

2022 | Fall Edition

# CAPTIVE INSURANCE UPDATE



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# DEVELOPMENTS IN VERMONT

## Changes at the Top

After more than five years of continuity, Vermont's leadership team has seen significant turnover during 2022. In April, Michael Pieciak, the Commissioner of the Department of Financial Regulation (the "DFR"), announced that he was stepping down to run for State Treasurer. Mike will be replaced by Kevin Gaffney, the DFR's Deputy Commissioner of Insurance. Kevin has many years of insurance regulatory experience and we expect that he will excel in his new role.

Closer to home, David Provost, the Deputy Commissioner of Captive Insurance, announced that he will be stepping down at the end of the summer after serving as Vermont's top captive regulator since 2008. Just the third person to hold that office since it originally passed its captive insurance legislation in 1981, Dave has been an exceptional leader for Vermont's captive industry and will be sorely missed.

Fortunately, the DFR practices what it preaches to captives with respect to succession planning, and Sandy Bigglestone, the long-time Director of Captive Insurance, will become the new Deputy Commissioner of Captive Insurance. Already the recipient of numerous awards and accolades, Sandy has worked closely with Dave for many years to lead the captive division and has established herself as one of the preeminent voices in the captive industry. We expect a seamless transition and that, under Sandy's leadership, Vermont will remain the "Gold Standard" of captive domiciles.

## Continued Impact of COVID-19

The measures taken by the DFR in 2020 in response to the COVID-19 pandemic have been extended through 2022. These include a recognition that in-person board meetings in Vermont may not be advisable. Captives are invited to request a waiver of the physical presence requirement for their 2022 annual meetings.

## 2022 Captive Legislation

On May 31, 2022, Governor Phil Scott signed Vermont's annual captive "housekeeping" bill into law. The 2022 legislation, which was jointly proposed by the DFR and the Vermont Captive Insurance Association, includes the following notable provisions:

- **Authorization for Sponsored Captives to Write Controlled Unaffiliated Business.** The definition of Sponsored Captive is revised to permit a sponsored captive to insure controlled unaffiliated business, subject to approval by the DFR.
- **Parametric Contracts.** Language is added to make it clear that captives are authorized to utilize parametric contracts. A parametric contract is a contract to make a payment upon the occurrence of one or more specified triggering events without proof of loss.
- **Delinquency of Protected Cells.** Language is added to make it clear that the provisions governing the delinquency of a sponsored captive also apply to protected cells. The DFR is also granted authority to separate delinquent protected cells from a sponsored captive.
- **Sponsored Captive Books and Records.** New provisions are added governing the maintenance and storage of a sponsored captive's books and records.

In addition to the above, Vermont adopted a new Insurance Data Security law applicable to traditional insurance carriers. Captive insurance companies and risk retention groups are excluded, but we will be monitoring this area closely for future developments.

## 2021 Vermont Formations

In 2021, 45 new Vermont captives were licensed, bringing the total to 1,242 captives licensed, of which 589 were active as of December 31, 2021. The types of active captives break down as follows:

Type of Captive	Total Licensed in 2021
Pure	368
Risk Retention Group	89
Special Purpose Financial	39
Sponsored	52
Industrial Insured	21
Association	13
Branch	3
Affiliated Reinsurance Company	2
Agency	2

Notably, Vermont's 52 sponsored captives have experienced significant growth, with over 500 cells and separate accounts, of which nearly 100 were added in 2021.

## 2021 Aggregate Data

The aggregate amount of gross premium written by all Vermont captives for the year 2021 was \$30 Billion; total net written premium was \$25.2 Billion. Aggregate total capital and surplus as of December 31, 2021 was \$65 Billion and total assets were \$193 Billion. Total Vermont premium tax paid on 2020 gross written premiums was approximately \$28 Million.



# FEDERAL ISSUES

## IRS v. Delaware

In June of 2020, the Internal Revenue Service (the “IRS”) petitioned the U.S. District Court for the District of Delaware (the “District Court”) for an order to enforce document requests served on the Delaware Department of Insurance (“DDOI”). The IRS is seeking records relating to filings by Artex Risk Solutions, Inc. (“Artex”) and Tribeca Strategic Advisors, LLC (“Tribeca”) relative to the role of Artex in transactions involving micro-captive insurance companies formed under Section 831(b) of the Internal Revenue Code.

These micro-captive programs were designated as “Transactions of Interest” by the IRS in 2016, meaning that the IRS believes they have the potential for tax evasion. The IRS is also investigating whether Artex or Tribeca promoted micro-captive programs and whether their actions may result in penalties applicable to promoters of abusive tax shelters.

In its suit against the DDOI, the IRS alleges that the DDOI has failed to provide records responsive to its summons for records. The DDOI has moved to “quash” the IRS petition on the grounds that, among other things, enforcement of the summons would require the DDOI to violate a Delaware statute that prohibits disclosure by the DDOI of captive insurance licensing information unless the insurer consents to disclosure or such information is disclosed to another state insurance department or to a state or federal law enforcement agency and the department or agency agrees to hold the information as confidential. The DDOI also argues that, under the McCarran-Ferguson Act, the regulation of insurance is within the exclusive authority of the states.

On July 16, 2021, a magistrate judge assigned by the District Court to review the matter ruled in favor of the IRS and recommended that the DDOI be compelled to turn over the requested documents.

The District Court then reviewed the magistrate’s findings and recommendations and, on September 29, 2021, issued an opinion adopting the magistrate’s recommendations.

On November 1, 2021, the DDOI appealed the District Court’s decision to the United States Court of Appeals for the Third Circuit. That appeal remains pending.

## Reserve Mechanical: The 10th Circuit Drops The Hammer on Micro-Captive Abuse

In a long-awaited decision, the United States Court of Appeals for the 10th Circuit recently issued its decision in *Reserve Mechanical Corp. v. Commissioner of Internal Revenue*. This decision decided Reserve Mechanical's appeal of a 2018 decision of the United States Tax Court that we addressed [here](#). The 10th Circuit agreed with the Tax Court's findings with respect to the abusive nature of the micro-captive arrangement at issue, at points going to great lengths to point out all of the defects in the structure and operations of the micro-captive. These defects are, by now, familiar to the industry so we won't rehash them here. However, one notable aspect of the decision is that the 10th Circuit upheld the Tax Court's determination that the faux premiums paid by the micro-captive owner to the micro-captive could not be recharacterized as capital contributions because the micro-captive owner did not intend them to be capital contributions. Instead, the micro-captive must treat the faux premiums as income. These types of abusive arrangements may, therefore, be subject to a form of double taxation in that any deductions claimed by the parent / insured on the faux premiums may be disallowed and the micro-captive may be required to recognize those amounts as income subject to income or other withholding tax.

# STATE ISSUES

## Washington State Implements Premium Tax

Following several high-profile disputes between the Washington State Insurance Commissioner (the “OIC”) and Washington-based multinational corporations, the state of Washington, on May 12, 2021, enacted a legislative framework allowing for the taxation of Washington-based companies and public institutions of higher education that utilize captive insurance arrangements. Several months later the OIC adopted implementing regulations.

This new regulatory framework applies to “eligible captive insurers,” which are defined as insurance companies that, among other things, (i) include among their insureds at least one person or entity whose principal place of business is in Washington; and (ii) have assets that exceed their liabilities by at least \$1 million.

The principal place of business of an insured is “the place where a business entity’s management direct, control, and coordinate” the business’ activities. Subsidiaries must be analyzed separately from their parent or holding company. So, for example, if a multinational enterprise that is headquartered in New York uses its captive to insure a subsidiary that has its operations in Washington, the Washington-based subsidiary will be deemed to have its principal place of business in Washington even if all of its operations are directed out of the enterprise’s New York headquarters.

Eligible captive insurers are authorized to provide property and casualty insurance to their owners and their owners’ other affiliates (and to assume unrelated risk from other insurers as a reinsurer), but only if they register with the OIC.

The OIC will approve a registration if the captive (i) establishes that it meets the surplus criteria described above (verified by audited financials); (ii) is in good standing with its domiciliary regulator; and (iii) pays a fee of \$2,500. Registrations must then be renewed annually, for a further fee of up to \$2,500.

Each registered eligible captive insurer will be required to pay a 2% premium tax on all Washington-based risks. This new premium tax is applied retroactively for any premiums written after January 1, 2011.

“Washington risk” is defined as “the share of risk covered by the premiums that is allocable” to Washington, “based on where the underlying risks are located or where the



losses or injuries giving rise to the covered claim arise.” Registered eligible captive insurers have some discretion in determining the methodology for allocating risk, but such methodology must be reported to the OIC.

Eligible captive insurers that fail to register are subject to fines and penalties applicable to unauthorized insurers.

It remains an open question as to whether this taxation scheme is permissible under the Todd Shipyards line of cases, but unless and until it is challenged, captives insuring the Washington-based risk of an affiliate located in Washington will need to give careful consideration to its applicability.

DRM is available to assist with that analysis.

# OUR TEAM

Vermont is the leading U.S. domicile for captive insurers and risk retention groups (RRGs), and Downs Rachlin Martin has been at the forefront of the U.S. captive insurance industry for 30 years. Meet our team of dedicated captive lawyers.



## Kathy Davis, Director

A pioneering captive insurance attorney, Kathy has advised hundreds of captive insurance companies on formation and operational issues for over thirty years.

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## Zaw Win, Director

Zaw has a diverse practice with a focus on advising captive insurance companies and risk retention groups on matters related to organization, licensing, governance and operations.

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## Mary Parent, Director

Mary works with a wide variety of local and national businesses to advise them with respect to corporate, commercial, and transactional matters.

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For over 30 years, Bruce has been providing clients with cost-effective, practical advice and smart solutions to a wide range of business, insurance and captive insurance issues and disputes.

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