

## Downs Rachlin Martin PLLC

### Captive Insurance Update | Fall Edition | 2018



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## Developments in Vermont

### Vermont's Leadership Team

Vermont's leadership team largely stayed the course in 2017. Governor Phil Scott and Michael Pieciak, the Commissioner of the Department of Financial Regulation (the "DFR"), each completed a first full year in office. David Provost, the Deputy Commissioner of Captive Insurance, completed his 10th year in that position. Since Vermont originally passed its captive insurance legislation in 1981, only 3 individuals have served as Vermont's top captive regulators.

### 2018 Captive Legislation

The initial captive legislation for 2018 was relatively modest. Significant changes include:

- **Annual Report Due Dates.** For pure, association, sponsored, and industrial insured captives whose fiscal year corresponds with the calendar year, annual reports are due on or before March 15th. Annual reports for all other types of captives whose fiscal year corresponds with the calendar year are due on or before March 1st. For captives whose fiscal year does not correspond with the calendar year, annual reports are due 75 days after the captive's fiscal year end.
- **Premium Tax Due Dates.** Premium taxes for all captives are now due on or before March 15th.
- **Taxes on Loss Portfolio Transfers.** No premium tax is due in connection with loss portfolio transfers where a parent, or other affiliated company, transfers self-insured losses to a captive.
- **Branch Captives.** Branch captives are required to designate the Commissioner of the DFR as agent for service of process. Additionally, the requirement that branch captives petition the Commissioner of the DFR for a certificate of general good has been eliminated.
- **RRG Governance Standards.** Previously, risk retention groups were required to maintain an annual determination of director independence and provide same to the DFR upon request. Going forward, such determinations will have to be provided to DFR annually.

### Affordable Housing Tax Credits

In 2017, the Vermont Affordable Housing Tax Credit program was expanded to allow captive insurance companies to participate. The tax credits are available to apply against a purchaser's premium tax liability over a 5-year period, and are expected to generate a return of approximately 4%. The purchaser is not required to purchase an ownership interest in a project, and the return is not tied to the financial performance of the affordable housing project.

### 2017 Aggregate Vermont Data

Total capital and surplus (all Vermont captives combined) increased as of YE2017 to \$81.4 Billion, while gross and net premium written declined to \$22.2 Billion and \$18.2 Billion,

respectively. Pure (single-parent) captives held \$65.5 Billion in capital and surplus, while risk retention groups held \$3.5 Billion. Pure captives accounted for most of the decline in gross and net premium written, while gross and net premium written by risk retention groups increased to approximately \$1.976 Billion and 1.265 Billion, respectively.

As of YE2017, there were 573 active captives, of the following types:

Pure	375
Risk Retention Groups	85
Special Purpose Financial	44
Sponsored	32
Industrial Insured	23
Association	14

## Microsoft Settles Dispute with Washington State Over Captive Arrangement

On May 9, 2018, Washington State's Insurance Commissioner (the "Commissioner") issued a cease and desist order and a notice of intent to collect unpaid premium taxes in regard to the Microsoft Corporation's ("Microsoft") captive, Cypress Insurance Company ("Cypress"). Cypress, which is domiciled in Arizona, provides global property and terrorism insurance to Microsoft.

Through the cease and desist order, the Commissioner purportedly sought to bar Cypress from engaging in or transacting the unauthorized business of insurance in the state of Washington. The notice of intent, on the other hand, sought to collect from Cypress unpaid premium taxes for the years 2013 – 2018.

As the factual basis for his actions, the Commissioner alleged that (i) certain of Microsoft's liabilities insured by Cypress are located in Washington; (ii) Cypress's board of directors is made up of five individuals, four of whom are employees of Microsoft; (iii) four of Cypress's five corporate officers are employees of Microsoft; (iv) Cypress does not hold a certificate of authority or a surplus line broker's license; and (v) Cypress has not paid premium tax to Washington for the years 2013 – 2018. The Commissioner also asserted that Cypress owed unpaid premium tax in the amount of \$1,423,898.70, together with penalties and interest in the amount of \$611,540.

Microsoft/Cypress initially challenged the Commissioner's actions, essentially raising four arguments:

1. The Washington Supreme Court has held that self-insurance is not insurance because the risk of loss remains with the insured instead of being shifted to a third-party insurer;

2. Cypress was not engaged in the business of making contracts of insurance because it only insures Microsoft and its business consists of reinsuring Microsoft's risk with overseas reinsurers, none of which do business in Washington;
3. Under the *Todd Shipyards* line of cases, Washington lacks the authority to regulate or tax insurance transactions that are entered into outside of its borders; and
4. If Washington does have the authority to impose a premium tax, then any such tax should only cover the portion of the premium related to risk located in Washington.

The extent to which the Commissioner was persuaded by Cypress's arguments is unclear, because Microsoft/Cypress and the Commissioner ultimately reached a settlement pursuant to which Cypress's existing policies were cancelled and new policies were issued through a surplus lines broker. Cypress also agreed to pay \$573,905 in unpaid premium taxes and \$302,915 in interest and penalties. That is, of course, significantly less than the \$1,423,898.70 in unpaid premium taxes and \$611,540 in interest and penalties that the Commissioner originally sought.

There are a few important takeaways from this dispute. First, unlike almost all of the other states, Washington does not have a self-procurement tax. That left it in the awkward position of seeking to impose a premium tax on an entity that is domiciled in another state. It appears to have been bailed out by two factors—Arizona does not have a premium tax, so there was no issue of double taxation, and there was at least the implication that Microsoft and Cypress were not as careful as they could have been to ensure that all Cypress-related activities occurred outside of Washington.

The significant reduction in the taxes and penalties suggests that the Commissioner may have been persuaded, at least in part, by one or more of the arguments raised by Microsoft/Cypress. The most likely contenders are three and four. Under the *Todd Shipyards* line of cases, a captive that is scrupulous about limiting its contacts with a state still has strong arguments that such state is barred by the due process clause from asserting tax or regulatory authority over the captive. Similarly, captives can structure their insurance programs to limit or eliminate their exposure to states like Washington that appear interested in extending the reach of their tax and regulatory authority up to or beyond the constitutional limits.

## Johnson & Johnson: New Jersey Stakes out an Aggressive Position on Self-Procurement Taxes

On June 15, 2018, the New Jersey Tax Court ruled that Johnson & Johnson ("J&J"), the multinational consumer products company, must pay self-procurement tax on all of the premiums it pays to its captive insurer, not merely the portion of such premiums attributable to risk located in New Jersey.

J&J, which is headquartered in New Jersey, largely insures its U.S.-based risks through its Vermont-domiciled captive insurer, Middlesex Assurance Co. Ltd. ("Middlesex"). Middlesex pays premium tax on the related premiums to Vermont. Prior to the enactment of the NRRA in



2010, J&J also paid a self-procurement tax to New Jersey. In calculating such tax, however, J&J only included the portion of the premiums attributable to risk actually located in New Jersey.

After New Jersey enacted legislation apparently intended to implement various provisions of NRRA, J&J began to remit its self-procurement taxes to New Jersey based on total US premiums. In 2015, however, J&J apparently decided that, notwithstanding the NRRA-implementation legislation, it should only have been paying self-procurement taxes on the portion of the premium attributable to risk located in New Jersey. Accordingly, it filed a claim with the New Jersey insurance department seeking a refund of over \$55 million. Unsurprisingly, New Jersey denied the claim and J&J filed a complaint with the tax court.

The tax court determined that J&J is required to pay self-procurement tax on all of the premiums paid to Middlesex, not merely the portion of such premiums attributable to risk located in New Jersey. The tax court's decision was based on two important conclusions. First, that NRRA applies to captive insurers. While this had been assumed by the industry, the J&J decision provides the first formal confirmation. Following from this conclusion, the tax court found that New Jersey is J&J's home state under NRRA, meaning that New Jersey is the only state that is entitled to collect self-procurement taxes from J&J.

The more difficult issue was whether New Jersey's NRRA-implementation legislation actually applied to self-procurement taxes. Incongruously, the implementation legislation never mentions directly procured insurance, focusing instead on surplus lines policies. Somewhat surprisingly, the tax court ignored the principle of statutory construction that the plain language of a statute is paramount and, instead, deferred to the insurance department's interpretation of the relevant provisions to find that the New Jersey's enabling legislation was intended to apply to both surplus lines policies and self-procured insurance.

Based on those two factors (New Jersey is J&J's home state and New Jersey has adopted enabling legislation that applies to self-procured insurance), the tax court found that J&J was liable for self-procurement taxes on 100% of the premiums it paid to Middlesex.

It is important to note that (i) risk retention groups are expressly excluded from NRRA, and (ii) that New Jersey did not affirmatively seek to impose the self-procurement tax on J&J, it merely resisted J&J's demand for the return of amounts already paid. We will be watching the issue closely over the next months to see if the decision encourages other jurisdictions to take a more aggressive stance toward self-procurement taxes or if J&J's situation is an anomaly.

## **Reserve Mechanical: The IRS Cracks Down on 831(b) Abuse**

In the second installment of a string of cases brought by the Internal Revenue Service (the "IRS") to crack down on 831(b) captives, the United States Tax Court issued a memorandum opinion on June 18, 2018, determining that Reserve Mechanical Corp. ("Reserve") was not a bona fide insurance company.

A management company, Capstone Associated Services, Ltd. (“Capstone”) incorporated Reserve in Anguilla in 2009 as the captive insurer for Peak Mechanical & Components, Inc. (“Peak”) and two other entities controlled by Peak’s owners. Peak’s owners served as officers and directors of

Reserve, but neither was familiar with Reserve’s policies or the coverages provided by Reserve. Premiums charged by Reserve were set by Capstone based on historical premiums for other Capstone-managed captives, not an actuarial determination of the actual risk.

During its two years of operation, Reserve’s premiums fluctuated wildly with no apparent relation to the covered risks. Moreover, only one claim was ever submitted under Reserve’s policies and that claim was handled in an irregular manner.

A portion of the premium paid to Reserve was earmarked for a Capstone-managed entity called PoolRe. PoolRe provided stop-loss coverage to Reserve and approximately 50 other Capstone-managed captives. PoolRe then ceded its risks on a quota-share basis back to the captives (who served as reinsurers for the pooled risk). PoolRe also reinsured vehicle service contract coverage that it retroceded to the captives. This arrangement was intended to provide risk distribution to the captives.

In analyzing whether Reserve qualified as an insurance company, the Tax Court discounted the PoolRe pooling arrangement because PoolRe itself did not qualify as an insurance company. This conclusion was based largely on the circular flow of funds between PoolRe and the participants—there were no claims and the participants paid the same amount in premiums to PoolRe for stop-loss coverage that they received from PoolRe under the quota share arrangement.

Without the PoolRe arrangement, Reserve had little or no risk distribution and, therefore, could not qualify as an insurance company for tax purposes. Additionally, the Tax Court found that Reserve failed the test for insurance in the commonly accepted sense because it (i) failed to conduct any due diligence or underwriting for the risk it insured, (ii) did not handle claims in a regular and arms-length manner, (iii) did not provide coverage that was suitable to the needs of the insureds, and (iv) did not base premiums on the risks to be insured.

The Reserve decision doesn’t break any new ground, but it is another reminder of the importance of placing a legitimate, non-tax purpose at the center of any captive arrangement and requiring all subsequent decisions (e.g., pricing, coverage, risk distribution) to flow from that purpose.

## **Carlson: Decision Raises Important Issue for Captives with Operations in New York**

A recent decision by the New York State Court of Appeals has the potential to greatly expand the reach of Section 3420 of the New York State Insurance Law, which includes, among other things, New York’s direct-action statute and disclaimer laws.

Section 3420 applies to insurance policies that are “issued or delivered” in New York. Prior to the Court of Appeals’ decision in *Carlson v. American International Group, Inc.*, the general consensus was that in order for an insurance policy to be issued or delivered in New York, it had to have been issued by a New York-based insurer or physically delivered to an insured within the State of New York.

In *Carlson*, the Court of Appeals dramatically expanded the reach of Section 3420 by ruling that an insurance policy may be “issued or delivered” in New York even if the insurer issuing the policy is located outside of New York and the policy is delivered to an insured outside of New York. Instead, New York courts are directed to determine whether (i) the insured has a substantial presence in New York, and (ii) the risk to be insured is located in New York. If the answer to these questions is affirmative, then Section 3420’s provisions governing direct action and disclaimer may be applicable regardless of whether the insurance policy is otherwise governed by New York law.

While it is too soon to know how New York’s lower courts will apply *Carlson*, it seems prudent for insurers that have issued liability policies to insureds with operations and risks in New York to become familiar with Section 3420, and to be prepared to comply with its strict rules governing disclaimer. For example, Section 3420(d)(2) requires that a disclaimer be delivered to the “insured and the injured person or any other claimant.” The failure of an insurer to comply with the strict requirements of Section 3420(d)(2) will render unenforceable an otherwise valid disclaimer of coverage based upon a policy exclusion or breach of a policy condition.

As discussed in our 2014 Captive Update, the United States Court of Appeals for the Second Circuit has already determined that the direct-action provisions of Section 3420 are preempted by the federal Liability Risk Retention Act. Accordingly, the expansion of Section 3420’s reach, at least with respect to direct actions, likely does not apply to risk retention groups.

## Impact of Changes in the Federal Income Tax Law on Captives

Pursuant to the 2017 Amendments to the Tax Law, the tax rate cut and other major changes will impact many captive insurers. For example, the reduction in the corporate tax rate to 21% impacts the value of the deduction taken for premiums paid to a captive by some owners, as well as the value of deferred tax assets that may be carried by captives. Existing tax sharing agreements will need to be updated if the prior corporate tax rate of 35% is specifically referenced. Also, the rules governing the computation of insurance reserves may generate additional income for a captive (which may be offset by the lower tax rate). There are significant changes to international tax rules, including a new base erosion anti-abuse tax, which imposes a minimum tax on certain US corporations that make deductible payments to related non-US parties. This could cause captives and other insurers transacting business with foreign affiliated reinsurance companies to re-examine those arrangements.



## New Cyber Regulations

On October 24, 2017, the National Association of Insurance Commissioners (“NAIC”) adopted a model law establishing standards for data security and the response to cybersecurity events.

If adopted by a state, this model law would require insurance companies domiciled within that state to implement a wide-ranging information security program requiring ongoing risk assessments and comprehensive safeguards for the protection of personal data. It also includes detailed requirements for incident response and investigation and notification of regulators and affected parties. Finally, the model law establishes cyber security-related guidelines for corporate governance and board oversight and extends many of its provisions to third-party service providers.

The model law is based on New York’s cyber security law, which became effective in 2017. The DFR is reviewing the model law and expects to address cyber security in the captive insurance industry in the next few years. However, the DFR has also indicated that it hopes to make any Vermont laws or regulations related to cyber security scalable, such that they will be more rigorous for larger companies or companies holding significant amounts of personally identifiable information and less burdensome for smaller companies or companies with limited personally identifiable information.

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