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CAPTIVE INSURANCE COMPANIES ASSOCIATION®

Regulatory Interaction: A Small Captive Perspective in the Evolving State and Federal Climate

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Introduction

- The history of insurance and regulation of the industry.
- How the "Dirty Dozen," recent changes to 831(b) via the PATH Act, and Notice 2016-66 impact the entire captive industry.
- How the current federal regulatory climate has impacted the process of state insurance regulation.

The US History of Insurance and the Regulation of Insurance

- 1752: Ben Franklin helped found the insurance industry with the "Philadelphia Contributorship for the Insurance of Houses from Loss by Fire."

- 1851: New Hampshire appoints the first Insurance Commissioner.

- 1869: The Supreme Court holds in Paul v. Virginia that "issuing a policy is not a transaction of commerce." As a result, states were left with the job of taxation and regulation of insurance.

The US History of Insurance and the Regulation of Insurance

- 1871: The National Insurance Convention was formed, which later became known as the National Association of Insurance Commissioners.

- 1944: The US Supreme Court - in *United States v. Southeastern Underwriters* - overturned *Paul v. Virginia* by holding that the Sherman Antitrust Act applied to insurance companies and insurance was commerce. As a result, Congress then had the power to regulate the insurance industry.

Which was kind of a problem ….

State Regulation of Insurance

Turmoil ensued. Not even kidding. At the time of the *Southeastern Underwriters* decision there was literally no federal framework whatsoever for regulating insurance.

So, in 1945, the McCarran-Ferguson Act was enacted. In it, Congress recognized that although insurance is interstate commerce, ***it is appropriately the responsibility of the states to regulate insurance***, unless federal law expressly preempts state regulation.

State Regulation of Insurance

For many blissful years after the enactment of the McCarran-Ferguson Act, the states regulated and taxed the business of insurance without any involvement of the federal government.

But then …

The States or the Federal Regulators?

The Financial Modernization Act of 1999 – the Gramm-Leach-Bliley Act – established a framework to permit affiliations among banks, securities firms, and insurance companies. The Act acknowledged that the states should regulate insurance.

But, Congress also called for state reform to allow insurance companies to compete more effectively with each other in the newly integrated financial services marketplace and to respond with more innovation to consumer needs.

So you have insurance companies being viewed as part of our system of financial institutions.

The States or the Federal Regulators?

The Wall Street Reform and Consumer Protection Act of 2010 – the Dodd Frank Act – had an impact on state insurance regulation.

While primarily banking and securities reform regulation, Dodd Frank created the Federal Insurance Office as an information gathering entity to inform Congress on insurance matters.

The States or the Federal Regulators?

The Nonadmitted and Reinsurance Reform Act (NRRA) was also part of Dodd Frank.

This Act was "designed to streamline the taxation and regulation of non-admitted insurance in the US." It's clear that this Act was intended to apply to surplus lines but the ambiguity in the code raised the question of whether or not it was also intended to apply to captives.

The States or the Federal Regulators?

So the question at this point is whether insurance needs to be regulated by Congress and federal regulatory entities the same way other financial institutions are regulated.

The States or the Federal Regulators?

"The state versus federal oversight discussion is a 'binary debate' that is a relic of a bygone era."

FIO Director Michael McRaith, statement at a Congressional Hearing in February 2014.

The States or the Federal Regulators?

The fundamental reason for government regulation is to protect consumers.

FIO,
GAO,
NAIC,

Oh my.

The States or the Federal Regulators?

United States Government Accountability Office: "*Insurance Markets: Impacts of and Regulatory Response to the 2007 -2009 Financial Crisis*." Release Date: July 29, 2013.

Federal Insurance Office, U.S. Department of the Treasury: "*How to Modernize and Improve the System of Insurance Regulation in the United States*." Released: December 2013.

The States or the Federal Regulators?

"Our national system of state based insurance regulation organizes the insurance sector of our economy so that it is 'walled off' from the federal regulatory system that governs banks and securities firms. This is one reason that when the financial services sector experienced the worst of its crisis in 2007-2008, insurance was insulated from the damage.

In the crisis – as in the Great Depression of the 1930s – insurance policyholders were protected by the states' prudent supervision and regulation. Policyholders were also protected by the insurance industry's inherent nature: While banks and securities firms seek risk to make profits, insurance firms profit by insuring against risk. Banks and insurance companies are completely different, as are their products."

"Kindling an Ember: State vs. Federal Regulation," Property Casualty 350, Nov. 20, 2013

What is "Federal Regulation" of Small Captives?

Attack by the IRS!

Ongoing Dialogue, Street Fight or Blitzkreig?

Dirty Dozen List

PATH Act Revisions to 831(b)

Notice 2016-66

LB&I Micro-Captive Insurance Campaign (Jan 31, 2017)

- Audits
- Promoter Investigations
- Cases

Abuses? What the IRS Doesn't Like

Deferral + Conversion = Recipe for Mischief

- Premiums
  - No Actuarial Support
  - Inflated
- Coverages
  - Business Risk
  - Bogus Risk
- Pools
  - Low Loss Ratio
  - Premium Allocation
- Tax Motivation
  - Promoters
  - Estate Planning

Dirty Dozen List

In the abusive structure, unscrupulous promoters persuade closely held entities to participate in this scheme by assisting entities to create captive insurance companies onshore or offshore, drafting organizational documents and preparing initial filings to state insurance authorities and the IRS. The promoters assist with creating and "selling" to the entities often times poorly drafted "insurance" binders and policies to cover ordinary business risks or esoteric, implausible risks for exorbitant "premiums," while maintaining their economical commercial coverage with traditional insurers.

Total amounts of annual premiums often equal the amount of deductions business entities need to reduce income for the year; or, for a wealthy entity, total premiums amount to $1.2 million annually to take full advantage of the Code provision. Underwriting and actuarial substantiation for the insurance premiums paid are either missing or insufficient. The promoters manage the entities' captive insurance companies year after year for hefty fees, assisting taxpayers unsophisticated in insurance to continue the charade.

IR-2015-19, Feb. 3, 2015

PATH Act Comparison

- Original 831(b)
  - $1.2 million
  - Make the election

- New 831(b)
  - $2.2 million
  - Qualify for the election
  - Annual reporting

PATH Act
Elements of New 831(b)

- Increased limit
  - $2.2 million
  - Indexed for inflation
    - Annual
    - Rounded to next lowest $50,000

PATH Act
Elements of New 831(b)

- Qualify for the election – diversification
- 2 alternative diversification tests
  - 20% limit on single policy holder
  - No estate planning ownership structure

PATH Act
Elements of New 831(b)

Diversification Test 1

- 20% limit on single policyholder
  - Easy qualification for mutuals
  - Risk diversification vs. risk distribution
    - Single policyholder = all related parties
    - Single policyholder = pool (probably)
  - Possible solutions, but not current focus

PATH Act
Elements of New 831(b)

Diversification Test 2

- No estate planning ownership structure
  - Dense language
  - New concepts
- General rule – spouses and lineal descendants cannot own greater interest in captive than they own in insured enterprise

PATH Act
Elements of New 831(b)

Diversification Test 2

What's so difficult?

- Spouses – lineal descendants = specified holders
- Insured enterprises = specified assets
- Indirect interests are included
- De Minimus difference of 2% allowed

Therefore, must analyze every:

- Ownership interest
- Insured enterprise

PATH Act Guidance?

Possibilities:

- Treasury Regulations
- Statutory Clarification

Challenges:

- Industry – No Champion
- JCT – No Power
- IRS – No Motivation

Notice 2016-66

Occasionally Reasonable Behavior

- "[R]elated parties may use captive[s]. . . . For risk management purposes that do not involve tax avoidance . . ."
- Extended compliance deadline

Notice 2016-66

Magic Words

- Transaction of Interest
- Participant
- Material Advisor
- Disclosure Requirements
- Penalties

Magic Features

- Recites the usual suspects
- Targets on an unrelated basis
  - Loss ratio under 70%
  - Related Party Financing

LB&I Micro-Captive Insurance Campaign

- Jan 31, 2017 Release
  - Significant milestone
  - Redefine large business compliance work
  - Multiple treatment streams to achieve compliance objectives
    - Issue-based examinations (= audits?)
- Promoter Investigations
- Cases

How "Federal Regulation" Impacts the Entire Industry (Other Than State Insurance Regulators)

Pro

- Chasing out the riff raff
- Driving the industry to organize
- Importance of advocacy
- Move toward self-regulation

Con

- Resurrecting issues lost in large captive cases
- Decisions could affect all, not just small, captives
- Chilling the market
- Potential Penalties
- Legislating by administrative policy

How Has DC Impacted the States

The overarching role of state regulators is to ensure that licensed captives operate in compliance with state insurance law. There are protections built into state codes to ensure captives stay liquid and solvent and can meet claim obligation.

States regulate for the type of insurance business and they regulate for liquidity and solvency …. These aren't tax issues – or related to tax - at all.

The States Focus On:

- The character and business qualifications of a captive's owners, officers, and directors, as well as the corporate governance framework considering the nature, size and type of captive.

- Whether the proposed lines of insurance coverage make sense for the operating businesses being insured.

- Whether a Feasibility Study was prepared and, if so, was it prepared by a reputable actuary using expected and adverse scenarios, and confidence levels.

The States Focus On:

- The quality and qualifications of all service providers such as the captive manager, auditor (CPA), actuary, reinsurance intermediary, etc.

- The complete business plan of the captive including underwriting program, premium derivation, risk-sharing through reinsurance (including quality of reinsurers), and all other aspects of the business plan.

- Initial capital and surplus level, ability to pay a first year maximum claim, ongoing liquidity and solvency, and ability of captive owners to infuse additional capital and surplus in a contingency plan scenario.

The States Focus On:

- The risk management (loss prevention and safety) program employed by the affiliated insureds.
- A captive's investments vis-à-vis preservation of the captive's claims-paying ability (liquidity).
- Dividends to shareholders or other distributions are allowed by the insurance code, but should only be permitted to the extent undistributed earned surplus exists to support it.

The States Focus On:

- The character and business qualifications of a captive's owners, officers, and directors, as well as the corporate governance framework considering the nature, size and type of captive.

- Whether the proposed lines of insurance coverage make sense for the operating businesses being insured and are permissible types of insurance under state code.

- Whether a Feasibility Study was prepared and, if so, was it prepared by a reputable actuary using expected and adverse scenarios, and confidence levels.

Best Practices: State Regulation

Everybody wins when captives follow best practices.
It's the best way to keep the industry safe from "outside" scrutiny.

10. Know your state's insurance code.
9. Get required prior approvals.
8. Get Business Plan changes approved.
7. Don't mess with the money.
6. Follow the investment plan.
5. Respect the terms of the policies.

Best Practices: State Regulation

4. Meet filing and payment deadlines.
3. Build your written record.
2. Communicate Proactively.

And ….

Best Practices: State Regulation

1. Hire the Right People!

Thank You

Any Questions?

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