Captive Issues to Watch in 2019

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This year there a number of issues to watch that could change the business of captives—both in the short term and long run. The following are the top four things captive professionals are looking out for in 2019.

SELF-PROCUREMENT TAXES

Since the Nonadmitted and Reinsurance Reform Act (NRRA), part of Dodd-Frank, was passed in 2010 by Congress, the captive industry has been wondering if it was going to be applied to them. There was a lot of discussion about it for several years but hasn't been discussed much in recent years. That is until 2018.

In June of last year, the Tax Court of New Jersey rejected Johnson & Johnson's request for a tax refund for overpayment of self-procurement taxes for insurance through their Vermont-domiciled captive—Middlesex Assurance. Self-procurement taxes are levied by states when a company purchases insurance from an insurer not licensed or registered in the state. Johnson & Johnson's claim was that they had overpaid their self-procurement taxes since 2011, when New Jersey updated their tax

law to be in alignment with the NRRA. Johnson & Johnson's argument for a tax refund was based on the assumption that the NRRA was meant to apply only to surplus lines and reinsurance, not self-procurement insurance.

This was the first court case that adjudicated on the subject of the NRRA and captives and could open captives and their parent companies to more taxation. According to Anne Marie Towle, captive practice leader, JLT Insurance Management, "I think there's going to be an enhanced focus on procurement taxes. When the NRRA regulation came out a few years back there was a lot of discussion about whether or not it applied to captives. There was a bit of a scuttlebutt at the time about it but that died down for a bit. It seems now, after the recent cases, there is an interest coming from state governments to go after companies for self-procurement revenue. I don't think it's the end of the story. I think from a government stand point it could be a revenue grab."

Many states already have self-procurement, or direct procurement, taxes on the books. However, the decision in the Johnson & Johnson case indicates that a company's home state can tax all of the policies written even if the risk is not based in a company's home state.

The imposition of additional taxes on a company's private insurance transactions can steeply increase the cost of doing business. "Self-procurement tax exposure impacts the value analysis for a company forming or owning a captive insurer," said Sandy Bigglestone, director of captive insurance with the Vermont Department of Financial Regulation.

"It doesn't seem fair," she continued, "But the imposition of self-procurement taxes is between the company and the home state taxing authority. The impact on the captive market may affect a company's choice for a domicile and challenges the ongoing feasibility of a company already operating a captive in a chosen domicile outside the company's home state."

If states are emboldened by the New Jersey Tax Court decision, it may spark a burst of redomiciling by captives. Bigglestone said, "Vermont has had a number of redomestications since the non-admitted and reinsurance reform act came into effect, however some captives that chose to stay in Vermont executed other types of solutions to limit the self-procurement exposure. One such solution was to establish a captive insurance company in the home state for the risks in that state, then reinsure that risk to the Vermont captive."

Towle added, "I'm curious to see if the traditional domiciles that are known for great regulation and have been around for a long period of time will work to be more accommodating to retain the captives in their domicile. I wonder if there will be any sort of adjustment to their regulation—whether it's a tax reduction or something else—because they recognize that captives in their home states are being taxed more?"

CYBER SECURITY

The worry about cyber security crimes continues to grow as we become more and more dependent on our computing devices. The Internet Security Threat Report (ISTR), published annually by Symantec, reported earlier this year that in 2017 the number of successful cyber-crimes was down. However, the crimes that were successful exposed more private information than ever before and were exponentially more costly. 2017 also saw a 600% rise in attacks on IoT (the internet of things)—meaning more phones, watches, blue tooth accessories were subjected to a cyber-attack.

From an insurance perspective, it's hard to keep up with the constant changes. "The speed with which cyber security changes is so dramatic, as opposed to something like workers comp, it makes it a real challenge," said Towle. "I'm hopeful we'll get to a point where security systems will be able to handle new threats, but it's hard in today's digital age to try to sort through the risk. As fast as technology changes cyber security is still going to be on top of the mind for many risk managers."

Captives are taking the lead in establishing cyber security coverage. According to Bigglestone, "Many companies have already placed cyber liability coverages into their captive, well before the commercial insurance could establish pricing and policies, primarily because these companies know how to protect their own systems, and at the same time, set aside reserves for the uncertainties related to vendors, contractors and others the companies are doing business with that handle data (third-party liability)."

Both the traditional and the captive insurance marketplace will continue to find cyber security an issue because of its constantly changing nature. "[This issue] will be around for a very long time, as new digital platforms and developments are made, hackers will test and find new ways to disrupt, so insurance customers will be assessing the risks continuously and the insurance markets will have to keep pace," said Bigglestone.

ATTRACTING NEW TALENT

Recruiting new talent for the insurance industry has become a looming issue. Young people are not entering the profession as fast as people are retiring. Figures released in 2016 by the Bureau of Labor Statistics estimated that 400,000 insurance professionals would be retiring by 2020. The captive sector is likely to be hit even harder than the insurance industry as a whole, given the insular nature of captives and that many of today's leaders have grown with the industry since its beginnings in the 1970s and 1980s.

According to Towle, "We're starting to see a lot of retirements of people that started in captive management 20 or 30 years ago when captives were starting to grow. The question is, who's taking over? Who's going to step up? Why aren't we hearing from the next generation of thought leaders? Part of it is going to take time, but we need to look at how to groom new talent to give them the additional experience they'll need to become valued leaders."

The captive sector is seeking out new ways to attract professionals 35 and younger. However, there is a gap between what young professionals want in a career and what they perceive insurance to be—a stodgy, old-fashioned industry. That is changing with new initiatives from SIIA, Captive Insurance Companies Association (CICA), and other sources.

Last spring, SIIA launched the SIIA Future Leaders (SFL) initiative. This program is designed to encourage young talent to become involved in the self-insurance industry and to become members of SIIA. In late 2017, CICA began a mentorship program that pairs experienced captive leaders with new and mid-career professionals."

Speed to Market

We now offer a Conditional Certificate of Authority on the same day the application is received for licensing a Captive Insurance Company.

- Recently passed, HB 334 authorizes the Insurance Commissioner to issue conditional certificates of authority ("COA") to captive insurance company applicants.
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- Conditional Certificates of authority will be issued only upon receipt of evidence of the minimum capital and surplus required by Chapter 69 of Title 18 of Delaware Code and a certification from the captive owner that the application materials comply with the requirements of Chapter 69.
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- Delaware applies Know Your Customer; only certain managers may submit applications for a conditional license.

STEVE KINION, DIRECTOR
Bureau of Captive & Financial Products
Department of Insurance

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Trinidad Navarro, Insurance Commissioner

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Last year, Gamma Iota Sigma—a business fraternity for students of risk management, insurance, and actuarial science—held a groundbreaking online job fair to pair students with potential jobs. Additionally, at Butler University, students in the Davey Risk Management and Insurance Program had the opportunity to launch an actual captive insurance company domiciled in Bermuda—MJ Student-Run Insurance Company Ltd.

Bigglestone said, "Attracting future talent to the industry has been a real hot topic lately and different organizations in the industry are focusing their efforts on mentoring programs, education, outreach initiatives, and succession planning. We have to start somewhere, and all the efforts are commendable. It will remain to be seen if we can begin to track the outcomes, but I do think that new talent will choose to work in the industry if given opportunities to participate in activities that prove valuable to the industry or the organization the individuals are working for."

UPCOMING COURT DECISIONS

The captive industry has not been faring well under the scrutiny of the IRS in recent years. In the Avrahami decision in 2017 and last year's decision in Reserve Mech. Corp. v. Commissioner, the U.S. Tax Court has dealt some set-backs to captives operating under the 831(b) tax code. In 2019, no less than three similar cases are up for decisions from the Court. The pending cases are Caylor Land & Development v. Commissioner; Wilson et. al. v. Commissioner; and Syzygy Insurance v. Commissioner. The Wilson case is very similar to Avrahami and is being heard by the same Judge in that case. The Caylor case takes on risk distribution. In Syzygy, the only U.S. domiciled captive out of these recent cases, the Court will be judging whether or not its layered pooling arrangement is valid.

With the decisions still to come, many captive professionals that are following closely do not have a positive outlook on the outcomes. Even so, this should only be a temporary set-back for small captives that allows captive owners and managers insight into operating captives in a lawful and effective manner. ■

Karrie Hyatt is a freelance writer who has been involved in the captive industry for more than ten years. More information about her work can be found at: www.karriehyatt.com.