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Captive Newsletter

A Newsletter from the Captive Practice Group *February 2017*

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UPDATE ON TREASURY TRIA DATA REPORTING

In our last newsletter we reported that the U.S. Treasury Department had published notice of proposed new rules regarding the Terrorism Risk Insurance Program established pursuant to the Terrorism Risk Insurance Act ("TRIA"). The proposed rules addressed, in part, Treasury's collection of TRIA program data from participating insurers. Treasury published final rules on December 21, 2016 (the "Final Rules"), and notice of a request for comments related to data collection under TRIA on December 27, 2016 (the "Notice"). This article provides an overview of the following items related to data reporting under the Final Rules and the Notice.

- The first mandatory data report under TRIA is due no later than May 15, 2017;
- The Final Rules exclude captive insurers from the definition of "small insurer";
- Some captives may be exempt from submitting a data report; and
- Comments on the data reporting forms and instructions are due on or before February 27, 2017.

The Final Rules changed the annual data reporting date from March 1 to May 15 for all insurers participating in the program. The first mandatory data report is due no later than May 15, 2017.

The Final Rules exclude captive insurers from the definition of "small insurer" consistent with the proposed rules published in April 2016. Comments submitted to Treasury by captive insurers and groups expressed concern that the data reporting requirements would place undue burden on captive insurers and questioned the basis for excluding all captives (regardless of size) from the definition of small insurers. Treasury noted that the definition of small insurer has two consequences under TRIA. First, small insurers will be considered in studies that Treasury must conduct and reports that it must issue under TRIA. Second, small insurers may be subject to exemption from modified annual data calls under the Final Rules.

The principal purpose of the small insurer studies under TRIA is "to identify any competitive challenges small insurers face in the terrorism risk insurance marketplace." Treasury distinguished captive insurers from small insurers stating that their participation in the program "is subject to issues very different from those faced by small conventional insurers that must make available terrorism risk insurance generally in the insurance marketplace." Treasury further commented that captives should be excluded from the definition of small insurers because captives "do not present the concerns (regardless of their size) that led to the requirement for the study in question." Treasury reiterated that it has reserved Subpart E of the Final Rules to address the development of regulations for issues related to captive insurers that might justify special treatment.

Treasury noted that changes made to the proposed rules address concerns that captives will not be excused from annual data calls. Specifically, Section 50.51(c) of the Final Rules was changed to allow Treasury to annually modify the data and information required by type of insurer. Further, any proposed modifications to the data and information must be made during the prior calendar year with notice to participants of any newly specified data or information not less than 90 days before the data must be collected. Treasury indicated that it intends to develop data requests for captives that will be tailored to the manner in which they participate in the TRIA program.

The proposed captive insurer reporting form and data dictionary were published with the Notice. The data dictionary indicates that a captive insurer is not required to submit a data report to Treasury if it has not extended terrorism risk insurance subject to the TRIA program under any policy. We recommend that captive owners contact their captive manager to discuss reporting obligations under the Final Rules and captive insurer form.

Treasury has requested feedback on the captive insurer form and data dictionary. It anticipates that 400 captive insurers will submit the captive insurer form and that the collection, processing and submission of data will take approximately 50 hours. The captive insurer form and data dictionary are available on Treasury's TRIA website at www.treasury.gov/resource-center/fin-mkts/Pages/program.aspx.

Comments must be submitted to Treasury on or before February 27, 2017. We will continue to monitor and report any developments on this issue.

NAIC TERRORISM DATA CALL

On August 1, 2016, the New York Department of Financial Services ("DFS") sent a request for data to all National Association of Insurance Commissioners ("NAIC") annual statement filers writing commercial fire and allied lines, commercial multiple peril, ocean marine, inland marine, other liability, products liability and boiler and machinery coverages. DFS' communication indicated that all states and the District of Columbia had agreed to participate in a data call to collect data related to terrorism risk insurance and that DFS would serve as the single point of collection for the data call. The stated purpose of the data call was "to serve important regulatory objectives, such as monitoring the affordability and availability of insurance coverage for acts of terrorism and assessing insurers' financial exposure to terrorism risk."

The NAIC's efforts in 2015 to develop a template for a uniform method of submitting terrorism risk insurance data were abandoned following discussions with the Federal Insurance Office. The DFS communication appeared to be the NAIC's second attempt to play a role in terrorism risk insurance data collection by establishing a duplicative process to the process developed by Treasury under the Final Rules and related report templates.

Most captive insurers domiciled in Vermont were not subject to the DFS data call because they do not file annual statements with the NAIC. However, the DFS data call was sent to risk retention groups writing the covered lines and filing the NAIC annual statement. The DFS data call raised concerns regarding a non-domiciliary state's authority to obtain information from a registered risk retention group beyond that described in the federal Liability Risk Retention Act of 1986.

The Vermont Department of Financial Regulation ("DFR") addressed these concerns by issuing Memo #2016/7 on October 26, 2016. The Memo exempts all Vermont-domiciled risk retention groups from participating in the DFS terrorism data call. The DFR memo noted that most risk retention groups write non-participating lines such as professional liability and are not part of the general insurance market since coverage is restricted to their owners and members. Vermont-domiciled risk retention groups may voluntarily respond to the DFS data call.

RISK RETENTION GROUPS CONSIDER NEW YORK REGULATION

As most of our risk retention group ("RRG") clients are aware, the State of New York Department of Financial Services ("DFS") has proposed a new regulation "Cybersecurity Requirements for Financial Service Companies" (the "Regulation"). The draft, a second comment period for which has just concluded, seeks to require most financial institutions regulated by DFS to implement a cybersecurity policy addressing a broad range of issues including system and network security, data governance, device management, privacy and other matters. In addition, those covered by the Regulation would have to name a Chief Information Security Officer, perform penetration and vulnerability testing, conduct mandatory training, encrypt non-public data and develop an incident response plan, all either in-house or through third party service providers. At present, the Regulation includes within "covered entities" those companies with a "registration" with DFS, which includes RRGs domiciled outside the state but registered to do business there. Exemptions exist for very small programs.

We understand that the National Risk Retention Association ("NRRA") commented on the inclusion of non-New York RRGs during the first comment period, pointing out that the broad preemptions of the federal Liability Risk Retention Act of 1986 ("LRRA") do not have an exception for either cybersecurity or individual state regulation of such operational matters. We share NRRA's view that this is strictly preempted and that RRGs should be excluded from the final Regulation, slated to go into effect March 1, 2017. Nonetheless, there are reasons a substantial number of RRGs may choose to comply voluntarily.

First and foremost, many RRGs wish to avoid appearing to their members, regulators, rating agencies or insurance market competitors that they seek to avoid stringent cybersecurity measures. Also, the National Association of Insurance Commissioners ("NAIC") continues to evaluate its own adoption in the area, which could become binding on RRGs in most domiciles in the next few years, whether or not they have a New York registration. A notable difference, however, is that preliminary drafts of a NAIC model permit to a greater extent than New York a scaled approach for smaller, less sophisticated entities.

Those voluntarily complying with the Regulation will enjoy some time to implement all of its requirements. Most provisions take effect 180 days after final implementation. Other provisions apply after a year or two years, giving companies time to plan, implement new infrastructure and engage service providers as needed. Costs of implementation appear to vary greatly between RRGs. We know of several which, with limited new undertakings, believe they can be compliant with the Regulation in the allotted time. Others relate that while they believe their current programs provide adequate protection, specific terms of the New York Regulation represent an undue burden and embrace only one of several possible "best practice" solutions, including regimes promulgated by technology industry groups, European financial regulators and major consultants.

Some clients have communicated that they will rely on their rights under the LRRA and take no new actions to address the Regulation. Among these are some programs which might choose to undertake legal action against New York by themselves, with a trade organization or with other similarly situated RRGs. Dialog continues regarding which RRGs might fund or participate in such a lawsuit. We understand Vermont's Department of Financial Regulation may also weigh-in soon with what might be advocacy for its RRGs with New York or suggestions about its own future expectations.

A copy of the current draft regulation can be found at www.dfs.ny.gov/legal/regulations/proposed/rp500t.pdf**.**

AVRAHAMI AND ITS IMPACT ON 831(B) CAPTIVES

Benyamin and Orna Avrahami, the owners of an 831(b) captive that insured the couple's Arizona-based jewelry business and real estate holding companies, commenced an action in U.S. Tax Court in early 2015 in response to the issuance of notices of deficiency by the IRS totaling nearly $2.5 million in additional taxes and penalties. The IRS's preliminary statement contained in its October 2015 answering brief emphasizes that *Avrahami* is the first case to address a Section 831(b) transaction and that the Court's opinion may impact other participants in the risk distribution pooling arrangement at issue. But the impact could go well beyond that, since the structure of the 831(b) in the *Avrahami* case is not unusual.

<u>Summary of the Facts</u>. The Avrahamis were introduced to captive insurance by their CPA, who recommended that they consult with an estate planning attorney, Neil Hiller, and a New York lawyer, Celia Clark. According to the IRS, Hiller and Clark worked together to set up a St. Kitts-based captive, Feedback Insurance Co., Ltd., as part of the Avrahamis' estate plan and as an approach to lower the Avrahami's personal federal income taxes. Clark allegedly had established first a cross-insurance (from 2007 to 2008) and then a risk pooling arrangement (from 2009 to 2010) for many of her clients engaged in a variety of unrelated businesses. According to the IRS, the arrangements were designed for no reason other than to meet the risk distribution requirements of insurance for federal income tax purposes.

Under the arrangement developed by Clark, the captives first issued direct policies to the captives' related insureds, and they did not share that risk with any other captive. Under the cross-insurance program, Clark's clients would then swap insurance premiums with each other's captive insurance companies and operating businesses. As a result of the swap, each of Clark's clients could have their businesses pay $1.2 million in premiums and claim associated insurance deductions while each of their captives would receive $1.2 million in premiums to be excluded under Section 831(b), with $360,00 or 30% derived from Clark's other clients' unrelated businesses.

At the heart of the cross-insurance program was a terrorism policy to provide coverage in excess of the insured's TRIA backed commercial policies. Safeguards were built in to the policies reducing the actual risk to the insurer. For example, in the event of a loss, if an insured wished to repair damage at a cost in excess of the deductible amount, the written consent of the insurer was required.

In 2009 Clark set up a reinsurance arrangement for all of her clients through Pan-American, another St. Kitts entity, purportedly to generate more fees for herself. Under the arrangement, the client's captives would enter into a quota-share reinsurance agreement obligating the captive insurance company to assume 30% of the risk from the policies (with target premiums of $1.2 million) that Pan-American issued to all operating businesses participating in the arrangement. Because Pan-American was a St. Kitts insurer, there was no reserve requirement. Pan-American ceded 100% of its premiums to Clark's clients.

Not Insurance in its Commonly Accepted Sense. In its brief, the IRS has asserted that the Feedback cross-insurance and Pan-American reinsurance arrangements are not insurance in the commonly accepted sense. The Avrahamis learned about captive insurance through their CPA, not an insurance broker. Premiums were not actuarially determined. Feedback did not prepare financial statements or hold meetings of its board of directors. Feedback did not have any employees or contract with experienced insurance professionals to conduct insurance functions such as underwriting, setting of premiums and reserves, investment management, and claims administration. Feedback and Pan-American were not regulated by St. Kitts. The policies were confusing and sloppily drafted, combining features of both an occurrence and claims made-policy.

No Risk Distribution. As those in the insurance world know, in order for an arrangement to constitute insurance for federal income tax purposes, the risks must be distributed among a sufficient number of insureds so that the statistical law of large numbers permits the insurer to smooth out its losses. Exactly how many insureds are required has been debated. For many years, the rule of thumb was twelve subsidiary companies, with no one insurer representing less than 5% nor more than 15% of the total risk (see Revenue Ruling 2002-90). However, in 2014, the Tax Court called these rules into question when it decided in favor of the taxpayers in *Rent-A-Center* and *Securitas*. The taxpayers in both cases won the risk distribution argument in large part because the captives insured a sufficient number of "exposure units" — stores, employees, cars, etc.

Both Avrahami and the IRS have discussed "exposure units" in making their arguments. Avrahami emphasized that its four subsidiary insureds had different types of policies involving a rental management company, tenants, and customers. The IRS in its Answer Brief points out that in *Rent-A-Center* there were over 2,000 stores which operated in 50 states, had over 14,000 vehicles and operated over 7,000 vehicles. So it appears that, in the IRS's eyes at least, a taxpayer must have many thousands of exposure units in order to win that argument.

The IRS also cites the *Harper* case in asserting that there was no risk distribution in the Pan-American pool. *Harper*, decided in 1991, has long stood for the proposition that risk distribution has been met where there is 30% unrelated business. The IRS has stated in its Answer Brief that the 30% rule of *Harper* does not apply to the *Avrahami* arrangements, because the risks insured in *Harper* were all homogenous, and the risks insured in the *Avrahami* pool were diverse.

No Risk Shifting. In its Answer Brief, the IRS also asserts that the *Avrahami* entities did not shift risk to Feedback because Feedback was not financially capable of meeting its obligations. According to the Answer Brief, Feedback never had more than $1.5 million in cash or cash equivalents on hand during the years but Feedback's maximum total exposure under the policies was allegedly as high as $26 million in 2010.

Conclusion. If the IRS wins *Avrahami*, it could mean that 831(b)s and their managers will need to revisit their insurance programs to ensure that 831(b) captives do not resemble Feedback and Pan-American. They will also need to consider whether the requirement of risk distribution has been met in light of the IRS's focus on homogeneity of risks for the 30% rule to apply. Risk shifting could also become more challenging with the IRS's renewed focus on capitalization. Hopefully, as the IRS has requested, the Tax Court will reach a decision soon so that existing 831(b)s can plan accordingly. A decision is expected in early 2017.

NEWS FROM THE VERMONT STATE HOUSE

LEGISLATURE CONVENED AMID POLITICAL TRANSITION

The 2017-2018 Vermont General Assembly convened Wednesday, January 4, 2017, for the first year of the biennium. The session will last approximately sixteen weeks which puts adjournment sometime in May. We expect the Legislature will get off to a slower start than usual for a number of reasons. There is new leadership in both the House and Senate that will need to grow into those roles. The beginning of the biennium also means committees need to be newly formed and there are no assurances that members will return to the same committee. With some expected shake-up, members will need to become acquainted with the issues subject to the committees' jurisdictions. Finally, a new Governor and transition will also contribute to a slower start. Governor Phil Scott (R) took office January 5 and his team has been officially moving into state government since. Gov. Scott has reappointed nearly the entire leadership team at the Department of Financial Regulation, including Michael Pieciak as Commissioner and David Provost as Deputy Commissioner for Captive Insurance. Former Deputy Commissioner of Insurance (traditional) Kaj Samsom will lead the Department of Taxes. There will be new agency secretaries, commissioners and others who will be given some time before they assume the role of providing testimony to committees on administrative priorities, updates to carryover issues, and reactions to policy proposals.

The election of Phil Scott ends six years of one-party rule by the Democrats in Montpelier. Scott's main campaign themes of fiscal responsibility and job creation will carry over to his policy proposals as Governor. He can arguably govern with a mandate after an impressive showing in November, despite a tough opponent and being in the state first called for national Democratic candidates at 7:01pm on election night (polls closed at 7:00 pm). Scott, the former Lieutenant Governor and former state senator, is a known entity to this Legislature and that should help in the transition. He also has experience and a reputation for reaching across the aisle to find consensus, and we think that will continue.

As for the Legislature, Democratic majority in both the House and Senate continues for the next biennium with Democrats holding approximately 84 of 150 House seats, and 23 of 30 Senate seats. House Democrats have elected Rep. Mitzi Johnson (D-South Hero) to be the new Speaker. Johnson is a 14-year member of the House and most recently served as Chair of the powerful House Appropriations Committee where she was successful in reaching for and building consensus on issues. She has already signaled a willingness to work with Gov. Scott. Sen. Tim Ashe (D-Chittenden) was elected Senate President Pro Tem. Ashe, most recently chair of the powerful Senate Finance Committee, won the endorsement of his colleagues based upon his handling of Finance, his work ethic, and confidence in his ability to handle the demanding office and issues. Pro Tem Ashe, along with Speaker Johnson, will also be the titular heads of the Democratic Party in the State House, representing the "opposition" voice to Gov. Scott's initiatives.

A new legislative session also represents an opportunity for new ideas and amendments to the captive insurance laws and we expect legislation to be introduced and considered early by the General Assembly. While still an evolving package, discussions among the industry and regulators have focused on new ideas or efforts aimed at attracting captives to Vermont. These might include authorizing a Vermont version of agency captives and premium tax incentives for certain new captive formations. We can also expect the usual series of technical amendments to existing law, with discussions to date involving sponsored captives and continued reactions to implementation of governance standards for risk retention groups. Once a bill is introduced there will be time during the legislative process to refine proposed amendments as well as introduce new ideas to be included in the package.

Just a quick note on the regulatory front. There are two regulations from the Captive Insurance Division making their way through the rulemaking process. Regulation C-81-2, Captive Insurance Financial Regulation, and C-2012-2, Risk Retention Group Holding Company Systems, are both proposed to be updated with revisions largely related to NAIC accreditation. Regulation C-81-2 contains amendments related to annual reporting requirements for special purpose financial insurance companies, the audited financial statements of captives, and the annual Statement of Actuarial Opinion evaluating a company's loss reserves and loss expense reserves. Regulation C-2012-2, as proposed, includes an assessment of enterprise risk for one or more affiliates of a Risk Retention Group and a required report if applicable, and revisions to transactions subject to prior notice to the Department to include agreements for cost-sharing services and management services. The Vermont Captive Insurance Association continues its discussions with the Department on the Regulations and has submitted comments seeking clarification in certain areas. The Department will likely consider those comments and any revisions necessary before moving the Regulations along. They are anticipated to become effective at the conclusion of the rulemaking process.

We will report in more detail in future issues the elements of any legislative package once that package is settled, and on other developments impacting the captive insurance industry.

THINKING ABOUT DEFERRING EXECUTIVE COMPENSATION? SETTING UP A 409-A COMPLIANT PLAN IS A MUST

Company executives sometimes decide to delay receiving their salaries for a variety of reasons. Perhaps the company lacks sufficient cash to meet its compensation obligations. Or perhaps the executive would prefer to receive the salary in a later year to "smooth out" tax liability. Deferring executive compensation is permissible, but compliance with the Internal Revenue Code by setting up a deferred compensation plan that follows the rules under Section 409A is a must for almost every type of deferred compensation arrangement.

Section 409A was enacted as part of the American Jobs Creation Act of 2004 and in response to the Enron debacle. It provides a comprehensive and rigid set of rules regarding the taxation of what the Code refers to as "nonqualified deferred compensation," the specific requirements for the timing of deferral elections, and the designation of the time and form of payment of deferred amounts. The tax consequences (imposed on the employee) for failing to comply with Section 409A are described universally by practitioners as severe. They include the following:

- Inclusion of compensation in income in the year that it vests (i.e. executives must pay taxes on the amount of compensation deferred under the non-compliant arrangement, even if the executive does not actually get paid);
- A 20% penalty imposed on the amount involved (this is in addition to the taxes owed); and
- An increased interest rate imposed on the taxes paid late as a result of the noncompliant deferral.

On June 21, 2016, the Internal Revenue Service issued proposed Treasury Regulations clarifying the existing regulations on Section 409A. Though some commentators find that the proposed regulations give taxpayers more leeway under certain provisions, they also evidence that the IRS continues to focus on deferred compensation as a source of abuse of the income tax rules and to impose penalties where warranted.

<u>So what is "deferred compensation" and when does 409A apply?</u> "Deferred compensation" is defined very broadly as any form of compensation which is or may be paid in a year following the year in which the legal right to payment arises. "Plan" is likewise defined broadly under the Code to include any agreement, method, program, or other arrangement. A plan subject to 409A can apply to only a single individual and can be adopted by a simple agreement (such as a letter agreement) between the employee and employer.

There are some exceptions to 409A, such as the short-term deferral exception (generally permitting payments made no later than March 15 of the following year) and the severance pay plan exception. Nonetheless, every executive considering deferring compensation by a method other than a qualified plan (such as a 401(k) plan) should first consult with an attorney to determine whether Section 409A applies and if it does apply, set up a 409A-compliant deferred compensation plan. Putting a compliant deferred compensation plan in place can help prevent an executive from being subject to substantial penalties and interest imposed by the IRS under 409A. The attorneys in Primmer's tax practice group have extensive experience in setting up such plans, and can provide advice and counsel when contemplating a deferred compensation arrangement.

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