Dodd-Frank: in search of clarity

The Nonadmitted and Reinsurance Reform Act is proving a thorny issue for captives. Do they pursue a potential home state advantage conferred by the act or hope for a captive exclusion? Phillip England, Marshall Gilinsky and Andrew Walsh explore the question.

Since enactment by Congress of the Nonadmitted and Reinsurance Reform Act (NRRA) as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, questions about the NRRA’s applicability to captive insurance companies have been a hot topic within the industry. For nearly two years, professionals working on captive insurance matters have been asking: ‘What does the NRRA mean for me?’ Unfortunately, the answer is an unsatisfying: ‘It depends.’

It depends on who you are and what your stake is; on where you are domiciled and who your regulators are; on the fact patterns of the disputes over the NRRA that may arise regarding the application of the NRRA to captives; and the various courts that will eventually resolve those disputes. And, of course, it depends on whether clarifying legislation is proposed and enacted. If you were expecting a simple answer, we apologise in advance.

The NRRA sets forth a framework under which states may tax and regulate insurance placed with non-admitted insurers. It prohibits any state except the policyholder’s home state from levying a tax on premiums charged by non-admitted insurance companies and authorises the states to enter into a tax-revenue sharing compact if some of a policyholder’s risk is located outside of its home state.

This relatively small addition to Dodd-Frank was the product of a long-standing effort to give some order to the way premium taxes are collected from surplus lines insurance companies. It caused unexpected tremors across the captive industry because the language of the statute was less than clear about whether it applied only to surplus lines, or also to captives domiciled away from their parent’s home state.

After the NRRA was enacted, many captives found themselves wondering whether the benefits of being domiciled in a state other than their parent’s home state exposed the company to paying more in taxes via a self-procurement tax collected by the home state under the NRRA, plus a premium tax charged by the state where the captive is domiciled. Early on, uncertainty reigned. Some captives considered moving back in with their parents, where they would, presumably, be taxed only once. Others came up with different strategies, discussed in more detail below. Most opted to avoid incurring potentially wasted transaction costs if the NRRA were to be clarified by Congress or the courts in a way that conflicted with their chosen strategy, and took a wait-and-see approach.

While there have been no reported cases involving disputes over the application of the NRRA to captives, with substantial amounts of premium taxes at stake it is fair to expect that litigation (or rulings by tax authorities) involving various angles is likely to arise—most likely leading to varying, and possibly conflicting, rulings on the law.

Since the NRRA was enacted, the possibility has existed that the uncertainty for captives might be mitigated either by clarifying federal legislation or by action by the states themselves—namely by adopting the premium allocation compacts envisioned under the existing law. Unfortunately, we have seen little progress in either area.

Although legislative clarification that would come right out and say that the NRRA does not apply to captives may be in the works, it would be surprising to see the captive insurance wrinkle ironed out first, since
the core provisions of Dodd-Frank remain somewhat contentious. Assuming that a clarification of the NRRA does eventually arrive, it is more likely to be slipped into a larger amendment resolving the major banking issues under Dodd-Frank, much as the NRRA slipped into Dodd-Frank in the first place.

To share or not to share?

Although the NRRA authorises states to enter into tax-sharing compacts, most states, including the biggest, have refused to participate in a compact, leaving the door open to keeping for themselves 100 percent of the tax they collect. The plan to allocate premium taxes via a tax-sharing compact has been further undermined by the fact that the states that have been willing to share are divided between two competing compacts: the Nonadmitted Insurance Multi-State Agreement (NIMA) and the Surplus Lines Insurance Multistate Compliance Compact (SLIMPACT).

The Kentucky Proposal recently adopted under NIMA may attract sharing-averse states to that compact, since it permits a home state to retain 100 percent of the casualty insurance premiums it collects, except for taxes collected on policies that are rated on a state or location-specific basis. However, only time will tell. To date, 44 states have taken action to implement the NRRA, but only 20 states have signed NIMA or are working to implement the SLIMPACT. So, while the home state rule does simplify the collection of taxes (as the surplus lines insurance lobby wanted), it does not help allocate the tax dollars to the states where the insured risks reside, as the law was expected to do.

Since the enactment of Dodd-Frank, it appears that very few captives have made a change in domicile based solely on the statute. That is understandable, as any development emanating from the courts or Congress might undermine investment in a given strategy. Of those that have made a change in response to the NRRA, the most common move has been to create a captive within the parent’s home state, and either shift the captive business to that new entity or else use it as a front for insurance that is then ceded to the parent’s existing captive in its favoured jurisdiction. The strategy behind simply relocating an existing captive to the parent’s home state is that, instead of paying a high self-procurement tax under the NRRA in the parent’s home state, the only tax owed is the captive premium tax, because the captive is an admitted insurance company in parent’s home state.

Of course, this approach involves a certain amount of transactional costs, as well as the opportunity costs associated with abandoning an existing captive—often in a favoured regulatory environment and with an established management and administrative team. This is why other captives seeking certainty regarding self-procurement taxes have taken a slightly different tack by forming a new captive domiciled in the parent’s home state (thus avoiding the potential self-procurement tax under the NRRA), but then having the new home state captive cede that risk to the existing foreign captive (thus preserving the management and regulatory benefit associated with the existing captive).

While a simple amendment to the NRRA that expressly excludes captives would be welcome, continued congressional inaction is to be expected. Meanwhile, industry participants will each have to evaluate their home state’s laws and posture regarding self-procurement taxes and determine what—if any—strategy best advances their company’s interests. Given the complexities and uncertainties involved, analysis and guidance from experienced professionals is advisable before making any changes to an existing captive programme structure. 

Attorneys in Anderson Kill & Olick’s Alternative Risk and Captive Insurance Services Group advise on the full range of legal, structural, tax and regulatory issues that arise in the formation of captives and in their operation. We advise on fronted, direct and reinsurance structures, review capital deployment strategies and deal with various captive types and structures. We handle not just transactional captive issues, but also disputes and litigation that may ensue from the formation or operation of a captive. We stand ready to help you navigate not only the current challenges, but all the ongoing complexities of managing captives in a global economy.

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