Understanding 831(b) Captives

Presented by  |  Matt Murray, Cottingham & Butler
              |  Brad Mundine, Intuitive Captive Solutions
Welcome

Agenda:
• Review the most common misconceptions of an 831 (b) captive
• Discover the benefits and how to use 831 (b) captives to manage risk that is currently uninsured
• Determine if an Enterprise Risk Management captive is right for your company

Presenters:

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About Cottingham & Butler

• National provider of employee benefits and risk management solutions
• Privately held - established in 1887
• Headquarters in Dubuque, IA (population 60,000)
• Over 3,500 customers nation wide
• 600+ employees
• 37th largest Insurance Broker in U.S.
• 95% retention rate across entire book of business
• Posted $90 Million in revenue in 2013
About Intuitive Captive Solutions

Specialists in Enterprise Risk Management Captives

- Underwriting Managers, Insurance Company Administration, Claims, Reinsurance Structures
- Accounting & Regulatory Affairs
- Brokerage and Marketing
- Insurance Program Design

Registered Captive Manager in AL, DE, DC, KY, NC, TN, UT, MT

Additional Expertise from our Agency Partners
# Myth vs. Fact

<table>
<thead>
<tr>
<th>Myth</th>
<th>Fact</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. 831(b) programs are a fit for all companies of all sizes</td>
<td>1. Only companies of a certain size with a certain amount of risk tend to be suited for an ERM captive</td>
</tr>
<tr>
<td>2. I should put as much money in the 831(b) as I can, up to $1.2M</td>
<td>2. The risk placed into a captive needs to be underwritten and priced appropriately in addition to undergoing an independent actuarial review to validate coverage and pricing</td>
</tr>
<tr>
<td>3. Sharing risk with other captives in a reinsurance pool can be very risky</td>
<td>3. Reinsurance pools reduce overall risk for all participating members.</td>
</tr>
<tr>
<td>4. The most important consideration when thinking about a captive is the tax benefits</td>
<td>4. Identifying risk, pricing coverage, building reserves and sustaining profitability are the most important considerations</td>
</tr>
<tr>
<td>5. All captive managers are the same</td>
<td>5. Currently 6 captive managers are under IRS investigation.</td>
</tr>
</tbody>
</table>
Why Own a Captive?

- Insure Risks
- Formalize Enterprise Risk Management -- (utilize Underwriters, Actuaries & CPA’s)
- Capture Underwriting Profits & Investment Income
- Create Leverage Against Insurers and Banks
- Protect Assets
- Capture / Warehouse Risk Data – Quantify Results
  - Lower Costs & Your Tax Bill
  - Increase Owner’s Net Worth
- Efficiently Transfer Wealth
As defined by Casualty Actuarial Society:

“ERM is the process by which organizations in all industries assess, control, exploit, finance, and monitor risks from all sources for the purpose of increasing the organization’s short and long term value to its stakeholders.”
You’re Already in the Insurance Business

- Third Party Insured Risks
- Self-Funded Exposures

**Common Self-Insured Business Risks**

- Policy Deductibles & Coverage Exclusions
- Earthquake / Flood
- Errors & Omissions
- Contingent Business Interruption
- Bank Deposits (Excess Of FDIC Limits)
- Personal Guarantees (Financial)
- Product Recall
- Patent Protection And Infringement
- Liquidated Damages
- Political Risk
- Punitive & Exemplary Damages
- Environmental Liability

**Such as:**

- Workers’ Compensation
- Automobile
- General & Product Liability
- Property
- Professional Liability
- Medical Insurance

**Risk Continuum**
ERM Risk Response Strategies

Avoidance

Reduction

Share or Insure: transferring or sharing a portion of the risk, to finance it

Accept: no action is taken, due to a cost/benefit decision
What is an ERM Captive?

An insurance company that you own…a captive insurance company

Allows creation of pre-tax reserves

Maximum Annual Premium: $1,200,000
Shareholders/Owners of the Captive

Most common structures

- Same as Operating Company
- Trust for Children and/or Grandchildren
- Management Team
- Combination of above
How it Works

SHAREHOLDERS

Your Business

Premiums Up to $1,200,000 per year

Payments for Insured Losses

Your New Private Ins. Co. (CAPTIVE)
How it Works

Your Business

SHAREHOLDERS

A Deductible Expense

Premiums Up to $1,200,000 per year

Received Tax Free

Payments for Insured Losses

Your New Private Ins. Co. (CAPTIVE)
How it Works

Your Business

SHAREHOLDERs

A Deductible Expense

Premiums Up to $1,200,000 per year

Payments for Insured Losses

SHAREHOLDERs

Your New Private Ins. Co. (CAPTIVE)

Received Tax Free

Underwriting Profits

Dividend or Capital Gains Tax Rates
How it Works

Your Business

A Deductible Expense

Premiums Up to $1,200,000 per year

Payments for Insured Losses

SHAREHOLDERS

Profits

Ordinary Income Tax Rates

SHAREHOLDERS

Underwriting Profits

Dividend or Capital Gains Tax Rates

SHAREHOLDERS

Received Tax Free

Your New Private Ins. Co. (CAPTIVE)

You will continue to Purchase Third Party Insurance
What Would the Captive Insure?

- Current Policy Deductibles and/or Exclusions
- Coverage That You Don’t Currently Buy or Can’t Buy in the Traditional Insurance Market Such As…..

- Wind/Quake/Flood
- Errors & Omissions
- Product Recall
- Political Risk
- Liquidated Damages
- Environmental
- Regulatory Liability
- Directors & Officers
- Excess Liability
- Contingent Business Interruption
- Bank Deposits (Excess of FDIC Limits)
- Personal Guarantees (Financial)
- Patent Protection & Infringement
- Kidnap & Ransom
- Cyber Liability / Breach of Data
- Crisis & PR Liability
- Employment Practices Liability
- Workplace Violence
Risk Portfolio Changes

- Prop
- Liab
- D&O
- Business Interruption
- E&O
- Product Recall
- CBI

- Third Party Insured Risk
- Self Insured Risk, Unfunded
- Self Insured Risk, Funded
Risk Portfolio Changes

- **Prop**
- **Liab**
- **D&O Business Interruption**
- **E&O**
- **Product Recall**
- **CBI**

Legend:
- **Third Party Insured Risk**
- **Self Insured Risk, Unfunded**
- **Self Insured Risk, Funded**

Exposure $
Risk Portfolio Changes

![Diagram showing the changes in exposure for various risk categories including Property (Prop), Liability (Liab), Directors & Officers (D&O), Business Interruption, Errors & Omissions (E&O), Product Recall, and Business Interruption (CBI). The diagram uses different colors to represent third-party insured risk, self-insured risk, unfunded risk, and funded risk.](image-url)
What is the POM from The Captive?

10 Year Profit Potential…

- Total Profit: $10 million
- Underwriting Profit: $7 million
- Tax Arbitrage: $2.4 million
  - Capturing Underwriting Profits, Income & Tax Deferral, Tax Conversion, and Additional Investment Income.
- Return On Investment: 20% +

Assumes $1.2 million per year in premium
What Can You Do With the Captive’s Money?

Capital Preservation

• Any Type of Liquid Investments (Stock, Bonds, ETF’s)

Longer Term - Capital Planning

• Acquisitions, Financings, etc.

Capital Transfer

• Owned by a Trust for Children or Grandchildren
Reliable – This Tax Section is Safe

831(b) has been in the Code since 1954 updated in 1986.


Play by the Rules:

• It Must be a Legitimate Insurance Company
• Run it as an Insurance Company – don’t comingle funds
• Ensure Proper Risk Distribution

8 Intuitive clients received a “No Change” letter after an IRS audit.
## Fact Patterns Matter

<table>
<thead>
<tr>
<th>Description</th>
<th>Bad Facts</th>
<th>Good Facts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Op Co Revenue</td>
<td>$1,500,000</td>
<td>$176,700,000</td>
</tr>
<tr>
<td>Op Co Employees</td>
<td>3</td>
<td>470</td>
</tr>
<tr>
<td>Captive Premium</td>
<td>$440,000</td>
<td>$1,035,000</td>
</tr>
<tr>
<td>Prem % of Revenue</td>
<td>29.33%</td>
<td>.586%</td>
</tr>
<tr>
<td>Actuarial Reviews</td>
<td>None</td>
<td>Annual</td>
</tr>
<tr>
<td>Financials</td>
<td>Compiled</td>
<td>Audited</td>
</tr>
<tr>
<td>Loans</td>
<td>Yes to Op Co</td>
<td>None</td>
</tr>
<tr>
<td>Claims</td>
<td>1 in 5 years</td>
<td>Annually</td>
</tr>
<tr>
<td>Reinsurance</td>
<td>Non-Transparent</td>
<td>Fully Transparent</td>
</tr>
</tbody>
</table>
Does A Captive Need Outside Risk?

Yes, it’s required to meet the IRS rules:

**How:**
1) Write Third Party Insurance
2) 8 or more subsidiaries share risk
3) Join the CREX Reinsurance Pool

**The Fear:** Assuming Someone Else’s Risk.

**The Fact:** Loss Patterns are often less than the tax savings.

**The Benefit:** A portion of the claims are paid by the Reinsurance.
### Risk Distribution – Potential Costs

**Another Member’s Captive**

<table>
<thead>
<tr>
<th>Risk Distribution</th>
<th>Pool Members (35)</th>
</tr>
</thead>
<tbody>
<tr>
<td>52% of the Loss</td>
<td></td>
</tr>
<tr>
<td>Gross Amount of Loss</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Portion of Loss Paid by Reinsurance Pool ($1M x 52%)</td>
<td>$520,000</td>
</tr>
<tr>
<td>Portion of Loss Paid by Your Captive ($520,000 / 35)</td>
<td>$14,857</td>
</tr>
<tr>
<td>Your Annual Tax Savings ($1,200,000 x 39.6%)</td>
<td>$475,200</td>
</tr>
<tr>
<td>Your Net Tax Benefit ($475,200 - $14,857)</td>
<td>$460,343</td>
</tr>
</tbody>
</table>
## Risk Distribution – The Benefit

### Your Captive

- **52% of the Loss**

### Pool Members (35)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Amount of Loss</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Portion of Loss Paid by Your Captive</td>
<td>$480,000</td>
</tr>
<tr>
<td>Portion of Loss Paid by Reinsurance</td>
<td>$520,000</td>
</tr>
</tbody>
</table>
What is an 831(b) Captive?

A risk-based management tool that:

• Insures your selected risks in your own insurance company.
  - Transfers a portion of your risk to other captives.
  - Assumes a portion of other captives’ risks.

• Captures underwriting profits and beneficial tax consequences.

• Creates additional wealth for shareholders.
## Intuitive Captives by Industry & State

<table>
<thead>
<tr>
<th>Industry</th>
<th>Industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>Industrial Automation</td>
</tr>
<tr>
<td>Auto Dealer</td>
<td>Insurance</td>
</tr>
<tr>
<td>Commercial Linen Manufacturer</td>
<td>Insurance &amp; Private Equity</td>
</tr>
<tr>
<td>Commercial Linen Supplier</td>
<td>IT Services</td>
</tr>
<tr>
<td>Commercial Transportation &amp; Warehousing</td>
<td>Lighting Manufacturer</td>
</tr>
<tr>
<td>Computer Hardware and Software</td>
<td>Manufactured Housing Parts Distributor</td>
</tr>
<tr>
<td>Computer Software</td>
<td>Manufacturing</td>
</tr>
<tr>
<td>Construction</td>
<td>Metal Fabricator &amp; Manufacturer of Computer Controlled Machinery</td>
</tr>
<tr>
<td>Construction - General Contractor</td>
<td>Rail Equipment Service</td>
</tr>
<tr>
<td>Construction Materials</td>
<td>Real Estate &amp; Medical</td>
</tr>
<tr>
<td>Energy</td>
<td>Street &amp; Road Construction</td>
</tr>
<tr>
<td>Food Distributor</td>
<td>Technology</td>
</tr>
<tr>
<td>Fuels Distributor</td>
<td>Transportation</td>
</tr>
<tr>
<td>Hair Salons</td>
<td>Valve Manufacturer/Distributor</td>
</tr>
<tr>
<td>Hospitality</td>
<td>Wood Preserving and Processing</td>
</tr>
<tr>
<td>Merchandise Rental &amp; Sales, Video Production Marketing</td>
<td></td>
</tr>
</tbody>
</table>
Examples of Intuitive Captives

Lumber Supplier
• $700M Revenue
• 990 Employees
• Risks Insured by Captive – 15 including:
  - Product Recall
  - Contingent BI
  - Deductible Buy-downs (D&O, EPL, Pollution)

Manufacturers Rep
• $465M Revenue
• 33 Employees
• Risks Insured by Captive – 14 including:
  - Breach/Release of Data
  - Contingent Bus. Int. – Key Suppliers
  - Product E&O & Recall
Examples of Intuitive Captives

Home Décor Manufacturer
- 285M Revenue
- 475 Employees
- Risks Insured by Captive – 17 including:
  - Breach/Release of Data
  - Contingent Bus. Int. – Key Customer
  - Product Recall

Mechanical Contractor
- $465M Revenue
- 1500 Employees
- Risks Insured by Captive – 21 including:
  - Product Design E&O
  - Product Recall
  - Workplace Violence Expense
The First Step: The Feasibility Study

Includes:

- Risk Evaluation (Insured & Uninsured Risk Review)
- Reinsurance Structure & Details
- Financial Models
- Insurance Company Rules & Documents
  - Utmost Good Faith
- The Source Document for Client Advisors
## Annual Services Provided

<table>
<thead>
<tr>
<th>Service</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk, Insurance &amp; Reinsurance Reviews</td>
<td>✓</td>
</tr>
<tr>
<td>Actuarial Rate (Pricing) Review</td>
<td>✓</td>
</tr>
<tr>
<td>Accounting, Statutory and Financial Report Preparation</td>
<td>✓</td>
</tr>
<tr>
<td>License Applications, Business Plan Changes and Renewals</td>
<td>✓</td>
</tr>
<tr>
<td>Claims Documentation</td>
<td>✓</td>
</tr>
<tr>
<td>Annual Surplus Reviews</td>
<td>✓</td>
</tr>
<tr>
<td>Annual Financial Performance Report Card</td>
<td>✓</td>
</tr>
<tr>
<td>Annual Board Meetings and Minutes</td>
<td>✓</td>
</tr>
<tr>
<td>Annual Record Book</td>
<td>✓</td>
</tr>
<tr>
<td>Feature</td>
<td>Status</td>
</tr>
<tr>
<td>------------------------------------------------------------------------</td>
<td>----------</td>
</tr>
<tr>
<td>70+ years of Insurance, Underwriting, Captive and Corporate Management Experience</td>
<td>Yes</td>
</tr>
<tr>
<td>Geographic, Industrial and Line of Business Diversification &amp; Limitation</td>
<td>Yes</td>
</tr>
<tr>
<td>Captive Reserves &amp; Investment Income</td>
<td>Controlled by Captive Owner</td>
</tr>
<tr>
<td>Fronting Company Risk</td>
<td>None</td>
</tr>
<tr>
<td>Participation by Intuitive in the Reinsurance Pool as a Partner &amp; Pool Transparency</td>
<td>Yes</td>
</tr>
<tr>
<td>Client Confidentiality</td>
<td>Yes</td>
</tr>
<tr>
<td>IRS Audit Successes</td>
<td>Yes (8)</td>
</tr>
<tr>
<td>Business Systems Development and Investment</td>
<td>Yes</td>
</tr>
<tr>
<td>$50,000 Defense Fund for IRS Audit if needed</td>
<td>Yes</td>
</tr>
</tbody>
</table>
Our Commitment to You

Do things right (Integrity)

Get them done (Execution)

Make you money (Performance)