinsurance market presence of Bermuda, which developed the captive concept in the 1960s. Tax benefits facilitated by the recently introduced bilateral tax information exchange agreement between Canada and Bermuda offer an added incentive to domiciling a captive in Bermuda, as dividends received by a Canadian parent from the exempt surplus of the Bermuda subsidiary (i.e. premiums earned on non-Canadian risk and investment of capital of the captive) are not subject to further taxation in Canada. Proposals in the 2014 budget amending the existing anti-avoidance rule in the foreign accrual property income (FAPI) regime potentially impact aspects of the offshore captive model. However, the model remains viable, according to David Gibbons, director (assurance) at Pricewaterhouse-Coopers in Bermuda.

"The majority of captives with Canadian-based parents are either insuring non-Canadian risks of foreign affiliates solely or insuring Canadian-based risk and not combining the two," says Gibbons. "The former are subject to the tax rates in their captive domicile (e.g. Bermuda, with a zero per cent tax rate) and should not be subject to FAPI. They can still dividend back income to the Canadian parent tax-free. The latter may be subject to FAPI, but they can also benefit from tax deferral opportunities. Structures insuring non-Canadian risks of foreign affiliates should not be impacted by the renewed focus on FAPI in the budget. Captive structures insuring Canadian risks will be subject to the proposed FAPI changes, only to the extent that they are engaged in the narrow form of planning that the legislation is intended to curb. Both structures also continue to benefit from using the captive to focus on active internal risk management, loss mitigation, control over insurance cash flows and access to lower rates in the reinsurance market."

Once the economic feasibility of a captive is determined, an offshore captive may be set up relatively affordably and quickly, usually within several months. Given the advantages discussed, a captive should be on the table for every Canadian business looking to manage international risk.

Kim Willey, formerly of Fraser Milner Casgrain (now Dentons), is corporate counsel with ASW Law Limited, a leading specialist corporate and commercial law firm based in Bermuda, with a practice that includes establishing captive and commercial insurance risk management structures for international operations.

Lawddities

KOLBZ / ISTOCKPHOTO.COM

Hockey fans file small beer suit

A group of thirsty Idaho hockey fans have sued a Boise arena that they say charged $7 for the same amount of beer contained in a $4 "small" container, the Associated Press reports. Four fans filed the suit seeking $10,000 in damages on March 11, alleging that the taller cup advertised as "large" at Idaho Steelheads hockey games actually holds the same amount of beer as the shorter, wider "small" plastic cup. In the suit, one plaintiff argued that he had been attending events at the CenturyLink Arena for at least three years and bought beer every time. The lawsuit was filed just days after a YouTube video was posted in which an Idaho fan poured beer from a "large" container into a smaller-sized cup with no overflow. An arena official said the company would purchase larger cups to hold 24 ounces instead of the 20 ounces under the previous size, AP reported. — **STAFF**