Compliance Issues for Captives

State Taxation and Regulation in the Wake of the Nonadmitted and Reinsurance Reform Act of 2010

Kathy Davis
Kevin Moriarty
Downs Rachlin Martin PLLC

Points to Cover

- Powers of states to regulate and tax insurance companies and the business of insurance.
- State regulation and taxation of nonadmitted insurance.
- Effect of the Nonadmitted and Reinsurance Reform Act of 2010 (enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010).
- Compliance strategies for captive insurers.

State Powers to Tax and Regulate

- U.S. Constitution – state taxation of insurance companies must be consistent with Commerce Clause and Due Process Clause.
- Individual state constitutions must authorize the taxation of an insurance business (all states have interpreted their constitutions to allow such taxation).

State Powers to Tax and Regulate

- Federal Limits On State Taxation
- In 1945, the U.S. Congress passed the McCarran-Ferguson Act (15 USC Sec. 1011-1015), which affirmed the ability of the states to tax insurance companies consistent with the Commerce Clause
  - "the business of insurance, and every person engaged therein, shall be subject to the laws of the several states which relate to the regulation or taxation of such business." 15 USC Sec. 1012(a).

State Powers to Tax and Regulate

- McCarran Ferguson does allow the federal government to regulate and preempt state insurance laws:
  - "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by a State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act relates to the business of insurance." 15 U.S.C. Sec. 1012(b).

State Powers to Tax and Regulate

- The result of McCarran Ferguson:
  - Insurance is primarily state-regulated and taxed.
  - McCarran Ferguson effectively removes Commerce Clause restrictions on state taxation of insurance companies.
  - Federal legislation can preempt state taxation and regulation of insurance. Examples include: Risk Retention Act, Nonadmitted and Reinsurance Reform Act of 2010.

State Powers to Tax and Regulate

- Federal Limits on State Taxation of Insurance:
  - Due process requirements set a low bar for state taxation of insurance companies.
    - In 1962, the U.S. Supreme Court decided *State Board of Insurance v. Todd Shipyards Corp.*, 370 U.S. 451 (1962), and held that a state cannot tax an insurance transaction (insured or insurer) if the only connection to the state is the presence of insured risk.

State Powers to Tax and Regulate

- *Todd Shipyards* facts:
  - The insurance transactions involved in the present litigation take place entirely outside Texas.
  - The insurance, which is principally insurance against loss or liability arising from damage to property, is negotiated and paid for outside Texas.
  - The policies are issued outside Texas.
  - All losses arising under the policies are adjusted and paid outside Texas.
  - The insurers are not licensed to do business in Texas, have no office or place of business in Texas, do not solicit business in Texas, have no agents in Texas, and do not investigate risks or claims in Texas.

State Powers to Tax and Regulate

- *Todd Shipyards* facts (continued)
  - The insured is not a domiciliary of Texas but a New York corporation doing business in Texas.
  - Losses under the policies are payable not to Texas residents but to the insured at its principal office in New York City.
  - The only connection between Texas and the insurance transactions is the fact that the property covered by the insurance is physically located in Texas.
- *Todd Shipyards* is still in effect.

State Taxation and Regulation

- General Principles Applicable to All Insurance Companies
  - Primary authority: state statutes and regulations.
  - Each state taxes an insurance company if it conducts an “insurance business” in that state.
  - Taxation is generally an excise tax on gross premiums—tax applies regardless of whether the insurance company is profitable.

State Taxation and Regulation

- Tax applies to premiums written with respect to risks insured in the state (i.e., limited jurisdiction to tax).
- Generally, states don't use the federal income tax test to qualify as an "insurance company" for purposes of imposing the state premium tax; usually being licensed as an insurance company in any state is sufficient.
- Always check the statutes and regulations of a state; they are generally similar but NOT uniform.

Nonadmitted Insurance

- General Rule: an insurance company must obtain a certificate of authority before it can conduct the business of insurance in a state.
- Any insurer conducting an insurance business in a state without a COA is an “unauthorized” or “nonadmitted” insurer.
- Exceptions to the COA requirement include:
  - Reinsurance
  - Sales of insurance to “industrial insureds”
  - *Todd Shipyards*

Nonadmitted Insurance

- Insurers that transact insurance without a COA and without an applicable exception to the COA requirement, and those assisting the insurer, are subject to fines, penalties and cease-and-desist orders.
  - State laws include a number of exceptions to the COA requirement, including for insurance of "industrial insureds"
  - We have not seen any state impose these penalties with respect to a captive insurance company.
- Nonadmitted insurance may be taxable, regardless of whether the insurance is placed pursuant to an exception to the COA requirement.

Non-Admitted Insurance

- Currently, most of the states impose a tax on insureds who directly purchase insurance from a nonadmitted insurer.

NRRA

- NRRA is a federal statute, enacted pursuant to Congress' reservation of authority to regulate insurance under the McCarran Ferguson Act.
- Part I of NRRA deals with "nonadmitted insurance" which is "any property and casualty insurance permitted to be placed directly or through a surplus lines broker with a nonadmitted insurer eligible to accept such insurance."
- A "nonadmitted insurer" is "an insurer not licensed [by a state] to engage in the business of insurance in such state.

NRRA

- "Independently procured insurance" is "insurance procured directly by an insured from a nonadmitted insurer."
- NRRA preempts state laws regarding regulation and taxation of nonadmitted insurance:
  - Only the "home state" of the insured purchasing a policy of nonadmitted insurance may impose "premium taxes" for the nonadmitted insurance; they may tax 100% of premium.
    - "Premium tax" means "any tax, fee, assessment, or other charge imposed by a government entity directly or indirectly based on any payment made as consideration for an insurance contract.

NRRA

- NRRA Home state definition:
  - Determined on a policy-by-policy basis, i.e. a state may be home state with respect to one nonadmitted insurance policy issued to an insured, but not with respect to another nonadmitted policy issued to the same insured.
  - Home state is:
    - (i) The state in which an insured maintains its "principal place of business", or in the case of an individual, the state of the individual's principal residence;
    - (ii) If the policy doesn't cover any risk located in the state determined under (i), the state to which the greatest percentage of taxable premium for the policy is allocated.

NRRA

- NRRA definition of “home state” (continued)
  - (iii) if more than one insured from an affiliated group are named insureds on a single nonadmitted insurance contract, then:
    - (a) determine which of the named insureds has the largest amount of premium allocable to it under the policy; and
    - (b) do the analysis outlined in (i) and (ii) above with respect to such named insured.
- NRRA does not define “principal place of business”.

NRRA

- “Home state” definition under NIMA and SLIMPact-Lite:
  - Each model law includes the definition of “home state” from NRRA, and a definition of “principal place of business” as follows:
    - (a) the state where the insured maintains its headquarters and where the insured’s high-level officers direct, control and coordinate the business activities of the insured; or
    - (b) if the activities described in (a) take place in more than one state, the state in which the greatest percentage of premium for the nonadmitted insurance contract is allocated; or

NRRA

- (c) if the activities described in (a) don’t take place in any state (e.g., an offshore business has a US captive), the state to which the largest amount of premium is allocated. (Only NIMA includes (c)).

NRRA

- Preemption on non-home state taxation of nonadmitted insurance is tempered; states are specifically authorized to enter into a multi-state agreement or arrangement for the collection and allocation of taxes on nonadmitted insurance:
  - The home state would be permitted to collect premium tax on behalf of non-home states where risks insured under a nonadmitted insurance policy are located;
  - NAIC Nonadmitted Insurance Model Act (“NIMA”);
  - NAPSLO’s SLIMPact-Lite Model Legislation

NRRA

- How are premiums/risks allocated to a state for purposes of the “home state” determination?
  - SLIMPact-Lite provides for establishment of an interstate compact to collect and allocate premium taxes on nonadmitted insurance among participating states;
    - Compact will be governed by a new commission;
    - Commission will establish an “allocation formula” “by which insured risk exposures will be apportioned to each state for purposes of calculating premium taxes due.”
  - NIMA provides for a multi-state agreement to collect and allocate tax, per a schedule included in the agreement.

NRRA

- States have not uniformly adopted a model act for collection and allocation of premium taxes on nonadmitted insurance:
  - NIMA has been adopted in some states;
  - SLIMPact Lite has been in some states;
  - Some states have given the insurance administrator discretion to choose between NIMA and SLIMPact Lite.
  - Some states, including New York, have affirmatively stated they will not enter into NIMA or SLIMPact Lite.

NRRA - Enforcement

- NRRA is a federal law, but there is no designated federal agency with powers to interpret or enforce NRRA.
- Administration of NRRA is left to the individual states (but NRRA contemplates multi-state agreements).
- Virtually all states have adopted legislation to implement NRRA and its preemption provisions.
- Disputes regarding application of NRRA would be resolved on a state-by-state basis.

NRRA – Applicable to Captives?

- Does NRRA apply to captives?
  - VCIA White Paper questions applicability of NRRA to captive insurance companies;
    - Definition of “nonadmitted insurance” could be construed to include only surplus lines insurance;
    - Legislative history suggests that NRRA was intended to apply to surplus lines insurance only.

NRRA – Applicable to Captives?

- Problems with interpretation of NRRA as covering only surplus lines insurance:
  - NRRA specifically excludes risk retention groups from definition of “nonadmitted insurer”; no other specific exemption;
  - NRRA includes provisions specific to “independently procured insurance,” which is insurance “procured directly by an insured by a nonadmitted insurer” without the use of a surplus lines broker. Definition of “independently procured insurance” does not require purchase from an eligible surplus lines carrier.

NRRA – Applicable to Captives?

- Problems with interpretation of NRRA as covering only surplus lines insurance (continued):
  - The “surplus lines only” interpretation would require disregarding provisions of NRRA regarding independently procured insurance.

NRRA – Applicable to Captives?

- If NRRA does not apply to captives:
  - No benefit of preemption of non-home state taxation of direct insurance written by the captive;
  - No change to application of state laws taxing and regulating directly procured, nonadmitted insurance.

NRRA Compliance Strategies

- A state's regulation and taxation of insurance requires that the transaction at issue be "insurance" as defined under that statute and any applicable state regulations or judicial decisions.
- A nonadmitted insurer's position for federal income tax purposes would not be determinative of whether the insurer is engaged in "insurance" for state law purposes.

Implementation Strategies

- (i) Is the coverage provided by the captive "insurance" under applicable state law? Most state insurance codes include a definition of "insurance," which may include the requirement that the insured has shifted its risk of loss to the insurer. If the captive's coverage does not meet the definition of "insurance" under a state's laws, it should not be subject to regulation or taxation under that state's insurance laws.
  - Examples may include a captive that wants to qualify as a 501(c)(3) exempt organization; concerns with "commercial-type insurance under Code Sec. 501(m).

Implementation Strategies

- (ii) Is the insurance property/casualty insurance? Look to state laws and how the captive has reported the insurance the annual statement filed with its domicile state.
- (iii) What is the home state's position on the applicability of NRRA to captive insurance companies? Monitor state insurance regulators' published positions on application of NRRA.

Implementation Strategies

- (iv) The law of each non-domicile state where risk is insured on a nonadmitted basis should be carefully reviewed in terms of how the state has implemented NRRA. Moreover, such state laws should be monitored for any future amendments with respect to NRRA.
  - Specifically, monitor the positions of each state where risks insured by the captive are located.

Implementation Strategies

- (v) Is the only connection between the captive and the state the presence of the insured risk? If so, under Todd Shipyards the captive and its insured(s) can take the position that such state does not have jurisdiction to tax or regulate the insurance provided by the captive.

Implementation Strategies

- (vi) NRRA requires states to take a policy-by-policy approach to the regulation and taxation of nonadmitted insurance. If a captive is insuring, in a single policy, risks located within and outside of the home state with respect to the policy, it is exposed to home state taxation on the entire premium. To limit this exposure, the captive should consider dividing the policy into two separate policies—one that insures only home state risk (for a lesser premium) and the other insuring non-home state risks.

Implementation Strategies

- The policy covering non-home state risks may not be subject to tax in these non-home states, especially if the only connection between the state and the insurance is the presence of the insured risk. In that case, the captive can take the position that Todd Shipyards precludes the state from imposing a tax on the insurance.

Implementation Strategies

- (vii) If the majority of the risks insured by the captive are home-state risks, and the home state has a captive insurance law, the captive may consider moving its domicile to the home state. The captive would be an admitted insurer in such state, and likely would be subject to a substantially lower premium tax rate than the home state's tax rate on nonadmitted insurance. Any captive contemplating a change of domicile should carefully review: (a) the state's captive insurance laws and regulations; (b) the taxes applicable to the captive, and (c) the quality of the state's regulation of captive insurance.

Implementation Strategies

- (viii) If, as is the case in many states, the state-law NRRA amendments take effect for policies incepting or renewed on and after July 21, 2011, the captive may have a period of time to determine its strategy for dealing with the new law.

Implementation Strategies

- Want to discuss your captive's situation?
- Contact:
  - Kathy Davis, kdavis@drm.com, 802-863-2375
  - Kevin Moriarty, kmoriarty@drm.com, 802-863-2375