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# CAPTIVE INSURANCE UPDATE

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# DEVELOPMENTS IN VERMONT

## 2025 Captive Legislation

Every year, the members of the Vermont Captive Insurance Association's legislative committee and the Vermont Department of Financial Regulation (the "DFR") work to improve Vermont's captive insurance laws and regulations. On May 19, 2025, Governor Phil Scott signed Vermont's annual captive "housekeeping" bill into law. The 2025 legislation includes the following notable provisions:

**Certification**: Flexibility was added throughout the captive insurance laws to allow the governing body of a captive formed as an LLC or Reciprocal to appoint individuals to certify various actions (in lieu of the president and secretary).

**Captives Formed as Mutual Insurers**: Captives formed as mutual insurers now have the privileges and are subject to certain provisions of the statutes governing traditional mutual insurance companies.

**Reinsurance:** Language was added to clarify that captives are only permitted to reinsure risks of the captive's parent, affiliated companies, and controlled unaffiliated business.

## 2024 Vermont Formations

In 2024, the DFR licensed 41 new Vermont captives, bringing the total number of captives Vermont has licensed to 1362, of which 683 are currently licensed, and 654 are active. The types of currently licensed captives break down as follows:

| | |
|---|---|
| Pure | 442 |
| Risk Retention Group | 85 |
| Sponsored | 72 |
| Special Purpose Financial | 41 |
| Industrial Insured | 18 |
| Association | 15 |
| Agency | 4 |
| Branch | 4 |
| Affiliated Reinsurance Company | 2 |

## Aggregate Data

The aggregate amount of gross premium written by all Vermont captives for the year 2024 was $33.1 Billion; total net written premium was $27.7 Billion. Aggregate total capital and surplus as of December 31, 2024 was $82.4 Billion and total assets were $236.3 Billion. Total Vermont premium tax paid on gross written premiums was approximately $35.3 Million.

# FEDERAL TAX DEVELOPMENTS

## IRS Issues Final Rule Regarding 831(b) Micro-Captives:

Almost two years after the IRS Proposed Regulations aimed at extinguishing abusive uses of Section 831(b) of the Internal Revenue Code (the "Code"), the IRS issued its final regulation on January 14, 2025. We covered the Proposed Regulations in our 2023 Captive Newsletter. As we noted, the Proposed Regulations raised concerns over the broad scope of the classifications of Listed Transactions and Transactions of Interest. That scope was somewhat narrowed in the final regulation, but remains of concern. Taxpayers falling within the definition of either Listed Transactions or Transactions of Interest must now comply with Form 8886, Reportable Transaction Disclosure Statement filing requirements in Treas. Reg. § 1.6011-4.

For purposes of the final regulations, the IRS defines a "Captive" as any entity that (i) elects under IRC 831(b) to exclude premiums from taxable income; (ii) issues a contract to an insured or reinsures an intermediary's contract for an insured; and (iii) at least 20% of the captive's assets, voting power, or value of its outstanding stock or equity interests must be directly or indirectly owned, individually or collectively, by an insured, an owner of an insured, or persons related to an insured or an owner.

### Listed Transactions

The final regulations consider a transaction with a captive to be a **Listed Transaction** if it has both of the following features (or substantially similar features):

**1. Financing Test.** Within the most recent five taxable years, the captive must have made financing available, or made a conveyance, to a related party that does not generate taxable income; and

**2. Loss Ratio Test.** Within the most recent ten taxable years, the captive must have had an average loss ratio of less than 30%.

The final regulation provides exceptions from Listed Transaction treatment for (i) certain captive arrangements offering insurance for employee compensation or benefits; and (ii) captive arrangements that the IRS terms "Seller's Captives" – where the "Seller" is a service provider, dealer (including an automobile dealer), lender, wholesaler, or retailer that sells products to unrelated customers, who then purchase insurance products from Seller related to those products or services.

### Transactions of Interest

Certain micro-captive arrangements that don't qualify as Listed Transactions may still qualify as **Transactions of Interest** if they meet either the financing test or the loss ratio test. But for purposes of the Transaction of Interest analysis, the loss ratio test is considered to be met if the loss ratio is less than 60% rather than 30%. Also, the loss ratio test is applied for the prior ten years, or since the captive has been in existence. Thus, if the captive does not have 10 years of history, it can only be a Transaction of Interest, not a Listed Transaction. The same definitions from the Listed Transaction regulation generally apply to the Transactions of Interest, including "Captive," "Insured," and "Seller." The same exceptions for "Seller's Captive" and employee compensation and benefits insurance also apply to Transactions of Interest.

### Outlook

These final regulations provide some clarity in the area of Section 831(b) micro-captives. However, it is also important to note that since the Supreme Court's 2024 ruling in *Loper Bright Enterprises v. Raimondo*, agencies are no longer afforded broad deference in the area of regulatory interpretation. Further, it is reasonable to assume that these new regulations may encompass some non-abusive transactions, leaving the courts to work out how much deference these regulations should be afforded. Several notable cases are already making their way through the courts. In *Ryan LLC v. Internal Revenue Service et al*, *CIC Services, LLC v. Internal Revenue Service et al*, and *Drake Plastics Ltd. Co. et al v. Internal Revenue Service et al*, the plaintiffs seek an order from the court declaring that the final rule violates the Administrative Procedure Act.

## United States Tax Court Sustains IRS Deficiency Determinations Against "Micro-Captives" Claiming 831(b) Deductions in Two Recent Cases:

**Swift v. Commissioner**

The taxpayers in *Swift* were the founders of more than a dozen urgent care and rehabilitation centers in Texas. From 2004 through 2015, the Swifts' businesses supplemented their traditional insurance by purchasing assorted policies from micro-captive insurance companies that Dr. Swift also controlled. The premiums paid to the micro-captives dwarfed more traditional insurance premiums, resulting in significant deductions for the Swifts. Relying on Section 831(b), the micro-captives themselves paid no tax on the premium income received from their sister entities, investing the money as directed by Dr. Swift.

Consistent with its decision in a number of other cases involving Section 831(b) micro-captives, the Tax Court sustained the IRS's adjustments. Among other things, the Court found there to be evidence of a circular flow of funds, absence of arm's length pricing, and a lack of actuarially determined premiums. Further, the Court held there was not adequate risk distribution and the contracts did not constitute insurance in the commonly accepted sense, among many other unfavorable factors. Accordingly, the Court held that the captives were not insurance companies and could not benefit from the exclusion of premium income under 831(b), and also that the taxpayers could not deduct the premiums as ordinary and necessary business deductions.

**Patel v. Commissioner**

The taxpayers in *Patel* were two doctors who operated an eye surgery center and two research centers in Texas. Beginning in 2011, the Patels' businesses supplemented their commercial insurance coverage by purchasing assorted policies from purported micro-captive insurance companies that the Patels also controlled. The premiums paid to the micro-captives were substantially more than the premiums paid to the Patels' commercial insurers, creating substantial tax benefits for the Patels.

The IRS assessed the Patels on the basis that the insurance premiums paid to the 831(b) micro-captives were not bona fide insurance and thus the premiums could not be excluded from income or deducted as ordinary and necessary business expenses. The Tax Court sustained the IRS's determinations. Similar to the *Swift* decision above, the Tax Court reasoned that there was evidence of a circular flow of funds, lack of arm's length contracts, and a lack of actuarially determined premiums, among many factors weighing against the taxpayers.

## Outlook

Based on the written decisions, neither of these cases appeared to be close calls for the Tax Court. In short, the taxpayers in both cases appeared to have “bad facts”: there was evidence of a circular flow of funds and apparent lack of supportable arm’s length contracts, actuarially determined premiums, and adequate risk distribution, among other issues. Nonetheless, they provide important guidance for any business with a captive insurance arrangement – not just limited to the Section 831(b) context – as they illustrate a number of fact patterns that can be problematic for taxpayers on audit.

# 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 40 years. Meet our team of dedicated captive lawyers:

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