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We are pleased to present an overview of recent tax changes affecting some small insurance companies, written by Gary Bowers, a CPA and Tax Principal with Johnson Lambert & Co.

Johnson Lambert & Co. (www.jlco.com) is well known to the Vermont captive industry. The firm provides auditing and tax services to many Vermont captive clients, as well as a full array of consulting services to insurance companies generally, with a focus on captives and alternative risk. Gary has overall responsibility for Johnson Lambert's tax services to the property-casualty insurance industry, and can be reached at 919-865-1070 or gbowers@jlco.com.

A prior version of this article previously appeared on the Captive Insurance Companies Association ("CICA") website at www.captiveassociation.com.

REVISION TO "SMALL" INSURANCE COMPANY TAX LAW

– By Gary Bowers

On April 10, 2004, the President signed new legislation, The Pension Funding Equity Act of 2004, which includes

provisions that will change the manner in which "small" property and casualty insurance companies are taxed. Small property and casualty insurance companies are those that take advantage of Sections 501(c)(15) or 831(b) of the Internal Revenue Code. Pursuant to these sections certain property casualty insurance companies, including many formed under various captive laws, could either be exempt from federal income taxation (501(c)(15)) or alternatively taxed only on investment income (831(b)). These changes are effective for tax years beginning after December 31, 2003.

Fueled by articles in the press, Congress and the IRS perceived that a number of insurance companies were formed primarily to take advantage of the provisions of Sections 501(c)(15) or 831(b), rather than primarily to conduct the business of a property and casualty insurance company. Accordingly, Congress and the IRS sought to change the Internal Revenue Code to combat the proliferation of these companies for unintended uses.

Historically, the Internal Revenue Code did not include any definition as to what constitutes a property casualty insurance company. The Pension Funding Equity Act

of 2004 now includes such a definition by referencing existing Code section 816(a), a section that previously applied only to life insurance companies. Thus, an insurance company is now defined as, "any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies."

Prior Law Requirements For Tax-exempt Status

Under prior tax law (501(c)(15)), a property and casualty insurance company was exempt from federal income tax if the greater of net or direct written premiums was \$350,000 or less. Under the prior law, for purposes of the premium limitation, premiums of all members of a "controlled group" were required to be aggregated. "Controlled group" is a term defined in the Internal Revenue Code but generally includes entities under common control and generally includes for this purpose the insurance company's parent company, brother/sister corporations if a parent corporation owns 50 percent and brother/sister corporations if five or fewer persons own 50 percent or more of the insurance company and the brother/sister corporations.

New Law Changes Related to Tax-exempt Status

Under the new law, different rules apply to mutual companies than apply to companies formed as stock companies.

Section 501(c)(15) has been amended to indicate that a stock property casualty insurance company or reciprocal is tax-exempt if: 1) its gross receipts, all sources of income not just premiums, for

the tax year do not exceed \$600,000, and the premiums received for the tax year are greater than 50 percent of its gross receipts. For purposes of the premiums and gross receipts testing, the premiums and gross receipts of **all** entities, not just property casualty insurance companies, that are members of the same controlled group are aggregated. The definition of controlled group for this purpose did not change.

A mutual property casualty insurance company will be exempt from income tax if the gross receipts for the taxable year do not exceed \$150,000, and more than 35 percent of such gross receipts consist of insurance premiums. For purposes of the determination of premiums and gross receipts, the premiums and gross receipts of all entities that are members of the same controlled group are aggregated. The controlled group test for mutual companies includes a new special provision that provides that tax-exempt status shall not apply to a company if any employee of the company, or a member of the employee's family is an employee of another company exempt from taxation by reason of this section (or that would be exempt except for this section).

Prior Law Related to Taxation of Investment Income Only

Under prior tax law (831(b)), a property and casualty insurance company could elect to be taxed only on investment income if the greater of its net written premiums, or direct written premiums, was between \$350,001 and \$1.2 million. Once made, the election was irrevocable without the consent of the IRS Commissioner. The controlled group rules described above are applicable for purposes of determining applicability.

New Law Related to Taxation of Investment Income Only

Under the new law a property casualty insurance company that has less than \$1.2 million in direct premium (or written premium, if greater) can make the election to be taxed on investment income only. Once made, the election is irrevocable without the consent of the IRS Commissioner. The prior tax laws concerning controlled groups continue to apply. A significant change relates to the ability of a company to make the election when its premiums are less than \$350,000, which under prior law they could not. There is no gross receipts test for purposes of the election, only a premiums test.

Limited Transition Rules

The Pension Funding Equity Act of 2004 has enacted a transition rule for companies in bankruptcy, or other similar proceedings, for tax years beginning after 2003. A company that on April 1, 2004 meets the pre-2004 Pension Funding Equity Act tax-exempt requirements of Section 501(c)15 and is in receivership, foreclosure, or similar proceeding in a state court, will be treated as tax-exempt after April 1, 2004, for so long as the company continues in the proceeding. The transition rule will not be in effect for tax years beginning after 2007.

Conclusion

The changes in the tax law recently enacted should be reviewed carefully by all captives that previously were treated as "small" property and casualty insurance companies pursuant to Sections 501(c)(15) or 831(b) of the Internal Revenue Code. As a consequence of this law, many previously

tax-exempt insurance companies may no longer be tax-exempt. For those companies that fail the gross receipts test under section 501(c)(15), they now may have the ability to elect under section 831(b) to be taxed on investment income only.

TRIA UPDATE

There have been several developments since our last update on the Terrorism Risk Insurance Act of 2002 ("TRIA"), including a final rule on claims procedures and a decision to extend the "make available" requirement under TRIA through 2005. Legislation has also been introduced in the U.S. House of Representatives that would extend the program for two to three years.

The Final Rule on Claims Procedures

Following public comment, on June 29, 2004 Treasury published the final rule on claims procedures, which establishes procedures for filing claims and receiving payment of the federal share of compensation under TRIA. The final rule adopts many provisions in the proposed rule without revision and is effective on July 29, 2004.

Advance Payments. The proposed rule on claims procedures would have required insurers to pay insured losses before seeking reimbursement from Treasury under TRIA. This requirement could have created cash flow problems and compromised the solvency of some captive insurers. Treasury acknowledged this risk and revised the final rule to provide for advance payments under certain conditions.

Under the final rule, an insurer may request payment of the federal share of

compensation for (1) claims payments already made, and (2) claim payments about to be made. Request for payment may be made on partial as well as final settlements of underlying claims for insured losses. An insurer requesting advance payment must certify that any advances that have been requested will be paid within five business days of receipt of funds from Treasury. A segregated interest-bearing account must be established to receive advance payments and to disburse advance payments to insureds and claimants. Any interest earned on funds in the segregated account must be remitted to Treasury at least quarterly.

"Gaming" Concerns. Treasury has included new provisions in the final rule which are aimed at discouraging attempts to "game" TRIA. The final rule authorizes Treasury to deny or suspend payment if it determines that an insurer's claim for federal payment or any underlying claim for insured loss is fraudulent, collusive, made in bad faith, dishonest or otherwise designed to circumvent the purposes of TRIA and its regulations. Treasury has not defined the types of activity that it would challenge, however, it has raised concerns about captives formed or utilized to avoid TRIA's requirements.

Payment of the Federal Share. The final rule is unchanged with respect to Treasury's commitment to "promptly" pay claims for the federal share of compensation, although that term remains undefined. The final rule also deletes Treasury's authority to pay claims under a reservation of rights. However, Treasury retains its authority to audit claims.

Losses in Excess of Policy Limits. Treasury sought comment whether an

insurer's payment of losses in excess of policy limits ("XPL") should be covered by TRIA. Treasury decided to adopt the proposed rule without revision and exclude XPL losses.

Adjustments to the Amount of the Federal Share of Compensation. The proposed rule would have reduced the amount of the federal share of compensation by amounts received by an insured or a third party from other federal programs. The final rule adopts this basic approach, but clarifies that compensation recovered from other federal programs means compensation provided for losses in the event of emergencies, disasters, acts of terrorism, or similar events. Such compensation does not include benefit or entitlement payments made under the Social Security Act, laws administered by the Secretary of Veteran Affairs, or railroad retirement and similar types of benefit payments.

Extension of "Make Available" Requirement

TRIA requires insurers to "make available" coverage for losses resulting from covered acts of terrorism from November 26, 2002, through December 31, 2004. Treasury has extended the "make available" requirement through December 31, 2005, and every entity that satisfies the definition of "insurer" under TRIA must offer TRIA coverage on all new and renewal commercial property and casualty insurance policies through that period.

Proposed Legislation to Extend TRIA

Since June 22, 2004, two bills have been introduced in the U.S. House of Representatives to extend TRIA. The "Terrorism Insurance Backstop Extension

Act of 2004" (H.R. 4634) was introduced on June 22, 2004. The "Terrorism Risk Insurance Program Extension Act of 2004" (H.R. 4772) was introduced on July 7, 2004. Both bills have been referred to the Committee on Financial Services.

H.R. 4634 would make the following key changes to TRIA: (i) extend the program two years through December 31, 2007, (ii) maintain the insurer deductible at 15% of direct earned premiums in Program Year 4 and increase the insurer deductible to 20% in Program Year 5, (iii) extend the "make available" requirement through December 31, 2007, (iv) increase the insurance marketplace aggregate retention to \$17.5 billion in Program Year 4 and \$20 billion in Program Year 5, (v) require the Secretary of the Treasury to submit a report to Congress on the conditions and developments in the market for group life insurance by June 1, 2005, (vi) require the Secretary of the Treasury to make a final determination as to the availability of group life insurance and whether TRIA should be applied to providers of group life insurance, and (vii) require the Secretary of the Treasury to conduct a study and submit a report on alternatives for expanding the availability and affordability of terrorism insurance.

H.R. 4772 would make the following key changes to TRIA: (i) extend the program three years through December 31, 2008, (ii) make the Final Program Year, January 1, 2008 through December 31, 2008, a run-off period for policies written or renewed in 2007 that extend into 2008, (iii) maintain the insurer deductible at 15% of direct earned premiums during the remaining Program Years, (iv) extend the "make available" requirement through December 31, 2007, (v) maintain the insurance

marketplace aggregate retention at \$15 billion during the remaining Program Years, (vi) expand the definition of "insured loss" to include group life insurance, and (vii) require the GAO to conduct an assessment of and submit a report on the effectiveness of TRIA and the likely capacity of the property and casualty insurance industry to offer insurance for terrorism risk after termination of the program.

VERMONT EXCLUDES CAPTIVE INSURANCE COMPANIES FROM ITS NEW UNITARY TAX SYSTEM

Thanks to the efforts of the Vermont Captive Insurance Association ("VCIA"), captive insurers will be excluded from Vermont's new unitary tax methodology for calculating state income tax. The unitary combined reporting method, an integral part of Governor Jim Douglas' 2004 income tax reform proposal, will be implemented in 2006. Under this method, a company's corporate income tax assessment will be based on the income of the entire company, including its divisions, subsidiaries and affiliates. Due to the VCIA's dedicated efforts, captive insurance companies are explicitly excluded from the definition of an "affiliated group," and are thus excluded from the application of the new approach. See 8 V.S.A. § 5811(22).

The favorable result achieved in Vermont, however, should not encourage captive insurance companies to ignore the issue of state unitary taxation. Any captive insurer who has affiliates, divisions or parents outside of Vermont should be aware that they, through those affiliates, still may be subject to unitary taxation in those other jurisdictions. Approximately 16 states other than Vermont utilize some version of unitary taxation, and some of these

jurisdictions treat captive insurers in the same manner as any other "C" corporation for the purposes of state income taxation. We are aware that this is an issue of interest to our captive clients, especially to those that have affiliates or parents outside of Vermont. We are currently evaluating the approaches taken toward captive insurers by other jurisdictions, and will provide an update in the next Primmer & Piper Captive Newsletter. If you have any immediate concerns about how your company might be taxed by another state, please contact a member of Primmer & Piper's captive team.

For more information on the 2003-2004 Vermont Legislative biennium and the results relevant to captive insurers, please see "*News from the Vermont State House*" later in this newsletter.

CONGRESS REVIEWS STATE TORT REFORM

In June, the Congressional Budget Office (CBO) released a report, "The Effects of Tort Reform: Evidence from the States." (A copy of the report is available at <http://www.cbo.gov/showdoc.cfm?index=5549&sequence=0>.) In this document, the CBO looks at nine major studies undertaken to evaluate the effects of state-level tort reform initiatives and assess their relevance in regard to tort reform proposals currently before Congress.

The CBO analyzed the extent to which state-level tort reform laws have had an impact on tort activity and general economic performance. A number of the studies evaluated by the CBO found that reform efforts had decreased the number of lawsuits filed, and lowered both the value of insurance claims and the size of damage awards. Nonetheless, these results were

viewed cautiously as the data was deemed to be limited and "not sufficiently consistent to be considered conclusive." Because tort reform measures are also typically enacted as part of a complex legislative package, the CBO found it difficult to draw conclusions from such efforts.

State tort reform efforts gained prominence in the mid-1980's, and initially focused on limiting exposure to liability. One general objective was to limit the cost of insurance and to ensure the availability of insurance coverage. The CBO found that insurance premiums fell by 40% in 1987, after tripling over the prior three years. Since 1986, many states have enacted tort reform laws. 38 states have limited recoveries by plaintiffs by modifying the concept of joint and several liability. 7 states have disallowed its use altogether. 25 states have modified the collateral source rule. 23 states have limited the extent of non-economic damages, and 34 states have limited the extent of punitive damages. Most states enacting reform measures have not limited recoveries in cases of intentional torts, hazardous waste, liability and medical malpractice.

Given the recent hard market conditions, it is likely that states will continue to consider measures which bring a greater level of rationality to the United States tort system. Notwithstanding the CBO's conclusion that there is not yet an absolute empirical basis on which to evaluate tort reform's success, there is actuarial evidence supporting, for example, the effectiveness of limitations on the recovery of non-economic damages. Until there is sustained improvement in the pricing and availability of insurance, efforts to reform the tort system will continue at both the state and federal levels.



NEWS FROM THE VERMONT STATE HOUSE: FOLLOWING ADJOURNMENT, IT'S CAMPAIGN SEASON

The 2003-2004 Vermont General Assembly adjourned in May for the biennium. All bills not formally acted on will need to be reintroduced when the next Legislature convenes in January. That body is likely to have some new faces in 2005, as legislative and statewide offices are up for re-election (Vermont and New Hampshire alone have two-year gubernatorial terms) this November.

The captive insurance industry had expected the past session to be fairly quiet, however, several issues emerged on the legislative front. Once again confirming Vermont's continued commitment to its captive insurance industry, Governor Jim Douglas (R) recommended \$50,000 be appropriated from the State's General Fund for the new International Center for Captive Insurance Education (ICCIE), a collaboration with the University of Vermont's Department of Continuing Education. The Legislature agreed, and appropriated the sum in the annual budget bill, to offset start-up costs of the program, which will provide a range of captive insurance educational programs to students, both in person and on the web.

In addition, a new option added to the captive statutes provides for more flexibility when forming a captive. Entities may now elect to form their captives as limited liability companies. A section of Vermont law dating back to the original LLC statutes specifically excluded insurance companies from electing that option. Lawmakers agreed that the exclusion did not make sense in the case of captive insurance

companies, and thus chose to exempt captives from that exclusion.

Finally, the captive insurance industry sought and received clarification from the Legislature and Administration that captives would be excluded from the scope of a comprehensive tax reform proposal from Governor Douglas. That proposal, now law, changes the accounting reporting method in Vermont from an optional consolidated reporting scheme to a system of required unitary combined reporting for an affiliated group of companies. The Vermont tax will now be computed on the apportioned income of the entire affiliated enterprise rather than using separate accounting for only those corporations that do business in Vermont.

Questions arose during deliberations as to the impact of unitary reporting on a Vermont captive, its parent or affiliated group of companies. The Administration and Legislators did not want to negatively impact Vermont's captive industry, and chose to specifically exclude captives from the definition of an affiliated group. As discussed earlier in this newsletter, Primmer & Piper is currently evaluating the likely treatment of Vermont captives for the purposes of state income tax in other jurisdictions that use the unitary combined reporting system.

Thoughts now turn to the November elections and possible changes in statewide and legislative offices. Most observers predict that Governor Douglas will prevail in his race against the current Mayor of Burlington, Peter Clavelle (D). The normal caveats to this wisdom include, of course: the time before the election, the possibility of a damaging issue arising, the effect of the national election on voter

turnout, and the fact that Gov. Douglas did not receive a plurality of votes in his inaugural race for Governor two years ago. At this point, and in contrast to the last few elections, it does not appear that a credible third-party candidate will emerge.

The Vermont General Assembly historically witnesses a 30% or so turnover in its 180 members every two years. Most observers expect that the Vermont Senate will remain strongly in control of the Democrats. In fact, the majority may even increase from its current 19-11 margin. Most eyes, however, will be on the House of Representatives. Although Republicans enjoyed a numerical majority and control of the leadership positions this past session, the Democrats may gain control this November. While the races typically don't heat up until after the summer, the race for the money and the recruitment of candidates is already well underway.

In January, the captive insurance industry will be eager to greet all elected legislators, both old friends and new acquaintances. Two-year election cycles and the appointment of new members to committees that deliberate captive insurance issues ensure there will be some

members of the General Assembly that are not yet aware of the captive industry and the benefits it brings to the State. It falls upon the industry and its supporters to help convey that message every year. We will report on the election results and any 2005 legislative initiatives in future issues.

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