CAPTIVE INSURANCE GROUP

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DRM'S CAPTIVE INSURANCE GROUP

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INTRODUCTION

This edition of the Downs Rachlin Martin PLLC ("DRM") *Captive Insurance Update* covers a variety of recent state and federal developments affecting the captive insurance industry. If you have any questions about this update or any other captive insurance developments, please contact Practice Group Chair Kathy Davis at kdavis@drm.com.

DEVELOPMENTS IN VERMONT

29 New Vermont Captives Licensed in 2013

In 2013, 29 new captives were licensed in Vermont, of which 16 are pure captives, 3 are risk retention groups, 3 are sponsored captives, 5 are special purpose financial insurers, and 2 are industrial insured captives. Year-to-date, Vermont has issued licenses to 6 new captives.

There were 588 active captives operating in Vermont as of December 31, 2013, writing an aggregate total of $27.5 billion in gross premium written, and retaining $22 billion of net premium written.

2014 Captive Legislation

On April 14, 2014, effective upon passage, the annual "housekeeping" bill jointly proposed by the Vermont Department of Financial Regulation and the Vermont Captive Insurance Association was enacted as Act No. 103. The following significant provisions include:

- **"Dormant" Captives**. A captive insurance company that has ceased transacting the business of insurance and has no remaining liabilities associated with insurance transactions may apply to the Commissioner for a certificate of dormancy. If it qualifies, a dormant captive is subject to a statutory minimum capital requirement of $25,000 (rather than $250,000), and is not subject to any premium tax.

- **RRGs: Risk Based Capital**. Section 6052 of Title 8 was amended to subject risk retention groups to the provisions of the statute governing Risk Based Capital for Insurers (Chapter 159 of Title 8). As a result, RRGs must file an annual risk based capital report with their Annual Statements each March 1. The Commissioner may, however, elect not to take regulatory action if an RRG's risk based capital amount fails to meet any of the minimum risk based capital levels if certain conditions exist, including evidence that all members or the sponsoring organization of the RRG hold an investment grade credit rating.

- **Incorporated Protected Cells**. Section 6032 was amended to allow sponsored captives to have protected cells formed as reciprocal insurers, as well as previously-authorized corporations, mutual corporations, nonprofit corporations, limited liability companies, or separate accounts created by contract.

- **Captives with Separate Accounts**. In 2013, subsection (p) was added to Section 6006, allowing any captive insurer to establish separate accounts by contract, which could provide that the assets of any such separate account are not chargeable with liabilities arising out of any other business conducted by the captive insurer. This year, the statute governing delinquency proceedings was amended to provide that the assets of a separate account established under subsection 6006(p) shall not be used to pay expenses or claims other than those attributable to such separate account in the event a captive insurer becomes subject to supervision, rehabilitation or liquidation proceedings.

TERRORISM RISK INSURANCE PROGRAM – U.S. CONGRESS CONSIDERS EXTENSION

The U.S. Senate and House Have Passed Extensions, But Have Not Yet Agreed on Terms

In July 2014, the U.S. Senate overwhelmingly approved The Terrorism Risk Insurance Program Reauthorization Act of 2014 (S.2244), which would extend the current federal terrorism insurance program for seven years. The Senate bill would maintain the current "trigger" amount of $100 million, but would require insurers to pay a greater portion of losses from terrorist attacks than under the current program.

The U.S. House is considering its own bill, the TRIA Reform Act of 2014 (H.R. 4871). The House bill extends the current program for only five years, and increases the minimum "trigger" amount gradually over the five years to $500 million for terrorism acts with the exception that there would be a minimum "trigger" for nuclear, biological, chemical, and radiological attacks of $100 million.

The current program expires on December 31, 2014 if the U.S. House and Senate do not reach agreement to extend the program.

RISK RETENTION GROUPS

Victory for RRGs in the Federal Circuit Court of Appeals

In April 2014, the U.S. Second Circuit Court of Appeals held that the federal Liability Risk Retention Act ("LRRA") preempts a New York state statute that allows a direct action suit against insurer. *Wadsworth v. Allied Professionals Insurance Company, A Risk Retention Group*, 748 F.3d 100 (2d Cir. 2014). This was a significant victory for RRGs.

The case involved Allied Professionals Insurance Company, A Risk Retention Group ("Allied Professionals RRG"), which is an RRG domiciled in Arizona and registered to transact insurance in multiple states, including New York. Allied Professionals RRG denied coverage to a chiropractor insured who failed to disclose that he had molested one of his patients. The patient obtained a judgment against the chiropractor and filed suit against Allied Professionals RRG pursuant to the New York state direct action statute. The Second Circuit Court ruled that the LRRA preemption language that limits non-domiciliary states from regulating, directly or indirectly, the operations of RRGs, prevents the application of a state direct action statute to an RRG not domiciled in the state. As a result, New York is not a direct action state in the case of an RRG chartered elsewhere. More important, the ruling stands as strong precedent against some states' efforts to regulate RRGs in a manner that is inconsistent with the preemption granted by the LRRA.

FEDERAL TAX MATTERS

Rent-A-Center: Tax Court Allows Tax Deduction for Premiums Paid to a Captive

On January 14, 2014, the U.S. Tax Court held that payments made to a captive insurer by its parent company on behalf of other wholly owned subsidiaries were deductible as insurance premiums. *Rent-A-Center v. Commissioner*, 142 T.C. 1. While the Tax Court was sharply divided, and a spirited dissenting opinion was issued, the decision is a significant taxpayer victory.

The IRS had denied the tax deduction on grounds that the transaction between Rent-A-Center ("RAC") and its subsidiary captive involved neither risk transfer nor risk distribution, contending that the captive insurer was a sham entity created primarily to generate federal income tax savings.

The case had several interesting facts relied upon by the IRS in denying the tax deduction. RAC was a listed policyholder on the policies issued by the captive, but no premium was attributed to RAC because it did not own stores, have vehicles, or have employees. RAC paid the premiums and estimated a monthly rate for each store's portion of the overall cost of insurance. The monthly rate was based on each store's payroll, each store's number of vehicles, and the total number of stores. RAC guaranteed the liquidity of the captive's deferred tax assets; the captive invested in treasury stock of its parent and the risks were concentrated in a relatively small number (15) of brother-sister corporations.

In the ruling, the Tax Court found that the transaction was not a sham but involved a bona fide insurance transaction. The requirement of risk shifting was met based on the Sixth Circuit Court of Appeals decision in *Humana v. Commissioner* (reversing the U.S. Tax Court) that brother-sister arrangements may shift risk. The Court also found that the requirement for risk distribution was met based on the thousands of store locations, employees, and vehicles that were insured; the Court "looked through" the 15 insured entities to the underlying insured risk.

<u>FATCA: Foreign Account Tax Compliance Act</u>

FATCA is a U.S. tax provision enacted in 2010 that is intended to prevent U.S. tax avoidance by U.S. taxpayers through the use of offshore accounts. FATCA imposes a 30% withholding tax obligation on all payments of U.S. source income to foreign financial institutions that are not in compliance with FATCA. Reinsurance premiums remitted by U.S. captive insurers to offshore reinsurers that are owned by U.S. owners may be subject to FATCA. The IRS has clarified that offshore reinsurers that elect to be taxed as U.S. taxpayers pursuant to Section 953(d) are considered to be domestic entities, and therefore not subject to FATCA. If a foreign captive does not elect to be treated as a U.S. taxpayer under Section 953(d), premiums paid to such foreign entity that are attributable to U.S. risk may constitute withholdable payments under FATCA absent a valid withholding certificate (such as Form W-8BEN-E).

U.S. captive insurers that conduct transactions with foreign reinsurers should research whether such entities are subject to and in compliance with FATCA.

STATE REGULATION OF CAPTIVES

<u>Nonadmitted and Reinsurance Reform Act of 2010 (Dodd Frank): The Saga Continues</u>

The federal Nonadmitted and Reinsurance Reform Act of 2010 ("NRRA") was enacted as Title IX, subtitle B of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203. NRRA includes significant changes to the state regulation and taxation of "non-admitted insurance," specifically surplus lines insurance and insurance independently procured by an insured from an unlicensed insurer without the use of an insurance producer. These provisions went into effect with respect to unauthorized insurance contracts issued or renewed after July 20, 2011.

Since that time, there has been considerable discussion and concern about the impact of NRRA on the U.S. captive insurance industry if NRRA applies to captive insurance as "non-admitted insurance." Industry leaders have also identified legislative history indicating NRRA was not intended to apply to captives, and they are exploring options for amending NRRA accordingly.

As part of this effort, in November 2012, the Coalition for Captive Insurance Clarity was launched by the Vermont Captive Insurance Association to focus on legislative and regulatory changes to NRRA that would exempt captives from the ambit of NRRA, consistent with the position that NRRA was never intended to apply to captives. The Coalition's members include VCIA, the captive insurance trade associations of Delaware, Missouri and Connecticut, the Captive Insurance Companies Association ("CICA") and the State of Vermont.

FaegreBD Consulting, which was involved in the drafting of NRRA, has been retained to work with VCIA's legislative counsel, McIntyre & Lemon PLLC, on these lobbying efforts.

A full briefing on NRRA is available in the June 2011 *Captive Insurance Update News Flash*. (http:/www.drm.com/resources/captive-insurance-news-flash-june-20110).

In December 2011, DRM conducted a webinar on the subject of Compliance Issues for Captives raised by NRRA. The slide deck from the webinar is available to download from the DRM website (http://www.drm.com/uploads/1267/doc/State-Taxation-Regulation-Nonadmitted-and-Reinsurance-Reform-Act-2010-slide-deck.pdf). For the complete webinar, please contact jfrechette@drm.com.

One development that has arisen in the last couple of years that may relate to the discussions about NRRA and the confusion it raised is that some states that have not had statutes imposing taxes on the purchase of unauthorized insurance have enacted such tax provisions, or may be considering doing so.

DRM'S CAPTIVE INSURANCE GROUP

Vermont is the leading U.S. domicile for captive insurers and RRGs, and DRM has been at the forefront of the U.S. captive insurance industry since the mid 1980s. DRM is a regional law firm, with offices in Burlington, Brattleboro, Montpelier, and St. Johnsbury, Vermont; and Lebanon, New Hampshire. The firm has been serving individuals, businesses, and institutions for more than half a century.

DRM's insurance team informs clients about choice of entity, operational issues, developments under legislation, such as the Federal Risk Retention Act and the Terrorism Risk Insurance Act, and complex coverage, claims-handling, or defense issues that can arise.

Our insurance clients seek advice on all aspects of their operations, including organizational matters for start-up companies, how to adapt or take full advantage of changes in federal and state regulations, and sophisticated risk transfer matters for established entities. Using the right resources drawn from the comprehensive legal services offered by DRM, we help clients solve both simple and complex problems involved in all aspects of the insurance industry:

- tax, regulatory, and legislative matters
- corporate governance
- entity selection: stock, mutual and non-profit corporations; LLCs; reciprocal exchanges
- securities laws
- domicile selection
- reinsurance matters
- coverage and defense matters
- policy language
- claims-handling procedures
- reciprocal formation and the role of the attorney-in-fact
- sponsored captives with segregated cells
- other issues involving alternate risk transfer mechanisms.

To explore how DRM's Insurance group can help with your captive insurance matters, please contact Practice Group Chair Kathy Davis at (802) 863-2375, or at www.drm.com.