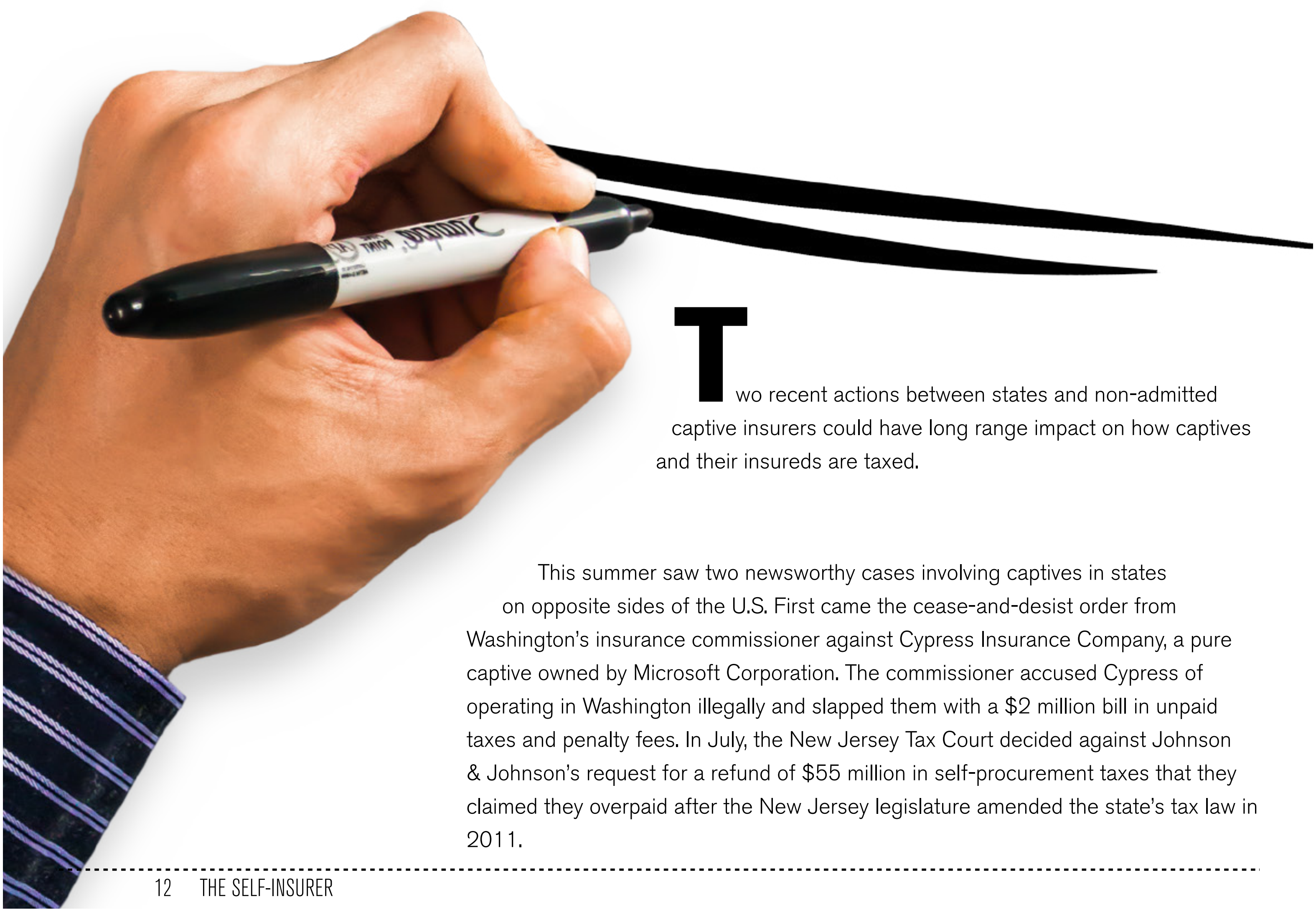
WRITTEN BY KARRIE HYATT

Captives, Parent Companies, State Regulators, and Taxes



Two recent actions between states and non-admitted captive insurers could have long range impact on how captives and their insureds are taxed.

This summer saw two newsworthy cases involving captives in states on opposite sides of the U.S. First came the cease-and-desist order from Washington's insurance commissioner against Cypress Insurance Company, a pure captive owned by Microsoft Corporation. The commissioner accused Cypress of operating in Washington illegally and slapped them with a $2 million bill in unpaid taxes and penalty fees. In July, the New Jersey Tax Court decided against Johnson & Johnson's request for a refund of $55 million in self-procurement taxes that they claimed they overpaid after the New Jersey legislature amended the state's tax law in 2011.

WASHINGTON INSURANCE COMMISSIONER VS. CYPRESS INSURANCE CO.

On May 9, 2018, Washington state insurance commissioner, Mike Kreidler, issued a cease-and-desist order to Cypress Insurance Company, a pure captive owned by Microsoft Corporation, requiring that Cypress stop selling insurance to its parent company. Microsoft is based out of Redmond, Washington, while Cypress is domiciled in and regulated by Arizona. Formed in 2008, the captive has been providing insurance coverage for Microsoft since that time and had not registered as a non-admitted insurer in Washington.

The cease-and-desist order established that Cypress had not paid any premium tax on written policies, was not eligible to sell insurance in Washington, and had not place insurance through a fronting company licensed to issue insurance policies in the state. The commissioner also requested $1.4 million in unpaid premium taxes—based on the 2% premium tax charged by Washington for non-admitted insurers—as well as more than $600,000 in penalties and interest.

In early July, Microsoft announced that it had secured a Washington licensed surplus line broker for Cypress policies and going forward would rely on their fronting carrier to pay premium taxes. On August 9, Cypress submitted a "Demand for Hearing" to the Office of the Commissioner.

In the document requesting a hearing, the attorney for Cypress made four arguments. First, Washington cannot regulate self-insurance as it has been decided by the Washington Supreme Court that it is not insurance. Second, Cypress is not in the business of "making contracts of insurance" as it only insures one party and that business consists of reinsuring Microsoft's global risks. Third, Washington does not have the authority to regulate or tax insurance contracts made outside its borders. Fourth, if the insurance commissioner has the power to tax premiums, then it must exclude premiums related to risks outside its jurisdiction.

Quickly following the "Demand for Hearing," the Commissioner announced on August 13, that Cypress had come to a settlement agreement with the insurance commissioner's office. The cease-and-desist order was lifted, and Cypress Insurance Company agreed to pay $573,905 in unpaid premium taxes and $302,915 in penalties and interest—a considerable reduction from the over $2 million the state originally said the company owed.

Unfortunately for the captive industry, since the issue was settled out of court the specific details of the settlement will not be known. However, two points to take away are the fact that Cypress was not registered as a non-admitted insurance company in the state of Washington and also did not use a fronting company. This is a large oversight on the part of the captive.

The second point is that Washington is one of the few states that does not have a direct procurement, or self-procurement, tax requirement. Self-procurement taxes are levied by states when a company purchases insurance from an insurer not licensed or registered in the state. Had Washington had self-procurement tax law on the books, this situation might have been avoided.

Commissioner Kreidler was pleased with the settlement agreement and announced in a press release that the state would be looking further into other captive insurance arrangements in the state.

JOHNSON & JOHNSON VS. NEW JERSEY

In 2015, Johnson & Johnson, a multinational corporation headquartered in New Brunswick, New Jersey, requested from the New Jersey insurance commissioner a $55 million refund for over-payment of self-procurement taxes. Since 2008, Johnson & Johnson has been paying self-procurement taxes to the state of New Jersey for the policies underwritten by Middlesex Assurance, their captive insurance company. Middlesex Assurance was formed in 1994 in Bermuda and is currently domiciled in Vermont and only covers risk for Johnson & Johnson.

Between 2008 and 2011, Johnson & Johnson paid self-procurement tax only on risks that were based in New Jersey. After the federal Non-admitted and Reinsurance Reform Act (NRRA) was passed in 2010, the New Jersey legislature updated their tax law to better align with NRRA requirements regarding surplus lines insurance. They began requiring self-procurement taxes on all risk that a company has coverage for, regardless of where that risk is located. Between 2011 and 2015, when Johnson & Johnson first brought up the issue, the company paid self-procurement taxes on all risk insured through Middlesex, not just for the risk within the state.

Congress passed the Non-admitted and Reinsurance Reform Act as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which went into effect in January 2011. The NRRA states that only an insured's Home State


Your
high
expectations
+
Our
expert
capabilities
=
Extra
peace of mind
Swiss Re
Corporate Solutions
We've got your back. Four words that anyone seeking to self-fund healthcare benefits needs to believe, particularly when contemplating the financial risks associated with catastrophic medical events. That's why we're firm believers at Swiss Re Corporate Solutions in building strong relationships, understanding exactly what our partners expect of us, and creating innovative ways of fulfilling those expectations. By working closely together, we combine our expertise and capabilities with our brokers, payers and advisors to provide enhanced value for your clients – not to mention extra peace of mind. When it comes to employer stop loss solutions, now, more than ever, we've got your back.
We're smarter together.
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may require the payment of premium tax for non-admitted insurance. NRRA defines an insured's Home State as the "insured's principal place of business," and if the insured has business in several states, the Home State would be considered the state in which the most premium is allocated. The Home State has no obligation to share tax revenue with any other state in which the insured has risk that is covered by their insurance policy.

Congress's intent as regards to including captive insurers in the NRRA was not explicit. Since the legislation was enacted, there has been debate among captive professionals and regulators as to whether captives should fall under the NRRA's purview.

In 2015, Johnson & Johnson applied to the New Jersey Department of Insurance for a refund on their self-procurement taxes claiming that they had overpaid their self-procurement taxes since 2011, when New Jersey updated their tax law. 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. They also claimed that the legislative changes made by the New Jersey legislature in 2011 altered the requirements for surplus lines insurance and did not apply to the original law regarding self-procurement tax.

The director of the New Jersey Division of Taxation, John Ficara, denied the refund claim based on the opinion that non-admitted insurance, as defined by NRRA, includes surplus lines insurance as well as self-procurement. Johnson & Johnson then took the matter to court.

On June 15 of this year, the Tax Court of New Jersey decided in favor of Director Ficara's original decision. The court's decision was founded on two issues. The first was that it was Congress's intention to apply the NRRA to captive insurers. The second was that the legislation passed in New Jersey in 2011—based on the NRRA—was meant to include self-procurement tax with the changes to the surplus lines insurance requirements, even though the law is not explicit.

While members of Congress have said that the NRRA was not meant to apply to captives, as Johnson & Johnson argued, the law is not specific regarding captives. According to the New Jersey Tax Court's decision based on NRRA's Home State Rule definition, non-admitted insurance includes both surplus lines insurance and captives in that one is placed through a surplus lines broker and the other is placed directly with a non-admitted insurer.

The decision handed down by the New Jersey Tax Court is the first major decision regarding the NRRA and captives. Until this time, there had been no precedent for how states were to proceed in applying NRRA to captive insurance companies. This case will likely be turned into case law for future similar cases. The decision also supports the NRRA's definition of an insured's Home State. ■

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