March 22, 2016

Paul Frank + Collins, the Vermont Captive Insurance Association ("VCIA") and the Vermont Department of Financial Regulation ("DFR") continue to work to maintain Vermont as the premier onshore captive domicile. The Paul Frank + Collins Captive Insurance Team of Stephanie J. Mapes, William D. Riley, Christopher J. Leff, Peter J. McDougall, and Benjamin L. Gould offer this summary of legal and legislative issues to keep you apprised of the most pertinent industry developments and initiatives from Vermont and nationally.

VERMONT LEGISLATIVE DEVELOPMENTS

As is the custom, the Vermont captive insurance industry, led by the VCIA and the DFR, have once again proposed changes to Vermont's captive insurance statute in an effort to respond to industry needs and to remain a leader in captive insurance. This year's "captive housekeeping bill" was introduced in the Vermont House of Representatives on January 12, 2016 and was assigned bill number H. 538.

As is typically the case, the Vermont House acted quickly passing the bill on January 22, 2016, only ten days after its introduction. The bill is now with the Vermont Senate and was assigned to the Senate Committee on Finance.

The current version of H. 538 contains three sections. First, a change has been proposed to include a sponsored captive insurance company as a type of entity permitted to make an application to file its Vermont Captive Annual Report on a fiscal year-end basis. The current statute only permits pure captives and industrial insured captives to file the report on a fiscal year-end basis.

Additionally, the bill includes a proposed revision to Vermont's dormant captive provisions. The ability of a captive to obtain dormant status was adopted by the Vermont legislature in 2014. The benefit of dormant status is the ability to keep the captive structure in place at a reduced cost, pending resurrection or the start-up of a captive insurance program. The initial dormant captive statute was limited to only pure captives that had never insured controlled unaffiliated business, ceased issuing new policies, and had no remaining liabilities associated with insurance business, transactions or policies. The proposed revisions contained in H.538 would permit a sponsored captive and an industrial insured captive to seek dormant status and permit a captive that has insured controlled unaffiliated business to apply for dormant status.

Finally, the proposed legislation includes some minor corrections to the governance standards for risk retention groups that were included in last year's captive housekeeping bill. Please refer to the Focus on Risk Retention Groups section of this memorandum for further updates concerning risk retention group captives.

CAPTIVE TAX DEVELOPMENTS

For some captive insurance companies, the most significant recent development in the federal tax arena relates to the excise tax on reinsurance premiums paid to foreign reinsurers. The Internal Revenue Code imposes an excise tax of one percent on reinsurance premiums for coverage that relates to "hazards, risks, losses, or liabilities wholly or partly within the United States."

In 2008, the Internal Revenue Service issued Revenue Ruling 2008-15 in which it took the position that the excise tax applied to reinsurance transactions between a foreign insurer or reinsurer and another foreign reinsurer. That ruling described two basic scenarios:

1. A foreign insurer issues policies of insurance to a U.S. corporation and then purchases reinsurance from a foreign reinsurer to cover all or a part of those risks. Neither the foreign insurer nor the foreign reinsurer is engaged in a trade or business in the U.S.

2. A foreign reinsurer issues reinsurance policies to a U.S. insurer and then purchases reinsurance from another foreign reinsurer to cover all or a portion of those risks.

The ruling also described two additional scenarios like the first one, except that provisions of U.S. tax treaties were also considered.

On May 26, 2015, the U.S. Court of Appeals for the District of Columbia Circuit issued a ruling in the appeal of *Validus Reinsurance, Ltd. v. United States of America.* That case challenged the IRS's position in Revenue Ruling 2008-15 in the context of reinsurance premiums paid by a foreign reinsurer on retrocessions with other foreign reinsurers. The plaintiff in that case was a foreign reinsurer that had sold reinsurance policies to insurance companies that covered risks in the U.S. and then purchased reinsurance from non-U.S. reinsurers to protect itself against losses on the reinsurance policies it sold. The IRS asserted that U.S. federal excise tax applied to the second level of reinsurance (and beyond) despite the fact that those reinsurance contracts lacked any U.S. person as a party. The appellate court sided with the taxpayer and ruled that the excise tax does not apply to reinsurance transactions between non-U.S. companies.

On December 23, 2015, the IRS issued Revenue Ruling 2016-03, which formally accepts the position taken by the appeals court in the *Validus* ruling. In that revenue ruling, the IRS formally revokes Revenue Ruling 2008-15 and states that it will no longer apply the excise tax to premiums paid on a policy of reinsurance issued by one foreign reinsurer to another foreign insurer or reinsurer under the situations described in Revenue Ruling 2008-15.

Revenue Ruling 2016-03 includes a caution that the ruling should not be interpreted too broadly. It notes specifically that this ruling does not apply to policies issued by a foreign reinsurer to (i) a foreign insurer that has elected to be treated as a U.S. domestic corporation or (ii) a foreign insurer or reinsurer that is exempt from excise tax on premiums it receives because those premiums are effectively connected with the conduct of a U.S. trade of business. In each of those types of situations, the party paying the reinsurance premiums has a connection to the United States that was not present in the *Validus* case.

MICRO-CAPTIVE UPDATE

As we reported in 2015, captives electing to be taxed under Section 831(b) of the Internal Revenue Code continue to draw the attention of Congress, the Internal Renevue Service and the media. Developments with respect to so called micro-captives include recent legislative changes to Section 831(b), the continuation of promoter audits by the IRS, and a soon-to-be-issued decision by the United States Tax Court in *Avrahami v. Commissioner*.

A. Legislative Changes to IRC Section 831(b)

The most significant development in this area is the December 18, 2015 enactment of the Protecting Americans from Tax Hikes Act of 2015 ("PATH"), which, among many other purposes, will increase the potential tax benefits of the 831(b) election, while also restricting the election's attractiveness as an estate planning tool. Prior to PATH, Section 831(b) allowed small property and casualty insurance companies collecting $1.2 million or less in written premium to make an election to be taxed solely on investment income and not on underwriting income. Effective for the 2017 tax year, PATH increases the maximum amount of written premiums allowed under the election to $2.2 million and provides that the maximum will thereafter be indexed to inflation. In addition, PATH requires that at least one of two alternative tests be satisfied to establish eligibility to take the election. The first test pertains to diversification and provides that no more than 20% of the captive's premiums can be attributable to a single policyholder. PATH's definition of "policyholder" applies various attribution and controlled group rules that essentially provide that related policyholders will be treated as one policyholder for purposes of the diversification test. The second test pertains to ownership (direct or indirect) of the captive and the businesses and assets insured by the captive. The amended statute states in part that "[a]n indirect interest includes any interest held through a trust, estate, partnership, or corporation." Although the statutory language comprising the second test has been described as complex and vague, it essentially provides that where the captive is owned by the spouse and/or children of a person who owns the businesses and assets insured by the captive, the election may not be taken where the spouse and/or children's ownership interest in the captive exceeds, by more than 2%, their ownership interest in the businesses and assets insured by the captive. For example, where a woman has an 80% ownership interest in the business assets insured by the captive and the captive is owned 100% by the woman's children, the captive may not elect to be taxed under Section 831(b).

The changes noted above will apply to existing and newly formed captives taking the 831(b) election. Accordingly, owners of existing captives that have made the election will need to analyze whether such captives remain eligible under the new tests and, if not, whether it is possible and desirable to make changes to the ownership structure of the captive's policyholders and/or the captive itself to establish eligibility.

B. IRS Promoter Audits/Dirty Dozen Listing

It is our understanding that the IRS continues to audit a number of captive management firms that specialize in and promote the use of micro-captives, or otherwise provide services for such captives. In addition, the IRS remains particularly interested in "risk pools" that are utilized by micro-captives in order to demonstrate the risk shifting and distribution needed to qualify as an insurance company for federal tax purposes. If the IRS determines that a risk pool is an invalid mechanism for risk shifting and risk distribution, it will have grounds to assess tax deficiencies against individual participants in that pool to the extent that each participant's tax position is not independently sustainable without the pool. Moreover, as in 2015, the IRS included abusive practices involving "certain small or 'micro' captive insurance companies" on its annual list of tax scams known as the "Dirty Dozen" for the 2016 filing season.

C. Avrahami v. Commissioner

The United States Tax Court is expected to decide sometime in 2016 the closely-watched case of *Avrahami v. Commissioner* (Docket No. 17594-13). *Avrahami* involves a micro-captive domiciled in St. Kitts and Nevis, which was formed in 2009 by a husband and wife to provide terrorism insurance and builder's risk insurance to Arizona-based jewelry stores and property management companies owned and operated by the couple. The IRS has broadly attacked the Avrahamis' captive insurance arrangement with a series of arguments designed to establish that the captive transactions do not satisfy any prong of the commonly recognized three-part test for deeming an arrangement to be "insurance" for federal tax purposes (i.e., the arrangement involves the existence of an insurance risk; there is the presence of both risk shifting and risk distribution; and the arrangement is recognized as insurance in its commonly accepted sense). Another major component of the IRS attack is based on arguments that the Avrahamis failed to substantiate the deduction of premium payments by the insureds as ordinary and necessary business expenses pursuant to IRC § 162.

The *Avrahami* case is being closely watched by the micro-captive community because it presents a number of alleged fact patterns that the IRS has previously indicated may be associated with abusive micro-captive arrangements. Such factual allegations include (1) the involvement at formation of promoters and service providers with little or no insurance experience; (2) the absence of compelling insurance and business reasons for forming the captive; (3) various operational and governance deficiencies, including the failure to prepare financial statements, substantiate arms-length premium calculations, conduct board meetings and develop adequate insurance policy documentation and claims validation processes; (4) inadequate capitalization to support the risks and limits insured by the captive; (5) the captive's participation in a thinly-capitalized risk pool sponsored by the promoter where the pool has little capability or incentive to enforce participant obligations; and (6) circular intercompany loan arrangements in which the captive's funds were loaned to entities controlled by the Avrahamis' children and then ultimately back to the Avrahamis.

TERRORISM RISK INSURANCE ACT REPORTING OBLIGATIONS

The Terrorism Risk Insurance Program Reauthorization Act of 2015 (the "Reauthorization Act") was signed into law by President Obama on January 12, 2015. The Reauthorization Act extends the federal Terrorism Risk Insurance Program (the "Program") until December 31, 2020.

One significant change to the Program that will directly impact captives is the Reauthorization Act's requirement that the Secretary of the Treasury, beginning in 2016, annually collect data from "insurers participating in the Program" regarding terrorism insurance for the purpose of "analyzing the effectiveness of the Program." On March 4, 2016, the Treasury Department, through the Federal Insurance Office ("FIO"), published a Notice in the Federal Register providing preliminary information regarding the data collection process. The Notice states that the information and data sought by the FIO will focus on "(1) Lines of insurance with exposure to such losses; (2) premiums earned on such coverage; (3) geographical location of exposures; (4) pricing of such coverage; (5) the take-up rate for such coverage; (6) the amount of private reinsurance for acts of terrorism purchased; and (7) such other matters as [the Treasury] considers appropriate." The Notice further indicates that proposed rules governing the submission of information and data will be forthcoming from the FIO. Based on the language of the Reauthorization Act, the Notice and the history of the Program as it has been applied to captives, we believe that the data reporting requirements are broadly applicable to all U.S.-domiciled captives writing lines of commercial property and casualty insurance that are subject to the Reauthorization Act, and not simply to those captives that actually write insurance covering losses resulting from acts of terrorism. In essence, the reporting requirements apply to

any captive that presently is required to attach a TRIA disclosure form to its policies pursuant to the Program's mandatory availability and disclosure requirements, regardless of whether the insured elects to accept or decline terrorism coverage.

In the short-term, the most notable aspect of the Notice is the FIO's decision to make the disclosure of data by insurers "voluntary" in 2016. Nonetheless, the FIO has encouraged "all participating insurers to report to the extent feasible." Furthermore, Deputy Commissioner David Provost, of the Vermont Department of Financial Regulation, has "strongly encourage[d]" Vermont captives to file the requested data. Insurers desiring to submit data regarding calendar year 2015 have been asked to do so by April 30, 2016. The full Notice issued by the FIO may be found here: https://www.gpo.gov/fdsys/pkg/FR-2016-03-04/pdf/2016-04821.pdf

Finally, the FIO has determined that insurers reporting data will do so through a web portal established by the Insurance Services Office ("ISO"), which has been retained by the FIO to provide insurance statistical aggregation services. The FIO has stated that "[t]he information collected by the aggregator will be maintained by the aggregator in a confidential fashion, and the aggregator shall provide information to [the FIO] in an aggregated format for purposes of [the FIO's] analysis of the Program." As a result, data reported to the ISO by any individual captive should not be identifiable by the FIO with respect to the reporting captive. Further information regarding the ISO web portal and registration requirements may be found here: https://www.tripsection111data.com/

We anticipate that most, if not all, captives that will be reporting information and data to the FIO will do so in conjunction with its captive management company. If you have any questions regarding the legal obligations of captives to report insurance data to the FIO, please contact us.

CAPTIVE INSURANCE COMPANIES NOW PROHIBITED FROM MEMBERSHIP IN FEDERAL HOME LOAN BANKS

Earlier this year, the Federal Housing Finance Agency ("FHFA") released a final rule amending its regulation on membership in Federal Home Loan Banks ("FHLBs"). This amendment took effect upon its publication in the Federal Register on January 20, 2016. Among other provisions, the effect of the amendment is to bar pure and other wholly-owned captive insurance companies from membership in the FHLBs.

A modest number of captive insurance companies had become members of FHLBs in order to gain access to low-cost borrowing options available to such members. Initially, these FHLB-member captives were organized by regional and national financial institutions to provide mortgage reinsurance. More recently, a number of captives formed by real estate investment trusts ("REITs") had become FHLB members as well.

While the FHFA will continue to allow insurance companies to become FHLB members if they otherwise qualify, the amendment introduces to the membership regulation a definition of "insurance company" which it sets forth as "an entity that holds an insurance license or charter under the laws of a State and whose primary business is the underwriting of insurance for persons or entities that are not its affiliates." Therefore, despite being licensed and regulated as insurance companies in their domicile state, pure and other wholly-owned captives no longer meet the FHFA's definition of "insurance company" and thus can no longer qualify for FHLB membership.

In promulgating this amendment, the FHFA stated that entities not otherwise meeting the statutory requirements for FHLB membership were forming captives "as conduits to circumvent the membership eligibility requirements" in order to gain access to low-cost funding. In a statement, Melvin L. Watt, director of the FHFA, said that the FHFA promulgated this amendment as part of its authority and duty

"to implement the statutory membership provisions of the Federal Home Loan Bank Act" and ensure that institutions could not "frustrate the intent of Congress." He advised that Congress could amend the Federal Home Loan Bank Act should it wish to make clear that captives are, in fact, entities deserving of membership in the FHLB.

By and large, the final rule, in relevant part, mirrors the initial proposed regulation, which the FHFA published in September 2014, in spite of numerous comments submitted by the captive insurance industry urging the FHFA to reconsider this proposed action. One difference between the final rule and the initial proposal was the introduction of a grace period, allowing captives to wind down their FHLB membership in an orderly manner rather than having it terminated with immediate effect. Captives whose FHLB membership preceded the September 2014 publication of the proposed rule will have five years following the January 20, 2016 effective date to withdraw their FHLB membership, and in the meanwhile, their outstanding advances from the FHLB may not exceed 40 percent of the captive's assets and must mature before the end of this five-year sunset period. Captives that obtained FHLB membership after September 2014, by contrast, only have one year to withdraw their membership and may no longer take new advances or renew existing advances.

PROTECTED CELL STRUCTURE ADDRESSED BY FEDERAL COURT

In what is believed to the first judicial decision of its kind, a Montana federal magistrate judge recently assessed the legal status of an unincorporated cell within a protected cell captive insurance company structure (analogous to a sponsored captive insurance company structure in Vermont and other states), holding that the unincorporated cell did not have its own legal identity, but suggesting that the segregation of its assets and liabilities was nonetheless valid.

At issue was an arbitration clause in a reinsurance agreement between the sponsored captive, known as Pacific Re, Inc., which was acting on behalf of the protected cell, and AmTrust North America, Inc., which was acting on behalf of Technology Insurance Company, Inc. When a dispute arose under the reinsurance agreement, AmTrust filed a demand for arbitration upon both the cell and Pacific Re. Pacific Re then filed suit, seeking a declaratory judgment that the proper party to be named is only the cell, and not the captive. AmTrust asserted counterclaims, arguing not only that Pacific Re was also a proper party to be named in the arbitration, but that the cell at issue was not a valid protected cell, and that the protected cell statute could not be relied upon to limit the captive's exposure.

In ruling upon the matter, the magistrate judge analyzed the Montana statute governing protected cell captive insurance companies. She noted that the statute allows for each cell to be either incorporated or unincorporated, and requires that each cell have separate and identifiable assets and liabilities. She also seized upon statutory language stating that "the creation of a protected cell does not create, with respect to that protected cell, a legal person separate from the protected cell captive insurance company unless the protected cell is an incorporated cell." Therefore, she concluded that the cell at issue in the case, since it was unincorporated, did not have a separate legal identity. Instead, it was part of the larger captive insurance company. As a result, the protected cell did not have the capacity to sue and be sued independently of the larger captive, and the demand for arbitration properly named Pacific Re in addition to the cell.

The magistrate judge did not need to reach the issue as to whether the protected cell statute could be relied upon to limit the exposure of the captive overall. Nonetheless, she indicated that such a structure would be valid, noting that the statutory language makes "clear that the liabilities and assets of a protected cell are segregated from the other cells and from the" captive. She also appeared to be comfortable with the concept that the "assets of a protected cell [could not] be used to satisfy the liabilities of any other cell," in

spite of the fact that the "cells are not entirely independent from" the captive. As a result, although this opinion has limited precedential value outside of Montana, this opinion could support a legal defense in the future event that the assets of a protected cell – particularly an unincorporated cell – are sought by a party making a claim against another cell or the captive as a whole.

The case is *Pac Re 5-AT v. AmTrust North America, Inc.*, No. CV-14-131-BLG-CSO, 2015 U.S. Dist. LEXIS 65541 (D.Mont. May 13, 2015).

FOCUS ON RISK RETENTION GROUPS

Numbers are Holding and Vermont Continues to be the Largest RRG Domicile

Last year, we reported that although the total number of risk retention groups may be shrinking, average premium increased more than 10 percent in 2014, its highest growth rate in a decade, and in a soft market environment. The 2015 figures show that the number of operating risk retention groups has held steady, signifying that the trend of record numbers of RRG retirements in 2013 and 2014 may have abated. New formations remain stagnant with some exceptions in the transportation industry. The figures for 2015, once they become available, are expected to reflect modest premium growth. It is also important to note that Vermont remains the most popular RRG domicile, with September 2015 figures putting Vermont at 79 active RRGs, or about 34 percent of all active RRGs. Vermont has more healthcare RRGs than any other state, and its remaining RRGs span all industry sectors making Vermont a very diverse RRG domicile.

Expansion of the LRRA HR 3794 - Nonprofit Property Protection Act

HR 3794 was recently introduced in the U.S. House of Representatives. Under the current version of the federal Liability Risk Retention Act (the "LRRA"), RRGs are limited to writing commercial liability coverage. This limitation forces businesses to purchase their property and auto physical damage policies as "stand-alone" policies from commercial insurers. Unfortunately, many small to mid-sized organizations are only offered "package policies" — property and liability bound together — from commercial insurers. When members of RRGs try to purchase "stand alone" property policies, they find their options are extremely limited. HR 3794 is aimed at providing some relief for this problem. Its scope, however, is limited to serving only small to mid-sized nonprofits. HR 3794 limits property coverage that an RRG may offer to 501(c)(3) tax-exempt nonprofits and caps any individual total insured value ("TIV") at $50 million. In addition, any RRG offering property coverage must have a minimum of $10 million in capital and 10 years of experience writing liability insurance.

There has been much talk over the last several years, and only limited action, about the need to expand the LRRA to include commercial property coverage. HR 3794 is a baby step in this direction, with estimates that of the 50 RRGs meeting the size and seasoning requirements, only about 15 serve the nonprofit sector, and of those 15, only six are small enough to not exceed the TIV requirement for any one member.

Unfortunately, the bill as currently drafted also throws in a new definition of "commercial insurance" which prejudices a larger number of RRGs and seeks to preclude RRGs from writing certain contractual liability coverage. As a result, some organizations, such as the National Risk Retention Association, have voiced their opposition to the bill, arguing that the benefits of the baby step forward do not outweigh the detriment to a larger number of RRGs that will be prejudiced by the new definition of commercial insurance.

RRG Governance Standards

We reported last year that the Vermont legislature adopted the National Association of Insurance Commissioners' proposed governance standards as part of the 2015 captive housekeeping bill. A summary of the new standards was included in our 2015 legislative memorandum. These standards apply to risk retention groups first licensed on or after May 7, 2015, the effective date of the act. All Vermont-domiciled RRGs in existence on the effective date have until May 7, 2016 to come into compliance. PF+C has worked over the past year with our risk retention group clients to ensure compliance within the one year grace period.

Most of our clients have adopted our recommended policies and procedures for complying with the standards. However, we are still working with the DFR to resolve various uncertainties and grey areas, many of which are centered on the determination of "independent" directors. While we do not yet have perfect clarity, we can report that the DFR has been very reasonable, supportive and cooperative in working with us to find the best balance between the prudent steps toward good corporate governance and avoiding undue burdens on our RRG clients, especially our smaller and closely-held RRG clients.

This year's captive housekeeping bill summarized earlier in this memorandum included some corrections and tweaks to the standards passed last year. These changes, for the most part, are not substantive, with the exception of a provision added under the director independence section that provides a time frame for responding to a disagreement from the DFR related to board independence. It states that if the Commissioner disagrees with the board's determination regarding independence, the board shall, within six months, take such actions as are necessary in order to obtain written confirmation from the Commissioner that the board meets the independence requirements set forth in this subsection.

Lead State Regulation Upheld

The benefit of forming a risk retention group centers around lead state regulation, with the state of domicile being charged with full regulatory authority over the RRG and the states where the RRG does business being limited in their regulatory authority to only those powers specifically granted under the LRRA. As we have discussed in many of our prior client communications, lead state regulation causes some consternation with the regulators in other states at times, and sometimes (if not often) non-domiciliary states can't help themselves but to over-reach and overstep their boundaries. While no one likes the idea of going to court to assert their rights, sometimes RRGs have no choice. Recently, some courts have done a nice job of upholding the intent of the LRRA.

In *Courville v. Allied Professionals Ins. Co*., 179 So.3d 615 (La. 2015), the Louisiana Supreme Court refused to hear an appeal from a lower court decision holding that the insured cannot take advantage of Louisiana's "direct action" statute (granting the ability of a plaintiff to sue a defendant's insurance company directly) because the RRG's policy prohibited such actions. A recent case in New York, *Wadsworth v. Allied Professionals Ins. Co.*, 748 F.3d 100 (2d Cir. 2014), reached the same conclusion, thereby holding that the policy should be interpreted under the laws of the RRG's lead state and not under the laws of the non-domiciliary state where the RRG was doing business. In past communications with our clients, we reported similar wins (in the Eleventh Circuit and in the Nebraska Supreme Court) regarding the ability of an RRG to enforce an arbitration provision specified in its policy in a state where the local law prohibits such enforcement.

PAUL FRANK + COLLINS P.C. – ADDITIONAL SERVICES

Vermont is now well into its fourth decade as a captive insurance domicile, and Paul Frank + Collins has been among the leading captive insurance law firms since the inception of the domicile in 1981. Today, we represent clients with captive insurance companies not only in Vermont, but also in several other domiciles throughout the United States, including Missouri, New York, New Jersey, Texas, Arizona, and South Carolina, as well as offshore domiciles including Bermuda, the Cayman Islands and Guernsey. In addition, Paul Frank + Collins offers a number of services ancillary to our primary captive insurance company representation, including, among others:

- Claims management
- Coverage analysis
- Claims and underwriting audits
- Federal and state tax analysis
- Patent, trademark and other intellectual property services
- Arbitration and litigation including coverage disputes, insurance defense and commercial matters
- Impact analysis relating to the solvency issues of parent companies/members
- Immigration, including legal counsel on a broad range of immigration matters, such as foreign investments, immigrant and non-immigrant visas, and corporate compliance.

If any of the foregoing services might be of interest to you, please let us know how we may assist.