

## Revealing Right Answers Means Asking Right Questions: Will the NRRRA Provision of the Dodd-Frank Reform Act Affect My Captive?

### Mancini's Musings from the 2011 Cayman Captive Forum

by Christina Mancini, Partner and CEO, Captive.com, LLC, January 2012

In recent months, many in the captive insurance industry have grown increasingly concerned about what impact, if any, the NRRRA provision in the Dodd-Frank Act might have on the captive insurance industry. Captive owners and prospective captive owners have asked regulators, associations, legal counsel, and accountants, "Might my captive insurance company be impacted by the Dodd-Frank Reform Act?" Then, "If so, how." Now, it appears that another question is emerging, "If the Act DOESN'T specifically apply to captives, will it affect me anyway?" Some say unequivocally that there will be no impact on captives; others are not so sure. Those of you who follow [Captive Daily Wire™](#) have read many differing opinions on how this Act will apply to various insurance and financial services entities, leaving us scratching our heads over the reality that it is now standard operating procedure for complex bills to be signed into law so that the politicians who signed them would be able to find out what was in there! Eventually, they will also learn how it will affect US and international commerce so that any problems it may create can be fixed with new legislation or regulations. I think the top of my head just hit the ceiling....

In her thought-provoking presentation at the **2011 Cayman Captive Forum**, Tracy D. Williams, an insurance tax lawyer from [Sidley Austin LLP](#) offered conference attendees in the crowded room intriguing insight into this confusing muddle, suggesting that captive owners and advisers have been asking the wrong question.



As most of us know, Jim McIntyre of McIntyre & Lemon recently authored a White Paper Report on the new federal Nonadmitted and Reinsurance Reform Act (NRRRA), provision of the Dodd Frank Act. This opinion paper concluded that the law has no applicability to captive insurance. CICA, VCIA, and representatives of Vermont's regulatory team have released statements largely agreeing with McIntyre's opinion. [Follow this link](#) to a summary press release issued by Dan Towle. Also, the McIntyre White Paper in may be downloaded [here](#).

It is significant that over one third of the delegates in this break-out session were captive owners, suggesting that ambiguity and apprehension surrounding the applicability of this legislation to captives is still of considerable concern to the industry. Early in her presentation, Ms. Williams told the group that Jim McIntyre was invited to speak on the panel, but he was unable to travel that day. The session was excellent, but Jim's views would have made it all the better.

Instead of offering an opinion on whether the Act applies to captives, Williams suggested that we should instead analyze the results of both conclusions; what are the consequences to a captive if the Act does apply, and what are the consequences if the Act doesn't apply to captives?

Following a bit of background on captives, Williams spent some time explaining the Pre-NRRRA status of state taxation of captives. Prior to passage of Dodd-Frank's NRRRA, captives paid premium tax only in the captive's state of domicile. Additionally, self procurement tax on insureds that

procure insurance directly from nonadmitted insurers was generally imposed on premium allocable to the insured's risk located in a state. In these cases, payment of tax to multiple states was based on location of the insured's risk. Theoretically, each state that imposes a self-procurement tax was entitled to tax the insured for premium paid allocable to risk in that state.

But wait – if that were correct then insureds that purchase insurance from captives would be paying self-procurement tax in multiple states, right? So why aren't they?

To answer this question, Williams enriched our background by briefing the group on the legislation and case law that existed prior to NRRRA, including *Allgeyer v. Louisiana* in 1897, which determined that Louisiana could not regulate an insurance contract where the only connection with the state was the location of the risk; *St. Louis Cotton Compress Co. v. Arkansas*, a 1922 case wherein the court ruled that Arkansas could not impose a premium tax on a Missouri insurance company where the insurer had no office or agents or performed any acts in Arkansas; the McCarran Ferguson Act of 1945, which returned to the states the regulation and taxation of insurance except where preempted by federal law. Then, the *State Board of Insurance v. Todd Shipyards* case in 1982, which decided that McCarran Ferguson does not overrule *Allgeyer* and other historic cases; and that Texas' self-procurement tax violates the due process clause, where the only connection between Texas and the transaction was the location of the insured property.

So, essentially, the Supreme Court said, we think the old pre-McCarran Ferguson cases that came before the Supreme Court are still valid! Based on this case, insureds have generally taken the position that *Todd Shipyards* protects them, and no self-procurement tax may be collected. However, several cases since *Todd Shipyards* have called its holding into question, suggesting that maybe insureds should be paying self-procurement taxes after all.

Confused yet? Wait -- it gets worse. Fast forward to July 21, 2011, when the Dodd-Frank Non-admitted and Reinsurance Reform Act took effect. The point of the legislation was to make life easier for surplus lines brokers who are subject to surplus lines tax on all transactions in all states. Brokers wanted a simpler task, so applauded the legislation initially. The key NRRRA provisions can be summed up in two bullets:

- No State other than the home State of an insured may require any premium tax payment for nonadmitted insurance. This applies even where a portion of the risk or premium is allocable to risk located in another state;
- Authorizes states to enter into a Compact prescribing regulatory and premium allocation guidelines. This is the only mechanism for a state that is not an insured's home state to collect its share of the tax on independently procured insurance

To clarify, the pre-emption rule in the first bullet above tells us, in effect, that Dodd Frank preempts state law. Those of you who know me well can probably see my eyes leering in suspicion by now. I always like to see a doggone good justification before federal regulatory bicep flexing is allowed to overrule states' rights. The second bullet authorizes the states to enter into a compact prescribing regulatory and premium allocation guidelines. That, too, sounds like an awful lot of fun in a world where it's tough to get a conference call organized, let alone a regulatory and premium allocation compact!

As we ponder those thoughts, let's look at two key NRRA terms: First, **Non-admitted insurance** is defined as "Any property and casualty insurance permitted to be placed directly or through a surplus lines broker eligible to accept such insurance." Already, there has been discussion around "permitted to be placed" and "eligible." Second, **Non-admitted insurer** is defined as "An insurer not licensed to engage in the business of insurance in such state."

Given all of the above, does NRRA apply to captives? One perspective says NO. Vermont, VCIA, CICA, National Risk Retention Association stand with the McIntyre memo, which opines that the NRRA was not intended to apply to captives. Dan Towle, VT Director of Financial Services, has been quoted in the press as follows: "There is considerable misinformation circulating regarding NRRA...Certain states are using this as an opportunity to try to domicile captives in their state." Point well taken, Dan. He continues, "It is prudent for captive insurance companies to seek counsel from their attorneys, tax advisors and captive managers if they have questions on the applicability of self procurement taxes. Generally speaking, if you have been advised that self procurement taxes were not applicable before the NRRA, they would not be applicable now. The NRRA itself did not create any new taxes."

At this point, Ms. Williams assumed the role of Devil's Advocate: "Let's say, for the sake of argument, that NRRA does NOT apply to captives. If the preemption rule **doesn't** apply you are **NOT** protected from what other states decide to do! Many states have amended their statutes in response to the NRRA and now tax 100% of premium regardless of where risk is located! If the NRRA does not preempt the state statute taxing 100% of premium, could an insured pay tax on 100% to multiple states? Or no states?" As an example, she explained that the state of Texas taxes 100% of premium for insurance procured from a non admitted insurer. New York also taxes 100% of premium paid on a "taxable insurance contract" which could be read to mean only surplus lines policies. See the potential problem here?

But what if NRRA DOES apply to captives? In that case, captive owners and advisers need to work through the definitions in the Act to see how the preemption rule might apply to their program:

**Home State** means:

- 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
- If 100 percent of 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

Then there's another confusing term -- the **Affiliated Group rule**, stating, "If more than one insured from an affiliated group are named insureds on a single nonadmitted insurance contract, the term "home state" means the home state of the member of the affiliated group that has the largest percentage of premium attributed to it under such insurance contract."

Williams then went on to give an example of the utter confusion that can ensue when attempting to define "home state." Let's say the parent has its principal place of business in Illinois. The Parent has multiple U.S. subsidiaries, including Sub 1, which is domiciled in Delaware and has its principal place of business in New York. The Parent purchases a single policy naming 'Parent and all of its subsidiaries' from its Cayman captive. The largest percentage of premium under the

contract relates to Sub 1's operations in Texas. Okay, folks, in this case, who is the insured? And where is the insured's home state?

As the states begin to respond to NRRRA, ever more confusion arises. Some states have passed an amended statute to tax 100% of premium, with no compact authorized. Others have amended their statute to authorize a compact. Still others have amended their statute and adopted a compact. Nine states like the SLIMPACT compact; twelve states prefer the NIMA compact. Six states haven't taken any action whatsoever. I just love it when Washington "fixes" a problem....whether one exists or not. You can't make this stuff up!

So, the variations in state responses to NRRRA continue, with opinions all over the lot. A large number of states say they are going to enter into a sharing compact. Others states prefer to take the allocation out of their premiums. NAIC supports a NIMA compact for allocation of taxes to the states from whatever state collects the taxes. Participating states enact a uniform tax rate, then move on to define and implement a controversial allocation methodology, which is based on info that may or may not be available. In essence, in this model, a central clearinghouse collects and distributes tax revenue. At this point, it seems likely that tax will not be imposed on premium allocable to non-US risk but the issue is not yet completely settled.

SLIMPACT is the other proposed compact, wherein participating states establish a single rate of tax, and a clearinghouse is established to advise the broker or insured of the amount of tax due. Collection is handled by the participating states in this model.

The confusion ignited by NRRRA will likely be legendary, whether or not it applies to captives. But we are not quite done with the madness yet! Near the end of her presentation, Ms. Williams raised a few "Unanswered Questions" that NRRRA dishes up:

Does the NRRRA apply to premium paid to captive insurers? If not, what rules DO apply?

May a state collect an unapportioned tax on premiums paid for risk both inside and outside the state without violating the Commerce Clause and/or the Due Process Clause?

May State A leverage its ability to collect State B's tax from a taxpayer that lacks nexus with State B without violating the Commerce Clause and/or the Due Process Clause?

Does a tax on premiums paid for insurance of non-US risk violate the foreign commerce clause?

If the state where risk is located does not impose a non-admitted self procurement tax may the home state collect its tax on that risk?

So, by way of planning, what *should* captives be doing? Williams suggested captives take the following steps: Review the NRRRA with your advisor and consider whether the NRRRA applies to captive insurance arrangements. If so, what consequences might ensue; if not, same thing -- what consequences might ensue? Next, determine the home state of your insured(s). Follow any and all developments in home states, leading to a decision as to whether to restructure your captive arrangements. Finally, take the time to evaluate existing insurance policies. Consider whether to change the captive's insurance program to minimize risk regardless of whether the NRRRA does or doesn't apply.