

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.

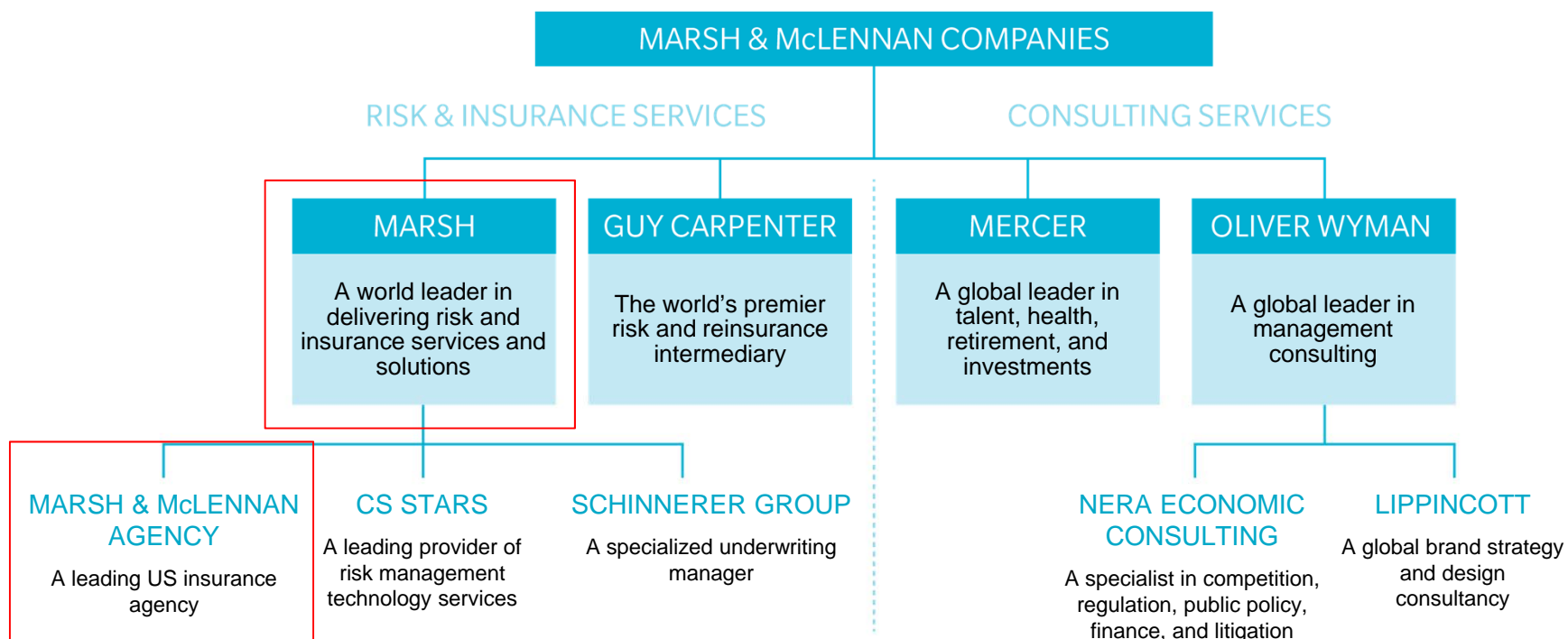
Section 2

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

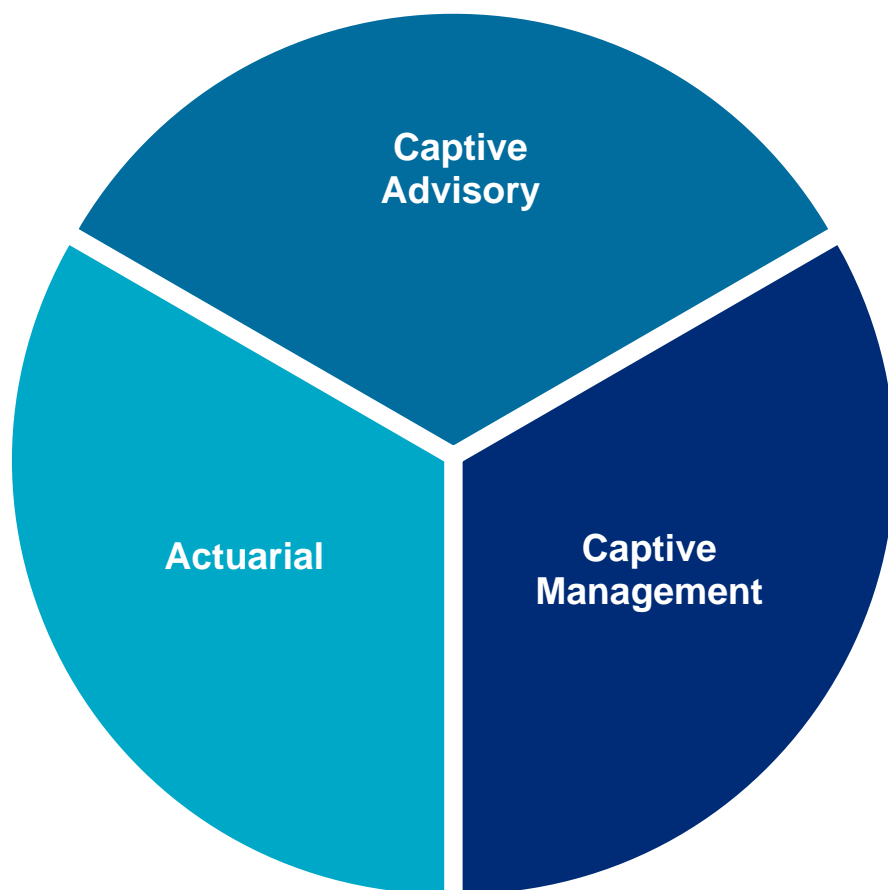


MARSH GENERATED ROUGHLY HALF OF MARSH & McLENNAN COMPANIES' TOTAL REVENUE OF \$11.9 BILLION IN 2012

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

Small Captives

How do I use this idea with my company?



How do I use this idea with my clients?

Captive Creation Identifying Candidates

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

Economic Incentives Insurance Company Taxation

Recall:

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

- Risk Distribution
- Risk Transfer

Economic Incentives

Wrong Turns

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

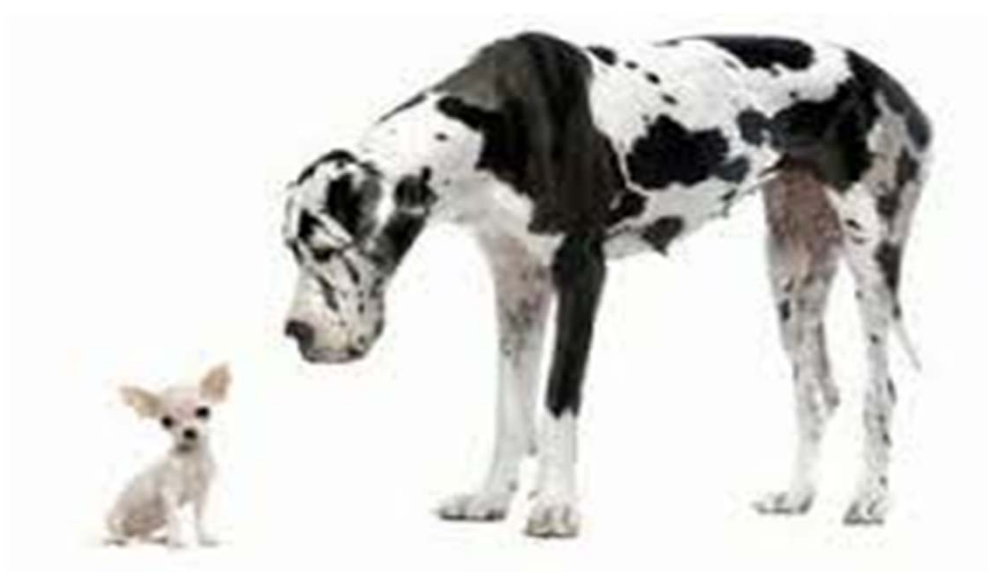
 - b. Risk Pooling
 - i. **Potential Wrong Turn:**
 - Pool insures policies that do not Shift Risk

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

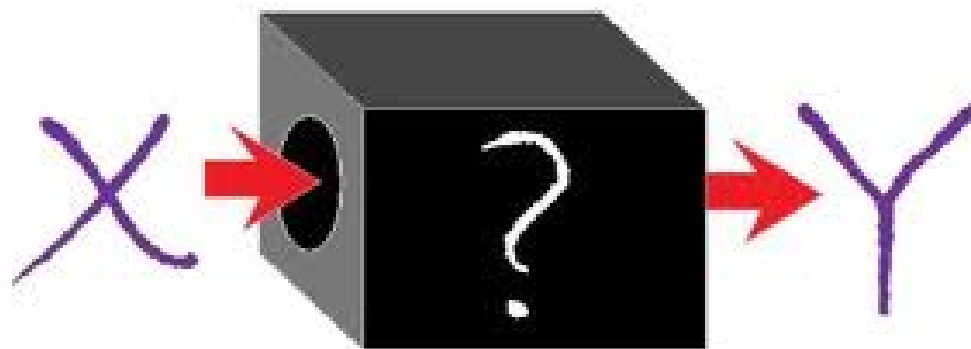
Premium

Economic Incentives

Wrong Turns

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?



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