What Does the NRRA Mean for Captives?

by Joshua Gold and Marshall Gilinsky

For the past year, industry professionals have been trying to determine whether or not the Nonadmitted and Reinsurance Reform Act (NRRA) applies to captives and, if so, what they should do about it. This relatively small addition to the landmark Dodd-Frank financial reform caused outsized tremors across the captive insurance industry because the language of the statute was less than clear about whether it applied only to surplus lines insurers or to captives as well. While the NRRA was the result of a long-standing effort to organize the way premium taxes are collected from surplus lines insurance companies, the lack of clarity allows for differing interpretations.

Rather than using a definition that limited the statute to surplus lines companies, the NRRA states that it applies to any "nonadmitted insurer," which it defines as "an insurer not licensed to engage in the business of insurance" in the policyholder's home state. Naturally, this sparked discussion over whether Congress, in its haste to insert a minor provision into the already unwieldy Dodd-Frank Act, inadvertently upended one of the organizing principles of the captive insurance world: regulation and taxation by the captive's domicile.

Potential Legislative Developments

There are two easy ways lawmakers could put an end to this uncertainty: Congress could enact clarifying federal legislation, or states could take action regarding the premium allocation compacts envisioned under the existing law. Unfortunately, we have seen little progress in either area since the NRRA was passed in July 2011.

Although many in the captive industry hope that a legislative clarification is in the works, the core provisions of financial reform remain the hot topics in Washington. So until the major issues of Dodd-Frank, such as the application of the Volcker Rule, get ironed out, it will be very surprising to see the captive insurance wrinkle clarified. Once the issues on the front burner are addressed, it would not be surprising for an NRRA clarification to slip into a larger amendment, but until then, the issue will likely remain ambiguous.

As far as state compacts are concerned, the NRRA authorizes the states to enter into a tax-sharing compact or agreement, but it does not mandate any uniform process for collection among states. Most states, including the biggest states with the most to gain from not sharing, have refused to participate in a compact, however, opting instead to keep 100% of the tax they collect for themselves. 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).

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.

Emerging Captive Strategies and Trends

In light of the uncertainty raised by the NRRA, some captives have implemented strategies designed to address the possibility that taxes would be collected under the NRRA by the parent's "home state" and also by the state where the captive is domiciled. Some captives, for example, have moved to their parent's home state, where they presumably would be taxed only once. And some captives that wanted to stay where they are–typically due to more favorable conditions there–simply began accepting the same risk via reinsurance sold to a fronting captive established in the parent's home state. For most captives, the uncertainty over the NRRA caused them to avoid transaction costs, whose value would be wiped out if the NRRA were to be clarified by Congress or the courts in a way that conflicts with their chosen strategy.

Ultimately, what the NRRA means for any particular captive depends on its profile, such as the domicile of its parent, the taxes imposed by the relevant taxing authorities and the approach of the applicable regulators in general. Obviously, given the complexities and uncertainties involved, analysis and guidance from experienced professionals is advisable before making any changes to an existing captive program structure.

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