Retaliatory Premium Taxes – The Controversy & Solution

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Introduction

The power granted a government body to tax is constantly debated. This article discusses the limits to a US state's jurisdiction to tax premiums, and predicts how this confusing compliance area impacting captive insurance will eventually be resolved within the US.

Background

Before the governmental entity known as the United States was formed, North America was governed by several independent states. When the states unionized, they contributed some governing power over to a central body known as the Federal government, and retained certain powers. One of the powers partially released and partially retained by the states is the power to tax. While this occurred hundreds of years ago, the question still remains today concerning exactly how much of this power to tax did the states transfer, how much did they retain, and how far can a state extend its taxing power onto businesses without offices or employees in that state. The Due Process Clause and Commerce Clause of the US Constitution are the most often cited legal sources bearing on the issue.

The constitutionality of the Affordable Care Act's (Obama Care) requirement to buy health insurance or pay money to help address escalating health care costs is a related constitutional controversy that may impact state tax case law applicable to captives discussed below. The Dodd-Frank Act state based insurance reform provisions known as NRRA provision Title V is an attempt by the Feds to simplify compliance with the complex web of state based retaliatory premium tax ("RPT") statutes. Whether the NRRA's language makes it inapplicable to captive insurance companies is a secondary issue to whether a state can levy a tax on premiums paid to cover risks within the state when the insurance premium is paid to an insurance company not doing business within the state.

RPT taxes have many names and labels. The US government calls its RPT an excise tax, applied to premiums paid offshore insurance companies. US states use various other names including surplus lines, self-procured, independently procured, non-admitted and industrial insured taxes.

This is not just a US federal or US state constitutional tax nexus issue. It is fundamental to the power of any government to fairly tax transactions, and adopt efficient systems to levy and collect such taxes. The private sector needs to clearly know when these taxes apply, and who is responsible for collecting and paying them.

Sales and Use Tax Analogy

The widespread debate among the states about e-commerce eroding state sales tax revenue is helpful in understanding the RPT issue and where it may be going. Amazon's success is partially due to it selling goods without buyers paying state sales taxes. In the states where Amazon has any physical office or warehouse presence, Amazon has conceded it has the obligation to collect and pay sales taxes on orders by residents of those states. This physical "doing business" presence has been the constitutional hallmark of sufficient nexus for a US state to require collection and payment of its taxes. However a physical presence has not always been required. In ***Tyler Pipe Industries v. Washington*** and ***Scripto v. Carson*** the out-of-state taxpayer did not actually have offices or employees in the taxing state, but attributional nexus was found based on the in-state activities carried on by affiliates or independent contractors on its behalf.

States without a jurisdictional basis for requiring Amazon or other out of state e-tailers to collect and pay state sales taxes are increasingly chasing revenue from the other direction – the resident shopper – these states are starting to modify state tax forms to require residents to disclose online shopping and pay use taxes on purchases from out of state businesses. These types of taxes are becoming increasingly common in the US as governments explore new non-income tax based transactional revenue sources. They have long been the hallmark of many offshore "income tax haven" jurisdictions who understand the simplicity and efficiency of transaction based tax systems.

Application to Captives - State Specific Examples

The Amazon analogy offers great insight into how the RPT issue might ultimately be resolved in the US. Most states have premium taxes ranging from 2% to 6% targeting non-admitted insurers selling insurance to resident business and individuals. These RPTs are generally higher than the premium tax rates charged admitted insurers.

While US constitutional court decisions and state statutes protect the right to purchase insurance from non-admitted insurers, when these taxes apply, who is responsible to pay them, and whether a state can enforce collection are complex issues not always agreed upon. The NRRA provisions attempt to help simplify this area for larger companies with a business presence in multiple states who buy from insurance companies not admitted to do business within those states by allowing only the insured's "home state" to collect RPTs. That NRRA legislation needs clarification in many respects including its application to captives.

Every state has authorized surplus lines business. As surplus lines insurers do not conduct an insurance business within the states, states do not tax them directly. Rather, state statutes generally require surplus lines taxes to be collected and remitted by the surplus lines broker. Self-procurement RPT mechanisms are distinguishable from both licensed and surplus line insurance coverage due to no broker or admitted insurer party to the transaction. Unlike surplus lines laws, the thrust of captive applicable RPTs is to tax the transaction after the fact. Unlicensed, unauthorized insurers include not only traditional insurers that have neither obtained licenses in a state nor become a qualified surplus lines insurer therein, but also most captive insurance companies.

Self-procurement statutes codifying an insured's right to contract with unlicensed insurers vary from state to state. Many states condition the effectiveness of the exemption upon reporting of the transaction and the payment of tax by the insured. Industrial insured statutory exemptions to the doing-business laws exist in over 20 states, permitting corporations that meet a statutory standard of sophistication to procure insurance from unlicensed insurers. Because industrial insured exemptions are complete exemptions to the doing-business laws, certain in-state activities by insurers that are prohibited in direct placements are permissible under industrial insured placements. Insureds pay a premium tax on these placements in virtually all states that have enacted industrial insured exemptions. The tax rate is generally the same as the rate applied to surplus lines placements.

Consider as examples New York, Colorado, California, Arizona and Texas. Each has slightly different rules governing the conditions of when their RPT statutes apply to a transaction verses a transaction elevating to the unauthorized conduct of insurance business within the state. New York exempts "transactions with respect to policies of insurance on risks located or resident within or without this state ... which policies are principally negotiated, issued and delivered, without this state in a jurisdiction in which the insurer is authorized to do an insurance business...." Colorado exempts "[t]ransactions involving

contracts of insurance independently procured through negotiations occurring entirely outside of this state which are reported and on which premium tax is paid...."

California does not couch its direct procurement provision as an exemption from, or exception to, the doing-business laws. Instead, the California statute merely states that "[a]ny person may negotiate and effect insurance to protect himself, herself, or itself against loss, damage or liability with any nonadmitted insurer." As is the case with most other states, California imposes a tax and reporting requirement on the insured buying insurance from a nonadmitted insurer in reliance on this provision.

Arizona defines the conduct of insurance within the state very broadly. Arizona also has a far reaching 2% premium tax statute applicable to any insurer collecting premium for Arizona based risks with the notable exception of admitted captive insurers who are exempt from premium taxes. Where there is no broker or insurer doing business within Arizona, it is unclear how Arizona can enforce collection of non-admitted and self-procured premium taxes. Its statutes appear to exonerate the insured from liability. Most states do not have such an insured protective provision. ARS 20-107 (B) reads, “No provision of this title shall be deemed to require any license or other authority, or impose any penalty or requirement except as provided by section 20-421 (requiring disclosure of records), of or upon any person for negotiation or procurement of insurance by him upon his own insurable interests, with or from an insurer not authorized to transact insurance in this state.”

Texas has a 4.85% independently procured tax due from policyholders domiciled or headquartered in Texas on Texas based risks where the insurance was procured outside the state from an unlicensed insurer. Exactly how Texas and the other states are attempting to enforce their respective RPT taxes is beyond the scope of this introductory article.

Landmark Jurisdictional Nexus Cases

This section addresses the historical nexus an insured or insurer has to have with a state in order for the state to have sufficient constitutional grounds to regulate and tax activity.

In ***Allgeyer v. Louisiana***, which was decided in 1897, the United States Supreme Court ruled that a citizen of a state has the inalienable right under the due process clause of the Fourteenth Amendment of the U.S. Constitution to contract for insurance with an unlicensed carrier so long as the contract is concluded outside of the state.

In ***St. Louis Cotton Compress Co. v. State of Arkansas***, the United States Supreme Court considered the constitutionality of an Arkansas premium tax imposed on premium paid to an unlicensed insurer. Under the facts of the case, a Missouri insured placed coverage under a multi-state policy with a known insurer that covered Arkansas property. The insurer conducted no business in the state of Arkansas. The Court held that based on the facts the statute was invalid under the due process clause of the Fourteenth Amendment.

In ***Connecticut General Life Insurance Co. v. Johnson***, the Supreme Court held a California premium tax on a foreign corporation to be unconstitutional under the due process clause. In that case, California sought to impose the tax on premiums paid pursuant to reinsurance contracts entered into by a California insurer where the contracts were entered into in Connecticut, where premiums were paid and losses were payable.

Allgeyer, St. Louis Cotton Compress and Connecticut General Life Insurance were decided before the enactment of the McCarran-Ferguson Act in 1945, which clarified that the power to regulate and tax insurance is within the exclusive province of the states, however Congress made clear that this power is subject to the limitations set by the Allgeyer, St. Louis Cotton Compress and Connecticut General Life Insurance decisions.

Relying upon this legislative history and citing these decisions, the court ***in State Board of Insurance v. Todd Shipyards*** invalidated a Texas premium tax levied on a wholly out-of-state transaction where the insured property was located in the state. The insurance at issue was a multi-state policy issued by unlicensed U.K. insurers that insured the Texas property of a New York corporation licensed to do business in Texas. In finding that due process, as well the McCarran-Ferguson Act, limited the state's power to tax this transaction, the Court gave great weight to the following facts: the policy was negotiated and issued outside of Texas; the premium was paid outside the state; and all losses were adjusted and paid outside of Texas. In addition, the insurers were not licensed in Texas, had no offices or agents in Texas, did not solicit business in Texas and did not investigate risks or claims in Texas.

State supreme courts have since used the Todd Shipyards analysis to determine when a state has the power to tax an insurance transaction. In ***Ministers Life & Casualty Union v. Hasse***, the Supreme Court of Wisconsin distinguished Todd Shipyards and held that the state could tax a mail order life and health insurer that was not licensed in the state if there was a systematic and continuous solicitation of Wisconsin citizens by mail and the use of Wisconsin investigatory services and physicians for claims settling and underwriting purposes.

In areas not involving insurance products, states have systematically been successful in extending taxes to transactions with companies based out of state with no presence within their states.

Some state courts allow enforcement against the resident company doing business with out of state company, and in other cases the state courts a have allowed direct levy against out of state companies on very thin constitutional grounds. In ***Quill Corporation v. North Dakota***, the U.S. Supreme Court held that Quill Corporation, a mail order business incorporated in Delaware with no sales force and insignificant tangible property in North Dakota, was not required to collect a use tax levied by North Dakota from its North Dakota customers however the use tax was not challenged. In ***Geoffrey, Inc. v. South Carolina Tax Commission***, decided by the South Carolina Supreme Court in 1993, the court applied the Quill case and sustained South Carolina's right to tax the royalty income of Geoffrey, Inc., a wholly-owned, second tier subsidiary of Toys R Us, Inc., incorporated in Delaware with no employees or offices in South Carolina and no tangible property in the State. The court found that Geoffrey, Inc. purposefully directed its activities at South Carolina residents because the company owned intangible property in South Carolina, a franchise that generated revenue and, therefore, South Carolina could tax that revenue without violating the due process clause. This rational can conceivably be extended to a resident insured owning or controlling an out of state related party captive and directing it to do business within the state.

Conclusion

If the state's taxing power does not extend to the out of state insurance company due to a lack of constitutional nexus over that out of state party, provided it has enacted a statutory basis and installed an administrative system for reporting and collection, a state could impose a use type transaction tax on an insured doing business within the state. Attempting to levy and enforce RPT taxes against out of state domiciled captives who do business directly with captive insureds verses through brokers makes little

economic sense; state departments of revenue have bigger fish to fry such as replacing the lost sales tax revenue due to e-commerce. States are already discovering the lack of economic incentive to participate in and monitor NRRA compacts; they will similarly find budgeting staff time and money to justify levying RPT taxes paid out of state captives costs more than it generates. The only efficient method of levying and collecting RPT taxes is by clarifying statutes and creating easy to administer reporting methods that require payment by insureds doing business within the state. While premium taxes evolved as a way to generate needed funds for states to perform consumer protection functions, and levying them against insurers was perceived most fair, sales and use type transaction taxes on resident consumers is the most efficient government finance model.

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Tom Cifelli is managing director of Captive Experts. He practiced law and public accounting in multiple states for 20 years including working as a financial auditor of banks and municipal entities. He also was General Counsel and Chief Financial Officer with publicly traded companies. Mr. Cifelli works as a research consultant with leading captive managers on special projects.