

Taxing Captive Insurance

Briefly

Captive insurers are insurance companies that are controlled by the company, group, public entity, or individual they insure. They can provide a less costly way to manage risk. Current law in Washington does not recognize captive insurers as a distinct form of self-insurance that is different from commercial insurance. The Office of the Insurance Commissioner has begun an effort to subject captive insurers to insurance premium taxes.

If Washington is going to regulate captive insurers, it should do so along the lines of the new, bipartisan SB 5315 (which is similar to E2SSB 6331 from 2020). Such a bill would increase state revenues while not making captive insurance so costly as to negate its benefits.

Businesses carry various types of insurance, as a normal part of their operations. Companies and other entities may decide to manage risk through a captive insurer. A captive insurer is defined by the Office of the Insurance Commissioner (OIC) as “an insurance company that is controlled by its insured” (OIC n.d.a). An entity might use a captive rather than a commercial insurer because, for example, commercial coverage is too costly or may not even be available for some types of risk. There may also be some tax advantages.

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National Treatment

According to the National Association of Insurance Commissioners (NAIC), there were 4,207 captive insurers in the U.S. in 2019, in 33 states and the District of Columbia, with total premiums of \$80.2 billion (NAIC 2020). (These figures do not include any information for Washington. NAIC notes, “Often, a captive is domiciled in a different state than where it writes its business. Many captive insurers only report premium to their domiciliary state, and it can be difficult, if not impossible, for non-domiciliary states to provide allocations of premium written within their state” (NAIC 2020).)

Tax Advantages. Businesses may deduct business insurance expenses from their federal income taxes. Such expenses include claim reserves on premiums paid to a qualifying captive insurer if it meets certain risk distribution and risk transfer thresholds. This allows businesses to deduct future claim expenses in the current period. The premiums remain with the captive. If the captive insurer issues dividends to the parent company, those dividends may be subject to a lower income tax rate than ordinary income. (However, the value of these benefits depend on the company’s actual loss experience and current corporate tax rates.)

Additionally, under Sec. 831(b) of the federal internal revenue code, small captive insurers may be taxed

on their investment income only, and not the premiums they are paid.

Current Treatment in Washington

Generally, insurance companies must pay a 2% tax on premiums (RCW 48.14.020). However, the OIC notes, “Washington state law does not have a regulatory framework for captive insurance companies that insure Washington-state risks. Captive insurance is considered unauthorized insurance in Washington” (OIC n.d.a).

In recent years, the OIC has acted to try to change that:

- August 2018: Microsoft’s captive insurer paid \$876,820 in unpaid premium taxes and penalties. Commissioner Mike Kreidler said, “Captives are a gray area in state law and this is the first case where we’ve tested them” (OIC 2018a).
- December 2018: Kreidler asked captive insurance companies to self-report in exchange for reduced fines and tax penalties (OIC 2018b).
- March 2019: Costco’s captive insurer paid \$3.6 million in taxes and penalties (OIC 2019a).
- September 2019: Alaska Air’s captive insurer was ordered to pay more than \$2.5 million in taxes and penalties (OIC 2019b). However, the order was challenged and later rescinded (OIC n.d.b).
- December 2019: Kreidler ordered Starbucks’s captive insurer to pay \$23.9 million in taxes and penalties (OIC 2019c). The order was challenged and later rescinded (OIC n.d.c).

According to the OIC, through December 2019, “16 captives have self-reported and two captives have paid \$2.9 million in unpaid premium taxes and \$1.4 million in fines, tax penalties and interest” (OIC 2019c).

In 2020, the OIC contracted with Milliman “to conduct a survey and study to help understand the captive insurance market in Washington” (OIC n.d.a). According to the OIC, “The information gathered will not identify organizations failing to pay the premium tax but will show an overall projected amount owed” (OIC 2020).

The study has not yet been published, but captive insurance is one of the OIC’s five priorities for the 2021 legislative session (OIC n.d.a).

2020 Legislation

In 2020, two bills on captive insurance were introduced in the Legislature; neither was enacted.

SB 6241. The OIC requested this bill, which was not passed by either house. The bill would have required captive insurance companies to register and pay the 2% premium tax. The tax would have been computed on the entire premium, “without regard to whether the policy covers risk or exposures that are located in this state.” It also would have authorized “independent procurement” (i.e., the insured could purchase the insurance without going through a licensed insurance agent or broker).

In the fiscal note, the OIC noted that it “does not have data concerning the number of companies which may utilize independent procurement.” Nevertheless, the OIC estimated that this would increase revenues by \$90.3 million in 2021–23 and \$76.2 million in 2023–25 and thereafter.

E2SSB 6331. At the end of the 2020 legislative session, with business support, E2SSB 6331 was included

in the final budget deal. The bill had been passed unanimously by the Senate, but the House ultimately failed to pass it.

The bill would have required captive insurers to register with the OIC and pay a \$2,500 fee annually. Captive insurers would have had to pay the 2% premium tax “for insurance directly procured by and provided to its parent or another affiliate *for Washington risks* during the preceding calendar year.” (Emphasis added.) The tax would have been retroactive to Jan. 1, 2010. (The captive insurers of a public institution of higher education would have been exempt from the premium tax.)

In the fiscal note, the OIC estimated that the premium tax could increase state revenues by \$9.5 million in 2021–23 and \$7.7 million in 2023–25 and thereafter. Collections of the tax back to 2010 could increase revenues by \$30.0 million, and the registration fees were estimated to bring in \$1.4 million a year.

2021 Legislation

This session, a bipartisan bill (SB 5315) has been introduced that would establish “a framework for registration by captive insurers that insure Washington-based entities and are licensed by the jurisdictions in which they are domiciled.” Under the bill, certain captive insurers (with assets that exceed liabilities by at least \$1 million and whose insured principally do business in Washington) would have to register with the OIC and pay a \$2,500 fee annually.

As in E2SSB 6331, SB 5315 would also require registered captive insurers to pay the 2% premium tax “for insurance directly procured by and provided to its parent or another affiliate for Washington risks during the preceding calendar year.” The tax would be retroactive to Jan. 1, 2011.

A proposed substitute bill was heard by the Senate Committee on Business, Financial Services & Trade on Jan. 26. (The proposed substitute is identical to SB 5315 as introduced, except it would exempt from the premium tax the captive insurers of public higher education institutions.) At the hearing, the OIC and representatives from the business community testified in support of the bill.

There is no fiscal note for the bill yet. However, at the hearing, the OIC said that they expect that collections of the tax for the lookback period would increase state revenues by about \$29 million. Going forward, the OIC said revenues could increase by about \$2–\$2.6 million a year. Sen. Mullet said that producing the fiscal note for this bill has been a challenge because, “going back to the fall of 2019, a couple of large businesses suspended their captives, but I think our understanding is that they will restart if this bill passes.” Indeed, a business lobbyist at the hearing said that if the bill passes, some companies would restart, which would bring annual collections of the tax closer to \$5 million.

Comment

The lack of regulatory oversight for captive insurers is not obviously a problem—with captive insurers, consumer protection is not an issue (the consumer and the insurer are one and the same), and the captives are already regulated by their states of domicile for basic solvency and accounting compliance. The goal, then, is to increase state revenues. To that end, if Washington is going to regulate captive insurers, it should do so along the lines of the bipartisan SB 5315 (similar to E2SSB 6331 from 2020). Although OIC estimated that SB 6241 would have yielded more revenues for the state than E2SSB 6331, that estimate did not consider the likelihood that many companies would stop, and indeed already have stopped, using captive insurers if the costs are too high. In that case, the state would not collect any new revenues.

When companies use captive insurers, they improve their risk management, fill gaps in insurance coverage (e.g., when they can't get the coverage they need on the market), and may reap federal tax benefits. It would be a loss to those companies—and our economy—if new state taxes were so high as to negate those benefits.

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