Does NRRA capture captives?

Regulatory changes have continued to sweep the financial world in the wake of multiple recessions and crises, and the captive insurance sector is no different. **Christopher Flanagan** and **Nick Pearson**, of **Edwards Wildman Palmer LLP**, discuss the possible effects of the Non-admitted and Reinsurance Reform Act on captives in the US

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On 21 July 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act, which included the Non-admitted and Reinsurance Reform Act of 2010 (NRRA).[1] Among NRRA's reforms are provisions modifying the states' ability to regulate and tax transactions involving 'non-admitted insurance'. Although the statute is broadly worded, questions have nonetheless arisen as to whether these provisions extend to cover non-admitted insurance issued by captive insurance companies.

Before expanding into an analysis of the scope of NRRA's coverage here, it is important to first note what NRRA does not do. NRRA does not grant any new regulatory or taxing authority to the states. NRRA does not expand the taxing power of the states, nor does it require states to enact laws taxing non-admitted, independently procured insurance if they do not currently tax such insurance. Properly viewed, NRRA rather limits the authority of the states in these areas, reserving this authority solely to the "home state" of the insured.[2] The intent of NRRA in this regard was to eliminate much of the confusion and potential duplicate regulation and taxation that existed when the states were each permitted to separately determine their actions in these areas, not necessarily to impact the revenues of the separate states.[3]

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NRRA's provisions

NRRA's provisions are very brief, and centre around two primary sections pertaining to the payment of premium taxes and the regulation of non-admitted insurance. As to taxes, Section 521(a) of NRRA states succinctly that "[n]o State other than the home State of an insured may require any premium tax payment for non-admitted insurance". With respect to the regulation of non-admitted insurance, Section 522(a) of NRRA states that "except as otherwise provided in this section, the placement of non-admitted insurance shall be subject to the statutory and regulatory requirements solely of the insured's home state".

Key to understanding these two provisions is the definition of non-admitted insurance, contained within Section 527 of NRRA, which reads "any property and casualty insurance[4] permitted to be placed directly or through a surplus lines broker with a non-admitted insurer eligible to accept such insurance". A non-admitted insurer is further defined by this section to mean, with respect to any state, an insurer not licensed to engage in the business of insurance in such state.[5]

Within these few, seemingly straightforward provisions lies the confusion. The question is whether the definition of non-admitted insurance can be read to include insurance contracts with captive insurance companies. Proponents of a reading that would exclude such coverage generally focus on the use of the terms "permitted to be placed" and "insurer eligible to accept," and assert that these terms do not have any ready application in the captive arena.[6]

Specifically, these commentators note firstly that captive insurance is procured beyond the borders of any state (other than the captive's state of domicile); secondly that captive insurance is not typically placed through surplus lines brokers; and finally that the "eligibility" requirement thus does not have a ready application to captives. Coupling the use of these terms with certain legislative history in which advocates of NRRA refer specifically to surplus lines insurance as being covered by these provisions. These proponents view NRRA's provisions, at least insofar as they relate to the imposition of premium taxes, as being properly read as applicable only to surplus lines type of insurance.

The unfortunate circumstance is that there is a lack of clarity as to whether these provisions do or do not apply to captive insurance arrangements. Notwithstanding the analysis advanced by the proponents of the alternative view, the statute's language on its face is arguably broad enough to include such captive arrangements. Further, other provisions of NRRA appear well suited to include captive insurance arrangements[7] or include exceptions to the application of their provisions applicable to other types of insurance arrangements,[8] but not to captives.

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What's at risk?

All one needs to do is mention the possibility of a tax, and it becomes clear what is at risk. Here, however, as mentioned above, NRRA does not create any new taxes. It is a limiting provision, preventing all but the "home state" from imposing a tax in the subject area. The determination of whether that home State (within NRRA) or any other state (outside NRRA) actually imposes any tax in a covered situation is a function of the particular states' internal laws and regulations, not NRRA.[9] In fact, arguments have been advanced that insureds covering their risks under a captive insurance arrangement may be better off under the protections of NRRA, which could lessen the risk of multiple states asserting the right to tax the related premiums, and thus the possibility that inconsistent views adopted by the states could result in multiple taxation of the same premiums.

If this is the case, then why are some advocating for the exception of captive insurance arrangements from NRRA's coverage? The answer to this appears to be based at least in part on the concern that, if NRRA applies to captives, insureds may choose to relocate their captive insurers to their home state in order to lessen the impact of the imposition of 'non-admitted insurance' tax on their premiums.[10] In addition to the issue of lost revenue for the jurisdictions that currently house most of the captive insurance companies, the concern is that the regulation of captive insurance companies could be adversely affected by a spreading of such companies over numerous jurisdictions (or the consolidation of captives within states hosting the home offices of the insureds), without sufficient regard to the regulatory infrastructure in place in such jurisdictions.

Conclusion

While a clarification of whether NRRA applies to captive insurance arrangements is certainly desirable, it may fall in the category of closing the barn door after the cow has gotten out on this issue. NRRA, and the controversy that it has created on this issue, appear to have raised the states' regulatory consciousness regarding the potential imposition of non-admitted insurer premium taxes on captive insurance arrangements. Whether prior loose implementation of premium taxes in this area was the result of intent or the issue slipping through the cracks, it can be expected that states will now likely focus on this issue, whatever the decision as to whether NRRA applies to captive insurance arrangements.[11] In analysing their potential exposure on this issue, insureds utilising captive insurance arrangements will need to focus on the states involved in their particular circumstances, and take into account whether such states would take the position that their rules permit the imposition of non-admitted premium taxes in the case of captive insurance arrangements, along with the basic question of whether NRRA applies to such arrangements.

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[1] NRRA's provisions became effective one year later, on 21 July 2011.
[2] NRRA specifies how to determine the "home state" of an insured for this purpose, along with certain exceptions to the application of this rule. A full discussion of these provisions is not relevant to the issue at hand (that is, whether NRRA applies to captive insurance arrangements), and is thus left for another day.
[3] Consistent with this approach, Section 521(b) of NRRA suggests, but does not require, that the states enter into tax sharing agree ments providing for the allocation among them of premium taxes collected on covered insurance. To date, it does not appear that there has been any significant rush toward implementing such agreements.
[4] Note that NRRA's provisions in this regard do not apply to insur ance other than property and casualty insurance.
[5] Most captive insurance companies are non admitted insurers with respect to states other than their state of domicile.
[6] See, for example, '*White Paper Discussing the Non admitted and Reinsurance Reform Act of 2010 and Its Potential Application to Captive Insurance*', 6 October 2011, commissioned by the Vermont Captive Insurance Association and prepared by the law firm of McI ntyre and Lemon, PLLC, Washington, D.C.
[7] See, for example, the definition of "independently procured insur ance" contained in Section 527 of NRRA, which is referenced as a part of the definition of premium tax, and references to the use of reports relating to the coverage of such insurance to facilitate the allocations among the states of premium taxes.
[8] See, for example, the exclusion of risk retention groups from the definition of "non admitted insurer".
[9] In addition, a state's attempts to tax such a transaction would have to satisfy the due process standards set forth in State Board of Insurance v. Todd Shipyards Corp., 370 U.S. 451 (1962).
[10] This potential benefit would of course need to be compared with the cost of redomiciling the captive in the home state of the insured (including any potential increase in the taxes of the captive) to determine whether there is any net financial benefit to such action.
[11] In addition, there is some concern that states may take the posi tion, based upon their existing law or a modification of that law, that, where they are the home state, they can tax 100% of the pre mium for non admitted insurance coverage (New York has adopted this view). This could result in an increase in the effective tax rate for this coverage if the insured was, before NRRA, relying on the principles of Todd Shipyards to avoid the non admitted premium tax for some of the jurisdictions of the covered risks.