SOLUTIONS…DEFINED, DESIGNED, AND DELIVERED.

831(b) Captives and Tax Issues

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Section 1

WHAT IS AN 831(B) CAPTIVE?

What is an 831(b) Captive?
Widely Accepted Definition

A captive insurance company is a bona fide licensed insurance or reinsurance company owned by a non-insurance company and which insures or reinsures the risks of its parent or affiliated companies.

What is an 831(b) Captive?
What do Captives do?

- Fund retained corporate risk:
  - Workers' compensation (WC).
  - General and products liability.
  - Auto liability.
  - Property risk including wind and quake.
  - Surety risk.
  - Professional liability.
  - Subcontractor default.
  - Pollution.
  - Employment practices liability.
  - Weather risk.
  - Cyber risk.
- Means to access reinsurance markets for insurance capacity:
  - Third party reinsurers offer alternative source of risk transfer capacity.
  - Captive can access government sponsored terrorism pool under TRIA provisions for catastrophic terrorism protection at no cost.
- Profit center (underwrite risk of third parties):
  - Subcontractors workers' compensation, general liability, and auto liability risk.
  - Customer risk (extended warranty, credit life).
  - Tenants property risk (for example, renters insurance).

What is an 831(b) Captive?
Facts

- Often referred to as “Small Captives”, “Micro-Captives” or “831(b) Captives” in reference to the line of the IRS Code that grants favorable tax treatment to qualifying small captives;

- **Fastest growing segment of the captive market;**

- There are estimated to be more than 3,000 captives established by US companies in the past 5 years;

- This explosion of captive growth has occurred primarily in a few domiciles both onshore and offshore;

- Creators of these small captives have expanded from the captive consultant arms of large brokerage firms to attorneys and wealth advisors, giving us a clue to the estate planning angle of some of these formations.

What is an 831(b) Captive?
Similarities to Large Captives

At a very high level, Small (831(b))Captives are just like large captives……….

- Fund retained corporate risk;
- Means to access reinsurance markets for capacity;
- Profit center (underwriting risk of third parties); and
- Must satisfy Risk Transfer and Risk Distribution.

…………only smaller and with a special tax election

What is an 831(b) Captive?
831(b) Simplified

Section 831(b) of the US Tax Code states that if a company:

- Is a Property & Casualty Insurer (satisfies Risk Shifting & Distribution); and
- Writes less than US$1.2 million in premium annually;

Then Company may choose to make the 831(b) election which will:

- Allow them to be taxed on investment income only.

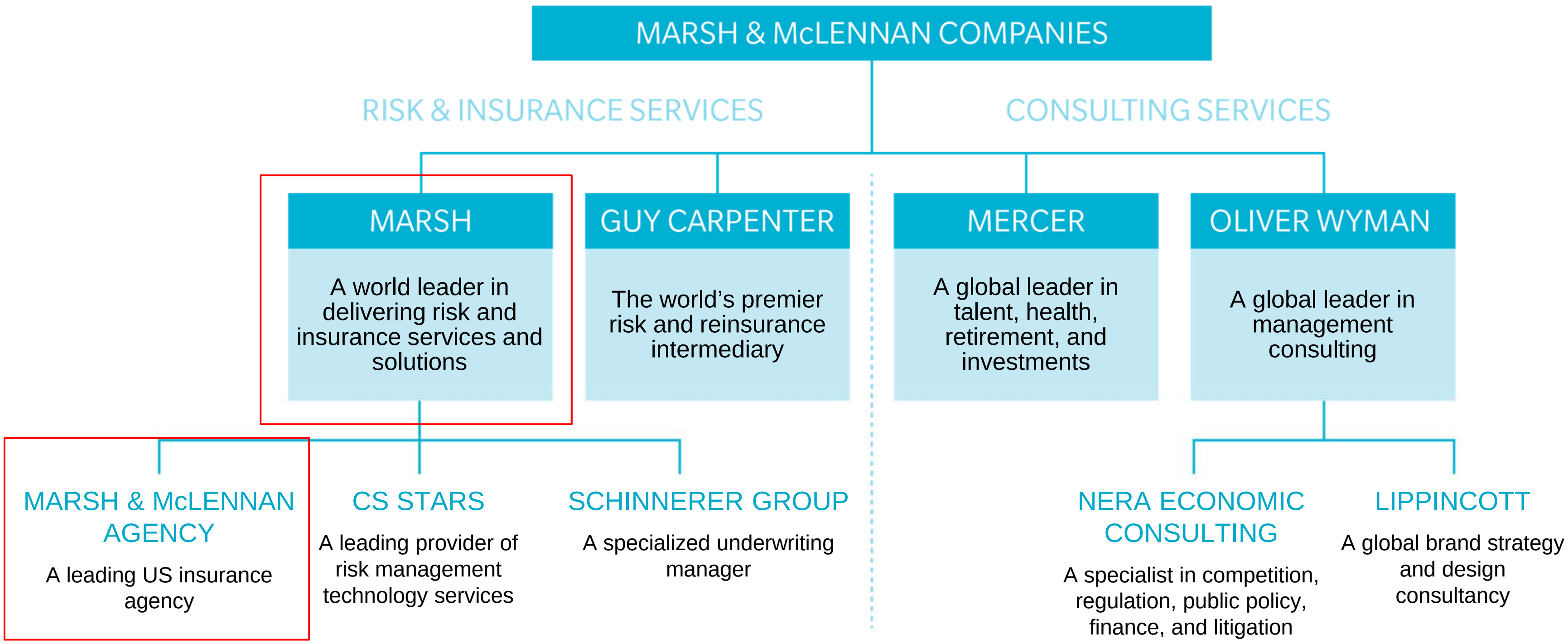
Section 2

HOW DOES MARSH INTERACT WITH CAPTIVES?

Marsh & McLennan Companies

WHO WE ARE We are a global professional services firm

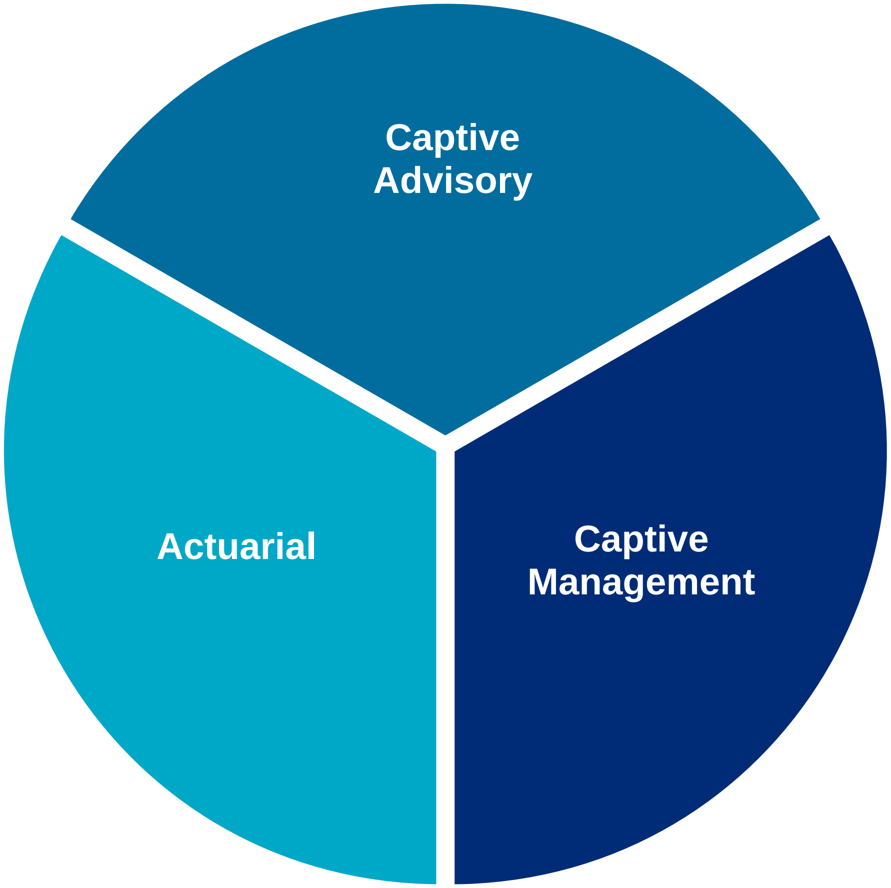
WHAT WE DO We offer clients advice and solutions in the areas of risk, strategy, and human capital



MARSH GENERATED ROUGHLY HALF OF MARSH & McLENNAN COMPANIES' TOTAL REVENUE OF $11.9 BILLION IN 2012

Marsh's Captive Solutions Group
What We Do

- Marsh's Captive Solutions Group exists to provide solutions to our insurance brokerage clients and is comprised of three key disciplines.



Marsh's Captive Solutions Group
Captive Advisory

- Our captive advisory professionals give specialized advice on the financial, strategic and operational matters relating to captives.
- This advice is given to:
  - Organizations considering the establishment of a captive.
  - Organizations who have a captive and wish to reaffirm the captives rationale and ensure it is achieving the maximum value for the parent company.
- **We are engaged to perform a "Feasibility Study"**

Not Tax Advisors!!!

Section 3

CAPTIVE CREATION PROCESS

How do I use this idea with my company?

How do I use this idea with my clients?

What does a Small Captive Candidate look like?

- Substantial high severity/low frequency risks that are uninsured or self-insured;
- US Taxpayers;
- Privately held or Closely held (doesn't have to be);
- Revenue: $40 million or greater (varies based upon industry);
- Cash Flow: $5 million or greater; and
- Consistently cash flow positive.
- Willingness to post necessary Capital (minimums typically $250,000)
- Willingness to assume risk of others (Risk Pool)

Find Retained Insurable Risks

1. Deductible Layers (non-working so few frequency claims);
2. Excess Layers;
3. Exclusions to existing policies; and
4. Uninsured exposures
   a) Cyber Liability
   b) Supply Chain Contingent Business Interruption
   c) Intellectual Property

The Feasibility Process

- Information gathering.
- Review of insurance data, loss data, and financial information.
- Captive modeling.
- Business plan development.
- Determination of optimal ownership structure.
- Analysis of tax issues.*
- Analysis of investment policy of captive.
- Domicile analysis.
- Final recommendation and presentation to client.
- Feedback and ongoing relationship as the captive implementation and formation progresses.
- Captive management services and day to day activities they will perform.

* *All such matters should be reviewed with the client's own qualified tax, accounting, and legal advisors.*

Section 4

ECONOMIC INCENTIVE & WRONG TURNS

Economic Incentives
831(b) Election

	US 831(b) Captive
Start-up Cost	$50,000
Annual Operating Cost	$50,000
Expected Losses	$120,000
Premium Volume	$1,200,000
Underwriting Income	$980,000
US Effective Tax Rate	40%
Net Federal Tax Benefit to Parent Co.	**$392,000**

Recall:

To take a tax position as an insurance company, must satisfy:

- Risk Distribution
- Risk Transfer

Risk Distribution (previously discussed)

1) Brother/Sister ("Humana") Structure
   a. Few capable of utilizing this approach

2) Third Party Business
   a. Organic Third Party Business
      i. Potential Wrong Turn:
         - Aggressive Stance on definition of 3rd Party Business

   b. Risk Pooling
      i. Potential Wrong Turn:
         - Pool insures policies that do not Shift Risk

Economic Incentives
Wrong Turns

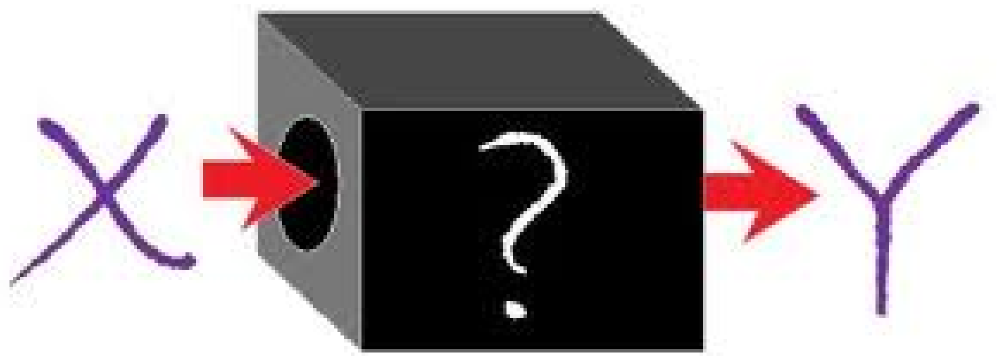
Risk Shifting (previously discussed)

1) Insurance contract must shift financial risk to the captive with no parental guarantees.
   a. Potential Wrong Turn:
      - A large premium is charged for a minute risk.

Risk Premium

Feasibility Process Requires Actuarial Defense of Premiums

1) Premiums derived via historical loss analysis.
2) When risk to be insured has no or limited loss history:
   a. Rely upon market indications
   b. Loss simulation with loss distribution assumptions
      - Black Box…must be careful



Wrong Turns
Actuarial Impact

Actuaries Hold the Key to Ensuring Proper Utilization

1) RISK SHIFTING:
   a) Actuaries must take seriously their roles in reviewing premiums charges to Small Captives.
   b) Given the “Black Box” nature of the pricing process, and significant amount of subjectivity, this is the most difficult for those challenging tax status of a captive to dismantle.
   c) We simply know when it STINKS.

Questions?

MARSH