“Dodd-Frank Act’s Non-admitted and Reinsurance Reform Act Impact on Captive Domicile Decisions”

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Article Except:
Captive insurance is a prominent sector within many offshore jurisdictions including the Cayman Islands. A very substantial portion of captive business for these leading offshore domiciles originates from the US. This article considers the recently effective Nonadmitted and Reinsurance Reform Act of 2010 provisions that may increase interest in re-domestication from offshore to a US domicile by some existing captives or alternatively cause some offshore captive US owner-insureds to create a related US domiciled captive to retain a portion of the premiums currently paid the offshore captive.

Full Article:

Background

U.S. and non-U.S. insurers are greatly impacted by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “DFA”). The DFA created the Federal Insurance Office (FIO), the first ever U.S. federal agency specifically established to oversee the insurance industry, promote regulatory uniformity amongst the US states, and empower the FIO to usurp state authority on international insurance matters by entering into covered agreements with foreign jurisdictions.

The state based insurance reform provisions found in Subtitle B, section 511 to 542 took effect this July and are referred to as the “Nonadmitted and Reinsurance Reform Act of 2010,”or NRRA. These provisions were written in response to global surplus insurance line company complaints about having to prepare, file and comply with distinct rules by every individual state and its impact on the cost of doing business. These NRRA rules clearly impact state levied non-admitted and self-procurement premium taxes whether intended to or not, and states are gearing up to start enforcing applicable taxes due to the increased potential revenue to help offset revenue contraction to state’s in these lean economic times.

Expanding Role of FIO Over the State Based Regulatory System in the U.S.

The FIO’s power to enter into covered agreements with foreign jurisdictions that pre-empts state laws should be an area of interesting developments next year. The Senate summary on the Dodd-Frank Act states the FIO “… will serve as the uniform, national voice on insurance matters for the United States on the international insurance stage.”

Preservation of state based insurance regulation has been heavily debated since 1945 when the US Congress passed the McCarran-Ferguson Act ceding insurance regulation to the states. Every decade since 1945 Congress has conducted investigations to assess whether the states were

regulating insurance adequately. A 1958 report found "state regulation lacking, incapable of dealing with interstate and international issues, and unwilling or unable to 'bring the blessings of competition.'" While the EU initiatives including Solvency II and ORCA may have paved the way for creation of the FIO in the US, it was inevitable that self-regulatory organizations like the National Association of Insurance Commissioners (NAIC) would prove insufficient to address the deficiencies of the state-based insurance regulatory system.

Non-Admitted and Reinsurance Reform Act Implications

The NRRA advances "lead state" regulation efficiencies started in 1981 with passage of risk retention group enabling legislation. The NRRA provisions aim to eliminate overlapping reporting and taxes that have caused all manner of compliance difficulty and costs for businesses with multi-state operations. Perhaps unintended, the NRRA creates a potential loophole which may encourage these large multi-state companies to re-domicile captives to "home based" states to reduce premium taxes associated with non-admitted and reinsurance premiums. Claim of exemption for restructured arrangements may also be attempted with respect to the Internal Revenue Code § 4371 foreign insurance excise tax.

Aspects of NRRA address the premium taxes charged by states on premiums paid non-admitted insurance companies. Prior to the NRRA taking effect in July, many large companies were required to file reports with every state they did business in, involving complicated forms and difficult allocation calculations aimed to share premium taxes amongst the states. These large organizations were successful in lobbying the US Congress and get NRRA provisions enacted as part of the DFA that allows only a "home based" state to require reporting and taxation on the premiums paid non-admitted insurance companies. NRRA intends to create one collection point for surplus lines premium taxes and encourage states to enter into an interstate compact or agreement to allocate shares of the premium taxes, based on the risks covered in a state.

The Act's definitions of "nonadmitted insurer" and "nonadmitted insurance" are broad. Some attorneys believe however that a strong argument can be made that NRRA was intended to apply only to surplus lines insurance and that captive insurance is not covered. Separate provisions of NRRA apply to "independently procured insurance," which likely encompasses captive insurance. So while some captive industry attorneys are taking the view that the NRRA's definition of nonadmitted insurance excludes captives, this view is unlikely to prevail. We anticipate states will soon aggressively start levying taxes ranging from 2% to 6% on nonadmitted and reinsurance premiums paid by insured's they consider based within their jurisdiction.

Conflict and controversy between states will likely ensue including determining where an insured "home state" is, creating yet another area ripe for dispute resolution via arbitration within the FIO if such an alternative dispute resolution mechanism is created and mandated as most within the captive industry believe appropriate to address the high costs and delays of dispute resolution through the court system. Large corporations with multiple subsidiaries and widespread geographic footprints will continue facing complex compliance issues.

Top tax attorneys advising large single parent captives are already suggesting that if these companies domicile their captive in their "home state," they may be able to avoid the 2% to 6% premium tax imposed by many states on non-admitted and reinsurance premiums.

DFA's Section 521 of the NRRA states that, "No state other than a home State of an insured may require any premium tax payment for non-admitted insurance." The definition of home state may be debated amongst the states pending clarification by the FIO, but generally a company's home state is wherever its "nerve center" is – essentially where it is headquartered and executive decision making occurs according to tax attorney Bruce Wright. Operating subsidiaries clearly could have different "home states" than parent companies adding a significant layer of compliance complexity.

With so many US states now authorizing captives, many large corporations may consider domiciling a captive within their home state to reduce and potentially avoid all taxes on non-admitted insurance premiums. Historically the states have been quite lax in enforcing such non-admitted premium taxes; however increased enforcement by state's with significant business activity is now expected due to their capacity to be the "home state" with exclusive taxing authority for impacted insurance purchased by insured's headquartered within their state.

Where a company's home state is not the domicile of their captive, the state where they conduct the highest percentage of business will likely be deemed the "home state" that can then levy premium taxes on non-admitted insurance.

US States Implementing NRRA

NRRA encourages the states to enter into tax sharing compacts. As of August 2011, 44 states have passed legislation conforming to the requirements of NRRA allowing the states to enter into non-admitted insurance premium tax sharing agreements. Three approaches have surfaced. The NAIC's multi-state agreement known as NIMA has been agreed to by 12 states. A competing approach known as SLIMPACT has 9 states on board. Ten states have elected to not join any tax sharing pact including many of the leading captive domiciles and larger population states as these states intend to keep all non-admitted premium taxes rather than share them with other states as seems clearly allowable under the now effective NRRA provisions.

Future Related Events to Watch For

Section 526 of NRRA requires the U.S. Controller General to issue a study and report to Congress on the nonadmitted insurance market and impact of NRRA within 30 months of enacting DFA, or by the end of 2012.

Also, the Neal Bill (HR 3424) has not yet been reintroduced but likely will be as the US Congress looks for ways to address the US deficit issue. President Obama's budget proposal contained aspects of this bill that would deny an insurance company deduction for reinsurance premiums paid to an affiliated foreign reinsurance company if the foreign reinsurer (or its parent) is not subject to US income tax.

The US Congress certainly did not intend to reduce government revenue streams with passage of NRRA. Tax advisers suggesting a loophole to save non-admitted taxes by domiciling captives in a client home state is subject to interpretation and may be revisited if it results in creation of home state captives to avoid non-admitted premium taxes previously levied and collected by states. Affected jurisdictions might consider lobbying the FIO to adopt regulations dispelling this construction of the NRRA to avoid nonadmitted premium taxes.

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