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USA RISK GROUP

Regulatory Update

Recent Regulatory Developments with Captive Implications

This communication is directed to our captive clients and their parent companies and to the agents/brokers/producers that have entrusted their clients with our captive management services. There are two significant issues currently in the press affecting our industry. USA Risk Group would like to keep you apprised of these issues and offer our insight into the ramifications of these issues to your specific situation. Please feel free to contact us directly to discuss these important issues and how they may affect the operations of your captive or potential captive formation.

Terrorism Risk Insurance Act Extension

The TRIA extension bill has passed the US House of Representatives and is now moving on to the full US Senate after passing through the Senate Banking Committee with a vote of 20 to 1.

We are not sure of the bill's final form since there are a few major differences between the bill that passed the House and the one that is currently before the Senate. The major differences in the bills are as follows:

- House bill extends for 15 years while the Senate bill extends for 7 years

- House bill expands coverage for Credit Life Insurance and Nuclear, Biological, Chemical and Radiological attacks while the Senate bill does not expand the coverage

- House bill reduces the coverage trigger level from \$100 million to \$50 million while the Senate bill maintains the \$100 million level

The bills eliminate the distinction between foreign and domestic acts of terrorism.

As a by-product to these two bills, the Government Accountability Office has been asked to conduct two studies. The GAO has been asked to examine the NBCR issue with recommendations on the best ways to expand coverage for such events and the GAO has been asked to analyze various areas of the country that may have unique capacity constraints with recommendations on ways to address those situations. The House version of the bill addresses this second study by adding a "re-set" provision, but there wasn't a consensus among Committee members to include such a provision in the Senate version of the bill.

Proposed IRS Regulation on Insurance between Members of a Consolidated Group

The Focus

The proposed regulations currently being debated between members of the captive insurance community and the IRS relate to the precedence set by what we in the industry affectionately refer to as the "Humana Model". As many of you know, the "Humana Model" is a corporate structure implemented by the Humana Health System back in 1989 whereby the parent company, which was a holding company, created a captive insurance company at the same corporate level as the other brother-sister affiliated companies within the Humana corporate structure. The captive then insured the other brother-sister affiliated companies and took the position that there was proper risk shifting and risk distribution to allow the transaction to qualify as insurance.

Jeff Kenneson, Senior Vice President, Business Development

Under this model the brother-sister affiliated companies took a deduction for the premiums paid into the captive and the captive was afforded the special insurance company treatment for tax purposes, namely, it was allowed to deduct the outstanding loss reserves including IBNR on its tax return; unlike self insurance where only paid losses are allowed to be deducted currently.

Regulatory Update Continued

This new proposal targets captives which are part of the same US consolidated tax return group. This would include domestic captives and foreign captives that have made the 953(d) election to be taxed as a US taxpayer. To be included in the consolidated tax return, the domestic parent must own 80% or more of the captive.

What's the Impact

The proposed regulations are an attempt by the IRS to turn back the clocks on a position upheld by the tax courts since 1989. The IRS is attempting to reverse the benefits of the "Humana Model" in practice. This has the effect of classifying the "Humana Model" transaction as a non-insurance transaction which would disallow the deduction the captive takes on its loss reserves including IBNR currently. Any captive following the "Humana Model" would be affected with the most significant impact to captives which write long-tail coverages such as Medical Malpractice, Product Liability and Workers' Compensation.

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The tax detriment would be the present value of the difference between a current deduction for discounted loss reserves and a future deduction for paid claims.

As a management company, we believe we would see a shift in domicile activity, namely, more interest would be seen in the offshore domiciles with an eye to have those captives set up outside of the consolidated group to avoid the net the IRS is trying to create with these new proposed regulations.

Please feel free to contact Jeff Kenneson, Senior VP of Business Development at 800/872-7475 x2220 or Andy Sargeant, Chief Operating Office, x2202 with any questions.

About USA Risk Group

USA Risk Group of Vermont, Inc. ("USAVT"), formerly known as Vermont Insurance Management, Inc., was established in Vermont in 1981 by H. Lincoln ("Linc") Miller Jr. As our company expanded into other captive domiciles and started to offer other insurance services, we adopted USA Risk Group as our business name. USA Risk Group now includes captive operations in Vermont, South Carolina, Arizona, Nevada, Bermuda, British Virgin Islands and Grand Cayman, managing captives in 16 different domiciles, as well as a reinsurance intermediary operation in Greenville, South Carolina. All companies under the USA Risk Group umbrella are owned by Linc's family and various key employees. We believe that, as an independent company, not owned by a broker, insurance company or bank, we can provide a superior, objective service to our clients without any conflict of interest.

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Chief Operating Officer

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