DEMYSTIFYING THE DODD-FRANK EFFECT

Steven D Cohen and Logan R Gremillion of Capstone Associated discuss Dodd-Frank on the controversial Act's four-year anniversary

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On 21 July 2014, corporations, banks, and regulators marked the anniversary of one of the most impactful pieces of legislation the US has seen in recent years. The Dodd-Frank Wall Street Reform and Consumer Protection Act, more commonly known as Dodd-Frank, was implemented to prevent the recurrence of events that prompted the financial crisis of 2008.

Transparency, accountability and consumer protection are at the heart of the act and several regulatory groups were established to keep banks and corporations compliant.

Dodd-Frank includes verbiage relating to the world of taxation, licensing, and eligibility rules associated with the procurement of insurance from non-admitted insurers across the 50 states, the District of Columbia and five US territories. This section was titled the Non-admitted and Reinsurance Reform Act (NRRA).

The legislation has brought dramatic changes for those procuring non-admitted insurance for their organisation from wholly owned captives.

Four years later, prospective captive owners are still trying to make sense of their responsibilities and tax obligations. Are captive insurance companies expected to pay premium taxes to their respective domiciles? What about the operating company — who would ultimately be responsible for the tax burden, if any?

The draw for many business owners to form captives is multi-faceted. This alternative risk management tool provides them the ability to pay tax-deductible premiums to the captive and realise major benefits, such as broad insurance coverage for non-standard or otherwise excluded risks.

Unfortunately, the general chaos caused by the law has given many captive owners a great deal of concern. It is why business owners looking to form captives must elicit the expertise of legal professionals specialising in insurance regulation and taxation to navigate the complexities of Dodd-Frank.

Who has jurisdiction?

Prior to the passage of Dodd-Frank, insurance companies had an obligation to pay state taxes. The premium tax on the insured was included in the premium calculations without specific notice that the tax was being paid.

Insureds purchasing non-admitted surplus lines insurance were assessed for a premium tax that was collected by licensed insurance agents or brokers. The broker would remit the tax on behalf of the insured.

Insureds that purchased insurance directly from non-admitted insurers, such as captive insurance companies were generally required to remit tax payments to the state directly, with no third-party intervention.

But on 21 July 2011, the bi-partisan NRRA was added to Dodd-Frank — a provision that was intended to create certainty in the tax treatment and regulation of the surplus lines and reinsurance industry.

It was to unify premium tax reporting on surplus lines insurance, such as being state-licensed insurance brokers' use of out-of-state/non-admitted insurance companies to write generally unusual or large coverages (e.g. $50m umbrella coverages) for clients.

The state-licensed brokers had to apportion premiums, file and pay state tax in every state where the insureds did business, often requiring dozens of tax filings. The NRRA gave sole authority to tax 'non-admitted insurance' to the 'home state' of the insured, which is generally defined as the insureds' principal place of business.

The open definition of 'non-admitted insurance' in the federal statute led several states, including Texas, California, and New York, to promptly conclude that the NRRA granted them sole authority to tax independently procured insurance (including captive insurance) purchased by home state insureds.

However, these aggressive states misinterpreted the application of the NRRA's definition of 'non-admitted'. It is well-established among the bill's sponsors that Dodd-Frank had no intention of including captives in the definition of non-admitted.

To be sure, the tax obligation of Dodd-Frank was already being met in the captive's domicile. Many states quickly amended their independently procured tax laws to tax 100% of premiums on insurance acquired by their home state insureds, regardless of where the actual risks lie.

The authors fully expect that other states will follow this erroneous path, which would end Vermont, South Carolina, Delaware and Utah as significant domiciles in favor of the states where large companies are based, such as Texas, Illinois, New York and California.

That is, most captives would need to reincorporate into the single state where the captive's insureds have their principal business. Only those few companies whose principal office and operations are in Vermont would be left using it as a domicile. The same goes for Delaware, which would be left with the du Pont captives, but little else.

The case for captive insurance

There has been substantial resistance and controversy surrounding the Dodd-Frank Act. States created new captive insurance domiciles in an attempt to capture tax revenues from companies based in states that have captives.

Captives domiciled in a state other than its parent company's home state would expose the parent company to double taxation: a self-procurement tax on the corporate policyholder collected by the home state (under the NRRA) and a premium tax on the captive charged by the state where the captive is domiciled.

After the authors of this article brought to the attention of Delaware and other state regulators and captive associations in 2011 the problems created by the loose definitional language in the NRRA, significant captive domiciles formed a coalition to address issues of the NRRA with respect to captive insurance.

The Coalition for Captive Insurance Clarity has been working to co-ordinate efforts in promoting corrective legislation to the NRRA since 2012. The objective is to address the misplaced reliance of certain states on the NRRA as an authority to tax captive insurance premiums.

The National Association of Insurance Commissioners (NAIC) found issue with section 171 of the Dodd-Frank Act and the perceived ambiguity of banking capital requirements. The NAIC stated the US Senate Banking Committee must consider amendments to the Dodd-Frank Act so that insurance policyholders are not put at risk.

The Senate attempted to heed those sentiments. In June 2014, the 'Collins Amendment,' received unanimous backing. The bill, formally known as the Insurance Capital Standards Clarification Act of 2014, would revise section 171 of the Dodd-Frank Act.

It would "clarify that the Federal Reserve Board can apply insurance-based capital standards to the insurance portion of any insurance holding company it oversees". Unfortunately, while it addresses the concerns of ambiguity under section 171 of the Dodd-Frank Act, the Collins Amendment did not address the NRRA as it relates to captives.

Turnkey services and support

Alternative risk or captive insurance planning is a sophisticated insurance, corporate and tax planning tool. The design, structuring, formation and ongoing management of a captive insurer operating under any of Internal Revenue Code sections 831(b), 831(a) or 501(c)(15) should be overseen by an experienced team of legal and tax professionals that understand the insurance, tax, regulatory, corporate and financing aspects of the captive, its parent and its insureds.

Because a captive is a regulated insurance company – subject to parallel regulation at the state level and, as to taxation, at the Federal level – most business owners quickly recognise the need for a captive team with the expertise and onboard talent to address the many moving parts of a legitimate captive's operations. For the same reason, good regulators demand ongoing professional management.

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Most so-called 'captive managers' may be able to help with the clerical nature of the formation of a captive, but the ability to support the client stops there. The captive world is full of marketers with websites reflecting purported great expertise and talent in the captive world, which upon even cursory examination reveals a defrocked lawyer or CPA that is not eligible to practice because of judgments for selling tax shelters, practising without a licence or other misdeeds.

While on the one hand offering turnkey services, the client contract of most captive managers disclaim all responsibility for tax, accounting, actuarial and insurance work. Despite disclaimers, banks offering captive services offer mail drop and clerical services for tens of thousands of dollars a year.

Only by working with a true turnkey service provider, with legal backing can captive owners ensure state and federal compliance of this sophisticated planning. The benefits of owning a captive are far-reaching and the adoption of captive insurance is on a strong growth curve. Navigating Dodd-Frank is a necessary part of the process that can only be done with a properly-assembled team.