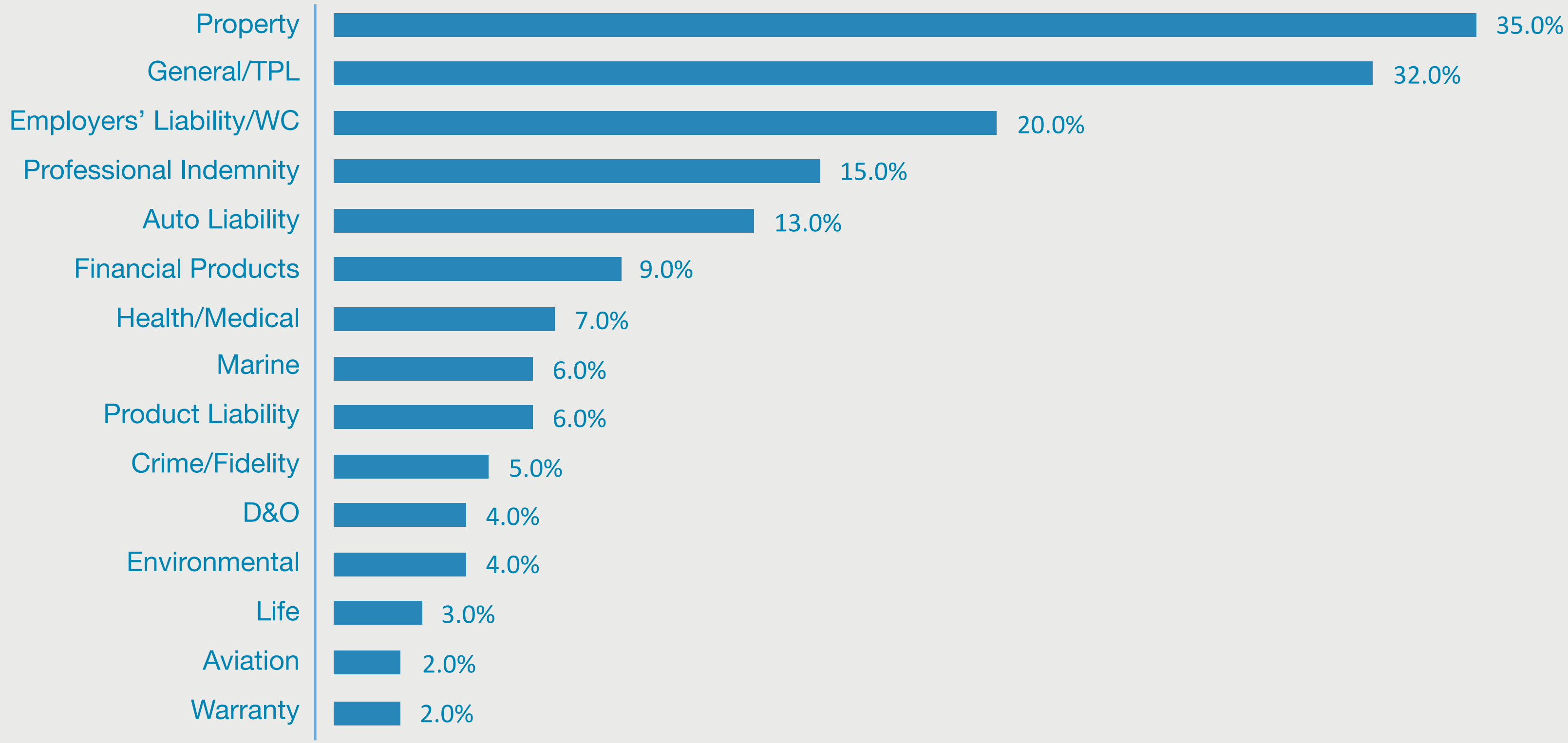
Introduction to Captives and Segregated Cell Captives

Introduction to Captives

Captives account for approximately 50% of the premiums of North American Insurance Industry

- Over 40% of the largest US, Canadian and European companies have their own captive subsidiary (over 5,500 captives worldwide)
- Biggest gap for both existing and new captives is getting the best advice on innovative solutions for the captive
- Captive advice is typically based on reducing the cost of current programs rather than creative risk solutions and tax optimization strategies
- Best profile is a Canadian parent company with significant risks and profitable international operations operating in high-tax jurisdictions

Background: Common Problems



Emerging Trends: looking at 'esoteric' risks that the company has exposure to, but where no coverage is commercially available or available at commercially reasonable prices – e.g. wear and tear on assets, fines and penalties etc.

Captive Strategies: Benefits

Reduce Cost of Insurance	The price of insurance coverage purchased in the conventional market typically reflects a significant mark-up to cover Insurer G&A, broker compensation and profit.
Pricing Stability	Where the insured enjoys a stable and reasonable loss experience, a captive affords the ability to price insurance coverage accordingly.
Tax Advantage	Tax advantages include the tax-favoured accumulation of underwriting and investment income, deductibility of premiums paid, deductibility of loss reserves and reduced premium taxes.
Global Insurance Programme Coordination	Captives allow parents to aggregate and coordinate efficient retention levels and insurance programs across various divisions and operating jurisdictions.!
Improved Cash Flow / Profits	The ability of a captive to generate investment income is an advantage in forming a captive. A captive might also offer insurance coverage to unrelated customers to generate additional profits.
Access to Reinsurance	A captive affords direct access to the reinsurance market, bypassing insurers, eliminating mark-up costs.
Customized Insurance Programmes	A captive has freedom to insure risks it chooses and customize the terms and conditions of policies.
Improved Claims Handling	A captive is free to establish its own claims handling policies and procedures. This may lead to quicker claims processing and payment.

Captive Strategies: Considerations

Cost of Capital	When the captive is incorporated, the company must allocate funds into an area of operation that is not part of the mainstream activities.
Capital and Start-Up Costs	A captive involves a commitment of capital and start-up costs not incurred with other risk financing plans. Some sources state that the range of start-up and annual operating costs for a captive range from $35,000 to $150,000. per year depending on complexity of risks underwritten; premium volume and claims activity.
Management Time	Feasibility, incorporation and ongoing management of the captive structure requires management attention to ensure that business objectives are met and the structure is compliant with audit standards and local and foreign regulatory and tax authorities, including "mind and management" and transfer pricing standards.
Long-Term Commitment	When a company decides to use a captive, there must be a firm commitment at senior levels of the corporation to balancing long-term goals of permanently lowering corporate tax and premium costs while absorbing new administration costs associated with operating an insurance subsidiary. Without a senior management understanding and commitment, the parent may face unintended tax losses offsetting gains.
Availability of Fronting	Where required for compliance fronting insurance policies provided by third party insurers will add frictional costs including fees and collateral to backstop the credit risk of the captive to the third party!
Availability of Reinsurance	Reinsurance may not be available at a level that sufficiently reduces the volatility associated with retaining risks in the captive insurer.

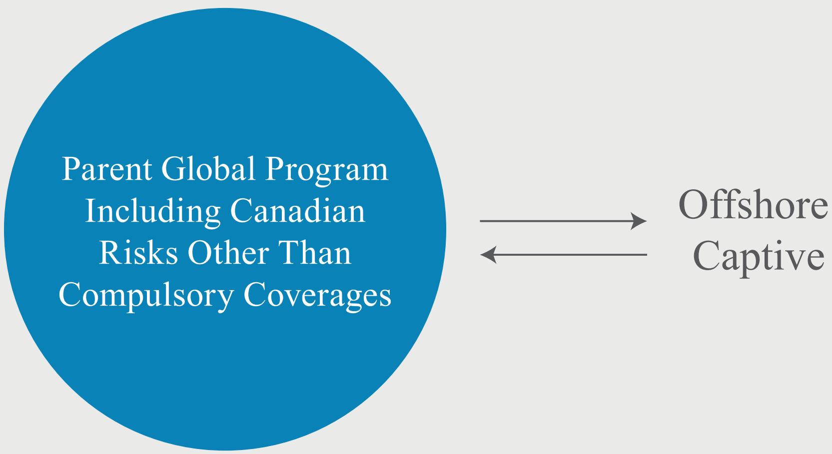
Captive Structures

- Owning and operating your own captive comes with administrative and management fees, as well as capital requirements
- An option is to 'rent' a cell within a Segregated Cell Captive (SCC)
- This option is particularly attractive if the parent does not have significant assets, or revenues outside of Canada
- With much lower costs and similar benefits, the SCC structure is appealing to smaller companies
- Companies in the same industry with similar risk profiles and loss histories may choose to rent a cell together

Captive Structures

- A pure captive that is wholly owned by a parent company will be considered a Controlled Foreign Affiliate (CFA) for the purpose of taxation
- Any captive structure that provides a company with more than 10%, but less than 51% of voting control will be considered a Foreign Affiliate (FA)
- When that captive insures primarily Canadian risks, the captive income is taxed as accrued, whether or not distributed to the parent
- Groups of companies that pool risk in association type captives often struggle to achieve equity and voting rights combinations that will put them below the thresholds that trigger the same treatment
- Each cell within an SCC is an ‘account’ within the SCC and is not considered a corporate entity
- Because the cell does not own or control the SCC itself, the income earned by the cell is considered passive income that does not come from an FA, meaning the income is not taxed until it is brought back to the parent in Canada as a dividend.

Structure 1: Wholly Owned Captive Subsidiary



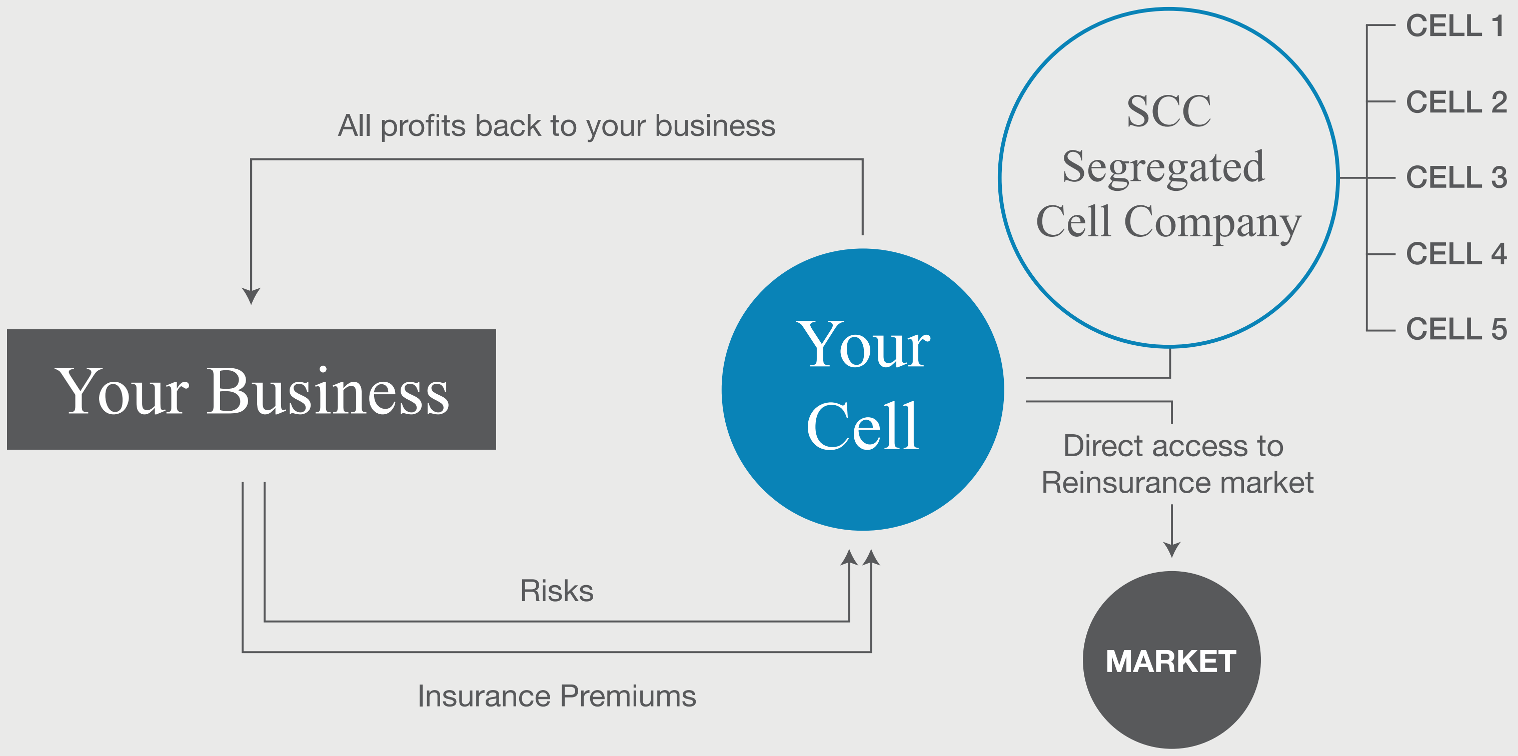
Pros

- Parent has sole control over captive
- Captive underwriting and other decisions are made by Captive Board
- Simplified structure
- All income earned within captive ultimately belongs to Parent

Cons

- Potential compliance and associated tax penalties
- Initial capital requirement of $250,000 plus
- No sharing of risk opportunities
- Income tax accrued as earned for Canadian risks
- Captive pays 100% administrative and management costs

Structure 2:
Segregated Cell Company (SCC)



Palm SCC

Palm owns and operates an SCC and provides:

- Administrative, accounting and governance framework
- Local Barbados management and underwriting
- Preference shares in the capital of the SCC representing no more than 10%, which constitutes the entire cellular shareholding of each cell
- Local administrative work such as policies, invoices, claims management, financial reporting, etc.
- Fronting as needed by Canadian licensed Insurer(s)
- Creation of By-laws
- Board and Committee meetings
- Regular Financial reporting

Palm Captive Consultants

PCCL also provides captives and cells with services that enable the cells to grow strategically and provide value to their parent companies.

These services include:

- Underwriting support
- Governance support
- Risk Management support
- Development of New products
- Compliance expertise

Underwriting Support

Palm's underwriting support services include:

- Identification of opportunities and issues through risk assessment
- Clear identification of captive rules and how to comply with them
- Only captive company on island with local underwriting support
- 5-year business plan
- Staffing/advisors
- Study is tailored specifically for the client; it is not a boiler plate
- Financial modelling

Key Features Continued

Run as properly managed insurance companies, with:

1. Board committees providing oversight on claims and underwriting
2. Diverse portfolio of risks
3. Appropriate reinsurance arrangements
4. Underwriting decisions of acceptable risks
5. Offers of insurance to clients
6. Service Agreements
    i. Parent resources
    ii. External resources
7. Annual IBNR study
8. Claims Procedures
9. Claims Adjustment

Key Features Continued

Follow the various rules that apply to captive operations, including:

1. Risks being transferred must include element of fortuity
2. Adequate spread of risk
3. Arms-length transfer pricing, including transfer pricing report
4. Issuance of contemporaneous documentation
5. Mind and Management in domicile
6. Inclusion of Third Party Risk?
7. Self-auditing of operations and practices to ensure ongoing compliance

Key Features Continued

Follow Sound Business Principles: Board committee oversight on financial management

1. Board investment committee
2. Up-to-Date business plans
3. Annual strategic planning
4. Clear risk management and insurance purpose (not just tax)
5. Staff skill development

Key Features Continued

Identify Clear Long-Term Objectives

1. Risk Management Hub
   i. Collection of data and risk information for decision making
   ii. Risk Control / Loss Prevention
2. Effect on insurance purchasing practices

Key Features Continued

6. Development of Strategic Relationships
   i. Advisors
   ii. Insurance Partners
   iii. Peers – captive benchmarking
   iv. Education resources
7. Captives must constantly assess their operations, viability, value and plans in order to ensure continuous development