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**MEMORANDUM**

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**TO:** HOUSE COMMITTEE ON COMMERCE AND ECONOMIC DEVELOPMENT  
**FROM:** DAVID PROVOST, DEPUTY COMMISSIONER, DEPARTMENT OF FINANCIAL REGULATION  
**SUBJECT:** CAPTIVE BILL, H.R. 85  
**DATE:** JANUARY 19, 2017  
**CC:** RICHARD SMITH, VCIA  
DAN TOWLE, DIRECTOR OF FINANCIAL SERVICES, ACCD

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**Following is an outline of proposed changes to Vermont's captive statute:**

**\*\*\*Accounting Standards\*\*\***

**Sec. 1. – Reports and Statements – Accounting Principles**

Background: Our captive law currently *requires* the use of U.S. Generally Accepted Accounting Principles (GAAP), but *allows* the use of other comprehensive bases of accounting with permission. Many companies have expressed a strong preference to follow the law without requesting special “permitted practices” such as a different basis of accounting. There are three bases of accounting commonly used by Vermont captives: US GAAP, NAIC Statutory Accounting Principles (SAP), and International Financial Reporting Standards (IFRS).

GAAP is the preferred accounting for most of our pure captives with U.S.-based parent companies. IFRS is preferred by our captives owned by companies based in Europe and Asia. Group captives commonly use SAP, or it may be prescribed by DFR for certain insurance products.

All three accounting methods provide ample information for DFR to ascertain the financial condition of the captive.

Proposal: Amend statute such that the three commonly-used major comprehensive bases of accounting are allowed by statute, and any other basis may be used with permission.

**\*\*\*Premium Tax Credit\*\*\***

**Sec. 2. – Premium Taxes**

Background: Vermont has long been known as the home of the largest captives. We are home to many of the Fortune 100 companies' captives, and 18 of the 30 companies that comprise the Dow Jones industrial average call Vermont home for their captives. An “average” captive in Vermont has over \$40 million in premium revenue. We are also

home to many small business captives – half of our captives have less than \$5 million in revenue – but the fact that we welcome small captives remains a difficult message to convey. Various sources estimate that more than 90% of the Fortune 1,000 companies already have a captive, so we need to be sure that small companies keep Vermont on their list when selecting a domicile. A tax incentive helps Vermont to be comparable in cost to other domiciles – at least for the 3 to 5-year projection period that captive feasibility studies are usually based on.

This tax credit would make Vermont less expensive for a three-year look, equal for four years, and more expensive for 5 or more years than some of our competitors that have a lower tax rate.

Here’s why we are focused on attracting small business captives:

Number of New Captive Formations, 2014:

Utah	106	Nevada	26
Delaware	87	Cayman	22
N. Carolina	49	S. Carolina	20
Tennessee	42	Bermuda	16
Oklahoma	37	<b>Vermont</b>	<b>16</b>
Montana	34	Hawaii	15

We are certain that many of the captives formed in other jurisdictions would not meet our standards, but if only 1% of the captives formed in Utah, Delaware, North Carolina, and Nevada in 2014 were formed here instead, that would be the 2 to 3 captives necessary to make this proposal pay off very nicely.

The legislature has passed provisions reducing premium taxes on captives several times over the years. Most recently, a first-year credit of \$7,500 (the minimum tax) was approved. The intent of reducing the tax burden in the early years of the captive’s life is to keep Vermont comparable in cost to other domiciles with low (or no) taxes, at least for the first few years. After that, we count on our quality environment to demonstrate that our higher tax is justified.

Domicile cost comparison:

State	DE	DC	HI	MT	UT	VT
Application	200	500	1,000	300	200	<b>500</b>
Review	3,000	0	0	0	0	<b>5,000</b>
License	300	300	300	300	5,250	<b>500</b>
Min. tax*	5,000	7,500	3,750	5,000	0	<b>7,500</b>
3-year cost	19,100	23,900	13,150	16,200	15,950	<b>22,000</b>
3-yr w/credit	19,100	23,900	13,150	16,200	15,950	<b>19,500</b>
Min. ongoing	5,300	7,800	4,050	5,300	5,250	<b>8,000</b>
Max tax	75,000	100,000	200,000	100,000	0	<b>200,000</b>
2014 new	87	5	15	34	106	<b>16</b>

\*Note: Hawaii does not have a minimum tax, and does not tax premiums that are taxed elsewhere. Example cost given is based on \$1.5 million direct premiums.

Proposal: Change the \$7,500 first year credit to a \$5,000 credit in each of the captive's first two years.

In an average year, we license about 25 captives. If we license 25 companies, and this credit produces no new business, the cost is \$5,625 per year, or \$562,500 over 10 years. If we add just two new small companies (i.e. minimum taxpayers) per year to that 25 because of the credit, we have a net gain of \$217,500 over 10 years. If we add just 1 new company that grows to almost an "average", we gain \$127,500 in the 10-year span.

That is only the tax impact: 2 new companies per year would add management jobs (roughly 1 job per 5 captives) and other ancillary benefits such as travel and tourism revenue, and professional service fees for accountants, actuaries, and attorneys.

In 2015, 230 Vermont captives paid the minimum tax of \$7,500.

**\*\*\*Agency Captives\*\*\***

Background: An agency captive is a reinsurance company controlled by an insurance agency or brokerage. Through a reinsurance agreement with a traditional insurer, the agency captive receives a share of the premiums written, and is obligated to pay its share of claims. Agency captives creates a long-term relationship between the agency and the insure, and creates incentive for the agency to place business with the insurer. All interests are aligned: risk appetite, selection, pricing, loss control, claims management, etc. Success or failure is shared.

The captive is invisible to the insurance buyer. The traditional insurer issues the policy, and as with any reinsurance, the reinsurance of the policy is behind the scenes; the front remains responsible for claims regardless of any reinsurance. To avoid any potential conflict of interest, we are requiring that disclosure be made to the buyers so that they may understand the program.

This is restricted to commercial business; no personal lines business is allowed.

The following statutory changes are needed to add these companies:

**Sec. 3. – Definition**

Section 3 adds the definition of an Agency captive insurance company in 6001(2), and renumbers subsequent paragraphs.

**Sec. 4. – Agency Captive Requirements**

Section 4 amends 6002(a) to set out the requirements of and restrictions on the business of agency captives. In particular, it requires that the sponsoring agency(ies) remain in good standing with their regulatory authorities, and that the agency captive arrangement is disclosed to policyholders. It gives the commissioner discretion to place further controls on the business, notably the requirement to use a front company with the captive as a reinsurer.

**Sec. 5. – Minimum Capital and Surplus**

Section 5 establishes the minimum capital and surplus of an agency captive at \$500,000

**Sec. 6. – Formation**

Section 6 set out the types of corporate forms an agency captive may use – it mirrors the provisions allowed for pure captives.

**Sec. 7. – Investments**

Section 7 requires agency captives to conform to the traditional investment rules.

**\*\*\*Dormant Captives\*\*\***

**Sec. 8. – Dormant Captives**

Background: The legislature passed provisions allowing captives to enter a dormant status in 2014. Since then 8 captives have taken advantage of the law. By the time a company qualifies to enter dormant status, it has served its purpose. It is only paying a \$500 license fee and the minimum tax of \$7,500 per year; it is ready to close up shop. When we permit the company to enter a dormant status, we waive the premium tax and the company stays in Vermont, ready to be reactivated when and if the need arises. There is no current fiscal impact (we were about to lose the company entirely), but there remains a potential for the company to be reactivated in Vermont, with no consideration

for a change in venue. Last year we expanded eligibly to Industrial Insured and Sponsored captives

To date, 9 companies have elected the dormant status.

Proposal: Allow all types of captives to enter dormant status. The same logic applies as before: keep the company here rather than have it dissolve. The safeguards and conditions imposed on dormant captives limit the practicality to companies that are a step away from dissolution. This will also encompass new types of captives that we develop without having to revisit the applicability of dormancy.

### **\*\*\*Incorporated Protected Cells Naming Conventions\*\*\***

#### **Sec. 9. – Incorporated Protected Cells Naming Conventions**

Background: As the law currently stands, both the captive law and corporations law require specific terminology, and both are being enforced simultaneously. The captive law requires an incorporated cell to include “Incorporated cell” or “IC” in its name, the same way the corporation law requires “corporation”, “Incorporated”, or “Inc.”

The result is that companies are using both, and producing names such as “Green Mountain Insurance Company Incorporated Cell A, Incorporated” or “Blue Ridge Cell 42, IC, Inc.”, with the “Incorporated” or “Inc.” being redundant

Proposal: Let the captive statute determine the naming convention. The inclusion of “Incorporated cell” or “IC” in the name of each incorporated cell is sufficient to identify the business entity.

### **\*\*\*Risk Retention Group Governance Standards\*\*\***

#### **Sec. 10. – Risk Retention Group Governance Standards**

Background: The legislature adopted governance standards for risk retention groups during the past two sessions. Auditor rotation requirements of the governance standards overlap with and conflict with other statutes and regulations.

Proposal: Provide for relief from partner rotation requirements under the same circumstances and with the same considerations as other current captive and traditional insurance regulations require, to eliminate conflicting provisions in statute and regulation.