Introduction to Micro Captives & the 831(b) Election

Why a Micro Captive?

- Greater control and management of risk
- Reduced expenses (captive vs. admitted insurer)
- Ownership of improving results
- Additional, customized coverage
- Reasonable capital requirements
- Minimal regulatory barrier to entry
- Tax advantage
- Buy-out or retirement planning, deferred compensation, business succession, asset protection
- Supplements Group Captives very well

Section 831(b)

- IRC Section 831(b) provides that:
- Insurance companies with less than $1.2 million of annual premium pay $0 income tax on insurance profits. For 2017 and subsequent years, limit is $2.2 million, adjusted for inflation
- Investment income is taxed as income to C-corporation
- 831(b) must be timely elected and cannot be revoked without the permission of the Secretary

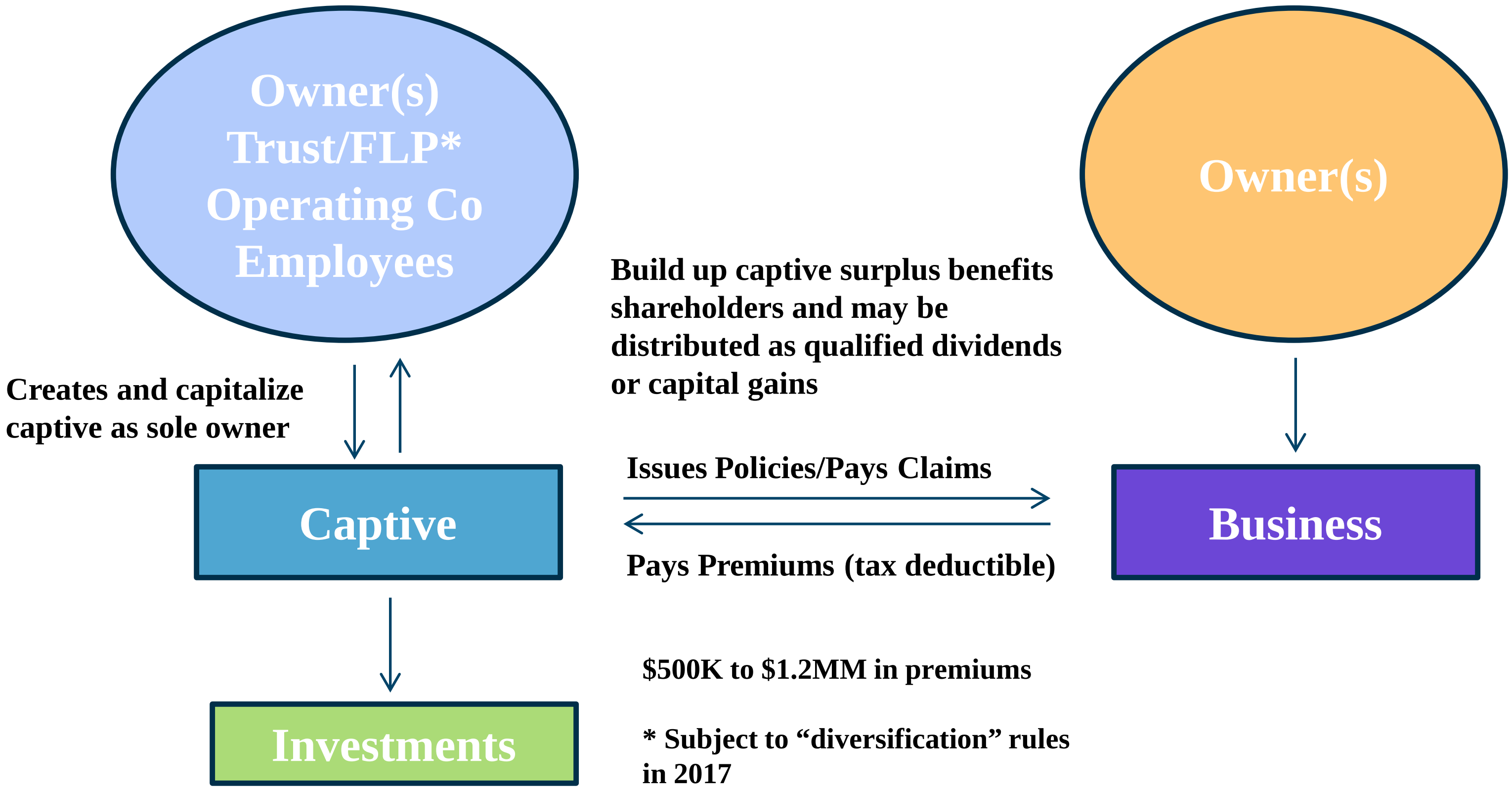
CAPTIVERESOURCES

M I J S
Moore Ingram Johnson & Steele
A Limited Liability Partnership

Section 831(b) 2017 Law Changes

- **Effective January 1, 2017, the annual premium limit is $2.2 million, adjusted for inflation**
- **The "Diversification" requirement provides that either**
  - **20 percent or less of written premium is attributable to one policyholder, OR**
  - **No owner of captive who is a lineal descendant or spouse of any owner of insured business owns more than two percentage points of captive than their respective ownership in insured business**
- **Annual reporting on diversification to be required**

831(b) Captive Structure



Ideal Candidates

- **Privately owned businesses**
- **Public companies**
- **Profitable operations**
- **Businesses with substantial self-insured or uninsured risks**
- **High net worth business owner with tax and asset protection planning needs**
- **Insured must be a long-term strategic planner**

Key business factors

Businesses with at least $10 million in gross revenues

Positive cash flow and positive projected taxable earnings

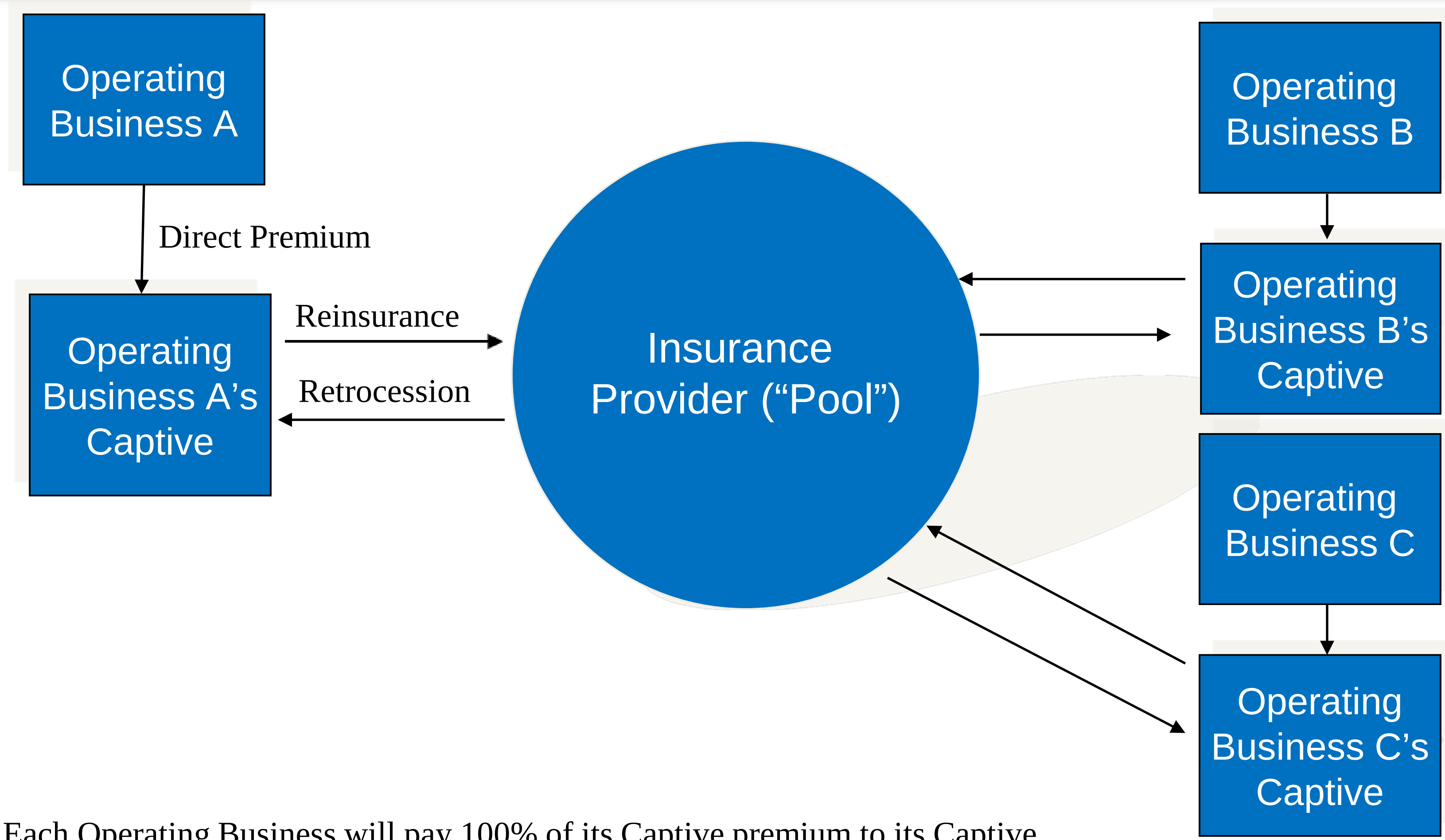
What makes it an insurance company?

- Primary business activity must be insurance
  - (a.k.a. Legitimate Business Purpose)
  - Needs to be operated like an insurance company
- Premiums and policies must be
  - Market-comparable
  - Risk-based
  - Established at arms length
  - Actuarial support is strongly encouraged
- Initial capitalization must be adequate
  - 4:1 (premiums to capital) with certain minimums
  - Generally $280,000 of initial capital through cash or LOC
- Insurance transaction
  - Risk transfer
  - Risk distribution

Risk Transfer and Distribution

- Risk Transfer
  - Must involve shifting of risk
  - Must involve significant chance of a significant economic loss
- Risk Distribution
  - "Unrelated Related" Model
    - At least 50% unrelated risk-Revenue Ruling 2002-89
    - At least seven unrelated entities (Group Captive)-Revenue Ruling 2002-91
  - Brother-Sister Model
    - 12 or more insureds-Revenue Ruling 2002-90
    - Fewer may be acceptable, each must have between 5% and 15%
    - Limits on the types of entities that can be counted separately

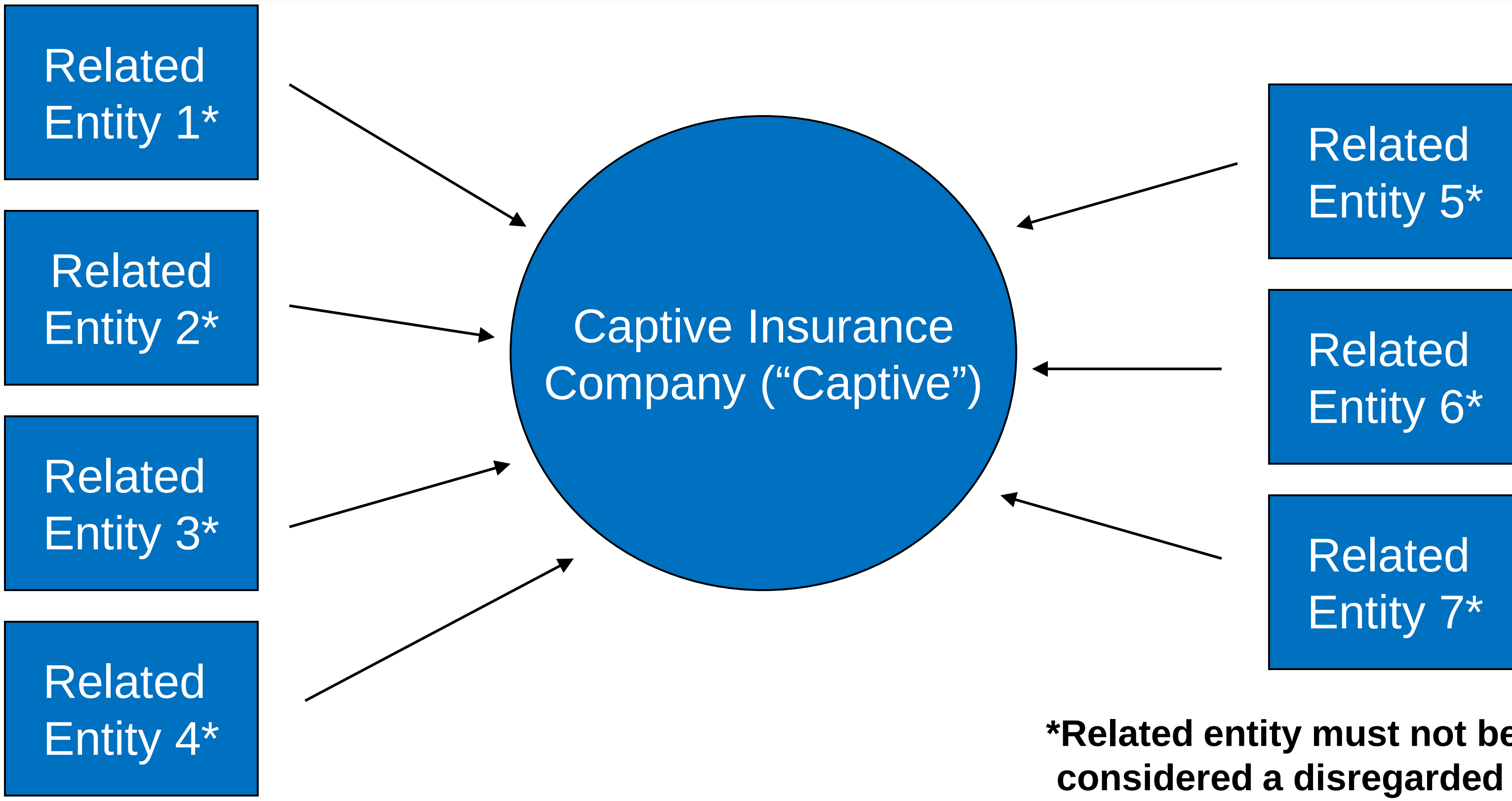
Achieving Risk Distribution under unrelated risk model



- Each Operating Business will pay 100% of its Captive premium to its Captive.
- Each captive then reinsures certain risks with the Pool, representing over 50% of risk and premium of the Captive.
- The Pool retrocedes to each Captive a quota share premium equal to the premium ceded from Captive to the pool.

•Example: Assume Operating Business A's captive pays \$200k to the Pool and that \$200k premium represents 2% of all premiums received by the Pool. The Pool will then pay Operating Business A's Captive \$200k to reinsure 2% of the Pool's total risk (i.e. 2% of all of the other participating Operating Businesses' risk).

Achieving Risk Distribution under brother sister model



***Related entity must not be considered a disregarded entity**

- Related entities pay premiums directly to the Captive for various lines of P&C insurance.
- Each Related Entity's premium cannot be less than 5% nor more than 15% of the total premiums received by the Captive.

CAPTIVE RESOURCES

MIJS
MOORE INGRAM JOHNSON & STEELE
A LIMITED LIABILITY PARTNERSHIP

Captive Insurance Company Policies

The insurance in a micro-captive is customized coverage designed to enhance, complement, and integrate with existing insurance policies. It is generally designed as first party liability and claims made policies.

- **Everything a business currently self-insures:**
  - **Deductibles**
  - **Excess losses above coverage limits**
  - **Environmental Liability**
- **Loss of income as a result of:**
  - **Losing key employee/salesperson**
  - **Loss of license/professional risks (professionals)**
  - **Loss of a key contract (Gov't. contractors)**
  - **Weather, terrorism, etc.**
- **Liability defense expenses:**
  - **Employee lawsuits – sexual harassment, wrongful termination, discrimination, etc.**
  - **Environmental issues**
  - **Professional claims**
- **Second A Fund for CRI Clients**

Examples of Captive Insurance Policies Written

- Professional liability Gap Coverage
- HIPAA/Billing Audit Liability
- Contractual Liability
- Cyber Liability
- Environmental Liability
- Excess Environmental Liability
- Labor Shortage/Strike Loss Reimbursement
- Employment Practices
- Employee Dishonesty
- Patent Infringement/Intellectual Property
- General Liability Gap
- Property Management Professional
- Professional Misconduct
- Product Recall
- FDA Administrative Actions Liability
- Product Liability Gap
- Directors and Officers Liability
- Punitive Damages
- Loss of Key Employee
- Wind Deductibles on Property

Tax Considerations

- Premiums are deductible when paid under IRC Sections 162 and 212
  - Assuming premiums are market comparable or can be valued by an actuary
- Taxation of CIC's profits
  - Income tax on investment income only
  - Minimum premium taxes
- Dividends from the micro-captive are taxed as qualified dividends when distributed and capital gains upon liquidation
- Retirement
  - Certain investments and structures could allow client to access CIC invested funds tax efficiently

Potential Savings- 5 Years - 2016 Law

	Captive Model								Non-Captive Scenario	
	Year 1	Year 2	Year 3	Year 4	Year 5	Total Captive Cash	Company Cash	Total Cash		
Premiums	$1,100,000	$1,100,000	$1,100,000	$1,100,000	$1,100,000	$5,500,000		$5,500,000	$5,500,000	No Premium paid
Claims	-50,000	-50,000	-50,000	-50,000	-50,000	-250,000	-250,000	-500,000	-250,000	Cost of claims
Claim Reimbursement							250,000	250,000		
Tax Savings (federal and state)							2,453,000		111,500	44.6%
Mgmt Fees	-75,000	-85,000	-85,000	-85,000	-85,000	-415,000		-415,000		
Tax benefit (Note)	0	0	0	0	0	0		0		
Net Cash	975,000	965,000	965,000	965,000	965,000	4,835,000	2,453,000	7,288,000	5,361,500	
Projected Net of Tax Earnings @ 3%	29,250	59,078	89,800	121,444	150,394	449,965	228,286	678,251	498,963	Earning @ 3% on after tax dollars
Projected Cash Balance Prior to liquidation						5,284,965	2,681,286	7,966,251	5,860,463	
Capital Gain Tax on Liquidation						-1,257,822		-1,257,822		23.8%
Net Cash Available						4,027,143	2,681,286	6,708,430	5,860,463	

Increase in Net Worth After All Expenses $847,966

Note: some portion of these fees would be deductible as investment expenses. Assumed $0 for conservatism.

Potential Savings- 5 Years - 2017 Law

	Captive Model								Non-Captive Scenario	
	Year 1	Year 2	Year 3	Year 4	Year 5	Total Captive Cash	Company Cash	Total Cash		
Premiums	$2,100,000	$2,100,000	$2,100,000	$2,100,000	$2,100,000	$10,500,000		$10,500,000	$10,500,000	No Premium paid
Claims	-75,000	-75,000	-75,000	-75,000	-75,000	-375,000	-375,000	-750,000	-375,000	Cost of claims
Claim Reimbursement							375,000	375,000		
Tax Savings (federal and state)							4,683,000		167,250	44.6%
Mgmt Fees	-75,000	-85,000	-85,000	-85,000	-85,000	-415,000		-415,000		
Tax benefit (Note)	0	0	0	0	0	0		0		
Net Cash	1,950,000	1,940,000	1,940,000	1,940,000	1,940,000	9,710,000	4,683,000	14,393,000	10,292,250	
Projected Net of Tax Earnings @ 3%	58,500	118,455	180,209	243,815	302,015	902,993	435,501	1,338,495	957,141	Earning @ 3% on after tax dollars
Projected Cash Balance Prior to liquidation						10,612,993 0	5,118,501 0	15,731,495	11,249,391	
Capital Gain Tax on Liquidation						-2,525,892		-2,525,892		23.8%
Net Cash Available						8,087,101	5,118,501	13,205,602	11,249,391	

Increase in Net Worth After All Expenses **$1,956,212**

Note: some portion of these fees would be deductible as investment expenses. Assumed $0 for conservatism.

Expenses

- Initial feasibility study at no charge
- Implementation costs: $60,000 to $75,000
- Annual costs: $70,000 to $85,000-paid by captive
- No additional fees for corporate tax planning or legal work with MIJS
- Lower fees for multiple captives for one organization

About the Captive

- Annual Board meeting conducted via teleconference
- Multiple state domiciles available
- Owner of captive need not be insured corporation
- Investments individually managed, but must meet regulatory guidelines; bank could manage
- Utilizing Ernst & Young for 831(b) tax preparation
- Utilizing Pinnacle Actuarial Resources for premium support

Why use Captive Resources and MIJS?

- Former Ernst & Young ("EY") Insurance Tax partner heads up Captive Resources team
- Captive Resources is the preeminent captive service provider
- MIJS law firm has extensive expertise and attention to all details; also, their insurance partners can design custom policies
- Terrorism pool pricing and structure has been reviewed by IRS and two actuarial firms
- MIJS legal expertise is included in costs
- High quality actuarial service provider (Pinnacle Actuarial Resources) and tax firm (EY) included in team
- MIJS has an excellent relationship with the IRS
- Costs are frozen and never increase
- No costs to eventually terminate program
- Use your own investment advisors

Next Steps

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