PRIMMER PIPER EGGLESTON & CRAMER PC

# Captive Newsletter

*A Newsletter from the Captive Practice Group* *August 2019*

## Captive Team


**Jeffrey Johnson**
jjohnson@primmer.com

**Russell Young**
ryoung@primmer.com

**Denise Deschenes**
ddeschenes@primmer.com

**Randall Wachsmann**
rwachsmann@primmer.com

**Jesse Crary**
jcrary@primmer.com

**R. Ryan Gadapee**
rgadapee@primmer.com

**Jamie Feehan, Government Relations Director**
jfeehan@primmer.com

**Kurt Lutes, Paralegal**
klutes@primmer.com


## Vermont Offices


**Burlington:**
30 Main Street
Suite 500
Burlington, VT 05401
PH: (802) 864-0880
FAX: (802) 864-0328

**Montpelier:**
100 E. State Street
Montpelier, VT 05602
PH: (802) 223-2102
FAX: (802) 223-2628


## NEW SPONSORED CAPTIVE CLARITY

The Vermont Department of Financial Regulation ("DFR") recently issued new instructions for sponsored captives seeking to add a new cell. Under the captive law, every new cell's participant contract must be approved by DFR, but the process of seeking the approval had not been described with specificity, and practices among practitioners varied. With the recent proliferation of cell programs, different approaches could cause delays when applications lacked necessary materials.

The new application closely resembles that for traditional (non-cell) captive programs. The key piece remains the cell's business plan, but additional information regarding capitalization, governance (for incorporated cells) and key service providers should accompany the package. The process culminates with a Certificate of Approval from DFR necessary to organize the cell with the Vermont Secretary of State, if required.

Captive managers, attorneys and consultants familiar with Vermont captives can assist clients through the form and instructions, which are available online.

## UPDATE ON WASHINGTON STATE SELF-REPORTING PLAN

As we reported in April 2019, the Washington Insurance Commissioner (the "Commissioner") established a captive insurer "Self-Reporting Plan" following its settlement of premium tax, interest and penalties assessed against Microsoft's Arizona-domiciled captive for allegedly engaging in the unauthorized business of insurance. Under the Plan, captives self-reporting prior to June 30, would pay a reduced penalty, fine, back premium tax and interest. Amounts owed will be calculated based upon a "look-back" period and with preceding activity forgiven. The length of the look-back depends upon the timing of self-reporting. Reporting before December 31, 2019 includes the current year and the previous ten years. January 1, 2020 to June 30, 2020 reporting includes the current year plus the fifteen previous policy years, and any reporting after June 30, 2020 includes all years since inception of the captive. The Commissioner argues there is no applicable statute of limitations.


**© 2019 Primmer Piper Eggleston & Cramer PC**
**All Rights Reserved**

Effective July 1, 2019, the penalty and fine amount under the Self-Reporting Plan increased to 50% of the tax penalty and a $100,000 fine. The penalty and fine will continue to increase every six months until reaching a "maximum" on July 1, 2020, when the tax penalty will be equal to the full amount of premium tax owed with no limits on fines.

Regardless of the Commissioner's position, limits exist for many captives as a result of basic constitutional due process. There are several grounds on which premium taxes may not apply to captive programs. Captives with Washington activity should nonetheless evaluate the self-reporting regime and review with advisors whether a risk exists.

The Vermont Captive Insurance Association ("VCIA") and the Captive Insurance Companies Association ("CICA") continue to explore possible solutions for Washington-based companies utilizing captives in risk management programs.

## CAPTIVE AND RRG RELATED ACTIVITY AT THE NAIC

Recent activities of the National Association of Insurance Commissioners ("NAIC") demonstrate increased attention to issues impacting captives and risk retention groups. The NAIC's Risk Retention Group (E) Task Force has begun review of RRG registration in non-domiciliary states and considering whether current actions by many of these states warrant clarification of regulator rights and duties. Both the National Risk Retention Association ("NRRA") and the Vermont Captive Insurance Association ("VCIA") request the Task Force's involvement in RRG registration matters, including review of state-mandated fees, extended and extensive registration review procedures, and registration renewal requirements. Possible actions include review and updates to the Model Risk Retention Act, the Risk Retention and Purchasing Group Handbook, the uniform registration form and development of a regulator "FAQ" guide.

Task Force members include a number of states home to many RRGs including Vermont (Chair), District of Columbia (Vice-Chair), Hawaii, Nevada, and South Carolina.

Beyond RRGs, the NAIC will examine credit for reinsurance provisions for life and health insurer special purpose captives, accounting treatment of related reinsurance agreements and regulation of legacy transactions.

## FEDERAL COURT STYMIES ASSOCIATION HEALTH PLANS

On March 28, 2019, the United States District Court for the District of Columbia issued a decision invalidating key provisions of new Department of Labor ("DOL") regulations made applicable to Association Health Plans ("AHPs"). On June 21, 2018, the DOL issued final regulations significantly broadening access to AHPs by permitting owners of businesses with no employees (referred to as "working owners") to join AHPs and permitting employers from a single state or metropolitan area to form an AHP regardless of the existence of any close economic or representational ties between the employers. Eleven states and the District of Columbia filed a lawsuit against the DOL arguing that development of the AHP regulations violated the Administrative Procedures Act and that the regulations themselves violated provisions of the Affordable Care Act ("ACA") and Employee Retirement Income Security Act ("ERISA"). The U.S. District Court, in an opinion by Justice John Bates, sided with the states finding that the DOL exceeded its statutory authority under ERISA and circumvented ACA requirements.

Specifically, the Court vacated the regulations' definition of bona fide employer associations, the new



**© 2019 Primmer Piper Eggleston & Cramer PC**
**All Rights Reserved**

"commonality of interest" standard, and the language equating working owners with employees.

The DOL filed an appeal in the D.C. Circuit Court of Appeals. The government has not yet obtained a stay of the district court order, and therefore, no new AHPs may be established under the vacated final regulations. Subsequent to filing the appeal, the DOL issued two sets of FAQs in an effort to clarify the effect of the decision on current AHPs. The first, issued on April 29, 2019, assured businesses and employees that coverage obtained through an AHP would continue through the end of the plan year, or if later, the contract term, and that the DOL was adopting a non-enforcement policy for employers continuing coverage through AHPs in good faith reliance on the vacated final regulations. The second, issued on May 13, 2019, distinguished between AHPs designated as Pathway 1 (formed under pre-rule DOL guidance) and Pathway 2 (formed under the now-vacated final DOL regulations). This FAQ confirmed that Pathway 1 AHPs were unaffected by the Court decision and could continue to operate consistent with the pre-rule guidance (prohibiting AHP participation by working owners or by employers with no close economic or representational ties (regardless of geographic proximity)). The DOL further clarified that its non-enforcement policy would not extend to Pathway 2 AHPs that continued to market or enroll new members after the date of the Court's decision.

We will continue to monitor and provide updates on the federal court case as it moves through appeal.

**831(B) CAPTIVES UPDATE**

Microcaptives electing taxation under section 831(b) of the Internal Revenue Code have been under consistent attack by the Internal Revenue Service. On June 18, 2018, the United States Tax Court decided against the taxpayer in *Reserve Mechanical Corp. v. CIR* (T.C. Memo. 2018-86), a case involving a small Anguillan captive purportedly tax-exempt under section 501(c)(15) of the Internal Revenue Code. Although section 501(c)(15) captives differ from section 831(b) captives in a number of ways, they are similar to 831(b)s in that they are "microcaptives" and often utilized by closely-held businesses to produce favorable income tax results. In invalidating the *Reserve Mechanical* captive, the Tax Court repeatedly cited its *Avrahami* decision in August of 2017, which signaled the demise of 831(b)s used as tax-avoidance schemes. The Tax Court in both cases discussed all of the traditional factors courts consider when determining whether a captive qualifies as an insurance company – true insurance risk, risk distribution, risk shifting, business purpose, and insurance in its commonly accepted sense. The Tax Court also examined the risk pools at issue, analyzing whether they were "bona fide insurance companies" and, in particular, whether the reinsurance pools involved a circular flow of funds.

Since *Avrahami*, there have been a number of additional cases in which the IRS has alleged that the taxpayers' microcaptives avoided federal income taxes, and the risk pools in which the microcaptives participated were not bona fide insurance arrangements. The Tax Court has almost uniformly disallowed deductions, resulting in additional taxes and penalties. It is therefore not surprising that taxpayers are now looking to the service providers involved in recommending, establishing and running the microcaptives to recover damages. Most recently, the taxpayers in the *Avrahami* case joined other participants in the invalidated risk pool to create a class action lawsuit against Celia Clark, a New York attorney who promoted 831(b) captives as an estate planning tool, as well as her law firm; the Estate of Craig McEntee, the CPA involved as well as his accounting firm; Neil Hiller, the estate planner who referred Orna and Benyamin Avrahami to Clark, as well as his law firm; Alan Rosenbach, the actuary who could not establish a recognizable basis for his premium calculations in Tax Court, as well as his actuarial firm; Heritor Management, Ltd., the St. Kitts captive manager that facilitated the arrangement for Clark's clients; as well as Pan American Reinsurance Company, Ltd., a risk pool owned by Celia Clark and members of her family, which served as the risk pool for


**© 2019 Primmer Piper Eggleston & Cramer PC**
**All Rights Reserved**

participating 831(b)s, including the Avrahamis' captive, Feedback Insurance Company Ltd. The defendant service providers allegedly made material misstatements to taxpayers and the complaint alleges civil racketeering, fraud and conspiracy where the service provider knew or should have known that the purported insurance arrangements were, in reality, nothing more than illegal and abusive tax shelters.

The complaint constitutes merely a set of allegations against the defendants. However, depending upon how the litigation unfolds, such suits may become more common.

**TRIA REAUTHORIZATION**

The Terrorism Risk Insurance Program (the "Program" or "TRIP") will expire on December 31, 2020. In light of the disruptions that arose from the brief lapse in the Program in early 2015, insurers and insurance industry trade organizations have begun efforts to advocate for reauthorization of the Program well in advance. Brokers fear capacity shortfalls and increased pricing in the event of non-renewal and are working to develop solutions in advance of year-end renewals.

On June 18, 2019, the Senate Committee on Banking, Housing and Urban Affairs (the "Banking Committee") held a hearing regarding reauthorization of the Program. In prepared remarks, Senator Mike Crapo, Chairman of the Banking Committee, commented that the Committee has met with key stakeholders to explore reforms consistent with prior reauthorizations. Chairman Crapo stated that his goal is to "find ways for the private insurance industry to absorb and cover the losses for all but the largest acts of terror," and explore "reforms to improve the Program and reduce taxpayer exposure without having a material negative effect on the cost and take-up rates for terrorism coverage."

Chairman Crapo also referred to the conclusions in the June 2018 Federal Insurance Office's "Report on the Effectiveness of the Terrorism Risk Insurance Program" that "The Program has accomplished its principle goals identified in TRIA," and that "Private reinsurance of terrorism risk has significantly increased under the Program, and there is now increased private reinsurance capacity for the exposures that remain wholly with the private market under TRIP."

Congressional gridlock raises concerns for advocates of reauthorization. We will continue to monitor this issue and report on developments.

**NEWS FROM THE VERMONT STATE HOUSE**

Late May 2019 saw another disjointed close to Vermont's legislative session. Negotiations on high profile bills dramatically increasing the minimum wage and creating a paid family leave program broke down despite both being labeled priorities for the strongly Democratic House and Senate. In the coming election year, cooperation between bodies and with the Republican Governor will be on everyone's mind.

For now, here is a summary of those relevant bills of interest to the captive insurance community from the recently concluded session.

Captive Insurance Companies and Risk Retention Groups – S.109 (Act 3) represented this year's omnibus captive insurance bill and contains several amendments to the captive and risk retention group laws. This year's bill includes a mix of new and technical amendments, which:



**© 2019 Primmer Piper Eggleston & Cramer PC**
**All Rights Reserved**

- Clarify that protected cells incorporated as nonprofits can issue dividends to their owners like other nonprofits, provided prior approval is obtained from the Commissioner.

- Revise the law referencing the specific form of entity a captive may utilize when organizing to choose any type of entity permissible under Vermont law. This will, for example, negate the need to continuously update the law once and if a new type of entity is so authorized.

- Provide additional flexibility in meeting the bonding requirements for attorneys-in-fact of captives formed as reciprocals by exempting that requirement if the reciprocal is formed as an association captive, or each member of the reciprocal insurer qualifies as an industrial insured, or the reciprocal insurer is an incorporated protected cell of a sponsored captive.

- Change the exam period for captives from once every three years to once every five years, but allows the Commissioner to shorten that period if deemed prudent.

- Revise the investment standards for risk retention groups, association captives, and agency captives to allow those entities to either comply with the current investment requirements or instead submit an investment policy to the Commissioner for approval. This may provide some investment flexibility for the captive, and mirrors an option provided to affiliated reinsurance captives, which were newly authorized last year.

- Update the new law for affiliated reinsurance captives ("ARCs") by requiring their use of NAIC statutory accounting as the standard.

- Revise or restate when an individual is an "independent director" for purposes of corporate governance of risk retention groups.

- Extend to risk retention groups chartered in Vermont the Own Risk and Solvency Assessment ("ORSA") provisions in place for certain traditional insurers to assess the adequacy of their risk management and current and prospective solvency positions. The impact on Vermont RRGs will be minimal, however, as the threshold triggering ORSA provisions applies to insurers that write more than $500 million of premium, which is well above the annual volume of even the largest Vermont RRG.

There were a few other bills from the recently-concluded session worth mentioning as they may have some impact on certain captives or risk retention groups, or captive insurance service providers.

<u>Insurance Regulatory Sandbox</u> – S.131 authorizes the Department of Financial Regulation to create an insurance regulatory "sandbox" where companies may apply to test a new product or service that otherwise faces a statutory or regulatory hurdle, subject to certain limitations and procedures. A successful test within the sandbox may lead to subsequent statutory or regulatory changes to permit use in a broader context. The Department will now have to adopt related rules before the "sandbox" can go live.

<u>Corporate Income Tax/Market-Based Sourcing</u> – H.514 is a miscellaneous tax bill that contains numerous amendments to the tax code, including one related to corporate income tax which moves Vermont from cost of performance to market-based sourcing for the apportionment of corporate income tax for a company and its affiliates. Vermont currently considers property, wages, and double-weighs tangible property sales in the apportionment methodology. This, in essence, adds the sale of services to a Vermont purchaser to be among the factors. We do not anticipate any impact on a captive insurer's tax treatment or obligation. Rather, any



**© 2019 Primmer Piper Eggleston & Cramer PC**
**All Rights Reserved**

positive or negative impact may be on certain service providers. The impact will be company-specific, but in general terms large out-of-state service companies with little to no Vermont property or wages providing services to Vermont captives may pay more to Vermont while in-state service companies may pay less. The Tax Department will now have to begin the process of issuing Guidance for affected entities this summer, or rulemaking – or both. This will apply beginning in January, 2020, and thereafter.

Statute of Limitations for Child Sexual Abuse Civil Actions – H.330 entirely removes the statute of limitations for a person to bring a suit for damages suffered as a result of childhood sexual abuse. For retroactive claims, damages may be awarded against an entity that employed, supervised, or had responsibility for the person allegedly committing the sexual abuse only if there is a finding of gross negligence on the part of the entity.

Autonomous Vehicles – S.149 is an omnibus motor vehicle bill that includes authority to test autonomous vehicles ("AVs") on Vermont's roads subject to certain restrictions. A municipality may preapprove testing on its roads but may also opt-out of such preapproval. AV testers are required to show proof of liability insurance in the amount of $5 million, register the vehicle with the DMV, conduct background checks of operators, have a zero tolerance policy for operators, comply with NHTSA standards, report crashes resulting in damage to persons or property within 72 hours, and other requirements.

Contract Terms – S.18 creates a rebuttal presumption that certain terms or conditions are unconscionable when used in contracts when only one of the parties to the contract is an individual and that individual does not draft the contract or have a meaningful opportunity to negotiate the contract. This bill, however, does not apply to a contract in which one party to the contract is regulated by the Department of Financial Regulation, including captive insurers. For those subject to the bill, terms or conditions such as an inconvenient venue, a waiver to a right to a jury trial or class action suit, a waiver to seek punitive damages, a provision that seeks to limit the time in which an action can be brought or that waives the statute of limitations, and others are deemed unconscionable and thus prohibited.

And lastly — and the one about which more clients ask than any other — a bill creating a regulated market for the purchase and sale of cannabis passed the Senate but stalled in the House. Vermont decriminalized personal possession and "grown your own" cannabis a year or so ago. The House has said it needs more time to consider all relevant issues, including traffic safety, education, and others related to implementation. The Governor is also lukewarm to the idea. Nevertheless, expect a push next session.

---

## E-MAIL OPTION AND ARCHIVE

To receive Primmer's *Captive Newsletter* via e-mail, please contact Kurt Lutes at **klutes@primmer.com** or at 802-223-2102.

This and prior editions of the *Captive Newsletter* are also available at **www.primmer.com/captive-insurance-newsletter-archive**.

***www.primmer.com***



**© 2019 Primmer Piper Eggleston & Cramer PC**
**All Rights Reserved**