

FINAL

Market Conduct Examination Report

**NEW HAMPSHIRE MEDICAL MALPRACTICE JOINT
UNDERWRITING ASSOCIATION
Concord, New Hampshire**

**As of
October 24, 2013**



State of New Hampshire Insurance Department

Roger A. Sevigny, Commissioner

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Additional Exhibits and Documents Comprising the Final Examination Report

- Exhibit A: Certificate of Authority for Examination
- Exhibit B: Background Statement of Commissioner Sevigny on Examination Purposes
- Exhibit C: Department of Insurance Letter, December 2, 1975, Requesting Tax Exemption
- Exhibit D: IRS Letter, January 14, 1976, Granting Tax-Exempt Status
- Exhibit E: Ins 1700 Initial and Final Proposal, JLCAR Comments, JLCAR Preliminary and Final Objections and Joint Resolution
- Exhibit F: Preliminary Analysis of Examiners Regarding Material Federal Income Tax Issues (Including Compilation of JUA Rules)
- Exhibit G: IRS Closing Agreement, June 3, 2013
- Exhibit H: NHDRA Closing Letters, July 16, 2013 and August 1, 2013
- Exhibit I: SB 170 Study Commission Report

I. INTRODUCTION

This Report of Examination (“Report”) is being delivered to the New Hampshire Medical Malpractice Joint Underwriting Association (“JUA”) in connection with the New Hampshire Insurance Department’s (the “Department”) examination (the “Examination”) of the JUA. This Report completes the Department’s Examination.

A. Appointment of Examiners

Roger Sevigny, as Commissioner of the State of New Hampshire, commenced this examination by order dated February 22, 2010, appointing the Department’s Examination Division and attorneys or other professionals and specialists retained by the Department as examiners.¹ On February 25, 2010, the Department engaged William F. J. Arding and Steven J. Lauwers of Rath, Young and Pignatelli, P.C. to serve as examiners with respect to the Examination. The Commissioner also retained the law firm of Skadden, Arps, Slate, Meagher & Flom LLP (“Skadden”) on August 6, 2010; and the actuarial firm of Milliman, Inc. on August 13, 2010. The collected findings of these examiners are included in this report. This examination follows examinations of the JUA conducted in 1984 and 1999.

B. Purpose of the Examination

As stated by the Certificate of Authority establishing the examination, the purpose of the examination is “to determine the solvency and financial status of the New Hampshire Medical Malpractice Joint Underwriting Association in light of the recent Supreme Court decision in Tuttle v. New Hampshire Medical Malpractice Association et al.”²

The Commissioner has explained the purpose for the examination as follows:

“During the course of the Tuttle litigation, it became clear that the current rules that establish the governance of the [JUA] Plan left many important operational issues unanswered. Our current examination has also uncovered several important operational issues that are not addressed by the current rules. These unanswered questions need to be resolved to prevent any further confusion to the public and to those who purchase Plan policies. ... In addition to these operational issues, the examination has focused on one issue that is of critical concern. The arguments of the Tuttle Plaintiffs and the decision of the lower court in Tuttle

¹ Certificate of Authority, attached as Exhibit A.

² Tuttle v. New Hampshire Medical Malpractice Joint Underwriting Association et al., 159 N.H. 627 (2010)

have challenged the Plan's status as a public entity and, therefore, have threatened the plan's exemption from taxation by the federal government."³

C. Conduct of the Examination

In accordance with the requirements of the statute governing examinations (RSA 400-A:37, III), the Examiners developed information relevant to the purpose of the exam through review of books, records, papers, accounts and other documents relating to the establishment and operation of the JUA, and through interviews with persons with knowledge of the history, operations and financial statements of the JUA.

The Examination focused on an analysis of financial risk associated with a change in the JUA's federal and New Hampshire tax status. The Examination necessarily included an analysis of applicable statutory and regulatory authority with respect to the JUA that had been in place at various times in order to analyze the tax status of the JUA. As an essential part of both phases of the Examination, the authority and responsibilities of the Department and the JUA Board, respectively, were considered in light of statutory and regulatory authority in existence at different period of times. Finally, the Examination also considered the impact that judicial (e.g., the Tuttle decision) and legislative developments (SB 170⁴ and response of the Joint Legislative Committee on Administrative Rules, "JLCAR," to the Department's proposed amendments to the JUA's administrative rules) had on the JUA's ability and authority to issue (and the implications of issuing) so-called "participating policies" and to raise needed funds in the event of deficits. All these factors were reviewed and analyzed to ensure that the JUA could act in compliance with the law while meeting its long-term financial obligations.

The Examination may be categorized into two phases: (1) an immediate analysis, on a preliminary basis, of the JUA's exposure to retrospective federal and New Hampshire tax liabilities; and (2) a more lengthy review and management of a process to resolve this exposure, including recommended changes to the plan of operation of the JUA (Ins 1700), assessment of impacts of State legislation (SB 170) and participation in negotiations with the Internal Revenue IRS (the "IRS") and the New Hampshire Department of Revenue Administration (the "NHDRA") regarding mitigation of risks of retrospective federal or New Hampshire income tax liabilities, and establishment of the JUA's tax status going forward. The effect of taxes imposed by any other jurisdictions, if any, was beyond the scope of this Examination. The Examination was conducted during the period from the establishment of the examination on February 22, 2010, through the resolution of the JUA's federal and state tax exposures for prior periods and

³ "Background Statement of Commissioner Roger A. Sevigny Announcing Proposed Rules for the New Hampshire Medical Malpractice Joint Underwriting Association Plan," attached to this Report as Exhibit B.

⁴ 2011, Chapter 201, SB 170, now codified at RSA 404-C:14.

final review and analysis of operational issues that were impacted by tax issues. While the resolution of federal and state issues was achieved by the close of the Examination, there remain critical operational issues yet to be resolved by legislative action.

1. Phase 1: Preliminary Tax Risk Assessment

The first phase of the Examination involved developing a preliminary assessment of the potential for the JUA to become exposed to a very substantial federal and state income tax liability as a result of the loss of the State's longstanding position treating the JUA as an "integral part of the State" for federal income tax purposes. This first phase of the Examination was conducted between February 22, 2010 and October 22, 2010. It involved:

- (1) A review of the applicable legal framework of the JUA, including the governing statute (RSA Chapter 404-C, which authorizes the Commissioner to establish "mandatory risk sharing plans" and to promulgate administrative rules to govern all aspects of the JUA's operations), the administrative rules governing the JUA (N.H. Admin. Rules Ins Part 1700), and the Supreme Court's opinion in the Tuttle case (159 N.H. 627 (2010));
- (2) A review of the history of the establishment, maintenance and operation of the JUA;
- (3) A review of the insurance policies issued by the JUA and the JUA's practices and procedures with respect to such insurance policies;
- (4) A review of the history of the financial status of the JUA, including past and current financial statements and actuarial analyses;
- (5) A review of facts and law concerning the JUA's status under federal and state tax laws, including the original exchange of letters between the Department and the IRS in which the IRS concluded that "[s]ince the association activity is conducted under the Insurance Department of the State of New Hampshire which is an integral part of the State of New Hampshire, it follows that the association is an integral part of the state government and is exempt from taxation under section 115 of the Internal Revenue Code" and the history and practice of reliance on such letter by the Department and the JUA Board and their advisors;⁵ and
- (6) A preliminary review of administrative rules initially proposed by the Department on May 24, 2010 and proposed as final rules on September 2, 2010 with respect to whether the terms of these proposed rules would address deficiencies in the current rules concerning JUA governance and operational practices and thereby strengthen the

⁵ Department of Insurance Letter dated December 11, 1975, attached as Exhibit C; Internal Revenue Service Letter dated January 14, 1976, attached as Exhibit D.

longstanding position that the JUA was an integral part of state government and accordingly exempt from federal and state income taxation.⁶

The first phase of the Examination culminated in a “Preliminary Analysis of Examiners Regarding Material Federal Income Tax Issues” dated October 22, 2010 (the “Preliminary Tax Report”). A full copy of this Preliminary Tax Report, including all exhibits to it, accompanies this Report as Exhibit F and is incorporated herein by reference. As detailed in the Preliminary Tax Report, the Examiners summarized their preliminary conclusions as of October 22, 2010, as follows (quoted in full from page 4 of the Preliminary Tax Report, with emphasis added):

Since the original establishment of the JUA in 1975, the State, the Department and the JUA Board have consistently treated the JUA as an integral part of the State that is not subject to the federal income tax. The actions of the State, the Department and the JUA Board with respect to the taxation of the JUA, including the decision not to file any federal income tax returns, have been consistent with this position. Further, this longstanding position is consistent with the analysis set forth in the Department’s 1975 letter to the IRS and not inconsistent with the letter received from the IRS by the Department in 1976.

However, largely due to the recent uncertainties regarding the meaning of certain provisions of the JUA rules and policies raised during the Tuttle litigation and subsequent contentions by certain policyholders, we have determined as a preliminary matter that there is a material risk that the State’s longstanding position treating the JUA as an integral part of the State could be challenged by the IRS.

In response to this concern, we have provided the Department with two preliminary recommendations. First, based on our review of the administrative rules that govern the JUA’s establishment, governance and operation, we assisted the Department in preparing amendments to the current JUA rules that would, if they become final, clarify certain practices and establish guidelines where the prior rules have been silent in a manner that is consistent with the longstanding position that the JUA is an integral part of the State that is not subject to federal income tax. The details of these proposed amendments are addressed in more detail below. Second, we have recommended that the State retain legal counsel with specific expertise in working to resolve conflicts with the IRS’s national office to: (i) review and confirm our analysis; (ii) add any further insights; and (iii) develop a strategy on how to approach the IRS to resolve all outstanding questions regarding the status of the JUA under the federal income tax laws. We

⁶ The proposed amendments to JUA rules were introduced in a Final Proposal dated September 2, 2010 and were then modified and re-submitted on September 10, 2010 based upon comments received from the legal staff of the JLCAR. The amendments were ultimately rejected by JLCAR and a Final Objection and Joint Resolution were issued on November 18, 2010. Subsequently, SB 170 was enacted which, among other things, established a commission to review the JUA. These materials are included in Exhibit E.

understand that the Department has engaged the law firm of Skadden, Arps, Slate, Meagher & Flom LLP (“Skadden”) for this purpose, and we agree that this selection is excellent for the required purpose.

2. Phase 2: Resolution and Mitigation of Potential Tax Risks

The second phase of the Examination involved negotiations with the IRS, working with the Department, Skadden, and representatives of the JUA to resolve and mitigate any potential federal (and consequent) state tax risks identified in the Preliminary Tax Report, as well as to understand and establish the JUA’s tax status going forward. At all times, the parties also consulted with the firm PriceWaterhouseCoopers (“PWC”), which was retained by counsel for certain JUA policyholders as required by SB 170. Extensive submissions to the IRS and negotiations to resolve federal tax issues both retrospectively and prospectively began with a written submission to the IRS on March 31, 2011 and then a meeting in Washington, D.C. with IRS officials in early May.

The objective of negotiations with the IRS was to confirm the JUA’s exemption from federal tax as an entity integral to the state, or in the alternative, to eliminate to the extent possible the retrospective exposure of the JUA to federal taxes for prior periods. In light of various facts (significantly, the Tuttle litigation, the rejection by JLCAR of the Department’s proposed amendments to Ins. 1700 and ultimately the enactment of SB 170) and despite the best efforts of the JUA, the Department, and Skadden, the IRS would not confirm that the JUA was permitted to operate as an exempt governmental entity, integral to the state and not subject to federal taxes or federal tax filings.

Further negotiations with the IRS then focused on minimizing the exposure of the JUA for federal taxes during the period from 1976 forward. In addition to possible imposition of retrospective federal taxes, critical issues relating to the tax attributes of the JUA associated with its treatment as a taxable entity needed to be handled. Failure to adequately address the tax attributes of the JUA as of the date on which the JUA became taxable could have had a severe, adverse impact on the finances of the JUA, which could have been much greater than the \$25 million tax reserve established in SB 170. For example, as to future tax filings [REDACTED]

[REDACTED]

[REDACTED]

Efforts to resolve the JUA’s federal tax liability, and to establish its tax attributes as of the date it became a taxable entity, continued from approximately November 1, 2010, until June 3, 2013, and resulted in a final “Closing Agreement on Final Determination Covering Specific Matters” between the JUA and the IRS that was finally executed by the IRS on June 3, 2013 (the

“IRS Closing Agreement”).⁷ As discussed in more detail below,⁸ the IRS Closing Agreement (i) concluded that the JUA was a taxable entity for the entire period of its existence from December 31, 1975 through December 31, 2012 (resolving uncertainties over liabilities for gain on investments), (ii) revoked the original January 14, 1976 letter from the IRS that concluded that the JUA was exempt from federal income tax, and (iii) determined, relying on discretionary power granted to the IRS, that the “JUA has and had no income tax return filing obligation or liability for Federal income taxes, interest or penalties due for any tax year ending on or before December 31, 2012.” Importantly, this favorable resolution took into account the adverse tax impacts of the State’s enactment of SB 170.

Subsequent to the IRS Closing Agreement, the Department and the JUA engaged in communications with the NHDRA to resolve and mitigate any potential state tax risks. These communications resulted in the receipt of letters from the Commissioner of NHDRA, dated July 16, 2013 and August 1, 2013 (the “NHDRA Closing Letters”) confirming that, “based on the IRS Closing Agreement, the DRA confirms that it intends to take no action against the JUA regarding any New Hampshire business tax liabilities, including both business profits tax (BPT) and business enterprise tax (BET), for the tax periods ending on or before December 31, 2012.”⁹

In addition to this very successful effort by the Department and the JUA to obtain these letters, the second phase of this Examination also addressed two ancillary issues arising under federal tax laws which were direct consequences of the surrender of the original 1976 IRS letter establishing the JUA’s tax exemption.

D. Summary of Determinations and Recommendations

The Examination determined that the federal income tax risk identified in the Preliminary Tax Report--the JUA could become subject to federal income tax for all years since its formation, and could lose its exemption for future years--was material and required immediate and focused discussions with the IRS to resolve and mitigate these risks. With the issuance of the IRS Closing Agreement and the NHDRA Closing Letters, the Department and the JUA Board have fully mitigated the risk of retrospective federal and state tax liabilities. However, this favorable retrospective resolution resulted in the termination of the JUA’s status as tax exempt. Accordingly, for all tax periods beginning after December 31, 2012, the JUA will be subject to federal income tax and New Hampshire business profits tax (BPT) and business enterprise tax (BET), and will be required to file returns in accordance with federal and state tax requirements. In addition to these income tax issues, the Examination also addressed certain

⁷ A copy of the executed IRS Closing Agreement is attached to this Report as Exhibit G.

⁸ Section III.B.

⁹ A copy of the NHDRA Closing Letters are attached as Exhibit H.

ancillary federal tax matters relating to preparation of the JUA's first and future federal tax returns. Ultimately, these matters are issues for the JUA to decide and the views provided in the context of this Examination are for the exclusive benefit of the Department.

The Examination also identified other areas of concern regarding the viability of the JUA's current Plan of Operation; as such plan is set forth in current administrative rules. These concerns principally arise as the result of the legislative action, including the enactment of SB 170, which affect and are inconsistent with the terms of the current rules and render uncertain the Department's authority to establish and oversee the JUA's operation, or even to promulgate administrative rules to continue the JUA when the current rules expire in January 2017. In addition, the ability of the JUA to raise necessary funds in the event of a deficit is in question as a result of the limitations placed on the Board by SB 170. Further, there is a concern that continued provision in the Plan of Operation for distribution to policyholders may further erode the private market in violation of state law, and may result in an inequitable allocation of the burdens of assessment and the benefits of distribution. Remedies for these and other related operational issues will require the enactment of legislation.

E. Overview of Remainder of this Final Report

The remainder of this Examination Report provides the final analysis of key aspects of the Examination. Section II states the Examination's final adoption of the facts, analysis and conclusions set forth in the Preliminary Tax Report. Section III sets forth the Examination's review and conclusions regarding: (1) the enactment of SB 170; (2) the IRS Closing Agreement; (3) the NHDRA Closing Letters; (4) operational issues and continued operations; and (5) certain ancillary tax matters that have arisen during the course of the Examination.

II. FINALIZATION OF THE PRELIMINARY TAX REPORT

The Preliminary Tax Report, attached as Exhibit F, was prepared and submitted to the Department in draft form on October 22, 2010. The facts, analysis and conclusions stated in that Report are accurate, and we render the Preliminary Tax Report, without any modifications, as a final document for incorporation into this final Report of Examination. In the following paragraphs, we refer to pages and exhibits to the Preliminary Tax Report as "PTR at p. x" and "PTR, Ex. x", respectively.

III. EXAMINATION OF MATERIAL EVENTS SINCE THE DATE OF THE PRELIMINARY TAX REPORT

A. Enactment of SB 170

1. Terms of New RSA 404-C:14

During the Examination, the State enacted SB 170, which became law on June 16, 2011 as Chapter 201 of N.H. Laws. This new provision, in its entirety, currently states as follows:

404-C:14 New Hampshire Medical Malpractice Joint Underwriting Association (NHMMJUA). –

- I. Notwithstanding any provision of law to the contrary, no officer or agent of the state shall take or transfer, through taxation of the New Hampshire Medical Malpractice Joint Underwriting Association (NHMMJUA) or otherwise, any funds held by the NHMMJUA on the effective date of this section in a manner inconsistent with this section. Nothing in this section shall preclude the collection of applicable state taxes, if any, owed by policyholders as a result of the return of funds referenced in this section.

- II. All funds held as of the effective date of this section by the NHMMJUA in excess of the amount required for the fund to remain actuarially sound, as determined by a qualified actuary, shall constitute excess surplus funds and shall not be less than \$110,000,000 in accordance with 2009, 144:1. Such determination shall be completed under the direction of the NHMMJUA board of directors not more than 45 days from the effective date of this section. All such excess surplus funds have resulted from premiums paid under assessable and participating medical malpractice insurance policies, belong to the policyholders who paid these premiums, and shall be returned as directed under this section. Within 60 days from the effective date of this section, all excess surplus funds, except for a reserve of \$25,000,000 for the payment of any federal tax liability, shall be interpleaded into the Merrimack County Superior Court, docket no. 217-2010-CV-00414 for the purpose of adjudicating all policyholders' claims to excess surplus funds. All distributions made to policyholders shall be subject to a claim from the NHMMJUA to reclaim a pro rata portion of the distribution to satisfy any federal tax liabilities in excess of the \$25,000,000 reserved for such claims.

Notwithstanding any other provision of law to the contrary, in no event shall any insurer which is a member of the NHMMJUA, as defined in Ins 1703.01(i), be assessed nor shall there be a surcharge, as provided in Ins 1703.07(f)(2), with

respect to any deficit arising from the distribution of excess surplus funds described in this paragraph.

- III. Within 30 days of the effective date of this section, the NHMMJUA, the insurance commissioner, or designee, and a representative of NHMMJUA policyholders, designated by the president of the New Hampshire Medical Society, shall jointly approach the United States Internal Revenue IRS to obtain a closing agreement, or its equivalent, determining whether the NHMMJUA has any federal tax liability arising from the excess premiums paid and that shall be returned to policyholders.
- IV. No later than 30 days after receipt of the closing agreement, or its equivalent, the NHMMJUA shall interplead into the Merrimack County Superior Court docket no. 217-2010-CV-00414 for the purpose of adjudicating all policyholders' claims to these remaining excess surplus funds the remaining amount of the tax reserve after satisfaction of any taxes owed.
- V. Funds that cannot be distributed to a policyholder in the court proceedings referenced in this section due to the inability to locate the policyholder after reasonable efforts, shall revert to the NHMMJUA. Undistributed funds that revert to the NHMMJUA as provided in this section shall be used to provide grants in aid to health care providers servicing medically underserved populations to assist in the NHMMJUA coverage.
- VI. The approval of the commissioner of insurance shall not be required for any action contemplated under this section.
- VII. [Repealed.]¹⁰

2. Analysis of Material Aspects of SB 170

RSA 404-C:14, as enacted by SB 170, substantially altered the status of the JUA under previously existing New Hampshire law and administrative rules (See the Preliminary Tax Report for a full description of this prior treatment). This statute may be viewed as mandating five things:

- (1) to declare certain JUA funds (not less than \$110,000,000) to be “excess surplus funds” without any further administrative review by the Department, to declare such excess surplus funds to “belong to the policyholders,” and to instruct the JUA to commence a judicial process to deliver such funds to policyholders;

¹⁰ RSA 404-C:14, VII established a commission to study the future of the JUA. This provision was automatically repealed effective December 31, 2011. The commission’s report is attached as Exhibit I.

- (2) to prohibit any officer or agent of the State to “take or transfer, through taxation ... or otherwise, any funds held by the NHMMJUA on the effective date of this section in a manner inconsistent with this section”;
- (3) to instruct the JUA, the Department and representatives of the JUA policyholders to “approach the United States Internal Revenue Service to obtain a closing agreement, or its equivalent, determining whether the NHMMJUA has any federal tax liability arising from the excess premiums paid and that shall be returned to policyholders;”
- (4) to eliminate any exposure of licensed insurers who are “members” of the JUA under the administrative rules to any assessment or surcharge to cover any “deficit arising from the distribution of excess surplus funds;” and
- (5) to eliminate any regulatory authority of the Department over the JUA’s actions “contemplated under this section.”

With these changes, SB 170 effectively eliminated the basis for the State’s longstanding position that the JUA was an “integral part of the State” and therefore not subject to federal income tax. As discussed in more detail in the Preliminary Tax Report, characteristics of the JUA which supported this position included plenary oversight by the Commissioner of the Department (PTR at p. 30), the right to assess licensed liability insurers (PTR at p. 32), and emphasis of the JUA’s public purpose over any private property interest in the JUA’s accumulated earnings (PTR at p. 33). The General Court, in enacting SB 170, was aware that these substantial changes could trigger federal tax and so provided for a reserve of \$25,000,000 to be held against potential federal income tax liabilities pending the outcome of negotiations with the IRS.

Prior to SB 170, the State had the opportunity to take steps to seek to preserve the JUA’s valuable tax-exempt status, both retrospectively and prospectively. For example, the administrative rules initially proposed by the Department on May 24, 2010 and submitted to JLCAR on September 2 and 10, 2010, if approved by JLCAR, would have, in our view, clarified various aspects of the JUA’s structure and operations in a manner that would have confirmed that the JUA should be respected as an “integral part of the State” for federal income tax purposes.¹¹ JLCAR’s rejection of these administrative rules, followed thereafter by the enactment of SB 170 by the General Court, foreclosed any possibility of preserving that position

¹¹ For a discussion of the Department’s proposed rules and potential federal income tax consequences, please see the Preliminary Tax Report at pages 15-24.

and certainly contributed to the framing of the final IRS Closing Agreement, which revoked the JUA's favorable ruling and its previous tax-exempt status.

B. The IRS Closing Agreement

The IRS Closing Agreement (Exhibit G to this Report) contains six substantive paragraphs. The following discussion lists each paragraph and provides, in italics, brief comments with respect to each.

- 1. The JUA was an association subject to Federal income tax imposed by Section 11(a) of the Internal Revenue Code for the period from and including the tax year ending December 31, 1975, to and including the tax year ending December 31, 2012 (the "Applicable Period").**

Comment: For purposes of this Agreement, "JUA" is defined as the "New Hampshire Medical Malpractice Joint Underwriting Association" with specific reference to "(EIN: 02-604460)". This reference is to the entity that was originally established in 1975 and addressed in the exchange of letters between the Department and the IRS concerning tax status in 1975 and 1976. (See PTR Ex. E and F.) The reference to section 11(a) of the Internal Revenue Code refers to the section that imposes income tax on corporations. This first paragraph concludes that the JUA was an "association [a corporation] subject to the Federal income tax" for its entire existence through December 31, 2012. This conclusion specifically rejects the position that the JUA was an "integral part of the state" and therefore immune from federal income taxation under long-standing interpretations of the IRS. (See PTR, pp. 25-34.) As discussed above, while the Department and the JUA asserted that the JUA was integral to the state and exempt from federal tax, ultimately the parties agreed to surrender the private letter ruling issued by the IRS in 1976 in exchange for an IRS determination that no taxes were due for the period from 1976 through 2012 and that the JUA had full tax attributes as of December 31, 2012, as if it had filed returns during the tax periods 1976-2012.

- 2. The 1976 Determination Letter is revoked and shall be given no effect whatsoever, except that the issuance of such letter shall be the predicate for the relief under Section 7805(b) of the Internal Revenue Code provided by this closing agreement.**

Comment: This paragraph resolves the status of the effectiveness of the 1976 IRS letter. It concludes that the letter is "revoked" and "shall be given no effect." As noted in the Preliminary Tax Report, it was unclear whether the JUA could rely upon the 1976 letter to defend against the potential assessment of tax, interest and penalties for prior periods.

Importantly, however, this language establishes the letter as the “predicate” for the retrospective relief granted under the IRS Closing Agreement.

- 3. Pursuant to Section 7805(b) of the Internal Revenue Code, (a) the JUA has and had no income tax return filing obligation or liability for Federal income taxes, interest, or penalties due for any tax year ending on or before December 31, 2012; and (b) the JUA shall owe no estimated tax penalties for the first quarter of the tax year ending December 31, 2013.**

Comment: This paragraph grants retrospective relief from federal income taxation of the “JUA” for all periods through December 31, 2012. Generally, a taxpayer may rely on a letter ruling received from the IRS.¹² Also, in general, the IRS has the power to revoke a letter ruling found to be in error or not in accord with the current views of the IRS.¹³ Section 7805(b)(8) of the Internal Revenue Code provides that “[t]he Secretary may prescribe the extent, if any, to which any ruling (including any judicial decision or any administrative determination other than by regulation) relating to the internal revenue laws shall be applied without retroactive effect.” Accordingly, in general, a ruling or internal regulation, upon promulgation, is given retrospective effect unless the Commissioner exercises discretion under section 7805(b)(8) to limit the retrospective effect partially or completely.

Accordingly, this paragraph is the key provision of the IRS Closing Agreement. By this paragraph, the IRS offsets the potentially significant adverse impact of revoking the 1976 ruling letter by exercising its discretion to limit the retrospective impact of that revocation. This action is consistent with the discretionary authority granted to the IRS under section 7805(b). In our view, the JUA is entitled to rely on this determination entirely to conclude that, even though the JUA was taxable for the entire period of its existence, it owes no federal income tax, interest or penalties for any period through December 31, 2012.

- 4. The JUA’s basis in its assets on January 1, 2013 is the same as it would have been under the application of the normal basis rules had the JUA been obligated to file income tax returns absent this agreement and pay Federal income taxes during the Applicable Period.**

Comment: This is a very important paragraph. It provides guidance regarding a very important potential tax risk, namely whether the JUA would receive “credit” for the cost

¹² See, §11.01 of the first annual revenue procedure, issued each year.

¹³ See, §11.04 of the first annual revenue procedure.

it incurred in acquiring its investment portfolio with respect to subsequent transactions occurring during tax periods after December 31, 2012. In the absence of this guidance, and in the worst case, the IRS could have taken the position that the JUA had a “zero basis” in such assets as of January 1, 2013. With a zero basis, then any time the JUA sold an asset, it would be subject to federal tax on the full amount of the proceeds realized from the sale. This “zero basis” result could have completely undermined the benefits of the retrospective relief determination.

In our view, this paragraph resolves the “zero basis” risk. It directs that the JUA is to apply the tax rules for periods after December 31, 2012 assuming that any asset sold has a cost or other basis determined as if the asset was acquired by a taxable enterprise under regular tax rules, even if the asset were acquired in prior periods subject to the retrospective relief. This construction of this paragraph is consistent with the first paragraph, which determines that the JUA was subject to the federal income tax rules for all periods, including the Applicable Period. As described in more detail below, we also believe that this determination should be viewed by the JUA as providing guidance with respect to the value of other JUA tax attributes acquired or accumulated during the Applicable Period.

- 5. The JUA will not be deemed to have been a dealer in securities under Section 475(a) of the Internal Revenue Code during the Applicable Period, nor will it have been deemed to have made an election under Section 475(f) of the Internal Revenue Code during the applicable period. Furthermore, the JUA will not be deemed to have identified any securities as held for investment under Section 475(b)(1)(A) of the Internal Revenue Code during the Applicable Period.**

Comment: This paragraph is related to the prior paragraph with respect to determining the basis of the JUA’s investment assets for federal income tax purposes. Section 475 of the Internal Revenue Code provides special “mark-to-market” accounting rules for “dealers in securities.” If these rules applied, then JUA might be able to claim a basis for its investment securities equal to their fair market value, as opposed to their cost.

- 6. No opinion is expressed as to any other tax issues not addressed above or as to the calculation of the JUA’s opening balances as of January 1, 2013.**

Comment: The purpose of this paragraph, we believe, is to ensure that the JUA’s first tax return filed with respect to the period ending on December 31, 2013, and subsequent tax returns, will be subject to full examination by the IRS. For example, the JUA’s specific claim of the amount of the cost basis with respect to a particular sold investment

asset (i.e., the “opening balance” for that tax attribute) will be subject to audit, although the IRS will not be able to assert that the basis should be “zero” or determined under section 475 of the Internal Revenue Code. Similarly, the “opening” values of other tax attributes, such as the value of “unearned premiums” or “unpaid loss reserves” as of January 1, 2013, are fully subject to audit.

In conclusion, based on our review of the terms of the IRS Closing Agreement, we conclude that the JUA will not be subject to any retrospective federal income tax liability with respect to tax periods ending on or before December 31, 2012. Furthermore, we conclude that the IRS Closing Agreement establishes a framework for computing the JUA’s federal tax liabilities for periods ending after December 31, 2012 that should avoid any extraordinary “hangover” liabilities or assets attributable to federal income tax laws, such as a liability associated with a “zero basis” position with respect to JUA assets or, as discussed in more detail below, a tax asset associated with the position that no deductions have been taken for the JUA’s aggregate unpaid loss reserves. We understand that the Department will provide support to the JUA and its accounting and tax advisors with respect to (a) the establishment of an appropriate account for income tax liability on its financial statements for the periods commencing January 1, 2013, and (b) the preparation and filing of the JUA’s first federal income tax return with respect to the tax period ending December 31, 2013.

C. NHDRA Closing Letters

1. JUA’s Exposure to State Taxes

During the course of this Examination, the Department focused not only upon the risk that the JUA might become subject to federal income tax liabilities, but also upon the risk that the JUA might become subject to liabilities arising under New Hampshire tax laws.¹⁴ Since the original establishment of the JUA in 1975, the State and the Department consistently took the position that the JUA was an “integral part” of the State, and accordingly, the JUA never filed tax returns with the State of New Hampshire. While there is no express exemption in either the BPT or BET statutes for state governmental instrumentalities, such entities have never been subject to taxation under either statute.¹⁵ If the JUA were determined not to be a state instrumentality, but rather a taxable independent association, then, as a general matter, the JUA would fall within the definitions of “business organization” and “business enterprise” and would

¹⁴ See PRT at p. 37.

¹⁵ Cf., RSA 77-A:1, XXI(a)(4) and RSA 77-E:1, XIV(a)(4), treating certain “qualified community development entities” owned, controlled, or managed, directly or indirectly, by the New Hampshire Business Finance Authority as a “qualified investment company” exempt from BPT and BET.

be subject to the BPT and BET in accordance with the express terms of RSA Chapters 77-A and 77-E.

2. Impact of SB 170

Did the enactment of SB 170 alter this general conclusion that the loss of the JUA's federal exemption would trigger state taxation as well? For the reasons stated below, the Examination determined that SB 170 does not establish any general exemption from State taxation.

RSA 404-C:14, I, as enacted by SB 170, states:

- I. Notwithstanding any provision of law to the contrary, no officer or agent of the state shall take or transfer, through taxation of the New Hampshire Medical Malpractice Joint Underwriting Association (NHMMJUA) or otherwise, any funds held by the NHMMJUA on the effective date of this section in a manner inconsistent with this section. Nothing in this section shall preclude the collection of applicable state taxes, if any, owed by policyholders as a result of the return of funds referenced in this section.

The impact of this complex provision cannot be understood without carefully articulating each part. The plain language of this statute prohibits (i) any "officer or agent of the state" from (ii) "taking or transferring through taxation ... or otherwise" (iii) "any funds held by the NHMMJUA on the effective date" (iv) "in a manner inconsistent with this section." This rule, by its terms, does not impose an "exemption" from any tax statute. Traditionally, when the Legislature seeks to enact an exemption from taxation, it will do so through an exemption provision within the specific tax statute. Such exemptions are typically applied on a prospective basis, so that the enacting legislation will state that the exemption applies for tax periods ending on or after an express date, usually after the date the legislation takes effect.

In contrast, RSA 404-C:14, I prevents state officials or "agents" from taking or transferring certain JUA funds to pay a tax. Accordingly, an official employed by the NHDRA is not prohibited from auditing the JUA or assessing tax against the JUA. Instead, such an NHDRA official is prohibited only from acting to "take or transfer" JUA funds held on the effective date (June 16, 2011) to pay an assessed tax liability.

In other words, the prohibition is limited to apply only with respect to "any funds held by the NHMMJUA on the effective date." Accordingly, if NHDRA assessed tax against the JUA, the statute might prohibit State officials from transferring funds held on June 16, 2011, but it would not prohibit the transfer of funds earned and received by the JUA after that date, even if

the State taxes arose prior to the effective date. Indeed, because the statute does not enact a specific exemption from tax, the NHDRA is still legally obligated to apply its tax statutes in accordance with their terms.

Finally, it is unclear whether the final clause of this provision of SB 170 – “in a manner inconsistent with this section” – may further limit the scope of the prohibition on State official action to take or transfer. The purpose of SB 170 seems focused primarily on forcing the distribution of these funds to policyholders. The law nowhere states an express legislative intent to establish a broad exemption from taxes to be imposed upon the JUA or its activities or its income. If the prohibition language is construed narrowly in a manner consistent with the stated legislative purpose, then NHDRA could assess and collect a tax liability, but only to the extent that it did not reduce the JUA’s “excess surplus funds.” Accordingly, we concluded that RSA 404-C:14, I did not establish any general exemption from State taxation. During the course of the Examination, the Department thus determined that it would seek to resolve and mitigate any exposure to retrospective State tax liability through discussions with the NHDRA.

3. The NHDRA Closing Letters

Upon receipt of the executed IRS Closing Agreement, the Department approached the NHDRA to disclose the existence of the IRS Closing Agreement and to resolve the treatment of the JUA under the BPT and BET for all tax periods ending on or before December 31, 2012. The result of this approach is the letter received by Commissioner Sevigny from NHDRA Commissioner Beardmore, dated July 16, 2013. In this letter, the NHDRA:

confirms that it intends to take no action against the JUA regarding any New Hampshire business tax liabilities, including both business profits tax and business enterprise tax, for the tax periods ending on or before December 31, 2012.

A subsequent, follow-up letter from the NHDRA Commissioner, dated August 1, 2013, clarified that the prospective time period was “tax periods ending after December 31, 2012.”

As in the case of the IRS, the NHDRA Commissioner has broad authority to abate taxes subject to NHDRA’s jurisdiction.¹⁶ Taxpayers are entitled to rely on determinations by the NHDRA.¹⁷

¹⁶ RSA 21-J:3, XVI.

¹⁷ See Appeal of John Denman, 120 N.H. 568, 573 (1980).

Based on our review of the terms of the NHDRA Closing Letters, we conclude that the JUA will not be subject to any retrospective BPT or BET liability with respect to tax periods ending on or before December 31, 2012. Further, we conclude that, without further action of the Legislature, the JUA will be subject to the BPT and BET with respect to tax periods ending after December 31, 2012. Finally, we understand that the Department will provide support to the JUA's accounting and tax advisors with respect to (a) the establishment of an appropriate account for New Hampshire tax liability on its financial statements, and (b) the preparation and filing of its first New Hampshire tax returns with respect to the JUA's tax period ending December 31, 2013.

D. JUA Operational Issues

The Examination identified certain operational issues that potentially impact the JUA's ability to continue as a viable and solvent plan into the future. This section of this Report summarizes key aspects of these operational issues.

1. Creation, Management, and Control; Ins 1700

RSA 404-C:1 authorizes the Commissioner to establish the JUA by adoption of administrative rules. Regulation 17, now Ins 1700, was adopted in 1975, and the JUA was established by these rules. These administrative rule also established the JUA's Plan of Operation. Thus, pursuant to RSA 404-C:1, the Legislature has vested the Commissioner with the authority to establish and develop the Plan of Operations of the JUA through administrative rules, and this rulemaking authority cannot be delegated to any party, including the JUA Board.¹⁸

Legislative developments during the course of this Examination have called into question the Commissioner's authority to promulgate the JUA's Plan of Operation through rulemaking. In JLCAR's Final Objection issued in 2010¹⁹ the Committee questioned the Commissioner's authority to adopt Ins 1700 and concluded that the Commissioner's role with respect to the JUA, as established pursuant to Ins 1700, conflicts with RSA 400-A:12 and RSA 402:11-a. While RSA Chapter 404-C continues to grant authority to the Commissioner to promulgate rules to create the JUA and govern its operations, these legislative developments raise a material question about the scope of the Commissioner's authority. Because the current administrative rules expire in January 2017, these authority questions should be addressed through legislative action prior to that time.

¹⁸ RSA 541-A:9,II(d) Powers and Duties of Commissioners: "rulemaking authority shall not be delegated."
See also RSA 400-A:13 Delegation of Powers: "However, he shall not delegate his rulemaking powers..."

¹⁹ See Exhibit E.

2. JUA Assessment Authority

The ability of the JUA to raise necessary funds through assessment, if premium and investments are insufficient to pay claims and expenses, has been impacted by the limitations contained in SB 170. The current Plan of Operation authorizes the JUA Board to impose an assessment upon insurance company members of the JUA. However, SB 170 prohibits assessment against the insurer members of the JUA²⁰ to cover any “deficit arising from the distribution of excess surplus funds.”

Based on this limitation in SB 170 and the current Plan of Operation, if insurers are successful in establishing that a deficit results from the distribution of excess surplus (and they are not therefore subject to assessment) the only individuals or entities that would be held responsible to fund the deficit are New Hampshire health care providers.²¹ The JUA Board, does not however, have clear regulatory authority to directly assess New Hampshire health care providers.²² An assessment against parties other than insurers would appear to be inconsistent with the principles set forth in RSA Chapter 404-C which mandate that insurers (and not health care providers) participate in the risk sharing plan to address market deficiencies and are to bear “the burden imposed by the plan equitably and efficiently within the industry.” Because the power to assess parties in the event of a deficit is central to any evaluation of the long-term stability of the JUA, questions regarding assessment should be addressed through legislative action.

3. Profit Sharing- Participating Policy

The litigation over JUA excess surplus and the mandated distribution required by SB 170 has raised concerns over the use of a “participating” policy by the JUA. In addition the concern that distributions to policyholders has contributed to the loss of the JUA’s federal tax exemption as discussed in this report, there are other difficulties raised should the Plan of Operation continue to provide for distributions of excess surplus funds. Currently, Ins 1703.07(d)(2)

²⁰ SB 170 also prohibits a surcharge against liability policyholders.

²¹ Ins 1703.01 defines “health care providers” as “a person licensed or approved by the state to provide health care or professional services” including physicians, chiropractors, dentists, pharmacists, paramedic and other medical professions; and “institutions” including hospitals, nursing homes “or other facility or entity licensed by the state to provide health care services.” The term “health care provider” is not limited to JUA health care providers under the current Plan of Operation.

²² There is no surcharge or assessment that could be imposed under the regulations against only JUA policyholders. For deficits attributable to policies issued after 1986, the Plan of Operation (Ins 1703.07) only authorizes the JUA to assess member insurance companies. Member insurers that pay the assessment can recoup this assessment from liability policyholders or all New Hampshire health care providers. There is no surcharge or assessment against only JUA policyholders under the regulations. This conclusion does not mean that a surcharge or assessment could not be imposed consistent with the terms of a participating policy, provided it was consistent with Chapter 404C, 14, as amended by SB 170.

provides for distributions only to “health care providers covered by the association.” However while JUA policyholders alone can share in excess surplus when the JUA is profitable, a broader class of individuals and entities bear the burden of deficits.²³ SB 170 seems to recognize this disparity in benefit and burden by eliminating possibility of assessment against the insurance industry or liability policyholders should a deficit arise as a result of the distribution.

In addition, RSA 404-C:2,II requires that the JUA have “procedures that will create minimum interference with the voluntary market.” The requirement that the JUA minimize market interference is aimed at avoiding further deterioration in the market. A critical factor in preventing market interference is maintaining JUA premiums at levels that do not undercut those of the remaining private insurers in New Hampshire. The JUA Plan of Operation requires that JUA rates be consistent with the private market, and provides for the Department’s review of those rates. In addition, the Department conducts not only rate review of JUA rates, but an annual analysis of JUA rates in comparison to those of private insurers.²⁴ Distributions to policyholders of JUA excess surplus is, in this context, problematic as distributions lower the overall cost of insurance for JUA insureds and could bring otherwise acceptable costs to JUA insureds below market rates in violation of RSA 404-C.

4. Other Operational Issues

There are a number of other operational issues which were identified in the Examination and addressed in the rule proposal filed in 2010, which was the subject of the JLCAR final objection. Many of the 2010 proposed amendments to Ins 1700 are still relevant, needed changes to update the current Plan of Operation. Since that time, additional questions have arisen as a result of the shift of the JUA from a state entity to some undefined form of quasi-state entity, for example: whether as a quasi-governmental entity, there is still defense and indemnity protection available to the JUA Board, officers and employees under RSA 99-D as well as issues surrounding the JUA’s obligation to pay premium tax or the insurance assessment, to obtain an insurance company license and to comply with state right-to-know laws. These significant and critical operational issues must be addressed to ensure the JUA can act in compliance with the law while meeting its long-term financial obligations to its policyholders.

²³ See also fn 22 and 23.

²⁴ See Ins 1703.11 Coverage, Rates and Forms and Ins 1702.03(c). The Department also conducts an annual analysis and hearing of market competitiveness in the medical malpractice insurance market pursuant to RSA 412:13 and RSA 412:14. The most recent 2012 report concluded a competitive market for medical malpractice for physicians, surgeons and hospitals does not exist. An order of the Commissioner dated November 30, 2012, directs that rate filing standards applicable in non-competitive markets will therefore continue to apply.

In the 2012 legislative session the Department did seek legislation to create the JUA as an entity independent of the Department and provide the JUA Board with independent authority to manage and control JUA operations. The bill, HB 489, would enable the Board to move forward to establish the JUA under clear legislative direction and would permit the Board to update the Plan of Operation to address all the above operational issues. HB 489 was passed in the House with amendment on March 13, 2013, but on May 10, 2013, HB 489 was re-referred by the Senate Executive Departments and Administration Committee for further study.

E. Ancillary Tax Matters Related to Future Federal Tax Filings of the JUA

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IV. CONCLUSIONS AND RECOMMENDATIONS

Based upon our Examination, as defined by the scope of the Examination, and subject to the more complete discussion below, we reach the following conclusions:

- (1) The federal income tax risk identified in the Preliminary Tax Report, namely that the JUA could become subject to federal income tax for all years since its formation, was material and required immediate and focused discussions with the IRS to resolve and mitigate this risk.
- (2) The consistent efforts by the Department and the JUA, and their respective representatives, to obtain the IRS Closing Agreement, has fully mitigated the risk of the JUA realizing federal income tax, interest and penalty liabilities for all years from its formation through December 31, 2012.
- (3) The receipt of the NHDRA Closing Letters has fully mitigated the risk of the JUA realizing New Hampshire BPT or BET, interest and penalty liabilities for all years from its formation through December 31, 2012.

³³ Hillsboro National Bank v. Commissioner/U.S. v. Bliss Dairy Inc., 460 U.S. 370 (1983). Courts have applied a “tax benefit doctrine” and a “duty of consistency” in various contexts. In Hillsboro, the U.S. Supreme Court discussed the scope of the tax benefit doctrine. In Eagan v. U.S., 80 F.3d 13 (1st Cir. 1996), Judge Stahl of the First Circuit Court of Appeals applied the “duty of consistency” to “estop” a taxpayer from seeking a refund in a later year based on a position that was inconsistent with a position he took in a previous closed year.

- (4) The JUA has, however, surrendered its tax exempt status and its tax exempt status, so for all tax periods ending after December 31, 2012, the JUA will be subject to federal income tax and will be required to file a return reporting its income in accordance with all applicable federal income tax rules.
- (5) Similarly, for all tax periods ending after December 31, 2012, the JUA will be subject to New Hampshire business profits tax and business enterprise tax and will be required to file a return reporting its income in accordance with all applicable New Hampshire tax rules.
- (6) Our examination of the applicable statutory and regulatory authority with respect to the JUA has identified significant issues regarding the JUA's governance structure, the relationship between the JUA and the state, the nature of the participating policies issued by the JUA, the proper level of JUA premium rates, and the handling of future surplus. The stability of the JUA as a solvent and viable insurance enterprise requires resolution of these issues, and legislative action appears to be the only means of securing such resolution.
- (7) Finally, we have also considered certain ancillary federal tax matters relating to the preparation of the JUA's initial federal tax return. Our preliminary analysis and tentative conclusions on these matters are set forth in this Report. Our views provided in the context of this Examination are necessarily for the exclusive benefit of the Department.
- (8) We recommend that pursuant to RSA 400-A:37,IV(c)(3) that after this report is filed as a final report, the commissioner open the report for public inspection with the exception of sections III.E (pages 20-26) that address recommendations related to ancillary tax matters association with the JUA federal income tax filing that should be kept confidential.

