2023 Edition

CAPTIVE INSURANCE UPDATE

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DEVELOPMENTS IN VERMONT

2023 Captive Legislation

On May 8, 2023, Governor Phil Scott signed Vermont's annual captive "housekeeping" bill into law. The 2023 legislation includes the following notable provisions:

• Naming Conventions for Incorporated Protected Cells. The rules for Incorporated Protected Cells' names were modified to address issues that have arisen with the Secretary of State's online database.

• Beneficial Ownership. The provisions governing licensing were expanded to make it clear that evidence of beneficial ownership, sponsorship, or membership must be included in a captive's licensure application.

• Confidentiality. A provision was added making it clear that information submitted in connection with a captive's licensure application, as well as any subsequent updates, revisions, or amendments, will be kept confidential and, subject to certain limited exceptions, not subject to disclosure without the consent of the captive.

• Branch Captive Reports. The Vermont Department of Financial Regulation (the "DFR") was given additional flexibility with respect to the due date for branch captive reports.

• Premium Tax Revenue. The percent of premium tax revenue earmarked for the DFR's operations was increased from 11% to 13%.

• Books and Records. Minor modifications were made to the provisions governing the books and records of Special Purpose Financial Insurance Companies and Affiliated Reinsurance Companies.

2022 Vermont Formations

In 2022, the DFR licensed 41 new Vermont captives, bringing the total to 1,283 captives licensed, of which 639 were active as of December 31, 2022. The types of active captives break down as follows:

Pure	410
Risk Retention Group	88
Special Purpose Financial	38
Sponsored	59
Industrial Insured	20
Association	13
Branch	5
Affiliated Reinsurance Company	2
Agency	4

Notably, Vermont's 59 sponsored captives have experienced significant growth, with over 500 cells and separate accounts.

Aggregate Data

The aggregate amount of gross premium written by all Vermont captives for the year 2022 was $42.5 Billion; total net written premium was $27 Billion. Aggregate total capital and surplus as of December 31, 2022 was $67 Billion and total assets were $212 Billion. Total Vermont premium tax paid on 2022 gross written premiums was approximately $31 Million.

FEDERAL ISSUES

IRS Issues Proposed Regulation for 831(b) Captives

Following its loss in *CIC Services, LLC v. IRS*, which we covered in our Fall 2021 Captive Newsletter, the Internal Revenue Service ("IRS") has proposed a new regulation aimed at stamping out what it considers to be abusive uses of section 831(b) of the Internal Revenue Code (the "Code").

As a refresher, the Code allows small insurance companies (direct written premiums of less than $2.2 Million adjusted for inflation) to make an election under section 831(b), which exempts them from tax on their premium revenue (meaning that, for the most part, they are only taxed on their investment income).

While there are small insurance companies using the section 831(b) election as intended, unscrupulous promoters also began pushing section 831(b) as a wealth transfer mechanism. The structures devised by these promoters often involved a business owner setting up a captive owned by a close relative, paying inflated premiums to the captive for fanciful coverages (e.g., flood insurance in the desert), and deducting the premiums as business expenses. These arrangements shortchanged the US treasury in two ways: first, through the inflated premium-related deductions taken by the business owner; and second, by excluding such payments from the faux-captive's income. Unsurprisingly, addressing these abuses has been a priority for the IRS for many years.

Through the proposed regulation, the IRS is seeking to extinguish abusive 831(b) captive arrangements by characterizing them as listed transactions or transactions of interest. Each of these designations carries significant disclosure requirements on the part of owners, insureds, and material advisors which are, presumably, intended to provide the IRS with a roadmap to bringing an enforcement action.

The proposed regulation begins by defining "captive" as an entity that (i) makes the section 831(b) election, (ii) issues an insurance contract to an insured or reinsures an insurance contract of an insured, and (iii) has at least 20% of its assets or the voting power or value of its outstanding stock or equity interests directly or indirectly owned, individually or collectively, by an insured, an owner or persons related to an insured or an owner. So, if (i) – (iii) do not apply to a captive arrangement, the proposed regulation is not applicable.

The first step in the inquiry is to determine whether, during the most recent five taxable years (or all years if a captive has been in operation for less than 5 taxable years), the captive was involved in any kind of loan-back or other similar transaction to its owner or insured or other related party that the recipient did not include in its taxable income or gain. We'll call this the loan-back test.

The next step in the inquiry is to determine whether the captive's liabilities incurred for losses and loss adjustment expenses are less than 65% of premiums earned by the captive less policyholder dividends paid by the captive. We'll call this the loss ratio test. The loss ratio test is only applicable to captives that have been in operation for ten or more years.

Subject to certain exceptions that are not likely to have broad applicability in the industry, a captive arrangement that (i) fails the loan-back test or, if applicable, the loss ratio test, and (ii) does not qualify for one of the exceptions, will be deemed to be a listed transaction.

Additionally, if a captive's liabilities incurred for losses and loss adjustment expenses are less than 65% of premiums earned by the captive less policyholder dividends paid by the captive during the most recent nine taxable years (or for all taxable years if the captive has been in operation for less than 9 years), then (subject to the same exceptions as above) the captive arrangement will be deemed to be a transaction of interest.

If the proposed regulations are adopted, this analysis will apply retroactively to any prior period with respect to which the statute of limitations has not run.

Eliminating abusive captive arrangements is a worthy objective (we are, after all, in the business of insurance not wealth transfer) and few, if any, Vermont-domiciled captives will be impacted by the proposed regulation, either because they do not make the section 831(b) election or because they do not meet the odd definition of a "captive" in the proposed regulation. However, there are a number of concerning implications of the proposed regulation. Most notably, the loss ratio test is not an appropriate measure of the legitimacy of a captive arrangement.

Consider a mid-size business in California that runs property insurance for its 13 locations (each of which is owned by a subsidiary) through its captive. That business could have gone decades without a claim before the catastrophic flooding in 2022 and 2023 resulted in massive losses. A loss ratio below 65% in this situation is indicative of fortuity, not abuse.

It is true, as the IRS suggests, that the company could game the loss-ratio test by causing the captive to pay taxable policyholder dividends, but doing so would reduce the likelihood that the captive will have sufficient assets to pay a catastrophic claim, which is the whole purpose of the captive. The loss ratio test is a blunt instrument that has the potential to sweep up legitimate, along with abusive, 831(b) captives.

The concern for the larger captive industry is that the IRS (or courts) will begin viewing a 65% loss ratio as the magical dividing line between legitimate and illegitimate captive arrangements when, in reality, it is simply an arbitrary number that is no better or worse than any number of other numbers that could have been selected. Surely the IRS can come up with a better test.

The Vermont Captive Insurance Association is watching this matter closely and may seek to comment on the proposed regulations prior to their adoption.

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.

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