Captive Insurance Companies: State Tax Implications

2012 — Issue 50 — Last week’s Tax Advisor Weekly focused on using captive insurance companies to address the growing need for effective risk management strategies, as well as the federal income tax implications of forming a captive insurance company (see Issue 49–2012). This week’s newsletter focuses on the state tax implications of captives, as well as recent developments that are affecting captive-related decisions.

A common misconception has been that captive insurance companies are only subject to the favorable premiums tax rates in the desirable state or country of formation and are otherwise free from state tax. However, the potential for state-level tax is a cost that should be considered when evaluating the feasibility of a captive insurance company. The ensuing discussion covers how insurance companies are generally taxed at the state level and recent developments affecting organizations that either (1) have a captive insurance company or (2) are contemplating implementing one.

Favorable State Tax? Not So Fast My Friend!

It is true that insurance companies are generally not subject to state income tax. They are, however, usually subject to premiums taxes. The method and rate of taxation can vary depending on the type of insurance company being addressed. For purposes of this article, let’s break down insurance companies into three buckets: (1) admitted insurers, (2) approved, nonadmitted insurers and (3) nonapproved, nonadmitted insurers.

Admitted Insurers

Think: the insurance companies you regularly see in television ads. These are large, commercial insurance companies that have been “admitted” to write insurance in a state and are generally regulated by a particular state’s department of insurance. Admitted insurers are generally exempt from state income taxation, but are subject to tax on gross premiums collected from risks located in that state in lieu of income and other taxes.

Approved, Nonadmitted Insurers

Think: surplus lines insurance. Surplus lines insurance generally applies to large–dollar, infrequent–occurrence risk items (e.g., airplanes, cruise ships, trains, etc.). While nonadmitted insurers are not typically under the regulatory authority of states’ departments of insurance (except for their state of domicile), they generally must be approved to be able to write insurance in a state. The objective of the approval process is to ensure that the insurer is viable, and therefore that residents are buying “good” insurance.

Surplus lines insurance is usually procured through brokers, and any surplus lines insurance premiums tax is generally assessed against the broker for premiums collected for risks located in that state. The surplus lines rates tend to be higher than the admitted insurance premiums rates. If a broker is not used, the insured may be liable for a nonadmitted insurance premiums tax.

Nonapproved, Nonadmitted Insurers

Think: captive insurance companies and direct procurement from nonadmitted insurers. Captives are typically subject to
premiums taxes in their state of domicile. Certain states (e.g., Vermont and Delaware) have actively sought captive formation in their state by providing favorable premiums tax rates or fees for domestic captives. Further, because captives are often not subject to corporate income tax, any earnings on their assets and reserves escape income taxation. Companies that independently procure insurance are generally subject to a direct procurement or nonadmitted premiums tax in the jurisdiction where the insured risk is located. In these states, the self–procurement premiums tax rate will generally be higher than the admitted insurer’s rate.

Historically, captive insurance companies have pointed to State Bd. of Ins. v. Todd Shipyards Corp., 370 U.S. 451 (1962) to support the position that the only state that can subject their captive arrangement to premiums tax is the captive’s domicile state. The position that captives are not subject to multistate exposure for nonadmitted insurance premiums tax appears to be an overly broad application of Todd Shipyards, and each captive should evaluate its own facts before reaching this conclusion.

As Bob Dylan famously sang, “The times they are a–changin’.” The method of collecting these taxes and the appropriate jurisdiction to which they are owed is the subject of much debate right now.

**Dodd-Frank, What Have You Done?**

The Dodd–Frank Wall Street Reform and Consumer Protection Bill was signed into law by President Obama in July 2010. Buried deep within the bill is the much lesser known Nonadmitted and Reinsurance Reform Act of 2010 (NRRA), which became effective July 21, 2011. While not as recognizable as Dodd–Frank, the NRRA could have far–reaching consequences for the captive insurance market. The NRRA sought to clarify and simplify the process for collecting nonadmitted premiums taxes. A primary driver of these provisions was the surplus lines industry, which was seeking to simplify its multistate compliance burdens. However, the question of whether or not the NRRA is applicable to captive insurance arrangements is still up in the air.

The NRRA implemented what is commonly being referred to as the “home state rule,” which is codified in the federal code at 15 USC Section 8201(a) and provides, “No State other than the home State of an insured may require any premium tax payment for nonadmitted insurance.”


The NRRA provides several key definitions that may help shed a little light on the issue:

- **Home state**: either (i) the state in which an insured maintains its principal place of business or, in the case of an individual, the individual’s principal residence; or (ii) if 100 percent of the insured risk is located out of the state referred to in clause (i), the state to which the greatest percentage of the insured’s taxable premium for that insurance contract is allocated (15 USC Section 8206(6)(A)).

- **Nonadmitted insurance**: 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 (15 USC Section 8206(9)).

- **Nonadmitted insurer**: with respect to a state, an insurer not licensed to engage in the business of insurance in such state (15 USC Section 8206(11)(A)).

The clear part is that the state that houses an organization’s principal place of business (i.e., its place of commercial domicile) should be deemed its home state, and that home state “may require” a premiums tax on premiums paid for non–admitted insurance. But does this apply to captive insurance arrangements? Therein lays the conundrum. The definitions of nonadmitted insurance and nonadmitted insurer are broad, and there is no consensus on whether or not captive or independently procured insurance arrangements will fall under their auspices.

**Alvarez & Marsal Taxand Says:**

In a post–NRRA world, organizations now have more to consider when dealing with captive insurance arrangements. In addition to all of the requirements to make this a viable insurance vehicle, the following things should be taken into consideration when evaluating the viability of a captive and when deciding where to locate your captive:

- Potential state premiums tax obligations are a cost of a captive arrangement not present for an organization that self–insures. This potential cost should be considered in financial models evaluating the benefits and costs of establishing a
captive.

- Vermont and Delaware have historically been favorite captive domiciles, but in light of the “home state rule,” does it now make sense to put the captive in the organization’s state of commercial domicile? Maybe, maybe not — you’ll have to consider the various state premiums tax regimes and crunch the numbers.

- If there is a nonadmitted insurer premiums tax, has the state incorporated the provisions of the NRRA into its statutory framework? Be diligent about doing the research upfront to determine if the home state rule is an issue.

States that are strapped for cash (which is almost all of them) are surely going to pay close attention to this issue as it unfolds in the coming months. Anyone with a captive, or contemplating implementing a captive, should keep an eye on it as well.

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