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Captive Newsletter

A Newsletter from the Captive Practice Group *July 2016*

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NEW VERMONT COMMISSIONER TAKES OFFICE

Gov. Peter Shumlin recently appointed Michael Pieciak as the Commissioner of the Vermont Department of Financial Regulation ("DFR"). Pieciak replaces Susan Donegan, who left State employ the last day of June. Pieciak will serve as Commissioner for the remainder of the Shumlin term. Reappointment after the November election will be up to the next Governor.

Pieciak comes from within DFR where he most recently served as Deputy Commissioner of the Securities Division. Prior to joining DFR, Pieciak practiced law in private practice in New York and Vermont. Pieciak is an observer member of the SEC Advisory Committee on Small and Emerging Companies, is Chairman of the North American Securities Administrators Association ("NASAA") Corporate Finance Section Committee, and serves on NASAA's Federal Legislation, State Legislation and Capital Formation Committees.

The change is not expected to impact captives, with Deputy Commissioner Provost and Director Bigglestone remaining in office through the transition.

FHFA FINAL RULE EXCLUDES CAPTIVES FROM FHLB MEMBERSHIP

On January 20, 2016, the Federal Housing Finance Agency ("FHFA") released its Final Rule ("Rule") prohibiting captive insurance company membership in a Federal Home Loan Bank ("FHLB"). The Rule defines a captive insurance company as "an entity that holds an insurance license or charter under the laws of a State, but that does not meet the definition of 'insurance company' . . . or fall within any other category of institution that may be eligible for membership."

Eleven district banks regulated by the FHFA comprise the FHLB system. It seeks to enhance the availability of residential housing finance and community lending primarily through low-cost loans to members. More than 7,500 financial institution members own the FHLBs, including many insurance companies. As of late 2015, forty captive insurance companies were members of a FHLB. As of that date, captive members had cumulative borrowings in excess of $35 billion.

Subsequent to the 2008-2009 financial crisis, the FHFA became increasingly concerned about the increase in captive applicants, noting that virtually all the new captive members since mid-2012 were captives owned by REITs and other entities ineligible for direct membership in a FHLB. Attractive financing terms stimulated the growth. The FHFA chose at that time to prohibit captives from membership in a FHLB. It reasoned that captives face less stringent regulation than traditional insurers and noted with concern increasing competition among domiciles.

Under the Rule, Captives that became members of a FHLB prior to September 2, 2014 received a five-year window from the effective date in which to withdraw from FHLB membership. During this period, outstanding advances are limited to 40% of assets. Advances or renewals of advances maturing beyond the five-year transition are prohibited. Captives that became members of a FHLB on or after September 2, 2014 have a one-year period to terminate membership. At the end of that year or at the date of termination, if earlier, all existing advances must be repaid. Further, captives in this category are prohibited from obtaining any new advances.

The Rule was arguably unclear whether risk retention groups, mutual insurance company and association captives are included within the definition of "captive" and thereby excluded from membership. In connection with a membership application, it will be necessary to establish that the insurance entity is not controlled by an owner(s) that is prohibited from becoming a direct member of a FHLB.

We'll continue to track developments related to the FHFA Rule excluding captives from membership in a FHLB and assist clients addressing the new requirements.

TREASURY DATA-REPORTING AND OTHER RULES FOR TRIA COVERAGE

The U.S. Treasury Department published a notice of proposed new rules regarding the Terrorism Risk Insurance Program established pursuant to the Terrorism Risk Insurance Act ("TRIA"). 81 Fed. Reg. 18950 (April 1, 2016). Although Treasury has postponed drafting a broader set of rules focused specifically on captive insurers – which rules will eventually be placed within an already-designated Subpart E to 31 C.F.R. Part 50 – captives would be impacted significantly by the proposals if implemented as currently drafted.

As set forth more fully below, the Vermont Captive Insurance Association ("VCIA") met Treasury's May 31 deadline to comment on the April-proposed rules, focusing particularly on those that would impose significant new reporting requirements.

Though originally created as a temporary program to ensure the commercial availability of coverage for terrorist events after the September 11, 2001 attacks, TRIA has been extended three times (in 2005, 2007 and 2015), with the latest extension in place through 2020. To ensure that businesses and individuals can obtain at reasonable and predictable prices property and casualty ("P&C") insurance for losses resulting from certified acts of terrorism, TRIA mandates that all P&C insurers (captive as well as conventional) "make available" insurance for losses resulting from terrorist acts to the same extent as losses resulting from non-terrorist acts. To support that mandate, the federal government effectively acts as a re-insurer for the vast majority of losses above a certain industry-wide trigger and insurer-specific deductible.

Among other things, the 2015 amendments reduced somewhat the federal government's share of loss to be covered in the event of a covered event. They raised the industry-wide trigger from $100M to $200M (in yearly increments of $20M), and also reduced the government's share of coverage above the trigger, from 85% in 2015 to 80% in 2020 (with yearly decreases of 1%). Most relevant to the newly-proposed regulations, the 2015 amendments also mandated an annual reporting system by all insurers covered by the Program, which includes all P&C insurers licensed to provide primary or excess insurance in any State.

As noted, under the proposed rules, the first mandatory reports would be due March 1, 2017. Treasury anticipates that, "[f]or insurers reporting standard information, …approximately 50 hours [will be required] to collect, process and report the data, and approximately 25 hours for collection, processing and reporting data where more limited information is sought or available." 81 Fed. Reg. 18958. Treasury's website contains detailed templates for the required reporting as well as detailed instructions explaining the templates.

Although the proposed rules allow Treasury to exempt "small insurers" from the full data request required of other insurers (see proposed 31 C.F.R. § 50.51(e)), captives (small and large) are categorically excluded from the definition of small insurers, and thus also excluded from the possibility of exemption. 31 C.F.R. § 50.4(z) ("A captive insurer is not a small insurer, regardless of the size of its policyholder surplus or direct earned premium."). Treasury has estimated that about 500 insurers will have reduced reporting requirements as a result of their status as small insurers. 81 Fed. Reg. at 18957. Absent a rule change, captives will not be among them.

At the same time, however, Treasury invited comments concerning captives and said that "captive insurers might be subject to different data collection protocols than other insurers," id. at 18952. No timetable is given. VCIA's comments stressed that the same policy concerns behind avoiding undue burden to conventional small insurers should be applied to captive insurers. Even a quick glance at the Treasury-provided templates and instructions cited indicate that the reporting burdens on captives could be substantial — possibly far more than the 25-50 hours estimated by Treasury.

VCIA's May 31 comments to Treasury noted the significant role that captives play in U.S. risk financing, and that all terrorism-related coverage by insurance companies – conventional and captive – is strongly dependent upon the TRIA program, VCIA noted that captives are of particular importance with respect to nuclear, biological, chemical and radiological ("NBCR") risks, given conventional insurers' reluctance to provide such coverage — especially in metropolitan locations.

It is important that Treasury and the captive industry work together as the April-proposed rules are finalized and implemented – and the still-anticipated, broader Subpart E rules are drafted – to ensure that the rules do not place undue burden on captives and that needed TRIA-related coverage is in fact available to businesses and individuals.

FIELD CHANGES FOR MICRO CAPTIVES

In December Congress revised as part of its annual Appropriations Bill Section 831(b) of the Internal Revenue Service Code. Small captive insurance companies have long valued this Code provision as it permitted insurers with paid premiums of $1.2 million or less to pay tax only on investment income. The revised Code Section directly resolves two issues – one addressing small insurance companies' desire for an increase in the $1.2 million premium cap, and one addressing IRS concerns by curbing what some perceive as an abuse of the election by wealth transfer advisors.

Increase in $1.2 Million Limit. Proponents of the provision have long argued the $1.2 million threshold, set nearly thirty years ago, should be increased. Congress agreed to raise the limit to $2.2 million (and indexed it against inflation going forward). This will permit many existing micro captives to expand while still qualifying for the election and will allow many small captives previously unable to qualify for the election to now do so.

Abuse of Structure as Wealth-Transfer Tool. The IRS's "Dirty Dozen" list of tax avoidance techniques has the past two years included micro captives, and the IRS continues to aggressively audit these structures. Congress coupled expansion in the premium threshold with steps to curb use of captives as a strategy for transferring wealth without limited estate taxation. Most often, a pure captive is owned by a parent company to which the captive provides insurance. However, in some micro captives, the lineal descendants of the owner of the insured company own the captive (either directly or through trusts). This proved to be an attractive wealth transfer tool where a parent company deducts premium paid to the captive, the captive earns profits on a tax-advantaged basis and the descendant-owners later receive the captive's profits via dividends. Some structures were clearly abusive, including programs covering implausible risks (for example, asteroid strike insurance), or charging high premiums without actuarial substantiation.

The revised Code provision introduces a diversification rule requiring the captive to satisfy one of two tests — either that no more than 20% of premiums can come from any one policyholder (also limiting use of risk distribution pools), or to limit the captive ownership interest held – directly or indirectly – by any one heir or spouse of the owner of the insured to no more than 2% above the interest such heir or spouse owns in the insured.

The second diversification test is best understood through use of the examples:

Example #1. Construction business that needs liability insurance is owned 50% by Brother 1 and 50% by Brother 2. In order for the captive to qualify for the 831(b) election, no spouse or lineal descendant of Brother 1 or Brother 2 can own, directly or indirectly, more than 2% of the captive.

Example #2. Construction business that needs liability insurance is owned 30% by Brother 1, 30% by Brother 2, 20% by the spouse of Brother 1, 10% by the daughter of Brother 2 and 10% by the son of Brother 2. In order for the captive to qualify for the 831(b) election, the spouse of Brother 1 is limited to a 22% ownership stake in the captive and each of the daughter and son of Brother 2 is limited to a 12% ownership stake. No other spouse or lineal descendant of either Brother can own, directly or indirectly, more than 2% of the captive.

Many micro captives will need to closely consider their current ownership to determine whether the new provisions will require restructuring in advance of a 2017 effective date. The applicability of this rule is complex and far reaching. If you have any question regarding a current ownership structure's ability to comply with the new law, we encourage you to contact Primmer or your tax advisor.

***VALIDUS*: NO EXCISE TAX ON RETROCESSIONS**

In December the Internal Revenue Service published Revenue Ruling 2016-03 announcing that after the decision of the U.S. Court of Appeals for the District of Columbia in the case *Validus Reinsurance, Ltd. v. U.S.*, 786 F.3d 1039 (2015), it would no longer apply the one-percent federal excise tax ("FET") imposed by section 4371(3) to premiums paid on a policy of reinsurance issued by one foreign reinsurer to another foreign insurer or reinsurer (known as "retrocession").

Background. Section 4371 imposes the FET at a rate of 1% on contracts of reinsurance issued by foreign insurers covering insurance policies insuring casualty or life. The change announced in Rev. Rul. 2016-03 revokes an earlier position taken by the IRS in Rev. Rul. 2008-15; namely, that the IRS would impose the FET on reinsurance premiums on a "cascading" basis. As a result, the excise tax would apply to: (1) premiums paid by a U.S. insurer to the first non-U.S. reinsurer and (2) premiums paid by the first non-U.S. reinsurer to the second non-U.S. reinsurer. The *Validus* case involved the imposition of the excise tax on transaction (2).

D.C. District Court and D.C. Appeals Court Holdings. Validus is a Bermuda-based reinsurer with no place of business in the U.S. It sometimes buys reinsurance for liabilities under the reinsurance contracts it sells. The IRS assessed excise taxes against Validus for portions of its retrocession transactions during 2006 totaling $326,340. Validus paid the tax and sued for a refund. In 2014, the D.C. District Court found in favor of Validus based on the "plain meaning" of the statute, which it said limits application to reinsurance contracts "covering" property or life (not reinsurance). The IRS appealed.

In 2015, the D.C. Appeals Court found the language in Section 4371 (in particular, the reference to "covering" property or life contracts) to be ambiguous as to whether the FET applies to retrocessions. Nevertheless, the court held that the excise tax under Section 4371 does not apply because the case involved wholly foreign retrocession transactions, and there is no clear Congressional intent to give Section 4371 extraterritorial application.

RRG GOVERNANCE STANDARDS UPDATE

Last year's enacted Governance Standards for Risk Retention Groups become binding on every Vermont risk retention group ("RRG") on May 7, 2016, and kept RRGs, their advisors and Directors busy in winter and spring meetings. The breadth of the Standards (summarized in the August 2015 edition of Primmer's Captive Newsletter) and flexibility in meeting their requirements made each RRG's compliance effort different, but specific requirements for annual or other regular activities mean they will be a feature of RRG governance for the foreseeable future. The specific tasks for each RRG will depend on the policies, charters and practices put in place for initial compliance, but they include at least several of the following:

For Boards:

- Annual Board determination of Director independence.
- Review of the RRG's goals and objectives for compensation of officers and service providers.
- Review of the performance of officers and service providers as measured against the risk retention group's goals and objectives.
- Review and approval of the continued engagement of officers and material service providers.
- Review and approval of the amounts to be paid under a material service provider contract.
- Conduct Board evaluation and review of results.

For Audit Committees (or the whole Board, in some instances):

- Review of quarterly financial statements and annual audited financial statements with management.
- Review of selection and retention of independent auditor and certifying actuary.
- Review of annual audited financial statements with the independent auditor.

For Staff and Management:

- Provide evidence of ownership interest to each risk retention group member.
- Determine materiality thresholds for service providers and related testing.

As we have discussed with all our RRG clients, compliance with the Governance Standards is not a one-time project. Policies, procedures and practices developed for compliance should be revisited periodically and changes made to reflect practical approaches developed by staff, management and Boards as they work through the first few years of Standards compliance. Additionally, we expect that industry practice, as refined by the expectations of DFR examiners first reviewing RRG compliance, will develop over time. Please contact us for assistance with both regular compliance and the streamlining you will need.

NEWS FROM THE VERMONT STATE HOUSE

CAPTIVE LEGISLATION PASSES AND LEGISLATURE ADJOURNS

The 2015-2016 Vermont General Assembly adjourned in May, closing the books on this Legislature.

The lack of significant policy items addressed reflects that Vermont is in a significant political transition. The Governor, Lieutenant Governor, Senate President Pro Tem, and Speaker of the House are all moving on or seeking different offices – the first time since 1968 all four offices will open at the same time. The Governor and his Administration are in wrap-up mode and their level of engagement in the legislative process was far less than in preceding years. The Legislature declined to support a lame duck Governor's political agenda, including proposals to assess a tax on dentists and independent physicians, a call for divestiture of coal and fossil fuel assets, and marijuana legalization.

This unprecedented transition will also impact the rank-and-file of the next Legislature. Several incumbents have already signaled retirement or a decision to seek a different office. We can also expect some significant turnover in committee leadership and composition in the next biennium. Loss of institutional knowledge will underscore the need to educate legislators on issues of importance.

Regardless of who wins office, the captive insurance industry will continue to be warmly received as the partnership among the Legislature, the Administration and the industry has spanned numerous administrations and leaders over several decades. Lawmakers understand Vermont faces competition from a majority of states and is able to maintain its standing, in part, by calling on this partnership and annually updating its captive insurance laws to keep them fresh and respond to needed improvements.

This year's legislation, Act 74, contained several expansions of the captive law and clarified some provisions. Specifically, the bill:

- Allows sponsored captives and association captives to file annual reports on a fiscal year-end, matching that of the owner or insured.
- Allows sponsored captives or industrial insured captives to obtain dormant status or a "shelf license."
- Amends sponsored captive laws to:
    - Allow the conversion of a cell created by contract into an incorporated cell.
    - Allow the sale, transfer, or assignment of a cell to another sponsored captive.
    - Allow the conversion of a cell into a separate captive.
- Revises risk retention group governance standards enacted last year with a few technical amendments, including:
    - Revision of the definition of "director" for enhanced clarity.
    - Revision of the definition of "material service provider" to include defense counsel only if his or her annual fees are material in a majority of the previous five years.
    - Addition of authority for the Commissioner to refute a board's determination that any member of the board is "independent".

- Removal of the requirement that the attorney-in-fact of a reciprocal adhere to the same board standards, thereby recognizing that the attorney-in-fact is simply a legal construct that undertakes the reciprocal exchange of contracts among the members.

The bill provided that the amendments became effective upon passage. That was triggered by the Governor's signature on April 13, 2016.

Work on the next package of captive insurance legislative and regulatory initiatives is underway. If you have ideas for improvements, please contact us.

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