Dodd Frank and the NRRA: A continuing conundrum, by

by Paul Golden (reprinted from Captive Review, June 2013 issue - original can be found here)

It says something about the fiscal position of many US states that more than 18 months after the NRRA took effect, debate still rages over whether these jurisdictions may attempt to use it as a means of generating additional revenue from captive insurers.

The comments of former sub-committee chair Judy Biggert and Scott Garrett that the act was not intended to levy self-procurement taxes on premiums paid to a captive by a 'home-state' policyholder which has material risks located outside of that state have been widely reported. Yet there is general agreement that sooner rather than later, some cash-strapped state will chance its arm.

Dennis Harwick, president of the Captive Insurance Companies Association refers to observations by Michael Lusk, vice-president of insurance and risk management at Archer Daniels Midland (ADM), a global food processing and commodities trading firm. Lusk postulated that some captives domiciled in a state that has the enabling legislation may opt to create a local captive in their home state and reinsure their risk elsewhere in a bid to avoid becoming a test case.

"Some captives may choose to redomicile and there are probably a few jurisdictions that are at least quietly encouraging such activity, but I am not aware of any state taxing authority that has 'sent the bill' yet," says Harwick.

A further complicating factor is the extent of the commercial relationship between the state and the captive, he continues. "The state may decide it doesn't want to push the issue for fear of upsetting the insurer. Conversely the company may have relationships with the state outside the realm of insurance that it feels are worth protecting by forming a new captive in that state. But if they opted to do this, it doesn't automatically follow that they would close their 'legacy' captive."

Julie Boucher, Marsh's Vermont-based US captive solutions practice leader says that although her firm has not seen much movement, several captives have changed domicile to either their home state, or where most of their operations take place.

“For existing captives, the decision to redomicile depends on their premium volumes, but also on what their existing domicile is worth. Some captives will pay the tax because of the other benefits of their current location. New formations will consider the self-procurement tax status of each state and this may impact their decision on where to domicile. These taxes are a major element of the financial feasibility of the captive, although tax is not the only issue when deciding where to domicile.”

While confusion around self-procurement tax has not prevented new captive formations, Boucher reckons changes in activity volume have occurred as some lines are withdrawn.

Brady Young, chief executive officer of independent captive management firm Strategic Risk Solutions, suggests the implications of the NRRA have been overstated on the basis that self-procurement tax on all direct writing captive owners’ premiums would typically amount to only 2-4% of the cost of such premiums, taking into account the strategic and financial value most captives bring to their owners. “For risk retention groups and captives that are fronted it is a non-issue since the structure already calls for them to pay admitted premium taxes.”

He says the cost of reducing the impact of such tax by forming a branch in their home state, or a second captive to ‘front’ for the primary captive would not be prohibitive for most large direct writing captives. “We have moved captives from one domicile to another for years for various reasons.”

According to Philip England, chair of US- based law firm Anderson Kill’s captives group, the real issue is the risk of changing from dealing with well-established law for the complete unknown. “Before Dodd-Frank, surplus line brokers allocated taxes between states on an impartial basis. They would use their data to determine that State ‘X’ got 40% and State ‘Y’ got 60%. That allocation was done by a neutral third party, but now State X is supposed to determine how much State Y gets, so New York, for instance, is supposed to determine how much it is going to share with New Jersey, Connecticut and California. What if California doesn’t agree with New York’s allocation?”

“We are still waiting for the states to come to some sort of agreement on the actual rules,” adds England. “What happens when they are fighting over real money? Again, the issue is not the tax that has to be paid, the issue is replacing a system that worked - albeit imperfectly - with a new system that is inherently flawed and pits state against state in a battle for revenue.”

England suggests rewording tax law to specify that the term ‘nonadmitted insurer’ does not include captive insurance companies is the most practical solution. But Michael Byrne, partner in the insurance practice group of law firm Drinker Biddle & Reath, warns that excluding captive insurance from the NRRA reforms may have unintended negative consequences for captives.

“If the NRRA did not apply to captive insurance, the home-state rule would not apply to such insurance. This would potentially result in claims by multiple states to impose self-procurement tax on, and regulate placements with, captives. For example, an insured's home state could impose a tax on 100% of the premium paid to the captive and the NRRA would not prevent another state or states from also imposing a premium tax if its self-procurement tax were not limited to insurance procured by home-state insureds, or its definition of ‘home state’ yielded a different home state than under the NRRA definition.”

Vermont’s Views

As the leading US onshore captive insurance domicile, Vermont is particularly sensitive to regulations affecting captive insurers. Daniel Towle, Vermont’s director of financial services says a federal technical amendment would remove confusion over the application of the NRRA, but that the recent statements by key members of Congress will significantly strengthen the case for any company that chooses to litigate.

“I expect there will be some litigation and that it will provide positive results for captive insurance companies, but I think states will quietly ensure that they don’t go to court on the issue because when they lose, that ruling will apply to other captives.”

According to Towle, some states have intimated that re-domestication is a way of avoiding self-procurement taxes. “The reality is that if a state actually thought it could collect this tax, it would be far more beneficial not to have the captive change domicile. Self-procurement taxes can be as high as 5% so by having a company move to their ‘home state’, a state would potentially be forgoing a much higher tax.”

He acknowledges that the vast majority of captives are not changing domiciles as a result of the NRRA and that captives are still being formed, although he also suggests that the rate of formations will slow amid concerns about being regulated in an inexperienced domicile.

Vermont’s director of financial services concludes by referring to instances where captives have felt obliged to open branches in their home state “where often they will become the guinea pig for an insurance department that has little or no experience regulating captives.”