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The States' Role in Regulating Small Captives

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Small captives are rarely out of the headlines and under intense scrutiny from the Internal Revenue Service (IRS), but what is the role of state regulators is ensuring perceived abuses are not commonplace? Dana Hentges Sheridan, General Counsel and Chief Compliance Officer at Active Captive Management, discusses...

For quite some time, regulation of insurance in the United States has been left to the states, as opposed to the federal government. In fact, until the passage of Dodd-Frank, the federal government left the regulation of the insurance industry almost exclusively to the states.That said, history demonstrates that, over the years, there have been intermittent proposals for federal intervention with regard to insurance regulation.

The subject of state versus federal regulation is beyond the scope of this article. The reason history is being briefly brought up here is that in general, it's not the job of the states' insurance domiciles to regulate for tax considerations, nor is it the job of federal regulators to mandate insurance principles through the tax code.

Yet, something needs to be done to correct perceived "abuses" in the small captive world. If the question is which is the best regulator to help curb abuse, the answer is the states. State insurance regulation – if it's implemented strongly and correctly – should be enough to curb abuses. The states' governance and regulation relative to insurance can work to curtail even tax related abuse if one assumes that the state regulators aren't going to license any company that isn't performing an approved and compliant insurance function from a state insurance code perspective.

After all, many of those inclined to enter the small captive business for tax reasons are often the least sophisticated among us all in insurance. So one would think the process of regulating insurance would simply shake out – on some level – those entities that aren't really operating like an insurance company would.

As many are aware, in the world of small, enterprise risk captives, a form of federal intervention is currently taking place in that some policymakers are continuing efforts to propose changes to federal tax law impacting enterprise risk captives; notably, section 831(b) of the Internal Revenue Code. In seeking to advance alternate language to 831(b), proponents of change should be careful not to suggest or advocate for any change that imports insurance tenets or considerations into the tax code itself. To do so could compromise the integrity of state authority to regulate insurance.

In order to understand why it might be a problem to address small captive insurance considerations through changes to the tax code (as opposed to addressing insurer issues directly in insurance code or insurance cases), it's important to first understand what exactly is the role of any state regulator when it comes to small captives.

Role of the regulator

The overarching role of state regulators is to ensure that licensed captive insurance companies operate in compliance with applicable state insurance code. So, in licensing and regulating any captive, state regulators are literally qualifying that captive as an insurance company only for state regulatory purposes.

There are protections built into state insurance codes to help regulators ensure that captive insurers stay liquid and solvent such that they are able to meet claim obligations and perform general insurance operations. Questions of liquidity and solvency or questions addressing the type of insurance business any captive can write aren't questions tied to tax treatment considerations at all.

Thus, state insurance regulators recognise that insurer is a small/enterprise risk captive because such insurers have defining features, but still what they focus on is governing liquidity and solvency and insurance operations, from an insurance perspective. Small captive state regulators try to stay out of the business of tax, so perhaps it's fair to argue that federal regulators should stay out of the business of small captive insurance regulation.

The industry can and should rely on state regulators to do their job as state regulators – to regulate not only the captives but the service providers associated with them in such a coordinated, precise, rule oriented environment that literally by doing their very job they shake any bad apples out of the captive tree. With regard to what might be the job of state regulators when it comes to small captives, regulators focus on matters such as the following:

- The character and business qualifications of a captive's owners, officers, and directors, as well as the corporate governance framework considering the nature, size and type of captive.
- Whether the proposed lines of insurance coverage make sense for the operating businesses being insured.
- Whether a Feasibility Study was prepared and, if so, was it prepared by a reputable actuary using expected and adverse scenarios, and confidence levels.
- The quality and qualifications of all service providers such as the captive manager, auditor (CPA), actuary, reinsurance intermediary, etc.
- The complete business plan of the captive including underwriting programme, premium derivation, risk-sharing through reinsurance (including quality of reinsurers), and all other aspects of the business plan.
- Initial capital and surplus level, ability to pay a first year maximum claim, ongoing liquidity and solvency, and ability of captive owners to infuse additional capital and surplus in a contingency plan scenario.
- The risk management (loss prevention and safety) programme employed by the affiliated insureds.
- A captive's investments vis-à-vis preservation of the captive's claims-paying ability (liquidity).
- Dividends to shareholders or other distributions are allowed by the insurance code, but should only be permitted to the extent undistributed earned surplus exists to support it.
- Loan-backs are allowed by the insurance code, but should only be permitted to the extent that a dividend of the same amount would be permitted (i.e., there must be undistributed earned surplus of at least the amount of the loan).

The above list is a partial recitation of what state insurance regulators are looking for when they regulate captives via the licensure process, ongoing analysis of annual or other regulatory filings, periodic examinations, or other regulatory efforts. State regulation is clearly crucial for many reasons, but one important reason (in a tax context) is that the Service has acknowledged (in various tax court cases) that the treatment of an arrangement under applicable state insurance law as insurance can also mean that this same arrangement will qualify as insurance for federal income taxation purposes.

Thus, compliance with state insurance regulation can be a key factor to whether or not the captive is also found by a federal regulator to be an insurance company for federal income taxation purposes. A captive's state regulator is crucial; a domicile should be chosen wisely and well.

Captive ecosystem

It takes a seasoned team of insurance professionals to run a captive insurance company. Everyone in the small captive industry has a role and all the roles are different – from regulators, to underwriters, to claims personnel, to accountants, to captive managers, to actuaries and auditors and so on. Individuals and companies providing services to small captive insurers really need to come together as an industry and support initiatives that encourage positive growth and support industry wide best practices.

What is meant by best practices is really insurance best practices, where the gold standard is that all captives follow insurance industry standard best practices from how they underwrite and draft their policies, to how they adjust claims, to how they determine and book reserves, to how they are governed and managed. Assuming everyone involved in supporting a small captive carries out their respective roles meeting best practices objectives and criteria, that should serve to better position the enterprise risk industry as a whole.

Small captives provide great risk management and insurance benefit to their insureds and owners. States with captive enabling legislation provide great economic benefit to the states in that captives generate income for the states. As was so eloquently put by John K. DiMungo (albeit in a different context than captives): "[E]very for profit business will – and should – attempt to maximize profits, whether the business is a restaurant, flower shop, retail outlet, a medical practice, a law firm, or an investment bank. It is unrealistic to expect them to do otherwise. When incentives are properly aligned and markets function properly, profit maximization leads to economic growth and higher standards of living." (*Implications of Financial System Reform for the Insurance Industry,* Insurance Litigation Reporter, July 9, 2014).

Captives that follow best practices afford their owners and insureds some rainy day claim protection in ways that the commercial market simply cannot. Captives that are liquid and solvent and run compliantly from a regulatory standpoint are revenue producers for the domiciles that govern them.

Thus, when state and federal regulatory incentives and standards are aligned with the captive market functioning properly, this can and will lead to positive economic growth for the states that have captives, for the persons and entities that own captives, and for the states' insurance economy in general. The permanent tax benefits associated with some small captives can be controversial to federal regulators, but weighing against that controversy is a real risk management/insurance need for small captives in the Fortune 1500 industry space, and the ability of such small insurers to generate significant income for states causing positive economic growth for those states that have enabling legislation.

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