



NJ RIMS

WHAT'S NEW WITH CAPTIVE INSURERS

FEBRUARY 14, 2012 CHAPTER MEETING

The OLDE MILL Inn, Basking Ridge, New Jersey

Introductions

Here With You Today:

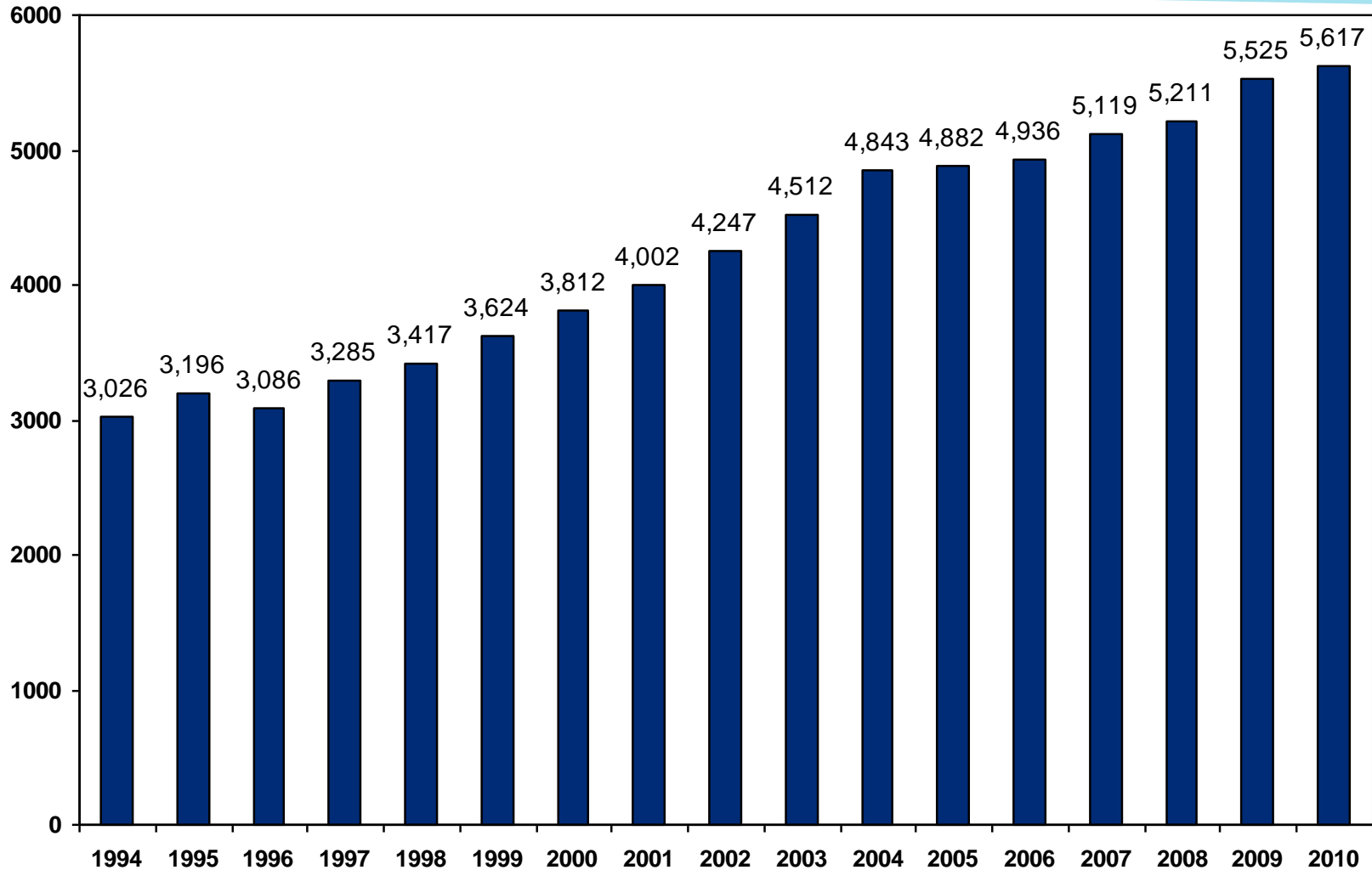
- **Moderator:**

- Anita DiGiulio, Director, Insurance and Risk Management, The Hartz Group, Inc

- **Speakers:**

- Michael Serricchio, SVP, Marsh Captive Advisory Group
- Cynthia Borrelli, Partner, Insurance Practice Group, Bressler Amery & Ross
- Terry Gorman, Consultant, American Benefits Consulting

Number of Captives Worldwide as of 2010



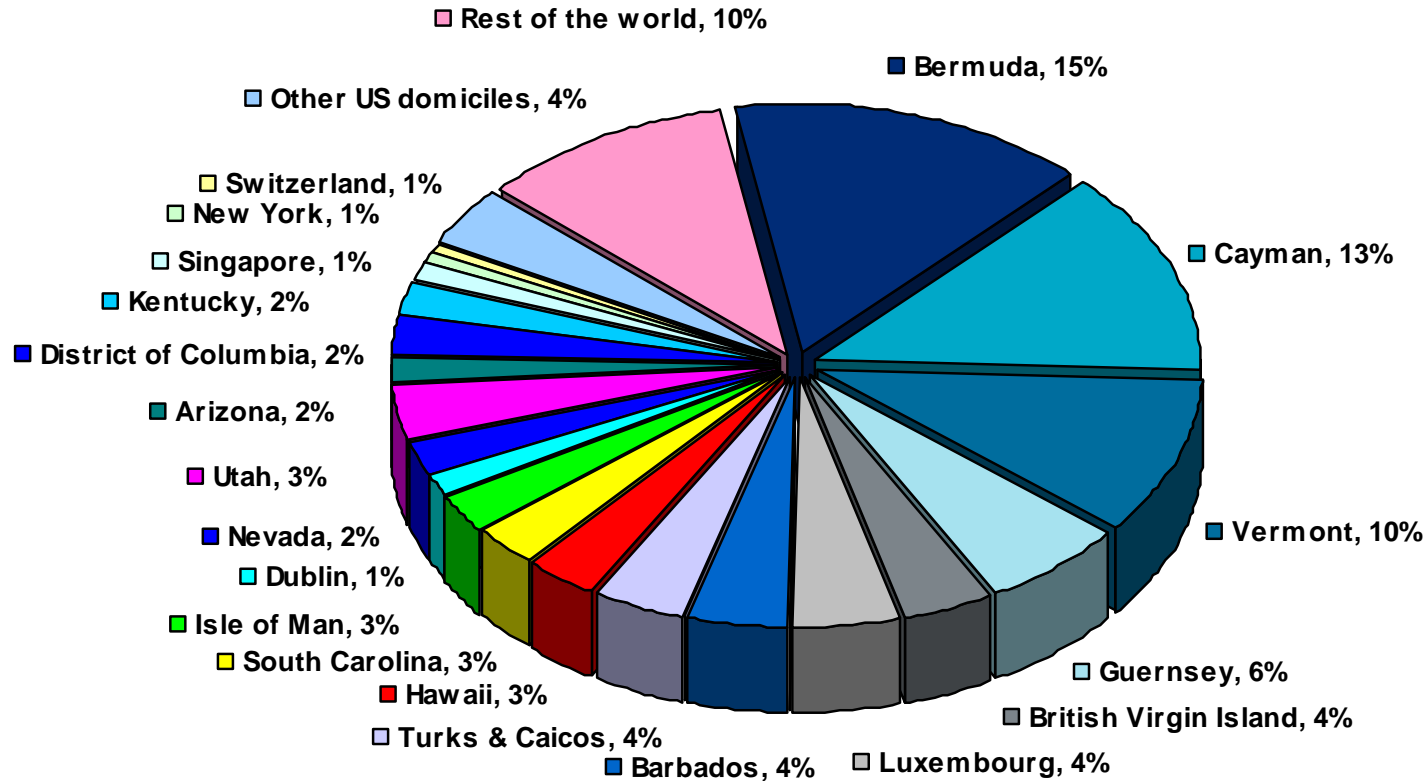
Source: Business Insurance Magazine, March 2011

Types of Captives

- **Single-Parent Captive** (largest sector):
 - Wholly owned by one parent company
 - Insures or reinsures the risks of its parent, affiliated entities, or chosen unrelated parties
- **Branch Captive:**
 - A division of a single parent captive that is usually formed in the U.S. (as a branch of a Bermuda or Cayman captive)
 - Allows a company access to TRIA and U.S. employee benefit coverages that are required to be in a U.S. domicile
- **Group/Association:**
 - Owned by multiple companies or an association, and insures or reinsures the risks of the group
- **Risk Retention Group:**
 - Regulated under federal legislation, licensed in one state, and able to operate in all 50 states on a registered basis
 - Can only write liability lines of risk (not WC)
 - Pending legislation may permit for RRGs to directly insure property coverage
- **Protected Cell Captives (PCC) or Cell Captives:**
 - Insures or reinsures the risks of unrelated parties, whereby insureds are “renting” capacity
 - Typically structured as PCCs

Marsh Captive Solutions Group

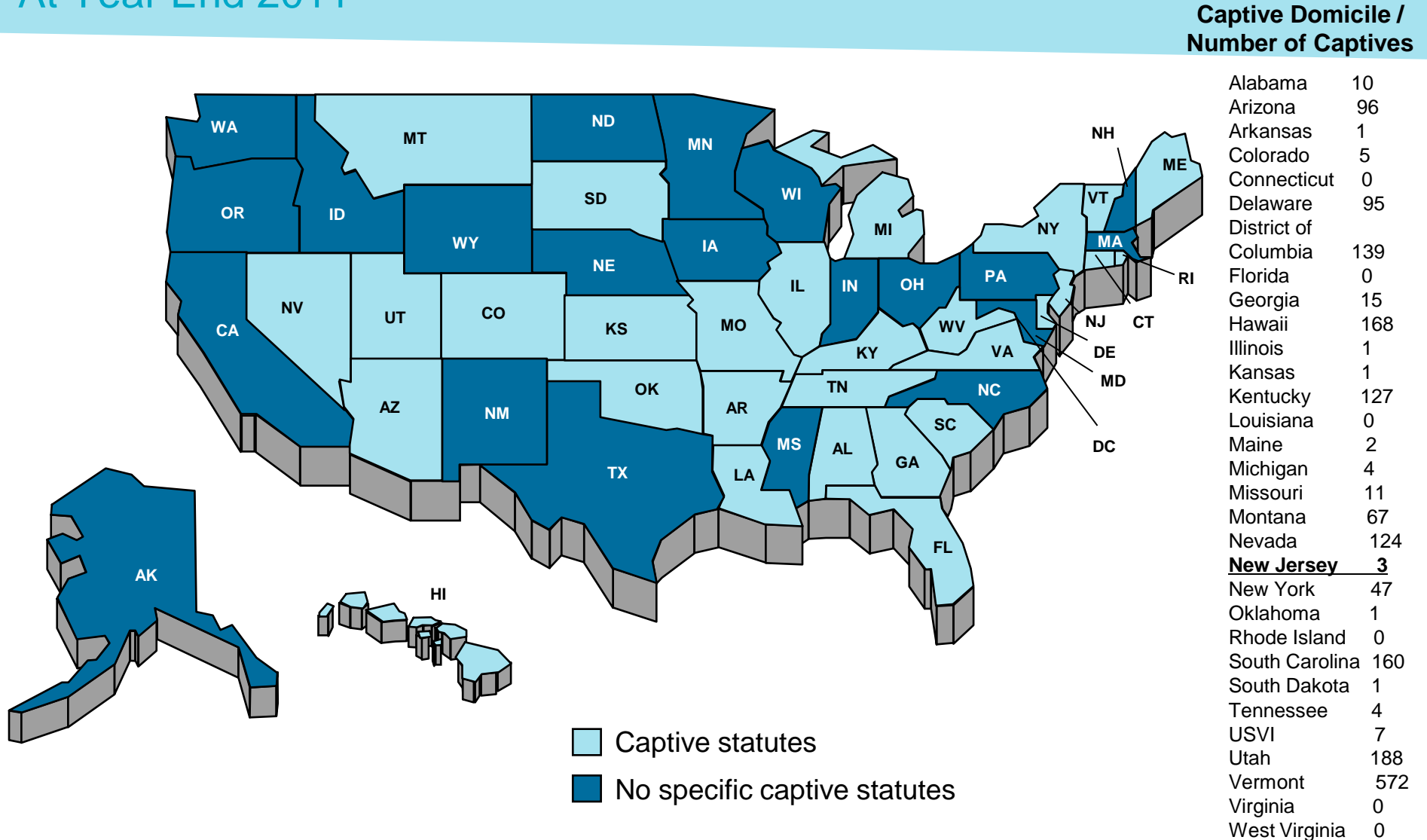
Active Captives by Domicile – Year End 2010



Total Active Captives: 5,617

Source: Business Insurance Magazine, March 2011

U.S. Domestic Captive Domiciles At Year End 2011



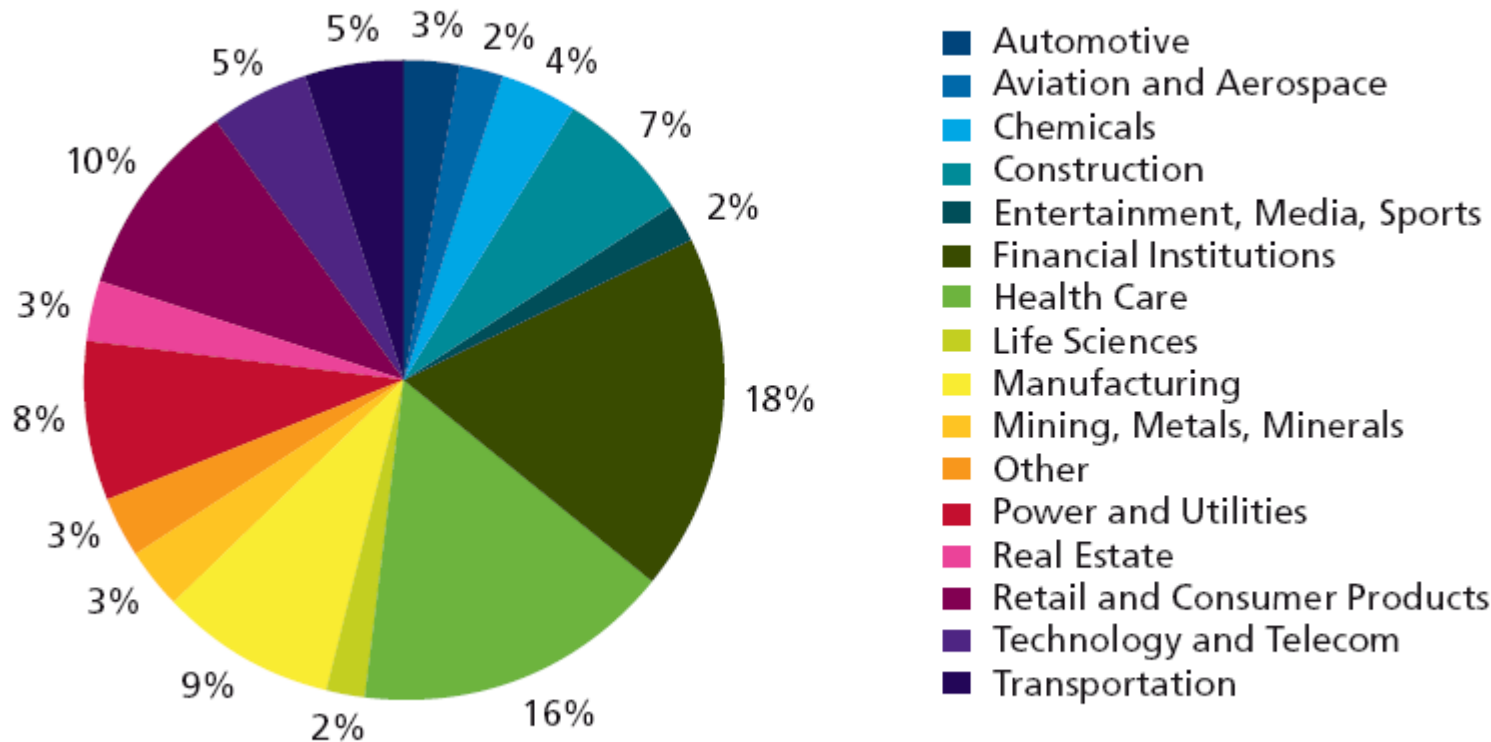
Captive Trends – 2011

- The Dodd-Frank Act of 2010
- Domicile trends:
 - Emerging jurisdictions, U.S. states – New Jersey and others
 - E.U. direct writing captives (slow with uncertainty of Solvency II)
- Solvency II
- Intercompany investments – access to captive's cash
- Unrelated risks in captives:
 - Employee Benefits:
 - U.S. companies: 30
 - Post-retirement benefits
 - Multinational pooling of global benefits
 - Voluntary benefits – payroll deduct
 - Customers, vendors, and independent contractors
 - Profit center:
 - Extended warranty, customer, vendor
- AM Best Ratings and other ratings
- Review of tax deductibility issues and recent IRS developments/guidance

Marsh's Captive Solutions Group

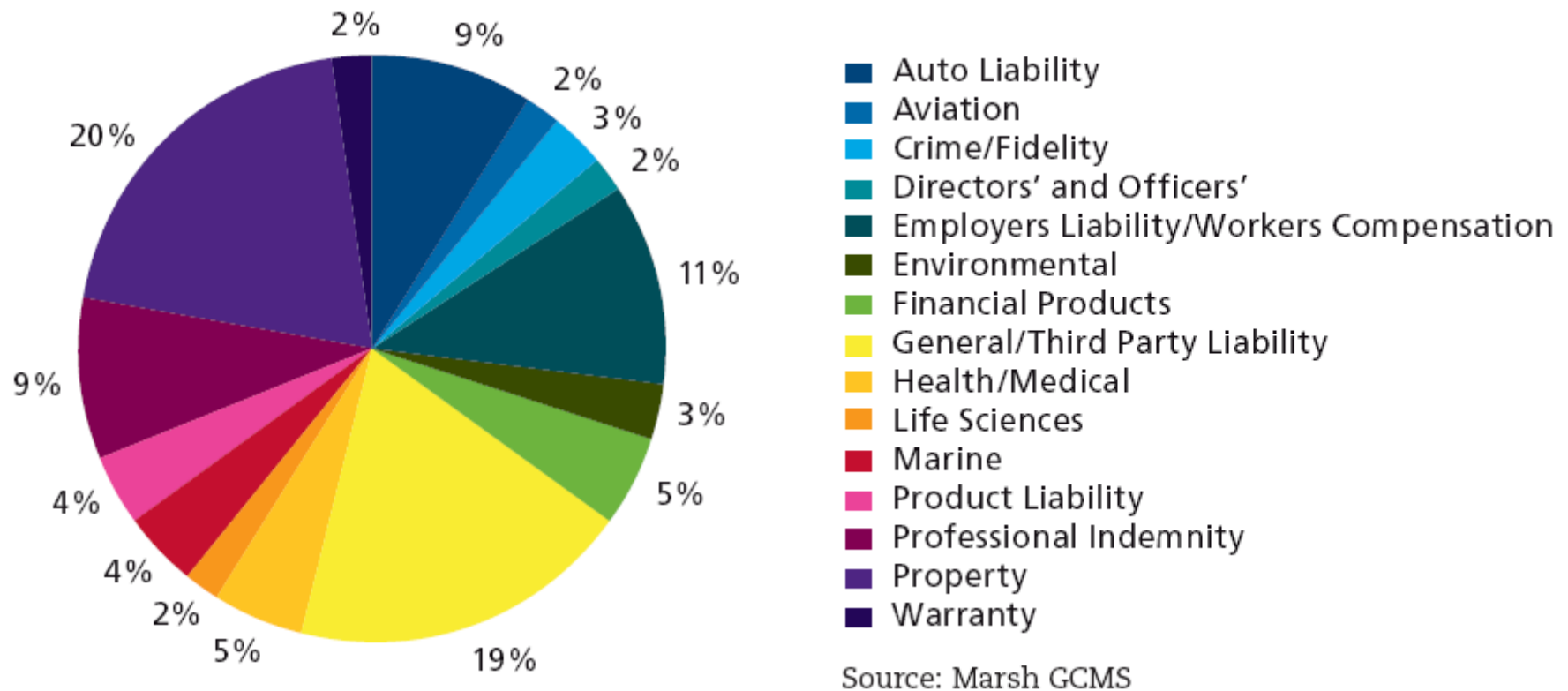
Captive Utilization by Industry Sector

Source: Marsh Global Captive Management System (GCMS)



Note: Other includes Education, Forest Products, Hospitality and Gaming and Public Entity sectors.

Marsh's Captive Solutions Group (Re)Insurance Lines Underwritten By Captives in 2010



Captive Frictional Cost Estimates

Category	Fees	Cost
Startup Costs:	Implementation Fee	\$20,000
Excludes FIN 48 Memorandum or other tax/legal advice	Application Fee	\$200
	Actuarial Certification	\$10,000
	Legal Fees	\$5,000
	Incorporation Fee	\$75
	Domicile Organization Tax	\$50
	TOTAL	
Annual Operating Costs:	Management Fee	\$65,000
	Actuarial Certification	\$20,000
	Audit Fee	\$25,000
	Legal Fees	\$7,000
	License	\$300
	Miscellaneous	\$4,700
	Regulatory Exam	\$3,000
TOTAL		\$125,000

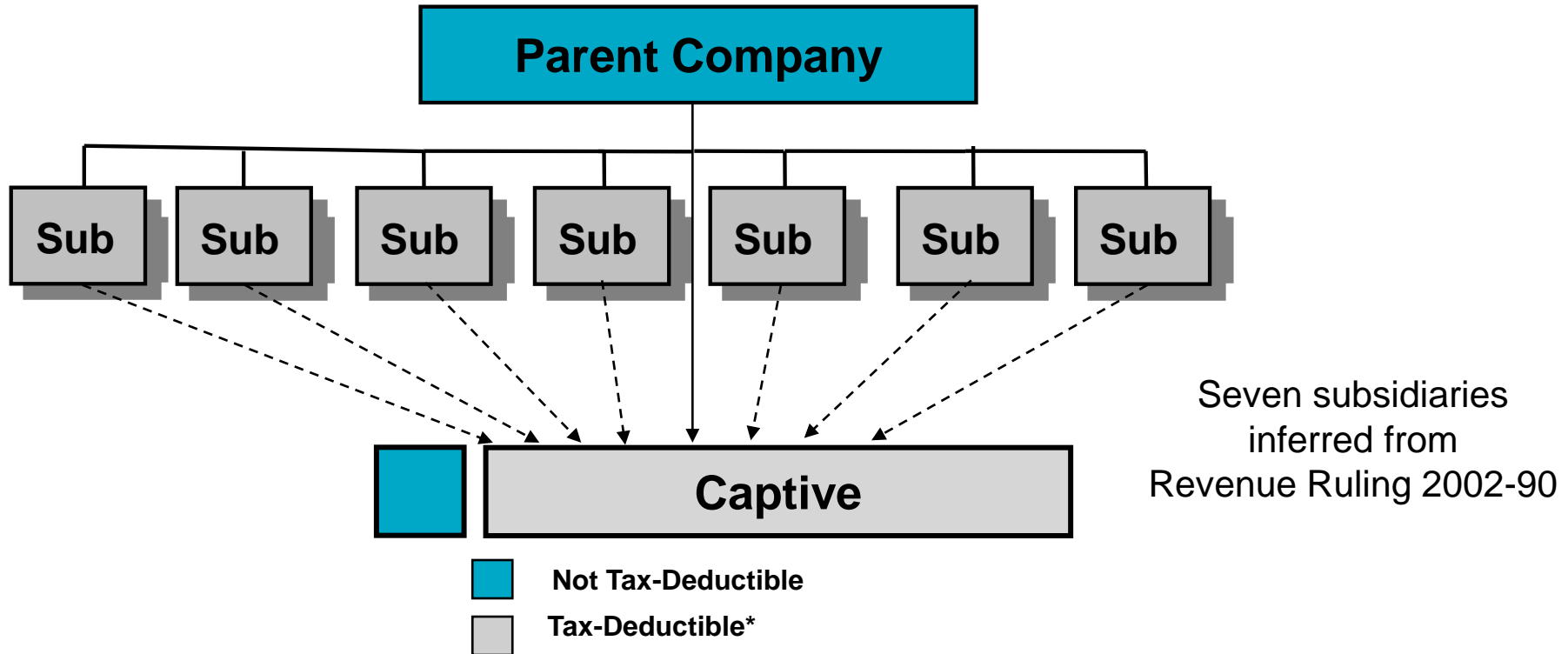
When Does a Traditional Captive “Fit”

- High casualty retentions and loss projections
- Uninsurable or costly insurance program
- Accelerated tax deductions on reserves
 - Brother-sister organization structure with captive; or
 - Significant source of unrelated risk—30 to 50 percent required
- Parent company is a tax-paying entity
- When subsidiaries need lower retentions than parent assumes
- Where company needs to reduce non-U.S. fronting fees:
 - E.U. direct writing captive
- Top-line growth from customer insurance programs
- Company needs access to reinsurance markets directly
- Not for profit companies want to lower insurance costs

Tax Issues – Qualification for Federal Tax Purposes

- Definition of Insurance
 - Risk Shifting
 - Legitimate Transfer of Economic Consequences to Insurer
 - Factors, e.g., Adequate Capitalization, Parental Guarantees / Loan-backs, etc.
 - Risk Distribution
 1. “Brother-Sister” Arrangements 7 – 12 entities
 2. Third-Party Risk / Pooled Risk

Supporting Favorable Tax Treatment: Risk Distribution Brother-Sister Approach



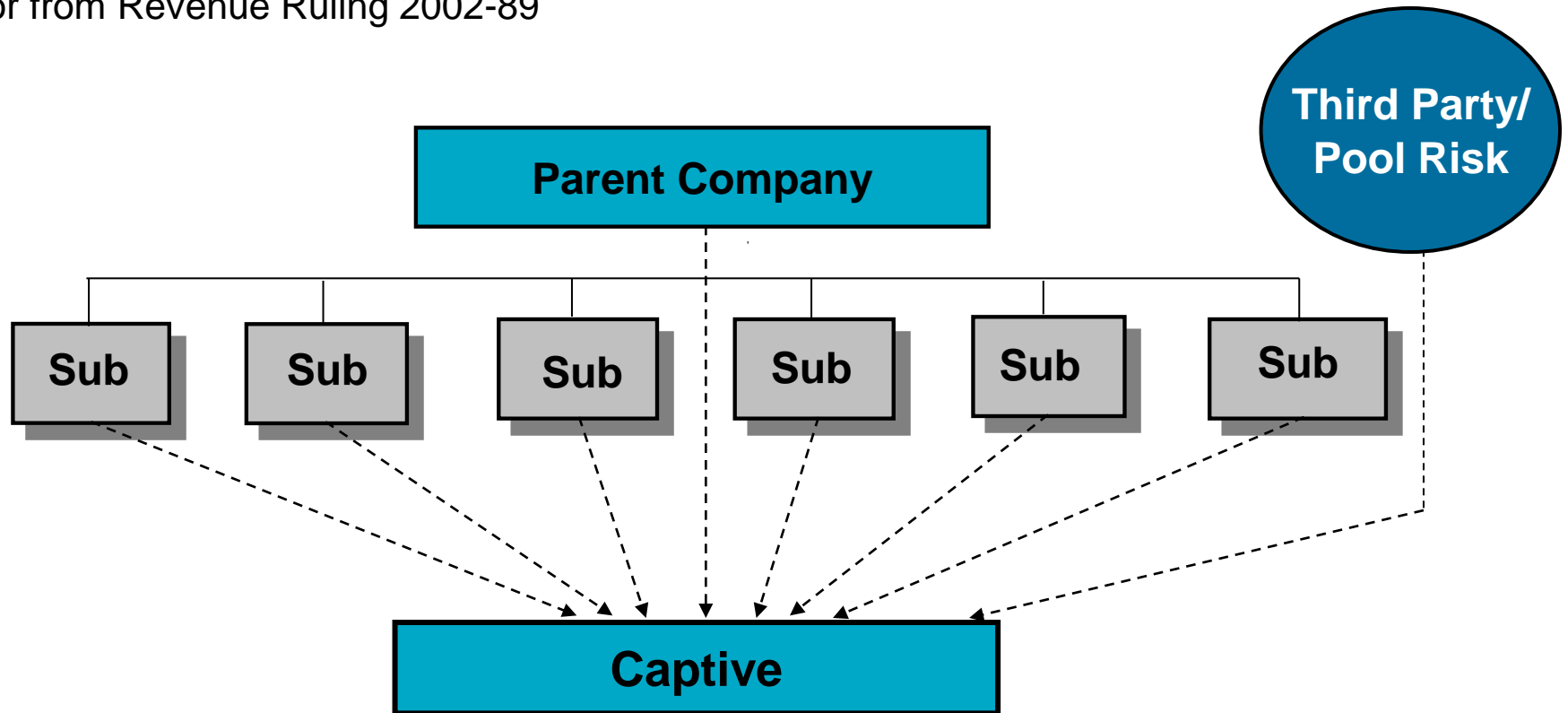
-----> Premium Payments

*Note: Subsidiaries must be legal C corporations or other qualifying "associations" but NOT disregarded entities for tax purposes

Supporting Favorable Tax Treatment: Risk Distribution

Traditional Captive Structure: Third Party Risk

50% unrelated risk stated as a safe harbor from Revenue Ruling 2002-89



-----> Premium Payments

Tax-Deductible

Insurance Taxation

Tax Position of Captives

Insurance Company for Federal Income Tax Purposes

- Premium payments are tax deductible
- Captive recognizes income
- Captive recognizes deduction for loss reserves on discounted basis
- Position supported through precedent setting case law

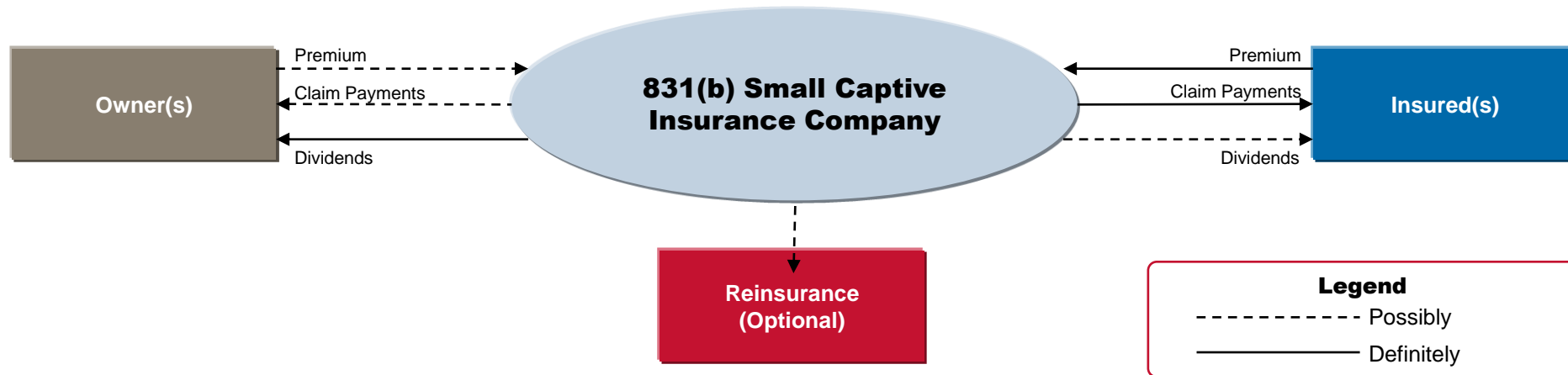
Self Insurance Model – Deposit Accounting

- Payments are non-tax deductible
- No tax deduction for loss reserves
- Claims are tax deductible when paid

Small Captives: “Mini” Tax-Advantaged Captives

- Internal Revenue Code Section 831(b) “Mini” captive
 - Election available to captives that qualify as insurer for tax purposes—must have risk shifting and risk distribution
 - Allows captive to be taxed on investment income only, i.e., no underwriting income taxation
 - Can make election if “net written premiums” for the taxable year do not exceed \$1,200,000 in all captive entities under same ownership
 - Ideal for low-frequency/ high-severity losses (e.g., property)
 - Less ideal for captives designed to break even (e.g., WC)
 - What’s It Worth?
 - \$1.2M x 40% tax rate = **\$480,000** (less captive expenses)

831(b): How it Works



- Premium(s) deductible.
- Premium income accumulated tax free.
- Investment income taxed as ordinary income.
- Dividends taxed capital gains rate.
- Claim payments are tax neutral.

Small Captives and Estate Planning

- Must have risk shifting and risk distribution
- Applies for family-owned privately held captives
- Captive owned by heirs
- Tax rate arbitrage by shifting wealth from higher tax rate individuals to lower tax rate individuals
- Savings optimized when captive insures low-frequency/ high-severity risks, which may produce more significant underwriting profits

This document and any recommendations, analysis, or advice provided by Marsh (collectively, the “Marsh Analysis”) are intended solely for the entity identified as the recipient herein (“you”). This document contains proprietary, confidential information of Marsh and may not be shared with any third party, including other insurance producers, without Marsh’s prior written consent. Any statements concerning actuarial, tax, accounting, or legal matters are based solely on our experience as insurance brokers and risk consultants and are not to be relied upon as actuarial, accounting, tax, or legal advice, for which you should consult your own professional advisors. Any modeling, analytics, or projections are subject to inherent uncertainty, and the Marsh Analysis could be materially affected if any underlying assumptions, conditions, information, or factors are inaccurate or incomplete or should change. The information contained herein is based on sources we believe reliable, but we make no representation or warranty as to its accuracy. Except as may be set forth in an agreement between you and Marsh, Marsh shall have no obligation to update the Marsh Analysis and shall have no liability to you or any other party with regard to the Marsh Analysis or to any services provided by a third party to you or Marsh. Marsh makes no representation or warranty concerning the application of policy wordings or the financial condition or solvency of insurers or reinsurers. Marsh makes no assurances regarding the availability, cost, or terms of insurance coverage.

Copyright 2012 Marsh Inc. All rights reserved.

New Jersey Captive Laws

- Cynthia Borrelli, Partner, Insurance Practice Group, Bressler Amery & Ross

Implementation of NJ Captive Laws: A One-Year Update

- New Jersey Captive laws were enacted on February 21, 2011 and became effective on May 23, 2011.
- Modeled after the Vermont Captive laws
- Provide for the creation of pure, association, industrial, branch and sponsored (protected) cell Captives:
 - A Pure Captive may be incorporated as a stock insurer, for profit or not for profit or an LLC
 - An Association or Industrial Captive may be a stock or mutual corporation, a reciprocal or an LLC

Implementation of NJ Captive Laws (Continued)

- Permit Captives to insure a variety of risks: life, health, annuities, indemnity, property and casualty, fidelity, guaranty and title. NJDOBI is also considering adding sureties to the list of acceptable risks.
 - Captives may not write private passenger automobile or homeowners insurance but they may cede and accept reinsurance for those risks
 - Captives may provide excess worker's compensation insurance and may reinsure worker's compensation of a qualified self-insured plan of its parent and affiliated companies and, further, may insure deductibles/SIRs for worker's compensation
- Captive must maintain its principal place of business in New Jersey with the appropriate number of in-state professional services provider staff to carry out the business of the Captive, including, but not limited to, attorneys, accountants, managers, actuaries, brokers and third party administrators.

NJ Regulatory Contact Details

- Crosby.Sherman@dobi.state.nj.us
 - (609) 292-7272 x-50503
- John.Tally@dobi.state.nj.us
 - (609) 292-7272 x 50220
- Captive Corner – website to access forms, regulations, statutes, etc.
 - http://www.state.nj.us/dobi/division_insurance/captive/index.html

Application Process

- **Step 1 : Pre-application Process**

- Contact the NJDOBI Captive Unit to schedule an initial meeting to discuss the proposed Captive, whether newly created or re-domesticated from another jurisdiction.
- At the initial meeting, applicants should be prepared to discuss the Captive parent, the proposed type of Captive to be organized, the proposed risk(s) to be insured by the Captive, the proposed corporate governance of the Captive and the application costs to be paid upon submission of the formal application.
- After the initial meeting, submit a pro forma application based upon the admission or re-domestication packet. Copies are located on the NJDOBI website link a at the end of this outline.
- After review of the pro forma and any necessary discussions, the Captive Unit will then request filing of the formal application.

Application Process (Continued)

- **Step 2 : The Application (N.J.S.A. 17:47B-2)**
 - Application packets can be downloaded from the NJDOBI Captive Unit website and require identification and/or inclusion of the following:
 - Identification of the Captive structure (e.g., pure captive, group captive)
 - Identification of the type of organization (e.g., LLC)
 - Organization documents, such as Articles of Incorporation (or Association), Bylaws (or Memorandum of Understanding)
 - Identification of the members of the Captive's Board of Directors, Officers – submit Biographical Affidavits for each.
 - Business Plan (e.g., coverage limits, rates; liquidity relative to risks; loss control)
 - Plans to satisfy actuarial, audit, financial, other requirements

Application Process (Continued)

- Identification of bank, investment accounts
 - Investments must comply with rules prescribed by Commissioner
 - Investments in, loans to affiliates must be approved by Commissioner
- Evidence of capitalization, cash, surplus requirements, *i.e.*:
 - Pure Captive: Minimum \$250,000
 - Association Captive: Minimum \$750,000
 - Industrial Insured/Sponsored Captive: Minimum \$500,000
- Application costs are non-refundable. The cost includes the post-operational examination performed after the Certificate of Authority is issued.
- Business formation documents shall be submitted to the NJDOBI Captive Unit, including filing fees. Checks must be made out to Treasurer, State of New Jersey. These documents will be filed directly by the Captive Unit.

Application Process (Continued)

- Confirmation that the proposed name of the Captive is available in New Jersey. The Captive Unit may review national databases to determine if a similar name is used in the insurance industry.
- See N.J.S.A. 17:47B-1, et seq. and NJDOBI Bulletin 11-08 for more detailed information
- Under N.J.S.A. 17:47B-2(b)(3), the Application information and documents shall be kept confidential.
- Under N.J.S.A. 17:47B-7(b), the information, documents and other material obtained and provided during an organizational or periodic examination shall be kept confidential.

Management and Governance Requirements

- Sarbanes Oxley
 - Type of Captive (e.g., Pure, Association, Industrial, Sponsored/Cell)
 - Committees (e.g., Underwriting, Risk Control, Finance, Audit)
- Corporate Books and Records / Financial Statements
- Annual Meetings, Annual Audit
 - Annual Report of Financial Condition
 - State Examination Every 3-5 Years
 - Annual Meeting Must be in New Jersey
- Regulatory Reports, Compliance
 - Local Service Providers
- Contracts with Service Providers
 - Accountants/Auditors/Actuaries/Captive Managers/Brokers/TPAs
- Policy Issuance
 - Arm's Length Pricing
 - Reinsurance Contracts
 - Fronting Arrangements.

Re-domestication of Existing Captive

- Call or e-mail NJDOBI to arrange a meeting with its Captive Unit to discuss.
- Bring to the meeting prepared drafts of the necessary admissions documents (“Admissions Packet”) found on NJDOBI website
- File certificates of business formation and pay applicable business formation fees to Treasurer, State of NJ
- Select NJ registered service providers, *i.e.*, captive manager, CPA and actuary
- Petition Commissioner to issue a Certificate of Public Good
- After the business formation documents are processed by the Department of Treasury, Division of Revenue, the NJDOBI will issue to qualified applicants a Certificate of Authority and forward to the applicant a stamped “Filed” copy of the business formation documents.

Re-domestication of Existing Captive (Continued)

- Turn around time for NJDOBI is ten days from the application being deemed complete.
 - Expedited procedures prescribed by regulation
- After Certificate of Authority is issued:
 - Formally appoint a New Jersey registered captive manager, CPA and actuary
 - An organizational exam **may be** performed by NJDOBI. If so, the applicant incurs the cost of the exam.
 - Structural Options
 - Merger, redomestication, new/runoff, assumption reinsurance
 - Regulatory approvals (former jurisdiction, new jurisdiction)
 - Additional Capital, Expense
 - Shut Down

Advantages to a New Jersey Captive Domicile

- Geographical Convenience
 - NJ is strategically located between New York and D.C. within close proximity to numerous Fortune 500 companies
 - Access to sophisticated financial service providers
- NJ headquartered companies may obtain additional benefits of scale by also domiciling their Captive in NJ
- Competitive Premium Tax Rates:
 - Tax on Direct Premiums – Rates
 - .38% on first \$20 million, plus
 - .285% on next \$20 million, plus
 - .072% on each dollar thereafter

Advantages to a New Jersey Captive Domicile (Continued)

- Tax on Reinsurance Premiums – Rates
 - .214% on first \$20 million, plus
 - .143% on next \$20 million, plus
 - .048% on next \$20 million, plus
 - .024% on each dollar thereafter
- Minimum / Maximum Amounts
 - Annual minimum aggregate tax is \$7,500
 - Annual maximum aggregate tax is \$200,000
- Various Deductions Allowed
- Department Accessibility
 - Dedicated Captive regulatory staff that are responsive to needs of those wishing to form or already have a Captive
- Legislative Backing
 - Unanimous bipartisan support of NJ lawmakers.

Tax Issues Incident To Re-domestications

- PLR 201108025 (Re-domestication)
 - Parent owns operating companies and Oldco
 - Old company is a foreign insurance company in country “X” that elected to be taxed as a U.S. company under Sec. 953(d)
 - Oldco followed the laws in country “X” and country “Y” to change to country “Y” corporation
 - Ruling
 - The IRS ruled that because this was an “F” reorganization:
 - The reorganization is tax-free
 - The taxable year does not end; it continues
 - The section 953(d) election continues

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

- Bill focused on banks, but legislation will affect insurance companies
- Provisions titled “Non-admitted Reinsurance and Reform Act of 2010” becomes effective twelve months after enactment:
 - Takes effect July 2011
- Will prohibit any state, other than the home state, from charging premium tax for non-admitted insurance
- Placement of non-admitted insurance and surplus line broker licensing will be handled by the insured’s home state
- What does this mean for your captive?
 - Many captive owners may not remit self procurement tax at the moment, and they may continue to take such a position
 - The Act is raising awareness on the fact that the tax provides a source of revenue for the states, and clients should keep that in mind looking forward
 - Presently, there is a lot of uncertainty of how various states are going to pursue and/or enforce self procurement tax – Marsh will keep you apprised on developments

Potential Application Of Dodd-Frank/NRRA: Regulates the “Non-Admitted Market” – Does It Include Captives?

- There are three types of placements plus captive insurance or self-insurance:
 - **A. LICENSED PLACEMENT**, *i.e.*, “admitted” business
 - “Doing business laws” limit the ability of unlicensed companies to do business in the state
 - Factors (e.g., N.Y. Ins. Law Sec. 1101(b)(1))
 - Solicitation, Underwriting, Claims handling, Negotiating
 - Licensed companies permitted to conduct business in the state
 - Generally, access through agents and brokers
 - Absolute power to regulate
 - Tax on premiums imposed on insurer
 - **B. SURPLUS LINES PLACEMENT**
 - Exception to doing business law
 - Regulation through comprehensive state regulation of surplus lines brokers
 - Generally, affidavit filed by surplus lines broker
 - Diligent search
 - Declination (s)
 - Surplus tax imposed on insured/remitted by surplus lines brokers

NRRA (Continued)

- **C. DIRECT PROCUREMENT / INDEPENDENTLY PROCURED INSURANCE**

- Contemplates insured directly accessing insurers
- Statutory provisions
 - Direct placement laws
 - Industrial insured exemptions
 - Non-statutory provisions
 - Case Law: Cases have addressed the state power to tax direct placements
- Application
 - Generally applicable to payments made by insured within a state to a non-admitted insurer domiciled in another state. Question is whether a captive is a non-admitted insurer.
 - Associated tax (*i.e.*, “Self Procurement” tax) imposed generally on insured

NRRA (Continued)

- **Self-Procurement Tax**
 - Procurement of insurance from non-admitted insurer
 - 5% tax on gross written premium
 - 34 states have similar provisions
- **Goals of the NRRA, effective July 2011**
 - Uniform System for Surplus Lines / Procurement Tax Regulation
 - Goal: Eliminate inefficiencies of multi-state system
 - Only home state may tax out-of-state, non-admitted insurance, including captives. See Sec. 521.
 - Interstate compact to collect, distribute taxes where risks located
 - **Does it apply to captives as non-admitted insurance or only surplus lines?**

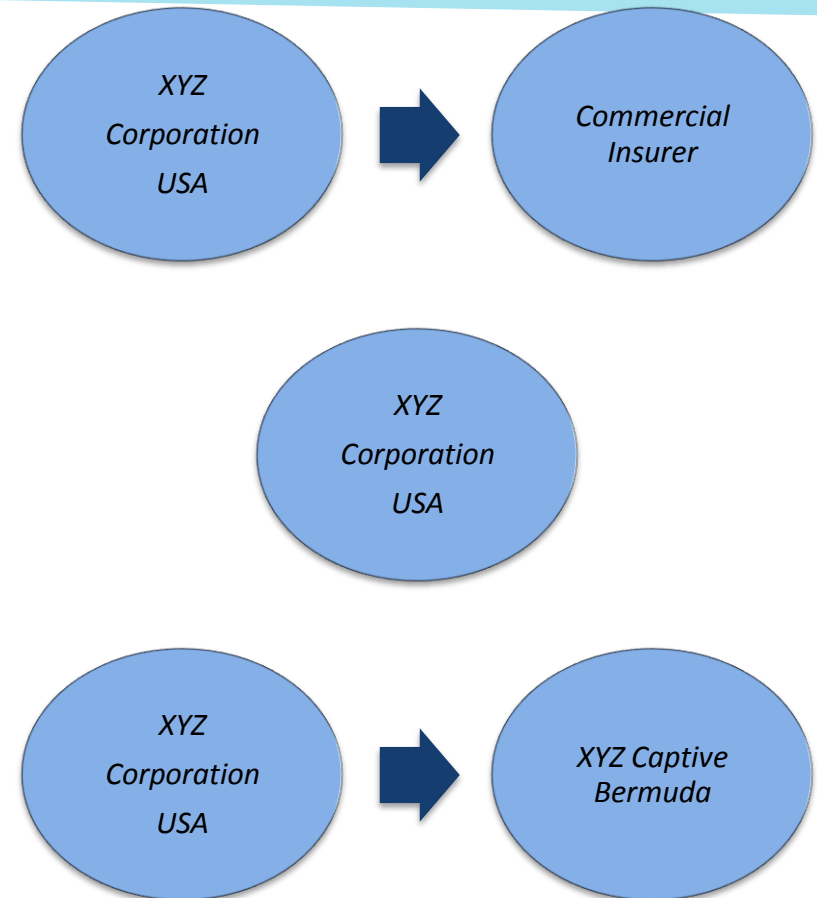
Employee Benefits and Captives

- Terry Gorman, Consultant, American Benefits Consulting

Captive Opportunity Overview

Benefit Risk Alternatives

- Commercial Insurer
 - Cash leaves corporation
 - Risk leaves corporation
 - Premium is tax deductible
 - State regulation may be onerous
- Self-Insurance Pay-as-you-go
 - Cash stays within corporation
 - Risk stays in corporation
 - Only claims payments are deductible
- Captive Insurer
 - Cash stays within corporation
 - Risk stays within corporation
 - Premium (claims & reserves) may be deductible
 - Captive insurer regulation is more relaxed
 - Captive has access to risk data and reinsurance markets



Captive Opportunity Overview

- The Department of Labor (DOL) will allow ERISA Benefits to be re-insured by a Corporation's Captive Subsidiary, through the issuance of a Prohibited Transaction Exemption (PTE) and the addition of benefits enhancements. There have been 30 PTE's issued thus far
- Filing and gaining approval for a PTE can be performed via expedited processing (EXPRO), for some benefit plans, thanks to the initial filings of Columbia Energy and Archer Daniels Midland (accomplished in 78 days)
- DOL Requirements include:
 - A benefit enhancement
 - An annual Independent Fiduciary review verifying market value rates and adequate reserve levels
 - U.S. domiciled Captive or U.S. branch is required
 - Captive must be at least 1 year old
 - Benefit must be fronted by an A rated (A.M. Best) or better Insurance Carrier
- Coca-Cola recently got permission to reinsure post-retirement medical funding through their Captive

Captive Opportunity Overview

- Group Personal Lines (Auto & Home) Program is also an excellent source for unrelated third party premium
 - Non-ERISA benefit
 - No Department of Labor (DOL) Approval Required
 - IRS Approved
 - Provides reasonable underwriting income which is generally profitable
- International Benefits and Multi-National pooling arrangements
- Group Benefits can provide:
 - Predictable unrelated third party premium and cash flow to the Captive
 - Potential for significant tax benefits
 - A generally stable risk for the Captive
- Reinsuring welfare Benefits through a Captive can better help manage Corporate and employee insurance costs but can't happen without cooperation between Benefit and Risk departments

Captive Opportunity Overview

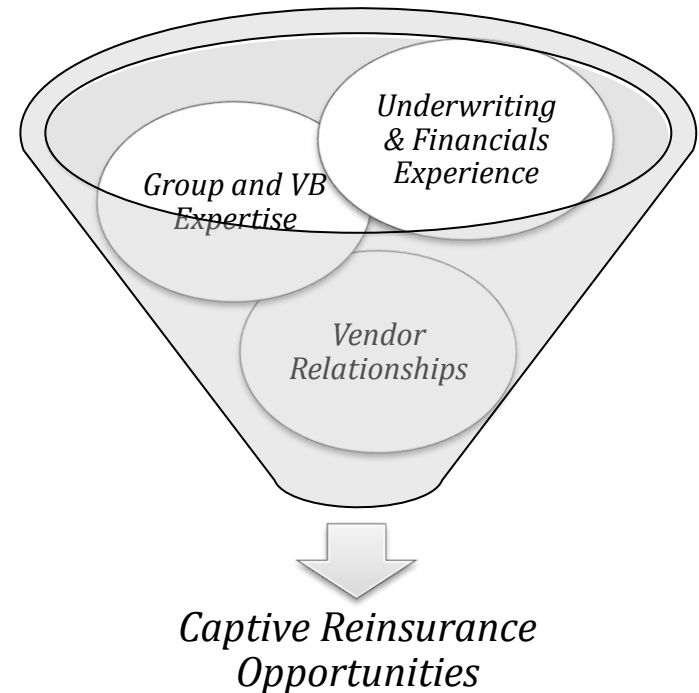
Benefits Analysis

- Life and Accident Insurance
 - Good tax opportunity
 - Without tax opportunity, use to accomplish any desired risk share
 - Retiree life may present good tax and cash opportunity
- Disability (LTD) Insurance
 - Good tax opportunity
 - Good for IDM or absence management programs if workers comp in captive
 - Can be a good cash opportunity for parent
 - Opportunity for Captive to manage investment of large, long-term reserves
 - Presents likely companion to workers comp in the captive
 - Unifies occupation and non-occupation leave liabilities in one financial tool
- Medical and Dental
 - Generally self-insured
 - Highly transactional nature and necessary state regulated policy make these programs potentially unattractive
- Personal Lines (Group Auto & Home)
 - Not subject to ERISA or DOL approval
 - IRS approved
 - Good cash flow and underwriting income

Required Expertise

Captive Reinsurance Experience

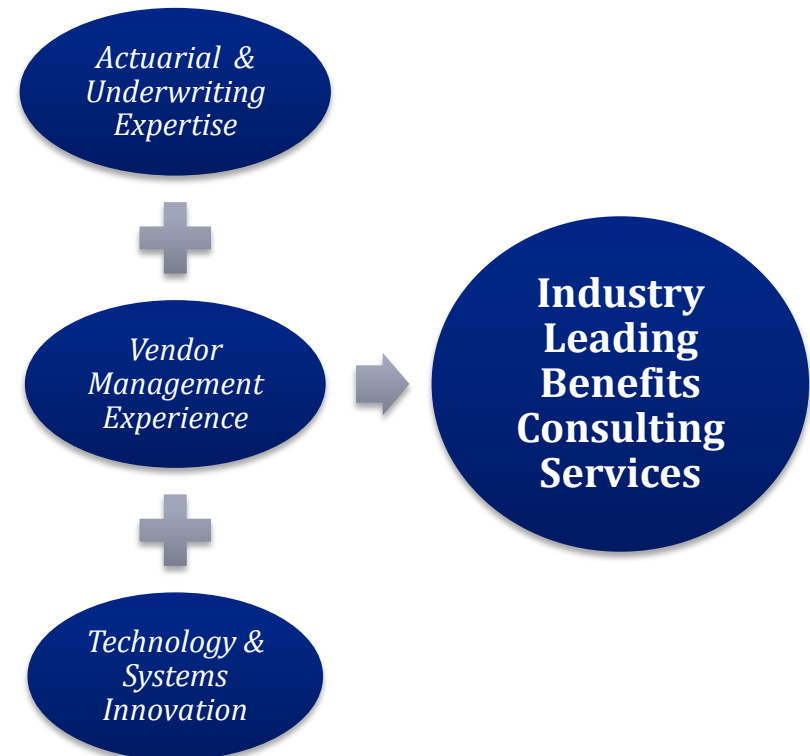
- Analysis of current Captive Arrangements
 - Holistic review of entire captive relationship to determine whether non-standard coverages should be placed into a captive subsidiary
 - Actuarial staff has significant captive experience
- Prohibited Transaction Exemption experience
 - Reinsurance of welfare benefit plans within clients' captive subsidiaries
 - Recommendations are based on needs/benefit/cost analysis, not “trend du jour”
 - ABC has helped clients navigate through the DOL Prohibited Transaction Exemption process with respect to benefit design and enhancement
- Benefits commonly placed in Captives include:
 - Group Basic and Supplemental Life plans
 - Group Auto and Home
 - Group Long Term Disability



Who We Are

Industry Leading Insurance Consulting with access to some of the best minds in the industry

- ▶ Leading provider of Benefits strategies to some of the world's largest organizations
- ▶ Over 30 years of experience solving some of the most complex Product Development, Financing, and Legal / Compliance issues in the industry
- ▶ Focus on Group, Voluntary, Executive, and International Benefits Consulting with significant domain expertise working with Captives



CASE STUDY: Fortune 50 Telecommunications Provider: Individual Lines of Coverage through Captive

■ CHALLENGE

The HR and Risk Management functions were looking for creative ways to create a valuable benefit option to their employees without adding extra expense. They were also looking for ways to leverage increased tax deductions from premium payments to their Captive if possible. ABC was contracted to help achieve these objectives through their Captive.

■ SOLUTION

After extensive analysis and stakeholder buy in from the Benefits and Risk Management teams, American Benefits assisted in the design and implementation of a Voluntary Auto & Home plan through the Captive that offered discounted Group rates to their active and retiree population from some of the best insurance carriers in the industry. The plan covers over 350,000 plan participants and over 50,000 participants have purchases coverage through the program.

■ BUSINESS VALUE

The client was able to offer their employees and retiree population a valuable voluntary benefit, at rates in most cases discounted off of the retail rates, at NO cost to the company. They were also able to take advantage of significant tax deductions on premium paid to Captive due to the additional unrelated third party premium. Furthermore, they were able create a valuable benefit to active and retired employees at a time when cost, expense and benefit reduction was the norm.

