The Tax Effects of New York State’s Captive Insurance Program

A Brief History of Research and Estimations

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Introduction

New York has allowed the licensing of captive insurance companies since 1997. The introduction of these entities to the state brought with it a number of unique tax issues. This paper explores the history of captive insurance in New York, and the past and present estimates of how the captive program affects tax revenues. It will also highlight the potential tax planning opportunities offered by captive insurance companies and some possible solutions. The paper will also touch on recent law changes that may create a similar potential problem with other insurance companies. Insurance tax abuse has become a topic of concern among the states recently. It is hoped that New York’s experience over the last nine years may provide some insight into these issues.

How Captive Insurance Works

A captive insurer is an insurance company that is created to manage the risks of its owner or owners. The type of entity forming a captive may vary, from a large multinational corporation, to a non-profit organization, or a professional association. A corporation that forms a captive insurer will normally organize the captive as a subsidiary. If the captive insures only the risks of its parent company or organization, it is considered a pure captive. One or more unaffiliated companies, usually in the same field, may also form a group captive together to insure the risks of the group. It is a common practice for a captive parent to hire an outside firm, usually an insurance company, to manage the captive for them.

There are many benefits to forming a captive insurer. Owning a captive gives the parent company control over managing its insurance needs. This means a lower cost of coverage, with premium rates that are lower than what the parent would have to pay in the traditional market. The parent will also be able to use the captive to obtain coverage for risks that would otherwise be uninsurable or unaffordable. Most captive domiciles also offer captives a favorable level of government regulation as compared with other insurers. This can include minimal restrictions on investments and low captive premium tax rates.
There are also certain federal tax advantages offered by captive insurance that cannot be realized through self-insurance. A company that self-insures retains all the risk itself and simply allocates reserves to pay potential claims. It cannot take a deduction for its reserves until a loss actually occurs. A company that forms a captive can take advantage of the tax treatment offered to insurance companies under the Internal Revenue Code. It can take a deduction for its reserves immediately instead of having to wait for a loss to occur, and it can also deduct the premiums paid to the captive as a business expense.

Captive insurance first began to appear in the 1980’s during a period in which businesses were having trouble meeting their insurance needs through the traditional market. Since that time, the captive market has grown worldwide. For a long time, captive growth was limited to domiciles offshore, like Bermuda, or in Europe. The exception was Vermont, which has been a leading captive domicile since the early 1980’s. In the last few years, many states have passed captive legislation and have actively tried to attract captive insurers. Nearly half the states now have captive laws. Hawaii and South Carolina have two of the fastest growing domestic captive markets.

*Origin of New York’s Captive Law*

New York has always been a vital center for the financial services industry, most especially the insurance sector. It was perhaps inevitable, then, that there would eventually be a move to allow the licensing of captives in the state. In 1996, the first captive insurance legislation was introduced. This came at a time when the captive insurance market worldwide had seen significant recent growth and was estimated to continue to grow by almost ten percent per year. Our next-door neighbor Vermont had demonstrated the potential of captive insurance. By 1995, Vermont had over 300 captives, which were generating $2 billion in captive premiums on an annual basis.

The argument in favor of captives was that the shift of premiums from the traditional insurance market to alternative market vehicles like captives would continue whether New York had a captive law or not. A competitive captive law would provide an incentive for companies to form their captives in New York or move their existing captives here. It would also mean that
New York risks that were being insured through captives domiciled in other states could be insured through captives here. There was also the economic development argument. Proponents of the bill claimed that captives would provide some direct employment themselves, and that they would produce business for captive management firms.

The original bill started as a legislative proposal by the New York State Insurance Department and eventually was introduced as legislation in the spring 1996 session. The Tax Department was asked to provide technical assistance in the drafting of the tax provisions of the bill and did so. The proposed captive premiums tax was based on that imposed by Vermont to ensure that New York would be competitive with Vermont on captive tax treatment. The bill had the support of the state’s business community but did not pass until the next year’s session. The 1997 bill, which was virtually the same as the one that had preceded it, was enacted as part of the 1997-98 State Budget along with a number of other corporate tax provisions. These included some insurance tax provisions like the creation of New York’s first CAPCO program and a reduction in tax rates for life insurers.

*Treatment Under the Law*

The captive insurance provisions were codified under Article 70 of the Insurance Law and Section 1502-b of Article 33 the Tax Law. The law provides for the formation of both pure and group captive insurers. Any entity forming a captive in New York must have a net worth of at least $100 million. Captives must meet minimum capitalization and reserve requirements. Pure captives must be initially funded with and must always maintain at least $250,000 in paid-in capital and surplus, while for group captives the amount is $500,000. There are virtually no restrictions on investments by captives, as long as solvency is not threatened. Notably, a pure captive is allowed to make loans to its parent and affiliates.

Captives are subject to a tax on premiums at graduated rates. The top rate is 0.4 percent on the first $20 million of direct premiums. There are three other tax brackets, but the rate goes down instead of up after the first $20 million. The rate on highest bracket, which is for premiums in excess of $60 million, is only 0.075 percent. Reinsurance premiums are subject to the same tax brackets but at lower rates. Unless stated otherwise, it is assumed that all premiums
are allocable to New York. There is a minimum tax of $5,000. Captives are not taxed on any other income except for premiums. A captive cannot be required to file on a combined basis with its parent.

The Insurance Department is responsible for the licensing and regulation of captives. Although captives are not subject to the same level of regulation as other insurers, they still have requirements to meet under the law. These include the filing of an annual report, periodic financial examination, and the maintenance of sufficient reserves, among others. The premiums tax is administered by the Tax Department. A captive may have its license suspended or revoked by the Insurance Department for failure to meet any of its requirements under the law, or if it is determined that it is in the best interests of the public or the policyholders of the captive.

*The Original Revenue Estimations*

The first estimate for the fiscal impact of the captive insurance program was drafted when the original bill was introduced in 1996. The most obvious impact was the potential revenue gain from the captive premiums tax. To formulate an estimate, we needed an idea of how much the captive market in New York would grow once the law was in place. We relied on the projections the Insurance Department had made for potential captive premium growth. It was estimated at the time that $650 million was being paid to captives outside the state to cover New York risks. Based on this, it was thought that New York captive insurers would generate $400 million in premiums in the first year of the program. The number was estimated to grow to $1.2 billion by year three, and close to $5 billion in ten years. This assumed a growth rate of seven percent, based on industry sources.

These premium projections seem very optimistic in hindsight. It was thought that the New York captive market would grow at a rate at least equal to that of Vermont, and that New York would eventually catch up with our neighbor in ten years. Even if captive premiums were this high, though, the captive tax would not generate much revenue because the rates would be so low. The effective rate for Vermont’s captive tax at the time was 0.35 percent. The rate was then applied to the amount of projected premiums. As a result, it was estimated that a New York
captive tax would bring in $1.4 million the first year, growing to $4.2 million by year three of the program.

However, we believed the bill would result in a net revenue loss, as the gain from the captive tax would more than be offset by declines in other corporate taxes. The state would lose revenue from the corporate franchise tax because captive parents would be able to take a federal deduction for premiums paid to the captive, which would flow through to New York. The insurance franchise tax would be affected due to the flow of premiums from the traditional market to the captive market. Because premiums received by captives would be taxed at a much lower rate than under the franchise tax, the revenue generated would be less. At the time, the insurance franchise tax also imposed a tax on the net income of all insurance companies. The computation of the tax on net income started with federal taxable income, which included premiums earned.

To estimate the potential revenue loss, we looked again at the amount of projected premiums. It was assumed that 80 percent of these premiums would have nexus with New York, and that 10 percent would be allocated here. The tax rate of 9 percent was then applied to the result. This was the tax rate on net income rate under the corporate franchise tax and the insurance franchise tax. The difference between the estimated gain from the captive tax and the loss from other corporate taxes would be the fiscal impact. The net result was an estimated revenue loss of $1.5 million in the first year, growing to $4.4 million by year three.

Proponents of the bill did not believe that there would be a revenue loss, and in fact said that it would increase revenues. The argument was that New York was already losing revenue because of the shift of New York premiums to captives in other states. The captive tax revenues and potential economic development associated with captives would outweigh any revenue loss that did occur. We did not take into account any economic development factors in our estimate. It was felt that any such effect would be minimal and that it was impossible to quantify anyway.

History of Captive Growth

The growth in New York’s captive insurance program did not exactly live up to these optimistic expectations. The captive law took effect in December of 1997, with the tax
provisions of the law effective for tax years beginning on or after January 1, 1998. The State’s first two captives were licensed in December of 1997. One was formed by a public entity, the Metropolitan Transportation Authority (MTA), and was exempt from the captive tax. The law specifically authorized the MTA to be the only public entity allowed to form a captive. The other was a privately owned captive formed by an upstate manufacturer. However, there were no captives formed throughout the whole of 1998, and so for the first year of the program we had only one captive taxpayer.

The situation did not change for the next three years. From 1999 to 2001 there was still only one filer, and this captive brought in almost no revenue. The parent, who was not a prominent or well-known taxpayer, paid the captive an average of only about $1 million in premiums each year. The captive wound up paying the minimum tax of $5,000 more than once during this period. It was not until 2002 that there was any growth at all, when two other captives were licensed. This was the first year that captive tax revenues reached above minimal levels, which for our purposes is more than $100,000. One of the new captives generated nearly $50 million in premiums, contributing to revenues from the tax growing to near $200,000.

The next couple of years saw significant growth in the captive program. There were twelve new captives formed in 2003 and thirteen more in 2004. Many of the parents of these new captives were large and prominent multinational corporations, and most of them had a significant tax liability in New York. The dramatic growth in the number of captives led to an equally dramatic growth in the revenue generated by the captive tax. There were fifteen captive tax filers in 2003, the latest tax year for which we have complete data. The amount of captive premiums collected in 2003 was $233 million, and total tax liability was $0.7 million. This seems significant compared to prior years, but the total liability for the captive tax is still less than $1 million. Even with the additional captive filers for 2004, it is not likely total liability will exceed $2 million. The captive tax is thus nowhere near being a significant source of revenue.

The significant recent captive growth may be partially due to increased efforts by our Insurance Department to promote the program. The Insurance Department was the strongest supporter for the captive law, and in early 2003 launched a new captive initiative. A new captive group was formed dedicated to promoting and working with captive insurance in New York. They also launched a new captive website designed to facilitate the application process. One of
the goals was to have all captive applications processed in full within thirty days of receipt. These increased efforts to promote New York captives undoubtedly contributed to the growth we have seen in the last two years.

*Proposals for Expansion of Captive Insurance*

There have been efforts in the last few years to expand the scope of the captive insurance provisions. These efforts have been largely supported by the Insurance Department as a way to encourage additional growth in the state’s captive market. Legislation was first proposed in 2002 that would allow a wider range of businesses to form captive insurers. The proposed bill has been introduced in each of the last three years as well, but has never advanced very far in the Legislature.

The bill would authorize the formation of sponsored captives in New York. Sponsored captives are a recent invention, in which multiple sponsors provide capitalization required for the formation of the captive. Each participant’s risk is individually segregated and protected within the captive. The sponsors are the shareholders and can be participants in the company, although a participant does not necessarily need to be a sponsor. All business of a sponsored captive would be required to be fronted by a regular insurer licensed in any state and backed by an authorized New York reinsurer. The captive sponsors would obtain coverage through the regular insurer, which would cede the risk to a captive reinsurer in New York.

The bill would also make it easier to form pure and group captives in New York by easing eligibility requirements for captive parents. These provisions are designed to encourage small businesses to form captives. The threshold for forming a pure captive would be lowered from $100 million in net worth to $25 million in annual revenues. The threshold for forming a group captive would be lowered from $100 million in net worth to a new three-part standard. A company forming a group captive would need to employ a full-time risk manager, pay at least $25,000 annually in premiums, and have at least 25 employees.

Public entities as defined in the bill would also be authorized to form captives. Any state agency, board, commission, or any other state entity would be able to form a captive, as well as any governmental entity that operates a college or university. A public corporation created
pursuant to an agreement with another state or with Canada would also qualify. Any captive formed by a public entity would be exempt from taxes or payments in lieu of taxes.

*Captive Insurers as Tax Shelters*

New York has become increasingly concerned in the last few years about the potential for New York taxpayers to use captive insurers as tax shelter devices. When the captive law was first being drafted in 1996, we were aware that captives offered a tax loophole for corporations. This issue had surfaced on the federal level and it was thought it might eventually become a problem for New York in the future. However, the issue that generated more concern at the time was the potential loss of revenue stemming from the transfer of risks from traditional insurers to captives.

A tax shelter can be created through the transfer of income-producing assets from a parent corporation to the captive. These assets are usually intangible in nature, such as patents and trademarks. The result is that the insurer is capitalized to an extent far greater than that necessary to maintain solvency and pay claims. The captive makes a loan back to the parent for the excess of its capitalization, and receives interest from the parent on the loan. The parent pays the captive royalties for the use of the intangible assets in addition to the premiums paid for insurance. The income earned by the captive on the assets is distributed back to the parent in the form of dividends.

The tax effects for New York turn the captive into what is basically an intangible holding company, but one located in our own state. The parent is able to expense the interest, royalties, and premiums paid to the captive on its federal return. On the state level, the parent is subject to tax on its net income under the corporate franchise tax. Because the computation of New York entire net income starts with federal taxable income, the deduction flows through to New York. It also is able to escape taxation on the dividends received from the captive. This is because New York provides a deduction from federal taxable income for dividends received from subsidiaries. The captive itself is subject only to the captive premiums tax, and cannot be combined with its parent under the Tax Law.
There is definitely awareness among corporate taxpayers of the possibility of using these so-called “fat captives”. As early as 2001, both the Tax Department and the Insurance Department received inquiries from tax practitioners as to the State’s treatment of assets held by captives. The concern has been whether the State would take a negative view toward a captive that held substantial assets of its parent or received significant non-premium income. We have also received requests from prospective captive parents to rule that captives can only be taxed on premiums, despite the clear nature of the law. These types of concerns seem to indicate that the parents of these captives may be considering the possible tax planning strategies.

*Other Closely-held Insurance Affiliates as Tax Shelters*

There is also a concern with other closely-held insurance affiliates besides captives. Insurance companies licensed and doing business in New York are subject to the Insurance Franchise Tax under Article 33 of the Tax Law. At the time the captive law was enacted, all insurance taxpayers were subject to a tax based on net income as well as a premiums tax. However, tax law changes in 2003 provided that only life insurers will continue to be subject to the income-based part of the franchise tax. The law changes greatly simplified the taxation of non-life insurers. It also brought New York more into line with the majority of states that tax only the premiums of insurance companies.

The law changes also created a new tax planning opportunity for corporate taxpayers. A large corporation can now potentially use a property and casualty insurance affiliate to shelter assets in the same way it can use a captive insurer. The mechanics of the tax shelter would effectively be the same, although such an arrangement would likely be less attractive. A traditional insurance company would not be given the same preferential tax and regulatory treatment under the law as a captive. The tax rate for property and casualty premiums is two percent, five times higher than the nominal captive rate. The affiliate would also be subject to all the licensing and reporting requirements as any other insurance company under the Insurance Law.
The Potential Fiscal Impact

It is likely that the tax planning opportunities offered by captive insurers, as well as other insurance affiliates, may result in a significant fiscal impact if corporate taxpayers take full advantage of them. However, it is not clear this has become a major problem as yet. We still have limited information to go on right now, but there is no solid evidence that widespread tax sheltering is currently taking place. It may be that any current abuse is limited a few taxpayers and has not yet grown to be a major problem. The potential for abuse is clear, though, and a significant amount of revenue could potentially be lost if corporations begin sheltering large amounts of income through their insurance affiliates.

In estimating the potential fiscal impact, we have been hampered by the fact that we have little historical data on captive insurance. We have only one full year of data on the captive tax since the recent growth in the program. Captive return data may not tell us much anyway, as they are only required to report total premiums. However, captives are also required to give us copies of their federal return and the annual statement they file with the Insurance Department. These contain a great deal of information that is not present on the captive tax return, although captives do not always comply with this requirement. We have also looked at the returns of the captive parent to see any effect of possible sheltering activities.

For similar reasons, we do not have a definitive idea of how the proposed expansion of the captive program may affect revenues. The state would lose any revenue from taxes on premiums paid to cover the risks of public entities if these entities start insuring through captives. The same effect would occur with private companies that would be able to form captives that could not now. Of course, it would exacerbate any problems that might occur with tax sheltering. However, we do not have enough data to determine how this bill may affect the captive program if it ever becomes law.

The estimate that we have was based on the tax due for companies it was thought might decide to use a captive insurer as a tax shelter. A company must have a net worth of at least $100 million to form a captive, so those companies that didn’t meet this threshold were eliminated from the analysis. The population of companies eligible to form a captive was further pared back by the number of companies that were believed to already be using an intangible...
holding company. The result was an estimated maximum impact of $500-700 million on an annual basis. This would be a worst-case scenario, though. Further assumptions were made regarding the likelihood of new captive formation and the amount of income that would be sheltered. It is believed an annual impact of approximately $200 million is more realistic.

This estimate is very uncertain due to the fact that so many assumptions were involved. However, anecdotal evidence suggests that a fiscal impact in the hundreds of millions is certainly possible. There are a couple of notable individual cases where we have seen specific evidence of potential problems. In one instance, a parent company wanted the Tax Department’s blessing on certain transactions between them and their captive before the captive filed its first return. The captive in question was clearly overfunded and we felt the risks that were being insured were dubious. Based on this, as well as recent history with this taxpayer, we responded that we could give no assurances as to any possible action on our part. The parent company has since dissolved this captive.

In another instance, analysis of a captive’s annual statement and federal return showed it received hundreds of millions in royalty income, but only a few million in premiums. This was the first year that it was licensed as a captive and filing a captive return. A look at the parent company showed that it had a significant tax liability in New York until the year it formed the captive, in which it paid the fixed dollar minimum tax. In this case, it was rather obvious that the captive was holding substantial assets of its parent, and it appeared these assets were not being taxed by the state. These transactions may be subject to adjustment on the return of the captive parent on audit.

Possible Remedies

The tax status of a captive insurer cannot be challenged. The Tax Law is clear that a captive can only be taxed on premiums and cannot be combined with its parent corporation. The same is true for other closely-held insurance affiliates. However, there are other options available to address these issues under the current Tax Law. If it is believed the shifting of assets to the captive has distorted the tax liability of the parent company, or if the transaction lacks business purpose or economic substance, the Tax Law gives us authority to address the distortion
at the level of the parent company. Possible actions include adjusting items of income, deduction and capital, and eliminating assets in computing any allocation percentage. It is likely that these types of adjustments would generate significant opposition from taxpayers, and would eventually lead to litigation over the matter.

Discretionary authority can only go so far. A permanent solution to the problem will require a legislative fix to close the loophole in the law. It would be preferable to do this in a way that prevents tax sheltering but permits legitimate transactions with captives or closely-held insurance affiliates. One way to do this is to apply an asset test to the insurer. An asset test would measure the level of capitalization of the insurer by comparing the amount of premiums received and risk involved with the amount and nature of the insurer’s assets. If the insurer is deemed to be overcapitalized by a threshold percentage based on this test, then either the parent or the insurer would be subject to specific remedies provided under the law to correct the distortion. A similar option would use gross receipts as the basis for the test instead of assets.

There are several options for remedies when dealing with a captive or closely-held insurance affiliate that is overcapitalized. An ideal solution would erase the benefits realized by the parents of these insurers, and so reduce the incentive for future abuse. One option is to require taxpayers to add back premiums, royalties, interest, or other expenses associated with funding the insurer that were deducted in computing federal taxable income. Another option is to partially or wholly disallow a deduction for subsidiary capital for dividends from the insurer. The law could also require non-premium income earned by the insurer to be attributed to the parent. Legislation that codified one or all of these requirements would go a long way toward preventing abusive transactions.

The Tax Department has considered some of these ideas as possible remedies. Currently, we have taken the position that we will use the discretionary authority available under the Tax Law in situations where it is appropriate.

Conclusion

It is likely that New York will continue to see growth in the state’s captive insurance market in the foreseeable future, although it appears we will not rival Vermont as a captive
domicile anytime soon. How much growth will depend on the overall captive market as a whole, and whether the state will continue to be seen as an attractive captive domicile. There are indications the overall market may be slowing. The licensing of new captives will likely further increase in any case if the program is expanded to allow more businesses to form captives. Whether any newly formed entities will be used for legitimate insurance purposes or as tax shelter devices cannot be known. There is also no real way to know if a significant problem will develop with other insurance affiliates.

There is still not much evidence to back up the claim that insurance tax abuse may have a large fiscal impact for the state. Because of this, it will be more difficult to support a legislative change to fix the problem. However, the reality of the situation, one way or another, will become more apparent as time goes on. There has already been some anecdotal evidence that this could be a real problem if left unchecked. As more data becomes available, it will undoubtedly become clear whether or not a significant problem with insurance tax abuse has developed. Until such time as a legislative fix is implemented, we will continue to use the authority given under the current law to make adjustments in individual cases where this issue presents itself.

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