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# Self Procurement Taxes

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# Agenda

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- What is a Procurement tax
- Todd Shipyards & Dodd Frank
- Washington Initiative
  - Microsoft
  - Costco Settlement
  - What other unknowns?
- Johnson & Johnson – New Jersey
- Illinois
- Macy's
- Questions

# What is a Procurement tax

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- A procurement tax is a tax to the insured entities on gross premium paid to nonadmitted (unauthorized out of state) insurance companies that was obtained without a broker.
- Approximately 80% of the states have a form of procurement tax.
- By using a nonadmitted carrier, the insured has no access to the state's insurance department resources or associations in case of a default or insolvency
- States discourage using nonadmitted carriers through the self-procurement tax

# Procurement taxes by state

<u>State</u>	<u>Procurement Tax Rate</u>	<u>State</u>	<u>Procurement Tax Rate</u>	<u>State</u>	<u>Procurement Tax Rate</u>
Alabama	4%	Kentucky	2%	North Dakota	1.75%
Alaska	3.7%	Louisiana	4.85%	Ohio	5%
Arizona	3%	Maine	3%	Oklahoma	6%
Arkansas	2%	Maryland	3%	Oregon	2%
California	3%	Massachusetts		Pennsylvania	3%
Colorado	3%	Michigan	2%	Rhode Island	4%
Connecticut	4%	Minnesota	2%	South Carolina	
Delaware	3%	Mississippi	3%	South Dakota	2.5%
District of Columbia		Missouri	5%	Tennessee	5%
Florida	5%	Montana	2.75%	Texas	4.85%
Georgia	4%	Nebraska	3%	Utah	4.25%
Hawaii	4.68%	Nevada	3.5%	Vermont	3%
Idaho	1.5%	New Hampshire	4%	Virginia	
Illinois	3.5%	New Jersey	5%	Washington	
Indiana		New Mexico	3.003%	West Virginia	
Iowa	1%	New York	3.6%	Wisconsin	3%
Kansas		North Carolina	5%	Wyoming	3%

*The general procurement tax rates disclosed above are for discussion purposes. Please note that other fees, taxes and exceptions may apply. Consult your tax adviser or the state statute prior to remitting tax.*

# Nexus Standards

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- In general, in order for a state to have authority to tax an entity such as an insurance company, the entity needs to have sufficient nexus, or connections, with the state.
- The nexus standards applicable to procurement taxes differ from the income tax nexus standards.
- In 1868, the Supreme Court ruled in *Paul v. Virginia* that the interstate commerce clause did not apply to the insurance industry. 75 U.S. 357 (1868).
- Unlike other industries the business of insurance is regulated by the states and is not subject to federal interstate commerce regulation – insurance is not commerce.
- *New York Life Insurance Co. v. Deer Lodge County* reaffirmed that the insurance industry is only subject to state regulation. 231 U.S. 495 (1913).
- Then in 1944 the Supreme Court ruling *United States v. South-Eastern Underwriters Ass'n.*, held that insurance was in fact interstate commerce which Congress could regulate under the Commerce Clause. 322 U.S. 533 (1944).

# Nexus Standards

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- With the contradictory Supreme Court ruling, clarification was needed regarding whether and to what extent the states could continue to regulate and tax insurance companies.
- As a result, in 1945 the *McCarran Ferguson Act*, 59 Stat. 33 (1945), was passed leaving the authority of regulation and taxation of insurance up to states without the restrictions of the Commerce Clause.
- Therefore an analysis of nexus is left up to the Due Process and Equal Protection Clauses of the Fourteenth amendment.

# Nexus Standards – Todd Shipyards

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- In *State Board of Insurance v. Todd Shipyards Corp.*, 370 U.S. 451 (1962), the Texas Board of Insurance levied and collected self-procurement taxes on a New York domiciled company that insured property in Texas.
- Facts:
  - Policies issued outside of Texas
  - Adjusted and paid outside of Texas
  - Insurers did not solicit business in Texas
  - Insurers had no agents in Texas
  - Insurers did not investigate risks or claims in Texas
- Although the Due Process Clause nexus standard is much lower than the Commerce Clause, The United States Supreme Court held that merely insuring a risk in a state was not sufficient activity under the Due Process Clause to subject a company to a procurement tax.

# Nexus Standards – Todd Shipyards

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- Although *Todd Shipyards* is still good law, the Supreme Court of Rhode Island argued that use of correspondence directed to insured entities in Rhode Island was sufficient to provide Due Process nexus for a procurement tax. *Associated Elec. & Gas Ins. Services, Ltd. v. Clark*, 676 A. 2d 1357 (1996).
- *Generally, there is a risk that sufficient activities will be conducted in the home state of the insured entities when officers of such entities are also officers of the captive.*
- Then in 2001, a case with similar fact patterns to *Todd Shipyards* reaffirmed that the ruling in *Todd Shipyards* is the current law and precedent.



# Dodd-Frank Implications

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- The federal Nonadmitted and Reinsurance Reform Act (NRRA) which was part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203 (July 21, 2010), did not specifically exclude captive insurance companies and many states have used this to justify imposing self-procurement taxes on the insured entities in their states.
- A number of states, generally captive domicile states, have argued that Dodd-Frank does not apply to captive insurance companies, however, these public statements are not binding on the states.

# Home state defined under NRRA

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- (6) HOME STATE. -
- (A) IN GENERAL. - Except as provided in subparagraph (B), the term "home State" means, with respect to an insured-
- (i) the State in which an insured maintains its principal place of business or, in the case of an individual, the individual's principal residence; or
- (ii) if 100 percent of the insured risk is located out of the State referred to in clause (i), the State to which the greatest percentage of the insured's taxable premium for that insurance contract is allocated.
- (B) Affiliated groups. - If more than 1 insured from an affiliated group are named insureds on a single nonadmitted insurance contract, the term "home State" means the home State, as determined pursuant to subparagraph (A), of the member of the affiliated group that has the largest percentage of premium attributed to it under such insurance contract.
- §527(6) of the Nonadmitted and Reinsurance Reform Act of 2010.

# Washington Initiative

# Microsoft

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- The state of Washington asserted premium tax on transactions between Microsoft and its Arizona captive.
- Case has been settled at approximately 50% of amount originally proposed with Microsoft agreeing to place all its future Washington risk covered by its Arizona captive through a Washington surplus lines broker resulting in its payment of a 2% of Washington premium annual tax.
- Washington state insurance department has requested all who are similarly situated to submit information on their captives covering Washington risks.
- The recently published notice (next slides) outlines the position they plan to take depending upon the date on which they are approached.

# Costco Settlement

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- On March 8, 2019, NW Re Limited, of Phoenix (“NW Re”) reached a settlement with the Washington State Insurance Commissioner, agreeing to pay **\$2.4 million** in unpaid premium taxes and **\$1.2 million** in fines, tax penalties, and interest.
- The Arizona-domiciled captive insurance company – whose sole insured and parent company, Costco Wholesale Corporation, is headquartered in Issaquah, Washington – provided deductible reimbursement for its parent company’s liability and workers’ compensation from 2000 until 2019 *without authorization*.
- However, in December 2018, NW Re self-reported its unauthorized activity to avoid even greater fines and penalties, as outlined by the Washington Insurance Commissioner
- The Office of the Insurance Commissioner has collected roughly \$4.4 million since announcing its plan for increased regulation of the captive industry.

# Washington – Self Reporting

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- Between 1/1/2019 and 6/30/2019: 100% tax on premium, 100% interest plus 25% of tax penalty, plus **\$25,000** fine
- Between 7/1/2019 and 12/31/2019: same regarding tax and interest but 50% of tax penalty plus **\$100,000** fine
- Between 1/1/2020 and 6/30/2020: same regarding tax and interest but 70% of tax penalty and **use of full fining authority**
- 7/1/2020 or thereafter: same as to tax and interest **but 100%** of tax penalty and **full fining authority**
  
- What other unknowns?

# Johnson & Johnson

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- The Tax Court of New Jersey
  - Middlesex Assurance Company – VT domiciled captive
  - Paid New Jersey independent procurement taxes in addition to VT premium tax
  - Denial of \$56 million refund claim
  - Argued NRRA was not intended to apply to self-procured insurers
  - Judge Mary Siobhan sided with New Jersey's Division of Taxation

# Illinois

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- Illinois imposed an Industrial insured statute with a “0” tax associated with it
- An income tax imposed on foreign captive with Illinois nexus with respect to Illinois risk
- An advantageous situation after Dodd-Frank as no home state tax was imposed
- Illinois passed law effective January 1, 2017 similar to other states imposing a direct procurement tax at a rate of 3.5% on industrial insured placements
  - Ilcs § 5/121-2 provides that it is unlawful to conduct insurance business in state without a license unless transaction described in sections of insurance law which include industrial insured transactions
- Prior to amendment industrial insured had to act by use of services of a full-time employee acting as insurance manager or through a continuously retained qualified insurance consultant.



# Illinois

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- The new law required a full-time employee needs to be a qualified risk manager (QRM) and, it defined QRM to mandate significant educational or experience requirements. (215 ILCS 5/121-2.08)
- Prior Illinois law required an industrial insured to have 25 full-time employees, gross assets >\$3 million or gross annual revenues >\$5 million
- 2017 law changes term to exempt commercial purchaser (“ECP”) with significantly greater premium, reserve, net worth or number of employee requirements
- New law proposed to reduce direct placement tax to .5% among other provisions

# Macy's

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- **Facts:**

- Captive domiciled in Vermont – *Leadville Insurance Company*
- 2010 Maryland audit of a Macy's subsidiary - *MRHI*
- *MRHI* -
  - \$2 billion deduction on subsidiary for intercompany interest paid to captive
  - \$52 million in insurance premiums paid to captive
- Leadville paid premium taxes to VT
  - No taxes paid to Maryland
- **Maryland assessed Leadville with more than \$23.8 million in taxes, penalties and interest for the tax years 1996 to 2003.**

# Macy's

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- **Response:**

- Leadville appealed
- Claim: it was an insurance company it is exempt from income tax under Maryland law.
- However, conceded to not being licensed in Maryland to conduct the business of insurance.
  - No business in MD
  - No agents in MD
  - No claims in MD
- No connection in Maryland to subject them to taxation.
- **Result:** Lost on appeal before Comptroller and appealed to Maryland Tax Court.

# Macy's

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- **Maryland Tax Court:**

- Agreed Leadville was not subject to tax because it was an insurance company.
- Comptroller then appealed to the opinion of the **Court of Special Appeals of Maryland.**

- **The Court noted:**

- Maryland imposes an income tax but exempts insurance companies
- Instead they pay premium tax on insurance revenues
- This only applies to authorized insurance companies
- **Unauthorized insurance companies are instead taxed on their revenues as if they were an ordinary corporation.**
- Leadville claimed that as a reinsurer it could be an authorized insurance company even without holding a MD certificate of authority.
- The Court disagreed, noting the plain language in the statute and lack of an exception for reinsurance companies, **Leadville was an unauthorized insurance company.**

# Macy's

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- **Rebuttal:**

- Leadville argued it should not be subject to the income tax for non-insurance companies, and if at all should pay the premium tax.
- Sited a Maryland Tax Court decision that unauthorized insurers are not subject to the corporate income tax.
- The Court of Special Appeals was not impressed with how in-depth the Tax Court considered the issue
- They sent the case back to the Tax Court
- Instructions to look more closely at whether Leadville would be exempt or not from the Maryland corporate income tax.

**Questions?**

# Disclaimer

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- The information provided herein is educational in nature and is based on authorities that are subject to change. You should contact your tax adviser regarding application of the information provided to your specific facts and circumstances.



# Thank you

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