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Captive Insurance Companies — Risk Financing For Self-Insurance and Underinsured Risks

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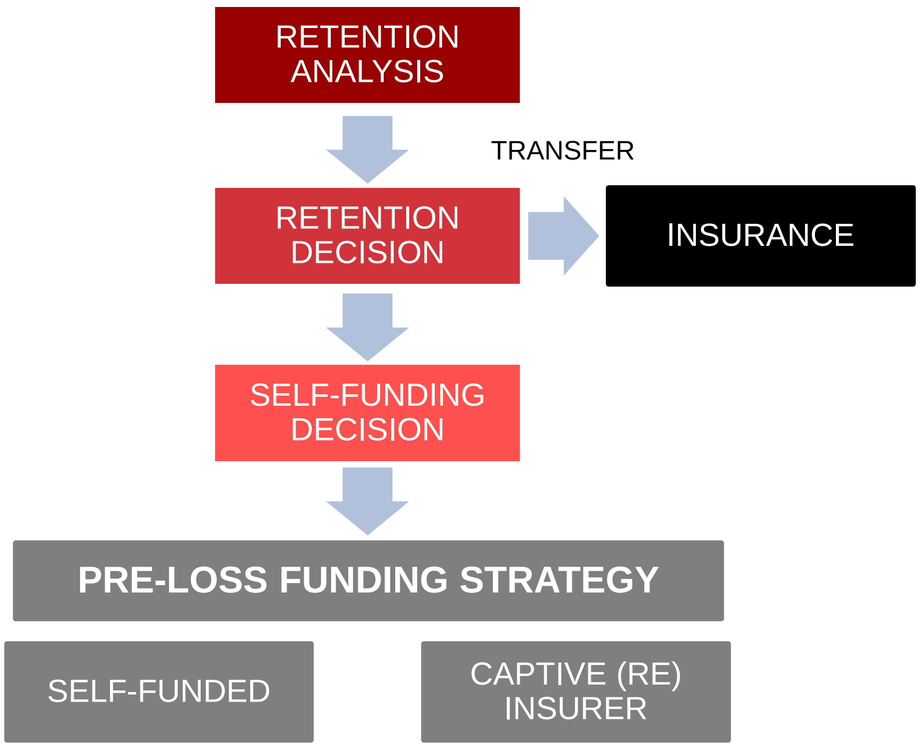
Making sense of it all.

History of Captives

Captive Industry Update

Retaining Risk vs. Financing Risk

A corporation's decision on the amount of risk to assume is independent and a priority over determining how to finance the risk, whether on the books of the parent or through a wholly owned captive insurer as illustrated below:



Definition of a Captive

- Licensed insurance company
- May insure or reinsure the risks of its owner or chosen unrelated parties
- May be owned by a single non-insurance parent or a group of companies
- Located onshore or offshore
- Regulated under special captive legislation

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Captive Industry Update

Insuring Corporate Casualty Risk

- Ability to buy-down qualified self-insurance retentions
- Ability to issue buy-down high deductibles and self-insured retentions
  - Admitted carrier would issue policies
  - Captive would assume deductible

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Captive Industry Update

Insuring Corporate Casualty Risk

- Federal tax benefits:
  - Accelerated tax deduction when reserve is established vs. when paid
  - Typically worth 3% to 5% of projected losses for one underwriting year
  - Contingent upon the captive operating as an insurance company for U.S. federal tax purposes

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Captive Industry Update

Insuring Corporate Casualty Risk

- U.S. state tax benefits:
  - Captives are generally not subject to state income tax
  - High severity risk with low claim frequency best fit

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Captive Industry Update

Insuring Traditional High Severity Corporate Risk

- Ability to segregate funds over time to stabilize annual cost
- Means to obtain formal evidence of coverage
  - Reimbursement purposes
  - Meet contractual requirements with third parties or regulators

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Insuring Traditional High Severity Corporate Risk

- Potential to build up underwriting profits of captive exempt from federal income tax per Section 831(b) of the U.S. Tax Code:
  - Premiums cannot exceed $1.2 million annually
  - Captive must operate as an insurance company for U.S. federal tax purposes

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U.S. Tax Considerations

What defines "insurance" for federal tax purposes

- Existence of "insurance risk"
- Regulated insurance company
- "Risk shifting"
  - No parental guarantees
  - Existence of risk transfer
- "Risk distribution"

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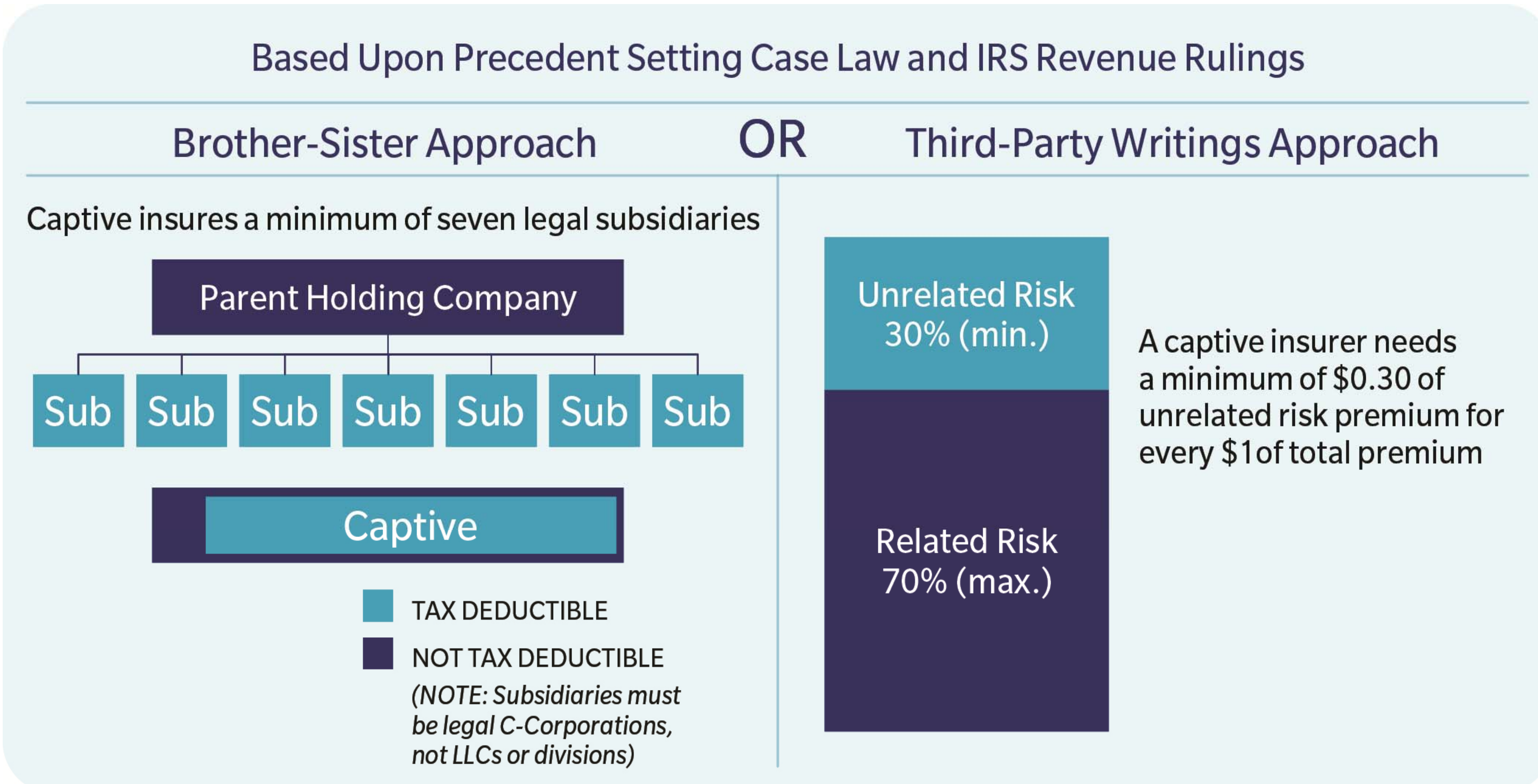
U.S. Tax Considerations

Qualifying as an insurance company



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Captive U.S. Federal Tax Treatment

Steps to realize federal tax benefits

STEP 1	STEP 2	STEP 3
Qualify as an insurance company for U.S. federal income tax purposes	Meet risk distribution requirements	Realize tax benefits
• Existence of insurance risks (not investment or business risks). • Shift financial risk to the captive ("risk shifting"). • Appropriately distribute the risks among a sufficient number of insureds ("risk distribution"). • Regulated insurance company.	Two Options: 1. Insure brother/sister companies (Must be legal C-Corps not LLCs or divisions). Case law — Insure minimum of seven sister entities. Revenue Ruling — Insure minimum of twelve sister entities. *or* 2. Insure unrelated third parties Case law— Minimum 30% premium from unrelated risk Revenue Ruling – Minimum 50% premium from unrelated risk.	1. 831(b) or the "Small Insurance Company" Election. – If premiums < $1.2 million annually, ability to earn underwriting profit on a tax exempt basis. – Beneficial when insuring risk high in severity with no expected claims such as Property. 2. Accelerated tax deduction when reserve established vs. when loss is paid due to special rules afforded to insurance companies (beneficial when insuring long tail risk such as Casualty).

IRS and Tax Court Issues

- Looking at abuse of 831(b) election, including investigation of Artex
- Revenue Ruling 2014-15 – treats retirees as individual risks for retiree medical-medical stop loss implications for 3rd party business

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IRS and Tax Court Issues

- 2014-notable tax wins for captive owners
  - *Rent-A-Center* – 60% of risk concentrated in one subsidiary and parent guarantee
  - *Securitas* – limited number of subsidiaries with large pool of risks
  - *Validus* – US federal excise tax N/A to retrocessions of reinsurance placed with foreign captive reinsurer

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IRS "Dirty Dozen" List of Tax Scams 2015

- Looking at abuse involving small or "micro" captives
- Unscrupulous promoters "sell" insurance to cover ordinary business risks or esoteric, implausible risks

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IRS Scrutiny of Captives

- Emphasis of Marketing Materials
- Realistic Probability of Applicable Coverage
- Lack of Adequate Risk Distribution
- Existence of Guarantees

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IRS Scrutiny of Captives

- Failure to obtain actuarial study
- Lack of Analysis of Cost and Availability of Commercial Insurance
- Materials emphasizing estate planning benefits
- Lack of claims history

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NAIC Initiatives

- Proposal to apply NAIC Part A Accreditation Requirements to Captives
- Intent to apply only to Captives that reinsure XXX/AXXX life insurance, variable annuities and long term care

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NAIC Initiatives

- Definition of “multi-state insurer” much broader
  - Domestic insurer operating in at least one state other than its state of domicile
  - Domestic insurer reinsuring business that was directly written by the ceding insurer in at least two states

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NAIC Initiatives

- If NAIC adopts"multi-state insurer" definition:
  – Some captive insurers would have to abide by same laws as commercial insurers
  – Businesses will lose benefits of alternative risk transfer offered by captives

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Types of Captives

- Pure captive
- Association captive
- Group captive
- Protected cell captive
- Reinsurer
- Special purpose financial captive

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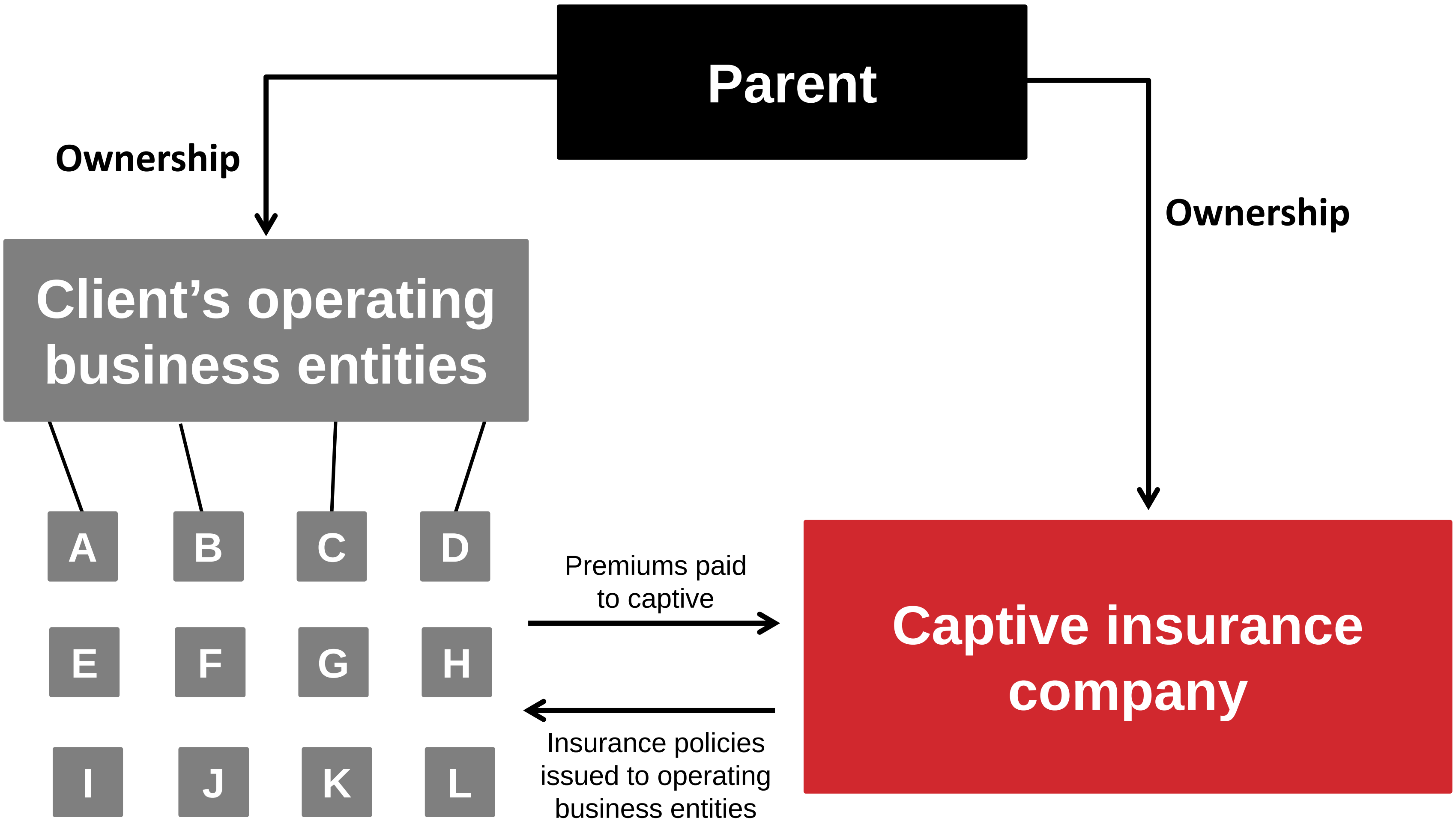
Pure Captive



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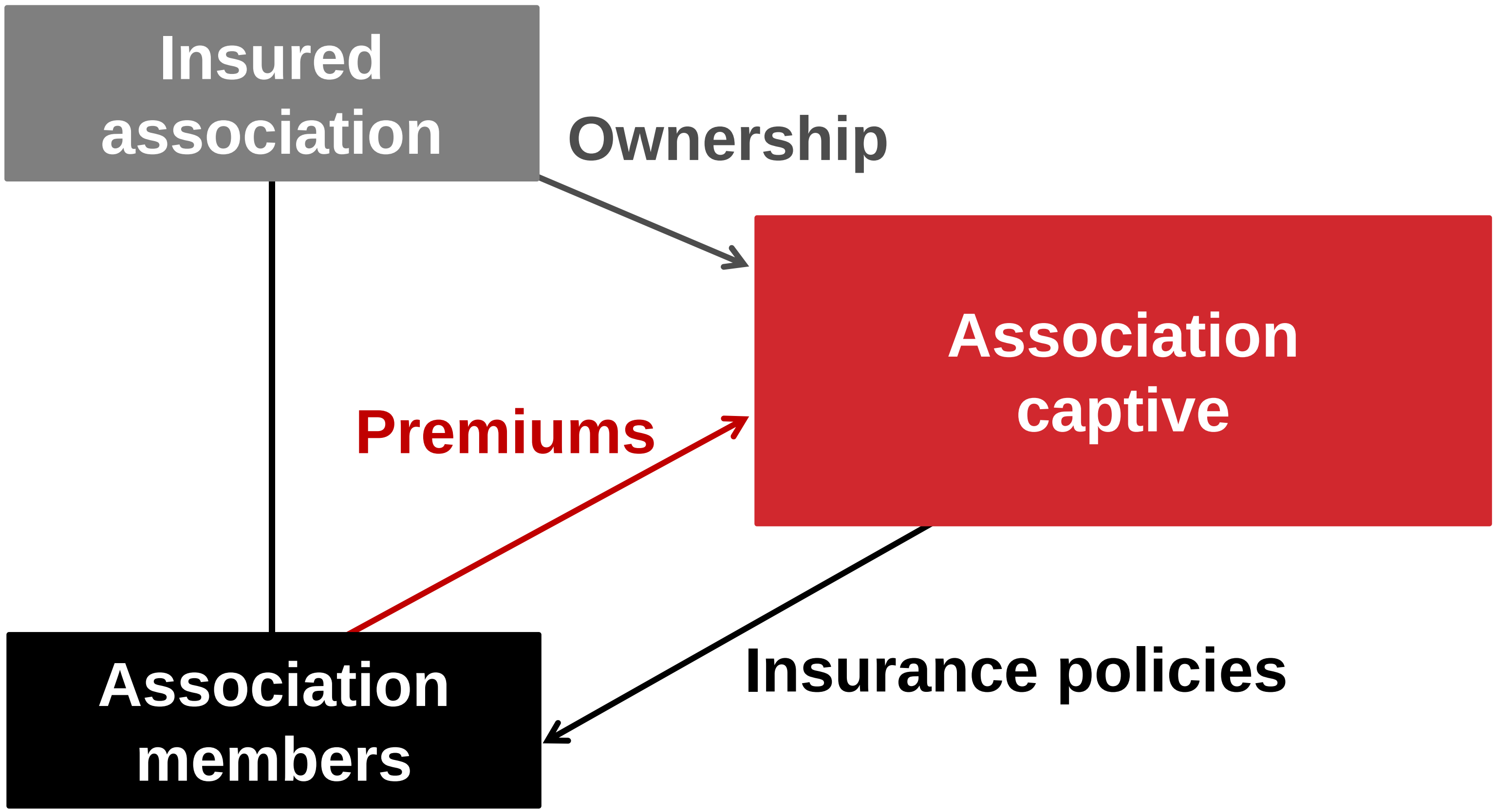
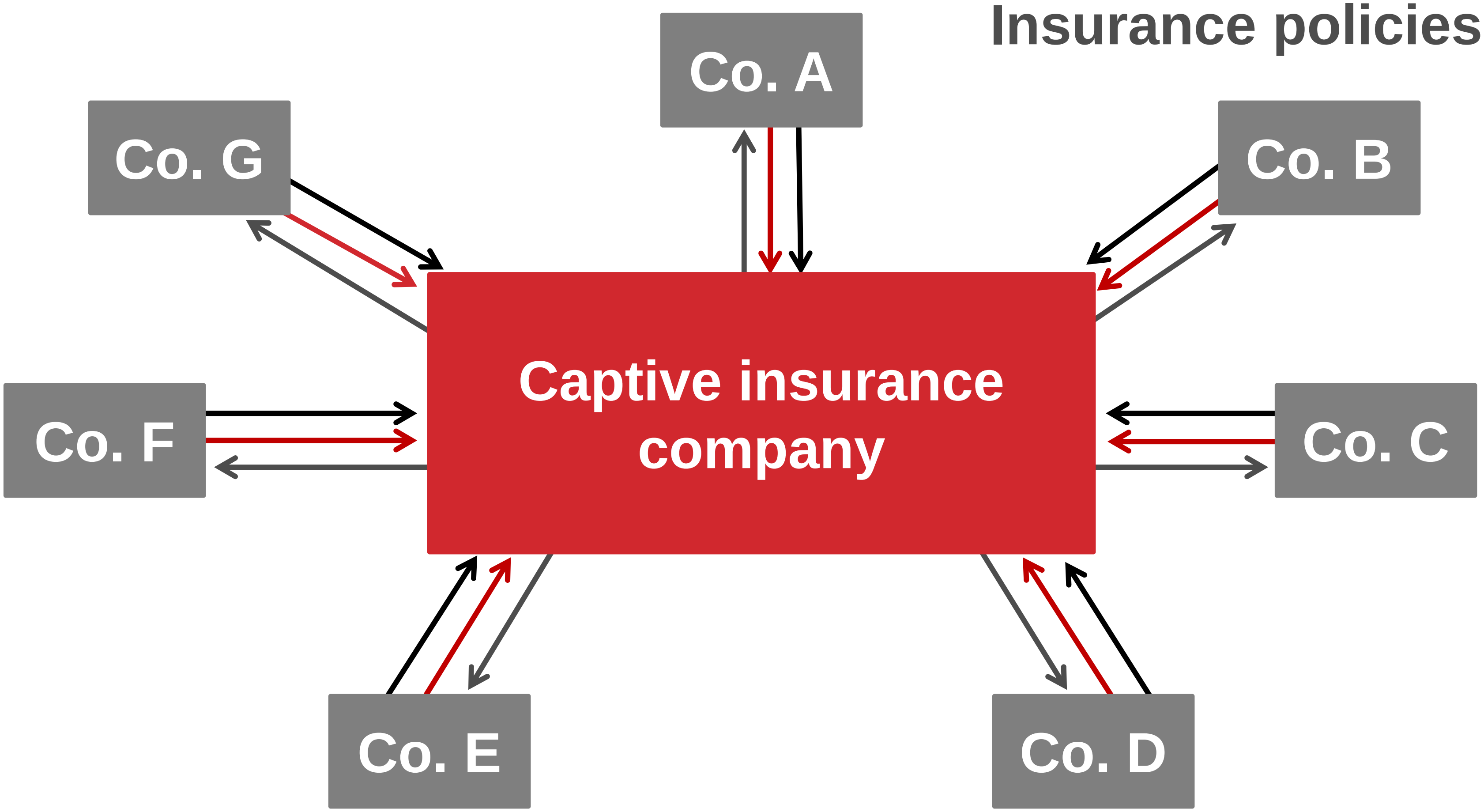
Association Captive



Group Captive

Ownership
Premiums
Insurance policies



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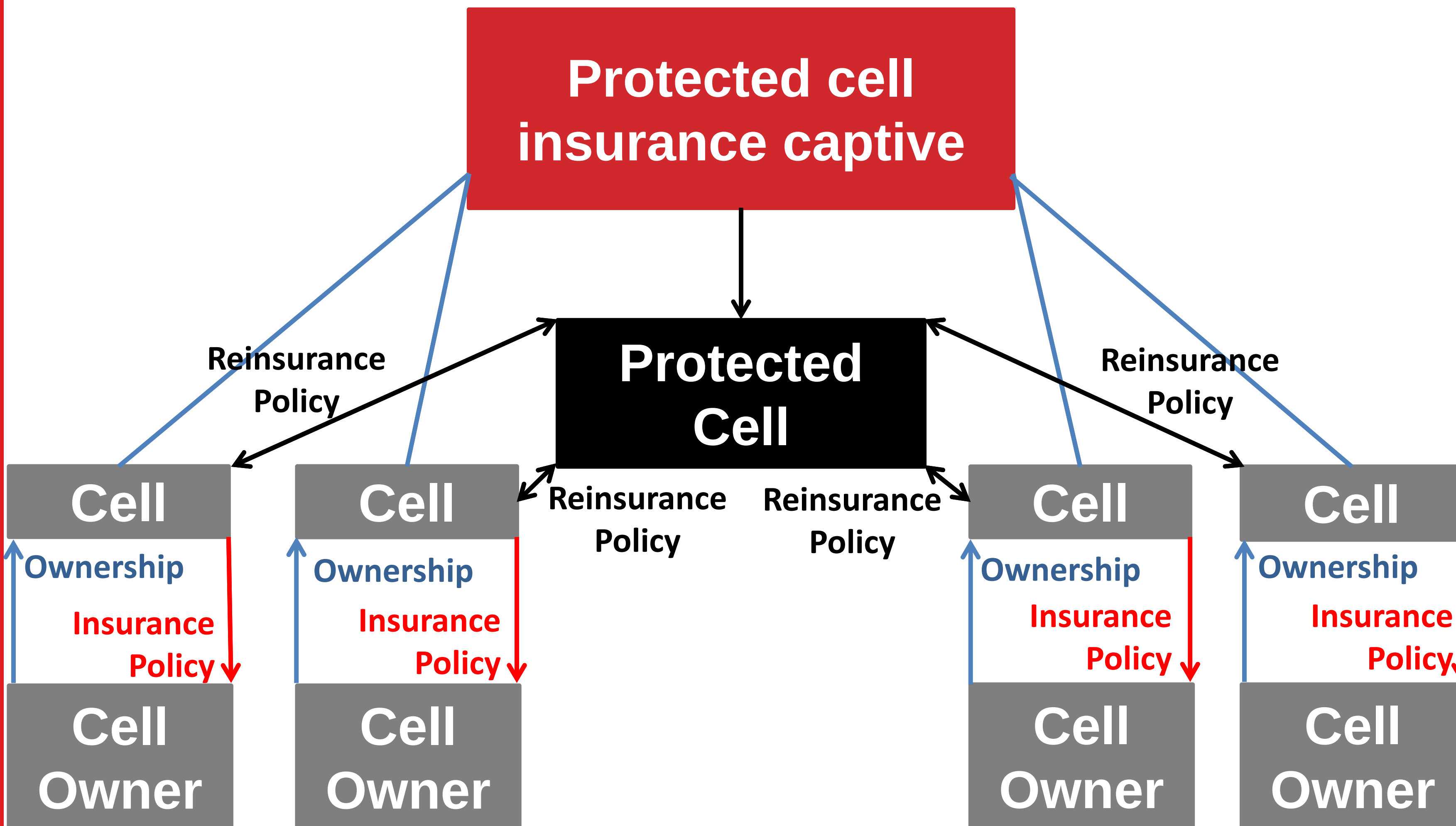
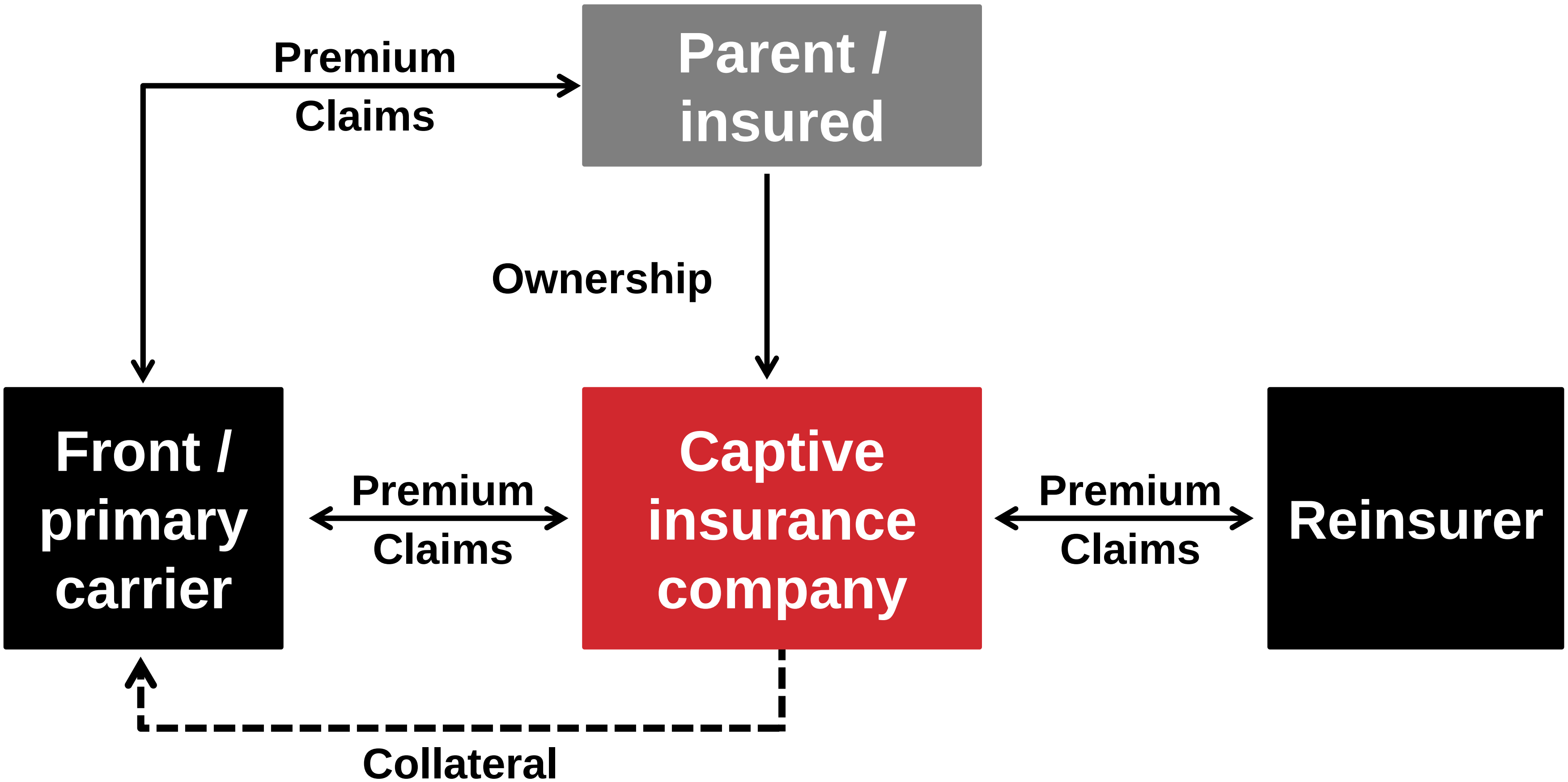
Protected Cell Captive



Fronted Captive Acting as Reinsurer



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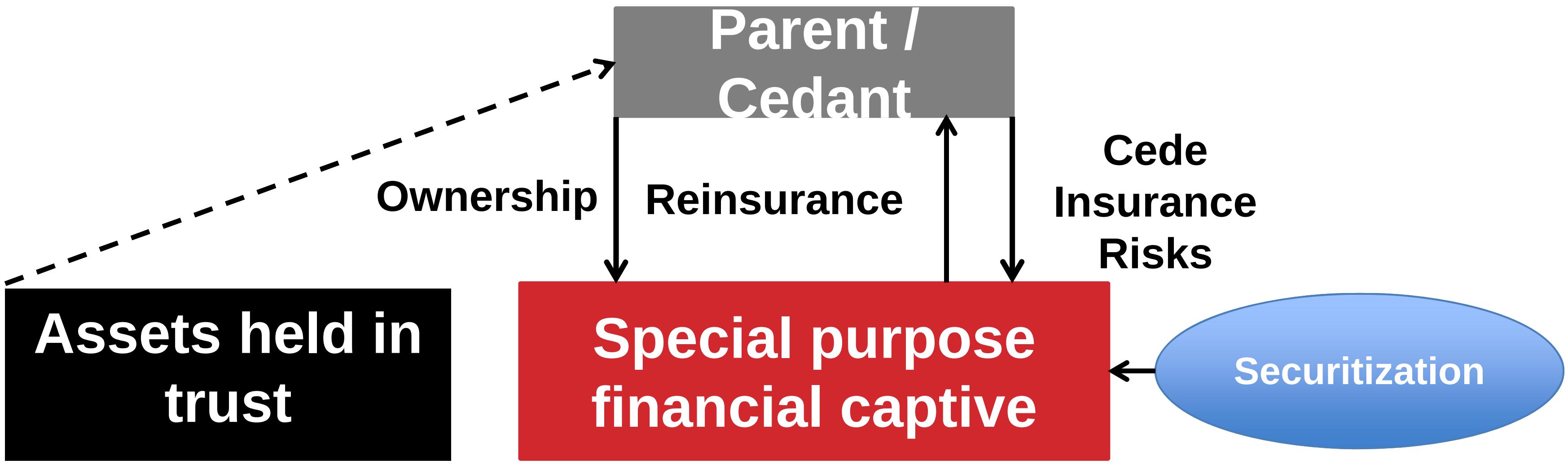
Special Purpose Financial Captive



Legal Structure of Captives

- Corporation
- Limited liability company
- Mutual
- Reciprocal

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Types of Risks Ceded

- Depends on Jurisdiction
- All lines but WC - Utah
- Expansive commercial and life/annuity - Delaware
- Includes title, credit life/credit disability - Hawaii
- No personal lines except Hawaii

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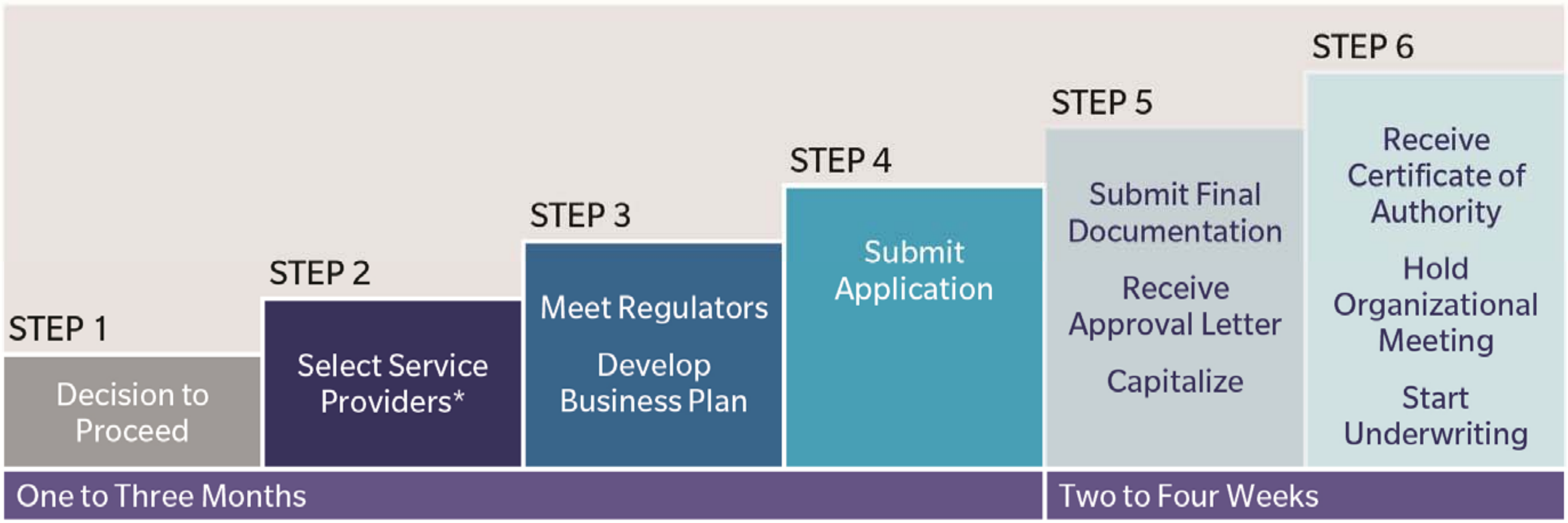
Building the Captive Program

Timing and Steps



* Including selection of captive manager, auditor, attorney, bank, actuary, and asset manager (optional)

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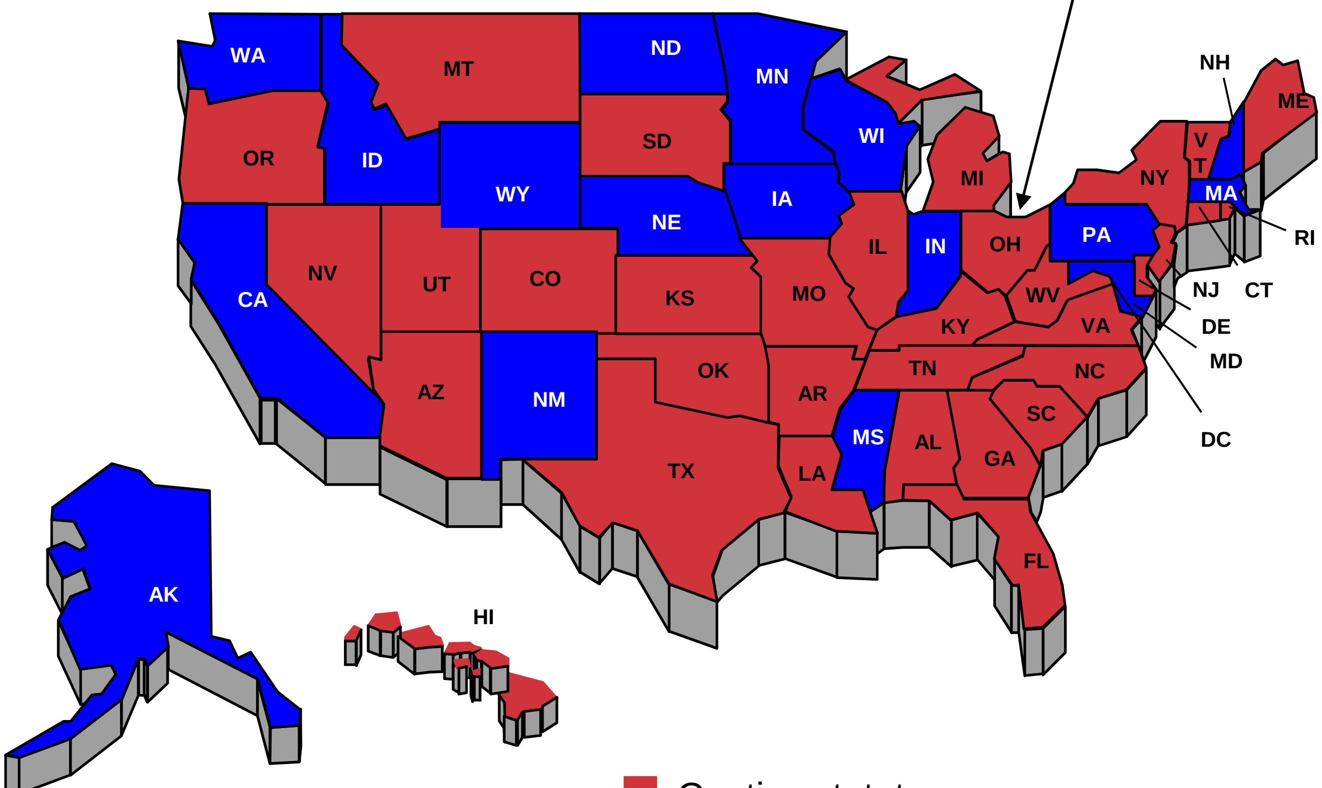
U.S. Domestic Captive Domiciles

February 2015

Most Recent U.S. Domicile



Captive statutes

No specific captive statutes

Captive Domicile, Number of Captives*

Alabama	27
Arizona	106
Arkansas	2
Colorado	4
Connecticut	4
Delaware	298
District of Columbia	172
Florida	0
Georgia	13
Hawaii	184
Illinois	1
Kansas	1
Kentucky	128
Louisiana	0
Maine	3
Michigan	7
Missouri	35
Montana	150
Nevada	148
New Jersey	15
New York	50
North Carolina	4
Oklahoma	11
Oregon	0
Rhode Island	0
South Carolina	145
South Dakota	9
Tennessee	32
Texas	0
USVI	8
Utah	342
Vermont	588
Virginia	0
West Virginia	1

Source: BI Survey, "Counting Captives," *Business Insurance*, March 17, 2014.

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* As of Feb. 3, 2015

2014

- Strong growth in captives – 8.6%
- Over 500 new captives reported
  - growth due to small captives and cells/series captives
  - more new cell or series formations than stand-alone captives

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2014

- Utah had the highest number of formations and highest net growth (106 / 23.3%)
- Delaware saw strong growth in captives and SBUs
- Kentucky set moratorium

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Emerging Domiciles

- Tennessee – 42 new; 144.8%
- North Carolina – 49 new; 122.5%
- Oklahoma – 37 new; 370%
- Missouri – 12 new; 34.3%
- Ohio – Legislation effective September, 2014

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Drivers of Growth

- Home state re-domestications
- Continued growth of small captive market
- Captive legislation including series LLC and cell structures

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Ohio

- 2003 – ODI advised medical providers of risks
- 2007 – Captive legislation considered and killed
- 2011 – Captive legislation initiated
- 2014 – Captive legislation signed into law

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The Ohio Captive Law

- Authorizes pure captives, protected cell captives and special purpose financial captives
- Organized as Ohio corporation or limited liability company and obtain license
- Maintain principal place of business in Ohio, appoint resident agent in Ohio, manager must be Ohio resident, hold at least one board meeting annually in Ohio, and obtain license

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The Ohio Captive Law

- Minimum capital and surplus $250,000 for pure and $500,000 for protected cell captives
- Form includes cash, marketable securities
- For pure or protected cell captives, form may include irrevocable, unconditional and automatically renewable letter of credit

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The Ohio Captive Law

- May only offer specified types of insurance; any other line is permitted in the sole discretion of Superintendent
- May reinsure any risks of parent or affiliate as approved by Superintendent
- May purchase reinsurance for any risk that captive directly writes

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The Ohio Captive Law

- Application for License
- Confidentiality
- Annual premium tax of 0.35% on net direct premiums; annual minimum aggregate tax of $7,500 and annual maximum aggregate tax of $250,000
- Charges for examinations
- Annual report regarding financial condition

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The Ohio Captive Law

- Investment policy — prudent man standard
- Dividends — notice for ordinary; approval for extraordinary
- Loans — prohibited to parent or affiliate without Superintendent approval
- No guaranty or insolvency fund
- Redomestication

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Ohio Department of Insurance

- Superintendent: Ohio not to be dominant captive domicile; to serve as valuable tool for Ohio businesses
- Focused on Ohio businesses; not to be competing with other states
- Moderate approach — in middle of regulatory ladder (intends to be practical in approach)

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Ohio Department of Insurance

- Dominant vs. competitive
- Tracy Snow named as Chief of Captives
- “Open for business”
- Applications available on-line

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Successful Captives

- Qualified legal and tax counseling
- Defining a proper domicile
- Appropriate understanding of captive formation risk transfer/distribution
- Strong relationship with insurance department
- Appropriate reinsurance

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Successful Captives

- Adequate capital and surplus
- Ongoing risk management and reporting
- Qualified “captive manager”
- Impeccable accounting and record keeping
- Open communication of subscriber groups (group captive)

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Risks Associated With a Captive

- Improper structure
  - DOL/insurance, regulatory/ERISA/IRS
- Premium rate/reserve issues
- Capitalization costs
- Lack of “risk transfer” or “risk distribution”
- Other

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Making sense of it all.