

# Captive Newsletter

*A Newsletter from the Captive Practice Group*

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## SPECIAL EDITION

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### RESPONDING TO NRRA

#### Introduction.

Over the last few months the captive industry has been considering the impacts of the Nonadmitted and Reinsurance Reform Act of 2010 (“NRRA”), enacted as part of the better known Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111-203). Service providers to captives and industry groups have issued guidance in the area ranging from alarmist to mundane. The most significant and, we believe, the most complete, was circulated over the last few weeks by the Vermont Captive Insurance Association (“VCIA”) joined by the Captive Insurance Companies Association (“CICA”) and National Risk Retention Association.

The VCIA piece took the form of a “white paper” by attorney and lobbyist James T. McIntyre. It examined the background of the law and concluded that NRRA was not intended to apply to insurance issued by captive insurance companies. We agree with this conclusion and the accompanying analysis of NRRA’s origins and definition of “Nonadmitted Insurance.”

We don’t purport to repeat it here, except to note that a close parsing of the language and legislative history make clear that NRRA focused on how surplus lines taxes would be collected and allocated among states. We agree with those who believe a clarifying amendment – to expressly exclude from NRRA insurance issued by captives – is necessary, and we understand efforts on that front are already underway. In the meantime, what to do?

NRRA could have a significant impact on captive arrangements in an indirect way. Uncertainty as to how its provisions will be applied and what actions states may take to implement them involves various legal issues which should be discussed with counsel before undertaking significant transactions intended to address possible ramifications. We are concerned, for example, that some captives may seek to redomicile to perceived “safe harbors,” but not ultimately obtain any relief from the taxing authority of other states.

Until now there has been limited enforcement of state statutes purporting to impose premium taxes on so-called

“direct procurement” of insurance. This would include coverage purchased from a captive insurer in some circumstances. We are somewhat concerned that NRRRA may have the effect of causing states to revisit these provisions and, when coupled with recent drumbeat calls for new sources of state revenue, lead insurance departments and taxing authorities to pay more attention to the issue of premium taxation. Captive insurers, and especially their customers, should anticipate that some states may become more aggressive in pursuing premium taxes attributable to direct placements. Indeed, at least one state has begun asking questions regarding captive arrangements and whether or not they constitute “admitted” or “non-admitted” insurance.

The good news is that not all purchases of insurance from captives are subject to direct procurement taxes in the first place. The purpose of this article is to detail the limits on state authority to tax insurance transactions, and suggest to our clients a process for reviewing their operations to determine whether their current tax positions are defensible if challenged by state taxing authorities.

#### Application of Direct Procurement Taxes.

Vermont is among the states with a direct procurement premium tax and its statute is typical of many others. It reads:

*Every insured and every self-insurer in this state for whom this is their home state who procures or causes to be procured or continues or renews insurance from any non-admitted insurer, covering a subject located or to*

*be performed within this state, other than insurance procured through a surplus lines broker pursuant to this chapter, shall, before March 1 of the year after the year in which the insurance was procured, continued or renewed, file a written report with the commissioner on forms prescribed and furnished by the commissioner. . . .*

8 VSA § 5036(a). And:

*A tax at the rate of three percent of the gross amount of premium, less any return premium, in respect of risks located in this state, shall be levied upon an insured who procures insurance subject to subsection (a) of this section. Before March 1 of the year after the year in which the insurance was procured, continued or renewed, the insured shall remit to the commissioner the amount of the tax. . . .*

8 VSA § 5036(d)

Roughly, the provision creates a default rule that if an insured buys insurance for a Vermont risk, it owes Vermont a premium tax of 3%. The “home state” language in the statutes is new, as a result of recent legislation to enact NRRRA provisions. In most states, analogous provisions do not yet have a “home state” requirement. Those statutes purport to apply to any insured, regardless of home state, which purchases insurance on a risk in the taxing state.

Large classes of common captive insurance transactions remain exempt from these taxes. First, RRGs and their members are generally exempted from direct procurement taxes and pay taxes in each state in which the RRG is registered. Second, fronted captives, because they function as reinsurance arrangements, are not directly procured insurance. Policyholders pay traditional premium taxes in each state in which policies are issued through the fronting company. NRRA should not have impacts on either class of captive transactions.

Even for pure captive owners and others procuring insurance from captives otherwise squarely “non-admitted insurers” for purposes of state law (even if not for purposes of NRRA), there are restrictions on a state’s ability to assert taxing authority.

#### Limitations on State Taxing Authority.

The taxing authority of the states is subject to the constitutional limits imposed by the Due Process Clause of the Fourteenth Amendment of the U.S. Constitution. Due Process requires minimum contacts between the taxing state and the entity being taxed, substantial enough to provide that entity with notice that it is subject to regulation by the state.

The Due Process analysis of a state’s self-procurement tax is rooted in a string of case law beginning in 1897. These cases established the rule that a state may not tax an insurance transaction that occurs entirely outside that state’s borders. Small contacts with the state were enough, however, to trigger taxing authority.

In one case in 1943, the U.S. Supreme Court upheld a New York premium tax imposed on an insurance company headquartered in Illinois. The Illinois company issued policies directly to New York residents, but all formalities of the issuance of those policies, including delivery of the policy and payment of premiums, were carried out in Illinois. The Court held that the entire transaction bore sufficient connections with New York simply because the insured’s application was mailed from New York, and representatives of the company would travel to New York to investigate the risks before and after the issuance of the policy.

The most important case in the area is a 1962 U.S. Supreme Court case known as *Todd Shipyards*. Much of the significance of that decision results from its clear delineation of the circumstances that will cause a state’s taxation of an insurance transaction to run afoul of the Due Process Clause. *Todd Shipyards* held that a tax could not pass Constitutional muster where: (1) the insurer was domiciled outside of the taxing state; (2) the insurer maintained no office or agents in the taxing state; (3) the insurer would not investigate or adjust claims within the taxing state; (4) the insurers were not licensed in the taxing state; (5) the insurance policies were contracted for, signed, issued, delivered, paid for, and accepted outside of the taxing state; (6) the insurers did not contact the insureds within the taxing state; (7) the insurers did not solicit business in the taxing state; and (8) the only connection to the taxing state was the fact that the insured property was located in that State.

Not surprisingly, many state courts have taken a restrictive view of *Todd Shipyards*. In addition, many insurance arrangements fail to have the “clean” circumstances in *Todd* necessary to escape taxing authority. Some of the failures include use of a corporation organized in a taxing state, payment of premiums from a state, adjustment of claims in a state, use of a state’s “economic market” and marketing efforts within a state.

#### Limitations on Taxing “Non-Insurance” Transactions.

Even if a state has adequate jurisdiction to tax a captive transaction through the necessary minimum contacts for due process, states may yet be limited in circumstances where a transaction does not constitute “insurance” in the first place.

In general, “insurance” is an arrangement which includes both risk shifting and risk distribution. Some pure captive structures lack one of both of these elements – especially risk distribution – when a parent is a sole insured of a captive insurer. Arguably, if an arrangement is not “insurance,” it cannot be taxed as such.

Unfortunately, this possibility for escaping direct procurement taxes has two significant shortcomings. First, many captive insureds seek to deduct premiums paid for the coverage purchased in a captive arrangement. Generally, if the transaction is not “insurance,” no deduction would be allowed. Most of the time, income tax on deductible amounts exceeds the procurement tax (generally in

the two to four percent range). Second, state law definitions of what constitutes “insurance” or in some cases the “business of insurance” include elements not dependent on the tax-origin case law in the area regarding risk shifting and risk distribution. Some of these elements include characterization of payments as “premium,” payment of “claims,” issuance of “policies” or other common indicia of insurance, even if the transaction would not qualify as insurance for other purposes.

#### Recommendation.

In light of the questions and uncertainties arising from NRRRA, and our expectation that states will find new zeal for enforcing direct procurement taxes in the months ahead, we recommend that our captive clients which might be subject to direct procurement taxes take another look at their captive arrangements to make sure that they understand either why the taxes don’t apply or what exposures they may have. Clients should discuss NRRRA with legal and tax advisors and determine an appropriate response which takes into consideration the significant uncertainty around its implementation and the non-tax ramifications of transactions aimed at reducing direct procurement taxes. We stand ready to assist in this analysis, and to work with clients’ other service providers to avoid unexpected outcomes.

#### **E-MAIL OPTION**

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