MILLIMAN REPORT

Captive Insurance Study

Washington State Department of Revenue and Office of Insurance Commissioner

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I. Background, Scope, and Intended Purpose

A. Background

The state of Washington provided us with the following background information:

> "The Washington state ("Washington" or "the State") insurance market is the 35th largest in the world, and insurance is the 8th largest industry in the State, with $47 billion in annual premiums. Insurance Commissioner Mike Kreidler protects consumers through fair and effective regulation of the insurance industry and collected over $1.2 billion in insurance premium taxes over the past 2 fiscal years for the general fund. State law requires Commissioner Kreidler to collect premium taxes on most insurance transactions.
>
> In 2018, Commissioner Kreidler discovered some Washington companies had created captive insurance companies in other states to cover Washington insurance risk without paying premium taxes on these risks. Captive insurance activity is legally designated as unauthorized insurance activity and a violation of State insurance code.
>
> In 2018, Commissioner Kreidler found that Microsoft's captive, Cypress Insurance Co., engaged in the unauthorized business of insurance from 2009 through 2018, owing $573,403 in unpaid premium taxes. Cypress Insurance Co. acknowledged its unauthorized activity and in September 2018 paid all unpaid premium taxes and $302,915 in interest and penalties. All $876,318 collected for this unauthorized activity went to the State's general fund.
>
> In 2019, Commissioner Kreidler found Costco's captive, NW RE Limited, engaged in the unauthorized business of insurance from 2008 through 2019, owing $2,392,907 in unpaid premium taxes. NW Re Limited acknowledged its unauthorized activity and in April 2019 paid all unpaid premium taxes and $1,241,188 in interest and penalties. All $3,634,095 collected for this unauthorized activity went to the general fund.
>
> During the 2020 legislative session, at the request of legislative leadership, Commissioner Kreidler discontinued enforcement action against Alaska Airlines' and Starbucks' captive insurers, pending completion of a study on captive insurance to understand, among other things, the extent of the use of captive

> insurance in Washington and options for regulating and taxing captive insurance in Washington."[1]

Specifically, together with the Washington Department of Revenue ("DOR"), the Office of Insurance Commissioner ("OIC") was asked to study the taxation and regulation of captive insurance more closely with the help of outside, independent captive insurance experts. In April of 2020, the State issued Request for Quotes and Qualifications ("RFQQ") #S202107 seeking proposals to conduct a study on captive insurance on behalf of the OIC and DOR (collectively referred to as the "Agencies" or "AGENCIES").

Milliman, Inc. ("Milliman") responded to the RFQQ and was awarded the contract in June of 2020. The final contract for the study was executed on July 29, 2020. Milliman is a Washington-headquartered consulting firm specializing in actuarial and other insurance and risk financing related matters. Milliman has subcontracted a portion of the work to the law firm of Morris, Manning & Martin LLP.

B. Scope and Purpose

Based on discussions with the OIC and the DOR, the focus of this report is to provide baseline information to the Legislature related to the use of captive insurance by companies headquartered in Washington, using the results of a survey of Washington headquartered companies we conducted. This is supplemented with an analysis of current state and federal law related to captive insurance, as well as how other states regulate and/or tax captive insurers. Finally, we review policy options selected by the Agencies for consideration by the legislature in terms of regulatory framework, premiums subject to taxation, and tax rates. Our review includes an evaluation of pros and cons, as well as estimates of premium tax revenues, for each option.

There are a number of other specific items spelled out in the contract and the RFQQ that are required to be in the report. A copy of those items is included as Appendix A.

The intended purpose of our report is specified in the contract between Milliman and the State as follows:

> "The purpose of this contract is for CONTRACTOR to conduct a study on the subject of captive insurance and prepare a report with the findings of the study. Results of the study and the report submitted will be used by AGENCIES to

[1] Provided by Washington Office of Insurance Commissioner

> inform, evaluate, and form a taxation framework recommendation to the Washington state Legislature."

Milliman is available to answer questions about our report or to further discuss our findings with the Agencies.

C. Limitations on Distribution

This report (including the accompanying appendices) is prepared solely for the benefit of the Agencies. Milliman does not intend to legally benefit any third party recipient of the report. The Agencies may distribute the final, non-draft version of this report at the Agencies' discretion. The Agencies may summarize or abstract the content of this report so long as any summaries or abstracts are not attributed to Milliman and any distribution must include a citation that will allow the reader to request and obtain the full report. The Agencies may distribute excerpts of the report, prepared by Milliman, as long as such excerpts contain a citation that will allow the reader to request and obtain the full report.

Mentions of this report by the Agencies shall provide a citation that will allow the reader to obtain the full report.

II. Executive Summary

A. Overview

This report provides the OIC and the DOR with information that can be used to recommend a regulatory and taxation framework to the Washington State Legislature with respect to captive insurance.

Through our extensive research, our working knowledge and experience with captive insurers, and a survey of Washington captive insurance company owners, we evaluated policy considerations with respect to:

1. Creating an overarching regulatory and taxation framework for captive insurance in Washington, including
2. Selecting the tax base / premiums subject to taxation
3. Selecting the tax rate(s) to be applied to the subject premium

The discussion below summarizes the policy options we reviewed with respect to each of these issues. A detailed discussion is in Section VIII of this report, “Policy Considerations and Revenue Forecasts.”

Creating an Overarching Regulatory and Taxation Framework

We reviewed three options selected by the Agencies for establishing an overarching regulatory and taxation framework, as follows:

1. **Independent procurement.** Under this option, insureds in Washington would be permitted to procure insurance from unauthorized insurers, including a captive insurer licensed in another state or offshore jurisdiction, and would be required to pay a tax on the premium.
2. **Registration of captive insurance companies.** Under this option, a captive insurer insuring any Washington headquartered company would be required to register with the OIC and pay a premium tax.
3. **Establish Washington as a captive insurance domicile.** This option would involve authorizing the OIC to license and regulate captive insurance companies that would be formed under Washington law. Although this option does not establish any regulatory or taxation framework for out-of-state captive insurers, it is not exclusive of the other options and could be implemented in tandem with one of them.

Selecting the Tax Base / Premiums Subject to Taxation

Regardless of what regulatory and taxation framework is established for captive insurance, any framework will require selecting the tax base / premiums subject to taxation. We identified three options in this regard, as follows:

1. **Tax premiums according to the "home state" rule established by the federal Nonadmitted Reinsurance and Reform Act ("NRRA").** Under this approach, the state would tax the premiums for a policy only if the insured's "home state" is Washington. Generally, an insured's home state is the state in which its headquarters is located. If the insured's home state is Washington, 100% of the premium for risks located anywhere in the US would be taxed.
2. **Tax premiums only for insurance covering risks in Washington (broad definition).** Under this approach, the state would tax only premiums attributable to risks located in Washington. This option would employ a broader definition of "risks located in Washington" than the first approach. In this case, the location of risk is determined by the trigger of the "reimbursement policy," that is financial loss, and 100% of the premium issued to an insured located in Washington would be taxed.
3. **Tax premiums only for insurance covering risks located in Washington (narrow definition).** Under this approach, the state would tax only premiums attributable to risks located in Washington using a narrow definition of what constitutes a risk located in Washington. In this case, for a "reimbursement policy," the location of risk is determined by the trigger of a separate policy attached or referenced in the "reimbursement policy."

Selecting a Tax Rate

The Agencies requested we analyze tax rates of 2.0% and 1.75%. In paragraph F of this section, we provide projections of future tax revenues if captive insurance is taxed at these rates under the three approaches to selecting a premium tax base identified above.

Our report is structured to allow the Agencies to easily reference various aspects of our research and conclusions. The report has the following sections:

- Section III – Insurance Regulation and Taxation
- Section IV – Captive Insurance: What, Why, How Much in Washington
- Section V – How Current Washington Law Treats Captive Insurance Premiums
- Section VI – Relevant Federal Law

- Section VII – How Do Other States Regulate and Tax Captive Insurers
- Section VIII – Policy Considerations and Revenue Forecasts
- Technical Appendices

B. Captive Insurance Is Both Simple and Complicated

In Section IV "Captive Insurance: What, Why, and How Much in Washington", we explain what captive insurance companies are, why companies choose to use captive insurance, and how much captive insurance activity there is in Washington (based on our survey results and on publicly available data and information).

On the surface, captive insurance is a fairly straightforward concept. For most captive insurance companies (in this report, also referred to as "captive insurers"), a company sets up a separate legal entity – either a subsidiary or affiliated insurance company – to insure risks for which the company has not purchased commercial insurance (in this report, we call these uninsured risks "retained risk"). In other words, the company owns the captive insurer, or the company and the captive insurer are under common ownership within a single group of affiliated companies. These captive insurers are called "single parent captives" or "pure captives."

Thus, single parent captive insurance usually only involves intercompany transactions between affiliates (other than expenses incurred by the captive insurer such as hiring captive insurance experts to run its day-to-day affairs). While there are other types of captive insurers and captive insurance policies, "reimbursement policies" (such as deductible reimbursement policies or contractual liability insurance policies) make up at least 85% of the premiums paid by Washington headquartered companies to their captive insurers based on our survey results. The characteristics of reimbursement policies are described in Appendix B8. For these policies, the captive insurance company owner and/or affiliates are the policyholders and the claimants, and the policies are written to cover the financial loss or losses paid by the policyholder. There are no claim payments to any other parties.

Understanding why companies choose to establish captive insurers (see Paragraph D below) can be complicated. It requires an understanding of the insurance industry, how captive insurance works, and how captive insurers can add value in terms of managing risk in a cost-effective manner. Regulation, both state and federal, as well as federal tax rules, also play roles in how and why captive insurers are used.

As a precursor to understanding captive insurance for single parent captives, it is critical to understand why companies choose to retain risk. The answer is, for certain risks, a company does not need commercial insurance because it can bear the "retained risk" of loss itself. Eliminating the corresponding insurance can often result in significant savings. For example, if a freight company knows that it will have a certain dollar amount of claims on average each year for lost or damaged freight, the company is likely to decide not to purchase insurance for this risk. If it did purchase insurance, the cost would be equal to the average annual cost of claims plus the insurer's overhead expenses and profit margin (in this report, we refer to these insurer expenses/margins as "frictional costs"). Under these circumstances, the company will likely choose to pay the claims itself and save the frictional costs of insurance. At this point, the company has achieved significant savings, perhaps upwards of 20% of the insurance premiums it was paying. (Note that the savings may be lower for Washington workers compensation risks given the unique structure of Washington workers compensation.) Additionally, the company is simply paying for claims as they occur and does not have a captive insurance company (in this report, we refer to this as a "pay as you go" basis).

Once the company has determined it makes sense to pay the claims itself, it may also decide to form an affiliated captive insurance company to cover this risk. In this case, funds equal to estimated payments for risks to be insured in the upcoming policy year are transferred to the captive insurer in the form of a premium payment. The captive insurer then pays the claims as they arise or, more commonly, reimburses the company for amounts paid directly by the company for claims.[2] Again, the concept and the operations of most captive insurance companies are fairly straightforward, without a lot of moving parts.

This report provides the Agencies with tools to use to support their recommendations. Developing some of the findings required an in-depth knowledge of federal insurance taxation. We have presented simplified examples to explain concepts, and then done the detailed calculations to help explain and quantify federal tax benefits potentially available to captive insurers. The federal tax benefit is also an important consideration for many captive insurance company owners (see Paragraph D below).

[2] This is a highly simplified example and does not take into account the ways companies seeking to qualify their captive insurer as an "insurance company" for federal income tax purposes insure multiple affiliates, unrelated third-party risk, or statistically independent risks.

C. Captive Insurers Are Different Than Other Insurers

Our report explains how and why most captive insurers (i.e., single parent captives) are different from commercial insurers. Domicile states that license captive insurers regulate and tax captive insurers differently than commercial insurance companies. Captive insurers cost less to operate than commercial insurers. Unlike commercial insurers, most captive insurers don't incur sales or marketing expenses since they only insure affiliated companies. Nor do most captive insurers have any employees; management functions are outsourced. Average expenses to operate a commercial insurer are 30% of premiums. In contrast, generally for a large captive insurer (over $25 million in annual premiums), expenses are typically 1% of premium or less. Enforcing a Washington premium tax on captive insurance could create an expense that exceeds the entire current cost of operating the captive insurance company, depending on the specifics of the premium tax (including tax rate and taxable base).

Perhaps the biggest difference between captive insurance and other insurance (from a risk financing perspective) is that most captive insurance can be cancelled without any material adverse impact on the captive insurance company owner. Most captive insurance is optional and unlike commercial insurance, is not designed to protect against large, catastrophic events. Additionally, captive insurers are designed to help cost-effectively manage risk that, while still involving fortuitous events, is more predictable. Risk managers at companies regularly perform cost/benefit analyses on their various risk management tools and if they are not providing adequate benefits, they can and will be changed.

The regulatory and taxation frameworks summarized above in paragraph A cannot prevent a captive insurance company owner from changing their behavior so that it is no longer subject to tax – the extreme example is cancelling or non-renewing the captive insurance policies. Based on our research, there are other strategies that captive insurance company owners could use as well to reduce their exposure to new taxes.

Any discussion of captive insurance needs to differentiate between single parent captive insurers and group captive insurers. Group captive insurers, which are captive insurers with more than one owner, represent a small fraction of the captive insurance premiums, both nationwide and in Washington. Some group captive insurers write direct insurance for their owners. These tend to have a relatively small number of larger, more sophisticated owners. Group captive insurers that have a large number of owners usually a) are risk retention groups (see Section III.B below) or b) limit their operations to reinsuring coverage written by an authorized insurer or surplus lines insurer.

D. Why Do Companies Use Captive Insurance Companies?

Captive insurers offer a myriad of benefits to their owners, and companies have specific business reasons for using captive insurance. The business reasons differ in some respects for single parent captive insurers versus group captive insurers.

Single Parent Captive Insurers

For single parent captive insurers, the primary business reason for the use of captive insurance (whether for large companies or small) is for the efficient management of retained risks. That is, the use of captive insurance is primarily a corporate risk finance and management tool to address risks that a company has chosen to retain instead of purchasing commercial insurance. While this is a transfer of risk from the company to its wholly owned captive insurer, the business purpose is focused on the management of the parent company's and its subsidiaries' retained risks. This could be as simple as wanting to have all of the retained risk of a large, multi-affiliate company centralized in one place for better tracking of the cost of the retained risk. This differs from the purchase of commercial insurance, where the business purpose is to transfer risk outside of the affiliated group of the parent company and its subsidiaries.

The key point here is that while both commercial insurance and captive insurance represent a transfer of risk, the business purpose of captive insurance – management of retained risk – is what drives the decision to use a captive insurer for most companies.

Procedurally, after deciding to retain risk (many times, years after the decision to retain risk and save upwards of 20% of insurance premiums), management will do a cost/benefit analysis to see if a captive insurer will provide any additional benefits or savings. In some cases, a captive insurance company is deemed not to be cost effective, and the benefits of retaining risk (20% or more of commercial insurance premiums) won't be materially enhanced with a captive insurance company. In our scope of work, we were asked to explain why companies are choosing captive insurance over the admitted market. That's not what's happening – it's that companies are choosing to retain risk rather than transfer it to the admitted market (or surplus lines market). The presence or absence of a captive insurer doesn't change this.

Embedded in “management of retained risk” is a potential federal tax benefit. Self-insurers cannot deduct liabilities for unpaid retained risk/claims, but insurers can. For captive insurance company owners that qualify, setting up a captive insurer allows for these “accelerated tax deductions.” We built a model to estimate the average annual federal tax benefit that companies could achieve through reimbursement policies. Our models show that as a percentage of premium, a typical large captive insurance company (over $25 million in annual premiums) can produce an expected annual federal tax benefit of 2.5% of premiums (this is an average – for some it will be higher, for others, lower). This is significantly smaller than the 20%+ savings achieved by retaining risk. Enforcing a premium tax on captive insurance companies used by Washington headquartered companies could be material for captive insurance company owners that are relying on that benefit. Future use of captive insurance by these companies will be affected in various ways depending on the size and scope of any tax.

In addition to management of retained risk, this report provides a detailed discussion of a range of common business uses of captive insurers. A few of the other more common ones are below.

- Access to Reinsurance Markets: Use of captive insurance as a conduit to transfer risk to outside parties (only way to access markets, or most cost effective way)
- Access to Government Pools: Access to some pools (like for terrorism risks) is only available to insurers, not self-insurers
- Unrelated Risks: Use of captive insurer to insure risks other than parent/affiliate; almost always assumed reinsurance and there is usually an existing business relationship between the company and the insured
- Certificates of Insurance: The captive insurer can provide a certificate of insurance to a customer or regulator when required, where a company simply retaining the risks will not be able to do the same

The four benefits above can only be achieved with the use of an insurance company. Other benefits can be achieved without the use of a captive insurer. In addition, we note that the first two items are related to the transfer of risk outside of the affiliated group of the parent company and its subsidiaries.

Group Captive Insurers

With respect to group captive insurers, there are two underlying premises that make an entity consider joining a group captive insurer. First, the entity may be too small to have its own captive insurance company. In this case, the motivations for joining a group captive insurer are the same as those that would motivate an entity to form a single parent captive insurer. Second, the entity may be part of a class of risks that the commercial insurance industry is not servicing efficiently – by not making adequate (or any) insurance available, by pricing the insurance too high, by not providing good service, or by not customizing policy language to a narrow class of risk. As noted above, group captive insurers make up a small share of the captive insurance premiums. A more complete discussion of group captives and their corresponding benefits and uses is included in Appendix B8, Benefits of Captive Insurers (Sub-Section C).

E. Captive Insurance Activity in Washington

We used two surveys to gather information for this report. The initial survey simply asked companies if they were using a captive insurer. If a company confirmed they were using a captive insured we sent them a second survey asking for detailed information about their captive insurance company (i.e. type of captive, how long they have been using a captive, where they are domiciled, total direct written premiums etc.). A copy of both surveys can be found in Appendix F.

We sent 5,015 survey's out to Washington companies identified by DOR as having gross revenues of $10,000,000 or more. After sending email remainders, certified return receipt mail as well as making phone calls, we were able to get 3,894 companies to respond to the initial survey asking if they were using a captive insurance company or not. Additionally, we sent 6,651 additional surveys to Washington companies identified by the Liquor and Cannabis Board ("LCB") to be licensed in the liquor and marijuana industries. We did send reminder emails but did not have sufficient time to send certified mail nor make phone calls. Consequently, only 362 companies from the LCB contact list responded to our initial survey.

For the survey's that went to the list of companies provided by DOR, 341 companies initially answered that they did use captive insurers. However, 124 of these respondents (approximately 36%) did not comply with the Agencies' request to answer our follow-up survey. Of the 217 companies that responded to the second survey, only 47 companies ("owners") confirmed that captive insurance was used at some point during the 10 year period 2010 through 2019. Most of those captive insurers were not active for the entire 10 year period.

For the surveys that went to the list of companies provided by the LCB, 17 indicated that they utilize captive insurance; however, none of those 17 companies responded to our second follow-up survey. To the extent that these companies have a significant amount of direct written premium in captive insurers, our forecasts would understate the premium tax revenue.

Also, we were able to separate captive insurance company owners into two broad categories: 1) those that actually paid premiums directly to their captive insurers, and 2) those that paid premiums to non-captive insurers (i.e., insurers that are operating lawfully in Washington and paying the corresponding premium taxes). For the latter category, the captive insurer is acting solely as a reinsurer, and therefore is not subject to Washington state premium tax as premium taxes would already have been paid by the insurer writing the direct policies.

The table below summarizes the survey results for each year. We split our results into two broad categories – single parent captive insurance companies (captive insurer has one owner, and insures risks of the owner and/or its subsidiaries/affiliates) and group captive insurance companies (captive insurers with multiple owners that insure the risks of the owners).

TABLE 1: CAPTIVE INSURANCE COMPANY COUNTS AND DIRECT WRITTEN PREMIUM BY YEAR SURVEY RESULTS

	Single Parent Captives			Group Captives		
Year	# of Active Captives with Gross Written Premium > $0	# of Active Captives with Direct Written Premium > $0	Direct Written Premium	# of Active Captives with Gross Written Premium > $0	# of Active Captives with Direct Written Premium > $0	Direct Written Premium
2010	12	10	254,940,119	3	1	272,467
2011	14	11	302,192,586	3	1	120,868
2012	15	12	329,084,625	3	1	109,772
2013	16	13	405,107,883	3	1	114,657
2014	19	15	472,248,632	2	0	0
2015	20	15	461,698,818	3	1	127,752
2016	23	18	485,440,598	3	2	220,674
2017	25	20	499,502,064	4	2	242,011
2018	28	21	545,820,569	5	3	1,570,229
2019	28	20	155,517,494	7	3	1,371,613

The five largest captive insurance companies in each year generally make up between 85% and 95% of the direct written premium.

See Appendix D for a range of estimated captive insurer counts and direct written premium amounts.

F. Projected Captive Insurance Premium and Premium Tax Revenues

Captive insurance premiums from Washington headquartered companies grew steadily from 2010 to 2018. Based on our survey and publicly available data on the overall size of the captive insurance market worldwide, we estimate that these captive insurance premiums reached $900 million in 2018, but then dropped to $300 million – a 67% decrease – between 2018 and 2019 (the last 2 years of data available/gathered in our survey). The decrease was due to the owners of four large captive insurers either stopping or reducing the use of their captive insurance companies. Without asking the specific captive insurance company owners, we can't be sure why this happened in 2019. We also don't know how 2020 captive insurance premiums in Washington changed relative to 2019.

In order to project future premiums under different frameworks/tax bases/tax rates, we need to forecast future captive insurance premiums. Our working assumption is that the higher the tax rate and the broader the tax base, the more captive insurance company owners will change their behavior so they are no longer subject to the tax. Our projections are based on the following captive insurance market direct written premium assumptions.

TABLE 2: PROJECTION OF POTENTIAL YEAR 1 SUBJECT PREMIUM
ASSUMES PREMIUM TAX APPLIES TO ALL COVERAGES

	Taxable Base				
Item	NRRA	WA Only (Broad)	WA Only (Narrow) Low Estimate	WA Only (Narrow) Medium Estimate	WA Only (Narrow) High Estimate
Estimated 2018 Premium*	900,000,000	765,000,000		200,000,000	
Estimated 2019 Premium*	300,000,000	255,000,000		100,000,000	
Estimated Year 1 Premium	75,000,000	63,750,000	100,000,000	110,000,000	130,000,000
Derivation of Estimated Year 1 Premium**	25% of 2019	25% of 2019	see below	see below	see below

* Based on survey results and publicly available data

** Judgementally selected based on our research, including but not limited to:

- Large captive insurance company owners ($25 million or more) will have most impact
- Large captive insurance company owners cost to operate captives is generally 1% of premium or less
- Large captive insurance company owners federal tax benefit generally averages 2.5% of reimbursement policy premiums
- Large captive insurance company owners may exit the market or restructure policies to legally avoid the new tax
- Several large captive insurance company owners supported the WA Only (Narrow) base and tax rate, resulting in estimates equal to or higher than 2019

The 2018 and 2019 estimated direct written premium amounts for WA Only (Narrow) and NRRA are based on our estimates of the total captive insurance direct written premium for Washington-headquartered companies. The WA Only (Broad) premium is based on the OIC definition of which premiums are subject to taxation, which includes all premiums from reimbursement policies based on the location of the insured's principal place of business. Specifically, the WA Only (Broad) premium is estimated to be 85% of NRRA, which is based on the estimated percentage of premiums related to reimbursement policies (as defined by the OIC) from our survey results.

See Appendix D for more detail.

The following tables apply the selected tax rates to the projected subject premium. The 1.75% tax rate assumption was provided by the DOR based upon the B&O tax rate, and the 2.00% tax rate assumption was provided by the OIC.

TABLE 3: PROJECTION OF POTENTIAL YEAR 1 TAX REVENUE
ASSUMES PREMIUM TAX APPLIES TO ALL COVERAGES

Taxable Base				
NRRA	WA Only (Broad)	WA Only (Narrow) Low Estimate	WA Only (Narrow) Medium Estimate	WA Only (Narrow) High Estimate
75,000,000	63,750,000	100,000,000	110,000,000	130,000,000
1,500,000	1,275,000	2,000,000	2,200,000	2,600,000
NA	NA	1,750,000	1,925,000	2,275,000

We were also asked to estimate premiums and premium taxes assuming that the premium tax did not apply to premiums related to reimbursement of Washington State workers compensation claim payments. In 2019, approximately 14% of survey premium was related to such coverage. Our total market estimates assume 20% of direct written premium is related to this coverage. See Appendix D for further detail.

TABLE 4: PROJECTION OF POTENTIAL YEAR 1 SUBJECT PREMIUM
ASSUMES PREMIUM TAX DOES NOT APPLY TO WA WC

	Taxable Base		
Item	NRRA	WA Only (Broad)	WA Only (Narrow)
Estimated 2019 Premium - Total*	300,000,000	255,000,000	100,000,000
Estimated 2019 Premium - WA WC Only*	60,000,000	60,000,000	60,000,000
Estimated 2019 Premium - excl. WA WC*	240,000,000	195,000,000	40,000,000
Estimated Year 1 Premium	60,000,000	48,750,000	50,000,000
Derivation of Estimated Year 1 Premium**	25% of 2019	25% of 2019	see below

* Based on survey results and publicly available data

** Judgementally selected based on our research, including but not limited to:

Large captive insurance company owners ($25 million or more) will have most impact

Large captive insurance company owners cost to operate captives is generally 1% of premium or less

Large captive insurance company owners federal tax benefit generally averages 2.5% of reimbursement policy premiums

Large captive insurance company owners may exit the market or restructure policies to legally avoid the new tax

Several large captive insurance company owners supported the WA Only (Narrow) base and tax rate, resulting in estimates equal to or higher than 2019

The following tables apply the selected tax rates (as provided by the OIC and DOR) to the projected subject premium.

TABLE 5: PROJECTION OF POTENTIAL YEAR 1 TAX REVENUE
ASSUMES PREMIUM TAX DOES NOT APPLY TO WA WC

	Taxable Base		
Tax Rate	NRRA	WA Only (Broad)	WA Only (Narrow)
Estimated Year 1 Premium	60,000,000	48,750,000	50,000,000
Premium Tax at 2.00% Rate	1,200,000	975,000	1,000,000
Premium Tax at 1.75% Rate	NA	NA	875,000

We were also asked to calculate premium taxes for each of the past 4 and 10 years under two tax bases/tax rates (OIC and DOR as the collection authority). For the OIC option, we were instructed to include applicable penalties and interest under the Insurance Code. The 2.0% tax rate was provided by the OIC and the 1.5% tax rate was provided by the DOR for the calculation of unpaid taxes. The penalty and interest rate assumptions of 20.0% and 12.0%, respectively, were provided by the OIC. See Appendix D for a range of estimates with detail by year.

TABLE 6: ESTIMATED UNPAID TAXES, PENALTIES, AND INTEREST

Collecting Authority	Tax Base	Tax Rate	Time Frame	Unpaid Tax	Penalties @ 20.0%	Interest @ 12.0%	Total
OIC	WA Only (Broad)	2.0%	10 Years	109,888,000	21,977,600	68,915,280	200,780,880
OIC	WA Only (Broad)	2.0%	4 Years	47,855,000	9,571,000	15,791,640	73,217,640
OIC	WA Only (Narrow)	2.0%	10 Years	29,400,000	5,880,000	18,100,800	53,380,800
OIC	WA Only (Narrow)	2.0%	5 Years	16,540,000	3,308,000	6,225,600	26,073,600
DOR	WA Only (Narrow)	1.5%	4 Years	9,885,000	NA	NA	9,885,000

DOR tax rate of 1.5% provided by DOR based on B&O rate in place prior to 2020

We appreciate the opportunity to assist the Agencies on this project.

III. Insurance Regulation and Taxation

A. Background

The basic concept of insurance is that one party, the insurer, promises payment for loss arising from an uncertain future event. The party to whom this promise is made, the insured or the policyholder, pays the insurer a premium in exchange for this protection. Consistent with this description of insurance, the Washington Insurance Code defines "insurance" as "a contract whereby one undertakes to indemnify another or pay a specified amount upon determinable contingencies."[3] Most state insurance codes have similarly worded definitions of insurance. Subject to certain exceptions, an "insurer" subject to regulation under the Washington Insurance Code includes "every person engaged in the business of making contracts of insurance...."[4]

The party purchasing the insurance is referred to as "the insured" or "the policyholder". The insured receives a contract, called the insurance policy, which specifies the conditions under which the insurer will compensate the insured and any limits on the insurer's liability to the insured. The amount of money charged by the insurer to the policyholder for the coverage is called the premium. The insurer may insure its own risk by purchasing reinsurance, whereby another insurance company agrees to carry some of the risk assumed by the insurer under its policies of insurance.

B. Regulation and Taxation of Insurance

Insurance is primarily regulated at the state level. Most states do not impose income taxes on insurers, but rather, tax the premiums collected (gross receipts) on risks located in their state.[5] Most states have separate premium tax rates for traditional "admitted" or "authorized" insurance in the 1.5% to 4% range, and "nonadmitted" or "unauthorized" insurance in the 2% to 6% range. Washington's premium tax for admitted carriers is 2%, which is equal to or less than 33 other states/territories. Washington's premium tax for nonadmitted, unauthorized or surplus lines is also 2%, which is less than 49 other states/territories. An admitted or authorized insurer is an insurer authorized by the state in which it is insuring risk. Most insurance, including, for

[3] Rev. Code Wash. § 48.01.040.
[4] Rev. Code Wash. § 48.01.050. *See* Rev. Code Wash. § 48.05.030 (prohibiting any person from acting as an insurer in the state other than as authorized by a certificate of authority issued by the Insurance Commissioner or as otherwise expressly provided by the Insurance Code).
[5] Some states, however, have sought to subject captive insurers to state income taxes. *See, e.g. Leadville Ins. Co. v. Comptroller of the Treasury,* 2020 WL 4433715 (Md. Tax*).* We do not include a discussion of this topic in this report because Washington State does not have a corporate income tax.

example, personal auto and homeowners insurance, is purchased in this market from authorized insurers. Generally speaking, a nonadmitted or unauthorized insurer is an insurer that is not authorized in the state in which it is insuring risk.

Nonadmitted or unauthorized insurance can be procured through a surplus line broker or, in states where permitted, independently procured by the insured. Generally, independently procured insurance must be negotiated by the insured primarily or entirely outside the state. Some states also permit more sophisticated entities, known as “industrial insureds” to procure insurance from unauthorized insurers. Industrial insureds generally are not required to go outside the state to obtain insurance from an unauthorized insurer. Currently in Washington, unauthorized insurance must be procured through a surplus line broker and in compliance with Chapter 48.15 RCW. When unauthorized insurance is procured without adherence to the Insurance Code, the transaction is deemed unlawful. The OIC has determined that captive insurance falls into this latter category.

Please note that we use the terms “industrial insurance” and “industrial insured” in this report as they are used in other states – namely, to mean unauthorized insurance of any type permitted to be purchased by larger, more sophisticated companies. This is distinct from how the term is used in Washington State to refer to workers compensation coverage.

Insureds also may purchase insurance from a type of insurer known as a “risk retention group.” A risk retention group is a form of insurer authorized by federal law and regulated primarily by the state in which it is chartered.[6] Although a risk retention group must be registered in each state in which it does business, federal law preempts states other than the chartering state from regulating most aspects of the risk retention group’s operations.[7] A risk retention group must be owned by its members and may insure only the “similar or related” commercial or professional liability exposures of its members.[8] Thus, a risk retention group may not provide insurance for personal, family, or household purposes, and the risks it insures must arise from the similar or related business or activities of its members – for example, the members might be physicians, health care facilities, or contractors engaged in a particular industry. Most risk retention groups are licensed as captive insurers by their domiciliary state.

Washington’s premium tax rate is 2% for most authorized insurance, surplus lines insurance, and insurance provided by risk retention groups; Washington does not

[6] *See* 15 USC §§ 3901(a)(4), 3902
[7] *See* 15 USC § 3902.
[8] *See* 15 USC § 3901(a)(4).

currently permit independent procurement, industrial insurance (as described above), or captive insurance.

Below is a table of tax rates by state / territory for authorized insurance, surplus lines, and insurance that is independently procured.

TABLE 7: INSURANCE TAX RATES BY STATE / TERRITORY

State	Authorized Premium Tax Rate	Excess/ Surplus Lines Premium Tax Rate	Independent Procurement Premium Tax Rate	State	Authorized Premium Tax Rate	Excess/ Surplus Lines Premium Tax Rate	Independent Procurement Premium Tax Rate
AK	2.700%	2.700%	3.700%	NC	1.900%	5.000%	5.000%
AL	3.600%	6.000%	4.000%	ND	1.750%	1.750%	1.750%
AR	2.500%	4.000%	2.000%	NE	1.000%	3.000%	3.000%
AZ	1.750%	3.000%	3.000%	NH	1.250%	3.000%	4.000%
CA	2.350%	3.000%	3.000%	NJ	2.100%	5.000%	5.000%
CO	2.000%	3.000%	3.000%	NM	3.003%	3.003%	3.003%
CT	1.500%	4.000%	4.000%	NV	3.500%	3.500%	3.500%
DC	1.700%	2.000%	N/A	NY	2.000%	3.600%	3.600%
DE	2.000%	3.000%	3.000%	OH	1.400%	5.000%	5.000%
FL	1.750%	5.000%	5.000%	OK	2.250%	6.000%	6.000%
GA	2.250%	4.000%	4.000%	OR	N/A	2.300%	2.300%
HI	4.265%	4.680%	4.680%	PA	2.000%	3.000%	3.000%
IA	1.000%	1.000%	1.000%	RI	2.000%	4.000%	4.000%
ID	1.500%	1.500%	1.500%	SC	1.250%	6.000%	N/A
IL	0.500%	3.500%	0.500%	SD	2.500%	2.500%	2.500%
IN	1.300%	2.500%	N/A	TN	2.500%	5.000%	5.000%
KS	2.000%	6.000%	6.000%	TX	1.600%	4.850%	4.850%
KY	2.000%	3.000%	2.000%	UT	2.250%	4.250%	4.250%
LA	N/A	4.850%	4.850%	VA	2.250%	2.250%	N/A
MA	2.280%	4.000%	N/A	VT	2.000%	3.000%	3.000%
MD	2.000%	3.000%	3.000%	WA	2.000%	2.000%	N/A
ME	2.000%	3.000%	3.000%	WI	2.000%	3.000%	3.000%
MI	N/A	2.500%	2.500%	WV	3.000%	4.550%	N/A
MN	2.000%	3.000%	2.000%	WY	0.750%	3.000%	3.000%
MO	2.000%	5.000%	5.000%	GU	4.000%	4.000%	N/A
MS	3.000%	4.000%	7.000%	PR	N/A	9.000%	15.000%
MT	2.750%	2.750%	2.750%	VI	5.000%	5.000%	5.000%

C. Regulation and Taxation of Insurance in Washington

1. OIC Role

The OIC is responsible for regulating insurance in the State. This includes, among other areas of regulation, a) solvency regulation (i.e., making sure insurers have adequate funds to fulfill their obligations to policyholders), and b) market conduct (i.e., providing consumer protection). It also includes regulation of insurance agents and brokers. Regulations vary by the type of insurance in question: traditional/authorized, surplus lines, and risk retention groups.

The OIC is responsible for collecting premium taxes from insurers (or in the case of surplus lines insurance, from licensed brokers).

With respect to premium taxes, the OIC has a well-designed process for collecting premium taxes for traditional/authorized insurance and surplus lines insurance. The OIC also has the authority to collect premium taxes, including interest and penalties, from unauthorized insurers (which it does in some of its enforcement actions). It also has a process for collecting premium taxes from risk retention groups. Taxpayers are required to report premiums subject to taxation and remit premium taxes on timetables based on the type of insurance involved. There are two types of insurance that are not taxed by the OIC – title and workers compensation insurance. Regarding workers compensation, Washington is just one of four states that has a monopolistic state fund for workers compensation insurance. Workers compensation in the State is regulated by the Department of Labor and Industries ("L&I"), and premiums paid to L&I are currently not taxed by any State agency. Premium taxes are paid, however, for excess insurance (also called "reinsurance" in Washington statutes) purchased by employers who self-insure their workers compensations risks.

The OIC has pursued captive insurers on the basis that they are acting unlawfully as unauthorized insurers and failing to pay premium tax. Under current Washington law, the only type of unauthorized insurance permitted is surplus lines.

2. DOR Role

The DOR's Business & Occupation ("B&O") tax is a gross receipts/excise tax on business activity in the State. RCW 82.04.320 exempts from the B&O tax any insurance premium revenue on which the insurance premium tax has been paid. Accordingly, captive insurers would not have to pay B&O tax on insurance premiums on Washington based risks if they have already paid the insurance premium tax on those amounts to the State, but otherwise would be subject to B&O tax. The DOR is not currently aware of any captive insurers paying B&O tax.

The DOR does not restrict its tax collections to companies headquartered in Washington. The DOR taxes business with nexus, and then only on gross receipts allocable to Washington.

A business must register to report B&O tax if the business meets any of the following conditions in the current or prior year:

- Has physical presence nexus in Washington
- Has more than $100,000 in combined gross receipts attributed to Washington
- Is organized or commercially domiciled in Washington

Businesses that are taxable in Washington and another state must use an apportionment formula to determine how much of their apportionable income is subject to the B&O tax in Washington. (RCW 82.04.462).

3. Summary

The following table provides an outline of Washington's insurance regulation and premium tax structure.

Washington State Insurance Regulation and Premium Tax

	Authorized Insurers	Surplus Lines	Risk Retention Groups	Captive Insurance
Description	Traditional Insurance	Coverage unavailable from authorized insurers or purchased by large, sophisticated companies.	Insurer owned by policyholders, who pool risk; limited to commercial liability insurance; most RRGs are licensed by their domiciliary state as captive insurers.	Insurer that insures its owners and/or affiliates; organized for the main purpose of funding the owners' risks; owners actively participate in underwriting, operations, and investments.
Regulatory Framework	Insurer must be "authorized"—i.e., have certificate of authority to do business in Washington State. RCW 48.05.030. See also RCW 48.15.020. ***Subject to solvency and market conduct regulation.*** 48.03 RCW; 48.05 RCW; 48.37 RCW. ***Producers*** (agents) that are involved must be licensed in Washington State. RCW 48.17.060.	Insurance purchased in the surplus lines market must be ***unavailable*** from authorized insurer, ***except*** when purchaser is a large company with an in-house risk manager RCW 48.15.040; RCW 48.15.043. Surplus lines **broker** licensed in WA state must be used to procure the insurance. RCW 48.15.040. Insurers providing surplus lines insurance are not directly regulated by Washington State, but ***surplus lines brokers are regulated by the State***. RCW 48.15.070. Surplus lines brokers must not knowingly place insurance with insurers that are financially unsound. RCW 48.15.090. Under NRRA, only "home state" of insured (generally where insured is headquartered) may regulate placement of surplus lines. 15 USC 8202.	In-state: chartered and licensed under RCW 48.92.030. Out-of-state: registered under RCW 48.92.040. ***Subject to solvency and market conduct regulation, but authority to regulate out-of-state RRGs is limited by federal law***. Instead, out-of-state RRGs are regulated primarily by state of domicile. RCW 48.92.030 (in-state) and RCW 48.92.040 (out-of-state); 15 USC 3902, 3905. ***Producers*** *(*agents) that are involved must be licensed in Washington State. RCW 48.92.120.	No regulatory framework in Washington State. Captive insurance is a form of unauthorized insurance not permitted under Washington law. RCW 48.15.020; RCW 48.05.030.[9] Unauthorized insurance is subject to a 2% premium tax even when not permitted by law. RCW 48.14.095.

[9] Two Washington companies in litigation with OIC have disputed this characterization of their captive insurers. This litigation is currently suspended.

	Authorized Insurers	Surplus Lines	Risk Retention Groups	Captive Insurance
Premium tax base	Premium taxes are assessed on premiums allocated to ***risks located in Washington State***. RCW 48.14.020.	"Home state" rule: Premium taxes are ***assessed on 100% of the premium covering US risks*** if the insured is headquartered in WA, unless the policy covers no risk in WA, then it is paid to whatever state has the most risk. If policy covers multiple affiliated companies as named insureds, home state is state in which affiliate to which greatest percentage of premium is attributed has its headquarters. RCW 48.15.010(5) (adopting NRRA definition of "home state"); RCW 48.15.120; 15 USC 8201.[10]	Premium taxes are assessed on premiums allocated to ***risks located in Washington State***. RCW 48.92.040(3)(a).	Premium taxes for unauthorized insurance are assessed on premiums allocated to ***risks located in Washington State***. RCW 48.14.095.
Who pays tax	***Insurer*** pays the taxes to OIC	***Broker***, not the insurer, pays the taxes to OIC	***Insurer*** pays the taxes to OIC	The ***insurer*** pays the taxes to OIC.
Tax rate	2.0%	2.0%	2.0%	2.0%

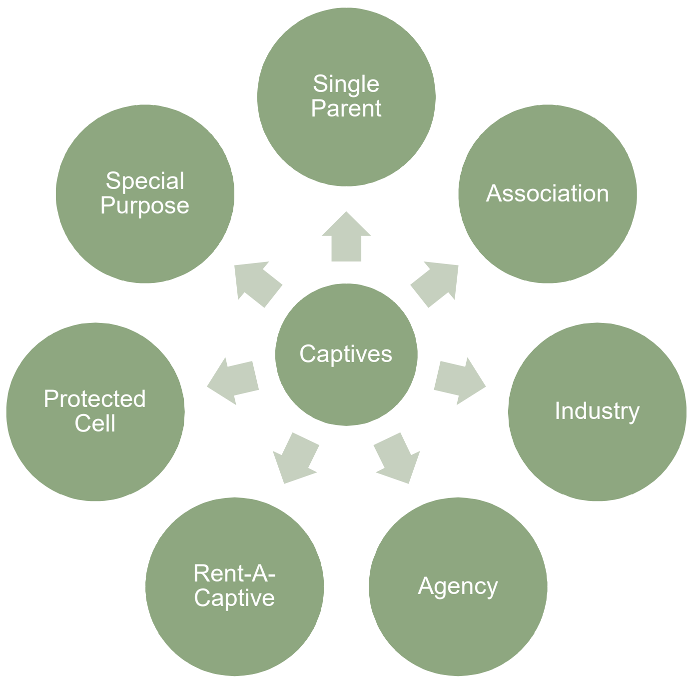
[10] This is a simplified presentation of the "home state" rule. See Appendix B4 for a comprehensive discussion of the home state rule as set forth in the NRRA.

IV. Captive Insurance: What, Why, How Much In Washington

A. The Different Types of Captive Insurers

1. Overview

There are many types of captive insurers, each designed for specific purposes and/or owners:



A publication of Captive Insurance Companies Association ("CICA"), an international trade association for captive insurance, provides an excellent overview of the different types of captive insurers. The publication is entitled "CAPTIVES: AN OVERVIEW" and was published in 2008. The discussion below borrows heavily from CICA's overview.

Single Parent Captives

Single Parent Captives are often described as "pure" captives. These are companies with a single owner, for whom they provide insurance coverage. The insurance provided by the captive insurer ordinarily covers the parent and the parent's subsidiaries. The captive insurer usually is monitored by a risk manager or financial officer at the parent company and managed by a captive management company located in the captive insurer's domicile. A common example is a manufacturing company that forms a wholly-owned captive to insure the deductible portion of the parent's Workers Compensation, General Liability, and Auto Liability policies.

Association Captives

An Association Captive is formed by an association to provide insurance coverage for its members. Ownership rests with the association or individual members. The association typically has a financial expert at the association level with primary responsibility for the captive. Where an association does not have an insurance specialist on its payroll, primary responsibility for managing the captive insurer is given to the captive management company, brokers, and other consultants. An example of an association captive is an association of mental health workers that provides its members with medical malpractice liability coverage through an association–owned captive. In this example, the malpractice coverage would be written by an authorized insurer and reinsured by the association captive. An association captive insurer is a type of group captive insurer.

Industrial Insured Captives

An Industrial Insured Captive is owned by a group of companies, usually within the same industry, that have joined together to solve a common insurance coverage problem. The owners of the industrial insured captive elect a Board to whom the captive management company reports. The owners of an industrial insured captive typically must be larger, more sophisticated companies to qualify as "industrial insureds." An industrial insured captive insurer is a type of group captive insurer.

Agency Captives

An Agency Captive is typically a reinsurance company owned by an insurance agent or group of agents. These are formed by agents so that they may capture additional profit from the insurance market by having their agency captive reinsure the business. An example is an insurance agency forming a captive to reinsure all or a portion of the insurance the agency markets. The agency can now derive additional benefit by participating in the risk. If the business is profitable, the agency not only will earn commissions on the business, but also benefit when its agency captive realizes profits on the reinsurance.

Rent-a-Captive

A Rent-a-Captive insures the risks of it renters and returns underwriting profit and investment income participation to the insureds. Certain companies rent their surplus to other entities wishing to establish a self-insurance program but do not want to capitalize their own captive. Rent-a-captives have become much less popular as Protected Cell Captives have come into wider use. What is described here is a true rent-a-captive. The term “rent-a-captive” often is used loosely in the industry to describe what is actually a Protected Cell Captive.

Protected Cell Captives

Protected Cell Captives (“PCC”), which also are referred to as Segregated Accounts Companies (“SAC”), Segregated Portfolio Companies (“SPC”), and other names, depending on where the company is formed, operate like a rent-a-captive but with an important difference. A rent-a-captive allows renters to shield their capital and surplus from other renters in the captive as long as the rent-a-captive's owner remains solvent. In a true rent-a-captive arrangement, if the captive becomes insolvent, renters may be exposed because their assets may have to pay claims of others. With a PCC, on the other hand, each "cell" within the company is shielded not only from sharing capital and surplus with other cells, but also from any legal action against the cell's assets to satisfy the liabilities of any other cell or the PCC’s “core.” In other words, the assets and liabilities of each cell are segregated by law from the assets and liabilities of every other cell in the PCC and from the assets and liabilities of the PCC’s “core.” Thus, even if one cell becomes insolvent, its creditors have no legal recourse against any other cell in the company. A cell within a PCC may function as a single parent, group, agency, or special purpose financial captive insurer.

Special Purpose Financial Captives

> Special Purpose Financial Captives ("SPFC") generally are used for insurance securitization transactions. The creation of SPFCs is intended to achieve greater efficiencies in structuring and executing insurance securitizations to diversify and broaden insurers' access to sources of capital and to facilitate access for many insurers to insurance securitization and capital markets financing technology.[11]

Most captive insurance is purchased directly by the insured without the use of a surplus lines broker, and the policyholder pays the premium directly to the captive insurer. For certain types of coverages, or for certain types of captive insurers (such as captive insurers formed as a risk retention group), brokers or agents may be involved, but this is the exception, not the rule.

2. History of Captive Insurance Companies

While the history of captive insurance companies goes back to the 1800's, the real emergence and growth in captive insurance companies has taken place in the past 50-60 years:

> "In the early 1960s there were approximately one hundred captive insurance companies in existence. In the 1970s captives began to popularize in response to a hardening insurance market.
>
> The insurance industry progressed through a cycle of hard and soft markets in which pricing and coverage policies are alternately made more rigid or more lax based on insurers' financial standings at any given period. The 1970s saw restrictive underwriting in lines such as product liability and medical malpractice causing workers compensation and liability rates to skyrocket. Hundreds of captives were formed during this period, including some by the world's large corporations. The number of captives worldwide increased to 1,000 by 1980.
>
> During the growth of the captive industry, Bermuda emerged as the top domicile, with the Cayman Islands and the British Virgin Islands vying for business, as well. Offshore domiciles attracted US companies for their (potential) tax advantages and because companies encountered less bureaucracy than what was found in the US. To compete, states began

[11] *See* "Captives: An Overview." Cicaworld.com, https://media.cicaworld.com/wp-content/uploads/2020/06/CICA_CaptiveOverview_2018_FINAL.pdf

> granting captive insurance companies the same benefits they could derive offshore. Colorado came first in 1972, [but other states followed and grew to domiciles with hundreds of captives while Colorado remains a small domicile].
>
> During the 1980s, as competition for business intensified, the IRS challenged the legitimacy of captives as insurance companies and the deductibility of insurance premiums. Under the "economic family theory," it was argued that no insurance relationship existed with a group of affiliated companies. The commonly accepted definition for "insurance" required: (1) risk shifting, where a company transferred risk to an unrelated party; and (2) risk distribution, where the insurer could spread its risk across a sufficient number of exposures.
>
> Risk shifting did not exist in a captive [according to the IRS], as liability remained within the same economic family. Through various court cases, US tax law came to allow the deductibility of premiums paid to a captive under circumstances where it is organized to cover affiliated companies other than a parent, and/or where the captive's third-party business makes up at least 30% of its total, with some exceptions.
>
> A soft market during the 1990s slowed the growth of captives, but it picked up again in the new millennium. Insurers tightened underwriting practices once more and after the September 11, 2001 attacks, one-third of property & casualty carriers lost significant value. As of 2007, there [were] over 5,000 captive insurance companies around the globe. Bermuda [was] the number one domicile, housing almost 1,000 captives. With over 750 captives, Vermont [ranked] first in the US."[12]

Today, interest in captive insurance is at an all-time high. In 2018, captive insurers were responsible for over $100 billion in premiums.[13] In 2019, there were over 6,000 captive insurers worldwide.[14]

[12] "Captives: An Overview." Cicaworld.com, https://media.cicaworld.com/wp-content/uploads/2020/06/CICA_CaptiveOverview_2018_FINAL.pdf
[13] Marsh & McLennan Companies.
[14] "Background on: Captives and other risk-financing options." Insurance Information Institute. March 12, 2020, https://www.iii.org/article/background-on-captives-and-other-risk-financing-options

TABLE 8: NUMBER OF CAPTIVE INSURERS BY YEAR

Year	Captives	US Captives
2010	5,587	1,831
2011	5,831	2,039
2012	6,125	2,225
2013	6,420	2,493
2014	6,739	2,782
2015	6,851	2,990
2016	6,700	3,246
2017	6,454	3,244
2018	6,359	3,227
2019	6,135	3,113

Compiled from data from the Insurance Information Institute[15]

In February of 2020, the NAIC referenced an AM Best report indicating that there are over 7,000 captive insurers worldwide.[16]

The figures in Table 8 a) don't include all of the individual cells within a Protected Cell Captive, b) count group captive insurers as one company, and c) count some captive insurers that are inactive. In trying to count companies that use captive insurance, the figures above are likely understated (i.e., understatement from groups and cells are likely greater than overstatement from inactive captive insurers). While we don't know how many cell owners or group captive insurance company owners there are, we are using 10,000 as an upper bound on the number of captive insurers (i.e., captive insurance company owners), and 6,135 (from the table above) as a medium estimate. These values are used to assist in projecting the number of Washington companies that use captive insurance. Our low estimate of Washington captive insurers is based directly on survey results.

We also note the significant growth in the number of US captive insurers from 2010 to 2016, followed by a period of no growth. Much of the growth is attributable to small captive insurers, referred to as "micro captives", "enterprise risk captives", or "831(b) captives", the latter name derived from the section of IRS code that exempts insurers electing to be taxed under this section from federal income taxes (other than on investment income). To qualify for this tax treatment, annual premiums cannot exceed $1.2 million (in 2017 the level was increased to $2.2 million, with an inflation index

[15] "Captives by state." Insurance Information Institute. https://www.iii.org/table-archive/21308
[16] https://content.naic.org/cipr_topics/topic_captive_insurance_companies.htm

provision thereafter). The maximum federal tax benefit from such a captive insurer is when losses are low/zero. The IRS has targeted captive insurers filing under Section 831(b) on the premise that the contracts don't meet the IRS definition of insurance, and/or the premiums paid were not commensurate with the risk (i.e., premiums were overstated, so losses were likely to be low/zero). As the IRS began to pursue situations of potential abuse in the middle of the past decade, the growth in the number of captive insurers in the US flattened.

We want to single out Risk Retention Groups, authorized under the federal Liability Risk Retention Act. These are normally licensed as captive insurers in their domiciliary state and regulated by the captive insurance division/department within a domicile and would be included in the figures noted in Table 8. Risk Retention Groups are common for physicians and other health care providers (for professional liability insurance), other professional service providers (e.g., lawyers, accountants), truckers, etc.

As of year-end 2019, there were 230 Risk Retention Groups that filed financial statements in the US, with approximately $3 billion of written premiums. Therefore, these companies make up a small portion of the $100+ billion captive insurance market. For risks in Washington covered by Risk Retention Groups, there were 66 Risk Retention Groups with positive direct written premium in Washington at year-end 2019, and approximately $51 million of written premiums.[17] As noted above, Risk Retention Groups already pay the 2.0% premium tax collected by the OIC. For the remainder of this report, Risk Retention Groups are not considered to be part of the captive insurance market.

B. Why Captive Insurance Is Used: Benefits of Captive Insurers and Discussion of "Reimbursement Policies" for "Retained Risk"

1. Overview

There are many types of captive insurance companies and captive insurance company owners, each with different goals and objectives. The type of captive insurer, or more succinctly, the type of owner(s) of the captive insurer, must be taken into account, as each derives different benefits from a captive insurer. We can think of captives insurance companies as falling into two broad categories: single parent captive insurers (single owner) and group captive insurance companies (multiple owners). In the description of captive insurance types above, Association and Industrial Insured captive

[17] Year-End 2019 Annual Statement data from S&P Market Intelligence

insurers would be groups; all of the other types are single parent captive insurers. Each has very different goals and objectives.

In general, single parent captive insurers are for large organizations with complex risk management needs, and group captive insurance companies are for smaller organizations (or even individuals) with less complex risk management needs. There are single parent captive insurers owned by smaller companies, but in general the reasons for using them mirror those of large companies.

There are a number of advantages of owning and operating a captive insurer. Some of these benefits are economic, such as accelerated federal tax deductions and participating in underwriting profits of commercial insurers that would not otherwise be available to the captive insurance company owner without a captive insurance company. Other benefits can't be directly quantified, like centralizing otherwise self-insured exposure and claims data into one place for a large corporation. Centralized risk management data would be considered as "best practices" for any organization, but it is especially important for a large, diverse entity. A captive insurer is a great tool for accomplishing this, but it could be accomplished without a captive insurer.

In addition to the accelerated federal tax deductions noted above, there are other benefits of captive insurance that cannot be achieved without having a captive insurer. These include accessing the reinsurance market (allows for risk to be transferred to the commercial reinsurance market in a cost effective manner), accessing government risk pools, providing insurance for unrelated/non-affiliated entities, and providing evidence of insurance. Most other advantages/benefits of captive insurers described in literature on captive insurance can be achieved without actually having a captive insurer, especially for single parent (non-group) captive insurers.

Benefits of captive insurance ownership are described in detail in Appendix B8. Federal tax benefits of single parent captive insurance ownership are also addressed briefly below, and in more detail in Appendix B9.

With respect to group captive insurance companies, only a small percentage of the premiums paid by Washington headquartered companies was to group captive insurance companies. In our experience, most group captive insurance companies involve a commercial insurer, either authorized or using a surplus lines broker. In these situations, premium taxes are paid to the State by the authorized insurer or surplus lines broker. A portion of the risk is then transferred ("reinsured") into the group captive insurance company. Here, the commercial insurer is responsible for paying claims, and is regulated for solvency and market conduct, so there is no extra risk to consumers.

Several of the surveyed companies were involved in these types of arrangements. However, there are examples of group captive insurance companies that don't use a commercial insurer and write business directly (as opposed to assuming reinsurance). Here, without legislation, the State relies on the regulation of the captive insurer by its domiciliary state, and there is risk to consumers/claimants. There were three survey respondents that participated in these types of group captive insurance companies in 2019.

In terms of premium volume in Washington, the survey results indicated that over 99% of the direct written premiums of captive insurers owned by Washington headquartered companies are from single parent captive insurers. Therefore, the focus of our analysis of why companies use captive insurance will be on single parent captive insurers. Also, of the 99% of premiums, 85% are from policies that reimburse captive insurance company owners for retained risk such as self-insurance or deductibles.

2. Using Captive Insurance to Insure Retained Risk

The following sequence of steps takes place for a large corporation when deciding to retain risks:

1. Decide how much risk to retain (self-insurance or deductible)
2. Decide how to finance retained risk (pay as you go or captive insurance)
3. Perform a cost benefit analysis (evaluate key benefits for single parent captive insurer)
    a. Risk management tool for tracking retained risk and budgeting; this would be considered as a "non-economic" benefit, since no direct value can be attributed to this.
    b. Federal tax benefits (related to timing of deductions); this would be considered as an "economic" benefit, since the value to the company can be quantified.
4. Factor in cost to own/operate captive insurer
    a. Expenses for large captive insurers ($25 million or more) are usually 1% or less of premiums (little overhead, rarely involve commissions)
    b. This compares to 30% for commercial insurers (overhead, commissions, profits)
5. If captive insurance is selected, policy "reimburses" company for self-insured claim payments
    a. Captive insurer is wholly owned subsidiary or affiliate

   b. Total estimated self-insured claims for the year are paid up front as premium
   c. Normally qualifies as insurance at state level and may qualify as insurance for federal income tax purposes
6. Result is that self-insurance is converted to insurance, and qualifying captive insurer is taxed as an insurance company by the IRS
   a. Self-insurer can only deduct claims as paid; insurer can deduct reserves (estimates of future claim payments on claims that occur during the year)
   b. Insurer can take tax deductions earlier than self-insurer, so the company transfers the retained risk to its insurance subsidiary
   c. Milliman estimates that the federal tax benefit generally averages 2.5% of premium for large captives
7. Reassess the cost/benefit of the captive insurer periodically (e.g., if new costs are introduced)
   a. Captive insurance company owners manage expenses closely
   b. Captive insurance policies can be either cancelled or restructured so as to no longer be subject to some premium taxes

Appendix B8 provides additional details on the sequence of events described above.

C. How Much: The Survey – What is the Extent of Captive Insurance in Washington

We conducted a survey of Washington headquartered companies to gather information on the use of captive insurance, including 10 years of premiums paid directly to their captive insurers (shown in the following chart). *[The figures shown below exclude non-Washington premium for a large captive of a holding company with few risk exposures in Washington.]*

CHART 1: DIRECT WRITTEN PREMIUM VOLUME

"All Risks" represents the total direct premium provided by the survey respondents. For 2017-2019, the survey also requested direct written premium allocable to Washington risks (generally corresponding to the location of the underlying exposures), which is shown as "WA Only (Narrow)." For 2010-2016, the survey did not request the breakdown between premiums allocable to Washington and Non-Washington risks. As such, we estimated this premium based on the percentage of premiums allocable to Washington risks for 2017-2019. This estimation is represented by the dotted line on Chart 1 above.

Approximately 99% of the premium decrease from 2018 to 2019 was attributable to four large captive insurance company owners.

A survey never gets a full response rate. Further, based on the responses and based on what Milliman and the OIC know about larger captive insurance company owners, we know that a few large captive insurance company owners didn't respond to the survey, despite multiple requests for the information.

For the survey's that went to the list of companies provided by DOR, 341 companies initially answered that they did use captive insurers. However, 124 of these respondents (approximately 36%) did not comply with the Agencies' request to answer our follow-up survey. Of the 217 companies that responded to the second survey, only 47 companies ("owners") confirmed that captive insurance was used at some point during the 10 year period 2010 through 2019. Most of those captive insurers were not active for the entire 10 year period. The table below shows the number of active captive insurers by year (as defined by having non-zero gross written premiums, where gross equals premium written directly by the captive insurer, plus reinsurance premiums written by another insurer) based on the survey results. In addition, it shows the number of captive insurers that would be subject to Washington premium taxes on the corresponding direct written premium. Captive insurers included in the first column that only show reinsurance assumed in their financial statements would not need to pay premium taxes.

TABLE 9: NUMBER OF ACTIVE CAPTIVE INSURERS BY YEAR BASED ON SURVEY DATA

Year	# of Active Captives with Gross Written Premium > $0	# of Active Captives with Direct Written Premium > $0
2010	15	11
2011	17	12
2012	18	13
2013	19	14
2014	21	15
2015	23	16
2016	26	20
2017	29	22
2018	33	24
2019	35	23

We recognize that the survey did not capture the full extent of captive insurers owned by Washington-headquartered companies that insure risk in Washington. Therefore, we estimated the number of captive insurers owned by Washington-headquartered companies covering risk in Washington and the amount of direct written premium they collect. We did this by using the data from those that did respond, combined with external data on the entire captive insurance market and data about the State of Washington's relative size. Below is a summary of our findings. For details on how we developed these estimates, see Appendix B11.

TABLE 10: ESTIMATED SIZE OF WASHINGTON CAPTIVE INSURANCE MARKET FOR CAPTIVE INSURERS WITH NON $0 DIRECT WRITTEN PREMIUM

	Number of Direct Writing Captives				Medium Direct Written Premium	
		Estimated				
Year	Survey	Low	Medium	High	Survey	Estimated
2010	11	16	22	35	255,212,586	418,000,000
2011	12	18	25	40	302,313,454	496,000,000
2012	13	19	26	42	329,194,397	540,000,000
2013	14	20	28	45	405,222,540	664,000,000
2014	15	22	31	49	472,248,632	774,000,000
2015	16	24	34	54	461,826,570	757,000,000
2016	20	27	38	61	485,661,272	796,000,000
2017	22	30	43	68	499,744,075	819,000,000
2018	24	34	48	78	547,390,798	900,000,000
2019	23	36	51	82	156,889,107	300,000,000

After our survey was completed, we were asked to estimate premiums paid to captive insurers from companies not headquartered in Washington, but where the premiums covered underlying risks located in Washington. Since we did not survey companies not headquartered in Washington in Survey 2 we turned to the DOR for a summary of data on the top 100 B&O taxpayers in the State, split between Washington headquartered companies and out of state companies with business activity in Washington. Table 11 below summarizes the data received from the DOR.

TABLE 11: SUMMARY OF DATA FOR TOP 100 B&O TAXPAYERS

	Count	Gross Income	Taxable
Washington	37	53,707,140,444	39,528,949,834
Out of State	63	120,854,219,905	100,786,695,529
Ratio (Out of State to WA)	1.70	2.25	2.55

To estimate captive insurance direct written premiums allocable to Washington risks for non-Washington headquartered companies, Milliman applied adjustment factors to our estimate of premiums allocable to Washington risks for Washington headquartered companies. These adjustment factors were selected based on the ratio of "out of state" to Washington for each of the data items provided by the DOR in Table 11 above. The premiums related to Washington risks for Washington headquartered companies is based on our survey results. Table 12 below summarizes our results.

TABLE 12: ESTIMATED 2018 CAPTIVE INSURANCE DIRECT WRITTEN PREMIUM NON-WASHINGTON HEADQUARTERED COMPANIES

Washington Risk for Washington Companies	200,000,000
Adjustment Factor - Low	1.50
Adjustment Factor - High	2.50
Washington Risk for Non-Washington Companies - Low	300,000,000
Washington Risk for Non-Washington Companies - High	500,000,000

V. How Current Washington Law Treats Captive Insurance Premiums

To briefly recap, the OIC has determined that captive insurance is a form of unauthorized insurance that is not permitted under Washington law and is subject to taxation.

With respect to the DOR's B&O tax, RCW 82.04.320 exempts from the B&O tax any insurance premium revenue on which the insurance premiums tax has been paid. Accordingly, captive insurers would not have to pay B&O tax on insurance premiums on Washington based risks if they have already paid the insurance premium tax on those amounts to the State/OIC, but otherwise would be subject to B&O tax. The DOR is not aware of any captive insurers that pay B&O tax.

VI. Relevant Federal Law

The discussion below reviews four areas of Federal law that are relevant to captive insurance companies:

- Nonadmitted and Reinsurance Reform Act of 2010
- How the IRS Defines Insurance / IRS Litigation of Captive Insurers
- Federal Excise Taxes on Foreign Reinsurance
- Department of Labor Rules on Captives Insuring Employee Benefits

A. Nonadmitted and Reinsurance Reform Act of 2010

Congress enacted the NRRA in 2010, and the law first took effect in 2011. Subject to certain narrow exceptions, under the NRRA the placement of "nonadmitted insurance" is subject solely to the statutory and regulatory requirements of an insured's "home state." In addition, the NRRA provides that only the insured's home state may require any premium tax payment for nonadmitted insurance. Generally speaking, an insured's home state is the state in which its headquarters is located.

Nonadmitted insurance subject to the NRRA includes surplus lines insurance and insurance that is independently procured. It is an open question whether the NRRA applies to captive insurance. If captive insurance is subject to the NRRA, then Washington may only tax insurance written by a captive insurer if Washington is the home state of the insured.

A detailed discussion of the NRRA is included as Appendix B4.

B. How the IRS Defines Insurance / IRS Litigation of Captive Insurers

In the 1970s when captive insurance first began to gain broader popularity, the IRS argued that a single parent captive insurance company insuring only the risks of its parent and affiliates was not an "insurance company" as defined by the Internal Revenue Code and therefore, did not qualify for the tax treatment afforded to insurance companies. The IRS lost this argument, and captive insurers that succeeded in qualifying as an insurance company by meeting certain criteria were able to obtain favorable tax treatment.

The federal tax benefit that captive insurance company owners were seeking was the deduction of loss reserves for unpaid claims that is not allowed for non-insurers/self-insurers. Non-captive insurance company owners that retain risk can only deduct actual payments of claims, but not the corresponding reserves. An insurance company, in contrast, can deduct the value of reserves established for future claims payments at the time the reserves are established. Thus, the deduction can be taken sooner. By transferring risk to a captive insurer that qualifies as an insurance company for federal tax purposes (also taxed by the IRS), insurance company taxation rules apply, thereby allowing “accelerated deductions” relative to not having a captive insurer. By taking the position that the transactions were not “insurance”, the IRS essentially would ignore the captive insurer altogether, thereby eliminating any possibility of accelerating deductions for loss reserves.

Although the IRS initially took the position that single parent captive insurers were not insurance companies for federal income tax purposes, over time a body of law has developed recognizing that such captive insurers may qualify as insurance companies so long as the captive insurance arrangement (a) involves insurance risk; (b) involves risk shifting; (c) involves risk distribution; and (d) meets commonly accepted notions of insurance. Generally speaking, meeting these criteria requires that the captive insurer be organized, operated, and regulated as an insurer under the law of its domicile, charge an actuarially reasonable premium for insurance, be properly capitalized, and be able to pay claims as they arise. In addition, to meet the requirement of sufficient risk distribution, a single parent captive insurer must insure a sufficient number of brother/sister affiliates for a substantial amount of risk, insure substantial unrelated third-party risk, or insure a substantial amount of statistically independent risks. As these principles have emerged from the case law, the IRS’s position has shifted to more closely reflect the jurisprudence in this area.

Recently, the IRS has focused its enforcement efforts on so-called “micro-captives” that take an election available under Section 831(b) of the Internal Revenue Code allowing the captive insurer to be taxed only on its net investment income. Some of these captive insurers have failed to meet the criteria required to qualify as an insurance company for federal tax purposes, and the IRS has aggressively pursued audits and enforcement actions against taxpayers making use of such captive insurers.

A detailed discussion of the treatment of captive insurance under the Internal Revenue Code is included as Appendix B5.

C. Federal Excise Taxes on Foreign Insurance and Reinsurance

The United States taxes the buyer of insurance sold by foreign insurers (that are not subject to federal income taxes) to US taxpayers/entities. This is not restricted to captive insurers and isn't an issue for most captive insurers owned by US companies. If a US company owns a captive insurance company that is domiciled outside of the US and their captive insurer is not subject to US federal income taxes, premiums paid directly to that captive insurer are taxed at a 4.0% rate and are due from the buyer (captive insurance company owner) and not the captive insurance company itself. If a captive insurer domiciled in the US purchases reinsurance from a foreign reinsurance company, the captive insurer (buyer) is taxed at a 1.0% rate.

D. Department of Labor Rules on Captives Insuring Employee Benefits

US Department of Labor rules establish special requirements to insure or reinsure employee benefits covered by the Employee Retirement Income Security Act if the employer sponsoring the benefit plan owns 50% or more of the captive insurer. Under these circumstances, the sponsor generally must receive a "prohibited transaction exemption" ("PTE") from the Department of Labor to proceed with the arrangement. A number of large employers have received PTE's to reinsure their employee benefits to a captive insurance company owned by the employer.

The rules are specifically aimed at protecting consumers. For example, the captive insurer cannot directly insure plan participants; instead, an insurer carrying an A or better rating from AM Best must write the policy, and then reinsure the retained risk into the captive insurer. Also, there must be an enhancement in benefits for the transaction to be approved.

VII. How Do Other States Regulate and Tax Captive Insurance

The discussion below reviews how captive insurers are regulated and taxed by states other than Washington. Captive insurance companies are regulated primarily by their domicile – i.e., the jurisdiction in which the captive insurer is formed and licensed. Captive insurer domiciles typically tax all the premiums written by a domestic captive insurer but at a fairly low rate and with a cap on the maximum annual amount of taxes.

A. Regulation of Captive Insurance

1. Regulation by State of Domicile

Most captive insurers covering risks in the US are domiciled in the US. A minority of captive insurance companies that insure US risks are domiciled offshore, with Bermuda and the Cayman Islands being the largest offshore domiciles for captive insurers insuring US companies. Of the 47 companies that responded to our survey:

- 22 captives are domiciled outside the US (Cayman Islands, Barbados, Bermuda, Turks & Caicos, Anguilla and Bahamas)
- 19 captives are domiciled in the US (Vermont, Arizona, North Carolina, Hawaii, Tennessee, Puerto Rico and Utah)
- 6 captives did not provided information regarding where they are domiciled

There are 38 US states and territories that license captive insurers. The discussion below focuses on US captive insurance domiciles, although the regulation of captive insurers by non-US domiciles is very similar.

Overview

In most states, captive insurers are regulated by a special division within the department of insurance devoted to captive insurance regulation. An application to license a captive insurer typically requires the submission of a proposed business plan and feasibility study with an actuarial analysis demonstrating that the captive insurer will be capable of paying expected claims. The application also includes information about key service providers, biographical affidavits for key personnel, financial information concerning the captive insurance company's owner, and other supporting documentation. Regulators review the application to determine whether the business plan for the captive insurance company is financially sound and compliant with the state's domestic law. The regulator also determines whether the captive insurance company's management and key service providers are appropriately qualified.

Minimum Capital

The table below shows the minimum capital and surplus requirements for single parent/"pure" captive insurers by state. These statutory minimums are a starting point, as regulators may require additional surplus depending on how much insurance the captive insurer intends to write.

TABLE 13: MINIMUM CAPITAL AND SURPLUS REQUIREMENTS FOR SINGLE PARENT CAPTIVE INSURERS

Minimum Capital & Surplus	Number of States	States
100,000	1	NE
150,000	2	GU, OK
175,000	1	VI
200,000	1	NV
250,000	29	AL, AZ, AR, CT, DC, DE, FL, GA, HI, IL, KS, KY, ME, MI, MO, MT, NJ, NY, NC, OH, OR, RI, SC, SD, TN, TX, UT, VT, WV
500,000	3	CO, LA, PR
4,000,000	1	VA

Minimum capital requirements are higher for other types of captive insurers (group captive insurance companies, etc.), generally either $500,000, $750,000, or $1 million, depending on the state and the captive insurance company type. As a general rule of thumb, the larger the captive insurer (either measured by premiums or reserves), the higher the capital level. Captive insurance company owners must demonstrate that the capital and surplus is adequate to cover potential adverse years when losses (underwriting and/or investment) are worse than expected. In summary, most captive insurers have much more capital and surplus than the minimum levels.

Additional Oversight and Regulation

A captive insurer's domestic regulator exercises oversight over the captive insurer in several ways. Some oversight is indirect by means of a "captive manager." By law, a captive insurer must retain a qualified captive manager to manage the captive insurer's operations. The captive manager keeps the captive insurer's accounts, assists with fulfilling regulatory reporting requirements, provides support for corporate governance, and acts as the primary point of contact for the captive insurer's domestic regulator. The captive manager is expected to report to the regulator any condition that may threaten the captive insurer's solvency or liquidity or otherwise impair the captive insurer's ability to meet its obligations to policyholders, services providers, or reinsurers.

A captive insurer's domestic regulator also exercises direct oversight over the captive insurer. The captive insurer is required to make annual filings, including an audited financial statement and in most domiciles, a certification by an independent actuary that the company's reserves are sufficient to meet its liabilities. In addition, the captive insurance company must submit any material change to its business plan for review and approval by the domestic regulator. For example, a material change in the captive insurer's reinsurance or insured risks would require regulatory approval. A captive insurer also must obtain the approval of its domestic regulator to declare a dividend or to establish a plan for the payment of dividends. Captive insurers are subject to financial examination by their domestic regulator every three to five years.

Why States Choose to Become Domiciles

For the most part, states choose to be captive insurance domiciles for economic development reasons. Enacting a captive insurance statute and then attracting captive insurers to the domicile creates jobs in the state – primarily in the accounting, auditing, legal, actuarial, and insurance regulatory fields. Domiciles seek to distinguish themselves and attract captive insurers by building a robust captive insurance infrastructure, and selecting premium taxes levels, license fees, and minimum capital levels that are competitive with other domiciles.

Many captive insurance laws require at least one "in person" board meeting every year, bringing more dollars to the local economy. Many domiciles also have captive insurance associations that organize annual meetings that can attract hundreds of attendees, also bringing dollars to the local economy.

Captive insurance premium tax rates and fees are normally low relative to other types of insurance premium tax rates and fees and fees and are considered as ways for funding the regulatory infrastructure required for being a successful domicile. The larger benefits to the domiciliary state's economy are the local jobs created and expenditures of visitors noted above. For example, in 2016, the State of Delaware estimated the economic impact of captive insurance in their state as follows: "The captive insurance industry also directly and indirectly supports 2,537 Delaware jobs, creates almost $109 million in additional income, and generates over $5 million for the state in tax revenue."[18] Note the difference between tax revenues and total "additional income" created.

A few states have become domiciles to specifically cater to the needs of companies headquartered in their state to help these companies meet their insurance needs. These states generally are not attractive to out-of-state captive insurance company owners.[19]

2. Regulation by Non-Domiciliary States

Captive insurers are regulated primarily by their state of domicile. Although captive insurance may be subject to regulatory oversight as a form of independently procured insurance or industrial insurance, it is rare for a non-domiciliary state to enforce its insurance laws against an out-of-state captive insurer.

B. Taxation of Captive Insurance

1. Captive Insurance Premium Taxation in US Domiciles

Focusing on US domiciles, most impose premium taxes on their domiciled captive insurance premiums. In most states, premium tax rates (i.e., marginal tax rates) decline as premiums rise (e.g., for the first $20 million of premiums, there is one rate, and then a lower rate for the next $20 million, etc.). Also, most states have different rates for each of direct premiums and premiums assumed from another insurer/reinsurer. The highest US domicile tax rate is 0.8% (we have ignored Florida, Louisiana, and Virginia, which, collectively had three licensed captive insurers as of 12/31/18), with most maximum marginal tax rates in the 0.2%-0.4% range. Many domiciles have minimum and maximum annual premium tax levels as well.

The tables below provide a summary of captive insurance tax rates and minimum and maximum annual taxes by US domicile.

[18] "The Economic Contributions of the Captive Insurance Industry to the Delaware Economy: An analysis by the University of Delaware's Center for Applied Business & Economic Research (CABER)." Delaware Department of Insurance. August 2016. https://captive.delaware.gov/wp-content/uploads/sites/18/2016/12/caber-narrative-updated-by-jerry-201610.pdf
[19] "The Four Models for "Why or Don't Go Captive?"" Captive Insurance Company Report, September 2019.

TABLE 14: MAXIMUM MARGINAL CAPTIVE INSURANCE TAX RATES BY STATE

State	Maximum Marginal Tax Rate	State	Maximum Marginal Tax Rate	State	Maximum Marginal Tax Rate
AL	0.400%	KY	0.400%	OR	N/A[1]
AR	0.250%	LA	3.083%	RI	0.200%
AZ	N/A[1]	ME	N/A[4]	SC	0.400%
CO	0.500%	MI	0.200%	SD	0.800%
CT	0.380%	MO	0.380%	TN	0.400%
DC	0.250%	MT	0.400%	TX	0.500%
DE	0.002%	NC	0.400%	UT	N/A[1]
FL	1.750%	NE	0.250%	VA	2.250%
GA	0.400%	NJ	0.380%	VT	0.380%
HI	0.250%	NV	0.400%	WV	0.500%
IA	N/A[3]	NY	0.400%	GU	N/A[4]
IL	0.500%	OH	0.035%	PR	N/A[2]
KS	0.2%	OK	0.200%	VI	N/A

[1]Requires annual renewal fee
[2]Pays annual contribution based on size of annual premium
[3]Only allows "limited purpose subsidiary life insurance companies" which is a reinsurance captive insurer for other life insurance companies
[4]Files corporate income tax only

TABLE 15: MINIMUM AND MAXIMUM ANNUAL CAPTIVE INSURANCE TAXES BY STATE

State	Minimum Tax	Maximum Tax	State	Minimum Tax	Maximum Tax	State	Minimum Tax	Maximum Tax
AL	$5,000	N/A	KY	N/A	N/A	OR	$5,000	$5,000
AR	$5,000	$100,000	LA	N/A	N/A	RI	$2,500	N/A
AZ	$5,500	$5,500	ME	N/A	N/A	SC	$5,000	$100,000
CO	$5,000	N/A	MI	$5,000	$100,000	SD	$5,000	$50,000
CT	$7,500	$200,000	MO	$7,500	$200,000	TN	$5,000	$100,000
DC	$7,500	$100,000	MT	$5,000	$100,000	TX	$7,500	$200,000
DE	$5,000	$200,000	NC	$5,000	$100,000	UT	$5,000	$5,000
FL	N/A	N/A	NE	N/A	N/A	VA	N/A	N/A
GA	N/A	$100,000	NJ	$7,500	$200,000	VT	$7,500	$200,000
HI	N/A	$200,000	NV	$5,000	$175,000	WV	N/A	N/A
IA	N/A	N/A	NY	$5,000	N/A	GU	N/A	N/A
IL	N/A	N/A	OH	$7,500	$250,000	PR	$5,000	$75,000
KS	N/A	$500,000	OK	$5,000	$100,000	VI	N/A	N/A

The table below shows all of the tax rates for the State of Vermont, the largest US domicile as measured by captive insurance premiums.

TABLE 16: VERMONT CAPTIVE INSURANCE PREMIUM TAX RATES

Premium Range	Direct Tax Rate	Assumed Tax Rate
0 to $20M	0.380%	0.214%
$20M to $40M	0.285%	0.143%
$40M to $60M	0.190%	0.048%
$60+	0.072%	0.024%

Minimum = $7,500; Maximum = $200,000

2. Captive Insurance Premium Taxes and Fees in Non-Domiciliary States

The taxation of captive insurance by states outside of the captive insurer's domicile varies from state to state.[20] Some states – for example, Ohio, North Carolina, and Georgia – only tax captive insurers domiciled in the state. Insurance provided by out-of-state captive insurers is not taxed. One state – Texas – taxes any captive insurer that insures risk in the state. Another state – Indiana – has a registration fee for some captive insurance companies. Other states – for example, New Jersey and New York – treat insurance obtained from a captive insurer that is not authorized in the state as a form of independent procurement and therefore is subject to taxation as such. In many states, the tax treatment of insurance obtained from an out-of-state captive insurer is not clear. If the state imposes a tax on independently procured insurance or industrial insurance, the captive insurance company owner may be subject to the tax, but in our experience, most states do not enforce their independent procurement taxes against captive insurance company owners.

Below is a summary of ways that captive insurance can be taxed/assessed in non-domiciliary states, along with the corresponding tax rates/fees.

Independent Procurement

Most states assess a tax on premiums written by unauthorized insurers for insurance that is directly procured by the insured on its own behalf. Such transactions are commonly referred to as "direct" or "independent procurement" or sometimes "self-procurement." Tax rates on independent procurement are generally in the 2%-5% range (i.e., 39 of 46 states/territories that permit independent procurement have rates in this range). Generally speaking, state laws governing independent procurement require

[20] This discussion focuses on premium taxes assessed on captive insurance transactions. A few states have sought to subject captive insurers to state income tax. Because Washington does not have a corporate income tax, we do not address this issue.

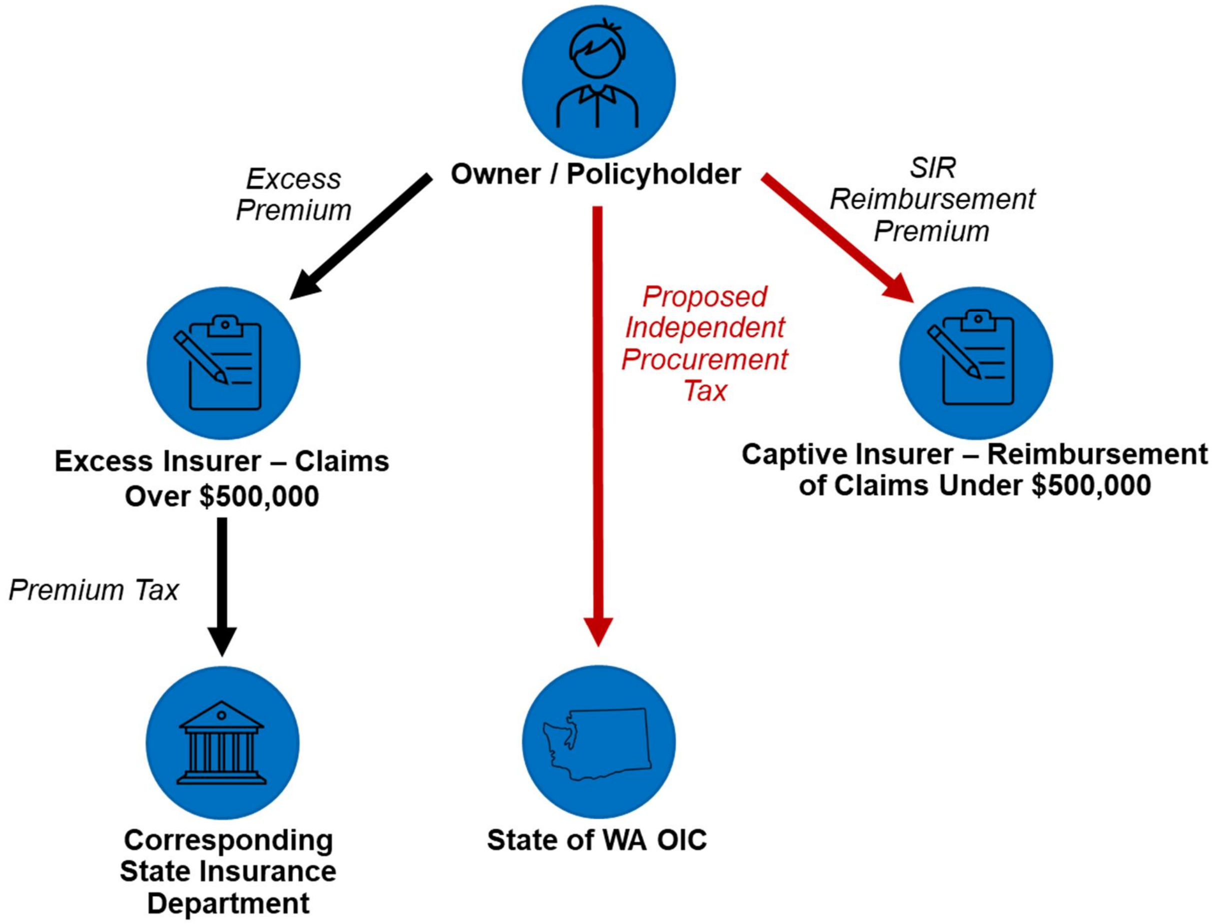
that the insurance be negotiated entirely or primarily outside the state. So long as the insured reports the transaction and pays the required premium tax, the unauthorized insurer providing the insurance is not required to be licensed in the state. Washington does not have an independent procurement statute, although different versions of this were proposed in the last legislative session where a 2% procurement rate was proposed. This rate would have been equal to or lower than 42 other states/territories.

TABLE 17: NUMBER OF STATES BY INDEPENDENT PROCUREMENT TAX RATE

Procurement Tax Rate	Number of States	States
Less than 1.000%	1	IL
1.000%	1	IA
1.001% to 1.999%	2	ID, ND
2.000%	5	AR, KY, MI, MN, OR
2.001% to 2.999%	2	MT, SD
3.000%	12	AZ, CA, CO, DE, MD, ME, MS, NE, PA, VT, WI, WY
3.001% to 3.999%	4	AK, NM, NV, NY
4.000%	5	AL, CT, GA, NH, RI
4.001% to 4.999%	4	HI, LA, TX, UT
5.000%	7	FL, MO, NC, NJ, OH, TN, VI
5.001% +	3	KS, OK, PR
N/A	8	DC, GU, IN, MA, SC, VA, WA, WV

The chart below shows the flows of premium taxes to the state if an independent procurement tax were to be enacted in Washington. The chart shows the premium tax paid by an excess insurer for an excess liability policy in accordance with current law and the independent procurement tax that would be paid by a captive insurance company owner for a reimbursement policy of a self-insured retention (“SIR”) of $500,000 per claim issued by the owner’s captive insurance company. The independent procurement tax represents one of the possible options under consideration and is shown here for illustrative purposes.

CHART 2: CAPTIVE INSURER / REIMBURSEMENT OF $500,000 SIR PER CLAIM PREMIUM AND PREMIUM TAX FLOW (AT POLICY INCEPTION)



Industrial Insurance

Some states permit larger, more sophisticated insureds known as "industrial insureds" to purchase insurance from unauthorized insurers without imposing the restrictions that apply to independent procurement. State laws permitting such insurance generally define an "industrial insured" by reference to factors such as aggregate annual premiums paid for insurance, annual revenues or gross assets, number of employees, and use of a full-time risk manager or risk consultant who meets certain criteria to purchase insurance. Typically, these laws do not require an industrial insured to negotiate the insurance outside the state, as is generally required for independently procured insurance. Industrial insureds are responsible for paying a premium tax on the insurance they purchase from an unauthorized insurer. In states that permit industrial insurance, captive insurance company owners that qualify as industrial insureds may purchase insurance from their captive insurers under this authority.

Registration Only

Only Indiana charges registration fees for captive insurers not domiciled in its state, and the annual fee of $2,500 only applies to a small subset of captive insurers – micro-captives and captive insurers owned by Indiana state educational institutions.[21]

Unauthorized Insurers

Generally speaking, states treat unauthorized insurers in the following ways: First, an eligible surplus lines insurer may place insurance in the state through a licensed surplus lines broker acting in compliance with state surplus lines laws. In this case, the surplus lines broker is responsible for paying a premium tax on the transaction. Second, in many states (but not Washington) an insured may independently procure insurance from an unauthorized insurer by negotiating the insurance entirely or primarily outside the state. In this case, the insured is responsible for paying a premium tax on the transaction. Third, some states (but not Washington) permit unauthorized insurers to write insurance for larger, more sophisticated insureds that qualify as an "industrial insured." In this case, too, the insured is responsible for paying a premium tax on the transaction. Fourth, many states permit unauthorized insurers to write certain lines of insurance, such as ocean marine. Finally, if an unauthorized insurer does not qualify for any exemption from licensing under state law, but writes insurance in a state nonetheless, the insurer generally is responsible for paying a premium tax on the transaction. The OIC has determined that captive insurers fall into this last category. An unauthorized insurer that transacts the business of insurance in a state without qualifying for an exemption from licensing is in violation of state law and may be subject to penalties.

[21] Indiana Code § 27-1-2-2.3

VIII. Policy Considerations and Revenue Forecasts

A. Policy Considerations

To establish a regulatory and taxation framework for captive insurers, we present three policy considerations for regulating and taxing Washington-headquartered companies using captive insurance:

1. Creating an overarching regulatory and taxation framework for captive insurance in Washington
2. Selecting the tax base / premiums subject to taxation
3. Selecting the tax rate(s) to be applied to the subject premium

The discussion below summarizes the policy options we reviewed with respect to each of these issues. The chart that follows expands on the pros and cons of each consideration.

Creating an Overarching Regulatory and Taxation Framework

We reviewed three options selected by the Agencies for establishing an overarching regulatory and taxation framework, as follows:

1. **Independent procurement.** Under this option, insureds in Washington would be permitted to procure insurance from a captive insurer licensed in another state or offshore jurisdiction and would be required to pay a tax on the premium. This option might include limiting the types of insureds permitted to engage in independent procurement to entities of a certain size and sophistication. If such limitations were established, this option would operate more like what is commonly referred to in other states as “industrial insurance.” Washington SB 6241/HB 2291, which was introduced in the 2020 legislative session, illustrates one form this option could take.

2. **Registration of captive insurer.** Under this option, captive insurers insuring any company headquartered in Washington would be required to register with the OIC and pay a premium tax. This option might include limiting captive insurers permitted to register to those owned by an entity of a certain size and sophistication. Washington SB 6331/HB 2493, which was introduced in the 2020 legislative session, illustrates one form this option could take, although that bill required registration of any captive insuring risks located in Washington, regardless of where the insured was headquartered.

3. **Establish Washington as a captive insurance domicile.** This option would involve authorizing the OIC to license and regulate captive insurance companies that would be formed under Washington law. Such captive insurers would be permitted to insure risks in Washington and in other states to the extent permitted by state law. They would be required to pay a premium tax on all of the insurance they write. Although this option does not establish any regulatory or taxation framework for out-of-state captive insurers, it is not exclusive of the other options and could be implemented in tandem with one of them.

Selecting the Tax Base / Premiums Subject to Taxation

Regardless of what sort of regulatory and taxation framework is established for captive insurance, any framework will require selecting the premium subject to taxation. We identified three options in this regard, as follows:

1. **Tax premiums according to the "home state" rule established by the federal Nonadmitted Reinsurance and Reform Act ("NRRA").** Under this approach, the state would tax the premiums for a policy only if the insured's "home state" is Washington. Generally speaking, an insured's home state is the state in which its headquarters is located. If the insured's home state is Washington, 100% of the premium for risks located anywhere in the US would be taxed. This is the approach now applied to surplus lines insurance in Washington and is the approach proposed in SB 6241/HB 2291. Note that if more than one insured from a group of affiliated companies are named insureds under a policy, the home state for that policy is the home state of the affiliate to which the greatest percentage of premium is attributable. The NRRA home state rule is discussed in detail in Appendix B4.
2. **Tax premiums only for insurance covering risks in Washington (broad definition).** Under this approach, the State would tax only premiums attributable to risks located in Washington, as in the first approach, but would employ a broad definition of "risks located in Washington". This approach is different from the narrow definition only with respect to "reimbursement policies," which would include deductible reimbursement policies and policies reimbursing the insured for self-insured risks, such as a policy providing reimbursement for self-insured workers compensation risks. This approach recognizes that the policy covers financial loss, and considers 100% of the premium for a reimbursement policy insuring a company headquartered in Washington to be

attributable to risk located in Washington and therefore taxable. Thus, for example, 100% of the premium for a policy reimbursing a Washington-headquartered company for self-insured workers compensation risks would be taxable, notwithstanding the fact that some of the company's employees are located outside of the state. This is the approach taken by the OIC in its most recent enforcement actions against captive insurers insuring companies headquartered in Washington.

3. **Tax premiums only for insurance covering risks located in Washington (narrow definition).** Under this approach the State would tax only premiums attributable to risks located in Washington. The state would "look through" the policy to determine the location of the risks giving rise to an insured loss and only tax premium attributable to such risks. For example, in the case of a policy reimbursing an employer for self-insured workers compensation risks, only premium attributable to the risk of loss for employees located in Washington would be taxed. This is the approach proposed in SB 6331/HB 2493.

Within each of the three tax bases, "carve outs" could be considered, such as non-profits/educational institutions, or certain types of coverages. At the request of the Agencies, we tested the impact of excluding premiums paid for reimbursement policies that reimbursed self-insurers for workers compensation payments for Washington risks. This would be an example of a coverage "carve out."

Selecting a Tax Rate

The Agencies requested that we use tax rates of 2.0% (from the OIC) and 1.75% (based on the DOR B&O tax rate).

Policy Considerations for Regulation and Taxation of Captive Insurance in Washington State

Option	Description and Major Policy Decisions	Pros	Cons
Regulatory framework			
1. Independent Procurement	• Washington insureds would be expressly permitted to procure insurance directly from unauthorized insurers without the use of a broker acting in the state • Insured would report the transaction to the state and pay any premium tax	• Simple approach: Insured reports the transaction to the state and pays any tax due • “Tried and true” approach: 46 states/territories permit independent procurement • Transparency regarding the number and amount of captive insurance transactions occurring in Washington	
	Major Policy Decisions		
	1. Should any limitations be placed on who may independently procure unauthorized insurance?		
	a. No limitations	• Small and mid-sized businesses and institutions would have access to captive insurance • Approach followed by other states that allow independent procurement ○ Other states place no limitations on who may independently procure insurance from unauthorized insurers. Instead, unauthorized insurers are not permitted to solicit business in the state, whether directly or through agents, which generally means only sophisticated insureds independently procure	• Less sophisticated insureds might not understand risks of transacting with insurer not regulated by Washington State

Option	Description and Major Policy Decisions	Pros	Cons
	b. Limit independent procurement to certain types of entities—for example, large entities that qualify as an "exempt commercial purchaser" under NRRA and Washington law (This approach is more akin to what is termed "industrial insurance" in other states)	• Presents less risk that unsophisticated insureds would independently procure insurance without understanding risk of obtaining insurance from insurer not regulated by Washington State	• Small and mid-sized businesses would not have access to captive insurance • Would likely limit tax base, resulting in less tax revenue
	c. Consider a different approach: Only allow commercial lines of insurance[22] to be independently procured and require purchaser to acknowledge understanding that insurer is not regulated by Washington State and guaranty fund protection may not be available	• More flexible, risk-based approach • Small and mid-sized businesses would have access to captive insurance • Easy to enforce and does not require picking "winners" and "losers" or establishing an arbitrary line between businesses that are allowed to use captive insurance and those that are not	• Even with acknowledgment, some insureds could ignore risk
	2. Should any limitations be placed on the types of unauthorized insurers from which insurance may be independently procured?		
	a. Allow insureds to independently procure insurance from any type of unauthorized insurer	• Approach taken in most other states	• Unsophisticated insureds might not understand risks of transacting with insurer not regulated in Washington State
	b. Only allow insureds to independently procure insurance from a captive insurer licensed in another state	• Presents less risk that insureds will independently procure insurance without understanding risks of obtaining insurance from insurer not regulated in Washington State	• Not the approach followed by most other states with independent procurement • Would likely limit tax base, resulting in less tax revenue
	c. Require purchaser to attest to the solvency of the insurer, as is required for surplus lines brokers in RCW 48.15.090	• May help ensure unauthorized insurer is solvent	

[22] By "commercial lines," we mean lines of insurance other than those primarily for personal, family or household use.

<table>
<tr><th>Option</th><th>Description and
Major Policy Decisions</th><th>Pros</th><th>Cons</th></tr>
<tr><td rowspan="4">2. Register Captive Insurers with OIC</td><td>• Captives insuring companies headquartered in Washington State would be required to register with OIC
• Registered captive insurers would be required to pay a registration fee, file evidence of good standing in state of domicile, and pay premium tax</td><td>• OIC would have evidence that captives insuring risks in state are in good standing in state of domicile
• OIC would receive annual registration fees</td><td>• Narrower option than broad independent procurement option</td></tr>
<tr><td colspan="3">Major Policy Decisions</td></tr>
<tr><td>1. Is commitment of resources necessary to register captive insurers worthwhile?</td><td colspan="2">Cost/benefit analysis – cost to state does not appear substantial</td></tr>
<tr><td>2. Should any limitations be placed on size or type of captive insurance company owners that may register their captive insurer to insure risks located in the state?</td><td colspan="2">Considerations are the same as for limiting persons who may procure insurance and types of insurers that may provide it under independent procurement; see Independent Procurement above</td></tr>
<tr><td>3. Establish Washington as Captive Insurance Domicile</td><td>• OIC would license and regulate captive insurers formed in the state
• Captive insurers licensed by OIC would be permitted to insure risks located in the state and elsewhere</td><td>• Would establish tight regulatory control over captive insurance
• Could generate revenue and, possibly, job growth for Washington if state became popular domicile for captive insurance
• This option is not exclusive. It could be selected in addition to other options.</td><td>• Uncertain whether Washington companies would form and license captive insurers in the state, for example Florida has been a domicile state for more than 39 years and only has 1 captive insurer
• Significant resources would be required to license and regulate domestic captive insurers
• Revenues and job growth generated from licensing and regulating captive insurance are fairly small; they are significant only for small states
• Does not establish framework for regulating out-of-state captive insurers</td></tr>
</table>

	Major Policy Decisions		
	1. Is commitment of resources necessary to become a captive insurance domicile worthwhile?	Cost/benefit analysis; probably not worthwhile given substantial costs and limited benefits	
	2. Would out-of-state captive insurers also be allowed to provide insurance for risks located in Washington State?	Policy considerations are the same as for options 1 and 2 above	
Tax base: **Needs to be considered in conjunction with Tax Rate**			
1. Apply NRRA "Home State Rule"	• Premium would be taxed only if Washington is insured's "home state" as defined by the NRRA • Would treat taxation of captive insurance the same way surplus lines insurance is now treated in Washington State	• Broad tax base, so potentially could raise more revenue than other options if tax rate is not so high as to drive out captive insurers • **Brings WA in line with the majority of states that enacted legislation conforming to the NRRA and takes advantage of law that only gives WA the right to collect premium tax - if WA does not collect it, no other state can**	• If tax rate is too high, captive insurance company owners would be incentivized to structure coverage so that Washington is not home state • Although NRRA can be read to apply to captive insurance, the issue is not settled.

2. Tax only premiums for risks located in WA state (narrow)	• Tax would apply only to premiums for insurance of risks located in Washington State	• Might result in greater use of captive insurance because tax burden would be lower	• Assuming NRRA applies to captive insurance, WA would forgo tax revenue that only WA state can collect under the NRRA. • If not limited to captive insurance, creates an incentive for companies to independently procure rather than use a surplus lines broker because they would only have to pay tax on WA risk, whereas if they used surplus lines, they would have to pay tax on all risk. • Potential for companies to avoid tax by excluding WA risks from captive insurance policies • NRRA home state rule may still apply, which would limit tax to WA headquartered companies; McCarran-Ferguson Act, as interpreted in *Todd Shipyards*, also could limit WA authority to tax captive insurers owned by insureds headquartered elsewhere if only contacts with state are presence of insured risk and fact that the insured does business in the state
	Major Policy Decisions		
	1. What methodology should be used to allocate premium to risks “located” in Washington State?		
	a. Allocate using narrow definition of WA risks	Narrower tax base, but expectation is that Washington companies may maintain use of captive insurance at the 2019 level	
	b. Allocate using broad definition of WA risks	Using this methodology likely is similar to using NRRA Home State Rule because most of captive insurance premium is attributable to “reimbursement” policies; estimated premiums are 85% of the NRRA definition	

Tax rate: **Needs to be considered in conjunction with Tax Base**			
Selection of Tax Rate	**Major Policy Decisions**		
	1. What should the tax rate be?	Tax revenues will depend on the interaction of the tax rate with the tax base	
	2. What agency should collect the tax?	The selection of the tax collection agency may influence the tax base and rate selection	
1. Tax rate of 2.0%		• Consistent with tax rate paid by most admitted carriers and for surplus lines insurance in Washington State • 2% is on the lower side of premium taxes compared to most states – see chart 7 on page 21.	• May result in continued drop in captive insurance use by Washington companies • 2% is higher than the premium tax rate applied by most captive insurance domiciles
	Major Policy Decisions		
	1. How does tax rate interact with tax base?		
	a. Base is NRRA Home State/WA risks using broad definition	Expectation is that Washington companies will continue to reduce use of captive insurance below the 2019 level, resulting in low premium revenues	
	b. Base is WA risks using narrow definition	Expectation is that Washington companies may maintain use of captive insurance at the 2019 level or higher if captive owners that discontinued use of their captive insurers in 2019 return to using their captive insurers.	
2. Tax rate of 1.75%		• Consistent with B&O tax rate in current statutes for premiums not otherwise taxed	• May result in continued drop in captive insurance use by Washington companies
	Major Policy Decisions		
	1. How does tax rate interact with tax base?		
	a. Base is NRRA Home State/WA risks using broad definition	Expectation is that Washington companies will continue to reduce use of captive insurance below the 2019 level, resulting in low premium revenues	
	b. Base is Washington risks using narrow definition	Expectation is that Washington companies may maintain use of captive insurance at the 2019 level	
3. Tax at some other percentage	Something lower than 2% currently taxes admitted and surplus lines or 1.75% for B&O	• Greater likelihood that captive insurance use and captive insurance premiums will increase from 2019 levels • May result in higher overall tax receipts due to increased use of captive insurance by large companies	• Tax rate will be different than those applied to other types of insurance

	Major Policy Decisions		
	1. How does tax rate interact with tax base?		
	a. Base is NRRA Home State/WA risks using broad definition	Assumptions are that Washington companies will increase use of captive insurance compared to 2019 if the rate is lower	
	b. Base is WA risks using narrow definition	Same assumptions as NRRA Home State scenario in 1a. above	
Require payment of back taxes?			
1. Require captive insurers to pay back (unpaid) premium taxes for unauthorized insurance going back 4 years/10 years 2. Require captive insurers to pay back (unpaid) B&O taxes for 4 years based on current DOR authorization for premiums not paid (4 years already in statute). 3. Don't include any authorization to collect back (unpaid) taxes.	**Major Policy Decisions** **1. Whether existing premium or B&O tax statutes should be used to collect back taxes** **2. If so, how many years should a lookback apply to?**	• Options 1 and 2: Potential additional revenue for the state • Option 3: Represents a "clean slate" for companies to begin operating under new framework	• Potential sizable taxes may be difficult for companies in current economic environment

B. Projected Captive Insurance Premium and Premium Tax Revenues

We estimated expected premium tax revenue to be collected in the first year under each framework. In estimating the future premium taxes, this involved trying to predict the behavior of a few large captive insurance company owners.

We assume that the subject premium will decrease as the tax rate increases or the taxable base expands. The underlying premise is that the higher the tax rates and broader definitions of the taxable base, captive insurance company owners will be less willing to pay the resulting tax and will either restructure their policies or otherwise change the use of their captive insurers to mitigate against this. Conversely, lower tax rates and narrower definitions of the taxable base will likely result in more captive insurers being willing to pay the resulting tax. Tax rates and tax bases were provided by the Agencies. With respect to the tax base, three definitions were provided by the Agencies: NRRA, Washington Only (Broad), and Washington Only (Narrow). To estimate the tax base, we started with 2019 premiums from the survey and estimated the missing premiums from captive insurance company owners that did not respond.

The estimated direct written premium amounts for NRRA and WA Only (Narrow) are based on our estimates of the total captive insurance direct written premium for Washington-headquartered companies. The WA Only (Broad) premium is based on the OIC definition of which premiums are subject to taxation, which includes all premiums from reimbursement policies based on the location of the insured's principal place of business. Specifically, the WA Only (Broad) premium is estimated to be 85% of NRRA, which is based on the estimated percentage of premiums related to reimbursement policies (as defined by the OIC) from our survey results.

Then, we estimated "Year 1" captive insurance premiums by estimating how much of the 2019 premium base would remain in the market if either a 2.0% premium tax or a 1.75% premium tax was enforced. The 2.0% and 1.75% tax rate assumptions were provided by the OIC and the DOR, respectively. See Appendix B12 and Appendix D for more details.

C. Estimated Unpaid Taxes

At the request of the Agencies, we calculated the potential unpaid taxes based on taxable bases and tax rates provided by the Agencies. Under the OIC (WA Only Broad") option, we were also asked to include potential penalties and interest. The 2.0% and 1.50% tax rates were provided by the OIC and the DOR, respectively. The

20.0% penalty and 12.0% interest rate assumptions were both provided by the OIC. See Appendix B12 and Appendix D for a range of estimates and details by year.

IX. Disclosures and Limitations

A. Acknowledgement of Qualifications

Joel S. Chansky, Craig R. Brophy, and David R. Kennerud are Principals of Milliman, Fellows of the Casualty Actuarial Society, and Members of the American Academy of Actuaries.

B. Data and Information

In performing this analysis, we relied on data and other information provided by the Agencies and by the survey respondents. We have not audited or verified this data and information. If the underlying data or information is inaccurate or incomplete, the results of our analysis may likewise be inaccurate or incomplete. In that event, the results of our analysis may not be suitable for the intended purpose.

We performed a limited review of the data used directly in our analysis for reasonableness and consistency and have not found material defects in the data. If there are material defects in the data, it is possible that they would be uncovered by a detailed, systematic review and comparison of the data to search for data values that are questionable or relationships that are materially inconsistent. Such a review was beyond the scope of our assignment.

C. Uncertainty

The estimates of historical and projected premiums and tax revenues are subject to considerable uncertainty. We estimated the overall size of the Washington captive insurance market based on various economic factors including the worldwide number of captive insurers and captive insurance premium, estimates of the percentage of captive insurers related to US entities, and estimates of the size of Washington's economy as a percentage of the US economy. We compared these estimates to the information provided by the survey respondents in selecting premium estimates by year, by taxable base (Washington-located risks vs NRRA) and by coverages including but not limited to reimbursement policies. To the extent that the information provided by the survey respondents is not representative of the overall Washington captive insurance market, the uncertainty in our estimates is increased.

In order to project premium and potential tax revenue under Year 1 of the various frameworks, we needed to predict how captive insurance company owners would react to the various tax rates and taxable premium definitions. Actual behavior by captive insurance company owners may vary significantly from the assumptions that underlie our estimates. In addition, the behavior of a handful of large captive insurance company owners will materially impact the results.

Appendices

Appendix A
Excerpts from Contract and RFQQ

From the Contract:

Data Collection and Research

CONTRACTOR must work with AGENCIES to develop a survey to be used to identify active captives in Washington State (Survey One). CONTRACTOR will use information from AGENCIES and any other available resources to establish a list of Washington companies and public entities that potentially own or use captive insurance companies in any and all forms. AGENCIES will review list to determine if any companies or entities should be excluded from the study. CONTRACTOR will distribute Survey One to the identified companies and public entities, as well as Washington industries known to participate in cell, agency, association, industry, micro, rent-a-captives and any other type of captive insurance.

CONTRACTOR will send all identified captives a survey to collect data for in depth analysis (Survey Two). Survey Two will collect data and documents such as:

- Documents supporting incorporation
- Feasibility study documents
- Annual statements going back five (5) years
- Copies of policies issued by the captive insurer, or reinsurance contracts entered into in the past five (5) years
- Premium volume data for those policies or reinsurance contracts

[Based on discussions between Milliman, OIC, and DOR, it was agreed to restrict the document list to three years of annual statements, a list of 2019 policies, and premium information for 2010-2019. This change was made to address concerns from industry stakeholders that the larger document request would be onerous and of little value.]

CONTRACTOR will work with DOR to ensure that the data requested is provided by identified captive in accordance with the DOR's statutory authority to examine the books and records of any person engaging in potentially taxable business activities in this State per the Revised Code of Washington (RCW) 82.32.070, .110. CONTRACTOR will handle such data consistent with the requirements of RCW 82.32.330 to the extent applicable.

The AGENCIES' anticipate that additional captive entities may be identified after Survey Two is initially distributed. CONTRACTOR will continue to distribute Survey Two to newly identified captive entities, and integrate any additional data received, up to submittal of the Draft Report described below.

Report

CONTRACTOR must prepare a Draft Report that compiles CONTRACTOR research into the captive insurance industry and analyzes the results of Survey Two.

The Draft Report must provide details on at least the following topics:

(Italicized items below are from RFQQ #S202107, where terms are generally the same as those in the contract, but with more details):

- An overview of how the insurance industry functions
  - *How individual states enact state-specific taxation laws and regulations*
  - *How Washington State consumers purchase policies via both the admitted and surplus lines markets*
  - *Detail how OIC collects premium taxes and how DOR collects B&O taxes*
- How captives developed and why some states choose to be domiciles for captives
  - *The regulatory and taxation landscape for captives across the United States*
  - *How states tax and regulate captives under independent procurement and surplus lines laws*
  - *How the current domicile states of captives currently tax and regulate captives*
  - *Any additional forms of captive regulation discovered*
  - *How states address the unauthorized use of captive insurance*
- Federal Law – Nonadmitted and Reinsurance Reform Act (NRRA), how it works and case law related to federal law
- How the IRS defines insurance companies and IRS litigation of captives
- What are the benefits of captive insurance companies and why do companies choose to use them over obtaining insurance through the admitted and surplus lines markets
- The scope and nature of captive insurance in Washington State and how this is impacting the insurance market in Washington
  - *Number of Washington companies using captive insurance companies*
  - *Industries that use captive insurance*
  - *Types of captives*
  - *Types of policies*

- *Premium volume*

The Draft Report must use the details provided to recommend regulatory framework for Washington State including at least the following:

- Identification of all frameworks for taxing captives identified through the study. They must include, but are not limited to, Independent Procurement, captive domiciles, registration only, and unauthorized insurance
- Pros and cons for each regulatory and taxation framework
- Estimated premium tax or B&O tax revenues under each taxation framework identified, using standard rates provided by AGENCIES for calculation
- Explanations of differing interpretations and options within the taxation frameworks and the differences in estimated premium tax or B&O tax revenue calculations if definitions are interpreted differently

[Based on discussions between Milliman, OIC, and DOR, it was agreed that it was not within the scope for Milliman to make recommendations on the regulatory framework.]

The RFQQ states the following:

Primary Objectives

Upon review of the study and report, an individual should be able to:

- Understand how insurance works in general and specifically in Washington State and how it is taxed
- Identify the number of Washington businesses and public entities who insure their risk through a captive insurer
- Understand how federal law (NRRA) impacts insurance and captive insurance specifically
- Understand why Washington businesses and public entities have decided to insure risk through a captive insurer
- Understand how the IRS treats captives insurers
- Understand what types of risk Washington businesses and public entities are insuring through captive insurers
- Understand how captive insurance functions in other states and the benefits of using captive insurers

- Understand the costs and benefits of insuring risk through a captive insurance company
- Understand the impact of captive insurance on the Washington insurance market
- Understand all of the optional taxing frameworks, their pros and cons and premium tax implications
- Understand the tax implications for Washington State when Washington businesses and public entities insure through a captive insurance company

Appendix B
Technical Appendix

Appendix B1
An Overview of How the Insurance Industry Functions

In this Appendix, we provide the following:

- Introduction to Insurance – Terminology, Overview of State Regulation
- How Washington Consumers Purchase Insurance

A. Introduction

1. High Level Review and Terminology

Insurance policies are contracts between two parties. Insurers are "companies that offer risk management in the form of insurance contracts. The basic concept of insurance is that one party, the insurer, promises payment for an uncertain future event. Meanwhile, another party, the insured or the policyholder, pays a smaller premium to the insurer in exchange for that protection on that uncertain future occurrence."[23]

The party purchasing the insurance is referred to as "the insured" or "the policyholder". The insured makes payments either directly to the insurer or through an intermediary, called an agent or a broker. "The insured receives a contract, called the insurance policy, which details the conditions and circumstances under which the insurer will compensate the insured. The amount of money charged by the insurer to the policyholder for the coverage set forth in the insurance policy is called the premium. If the insured experiences a loss which is potentially covered by the insurance policy, the insured submits a claim to the insurer for processing by a claims adjuster. The insurer may hedge its own risk by taking out reinsurance, whereby another insurance company agrees to carry some of the risks, especially if the primary insurer deems the risk too large for it to carry."[24]

[23] Brian Beers. "A Brief Overview of the Insurance Sector," Investopedia, October 11, 2019. https://www.investopedia.com/ask/answers/051915/how-does-insurance-sector-work.asp
[24] *Wikipedia, The Free Encyclopedia,* ""Insurance," https://en.wikipedia.org/wiki/Insurance

2. State Regulation and Taxation of Insurers

The regulation and taxation of the insurance industry has been left almost entirely to the states. The following is a brief synopsis of the history of state regulation and taxation of insurers:

> "A post-Civil War Supreme Court decision asserted the fact that insurance was subject solely to state regulation and that the congressional commerce power did not apply to the regulation and taxation of the industry. That changed in 1944, when the Supreme Court, in United States. v. South-Eastern Underwriters, held that the insurance industry was subject to the Constitutional commerce clause provisions, and specifically, the antitrust laws. Congress reacted almost immediately to overturn United States v. Southeastern Underwriters, 1944 by passing the McCarran Ferguson Act of 1945, which returned to the states the sole power over regulation and taxation of insurance ... In general, insurance companies are not subject to the state corporate income tax, but are taxed on the value of premiums written in a state. All companies writing policies in a state are subject to the premium tax, which is levied as a fixed percentage of the value of the premiums written in the state less a deduction for any premiums returned or dividends paid."[25]

See Appendix B6 for a more complete discussion of the McCarran Ferguson Act.

Next, looking into the actual process of taxation of insurance premiums, the following summarizes how this works:

> "If premiums are paid to a licensed or admitted insurer, premium tax is imposed on the licensed insurer. If premiums are paid to a non-admitted insurer whose insurance policies are placed in a state through a surplus lines broker on a surplus lines basis, the tax is imposed on the surplus line broker. And, if premiums are paid to a non-admitted insurer whose policies are directly placed with a policyholder who procures the insurance, the tax is imposed on the policyholder."[26]

[25] Grace, Sjoquist, and Wheeler. "Insurance Premium Taxes*." https://www.ntanet.org/wp-content/uploads/proceedings/2007/006-grace-insurance-premium-taxes-2007-nta-proceedings.pdf

[26] Brian T. Casey and R. Dean Conlin. "State Insurance Premium and Other Insurance Taxes." LexisNexis. October 9, 2009. https://www.lexisnexis.com/legalnewsroom/insurance/b/insuranceregulation/posts/state-insurance-premium-and-other-insurance-taxes

B. How Washington State Consumers Purchase Policies

Washington consumers purchase insurance no differently than consumers in most other states, i.e., through insurance agents and brokers, or directly from authorized insurers. Brokers represent the client and resident brokers must file a bond with the state backing their obligations. Agents are appointed by insurers and act on the insurer's behalf. Direct purchasers don't use agents or brokers. The only material exception to this is that workers compensation is purchased from a monopolistic state fund that is not regulated by OIC.

Most captive insurance is purchased without a broker or agent, where the policyholder pays the premium directly to the captive insurer. For certain types of coverages, or for certain types of captive insurance companies (such as risk retention groups), brokers or agents may be involved, but this is the exception, not the rule.

Appendix B2
How OIC Collects Premium Taxes and How DOR Collects B&O Taxes

Washington has a fairly standard insurance premium taxation law and process. Regarding taxation of other businesses, Washington is one of four states that imposes gross receipts taxes instead of corporate income taxes.

A. OIC Collection of Premium Tax

In general, insurance premiums covering risks in the State of Washington are taxed at 2.0% and the OIC is responsible for collecting these premium taxes. There are some exceptions to this, and the OIC has different forms to fill out for different types of tax paying entities.

There are five distinctive types of tax paying entities:

1. "Insurers" – RCW 48.14.020. Property, Life, Reinsurer, Risk Retention, and Title (where Title is not taxed, but is an insurer)
2. "Purchasing Groups" – RCW 48.92.095. Imposes the same tax rates as those applicable to the tax on premiums paid for similar coverage from authorized insurers or Surplus Lines Brokers
3. "Taxpayers" – RCW 48.14.0201. Health Maintenance Organizations, Health Care Service Contractors, and Multiple Employer Welfare Arrangements, collectively referred to as "Health" or "Health Carriers" below
4. "Surplus Lines Brokers" – RCW 48.15.120. Surplus Line Brokers
5. Unlawful, unauthorized insurers – RCW 48.14.095

Using the terminology above, Insurers, Purchasing Groups, Taxpayers, and Surplus Lines Brokers authorized in Washington pay a 2.0% premium tax for all types of insurance, except for a) Ocean Marine, which is taxed at 0.95% of gross underwriting profit, and b) Title insurance, which is not subject to premium tax (but is subject to B&O and retail taxes). Insurers/Purchasing Groups/Taxpayers/Surplus Lines Brokers are required to complete an electronic "State of Washington Premium Tax Form", due by March 1 each year. There are eight different types of tax forms, representing different types of entities: Life (and disability), Property (and Casualty), Health, Risk Retention

Group, Reinsurance, Purchasing Group, Surplus Lines Broker (representing non-admitted/surplus lines insurers), and Title. Unauthorized, unlawful insurers must contact the OIC to make arrangements for paying premium taxes.

Life, Property, and Health companies are all treated the same way with respect to the process of paying premium taxes to the State. Each fills out a "State of Washington Premium Tax Form" annually, due by March 1 (the forms are different for each type of insurer/entity, with different credits and other variations available to that type of insurer/entity). The premium tax is 2.0% of gross written premiums in the previous calendar year for risks in the State of Washington only, and in general, these premiums come directly from each company's Annual Statement filed with the OIC. Additionally, Life and Property insurers not domiciled in the State are required to report retaliatory taxes and fees. The instructions state the following:

> "Premiums entered in this section should, with few exceptions, match premiums reported for Washington on the corresponding lines of the Exhibit of Premiums and Losses (state page) filed with the NAIC [National Association of Insurance Commissioners]."

This establishes the final value of premium taxes due for the prior year (total less pre-payments are due March 1), as well as the basis for making quarterly pre-payments for the current/active year. The pre-payments are a percentage of the prior year's premium tax liability, payable 45% on June 15, 25% on September 15, and 25% on December 15. Also, as part of the March 1 filing, a Certificate of Authority Renewal fee of $25 and an Annual Statement Filing fee of $20 are due with the premium taxes.

Health Carriers (or Life insurers writing health coverage) must split the reporting of premiums between Health Exchange business and Non-Health Exchange business. The premium taxes collected by the OIC associated with Health Exchange premiums are segregated and deposited into the State's Health Benefit Exchange Account to fund the operating costs of the Health Benefit Exchange. All other premium taxes are deposited into the State's General Fund.

Surplus Lines Brokers, Purchasing Groups, Reinsurers, and Risk Retention Groups are not subject to pre-payments, and simply owe the taxes for the calendar year preceding each March 1 deadline for the Tax Form to be submitted. Purchasing Groups are subject to the same schedule, except that if the insurer or Surplus Line Broker providing the coverage has already paid the taxes, this is simply disclosed on the tax form and no premium tax would be due. Additionally, Purchasing Groups, Reinsurers, and Risk

Retention Groups not domiciled in the State are required to report retaliatory taxes and fees.

The taxes due from Surplus Lines Brokers are for policyholders with their home state being Washington, and the premium tax is levied against premiums corresponding to all US risks, as opposed to just risks physically located in / allocable to the State.

Title insurers are required to report their premium volume (used to calculate the Regulatory Surcharge and the Fraud Surcharge – see below) but are not subject to premium taxes, and only owe the Certificate of Authority Renewal and Annual Statement Filing fees of $45.

In addition to the above, the OIC also collects a Regulatory Surcharge and a Fraud Surcharge each year to fund the annual cost of operating the OIC, as determined by legislative appropriation. Property, Life, Health, Title, and Reinsurance companies pay the surcharges. The surcharge rates are applied to the premium volume reported on the prior calendar year's Tax Form by each entity. On or before July 1st, the OIC is required to calculate and bill each company for the surcharges. Payments are due by July 15th.

B. DOR Collection of B&O Tax

The DOR taxes businesses using a "Business & Occupation" ("B&O") tax, which is a gross receipts excise tax. The B&O tax is imposed on persons engaged in business activities that have substantial nexus in Washington. The tax law specifically exempts insurance premiums on which taxes have already been levied by the State.

The taxpayer is responsible for registering and estimating its annual B&O taxes. The DOR then reviews the submission and determines the frequency of tax payments – monthly, quarterly, or annually, depending on the taxpayer's estimate of yearly income.

B&O tax rates vary by type of business between 0.138% and 0.484% for most classes of business. Businesses not subject to a specified rate are taxed under the catch-all "Service and Other" business activities rate of 1.75% for taxpayers with over $1 million in revenues (recently increased from 1.5%). Insurance premiums would be subject to the 1.75% Service rate if they are not exempt. An exception to this is title insurance, which is not subject to the State's premium tax, but instead of being subject to the 1.75% Service B&O tax rate, its Washington gross receipts are taxed using the Retailer classification tax rate of 0.471%. Also, although there are some exceptions for certain types of gross receipts, non-profit entities are also subject to the B&O tax.

The exemption for insurance premiums that have not already been taxed by the State is spelled out in RCW 82.04.320:

> "Exemptions—Insurance business.
>
> This chapter shall not apply to any person in respect to insurance business upon which a tax based on gross premiums is paid to the state: PROVIDED, That the provisions of this section shall not exempt any person engaging in the business of representing any insurance company, whether as general or local agent, or acting as broker for such companies: PROVIDED FURTHER, That the provisions of this section shall not exempt any bonding company from tax with respect to gross income derived from the completion of any contract as to which it is a surety, or as to any liability as successor to the liability of the defaulting contractor**."**

RCW 82.04.320 exempts from the B&O tax any insurance premium revenue on which the insurance premiums tax has been paid (and workers compensation, which is separately regulated in Washington, and not subject to either the OIC premium tax or the B&O tax). Accordingly, captive insurers would not have to pay B&O tax on insurance premiums on Washington based risks if they have already paid the insurance premiums tax on those amounts to the State, but otherwise would be subject to B&O tax. The DOR reviewed a list of captive insurers and none of them paid B&O tax.

The DOR does not restrict its tax collections to companies headquartered in Washington. The DOR taxes business with nexus, and then only on gross receipts allocable to Washington.

A business must register to report B&O tax if the business meets any of the following conditions in the current or prior year:

- Has physical presence nexus in Washington
- Has more than $100,000 in combined gross receipts attributed to Washington
- Is organized or commercially domiciled in Washington

Businesses that are taxable in Washington and another state must use an apportionment formula to determine how much of their apportionable income is subject to the B&O tax in Washington. (RCW 82.04.462).

Appendix B3
Captive Insurance Regulation in Non-Domiciliary States

Captive insurers generally are licensed only in their state of domicile. Thus, they may be treated as unauthorized insurers in other states where they insure risks. States prohibit the transaction of unauthorized insurance unless the transaction qualifies for an exception from the general statutory requirement that an insurer be authorized before transacting insurance in the state. Common exceptions include transactions that qualify as surplus lines, independent procurement, or industrial insurance. These and other forms of unauthorized insurance are discussed below.

Note that the NRRA may limit the authority of states other than the "home state" of an insured to tax or regulate captive insurance. The NRRA is discussed in Appendix B4. In addition, the McCarran-Ferguson Act and due process principles established by the US Constitution place certain limitations on the authority of states to tax and regulate captive insurance. These limitations are discussed in Appendix B6.

A. Surplus Lines

Generally speaking, captives do not participate in the surplus lines market. Nevertheless, it is worth noting that surplus lines insurers for the most part are regulated only by the jurisdiction in which they are domiciled. The NRRA establishes minimum criteria that a surplus lines insurer must meet to be eligible to participate in state surplus lines markets. States may enforce these criteria, but otherwise generally do not assert jurisdiction over surplus lines carriers. Instead, states regulate the surplus lines market by regulating the surplus lines brokers whom insureds must use to obtain coverage in this market and who must be licensed in every state in which they do business.

B. Independent Procurement

Currently, 46 US jurisdictions have enacted independent procurement laws. Generally speaking, these laws exempt independently procured insurance from regulation under the state insurance code. State laws generally require independently procured insurance be negotiated entirely or principally outside the state and require the insured to report the transaction and pay a premium tax. Generally speaking, for a transaction to qualify as independent procurement, no agent or broker acting within the state may be involved. Most states place no restrictions on the types of insureds who may engage in independent procurement, the types of insurance they may procure, or the types of insurers from which they may obtain insurance, but there are exceptions. Illinois, for example, limits independent procurement to large, sophisticated "industrial insured."[27] Independent procurement also is known as "direct procurement" and "self-procurement."

Some states clearly consider insurance purchased from a captive insurer that is not authorized in the state to be a form of independently procured insurance and therefore subject to state premium tax for such coverage. States in this category include New Jersey and New York, where there is case law or regulatory guidance on this issue.[28] In addition, the Minnesota Department of Revenue recently amended its independent procurement premium tax return to clarify that it considers premiums paid to a captive insurer that is not authorized in the state to be subject to the tax.[29]

A few states expressly exempt out-of-state captive insurers from regulation and do not require the payment of independent procurement or other premium tax on insurance placed with such a captive insurer. North Carolina does not tax out-of-state single parent captive insurers.[30] Ohio does not tax any type of out-of-state captive. [31] Georgia exempts out-of-state captives from independent procurement tax by internal policy of its department of insurance.

The situation is less clear in states where there is no case law or regulatory guidance concerning the treatment of captive insurance under state independent procurement law, which is most states. In these states, captive insurance may be subject to taxation as independently procured insurance. Nevertheless, many captive owners take the position that they are not subject to the state independent procurement tax based on various grounds. The argument that captive insurance is not subject to independent procurement tax rarely is tested because states rarely seek to enforce their independent procurement laws against captive owners.

[27] 215 ILCS 5/121-2.08.

[28] *See, e.g., Johnson & Johnson v. Director, Div. of Taxation*, 31 N.J.Tax 560, 566 (N.J. Sup. Ct. App. Div. 2019) ("As the Tax Court properly recognized, 'captive insurance... is part of the self-procured market.'"); *In the Matter of the Petition of Johnson & Higgin*s, 1997 WL 696052 (N.Y. Div. Tax App. 1997) (insurance written by captive insurer was a "taxable insurance contract" within the meaning of New York law governing independent procurement); NY Gen. Counsel Op. No. 10-12-2005, 2005 WL 3980948 (establishment of captive insurance company domiciled outside New York State would cause parent to owe independent procurement tax).

[29] *See* https://www.revenue.state.mn.us/direct-procured-insurance-tax

[30] *See* N.C. Stat. §§ 58-28-5(a)(10), 105-228.4A(a), 105-228.5(g)(4).

[31] Ohio Rev. Code § 3905.36(C)(3).

The table below shows the independent procurement tax rates by state.

TABLE 18: INDEPENDENT PROCUREMENT RATES BY US JURISDICTION

State	Procurement Tax Rate	State	Procurement Tax Rate	State	Procurement Tax Rate
AK	3.700%	LA	4.850%	OK	6.000%
AL	4.000%	MA	N/A	OR	2.000%
AR	2.000%	MD	3.000%	PA	3.000%
AZ	3.000%	ME	3.000%	RI	4.000%
CA	3.000%	MI	2.000%	SC	N/A
CO	3.000%	MN	2.000%	SD	2.500%
CT	4.000%	MO	5.000%	TN	5.000%
DC	N/A	MS	3.000%	TX	4.850%
DE	3.000%	MT	2.750%	UT	4.250%
FL	5.000%	NC	5.000%	VA	N/A
GA	4.000%	ND	1.750%	VT	3.000%
HI	4.680%	NE	3.000%	WA	N/A
IA	1.000%	NH	4.000%	WI	3.000%
ID	1.500%	NJ	5.000%	WV	N/A
IL	0.500%	NM	3.003%	WY	3.000%
IN	N/A	NV	3.500%	GU	N/A
KS	6.000%	NY	3.600%	PR	15.000%
KY	2.000%	OH	5.000%	VI	5.000%

C. Industrial Insurance

Some states permit unauthorized insurers to write insurance for larger, more sophisticated businesses that qualify as "industrial insureds." Captive insurance company owners in states that have such laws may rely on their qualification as an industrial insured to purchase insurance from their captive insurer. Similar to independent procurement, the industrial insured must report the transaction to the state and pay a premium tax. An industrial insured purchasing insurance from an unauthorized insurer, however, generally is not required to negotiate the transaction outside the state, as is the case with independent procurement. Some states place limitations on the types of transactions that qualify as industrial insurance. For example, under Indiana law only insurance not readily obtainable in the ordinary insurance market may be purchased by an industrial insured from an unauthorized insurer.[32]

[32] Ind. Code § 27-4-5-2(a)(8).

Whether a business qualifies as an industrial insured typically depends on factors such as the business's net worth, how much it spends on insurance each year, how many employees it has, and whether the business uses a full-time risk manager or "continuously retained" consultant to purchase insurance. The size of a business that qualifies as an industrial insured varies from state to state.[33]

D. Other Unauthorized Insurance

States commonly establish certain other categories of transactions that may be lawfully conducted by an unauthorized insurer. For example, many states expressly permit unauthorized insurers to write certain lines of insurance, such as ocean marine.

If an unauthorized insurer does not qualify for any exemption from licensing under state law but writes insurance in a state nonetheless, the insurer generally is responsible for paying a premium tax on the transaction. An unauthorized insurer that transacts the business of insurance in a state without qualifying for an exemption from authorization is in violation of state law and may be subject to penalties.

[33] For example, New Mexico law defines an "industrial insured" as an insured:

(a) which procures the insurance of any risk by the use of the services of a full-time employee acting as a risk manager or insurance manager or by utilizing the services of a regularly and continuously qualified insurance consultant;
(b) which has aggregate annual premiums for insurance on all risks of at least twenty-five thousand dollars ($25,000); and
(c) which has at least twenty-five full-time employees.

N.M. Stat. § 59A-15-2(B)(5). Arizona defines an industrial insured as an insured that procures insurance through the use of a qualified risk manager, has aggregate annual gross premiums for certain insurance on property and casualty risks totaling at least one hundred thousand dollars, and meets one of the following criteria:

(a) Possesses a net worth of over twenty million dollars as of the preceding fiscal year end of the industrial insured as verified by a certified public accountant.
(b) Has net revenues or sales exceeding fifty million dollars as of the preceding fiscal year end of the industrial insured as verified by a certified public accountant.
(c) Has more than five hundred full-time employees or equivalent per individual company or is a member of an affiliated group employing more than one thousand employees in the aggregate.
(d) Is a municipality with a population of more than fifty thousand persons.
(e) Is a nonprofit organization or public entity generating annual budgeted expenditures of at least thirty million dollars.

Ariz. Rev. Stat. § 20-401.07(C).

Appendix B4
Federal Law – Nonadmitted and Reinsurance Reform Act

Congress enacted the Nonadmitted and Reinsurance Reform Act of 2010 ("NRRA" or the "Act") as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[34]. The NRRA was an attempt to streamline state regulation and taxation of "nonadmitted insurance" and reinsurance. Prior to the NRRA, surplus line brokers and insureds that independently procured insurance could be subject to regulatory oversight and required to pay premium tax in every state in which there was covered risk. To simply this situation, the NRRA specifies that only the "home state" of the insured may regulate the placement of nonadmitted insurance, or require any premium tax payment for nonadmitted insurance.[35]

- What constitutes "nonadmitted insurance" under the NRRA?
- What authority does the NRRA confer on the home state?
- How is the "home state" for nonadmitted insurance determined?
- What are some typical strategies for reducing exposure to premium tax for nonadmitted insurance?

A. What Constitutes "Nonadmitted Insurance"?

What constitutes "nonadmitted insurance" under the NRRA rests on two terms defined by the Act – "nonadmitted insurance" and "nonadmitted insurer." The NRRA defines "nonadmitted insurance" as:

> any property and casualty insurance permitted to be placed directly or through a surplus lines broker with a nonadmitted insurer eligible to accept such insurance.[36]

"Nonadmitted insurer" is defined as follows:

> The term "nonadmitted insurer"—

[34] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (July 21, 2010).
[35] 15 USC §§ 8201(a), 8202(a). The NRRA's limitation on state regulatory authority does not apply to workers' compensation insurance or excess insurance for self-funded workers' compensation plans. 15 USC § 8202(d). Washington does not allow private workers' compensation insurance and requires excess insurance covering self-insured workers' compensation plans to be provided by an authorized insurer.
[36] 15 USC § 8206(9).

> (A) means, with respect to a State, an insurer not licensed to engage in the business of insurance in such State; but
>
> (B) does not include a risk retention group, as that term is defined in section 3901(a)(4) of this title.[37]

Under these definitions, nonadmitted insurance clearly includes surplus lines, which is insurance "placed … through a surplus lines broker with a nonadmitted insurer eligible to accept such insurance."

"Nonadmitted insurance" also may include captive insurance, depending on how one reads the NRRA. Captive insurers typically are licensed only in their state of domicile. Therefore, with respect to other states, a captive insurer fits the description of "an insurer not licensed to engage in the business of insurance in such State" within the NRRA's definition of a "nonadmitted insurer." The NRRA's operative provisions, however, apply to "nonadmitted insurance." As stated above, the NRRA defines nonadmitted insurance as:

> any property and casualty insurance permitted to be placed directly or through a surplus lines broker with a nonadmitted insurer eligible to accept such insurance.

If one reads this definition to include "any property and casualty insurance permitted to be placed directly..." so that this phrase stands independently, captive insurance that is independently procured appears to fall within the definition of nonadmitted insurance and therefore would be subject to the NRRA. This is a reasonable interpretation of the NRRA based on the plain language of the Act.

If, however, one reads the definition of "nonadmitted insurance" so that it is limited to "insurance permitted to be placed directly... with a nonadmitted insurer eligible to accept such insurance," the definition of nonadmitted insurance and therefore the scope of the NRRA appears to be limited to insurance placed with an eligible surplus lines insurer. Historically, state insurance codes have referred to unauthorized insurers that meet state standards for surplus lines as "eligible" surplus lines insurers.[38] Moreover, the NRRA uses the term "eligibility" exclusively in reference to standards for determining

[37] 15 USC § 8206(11).
[38] *See, e.g.,* Fla. Stat. § 626.919 (Office of Insurance Regulation may remove insurer from "list of eligible surplus lines insurers" if insurer deemed to be insolvent or in unsound financial condition); 1993 Sess. Law News of N.Y. Ch. 663 (A. 4139–A) ("The legislature hereby declares that certain of these insurers should be allowed to provide coverage to citizens of this state, either as licensed insurers or as eligible excess line insurers, provided certain conditions and safeguards are met."); Tex. Ins. Code § 981.002(4) ("'Eligible surplus lines insurer' means an insurer that is not an authorized insurer, but that is eligible under Subchapter B or B-11, in which surplus lines insurance is placed or may be placed under this chapter.")

whether a nonadmitted insurer qualifies as an eligible surplus lines insurer under state law.[39] Thus, the NRRA's reference to a "nonadmitted insurer eligible to accept such insurance" most likely means an eligible surplus lines insurer. Most captive insurers do not qualify as an eligible surplus lines insurer.

The legislative history of the NRRA also suggests that Congress was focused exclusively on surplus lines when it debated and passed the Act.[40] In addition, following the enactment of the NRRA, two of the Act's sponsors issued statements clarifying that the NRRA was not intended to apply to captive insurance.[41]

Whether the NRRA applies to captive insurance is an open question. The plain language of the Act is reasonably interpreted to apply to captive insurance independently procured, but an alternative and also reasonable reading of the NRRA and the Act's legislative history suggest that the NRRA was intended to apply only to insurance placed with an eligible surplus lines insurer.

[39] Section 8204 of the NRRA states that a state may not impose eligibility requirements on, or otherwise establish eligibility criteria for, nonadmitted insurers domiciled in a United States jurisdiction, except in conformance with such requirements and criteria in sections 5A(2) and 5C(2)(a) of the Non-Admitted Insurance Model Act, unless the State has adopted nationwide uniform requirements, forms, and procedures developed in accordance with section 8201(b) of this title that include alternative nationwide uniform eligibility requirements. 15 USC § 8204(1). Sections 5A(2) and 5C(2)(a) of the Non-Admitted Insurance Model Act establish standards for surplus lines insurer eligibility. The Non-Admitted Insurance Model Act is a model law developed by the National Association of Insurance Commissioners. NAIC Model Law No. 870, available at https://content.naic.org/sites/default/files/inline-files/MDL-870.pdf.
[40] *See, e.g.,*156 Cong. Rec. E2144 (Dec. 15, 2010) (Statement of Rep. Dennis Moore (D.-Kan. stating, "The broader intent of the law is to provide a comprehensive, uniform solution to the current regulatory mess by addressing the full spectrum of surplus lines regulation...."); 155 *Cong. Rec.* H9362 (Sep. 9, 2009) (remarks of Rep. Garrett (R-N.J.) with respect to 2009 version of the NRRA equating nonadmitted insurance with surplus lines); 156 Cong. Rec. H9363 (remarks of Rep. Spencer Bacchus (R-Ala.) another sponsor stating "Surplus lines insurance, also known as 'nonadmitted insurance'...); Hearing before the Subcommittee on Commercial and Administrative Law of the Committee on the Judiciary, House of Representatives, 109th Congress, Second Session on H.R 5637, Sept. 19, 2006 (statement of Rep. Chris Cannon (R-Utah), the Committee Chairman, equating surplus lines and nonadmitted insurance in discussing 2006 version of the NRRA.).
[41] *See* Letter from Judy Biggert, Outgoing Chairman of the Subcomm. on Ins. of Comm. on Fin. Servs. in the House of Representatives, to Jeb Hensarling, Chairman-elect, Comm. on Fin. Servs., and Maxine Waters, Ranking Member-elect, Comm. on Fin. Servs. (Dec. 18, 2012) ("I can tell you unequivocally that the NRRA was never intended to include the captive insurance industry."); Statement for the record by Rep. Scott Garrett (R-NJ) 159 Cong. Rec .E111 (Feb. 6, 2013) ("it was never contemplated to have the captive industry fall under the NRRA.").

B. What Authority Does the NRRA Confer on the Home State?

The NRRA states, “No state other than the home state of an insured may require any premium tax payment for nonadmitted insurance.”[42] This provision clearly prohibits any state other than the home state from collecting premium tax for a nonadmitted insurance transaction. The NRRA does not expressly authorize the home state to collect premium tax on 100% of the premium for nonadmitted insurance. Nevertheless, as explained in Appendix B6, Section B, because the NRRA prohibits any other state from collecting the tax, we believe the home state likely may collect tax on 100% of the premium for US risks for a nonadmitted policy without running afoul of federal constitutional limitations on the authority of states to tax interstate transactions.

The NRRA also states, “Except as otherwise provided in this section, the placement of nonadmitted insurance shall be subject to the statutory and regulatory requirements solely of the insured’s home State.”[43] Thus, the NRRA reserves regulation of the placement of nonadmitted insurance to the home state of the insured.

C. How is the Home State for Nonadmitted Insurance Determined?

The NRRA defines the term “home state” as follows:

> (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.

[42] 15 USC § 8201(a). The term “premium tax” is defined as follows:

> The term “premium tax” means, with respect to surplus lines or independently procured insurance coverage, any tax, fee, assessment, or other charge imposed by a government entity directly or indirectly based on any payment made as consideration for an insurance contract for such insurance, including premium deposits, assessments, registration fees, and any other compensation given in consideration for a contract of insurance.

[43] 15 USC § 8202(a). The NRRA provides that this requirement does not apply to workers compensation insurance or excess insurance for self-funded workers compensation plans. These exceptions are not relevant to Washington because Washington does not allow private workers compensation insurance and requires excess insurance covering self-insured workers compensation plans to be provided by an authorized insurer.

> (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.[44]

Under this definition, the determination of the home state must be evaluated for each policy of insurance. The home state for any particular policy depends on two factors: (1) the insured's principal place of business (in the case of an entity) or residence (in the case of an individual) and (2) the location of the insured risk. The NRRA does not define the term "principal place of business," but for other purposes the Supreme Court has held that a company's principal place of business is the place where the corporate headquarters or "nerve center" is located – that is, the place from which the company's operations are directed, controlled, and coordinated.[45] The term "principal place of business" would likely be construed to have the same meaning under the NRRA as it was given by the Supreme Court.[46]

Because nonadmitted insurance most commonly is written to cover commercial entities, this discussion focuses on the rules for determining the home state of a policy covering a business. For a policy that has a single named insured and covers at least some risk in the state where the insured has its principal place of business, the home state is the state where the insured's principal place of business is located.[47] If, however, all of the insured risk for such a policy is located outside the state where the insured has its principal place of business, the home state is the state to which the greatest percentage of the insured's taxable premium for the policy is allocated.[48]

For policies under which more than one insured from an affiliated group are named insureds, the home state is the state in which the member of the affiliated group that has the largest percentage of premium attributed to it under the policy is located.[49] An

[44] 15 USC § 8206(6).
[45] See *Hertz Corp. v. Friend*, 559 U.S. 77 (2010).
[46] See *Kepner v. U.S.*, 195 U.S. 100, 124 (1904) ("It is a well-settled rule of construction that language used in a statute which has a settled and well-known meaning, sanctioned by judicial decision, is presumed to be used in that sense by the legislative body.").
[47] 15 USC § 8206(6)(A).
[48] 15 USC § 8206(6)(A).
[49] 15 USC § 8206(6)(B).

“affiliate” is any entity that controls, is controlled by, or is under common control with the insured.[50]

D. Strategies for Reducing Exposure to Premium Tax for Nonadmitted Insurance

If one assumes captive insurance companies are a type of nonadmitted insurer under the NRRA, there are a number of ways a captive insurance company owner may reduce the exposure of its captive insurance program to state premium taxes under the rules for determining the home state of a policy. For example, following enactment of the NRRA, some captive insurance company owners moved the domicile of their captive insurance company to the captive insurance company owner’s home state. So long as the captive insurer is domiciled in the home state of its insured, no other state may require any premium tax payment for insurance written by the captive insurer. Therefore, the captive insurance company is taxed only at the rate assessed by its domicile, which typically is fairly low (0.5% or less) and often subject to an annual maximum.

Alternatively, after the NRRA became law, some captive insurance company owners formed a second captive insurer in the owner’s home state, wrote the coverage in their captive insurance program through this new captive insurer and reinsured the coverage to the existing captive insurer. This arrangement has the same effect as the first alternative, except that premium tax is owed both by the new captive insurance company on the direct insurance it writes and by the existing captive insurance company on the reinsurance it provides. Maintaining two captive insurers in this fashion is economically viable for some captive insurance company owners, although generally only those with very large captive insurance programs, because premium tax rates for domestic captive insurers are very low both for direct insurance and reinsurance. In addition, at least one state, Hawaii, does not tax captive reinsurance. Captive insurance company owners who pursued this strategy likely did so because of the stability associated with keeping their captive insurance program under the oversight of a regulator with proven capabilities and long familiarity with the program.

There are various other strategies that can be employed to reduce the exposure of a captive insurance program to premium tax if the captive insurer is considered a

[50] 15 USC § 8206(2). An entity has “control” over another entity if “(A) the entity directly or indirectly or acting through 1 or more other persons owns, controls, or has the power to vote 25 percent or more of any class of voting securities of the other entity; or (B) the entity controls in any manner the election of a majority of the directors or trustees of the other entity.” 15 USC § 8206(4).

nonadmitted insurer for purposes of the NRRA. Where two or more insureds from an affiliated group of companies are named insureds under a policy, the home state for the policy is the home state of the member of the affiliated group that has the largest percentage of premium attributed to it under the policy. Applying this rule, it is possible to change the home state for a policy by adjusting the amount of insurance provided to any particular affiliate and therefore the percentage of premium attributed to that affiliate. Say, for example, the home state of Affiliate "A" is a state that taxes captive insurance as a form of independently procured insurance and applies a high rate of tax to such transactions, but the home state of Affiliate "B" does not tax captive insurance. If a policy insures both Affiliate A and Affiliate B as named insureds, depending on how much risk is insured for each affiliate, it may be a simple matter to make the home state of Affiliate B the home state for the policy by adjusting the insurance so that Affiliate B has the greater share. For example, by increasing the deductible payable by Affiliate A, Affiliate A will receive less insurance and therefore be attributed a lower percentage of the premium for the policy.

Other strategies are possible as well. The rules for determining the home state of a policy provide that if 100% of the risk is located outside the home state of the insured, the home state for the policy is the state in which the greatest percentage of the taxable premium for the policy is allocated. If an insured has operations that are national in scope but has its principal place of business in a state with a high rate of premium tax on captive insurance, the captive insurer could write a policy insuring risk only in states outside the insured's home state. The home state for such a policy would be the state to which the greatest percentage of taxable premium is allocated.

Appendix B5
Federal Law – How IRS Defines Insurance/IRS Litigation of Captive Insurers

In this section, we separate our analysis into the following areas

- History and IRS Definitions/Litigation
- Recent IRS Enforcement Actions Involving 831(b) Micro-Captive Insurance Companies

A. History and IRS Definitions/Litigation

The benefits of captive insurance from a federal income tax perspective are discussed in detail in Appendix B9. These benefits are available only if the risk financing provided by the captive insurance company qualifies as "insurance" for federal income tax purposes.

When captive insurers first began to gain wider popularity in the mid-1970s, the IRS took the position that such arrangements were not insurance for federal tax purposes where the captive insurance company was a single parent captive insurer that limited itself to insuring the risks of its parent and affiliates.[51] Initially, the IRS won a number of cases in which courts agreed that such single parent captive insurers did not provide insurance as that term is used in the Internal Revenue Code.[52] Over time, however, a body of law has developed recognizing coverage provided by captive insurers as a form of insurance for federal tax purposes if the captive insurer meets certain criteria. IRS guidance also has shifted to recognize these principles. Under these precedents, risk financing provided through a captive insurance company may be considered insurance if it:

- involves insurance risk;
- involves risk shifting;
- involves risk distribution; and

[51] *See, e.g.,* Rev. Rul. 77-316, 1977-2 C.B. 53.
[52] *See, e.g., Carnation Co. v. Commissioner, 71 T.C. 400 (1978), aff'd, 640 F.2d 1010 (9th Cir. 1981), cert. denied, 454 US 965 (1981); Beech Aircraft Corp. v. United States, 797 F.2d 920 (10th Cir. 1986); Stearns-Roger Corp. v. United States, 577 F. Supp. 833 (D. Col. 1984), aff'd, 774 F.2d 414 (10th Cir. 1985); Clougherty Packing Co. v. Commissioner, 84 T.C. 948 (1985), aff'd, 811 F.2d 1297 (9th Cir. 1987); Kurt Orban Co., Inc. v. Commissioner, 54 T.C.M. (CCH) 861 (1987); Anesthesia Serv. Med. Group, Inc. v. Commissioner, 825 F.2d 241 (9th Cir. 1987).*

- meets commonly accepted notions of insurance.[53]

Regarding the first prong of this test, courts have interpreted "insurance risk" to mean the assumption of risk for "hazards" faced by an insured, such as fire or other ordinary commercial perils, pollution, and workers compensation liabilities.[54] These risks generally involve a situation where the insured will experience a loss if the hazard occurs or have a neutral outcome if the hazard does not occur, but cannot experience a gain by assuming the risk. Such risks contrast with investment risk, where the insured may experience a gain by assuming the risk.[55] In addition, the IRS takes the position that "business risk" does not qualify as an insurance risk, although the distinction between business risk and insurance risk can be murky.

Regarding the second prong – whether a captive insurance arrangement involves risk shifting – important factors include whether the captive insurance company charges premiums reflecting an arm's length relationship between the captive insurer and the insured, whether the captive insurer is financially capable of satisfying the claims made against it,[56] and whether experiencing a covered loss would economically affect the insured notwithstanding the captive insurance company's insurance of the loss – in other words, whether the risk of loss truly is shifted away from the insured.[57]

Regarding the third prong – the presence of risk distribution – in the context of single parent captive insurance companies, the courts and the IRS initially focused on two questions: (1) whether the captive insurance company insures risks unrelated to its parent and affiliates and (2) how many "brother/sister" affiliates are insured by the captive insurance company and how much risk is attributable to each. With respect to the second question, the IRS has published a revenue ruling establishing a "safe harbor" under which a captive insurer would be deemed to be providing insurance if it insured at least 12 affiliated brother/sister companies, each accounting for between 5 and 15 percent of the total insured risk.[58] In addition, the IRS has suggested that the assumption of unrelated, third-party risk by a captive insurer, whether insured directly or

[53] *See Avrahami v. Commissioner*, 149 T.C. 144, 177 (2017); *Rent–A–Center, Inc. v. Commissioner*, 142 T.C. 1, 13 (2014); *R.V.I. Guar. Co. v. Commissioner*, 145 T.C. 209, 225 (2015); *Harper Grp.* v. Commissioner, 96 T.C. 45, 58 (1991), aff'd, 979 F.2d 1341 (9th Cir. 1992); A*MERCO & Subs. v. Commissioner*, 96 T.C. 18, 38 (1991), *aff'd*, 979 F.2d 162 (9th Cir. 1992); S*ecuritas Holdings, Inc. v. Commissioner*, T.C. Memo. 2014–225 at *18.
[54] *See* A*MERCO*, 96 T.C. at 39.
[55] *See id.*
[56] *Harper Grp., 96 T.C. at 59.*
[57] *See Rent–A–Center, Inc. v. Commissioner*, 142 T.C. at 21-22; *see also Clougherty Packing Co. v. Commissioner*, 84 T.C. 948 (1985), *aff'd* 811 F.2d 1297 (9th Cir. 1987).
[58] Rev. Rul. 2002-90.

through a reinsurance contract, may provide sufficient risk distribution to qualify the arrangement as insurance.

More recently, the Tax Court has ruled that sufficient risk distribution can be found where a captive insurance company insures a significant number of uncorrelated risks notwithstanding the fact that only a limited number of brother/sister affiliates are insured and no unrelated, third-party risk is assumed. In *Rent–A–Center, Inc. v. Commissioner*,[59] the Tax Court held that a captive insurance company provided sufficient risk distribution where it insured workers compensation liabilities for more than 14,000 employees, automobile liability for more than 7,000 vehicles, and general liability for more than 2,500 stores. Notably, the majority opinion in *Rent-A-Center* did not comment regarding how much risk was present with any one insured brother/sister affiliate. Rather, the court focused on the sufficiency of the number of statistically independent risk exposures insured by the captive insurance company. Similarly, in *Securitas Holdings, Inc. v. Commissioner*,[60] the Tax Court found that risk distribution existed in a captive insurer regardless of the fact that substantially all of the risk resided with a single insured in one year (approximately 90%). The Tax Court's focus in *Securitas* was on whether the captive insurance company insured a significant number of uncorrelated risks (as opposed to a sufficient number of insureds) stating:

> As a result of the large number of employees, offices, vehicles, and services provided by the U.S. and non-U.S. operating subsidiaries, [the captive] was exposed to a large pool of statistically independent risk exposures. This does not change merely because multiple companies [insured by the captive] merge into one. The risks associated with those companies did not vanish once they fell under the same umbrella.[61]

Thus, as in *Rent-A-Center*, the court emphasized that risk distribution may be achieved by pooling a large enough number of independent risks.

Regarding the final prong in the test outlined above – whether the captive insurance arrangement meets commonly accepted notions of insurance – a number of factors are brought to bear, including whether the captive insurer is organized, operated, and regulated as an insurance company; whether the captive insurer is adequately capitalized; whether the policies issued by the captive insurer are valid and binding; whether the premiums are reasonable and the result of an arm's-length transaction; and

[59] 142 T.C. 1 (2014).
[60] T.C. Memo. 2014–225.
[61] *Securitas* T.C. Memo. 2014–225 at *10.

whether claims are paid.[62] The Tax Court also has looked at whether there is a legitimate business reason for acquiring insurance from the captive insurer.[63]

B. Recent IRS Enforcement Actions Involving 831(b) Micro-Captive Insurance Companies

Most recently, the IRS has focused its enforcement efforts on so-called "micro-captives" that have taken an election permitted under Section 831(b) of the Internal Revenue Code that allows the captive insurance company to pay tax only on its net investment income. A captive insurer may take the 831(b) election if the greater of its annual direct written premiums or net written premiums does not exceed a specified level, currently $2.35 million (the number is indexed for inflation) and the arrangement meets certain diversification tests. In the last few years, the IRS has been auditing such captive insurers aggressively and has won a trio of cases before the Tax Court challenging these arrangements as unlawful tax shelters.

In 2016, the IRS identified most captive insurance companies taking the 831(b) election as "Transactions of Interest," requiring such captive insurers, their insureds, and their material advisors to make annual filings with the IRS concerning the arrangement.

In 2019, the IRS announced a settlement initiative whereby it would extend settlement offers to up to 200 taxpayers who had 831(b) captive insurance arrangement under examination. The IRS stated that the settlement would require substantial concessions and penalties, but penalties could be eliminated if the taxpayer properly relied upon the advice of a tax advisor. If the taxpayer did not accept the settlement offer, the IRS stated the examination would continue and the taxpayer could be subject to maximum adjustments and penalties. In October 2020, the IRS announced it would make another settlement offer to certain 831(b) captive insurance company owners.

In March and July of 2020, the IRS sent what is referred to as "soft warning letters" to taxpayers involved with a captive insurer taking the 831(b) election that have disclosed the arrangement under current reporting requirements. The letters warned that the IRS is increasing its examinations of such captive insurers, and exams may result in full adjustments and penalties. The letters also instructed taxpayers who no longer were claiming a deduction or other tax benefits from the captive insurance company to notify the IRS and recommended that taxpayers consult an independent tax advisor on the

[62] *See R.V.I. Guar. Co. v. Commissioner*, 145 T.C. 209, 231 (2015); *Rent–A–Center*, 142 T.C. at 24–25; *Harper Grp.*, 96 T.C. at 60; *Securitas*, T.C. Memo. 2014–225 at *27.

[63] *See Hosp. Corp. of Am. v. Commissioner*, T.C. Memo. 1997-482, 1997 WL 663283, at *26.

proper tax treatment of their captive insurer. The IRS also is investigating certain tax planning firms that have recommended 831(b) arrangements to their clients.

Appendix B6
Federal Law – Limitations on State Authority to Tax Captive Insurance

A. McCarran-Ferguson Act

Prior to 1944, Supreme Court precedent held that the business of insurance was not "commerce" and therefore was not subject to federal regulation as interstate commerce under the Commerce Clause of the US Constitution. Thus, regulation of the business of insurance was considered to be subject exclusively to the authority of the states. In 1944, the Supreme Court decided *United States v. South-Eastern Underwriters*,[64] in which the Court held that an insurance company conducting substantial business across state lines was engaged in interstate commerce and therefore subject to federal antitrust regulations. The decision in *South-Eastern Underwriters* threw into doubt the authority of the states to regulate interstate transactions involving insurance. In response, Congress enacted the McCarran-Ferguson Act of 1945,[65] which gives states the authority to regulate the "business of insurance" without interference from federal regulation, unless federal law specifically provides otherwise.

In its decision in *State Bd. of Ins. v. Todd Shipyards Corp.*,[66] the Supreme Court construed the McCarran-Ferguson Act as a broad grant of authority by Congress allowing the states to tax and regulate interstate insurance transactions, subject, however, to certain limitations. According to the Court, Congress did not intend to allow states to tax or regulate interstate insurance transactions where contacts between the state and the insurer are minimal.[67] Under these circumstances, state authority over an

[64] 322 U.S. 533 (1944).
[65] 15 U.S.C. § 1011 *et seq.*
[66] 370 U.S. 451 (1962).
[67] Reviewing the legislative history of the McCarran-Ferguson Act, the Court found that Congress intended to limit state authority to tax and regulate interstate insurance transactions within the parameters defined by three Supreme Court decisions decided prior to the enactment of the McCarran-Ferguson Act—*Allgeyer v. Louisiana*, 165 U.S. 578 (1897), *St. Louis Cotton Compress v. Arkansas*, 260 U.S. 346 (1922) and *Connecticut General Life Ins. Co. v. Johnson,* 303 U.S. 77 (1938). *Todd Shipyards,* 370 U.S. at 456. These cases were decided based on due process principles established by the 14th Amendment of the US Constitution. At the time *Todd Shipyards* was decided, the validity of at least two of these decisions was in question because Supreme Court's due process jurisprudence had evolved over time. Nevertheless, the Supreme Court stated that, although it might change its decisions on the constitutionality of state laws, it would not disturb the limitations placed on state authority by the McCarran-Ferguson Act because the power of Congress under the Commerce Clause to grant protection to interstate commerce against state regulation or taxation is so complete that its policy should prevail. *Id.* at 456-57.

interstate insurance transaction is preempted by the McCarran-Ferguson Act.[68] Thus, the Supreme Court held that under the limits on state authority established by the McCarran-Ferguson Act, the state of Texas could not assess a tax on insurance contracts written by out-of-state insurers where the only contacts with the state were the fact that the insured property was located in Texas and the insured did business in the state as a foreign corporation – i.e., a corporation formed under the laws of another state. In reaching this conclusion, the Court noted that the insurance transaction at issue took place entirely outside Texas – the insurance policies were negotiated, paid for, and issued outside of Texas and all losses were adjusted and paid outside the state.[69] In addition, the insurers had no offices or places of business in Texas, were not licensed in the state, had no agents in the state, and did not solicit insurance or investigate risks or claims there.[70]

Lower courts construing *Todd Shipyards* generally have been unwilling to apply its constraints on state authority beyond the limited set of facts presented in the case. In other words, if an insurance transaction involves any substantial contacts with a state aside from the presence of insured risk in the state and the fact that the insured does business there as a foreign corporation, courts generally have found that the state may tax and regulate the transaction.[71] Nevertheless, *Todd Shipyards* remains good law

[68] *Todd Shipyards,* 370 U.S. at 456-57.
[69] *Id.* at 454-55.
[70] *Id*.
[71] *See, e.g., Combs v. STP Nuclear Operating Co.*, 239 S.W.3d 264 (Tex. Ct. App. 2007); *Howell v. Rosecliff Realty Co.*, 245 A.2d 318 (N.J. 1968); *In re Markel Ins. Co.*, 724 A.2d 848 (N.J. Sup. Ct. App. Div. 1999); *People v. United Nat'l Life Ins. Co.*, 427 P.2d 199 (Cal. 1967). *But see Domino Oil, Inc. v. Phoenix Assurance Co. of New York*, 1998 WL 34170721 (D. V.I. 1998) (New York insurer was not subject to the regulatory or tax jurisdiction of the US Virgin Islands where its only contacts with the territory were the presence of insured properties, the fact that the insured did business in the Virgin Islands, and the fact that a claim was being investigated and defended by the insurer there.) Some courts have called into question the continued validity of *Todd Shipyards*. For example, in *Associated Elec. & Gas Ins. Srvs., Ltd. v. Clark*, 676 A.2d 1357 (R.I. 1996), the Rhode Island Supreme Court interpreted the Supreme Court decision in *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992), to supersede *Todd Shipyards* because *Quill* held that "'if a foreign corporation purposely avails itself of the benefits of an economic market in the forum state, it may subject itself to the state's *in personam* jurisdiction even if it has no physical presence in the state.'" *Id.* at 1361 (quoting *Quill*, 504 U.S. at 307-08). Thus, the Rhode Island court held that a Bermuda insurer that "purposefully availed itself of the benefits of an economic market in Rhode Island" by collecting $3.4 million in premiums from insureds domiciled in the state and negotiating business with insureds there by mail was subject to taxation by the state. *Id. See also Gage & Tucker v. Director of Revenue*, 769 S.W.2d 119, 126 (Mo. 1989) (holding surplus lines tax on insured did not violate due process because, in part, insurer "purposely availed itself of the benefits of conducting business within Missouri with Missouri law firms" where application for insurance was prepared in and mailed from Missouri and premium checks were mailed by insureds from Missouri). In *Lakehead Pipe Line Co., Inc. v. Am. Home Assurance Co.,* 981 F.Supp. 1205, (D. Minn. 1997), the Federal District Court for the District of Minnesota took the analysis of the Rhode Island court in *Associated Elec. & Gas* a step further, holding that Minnesota had authority to regulate an out-of-state insurer based solely the fact that the insurer had insured property located in the state and that the

and is relevant to the regulation and taxation of captive insurance in that it may preclude a state in which a captive insurer does no more than insure risks located in the state for a company that is not headquartered or domiciled in the state from taxing or regulating the insurance provided by the captive insurer. Under these circumstances, contacts between the captive insurer and the state are so minimal that they may fall within the scope of federal preemption by the McCarran-Ferguson Act articulated by the Court in *Todd Shipyards*.

This preemptive effect is important as applied to out-of-state affiliates of captive insurers, especially when one considers that much captive insurance involves deductible reimbursement policies and reimbursement policies covering self-insured workers compensation risks. To administer these types of policies, the captive insurer does not need to have any material contacts with a state in which the insured has operations. Claims are simply reported to the captive insurer by the insured and paid by the captive, all of which may occur outside the state. If the insured has its headquarters outside the state, reports of losses are likely made to the captive insurer and claims payments most likely are received by the insured in another state. Under these circumstances, the McCarran-Ferguson Act, as construed by *Todd Shipyards*, may preclude the state from regulating or taxing insurance, covering out-of-state insureds.

B. Constitutional Limitations

Federal constitutional principles also limit the authority of states over the interstate business of insurance. Under the Supreme Court's Commerce Clause and Due Process Clause jurisprudence, a state tax on interstate commerce must be fairly apportioned to the commerce carried on within the state and rationally related to values connected with the taxing state. Congress removed all Commerce Clause limitations on the authority of states to regulate and tax the business of insurance when it passed the

asserted liability of the insured arose from acts within the state. *Id.* at 1214-15. *Associated Elec. & Gas*, *Lakehead* and similar rulings mistakenly conflate due process principles under the 14th Amendment with the limitations on state authority to regulate interstate insurance transactions that the Supreme Court found the McCarran-Ferguson Act to establish in *Todd Shipyards*. By doing so, these cases reach the conclusion that modern due process decisions of the Supreme Court have fully or at least partially abrogated *Todd Shipyards*. This is clearly not the case, as the limitations on state authority recognized in *Todd Shipyards* arise from Congress's authority under the Commerce Clause to regulate interstate commerce, as expressed through the McCarran-Ferguson Act, not due process principles *per se*. *See Todd Shipyards* 370 U.S. at 456. Thus, the strength and validity of these precedents is questionable.

McCarran-Ferguson Act,[72] but limitations derived from the Due Process Clause of the 14th Amendment continue to apply.[73]

The NRRA provides that no state other than the home state of an insured may require any premium tax payment for nonadmitted insurance. A tax that applies to premiums for nonadmitted insurance covering risks outside of Washington could be challenged on the basis of due process principles requiring a state tax on interstate activities to be rationally related to values connected with the taxing state. The risk of a successful challenge on these grounds, however, is mitigated by the fact that under the NRRA, only the home state may collect a premium tax on nonadmitted insurance. Accordingly, the insured cannot be subject to multiple taxation by other states. The Supreme Court has upheld state laws that apply a tax to the entire value of an interstate transaction where there is no risk the transaction will be taxed multiple times or the risk is only minimal.[74]

[72] *Western and Southern Life Ins. Co. v. State Bd. of Equalization of Calif.*, 451 U.S. 648, 653 (1981).
[73] *See, e.g., Stonebridge Life Ins. Co. v. Dep't of Revenue*, 2006 WL 448682 (Or.Tax Regular Div. 2006) (analyzing whether Oregon insurance excise tax met 14th Amendment due process standard requiring income attributed to state for tax purposes to be "rationally related to values connected with taxing state").
[74] *See, e.g., Okla. Tax Comm'n v. Jefferson Lines, Inc.,* 514 U.S. 175 (1995) (sales tax on full price of ticket for bus travel from Oklahoma to another state did not violate dormant commerce clause); *Goldberg v. Sweet*, 488 U.S. 252 (1989) (Illinois excise tax on gross charge for interstate telecommunications was fairly apportioned).

Appendix B7
Costs of Owning and Operating a Captive Insurer

A review of expenses involved in owning and operating a captive insurer is important to know to judge whether or not the captive insurance company is cost beneficial. Material changes to the cost of owning and operating a captive insurer will be scrutinized by captive insurance company owners and captive insurance company service providers, and if there are ways to avoid these expenses, it is almost a certainty that captive insurance company owners will pursue those strategies. Also, the "captive insurance community" is fairly small, and ideas and tactics are often shared among captive insurance company owners and captive insurance company service providers.

Most captive insurers have no employees; instead, the various functions required are outsourced to "service providers." Below is a summary of the most common captive insurance company expense items, as well as a summary discussion of typical (as well as surveyed) expense levels of captive insurers.

A. Captive Insurance Company Management

Most domiciles require that an approved local management firm oversee day to day operations, which include performing accounting functions, preparing and submitting regulatory filings (primarily financial statements), organizing and attending board meetings, paying invoices, and interfacing with other service providers.

B. Other Professional Services

Annual regulatory requirements of most domiciles require an actuarial opinion on loss reserves and an audit opinion, and many captive insurance companies utilize the services of outside attorneys. Some captive insurers retain investment advisors.

C. Board Meetings, Bank Fees, and Other Miscellaneous Expenses

Most domiciles require at least one board meeting per year in the domicile. Other typical expenses include bank fees and overhead expenses such as postage and supplies/materials for meetings. Miscellaneous expenses are often referred to as "General and Administrative", or "G&A."

D. Domicile Costs

Most US captive insurance company domiciles impose premium taxes on captive insurers. Marginal rates often vary based on a) the level of premiums, where tax rates decline as premiums rise, and b) the type of insurance contract – direct vs reinsurance assumed. Marginal tax rates are normally between 0.1% and 0.4% depending on the state, premium level, and type of insurance contract. A few domiciles have annual renewal fees in lieu of taxes in the $5,000 - $6,000 range. Most domiciles with premium taxes charge $300-$500 annually to renew each captive insurance company's license.

E. Summary of Captive Insurer Expenses

Based on our experience in working with captive insurers, for a typical single parent captive insurance program with $10 million in premiums, a typical level of expenses would be $160,000. Adding in premium taxes of 0.4%, or $40,000, total expenses are $200,000, broken down as follows:

TABLE 19: TYPICAL SINGLE PARENT CAPTIVE INSURER'S EXPENSES ON $10M OF PREMIUM

Type of Expense	Amount	% of Premium
Captive Management	60,000	0.60%
Other Professional Services	60,000	0.60%
Board Meetings / Other G&A	20,000	0.20%
Commission & Brokerage	0	0.00%
Other	20,000	0.20%
Subtotal	160,000	1.60%
Premium Taxes	40,000	0.40%
Total	**200,000**	**2.00%**

Note that for the notional captive insurer with $10 million in premiums described above, the expenses of $200,000 represent 2.0% of premiums. For commercial insurers, with commission/brokerage, management/overhead, and profit provisions, expenses are typically closer to 30%.[75] Therefore, captive insurance companies are fundamentally different than commercial insurers. If the costs become too high so as to exceed the benefits of owning the captive insurer, the captive insurance company owner will choose to simply close the captive insurer, or only use it where it's truly needed, scaling back on costs. Risk managers are in the business of protecting the assets of their

[75] "Commercial insurance performance measurement." PwC. https://www.pwc.com/us/en/industries/insurance/library/performance-measurement.html

employers at reasonable costs; things like captive insurance expenses are closely scrutinized by the risk manager and often by the chief financial officer. For example, if Washington were to impose an additional 2.0% premium tax, for this notional captive insurance company, the cost of owning and operating the captive insurer would be doubled.

Smaller captive insurers, including micro captive insurance companies, would normally have expenses lower than this, but representing a higher percentage of premium. Larger captive insurers would typically have higher expenses, but since many of the expenses are fixed (i.e., don't vary directly/proportionally with premiums), expenses would be less than 2.0%. From our survey, larger captive insurers (over $25 million in annual premiums) had average expenses of less than 1.0%. Many domiciles have declining marginal tax rates as premiums rise, coupled with maximum premium tax amounts, so that once the maximum is reached, no additional taxes are imposed for additional premiums written. Thus, premium taxes also don't vary directly with premiums.

With respect to group captive insurance companies, in many cases, expenses more closely mirror those of the commercial insurance industry. Many group captive insurance companies involve broker commissions and other costs that are not required by single parent captives. As such, there is a wide range of expenses for group captive insurers depending on their structures.

Our survey of captive insurance companies owned by Washington headquartered companies supports the figures summarized above. The tables below summarize the results split between medium and large single parent captive insurance companies ($5 million and above) and small single parent captive insurance companies (below $5 million).

Note that the data in the tables below excludes companies with $0 in direct (or net) written premium. For most companies, the ratios are based on 2019 expenses and 2019 written premium. In a few instances where 2019 written premium was significantly lower than 2018, we instead related the 2019 expenses to the 2018 written premium. This was based on the assumption that certain captive insurance company owners reduced the captive insurer's writings based on the position taken by the OIC in recent years, but that the captive insurer's company expenses do not scale with premium.

TABLE 20: SURVEY RESULTS: SINGLE PARENT AND CELL CAPTIVE INSURER EXPENSES RELATIVE TO DIRECT WRITTEN PREMIUM (INCLUDES DATA FOR 14 CAPTIVE INSURERS)

	Less than 5M		Greater than 5M		Total	
Expense	Dollars	% of Premium	Dollars	% of Premium	Dollars	% of Premium
Captive Management	47,176	4.06%	117,171	0.15%	72,174	0.24%
Audit/Legal/Actuarial	18,817	1.62%	181,539	0.23%	76,932	0.26%
Board Meetings	732	0.06%	3,830	0.00%	1,839	0.01%
Other G&A Expenses	44,660	3.84%	53,726	0.07%	47,898	0.16%
Commission & Brokerage	25,556	2.20%	116,021	0.14%	57,865	0.20%
Other	0	0.00%	28,800	0.04%	10,286	0.03%
Premium Taxes	23,400	2.01%	87,902	0.11%	46,437	0.16%
Total	**160,341**	**13.79%**	**588,989**	**0.73%**	**313,430**	**1.06%**

The table above includes 14 of the 20 single parent and cell captive insurance companies with non-zero 2019 direct written premium. The remaining 6 captive insurance companies were excluded for various reasons, including:

- Four captive insurance companies were excluded due to a mismatch between premiums and expenses (premiums included only the Washington headquartered entity while expenses supported all captive insurance company operations).
- One captive insurance company was excluded due to a large, negative expense item that is not representative of “typical” captive insurer operations and would have distorted the averages.
- One captive insurance company was excluded due to an extremely large expense ratio, which appears consistent with the “winding down” of captive insurer operations.

TABLE 21: SURVEY RESULTS: SINGLE PARENT AND CELL CAPTIVE INSURER EXPENSES RELATIVE TO NET WRITTEN PREMIUM (INCLUDES DATA FOR 21 CAPTIVE INSURERS)

	Less than 5M		Greater than 5M		Total	
Expense	**Dollars**	**% of Premium**	**Dollars**	**% of Premium**	**Dollars**	**% of Premium**
Captive Management	29,645	1.81%	107,025	0.16%	51,754	0.25%
Audit/Legal/Actuarial	14,323	0.88%	163,270	0.24%	56,880	0.27%
Board Meetings	439	0.03%	12,364	0.02%	3,846	0.02%
Other G&A Expenses	29,479	1.80%	51,516	0.07%	35,775	0.17%
Commission & Brokerage	29,982	1.84%	96,684	0.14%	49,040	0.23%
Other	371	0.02%	24,000	0.03%	7,122	0.03%
Premium Taxes	18,681	1.14%	73,252	0.11%	34,273	0.16%
Total	**122,921**	**7.52%**	**528,111**	**0.77%**	**238,690**	**1.14%**

The table above includes 21 of the 28 single parent and cell captive insurance companies with non-zero 2019 net written premium. In addition to the six captive insurance companies noted above, expense information was not provided for one captive insurer.

Appendix B8 Benefits of Captive Insurers

A. Introduction

Captive insurance companies offer a myriad of benefits to their owners. The State of Vermont, the largest US captive insurance company domicile in terms of numbers of captive insurers[76] as well as premium volume[77], has the following on their website:

"The advantages of going captive are:

- Coverage tailored to meet your needs (S, G, M)
- Reduced operating costs (G) *
- Improved cash flow (G)
- Increased coverage and capacity (G, M)
- Investment income to fund losses (G)
- Direct access to wholesale reinsurance markets (S, G, M) *
- Funding and underwriting flexibility (S, G, M) *
- Greater control over claims (G)
- Smaller deductibles for operating units (S)
- Additional negotiating leverage with underwriters (S)
- Incentives for loss control (S, G)
- Alternatives to the costly practice of trading dollars with underwriters in the working layers of risk (G)"[78]

We have added letters after each entry signifying if the advantage is likely to be material for a single parent captive insurance company owner (S), a group captive insurance company owner (G), and/or a micro captive insurance company owner (M). Also, the * / asterisked items are the only ones that overlap with another list of captive insurance company advantages, this one from PwC's (Big Four Accounting firm) website:

"Why captive insurance? One of the primary goals of a captive insurance company is to provide improved risk management for an organization. Some of the risk management benefits that a captive insurance company can achieve:

[76] "Largest captive domiciles." Business Insurance. January 1, 2020. https://www.businessinsurance.com/article/20190103/NEWS06/912325933/Business-Insurance-2019-Data-Rankings-Largest-captive-domiciles
[77] "The Four Models for "Why or Don't Go Captive." Captive Insurance Company Reports. September 2019.
[78] "Advantages of Captive Insurance." State of Vermont Department of Financial Regulation. https://dfr.vermont.gov/industry/captive-insurance/become-vermont-captive/advantages-captive-insurance

- Increase financial efficiency of risk management (S)
- Create flexibility in responding to changes in risk retention and risk transfer strategies (S) *
- Mitigate the impact of marketplace pricing and capacity volatility (S, G)
- Obtain coverage for risks traditionally not readily available or economically feasible in the commercial markets (G, M)
- Obtain access to reinsurance markets (S, G, M) *
- Maintain control over claims analysis (S)
- Create centralized accountability for risk management of diverse operations, business units or insurance programs (S)
- Obtain access to government programs (e.g., terrorism insurance) (S)
- Reduce insurance administration costs and recapture underwriting profits (G)"[79] *

Again, the * / asterisked items are the only ones common to each of the two lists (and "control over claims" is not the same as "control over claims analysis"). It is interesting to note how different these lists are. Part of this is related to the myriad of benefits of owning a captive insurer and the list can get very lengthy. Part of this is because of PwC and their client base, which would generally be larger corporations that own single parent captive insurance companies, so they didn't list many of the benefits available to group captive insurance company owners. It is also interesting that both lists explicitly exclude two of the most important advantages/benefits to single parent captive insurance company owners: (1) favorable federal tax treatment (relative to self-insurance) and (2) ability to write "unrelated" third-party risks. Arguably these are embedded in Vermont's "reduced operating costs" and PwC's increasing "financial efficiency of risk management," but they are not explicitly mentioned.

A discussion of benefits of captive insurers needs to recognize two main points. First, it is critical to understand that many of the so-called benefits/advantages of a captive insurer can be achieved without actually owning a captive insurer. Most of the Vermont and PwC items can be accomplished by a large corporation by simply retaining risk/self-insuring, but would require time and effort of in-house staff. For example, in PwC's list, they note "Create centralized accountability for risk management of diverse operations, business units or insurance programs." A captive insurance company is a great way to do that. However, a good risk management department staffed by professionals with strong analytical and communication skills can do this without incurring the costs of

[79] "Captive insurance." PwC. https://www.pwc.com/us/en/industries/insurance/captive-insurance-and-risk-management.html

owning and operating a captive insurer. Below we discuss the list of items that cannot be accomplished without a captive insurance company.

Second, the type of captive insurance company, or more succinctly, the type of owner(s) of the captive insurance company, must be taken into account, as each derives different benefits from a captive insurer. The PwC list mostly focuses on single parent captive insurance company owners, while the Vermont list generally comingles benefits available to single parent captive insurance company owners and group captive insurance company owners. Several of these benefits only apply to one and not the other (i.e., single parent vs group).

As such, a discussion of single parent captive insurers vs group captive insurers is important in trying to understand why captive insurance companies are used. In general, single parent captive insurers are for large organizations with complex risk management needs, and group captive insurers are for smaller organizations (or even individuals) with less complex risk management needs. A third type of captive insurance company, which is often a hybrid of the single parent and group captive insurance company (since risks are often pooled with other captive insurers), is what we will call a micro captive insurance company.

B. Single Parent Captive Insurers: Medium to Large Corporations

1. Retained Risk

To understand single parent captive insurance companies and their corresponding benefits, it is important to understand the concept of “retained risk.” Starting with medium to large corporations, the typical approach to managing risks for which insurance is generally available is to decide what portion of the risk to retain in house. This is analogous to a consumer deciding what deductible to choose on automobile or homeowners insurance policies. However, unlike the consumer, who has maybe one or two vehicles and one home, a large corporation may have thousands of “risk exposures.” As such, the company’s risk manager, often working with the finance department or chief financial officer, will decide how much risk to take/retain. Normally the “retention” is a dollar amount per claim, where insurance is purchased to cover the portion of large/unusual claims that exceed the retained amount. Depending on the state or the coverage, the retention can be a) a deductible in an insurance policy or b) via self-insurance with a separate “excess” insurance policy that protects against large/unusual claims.

For example, a supermarket chain with hundreds of store locations can expect hundreds or even thousands of workers compensation claims every year. Ignoring large, “outlier” claims, the value of the smaller claims can be reasonably forecasted year over year for that company. An insurer would simply include an estimate of these smaller claims (sometimes referred to by insurers as “the working layer”) in their premium quote, marked up to cover overhead costs, broker commissions, premium taxes, and profit margins. It doesn’t make sense for this supermarket chain to purchase this insurance from “first dollar.” In the Vermont list of advantages of captive insurance ownership, they call this “the costly practice of trading dollars with underwriters in the working layers of risk.” In the PwC list of advantages, this is labelled “Reduce insurance administration costs and recapture underwriting profits.” However, a captive insurer isn’t needed to achieve these savings.

In our charts below, we use the example of a company that self-insures its workers compensation risks in multiple states, including the State of Washington. This means that the company pays injured employees/claimants directly. In our example, the company purchases “excess insurance” to cover the portion of claims above a specified level – that level is $500,000, and is referred to as a self-insured retention (“SIR”). This would be coupled with a substantial reduction in premiums, available for the policyholder that now newly retains the risk corresponding to claims up to $500,000. Again, a captive insurance company is not required to avoid that costly practice of trading dollars. Then, the process for selecting SIRs is repeated for every insurance policy purchased by the parent company. In some cases, the parent company may simply choose to not buy any insurance at all for a particular risk, like cyber liability. Here, the risk is “uninsured.”

The company can then summarize all of its “retained risks” – either through deductibles above which there is insurance coverage, self-insured retentions above which there is insurance coverage, or uninsured risks. Note that uninsured risks also include amounts above policy limits where insurance was purchased.

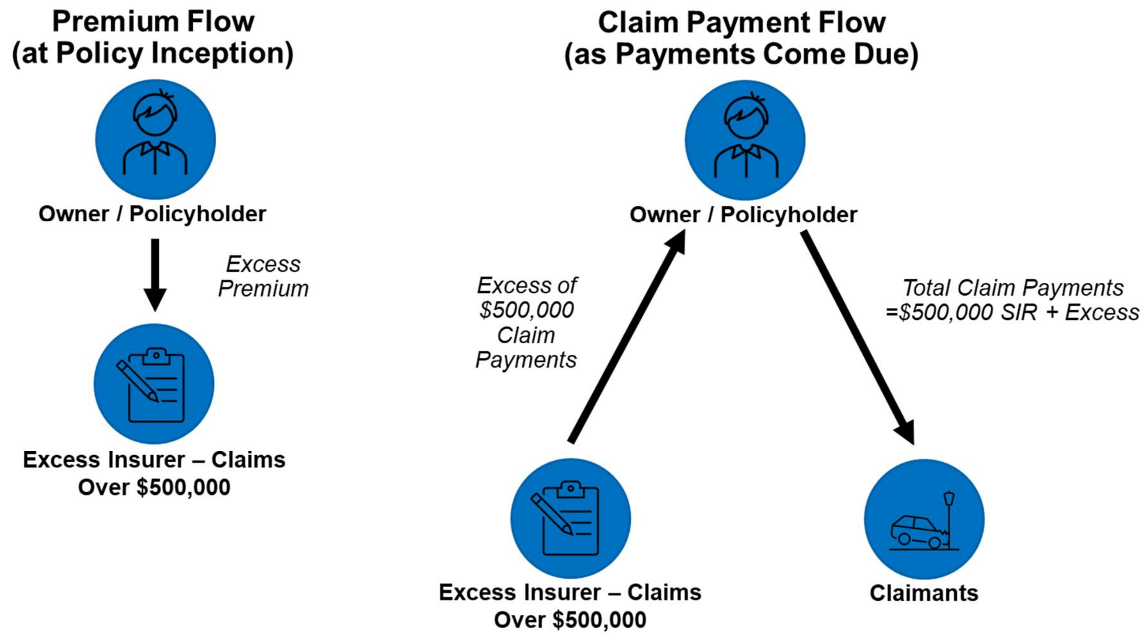
Normally, the SIR is selected such that the level of retained risk is relatively predictable year over year, and becomes a budgeted expense. Retaining risk, in turn, reduces insurance premiums: instead of purchasing an insurance policy covering all claims, the excess policy now only covers risks above the SIR. In addition to the reduction in the insurer’s expected claim costs, the insurer’s premiums will also reflect reductions in frictional costs like broker’s commissions, overhead, premium taxes, and profit margins (Washington’s monopolistic workers compensation state fund would not have things like commissions or premium taxes, but other workers compensation from most other states would). The elimination of these frictional costs is what the policyholder is after. In addition to recapturing insurer profits, investment income otherwise earned by the insurer is also recaptured – all without a captive insurer.

Therefore, retaining a moderate level of risk is usually cost effective, and since the risks are normally fairly predictable, the company is not jeopardizing its balance sheet. Again, this is just like the consumer choosing a deductible on an auto or homeowners policy. If a claim occurs, the deductible is borne by the policyholder.

In some states and/or for some insurance coverages, self-insurance is either not allowed or not cost effective. In these cases, in order to retain risk, a large deductible is used. Here, the insurance company issues a policy with a deductible. The retained risk is essentially the same under either structure – self-insurance or deductible – but the mechanics are different. For clarification, under liability and workers compensation deductibles (the most common coverages in captive insurance companies), the insurer pays the third-party claimant (for the entire claim, including amounts above the deductible, and is the de-facto “excess” insurer), and the policyholder pays the insurer for any deductible provisions in the policy. This is different from private passenger auto insurance “first party” comprehensive and collision claims (fire, theft, damage to car, etc.). For first party auto insurance claims, since the policyholder is the claimant, the insurer subtracts the deductible from the cost of repairs/replacement and pays the “net” amount. We did not create charts for deductibles, but the underlying premises are the same as self-insurance – retained risk is limited to some per claim amount, regardless of which party pays the claimant.

Chart 3 below shows how the flow of funds works under self-insurance. At this point, there is no captive insurance company. The company has saved money by eliminating frictional costs embedded in commercial insurance premiums.

CHART 3: NO CAPTIVE INSURER – PAY AS YOU GO
$500,000 SELF-INSURED RETENTION ("SIR") PER CLAIM



2. Pay as You Go or Prefund/Captive Insurance Company

For most companies, setting up a captive insurer is a completely separate and independent decision from deciding to retain risk. That is, risk retention and financing the resulting retained risk are separate and distinct decisions. Some companies choose to simply "pay as you go" and record liabilities on their balance sheets for estimates of unpaid self-insured risks. In our scope of work, we were asked to explain why companies are choosing captive insurance companies over the admitted market. That's not what's happening – it's that companies are choosing to retain risk and not buy it from the admitted market. The presence or absence of a captive insurer doesn't change this.

Companies choose to pre-fund the risk in a single parent captive insurer through a reimbursement insurance policy for a variety of reasons. In looking at the Vermont list of advantages of captive insurance companies, the idea that a captive insurer is required for medium to large sized companies to recapture underwriting profits and save insurance administrative expenses is normally not true. The same goes for "improved cash flow" and "investment income to fund losses." On the contrary, once the decision is made to retain risk and not pay a commercial insurer for this, improved cash flow and investment income to fund losses have already been achieved. In fact, since captive insurance companies are regulated by their domiciles, and most domiciles have some restrictions on how the captive insurer's assets can be invested, arguably, having a captive insurer reduces investment income to fund losses. Many of the items that Vermont noted apply primarily to group captive insurers, which are discussed below.

Moving on to availability of coverage, the PwC list includes "Obtain coverage for risks traditionally not readily available or economically feasible in the commercial markets." Again, for medium to large sized companies, absent some other need that can only be accomplished with an insurance policy (e.g., providing a certificate of insurance to a customer or regulator, or accessing reinsurance markets or government programs), a captive insurer is not needed when coverage is not available in the commercial markets. The parent company can simply be self-insured (or "uninsured").

Other benefits of single parent captive insurance companies listed above relate to more efficient risk management, such as centralizing risk management data, control over claims analysis, and managing smaller deductibles for operating units. While there is no economic benefit that can be attributed to these types of things, captive insurers are often the perfect solution for assisting risk managers with accomplishing these important objectives. Oftentimes, non-economic benefits are the main reasons articulated by risk managers as to why they own and operate captive insurance companies.

Another way to think about why companies choose to own and operate captive insurers is "what can be done with a captive insurer that cannot be done without a captive insurer?" If the company is trying to accomplish one or more of the things that can only be done with a captive insurance company, that often drives the decision. The other ancillary benefits are real, but are a harder sell to senior management as to why to spend the time and money to set up and operate a captive insurer.

Going back to the Vermont and PwC lists, most of the items on those lists can be achieved without a captive insurance company. Many of them are often much easier to do with a captive insurer, but don't actually require the captive insurer. However, the following cannot be achieved without an insurance company:

- Access to reinsurance markets *[Most reinsurers have direct purchasing options, but not all]*
- Access to government programs (e.g., terrorism)

Left off of these lists altogether are:

- Obtaining favorable federal tax treatment (relative to pay-as-you-go)
- Underwriting unrelated "third party" risks

- Providing certificates of insurance for otherwise self-insured risks

Below in paragraph 3 is a discussion of favorable federal tax treatment for retained risks. Paragraphs 5-8 provide a discussion of the other items listed above, which represent less common, specifically targeted uses of captive insurers. Paragraph 9 discusses advantages/benefits that can be achieved without a captive insurer, but that are often much easier to achieve with a captive insurer, and Paragraph 10 summarizes benefits of captives identified by survey participants.

Returning to the more common "retained risk" scenario, once the decision is made to use a captive insurer, retained risks are pre-funded by paying premiums into a subsidiary/affiliate captive insurer. The captive insurance company will collect premiums and reimburse the owner/insured for claim payments made on retained risks (e.g., under their deductible policies or SIRs). We refer to these types of policies as "reimbursement" policies or "deductible reimbursement" policies. Our survey showed that over 85% of premiums paid to captive insurers by Washington headquartered companies were for reimbursement policies.

The characteristics of a reimbursement policy (as described to us by the OIC) are as follows:

- Policyholder is the claimant
- Policyholder's claims represent reimbursements for amounts paid by the policyholder to other parties
- No other parties involved in claims transaction other than policyholder and captive insurer
- Policyholder owns/is affiliated with the captive insurance company

For any captive insurance reimbursement policy, the pre-condition is that the owner/policyholder retains otherwise insurable/fortuitous risks (deductible, self-insurance/SIR, no insurance) and is responsible for making any payments directly to claimants (or insurers in the case of deductibles); this is the exposure being insured.

For third party underlying risks (like liability and workers compensation deductibles or self-insurance/SIRs), where payments are made by the captive insurance company owner either directly to claimants or to an insurer (under a deductible policy), the captive insurance company reimburses the captive insurance company owner. For first party underlying risks (like property and auto physical damage deductibles or SIRs), in most cases the captive insurance company owner pays for repairs/replacement and is reimbursed by the captive insurer. If the captive insurer actually adjusts claims and pays directly for repairs, then it is not a true reimbursement policy.

Chart 4 shows the premium cash flows made at policy inception, and Chart 5 shows claims cash flows made over time after policy inception.

CHART 4: CAPTIVE INSURER / REIMBURSEMENT OF $500,000 SIR PER CLAIM PREMIUM FLOW AT POLICY INCEPTION

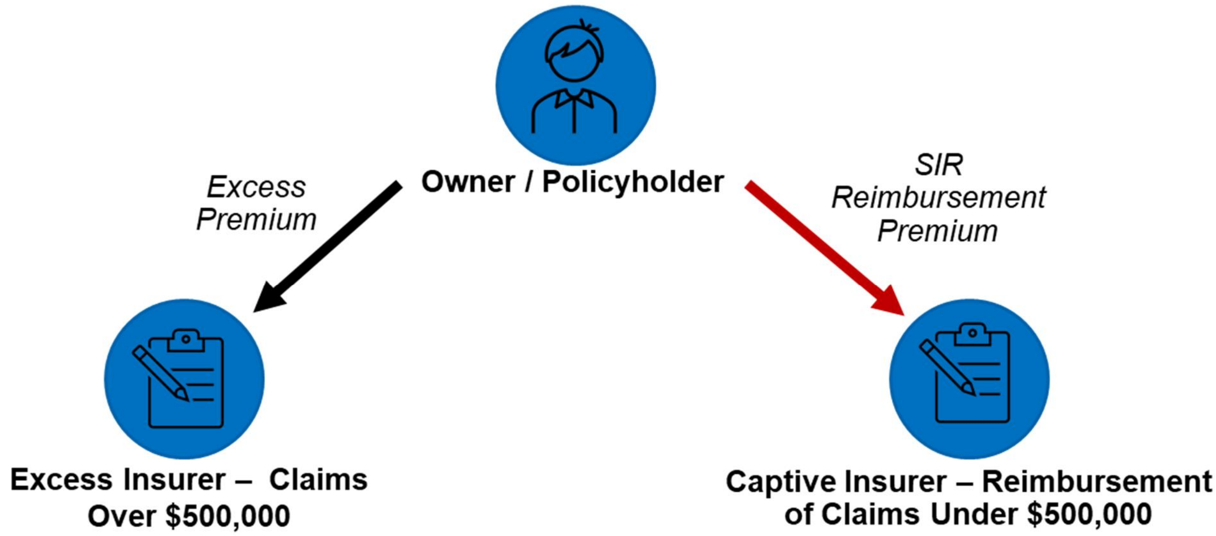
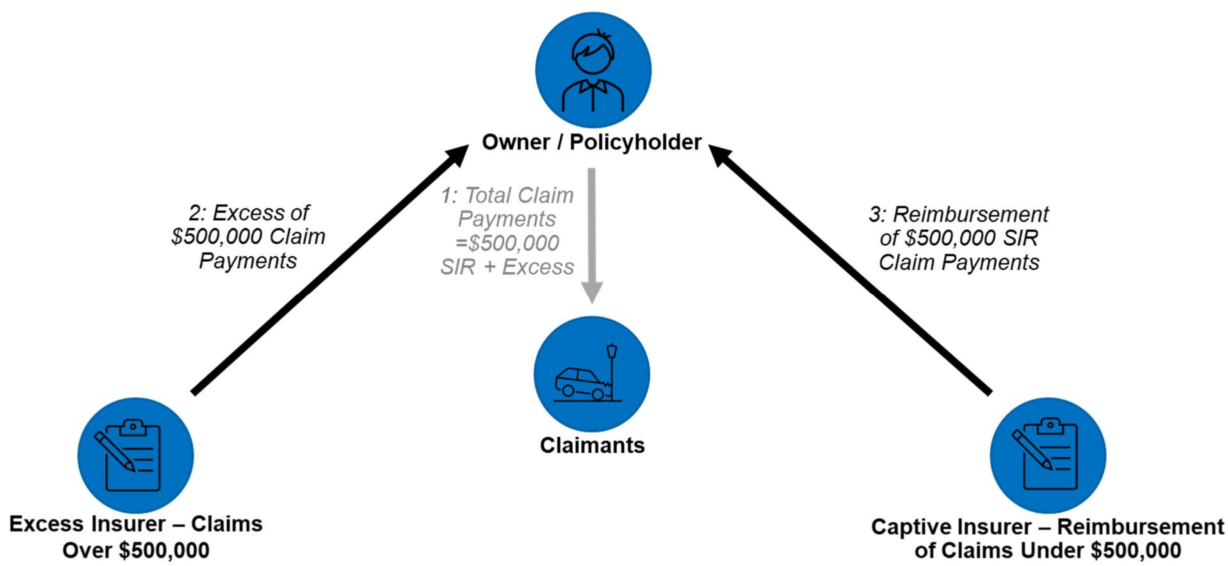


CHART 5: CAPTIVE INSURER/ REIMBURSEMENT OF $500,000 SIR PER CLAIM LOSS PAYMENT FLOW (AS PAYMENTS COME DUE)



Of particular note on Chart 5 is that there is no contact between the captive insurer and either the excess insurer or the claimants who incurred losses. Therefore, under reimbursement policies, consumers are insulated from the captive insurer, and are treated as if there were no captive insurer involved.

3. Why Buy Insurance from Affiliated Captive Insurer for Reimbursement of Retained Risk

Unlike traditional insurance, which protects the policyholder from financial ruin or significant financial consequences, reimbursement policies don't do that. While the literature on captive insurance companies lists a myriad of benefits of captive insurers, for reimbursement policies (85% of Washington captive insurance premiums), it almost always comes down to two reasons for having the captive insurer:

1. Risk management tool for tracking retained risk and budgeting; this would be considered as a "non-economic" benefit, since no direct value can be attributed to this.
2. Federal tax benefits (related to timing of deductions); this would be considered as an "economic" benefit, since the value to the company can be quantified.

Regarding federal taxes, not all single parent captive insurance company owners either qualify for the favorable tax treatment or choose to seek the favorable tax treatment (approximately 50% of single parent captive insurance company owners do this[80], and our survey results are consistent with this). So what is the tax benefit? With a captive insurer, the taxpayer can deduct estimates of unpaid claims ("reserves") since insurers are entitled to take such deductions. Without the captive insurer, retained risk is only deductible as claim payments are made. As such, the total deductions are the same – eventually all claims will be paid. However, the timing of the deductions are accelerated for the insurance company owner. The captive insurance company owner, by being able to take deductions sooner than a non-captive insurance company owner, is able to essentially earn investment income on the taxes temporarily saved.

Using a simple example, assume Company X has $10 million in annual retained/self-insured property losses, all of which occur late in the year due to weather related issues. The various damages to property due to weather events are accounted for as expenses in the year in which the events occurred. This is a basic principle of accounting – to match expenses to the year in which the underlying trigger for those expenses occurred.

[80] Marsh 2019 Captive Landscape Report

Further assume that Company X actually pays for the weather-related damages in the first quarter of the following year, and Company X files its federal tax returns on a calendar year 1/1-12/31 basis. With respect to these weather-related damages, Company X records a liability of $10 million as of 12/31, and then in the first quarter of the following year, the $10 million is paid, and the liability is reduced to $0 as of 3/31. In its tax return for the year in which the damages occurred, Company X cannot claim a deduction for the $10 million; it must wait until the following year.

Now, let's introduce a captive insurer, and for simplicity, we assume that the captive insurer has no overhead/operating expenses, and we further assume that any liabilities for unpaid claims (i.e., reserves) can be deducted at their full value (IRS rules require discounting of loss reserves, resulting in a small portion of reserves not being deductible).

The captive insurance company receives a premium of $10 million, and Company X takes a deduction for expenses of $10 million representing premiums paid to an insurer. At the end of the year, the captive insurer records income of $10 million and posts a liability (reserve) of $10 million, and deducts that $10 million, resulting in $0 of net, taxable income. Relative to the pay-as-you go self-insurer, the captive insurance company owner just got an extra $10 million deduction, temporarily saving 21% (the current marginal federal income tax rate on C-Corporations) of the $10 million, or $2.1 million. The pay-as-you-go self-insurer gets to take that $10 million deduction one year later than the captive insurance company owner, at which point everything seems to have balanced out.

However, since the captive insurance company owner temporarily saved $2.1 million that it doesn't have to pay to the IRS for a year, this can be viewed as a zero-interest loan from the government. The "economic benefit" of this can be quantified using interest rates (how much interest could be earned investing the money) or other rates (how much return on capital the company could achieve by investing in their growth/operations).

The longer it takes to pay claims, like for liability and workers compensation claims, the longer the company has the use of the temporary savings, and the larger the benefit.

We have modelled this using a range of assumptions, and the average "benefit", expressed as a percentage of premiums, is 2.5% annually, net of captive insurance company expenses. See Appendix B9 for a detailed analysis of how we estimate federal tax benefits for single parent captive insurers.

In summary, companies with retained risk are required to account for any corresponding liabilities for unpaid claims on their balance sheets under Generally Accepted Accounting Principles. However, the IRS does not recognize liabilities for retained risk/self-insured obligations (i.e., “reserves” for unpaid claims) as a tax deductible expense. The IRS requires removing the impact of these unpaid claims on a company’s financial statements as an adjustment. As noted above in Appendix B5, if properly structured, single parent captive insurers can qualify as insurers for federal tax purposes; why is this important? The answer is: “accelerated tax deductions for reserves for unpaid claims.”

4. Reimbursement Policies Are Optional

There is no regulatory requirement for captive insurance company owners to purchase reimbursement policies for retained risk. If the captive insurance company is no longer providing enough benefits, the captive insurance company owner can cancel or non-renew these policies and simply switch to a pay-as-you-go basis at any time.

5. Access to Reinsurance Markets

Reinsurers, by definition, can only provide coverage to insurers (including other reinsurers). They are not licensed to write coverage directly to a non-insurance company. If a particular coverage is either more competitively priced, or only available in the reinsurance market, then to “access” this coverage, a company can use a captive insurance company to insure the risk, and then the captive insurer, in turn, purchases the reinsurance and transfers the risk to the reinsurer. This was a common use of captive insurers in the past, but today, many reinsurers now have subsidiaries that write substantially the same coverages on a direct basis. While this is less of an issue relative to, say, the 1980’s, when there was a shortage of liability insurance capacity, there are still situations where reinsurance is either a better solution or the only solution.

Also, sometimes the desired coverage is not available from the US insurance market. Purchasing insurance directly from a non-US insurer results in a 4.0% Federal Excise Tax due from the buyer. As noted above, many reinsurers have subsidiaries that are direct writers, which means the opposite is true – direct writers have subsidiaries that are reinsurers. The Federal Excise Tax on reinsurance purchased from a non-US company is only 1.0%. The play here is, rather than the corporation buying the insurance directly from the non-US writing insurer and incurring a tax of 4.0%, instead, they insure the risk into a captive insurance company, and then the captive insurer cedes 100% of the risk to the offshore reinsurance company subsidiary of the direct writer. The incremental cost to do this is the premium tax rate of the captive insurance company domicile – usually around 0.3% - plus the 1.0% Federal Excise Tax. A 4% tax gets reduced to 1.3%, and this cannot be done without a captive insurer.

Note that using a captive insurer to access the reinsurance market results in a transfer of risk from the owner/affiliates to an unaffiliated party (the reinsurer). These risks are generally larger and of the type that would otherwise have the potential to impair the captive insurance company owner's balance sheet. This is a fundamentally different reason for using a captive insurer (i.e., transferring risk out of the organization) than for reimbursement policies.

6. Access to Government Programs

In 2002, the Terrorism Risk Insurance Act ("TRIA") was enacted to provide a reimbursement mechanism to insurance companies for "certified" acts of terrorism. TRIA had an expiration date and has been reauthorized several times, the latest being a seven year extension effective at year end 2020. The Terrorism Risk Insurance Program Reauthorization Act ("TRIPRA") of 2020 covers 80% of most property and casualty (including workers compensation) losses from certified (by the US Treasury) acts of terror. It only covers insurance companies, and each insurance company retains a deductible equal to 20% of the premiums corresponding to the coverages subject to TRIPRA.[81]

Going back to the "retain/keep" risk decision, if a company chooses not to purchase terrorism insurance, they have made a decision to retain that risk. However, at no additional cost, the federal program becomes available if the risk is written into a captive insurer. That is, the premium for the risk is paid to the captive insurance company, and if there are no claims, the captive insurer (and in turn, parent company) has not incurred any costs other than domiciliary premium taxes and any related captive overhead expenses such as designing the policy. If the captive insurance company already exists, there are no start-up costs, and the incremental cost to manage the captive insurer will not change materially. There is no charge for the terrorism coverage from the federal government. Without a captive insurer, this otherwise self-insured risk is not covered by TRIPRA.

[81] "Background on: Terrorism risk and insurance." Insurance Information Institute. December 16, 2019. https://www.iii.org/article/background-on-terrorism-risk-and-insurance

7. Unrelated / Third Party Risks

Moving to unrelated/third party risks, a captive insurance company owner, by virtue of having a licensed insurance company, is able to take on risks that a pay-as-you-go self-insurer legally cannot. These include insurable risks of parties that are not owned by the parent company or its affiliates. Normally, such risks are those that are connected to the parent company's operations in some way. Examples include customers (warranties), vendors/contactors (workers compensation, liability on projects/contracts with the company), and employees (employee benefits and other insurance). Of importance is that many of these risks would need to be underwritten by a commercial insurer, paying taxes to the corresponding state and being regulated for market conduct/consumer protection. This is due to various state requirements, such as the requirement by most states that companies be able to provide proof of insurance from an admitted carrier for workers compensation. Then, the risk would be transferred to the captive insurer via a reinsurance contract and no additional premium tax would be paid to the state where the risk is located.

A report prepared by Marsh, a large broker and captive insurance company manager, noted the following:

> "22% of Marsh-managed captives wrote some form of third-party business in 2018 representing a year-over-year increase of 12% and a 62% increase over the last five years. In particular, coverage for contractor, vendor, and customer risk continued its steep growth trajectory, increasing 138% among Marsh managed captives in the past five years. In 2018, Marsh captives writing such third-party risk generated a total of US$162 million in net premiums."[82]

In another Marsh report, they indicate that premiums written by the captive insurers that they manage are approximately $50 billion. Thus, the $162 million of premiums noted above is less than ½ of 1 percent of the premiums in captive insurers that Marsh manages. While we did not specifically ask captive insurance company owners to identify the amount of unrelated premiums in their captive insurance companies as part of our survey, we have assumed that the values are not material, based on the industry data.

In most cases, since the captive insurer doesn't have all of the necessary licenses to underwrite risks other than its own risks or because other circumstances require the use

[82] Marsh 2019 Captive Landscape Report and "Captive Insurers Grow Their Third-Party Business with Help from Digital Tools: Marsh." Insurance Journal. May 30, 2019. https://www.insurancejournal.com/news/international/2019/05/30/527880.htm

of an authorized insurer, the captive insurance company owner will partner with a licensed insurer, sometimes referred to as a “fronting company.” The licensed insurer underwrites the risks, and then transfers the desired level of risk to the captive insurer through a reinsurance contract. The captive insurer must compensate the fronting carrier for its overhead and operating expenses (including premium taxes paid by the fronting carrier to the corresponding states). Also, the fronting carrier normally retains a portion of the risk, either on a percentage basis, or in excess of a specified threshold per claim.

There are two key economic benefits to captive insurance company owners with respect to unrelated business. The first is the ability to capture underwriting profits that are not available to a non-insurance company. Viewed differently, instead of paying a contractor for insurance embedded in a quote, the quoted cost of the insurance is used to purchase insurance from a commercial insurer, and a portion of that premium and risk is transferred to the captive insurer. If the business is profitable, this represents a reduction in expenses for the contract in question. However, by doing this, the captive insurer moves away from being strictly a vehicle for reimbursing deductibles and other retained risk, and moves more towards being a traditional insurer. Second, the presence of unrelated premiums often means that the IRS is more likely to classify a captive insurer as an insurer using its definitions of what constitutes insurance. This, in turn, helps the captive insurance company achieve the federal tax benefit described above.

The benefits to the captive insurance company owner go beyond the pure economic benefits described above. For example, providing extended warranty coverage to customers allows the parent company to get closer to its customers, to provide one-stop shopping, and to control the quality of service provided to its customers when the warranty is needed. This should make the parent company more attractive to existing and prospective customers, although sometimes offering warranties is more of a defensive move to keep up with what competitors are doing. Similarly, making insurance products available to employees arguably is something that attracts people to work at that company and/or keeps them from looking to work elsewhere. Typically, the employee coverages are related to “employee benefits” such as life insurance, accident insurance, pet insurance, long term care insurance, and legal defense insurance, to name a few. Some companies even offer auto insurance and homeowners insurance, wherein their captive insurance company reinsures the fronting commercial carrier.

With respect to vendors and contactors, this can help out in at least two ways. First, it can make things more seamless/easier for the vendor/contractor to do business with a company that provides for some of its insurance needs. Second, since the parent company, through its captive insurer, is now “at risk”, it is more likely to impose safety and loss control measures that the vendors/contractors must follow. In theory, this would reduce the frequency and/or severity of the underlying claims. This, in turn, makes the vendor/contactor a “better than average” risk. Since the alternative to providing the insurance to the vendor/contactor is to have them include the cost of insurance within their service agreements/contracts, the parent company is incurring a cost – in theory, at some sort of “average” commercial insurance rate. If the parent company is able to drive that risk down to a lower level, the corresponding profit via the captive insurer represents the cost savings.

One more topic merits discussion here – agency captive insurance companies, which are described in “The Different Types of Captive Insurers” in Section IV. A. of this report. An agency captive insurance company is a type of single parent captive insurer, where an insurance agency or broker owns the captive insurer (it could be a group captive insurer as well, owned by multiple agencies/brokers). The benefit to the owner is to share directly in the underwriting profits generated by insurance policies provided to the owner’s customers – which are “unrelated risks” in terms of being reinsured into a captive insurer owned by the agency. Agency captive insurance companies are set up by insurers willing to enter into these types of risk sharing arrangements with their agents. While there are other ways for insurance companies to compensate their agents for finding profitable business, such as profit sharing and sliding scale commissions, an agency captive insurance company normally offers the most profit potential to the agent. It also puts the agent’s capital at risk, and insurers are often open to sharing their profits with agents that are willing to risk losing their own money on the business they are placing with those insurers.

To reiterate, virtually all of these types of unrelated third party risks would not be written by directly by a captive insurer. Instead, the premiums would be written by an admitted licensed carrier, and the captive insurance premiums would be achieved through reinsurance and would not be taxable by the State (by virtue of the State already having collected premium tax from the licensed carrier).

8. Certificates of Insurance

There are some risks for which a parent company is required to produce certificates of insurance to its customers, evidencing proof of insurance. In fact, as part of Milliman’s contract with the State, we were required to produce such certificates. If the risk/coverage in question is one that is retained/self-insured, the parent company cannot comply with their customers' requests. Normally, the parent company has insurance, but also has a deductible or self-insured retention, so the insurance kicks in once a claim reaches a specified threshold. Usually, providing the certificate of insurance from the commercial insurer satisfies the needs of the customer, even if there is a material underlying deductible or self-insured retention.

However, there are circumstances under which the parent company doesn't have the necessary insurance coverage. Here, a captive insurer could fulfill that role by issuing a policy for the coverage in question. This, in turn, can sometimes result in the customer challenging the validity of the insurance, since most captive insurance companies are not licensed in multiple jurisdictions, and/or don't carry a financial rating from a recognized rating agency that is required by the customer. Some captive insurers have gotten ratings from agencies like AM Best to meet these requirements.

The main point here is that in certain circumstances, a certificate of insurance is needed, and a self-insurer (or non-insurer) cannot satisfy the needs of a customer, rather only an insurance company can do this.

9. Soft / Non-Economic Benefits

With respect to most of the other benefits to a medium to large single parent captive insurers, most can be achieved without a captive insurer. For reference, the PwC list of reasons to consider a captive insurance company is repeated below.

- Increase financial efficiency of risk management
- Create flexibility in responding to changes in risk retention and risk transfer strategies
- Mitigate the impact of marketplace pricing and capacity volatility
- Obtain coverage for risks traditionally not readily available or economically feasible in the commercial markets
- Obtain access to reinsurance markets
- Maintain control over claims analysis
- Create centralized accountability for risk management of diverse operations, business units or insurance programs
- Obtain access to government programs (e.g., terrorism insurance)
- Reduce insurance administration costs and recapture underwriting profits

For example, the third item above on mitigating the impact of marketplace pricing does not require a captive insurer. However, having a captive insurer is a great way to keep track of the impact of retaining the risk due to marketplace disruptions, and to quantify the impact of making these decisions. Some risk managers use the results of the captive insurer as a "profit center," on the premise that the captive insurer is charging approximately what the commercial market would have charged. Then, any profits in the captive insurance company would be a way of showing senior management the amounts saved (and this would simultaneously fulfill the objective/benefit of "Create centralized accountability for risk management of diverse operations, business units or insurance program"). It's much harder to make this argument without a captive insurer. The question becomes, is it worth the cost?

10. Survey Results

Survey respondents generally listed similar benefits as those above, including:

- Provides access to coverage not available through traditional market
- Provides desired coverage at a more affordable premium
- Provides flexibility in coverage not afforded in commercial market
- Allows access to reinsurance (including terrorism) markets
- Formalizes existing self-insured/retained programs
- Allows parent to track/analyze trends in data
- Enables better control over claims handling and risk management
- Allows opportunity to share / retain underwriting profits
- Reduces operating costs

C. Group Captive Insurers – Smaller Companies and Individuals

Group captive insurance companies, as implied by this two-word description, have more than one owner and policyholder, while single parent captive insurers only have one owner and policyholder (here, for simplicity and to allow for comparisons to group captive insurers, multiple subsidiaries of a parent, each getting a separate policy from the single parent captive insurer, are considered as a single policyholder). Association captive insurance companies and industry captive insurance companies (or "industrial insured captive insurance companies") are both forms of group captive insurers. Most risk retention groups are formed as association captive insurance companies. For most group captive insurers, there are two underlying premises that make an entity consider joining a group captive insurer. First, the entity is too small to have their own captive insurance company. Second, the entity is part of a class of risks that the commercial insurance industry is not servicing efficiently – by not making adequate (or any) insurance available, by pricing the insurance too high, by not providing good service, or by not customizing policy language to a narrow class of risk.

Consider medical malpractice in the 1970's. As new types of claims that hadn't been seen before emerged with high verdicts, most medical malpractice insurers withdrew from the market, leaving physicians without coverage. Each individual physician faced potential financial ruin by being "uninsured." However, if larger groups of physicians banded together, they could achieve a level of critical mass whereby risks are spread out enough to protect the entire group without bankrupting any individual physician/policyholder. That's an example of an availability crisis.

Sometimes, the insurance industry doesn't fine tune its rates enough, resulting in a systemic subsidization of one type of policyholder by another type. For example, consider professional liability in the financial services sector, and think of a company that uses the same rates for CPAs as for consulting actuaries. In the 1990's, there were a number of large claims made against actuaries. If the insurer continued to charge the same rate (and if others did as well), the CPAs would be subsidizing the poorer claims experience of the actuaries. If the insurers choose not to budge, a group captive insurer for CPAs would represent a possible solution. While this is not an availability issue, it's a pricing issue.

Properly set up, priced, and managed, such a captive insurance company would end up reducing costs to its policyholders/owners. Initially, rates might be set at or slightly below the current (high) levels, but since the policyholders own the captive insurer, any expected profits would be captured, and made available to reduce future rates and/or pay dividends. Also, investment income previously earned by the insurer would now accrue to the benefit of the captive insurance company and its owners.

Turning to service and customization, another benefit of such a group captive insurance company is that there is often only a single class of risk involved, so the management of that captive insurer can hire experts that specialize in that class of risk. Using claims professionals as an example, larger insurers will often have claim adjustors or attorneys that handle a wide variety of claims. For our notional CPA group insurer, only claims made against public accountants are pertinent, and in theory, outcomes for these claims will on average be better than those of larger, more diversified insurers since the claims would all be handled by specialists, not generalists. Also, insurance policies can be custom designed to perhaps be more expansive in terms of what is covered versus what is excluded. Operationally, such an insurer is laser focused on a narrow list of risks, and can better accommodate its owner-insureds.

The list of benefits of captive insurance companies from the State of Vermont website is repeated below, with S, G, M notations signifying if the benefit applies to single parent

(S), group (G), and/or micro captive (M) insurance company. Note that most of the items apply to group captive insurers.

- Coverage tailored to meet your needs (S, G, M)
- Reduced operating costs (G)
- Improved cash flow (G)
- Increased coverage and capacity (G, M)
- Investment income to fund losses (G)
- Direct access to wholesale reinsurance markets (S, G, M)
- Funding and underwriting flexibility (S, G, M)
- Greater control over claims (G)
- Smaller deductibles for operating units (S)
- Additional negotiating leverage with underwriters (S)
- Incentives for loss control (S, G)
- Alternatives to the costly practice of trading dollars with underwriters (S)

For completeness, there are group captive insurance companies that cater to the needs of larger insureds, but, again, availability and/or price are normally the issues. Here, the precondition of "too small to have their own captive insurer" is a relative term. Examples of captive insurers or risk pools made up of large insureds include captive insurance companies for aviation risks, nuclear risks, and high policy limit energy risks. Thus, large corporations may still purchase insurance from a group captive insurer. A specific example of this is ACE, which started out as a captive insurance company owned by a group of large, mostly Fortune 500 companies, and evolved over time:

> "ACE was established in Bermuda in 1985 by 34 founding sponsors to combat the lack of available coverage in the U.S. insurance marketplace. Since 1985, ACE has evolved from a monoline excess insurer owned by its policyholders to a global publicly traded insurance company and one of the world's leading providers of commercial property and casualty insurance"[83]

Premiums paid to group captive insurance companies by Washington headquartered companies represent approximately 1.0% of the total direct written premiums in 2019 (less than 0.5% in 2018), and most of the group captive insurance premiums are reinsured to captive insurers by a licensed, admitted carrier. Therefore, premium taxes to the State are not material for group insurers and most of this business is already regulated by the State for market conduct/consumer protection.

[83] "Chubb History in Bermuda." Chubb. https://www.chubb.com/bm-en/about-chubb-bermuda/chubb-history-in-bermuda.html

D. Micro Captive Insurance Companies – Smaller Captive Insurers/Owners

Micro captive insurance companies are a type of single parent captive insurance company. However, to qualify as in insurer for federal tax purposes, this is usually accomplished by sharing risk with other micro captive insurers. The risk sharing has the effect of micro captive insurers functioning a lot like group captive insurers.

Micro captive insurance companies are designed to meet the risk management needs of smaller businesses that are not that well diversified. Typically, micro captive insurers are owned by businesses with less than $100 million in annual revenues and less than $20 million in annual pretax profits. For these entities, events like a tax audit, a regulatory or judicial action, a loss of a key customer, the loss of a key employee, or an interruption to the business caused by a pandemic, to name a few, can have a material impact on the bottom line. Micro captive insurance companies offer a tax efficient solution to managing the risks of smaller companies. Coverages offered by micro captive insurance companies are typically not available in the commercial insurance market.

Under IRS Section 831(b), an insurer with annual premiums less than a specified threshold ($1.2 million until 2017, and then increased to $2.2 million and indexed for inflation thereafter) that elects to be taxed under said Section 831(b) is not taxed on underwriting gains. Instead, the micro captive insurer only pays taxes on investment income. This has the effect of a) allowing underwriting profits in good years to be carried over tax free for future years/rainy day fund, and b) for the purposes of taking money out of the captive insurer, converting ordinary income to dividends, and lowering the marginal tax rates from 37% to 23.8% for most micro captive owners. See Appendix B10 for details.

To achieve risk shifting and risk distribution to qualify as an insurer for federal tax purposes, micro captive insurance companies often pool their risks with other micro captive insurance company owners. Typically, the micro captive insurer retains a fixed percentage of its own premiums and losses, normally between 20% and 50%. This gives the captive insurer the look and feel of a single parent captive insurer. Then, the micro captive insurance company transfers (cedes) the rest of the risk to a pool of other micro captive insurers, and simultaneously it assumes reinsurance premiums from the pool equal to the premiums it ceded. This risk sharing gives the captive insurer a bit of the look and feel of a group captive insurer. The sharing of risk with unrelated parties generally meets the IRS requirements for risk transfer and risk distribution.

Such an arrangement achieves a number of the benefits of captive insurance ownership shown on the Vermont and PwC lists noted above. Chief among these is access to the reinsurance market, which allows the business owner to spread out the cost of unpredictable large and unusual expenses over a number of years by transferring a portion of these risks to the risk pool. Thus, it promotes stability and allows any profits to accrue in a tax deferred manner, so it efficiently provides for a "rainy day fund."

With respect to the tax advantage of not paying taxes on underwriting gains and effectively converting ordinary taxable income to dividends (assuming no/few losses in the captive insurance company), again this begs the question of how much is this benefit worth. We developed a model to test this and found the benefit to be in the 7%-10% of premium range. See Appendix B10 for details.

A discussion of micro captive insurers would not be complete without mentioning that they are the target of an ongoing IRS investigation, which began over 10 years ago. In a nutshell, the IRS position is that certain micro captive insurance companies write policies that either present virtually no risk of loss, or the risk of loss is not proportional to the premium (i.e., the premium is too high). In effect, the IRS is challenging the way the underlying coverages and policies are priced. The taxpayer gets the biggest tax advantage when there are no losses.

The following is from the July 2020 GAO Report, Abusive Tax Schemes: Offshore Insurance Products and Associated Compliance Risks:

> "Sometimes micro-captives are established purely for tax reasons, which generally courts have ruled is improper. Indicators that businesses have established a micro-captive in an abusive tax scheme include artificially high premiums that do not make economic sense or that are not supported by actuarial science.
>
> IRS enforcement officials told us they first came across abusive micro-captive insurance schemes in the mid-2000s. Following many years of enforcement action, IRS determined that some micro-captive insurance transactions have the potential for abuse. Subsequently, IRS required U.S. taxpayers to disclose their involvement in micro-captive insurance transactions, based on certain criteria, through IRS Notice 2016-66, *Transaction of Interest: Section 831(b) Micro-Captive Transactions*.
>
> Between November 1, 2016, and December 31, 2019, IRS processed disclosures on thousands of micro-captive insurance transactions. IRS has said

> that the majority of micro-captive cases examined have been determined to be abusive. IRS officials told us that as the result of various enforcement actions, including a 2016 enforcement campaign, IRS offered settlements to 156 taxpayers who participated in abusive micro-captive transactions. Of those taxpayers, 76 percent had elected to accept the settlement terms as of June 2020.
>
> Since 2017, IRS has won three micro-captive cases before the Tax Court, which supported IRS's increased enforcement actions against abusive micro-captive insurance products. At issue in these cases was whether the micro-captive or related businesses could claim various deductions and tax benefits."[84]

Micro captive insurance companies make up a significant portion of the number of captive insurers used by Washington headquartered companies (11 of the 31 non-group captive insurance companies responding to Survey 2 make the 831(b) election). However, since premiums are limited by IRS regulation, these captive insurers would not be expected to contribute materially to the projected tax revenues to the State if captive insurance companies are in fact taxed by Washington. Based on our survey, direct written premium related to these captive insurers is less than 3% of the total in Washington in 2019 and less than 1% of the total in Washington in 2018.

[84] "ABUSIVE TAX SCHEMES: Offshore Insurance Products and Associated Compliance Risks", U.S. Government Accountability Office. https://www.gao.gov/assets/710/708520.pdf

Appendix B9
Federal Tax Benefits – Single Parent Captive Insurers

A. Overview

With respect to the federal tax benefit, having a captive insurer allows the owner to take tax deductions for unpaid retained risks ("reserves") that cannot be taken without having the captive insurer. This is a timing only benefit – the total deductions are the same under either scenario, but not having a captive insurance company means that the deductions are deferred and spread out over a longer period of time.

B. Modelling

We developed a model to quantify this benefit. The key input assumptions to the model are a) the underlying type of insurance/risk, b) the speed at which claims are settled/paid out ("payout patterns"), c) the interest rate that the captive insurance company owner can earn on temporary tax savings, and d) the expenses associated with owning and operating a captive insurer. The model then compares cash flows between the situation of retaining risk with no captive insurance company, and retaining the same risk but using a captive insurer that issues reimbursement policies.

For the pay-as-you-go self-insurer, the annual deductions are equal to the actual claim payments each year. For the insurer, the deductions equal the annual claim payments plus the annual change in reserves. With respect to reserves, insurers must discount reserves to present value using formulas prescribed by the IRS – the key input assumptions underlying the IRS's formulas are the speed at which losses are paid ("payout pattern") and the annual interest used in the present value calculation ("discount rate"), both of which are prescribed by the IRS. The payout patterns vary by coverage type/line of business and are derived from insurance industry data; the discount rate is derived from medium term corporate bond yields. The IRS looks to the underlying risk (i.e., workers compensation, general liability) to determine the payout patterns to be used. This determination of "coverage" is independent of whether the policy is structured as direct vs. reimbursement.

C. Range of Assumptions

We have run our model using a range of payout patterns and interest rates. Payout patterns start with average insurance industry data used by the IRS, and then we speed up the pattern for the “Faster” payout and slow down the pattern for the “Slower” payout based on alternative data sources. For interest rates for the present value calculations, we used 3%, 5%, and 7%. Some analyses use higher values to reflect a company’s overall cost of capital/rate of return on operations. We temper these higher values to reflect some opportunity loss by having to keep capital in the captive insurance company.

We took the results of our survey and concluded that a typical captive insurer writes mostly reimbursement policies covering retained risk for workers compensation and general liability, with 70% of the premium associated with workers compensation. While there are many other coverages written by captive insurers owned by Washington companies, we assumed that the balance was for general liability (this has the effect of slightly overstating the federal tax benefit but is not material to the model). We modelled this for a captive insurance company with an underlying risk profile of 70% workers compensation and 30% general liability, and with captive insurance company expenses of 2% of premium and 0.5% of premium respectively.

If there was no cost to own and operate the captive insurer, the expected benefit is in the 1.0% to 4.5% range. These values are independent of the size of the captive insurer, since before consideration of fixed expenses, the benefit is proportional to premiums (actually, to expected losses, which are a proxy for premiums for large single parent captive insurers). To incorporate expenses, the size of the captive insurer does matter. For a captive insurance company that insures $10 million of annual expected retained risk, expenses could be expected to be about 2% of premium (and tax effecting this at a 21% corporate federal marginal income tax rate, expenses net of taxes are approximately 1.6%). Since expenses don’t scale with premiums, for a larger captive insurance company, we could expect expenses to be more like 0.5% (0.4% after tax). The tables below summarize the results, all expressed as annual savings as a percentage of annual premium:

TABLE 22: POTENTIAL CAPTIVE INSURER FEDERAL TAX BENEFIT (PRIOR TO EXPENSES)

Interest	Payout Pattern		
Rate	Faster	IRS	Slower
3%	1.0%	2.0%	2.4%
5%	1.6%	2.9%	3.5%
7%	2.1%	3.8%	4.4%

TABLE 23: POTENTIAL CAPTIVE INSURER FEDERAL TAX BENEFIT (AFTER EXPENSES @ 2.0%)

Interest	Payout Pattern		
Rate	Faster	IRS	Slower
3%	(0.6%)	0.4%	0.8%
5%	(0.0%)	1.4%	1.9%
7%	0.5%	2.2%	2.9%

TABLE 24: POTENTIAL CAPTIVE INSURER FEDERAL TAX BENEFIT (AFTER EXPENSES @ 0.5%)

Interest	Payout Pattern		
Rate	Faster	IRS	Slower
3%	0.6%	1.6%	2.0%
5%	1.2%	2.6%	3.1%
7%	1.7%	3.4%	4.0%

A sample calculation corresponding to Table 23, 3% interest rate, IRS payout pattern of 0.4% is included in Appendix E.

D. Summary of Results

The tables above summarize the current situation for “typical” Washington single parent captive insurance company owners, using two different expense ratios (i.e., cost to own/operate the captive insurer) – 2.0% and 0.5%. At the 2.0% expense level, the tax benefit ranges from negative 0.6% to 2.9% with a “central value” (IRS payout, 5% interest rate) of 1.4%. Decreasing expenses to 0.5% improves the benefit (since it’s cheaper to run the captive insurer, as a percentage of premiums), to a range of 0.6% to 4.0%, with a “central” value of 2.6%. Based on this, we have selected 2.5% as a baseline “average” federal tax benefit as a percentage of captive insurance premiums.

If Washington imposes a captive insurance premium tax of 2.0% (after tax “cost” reflecting value of 21% deduction is 1.58%), this would eliminate all of the tax benefit in a number of scenarios above, and would reduce the others materially. The tables below quantify the federal tax benefit after reflecting the impact of an additional 2.0% Washington premium tax.

TABLE 25: POTENTIAL CAPTIVE INSURER FEDERAL TAX BENEFIT (AFTER EXPENSES @ 2.0% AND WA TAX @ 2.0%)

Interest Rate	Payout Pattern		
	Faster	IRS	Slower
3%	(2.2%)	(1.2%)	(0.8%)
5%	(1.6%)	(0.2%)	0.4%
7%	(1.1%)	0.6%	1.3%

TABLE 26: POTENTIAL CAPTIVE INSURER FEDERAL TAX BENEFIT (AFTER EXPENSES @ 0.5% AND WA TAX @ 2.0%)

Interest Rate	Payout Pattern		
	Faster	IRS	Slower
3%	(1.0%)	(0.0%)	0.4%
5%	(0.4%)	1.0%	1.5%
7%	0.1%	1.8%	2.5%

We have not modelled any state tax income tax benefits that may accrue to captive insurance company owners. Since Washington has no state income tax, this would not be applicable, although to the extent Washington headquartered companies have out of state income taxes, there could be potential state income tax benefits as well.

Appendix B10
Federal Tax Benefits – 831(b) Captive Insurance Companies

Benefits of micro captive insurers are a) no federal taxes on underwriting income, so gains can accrue tax free and act as a catastrophe/rainy day fund, and b) accessing the reinsurance market to transfer portions of a small company's risk profile to a risk pool in exchange for a share of other pool risks, thereby spreading and stabilizing risk.

Note that the IRS is investigating some 831(b) captive insurance companies on the premise that the risks are either not insurance, or that the premiums are too high relative to the risks being insured.

We start by looking at a notional 831(b) captive insurer that has no losses, and quantify the federal tax benefit of essentially moving funds from one tax rate to another tax rate.

We developed a model to do a cost/benefit analysis for a micro captive insurance company making the 831(b) election. The key input assumptions to the model are a) IRS marginal tax rates, b) the premium volume, c) loss experience of the captive insurance company owner compared to that of the risk pool for situations where risk pools are involved, and d) the cost to own the captive insurer.

For marginal tax rates, we assumed that most 831(b) captive insurance companies are S-Corporations where income passes through to the owner's personal income tax return. The top marginal tax rate on ordinary income is currently 37%. While the captive insurer's underwriting gains aren't taxed (investment income is), in order to take any gains out, the owner must pay tax on the distribution. We assumed that the distribution would be in the form of a dividend and a dividend tax rate of 23.8% applies.

Assuming the captive insurer has no losses and, further, that there are no losses for the entire risk pool (the best case, tax-wise for all parties), for $1.2 million in premiums and $100,000 in captive insurance operating expenses/costs, the tax "gain" is 7%. Adding Washington premium taxes of 2.0% would cut into this benefit, but would not necessarily be a deal breaker. However, it would cause captive insurance company owners in Washington to incur a higher level of expenses than those in other states if these premiums were to be taxed. The table below supports our calculation.

TABLE 27: NO LOSS SCENARIO, $100,000 CAPTIVE INSURER EXPENSES[85]

	Without Risk Pool		With Risk Pool	
	Pass-Through	**Captive**	**Pass-Through**	**Captive**
Income / Premium	1,200,000	1,200,000	1,200,000	1,200,000
Captive Operating Expenses		100,000		100,000
Insurable Loss/Captive Claim Costs		0		0
Pre tax income	1,200,000	1,100,000	1,200,000	1,100,000
Tax Rate	37.0%	23.8%	37.0%	23.8%
Owner's After Tax Income	**756,000**	**838,200**	**756,000**	**838,200**
Savings as a % of Premium		**7.0%**		**7.0%**

If expenses to run the captive insurance company were less (and often are less than $100,000 for these types of captive insurers), the savings would be greater. For example, using expenses of $65,000, that would increase the savings to 10%. This model is taken from a research paper published in Captive Insurance Companies Reports.[86]

Tax benefits are actually a secondary consideration for most micro captive insurance company owners. Rather, accessing the reinsurance market (risk pools) essentially allows micro captive insurance company owners to purchase insurance for coverages not available from the commercial market. Like any insurance product, there are “winners” and “losers”, where the losers are subsidizing the losses of others. Using after tax income as the benchmark, we can quantify the level of losses where the captive insurance company owner breaks even – with or without a risk pool.

Table 28 shows the breakeven point in terms of losses for each of “no risk pool” and “risk pool” scenarios. With no risk pool, when losses exceed $623,000, the company is better off without the captive insurer. That is, if losses exceed $623,000, the expenses to own the captive insurer and the inability to deduct losses would produce after tax income in the captive insurer scenario below the non-captive insurer scenario. With a risk pool, we test the case where the captive insurance company owner has no losses, but is required to pay a portion of losses from other pool participants. When that level exceeds $108,000 (about 9% of premium), the captive insurance costs, including paying others’ claims, exceeds the tax benefit.

There are risks involved here that aren’t faced by typical single parent captive insurance companies, such as subsidizing unrelated third parties (no customers, vendors,

[85] “Tax Reform and Captive”. Captive Insurance Companies Reports, September 2018.
[86] “Tax Reform and Captive”. Captive Insurance Companies Reports, September 2018.

contractors, or employees are involved, so there is no embedded ancillary advantage). Also, making the 831(b) election not only means that underwriting gains are not taxed, but also that underwriting losses are not deductible, and cannot be carried forward or backwards.

TABLE 28: BREAKEVEN LOSS SCENARIOS, $100,000 CAPTIVE INSURER EXPENSES

	Without Risk Pool [1]		With Risk Pool [2]	
	Pass-Through	**Captive**	**Pass-Through**	**Captive**
Income / Premium	1,200,000	1,200,000	1,200,000	1,200,000
Captive Operating Expenses		100,000		100,000
Insurable Loss/Captive Claim Costs	623,000	623,000		108,000
Pre tax income	577,000	477,000	1,200,000	992,000
Tax Rate	37.0%	23.8%	37.0%	23.8%
Owner's After Tax Income	**363,510**	**363,474**	**756,000**	**755,904**
Savings as a % of Premium		**0.0%**		**0.0%**

[1]Assumes parent company has of loss of $623,000

[2]Assumes no losses for the parent company but captive insurer assumes $108,000 loss in risk pool scenario

Appendix B11
Captive Insurance in Washington – Survey Results

Below we address the scope and nature of captive insurance in Washington and how this is impacting the insurance market in Washington. Our findings are based on the results of our survey of Washington headquartered companies. Below we provide more details on the survey. We have organized our discussion as follows:

- Two phase survey structure
- First survey process and results
- Second survey process and results
- Adjustments to data from second survey
- Results of second survey
- Projections of total captive insurance market in Washington

A. Two Phase Survey Structure

Milliman conducted a two phase survey to gather the information needed to a) understand the size and scope of the captive insurance market in Washington, and b) estimate potential premium tax revenue under the various taxation frameworks identified. We worked closely with the OIC and the DOR to develop the list of companies to be surveyed and to coordinate the logistics of the actual survey. Surveys were sent directly from Milliman. The first phase cast a wide net and was sent to thousands of companies. The second survey was targeted at companies that indicated that they used captive insurance. A copy of each survey is included as Appendix F.

B. First Survey Process and Results

The first survey was sent to more than 5,000 companies identified by the DOR based on revenue reported to the State. This list included both Washington and non-Washington headquartered companies. We initially sent the first survey to those companies with Washington-based mailing addresses (according to DOR records), as well as to companies that were known to have captive insurers as a result of the OIC's previous investigatory actions. The first survey simply sought to identify companies that used captive insurance at any time in the last ten years. See Appendix F.

The survey was sent via SurveyMonkey on August 20, 2020 with an initial deadline of August 28, 2020. Several email follow-up reminders were sent over the next three weeks. In addition, certified letters were sent jointly by the OIC and DOR to those companies that had not responded during the second and third weeks of September. Milliman fielded a significant number of phone calls related to scope and legitimacy of the survey, and accepted responses via telephone as well as via the SurveyMonkey link and via email. We received over 300 “yes” responses to Survey 1.

We sent a separate version of the first survey to companies identified by the LCB as operating in the cannabis space or subject to oversight by the LCB. We received 17 responses from those companies, indicating that they utilize captive insurance; however, none of those 17 companies responded to our second follow-up survey.

C. Second Survey Process and Results

A second survey was sent to those companies that a) are headquartered in Washington, and b) indicated they had used captive insurance within the last 10 years. This survey was sent with an initial two week deadline. Two reminders were generally sent to each company, with a revised deadline of one week from the date of the reminder. In addition, Milliman called approximately 40 of the companies with missed final deadlines to check on the status of the response.

A significant number of companies responded to Survey 2 indicating that they incorrectly responded to Survey 1 and that they did not, in fact, use captive insurance or that they were not Washington-headquartered. After removing these companies, the survey resulted in 171 Washington-headquartered companies that used captive insurance within the prior 10 years. Of the 171 companies, 47 completed Survey 2. *[Figures based on responses received through December 28, 2020.]* This survey requested captive insurance company background information, expenses information, and premium information. For policy years 2017-2019, the premium information included the following details:

- Risks allocable to Washington vs. non-Washington
- Direct, assumed, and ceded premium
- Premium by coverage

For policy years 2010-2016, the premium split was only provided between direct, assumed, and ceded premium.

D. Adjustments to Data from Second Survey

Several adjustments were made to the data received in the survey in order to make meaningful conclusions and comparisons:

- One captive insurance company owner is a large holding company with few risk exposures in Washington. We excluded non-Washington premium for this captive insurer.
- One captive insurance company owner had a very small Washington premium allocation. We excluded the non-Washington premium based on our expectation that the Washington-headquartered entity is a small part of the overall company operations.
- One captive insurance company owner assumed a significant premium from various fronting companies related to non-US employee benefits. We excluded this assumed premium.
- For 2010-2016, we estimated the overall split between Washington and non-Washington premium based on the data for 2017-2019.

E. Results of Second Survey

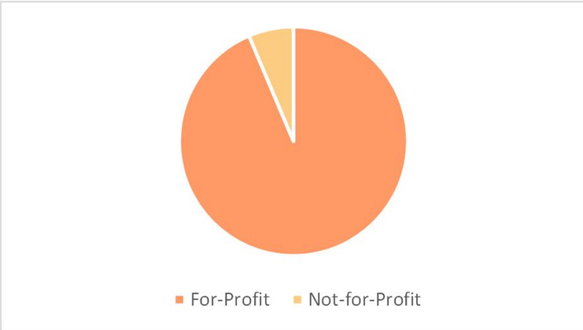
The graphs and charts below summarize key information gathered in the survey.

CHART 6: SURVEY RESPONSE STATISTICS

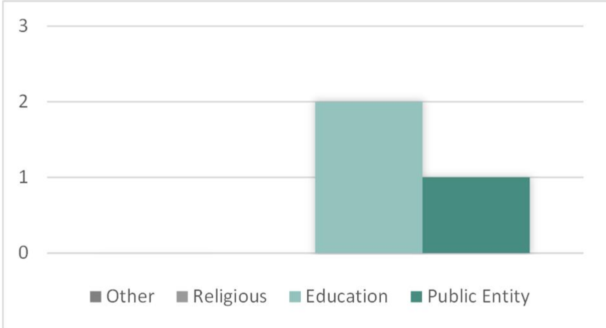
SURVEY 1	SURVEY 2
• 3,894 out of 5,015 companies have responded • 171 of 5,015 companies responded that they use a captive	• 47 out of 171 companies with captives have responded • 31 captives file federal tax returns • 11 of the 31 non-group captives make the 831(b) election

CHART 7: INDUSTRIES OF CAPTIVE INSURERS

NOT-FOR-PROFIT VS. FOR-PROFIT



NOT-FOR-PROFIT



FOR-PROFIT

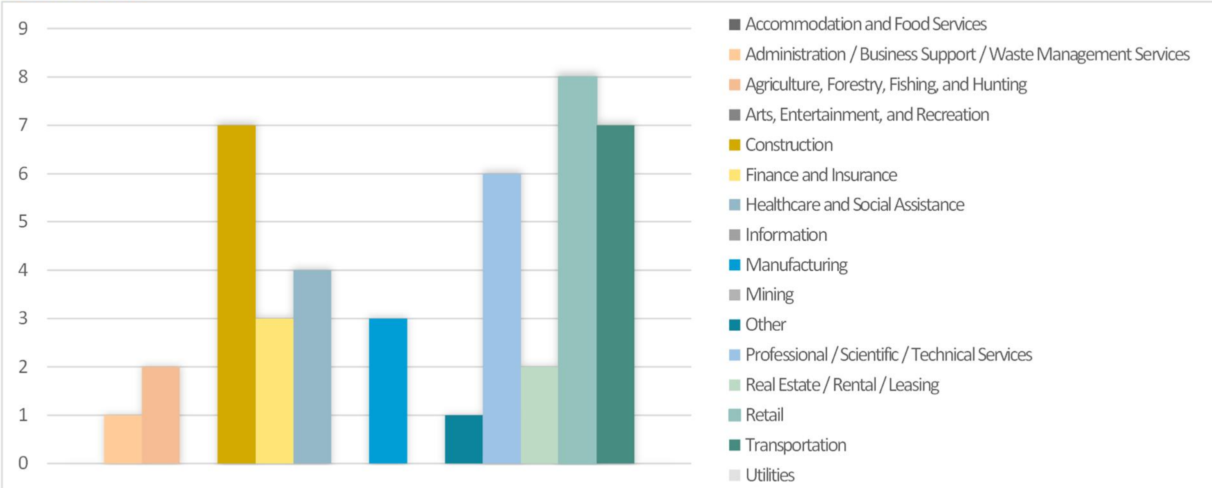


CHART 8: TYPES OF CAPTIVE INSURERS

NUMBER OF CAPTIVES BY TYPE

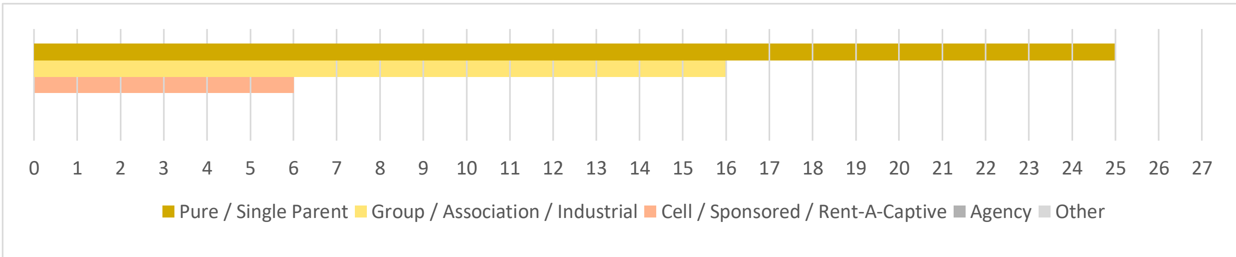
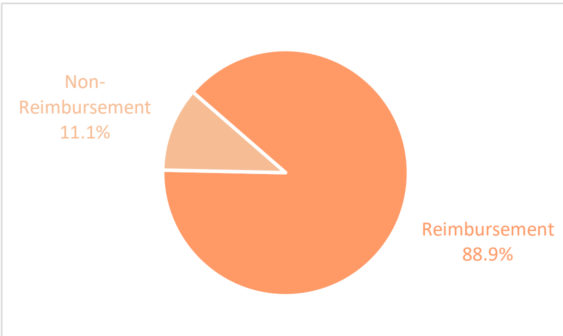
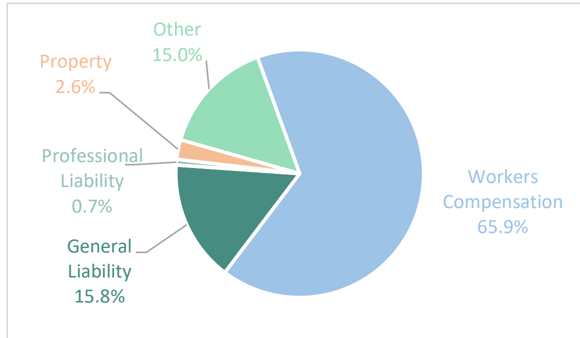


CHART 9: TYPES OF POLICIES

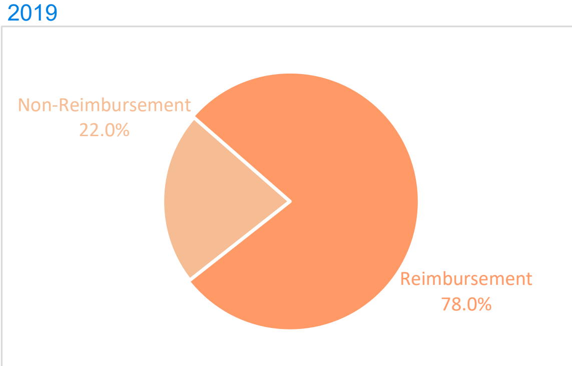
DIRECT PREMIUM BY POLICY FORMAT
2018



REIMBURSEMENT POLICIES BY UNDERLYING RISK
2018



DIRECT PREMIUM BY POLICY FORMAT
2019



REIMBURSEMENT POLICIES BY UNDERLYING RISK
2019

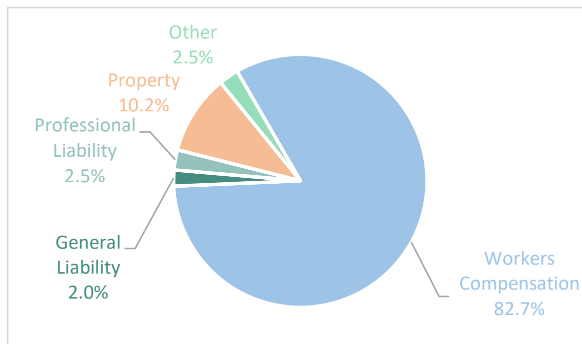


CHART 10: DIRECT WRITTEN PREMIUM VOLUME

[The figures show in Chart 9 and Chart 10 exclude non-Washington premium for a large captive insurer of a holding company with few risk exposures in Washington.]

In Chart 10, “All Risks” represents the total direct premium provided by the survey respondents. For 2017-2019, the survey also requested direct written premium allocable to Washington risks (generally corresponding to the location of the underlying exposures), which is shown as “WA Only (Narrow).” For 2010-2016, the survey did not request the breakdown between premiums allocable to Washington and Non-Washington risks. As such, we estimated this premium based on the percentage of premiums allocable to Washington risks for 2017-2019. This estimation is represented by the dotted line on Chart 10 above.

Also, Chart 10 shows a significant decrease in premiums from 2018 to 2019. Approximately 99% of the premium decrease from 2018 to 2019 was attributable to four captive insurance company owners.

TABLE 29: CAPTIVE INSURANCE COMPANY DOMICILES

DOMICILE	COUNT
Cayman Islands	11
Vermont	6
Barbados	3
Bermuda	4
Arizona	3
North Carolina	2
Hawaii	3
Turks & Caicos	2
Tennessee	2
Puerto Rico	2
Utah	1
Anguilla	1
Bahamas	1
Not Provided	6
TOTAL	**47**

F. Projections of Total Captive Insurance Market in Washington

We know that the survey results above did not capture the entire Washington insurance market. Based on the survey results and on publicly available data, we estimated the current (2019) size of the captive insurance market in terms of number of Washington headquartered captive insurance company owners and direct written premiums. For comparison purposes, we also estimated the 2018 year as well.

We estimated the size of the captive insurance market for Washington headquartered companies based on the following:

- Washington represents 2.8% of the 2019 US gross domestic product and 2.3% of the 2019 US population
- Based on the above, we estimate that 2.5% of the captive insurers covering US-based companies would be related to those headquartered in Washington.
- According to the Insurance Information Institute ("III"), there were 6,135 captive insurance companies worldwide in 2019 of which 3113 were domiciled in the US. Most of the US domiciled captive insurers would be owned by US companies, and a significant number of offshore captive insurers would be as well. But not all of these captive insurers are actively writing business. According to a Marsh captive report, approximately 60% of captive parent companies are based in North America[87]. We've assumed that 50% of the 6,135 captive insurers (or approximately 3,100) are owned by US companies and are actively writing business.
- This implies that 78 (= 3,100 x 2.5%) active captive insurers are owned by Washington headquartered companies. This is our "central" / best estimate of all active captive insurers in Washington.
- Further, we estimated the number of captive insurance companies that provide insurance directly to their owners (that is, have non-zero direct written premium). Based on the survey results provided, approximately 66% of captive insurers provide coverage directly to their owners. Thus, we estimate there to be 51 active captive insurers (= 78 x 66%) writing directly in Washington.

The III figures likely underestimate the number of captive insurance company owners since a) group captive insurers have multiple owners, and b) cell captive insurers are made up of cells from multiple owners. As a second estimate of the number of captive insurance company owners, we assumed that there were 10,000 captive insurance company owners, again with 50% located in the US. When multiplied by the 2.5% factor to convert to Washington only, we get 125 captive insurance company owners. This is our high estimate of the number of active captive insurance companies owned by Washington headquartered companies. Applying the same 66% direct-writing factor results in 82 captive insurance companies issuing direct policies to their owners.

The initial responses to Survey 1 indicated that 341 Washington headquartered companies use captive insurance. Of those 341 companies:

- 170 informed us that they incorrectly responded to Survey 1 and, in fact, did not use captive insurance.

[87] Marsh 2019 Captive Landscape Report

- 47 companies confirmed their use of captive insurance by virtue of responding to Survey 2.
- The remaining 124 companies did not respond to Survey 2.

Approximately 22% of the 217 companies that acknowledged Survey 2 confirmed their use of captive insurance (i.e., the 47 full Survey 2 respondents and the 170 that incorrectly responded make up the 217 companies). Assuming the same percentage applies to the 124 companies that did not respond, we would expect that 27 of those companies do in fact use captive insurance. Based on this calculation, we would add the 27 "missing" captive insurance companies to the 47 surveyed captive insurers to arrive at a total of 74.

However, in trying to get at the number of active captive insurance companies, we note that many of the 47 captive insurers that responded to Survey 2 did not participate in their captive insurer for all 10 years. The highest number of Survey 2 respondents with premiums written in their captive insurers in any one year was 35. In 2019, there were 35 captive insurance companies with non-zero premiums, or 74% of the 47. Adding in 74% of the 27 "missing" captive insurers to the 35 2019 known captive insurers gives us 55 captive insurers in 2019. This is our low estimate of all captive insurance companies operating in 2019. The low estimate of captive insurers writing directly in 2019 is 36 (= 55 x 66%).

Total premium managed by the ten largest captive insurance company managers was approximately $115 billion in 2018. If we assume that 50% of that total premium is related to captive insurers owned by US companies, resulting US captive insurance premium would be approximately $57.5 billion. Using the 2.5% value from the GDP/population data to represent the share of the captive insurance premium related to Washington headquartered companies results in a total estimate of approximately $1.4 billion. Based on survey results, the ratio of direct to gross written premium (excluding premium related to captive insurance pooling arrangements) was approximately 92%. The resulting direct written premium estimate for Washington headquartered companies is then 0.92 x $1.4 billion, or approximately $1.3 billion.

From the survey, 2018 direct written premium was approximately $883 million (includes the large captive insurer of holding company noted above), indicating that the survey captured approximately 68% of the market. We are aware of at least two large captive insurance company owners that did not respond to Survey 2.

In summary, taking the $547 million of 2018 direct written premiums and assuming that we captured between 58% and 68% of the market, this produces a range of $804 million to $943 million. We selected $900 million to reflect the absence of the two large captive insurance companies that didn't respond. Similarly, for 2019, the indicated range (based on $157 million in survey direct written premium) was $230 million to $270 million. We selected $300 million to reflect the absence of the two large captive insurance companies that didn't respond. We note that the calculations of the overall market size is subject to a significant amount of uncertainty. The table below summarizes our results.

TABLE 30: ESTIMATED SIZE OF DIRECT WASHINGTON CAPTIVE INSURANCE MARKET

	Number of Direct Writing Captives				Medium Direct Written Premium	
		Estimated				
Year	Survey	Low	Medium	High	Survey	Estimated
2010	11	16	22	35	255,212,586	418,000,000
2011	12	18	25	40	302,313,454	496,000,000
2012	13	19	26	42	329,194,397	540,000,000
2013	14	20	28	45	405,222,540	664,000,000
2014	15	22	31	49	472,248,632	774,000,000
2015	16	24	34	54	461,826,570	757,000,000
2016	20	27	38	61	485,661,272	796,000,000
2017	22	30	43	68	499,744,075	819,000,000
2018	24	34	48	78	547,390,798	900,000,000
2019	23	36	51	82	156,889,107	300,000,000

See Appendix D for more detail.

In addition, we estimated the percentage of direct written premium related to reimbursement of Washington State workers compensation claim payments. In 2019, approximately 14% of survey premium was related to such coverage. We've assumed that 20% of direct written premium is related to this coverage. Our selection of 20% is higher than the survey amount to reflect our assumption that some of the captive insurers that did not respond to the second survey would cover this risk.

Appendix B12
Estimates of Premium and Tax Revenue

A. Interpretations for Sensitivity Testing

The various items open for interpretation are discussed below.

1. Carve Out for Not-For-Profit Entities

The state may choose to carve out not-for-profit entities from its taxation framework. Based on the survey data received, more than 99% of direct written premium is related to for profit entities. Thus, carving out not-for-profit entities will have a de minimis impact on the overall revenue collected by the state and we have not estimated the impact of such a carve out.

2. Taxable Base

We tested three bases on which the premium tax would apply. These three bases, NRRA, WA Only (Broad), and WA Only (Narrow), are discussed in paragraph B.2 below.

3. Carve Out for Reimbursement of Washington Workers Compensation

The State could opt to carve out individual coverages or risks from captive insurance taxation. Given that Washington is a monopolistic state for workers compensation, the State could choose to carve out the reimbursement policies issued by captive insurance companies to their parent companies from taxation. The OIC asked us to quantify the impact on future tax revenues of carving out / exempting underlying Washington workers compensation risk from taxation.

B. Range of Results

The tables below estimate the potential premium tax revenue that could be raised under the various interpretations outlined above. The variables considered were provided by the Agencies and are as follows:

1. Tax Rates

- 2.0% – based on current tax rate charged by OIC on most insurance premiums

- 1.75% – based on current B&O rate charged by DOR for insurance premiums not otherwise taxed

2. Taxable Bases

- NRRA – apply NRRA “home state” rule, which allows taxation of premiums for risks located anywhere in the US if Washington is the “home state” of the insured; generally speaking, an insured’s home state is the state in which its headquarters is located
- WA Only (Broad) – expand definition of Washington risks to include all premiums in “reimbursement policies” as defined by the OIC
- WA Only (Narrow) – only tax premiums allocable to risks located in Washington

3. Treatment of Washington Workers Compensation Risks

- Applies premium tax to all coverages (including Washington-located workers compensation risks)
- Carves out Washington-located workers compensation risks from subject premium

We assume that the subject premium will decrease as the tax rate increases or the taxable base expands. The underlying premise is that the higher the tax rates and broader definitions of the taxable base, captive insurance company owners will be less willing to pay the resulting tax and will either restructure their policies or otherwise change the use of their captive insurers to mitigate against this. Conversely, lower tax rates and narrower definitions of the taxable base will likely result in more captive insurance company owners being willing to pay the resulting tax. Tax rates and tax bases were provided by the Agencies. With respect to the tax base, three definitions were provided by the Agencies: NRRA, WA Only (Broad), and WA Only (Narrow).

To estimate the tax base, we started with 2019 premiums from the survey and estimated the missing premiums from captive insurance company owners that did not respond. Then we estimated “Year 1” (first full year after any legislation is passed/effective) captive insurance premiums by estimating how much of the 2019 premium base would remain in the market if either a 2.0% premium tax or a 1.75% premium tax was enforced. In the table below, we specify the projected Year 1 tax base as a percentage of estimated 2019 captive insurance premiums in Washington. See Appendix D for more detail.

TABLE 31: PROJECTION OF POTENTIAL YEAR 1 SUBJECT PREMIUM
ASSUMES PREMIUM TAX APPLIES TO ALL COVERAGES

	Taxable Base				
Item	NRRA	WA Only (Broad)	WA Only (Narrow) Low Estimate	WA Only (Narrow) Medium Estimate	WA Only (Narrow) High Estimate
Estimated 2018 Premium*	900,000,000	765,000,000		200,000,000	
Estimated 2019 Premium*	300,000,000	255,000,000		100,000,000	
Estimated Year 1 Premium	75,000,000	63,750,000	100,000,000	110,000,000	130,000,000
Derivation of Estimated Year 1 Premium**	25% of 2019	25% of 2019	see below	see below	see below

* Based on survey results and publicly available data

** Judgementally selected based on our research, including but not limited to:

Large captive insurance company owners ($25 million or more) will have most impact

Large captive insurance company owners cost to operate captives is generally 1% of premium or less

Large captive insurance company owners federal tax benefit generally averages 2.5% of reimbursement policy premiums

Large captive insurance company owners may exit the market or restructure policies to legally avoid the new tax

Several large captive insurance company owners supported the WA Only (Narrow) base and tax rate, resulting in estimates equal to or higher than 2019

TABLE 32: PROJECTION OF POTENTIAL YEAR 1 SUBJECT PREMIUM
ASSUMES PREMIUM TAX DOES NOT APPLY TO WA WC

	Taxable Base		
Item	NRRA	WA Only (Broad)	WA Only (Narrow)
Estimated 2019 Premium - Total*	300,000,000	255,000,000	100,000,000
Estimated 2019 Premium - WA WC Only*	60,000,000	60,000,000	60,000,000
Estimated 2019 Premium - excl. WA WC*	240,000,000	195,000,000	40,000,000
Estimated Year 1 Premium	60,000,000	48,750,000	50,000,000
Derivation of Estimated Year 1 Premium**	25% of 2019	25% of 2019	see below

* Based on survey results and publicly available data

** Judgementally selected based on our research, including but not limited to:

Large captive insurance company owners ($25 million or more) will have most impact

Large captive insurance company owners cost to operate captives is generally 1% of premium or less

Large captive insurance company owners federal tax benefit generally averages 2.5% of reimbursement policy premiums

Large captive insurance company owners may exit the market or restructure policies to legally avoid the new tax

Several large captive insurance company owners supported the WA Only (Narrow) base and tax rate, resulting in estimates equal to or higher than 2019

The following tables apply the selected tax rates to the projected subject premium for each scenario.

TABLE 33: POTENTIAL YEAR 1 TAX REVENUE
ASSUMES PREMIUM TAX APPLIES TO ALL COVERAGES

Taxable Base				
NRRA	WA Only (Broad)	WA Only (Narrow)	WA Only (Narrow)	WA Only (Narrow)
75,000,000	63,750,000			
1,500,000	1,275,000			
NA	NA			

TABLE 34: POTENTIAL YEAR 1 TAX REVENUE
ASSUMES PREMIUM TAX DOES NOT APPLY TO WA WC

	Taxable Base		
Tax Rate	**NRRA**	**WA Only (Broad)**	**WA Only (Narrow)**
Estimated Year 1 Premium	60,000,000	48,750,000	50,000,000
Premium Tax at 2.00% Rate	1,200,000	975,000	1,000,000
Premium Tax at 1.75% Rate	NA	NA	875,000

The 1.75% tax rate (which is the rate prescribed the DOR) is applied to Washington-located risk only. We assume that if a 1.75% tax rate were applied, it would be under the DOR as taxing authority. Based on discussions with the DOR, the tax base would be underlying Washington nexus risks, which aligns with the industry definition. DOR also taxes non-Washington headquartered companies with business activities in the State, but federal law/NRRA would likely prohibit DOR taxing captive insurance premiums paid to non-Washington headquartered companies.

C. Estimated Unpaid Taxes

At the request of the Agencies, we calculated the potential unpaid taxes based on taxable bases and tax rates provided by the Agencies. Under the OIC option, we were also asked to include potential penalties and interest. The 2.0% and 1.5% tax rates were provided by the OIC and the DOR, respectively. The 20.0% penalty and 12.0% interest rate assumptions were both provided by the OIC. The results of our calculation are shown below.

TABLE 35: ESTIMATED UNPAID TAXES, PENALTIES, AND INTEREST

Collecting Authority	Tax Base	Tax Rate	Time Frame	Unpaid Tax	Penalties @ 20.0%	Interest @ 12.0%	Total
OIC	WA Only (Broad)	2.0%	10 Years	109,888,000	21,977,600	68,915,280	200,780,880
OIC	WA Only (Broad)	2.0%	4 Years	47,855,000	9,571,000	15,791,640	73,217,640
OIC	WA Only (Narrow)	2.0%	10 Years	29,400,000	5,880,000	18,100,800	53,380,800
OIC	WA Only (Narrow)	2.0%	5 Years	16,540,000	3,308,000	6,225,600	26,073,600
DOR	WA Only (Narrow)	1.5%	4 Years	9,885,000	NA	NA	9,885,000

DOR tax rate of 1.5% provided by DOR based on B&O rate in place prior to 2020

See Appendix D for additional detail.

Appendix C
Insurance Premium Tax Statistics by State

Insurance Premium Tax Statistics by State **Appendix C**
Sheet 1

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
State	Captive Domicile	Authorized Premium Tax Rate	Excess/ Surplus Lines Premium Tax Rate	Independent Procurement Premium Tax Rate	Minimum Marginal Captive Premium Tax Rates	Maximum Marginal Captive Premium Tax Rates	Minimum Captive Premium Tax	Maximum Captive Premium Tax
Alabama	Yes	3.600%	6.000%	4.000%	0.075%	0.400%	5,000	N/A
Alaska	No	2.700%	2.700%	3.700%	N/A	N/A	N/A	N/A
Arizona	Yes	1.750%	3.000%	3.000%	N/A	N/A	5,500	5,500
Arkansas	Yes	2.500%	4.000%	2.000%	5.500%	0.250%	5,000	100,000
California	No	2.350%	3.000%	3.000%	N/A	N/A	N/A	N/A
Colorado	Yes	2.000%	3.000%	3.000%	0.100%	0.500%	5,000	N/A
Connecticut	Yes	1.500%	4.000%	4.000%	0.072%	0.380%	7,500	200,000
Delaware	Yes	2.000%	3.000%	3.000%	0.002%	0.002%	5,000	200,000
District of Columbia	Yes	1.700%	2.000%	N/A	0.050%	0.250%	7,500	1,000,000
Florida	Yes	1.750%	5.000%	5.000%	1.750%	1.750%	N/A	N/A
Georgia	Yes	2.250%	4.000%	4.000%	0.300%	0.400%	N/A	100,000
Guam	Yes	4.000%	4.000%	N/A	N/A	N/A	N/A	N/A
Hawaii	Yes	4.265%	4.680%	4.680%	0.000%	0.250%	N/A	200,000
Idaho	No	1.500%	1.500%	1.500%	N/A	N/A	N/A	N/A
Illinois	Yes	0.500%	3.500%	0.500%	0.500%	0.500%	N/A	N/A
Indiana	No	1.300%	2.500%	N/A	N/A	N/A	N/A	N/A
Iowa	Yes	1.000%	1.000%	1.000%	N/A	N/A	N/A	N/A
Kansas	Yes	2.000%	6.000%	6.000%	0.200%	0.200%	N/A	500,000
Kentucky	Yes	2.000%	3.000%	2.000%	0.075%	0.400%	N/A	N/A
Louisiana	Yes	N/A	4.850%	4.850%	3.083%	3.083%	N/A	N/A
Maine	Yes	2.000%	3.000%	3.000%	N/A	N/A	N/A	N/A
Maryland	No	2.000%	3.000%	3.000%	N/A	N/A	N/A	N/A
Massachusetts	No	2.280%	4.000%	N/A	N/A	N/A	N/A	N/A
Michigan	Yes	N/A	2.500%	2.500%	0.100%	0.200%	5,000	100,000
Minnesota	No	2.000%	3.000%	2.000%	N/A	N/A	N/A	N/A
Mississippi	No	3.000%	4.000%	7.000%	N/A	N/A	N/A	N/A

Insurance Premium Tax Statistics by State

Appendix C
Sheet 2

(1) State	(2) Captive Domicile	(3) Authorized Premium Tax Rate	(4) Excess/ Surplus Lines Premium Tax Rate	(5) Independent Procurement Premium Tax Rate	(6) Minimum Marginal Captive Premium Tax Rates	(7) Maximum Marginal Captive Premium Tax Rates	(8) Minimum Captive Premium Tax	(9) Maximum Captive Premium Tax
Nebraska	Yes	1.000%	3.000%	3.000%	0.250%	0.250%	N/A	N/A
Nevada	Yes	3.500%	3.500%	3.500%	0.075%	0.400%	5,000	175,000
New Hampshire	No	1.250%	3.000%	4.000%	N/A	N/A	N/A	N/A
New Jersey	Yes	2.100%	5.000%	5.000%	0.072%	0.380%	7,500	200,000
New Mexico	No	3.003%	3.003%	3.003%	N/A	N/A	N/A	N/A
New York	Yes	2.000%	3.600%	3.600%	0.075%	0.400%	5,000	N/A
North Carolina	Yes	1.900%	5.000%	5.000%	0.300%	0.400%	5,000	100,000
North Dakota	No	1.750%	1.750%	1.750%	N/A	N/A	N/A	N/A
Ohio	Yes	1.400%	5.000%	5.000%	0.035%	0.035%	7,500	250,000
Oklahoma	Yes	2.250%	6.000%	6.000%	0.200%	0.200%	5,000	100,000
Oregon	Yes	N/A	2.300%	2.300%	N/A	N/A	5,000	5,000
Pennsylvania	No	2.000%	3.000%	3.000%	N/A	N/A	N/A	N/A
Puerto Rico	Yes	N/A	9.000%	15.000%	N/A	N/A	5,000	75,000
Rhode Island	Yes	2.000%	4.000%	4.000%	0.038%	0.200%	2,500	N/A
South Carolina	Yes	1.250%	6.000%	N/A	0.300%	0.400%	5,000	100,000
South Dakota	Yes	2.500%	2.500%	2.500%	0.800%	0.800%	5,000	50,000
Tennessee	Yes	2.500%	5.000%	5.000%	0.300%	0.400%	5,000	100,000
Texas	Yes	1.600%	4.850%	4.850%	0.500%	0.500%	7,500	200,000
Utah	Yes	2.250%	4.250%	4.250%	N/A	N/A	5,000	5,000
Vermont	Yes	2.000%	3.000%	3.000%	0.072%	0.380%	7,500	200,000
Virgin Islands	Yes	5.000%	5.000%	5.000%	N/A	N/A	N/A	N/A
Virginia	Yes	2.250%	2.250%	N/A	2.250%	2.250%	N/A	N/A
Washington	No	2.000%	2.000%	N/A	N/A	N/A	N/A	N/A
West Virginia	Yes	3.000%	4.550%	N/A	0.500%	0.500%	N/A	N/A
Wisconsin	No	2.000%	3.000%	3.000%	N/A	N/A	N/A	N/A
Wyoming	No	0.750%	3.000%	3.000%	N/A	N/A	N/A	N/A

Appendix D
Forecasts of Captive Insurance Company Numbers, Premiums, and Tax Revenues

Premium and Tax Revenue Forecasts
Assumes Tax Applies to All Coverages

Appendix D
Exhibit 1
Sheet 1

Taxing Entity:	OIC					DOR				
Tax Rate:	2.00%					1.75%				
Taxable Base:	NRRA	WA Only (Broad)	WA Only (Narrow) Low Estimate	WA Only (Narrow) Medium Estimate	WA Only (Narrow) High Estimate	NRRA	WA Only (Broad)	WA Only (Narrow) Low Estimate	WA Only (Narrow) Medium Estimate	WA Only (Narrow) High Estimate
SURVEY RESULTS - DIRECT WRITTEN PREMIUM										
2018	547,390,798	465,000,000	NA	103,121,275	NA	NA	NA	NA	103,121,275	NA
2019	156,889,107	133,000,000	NA	61,999,009	NA	NA	NA	NA	61,999,009	NA
ESTIMATED DIRECT WRITTEN PREMIUM										
2018*	900,000,000	765,000,000	NA	200,000,000	NA	NA	NA	NA	200,000,000	NA
2019*	300,000,000	255,000,000	NA	100,000,000	NA	NA	NA	NA	100,000,000	NA
Projected Year 1**	75,000,000	63,750,000	100,000,000	110,000,000	130,000,000	NA	NA	100,000,000	110,000,000	130,000,000
ESTIMATED TAX REVENUE										
2018	18,000,000	15,300,000	NA	4,000,000	NA	NA	NA	NA	3,500,000	NA
2019	6,000,000	5,100,000	NA	2,000,000	NA	NA	NA	NA	1,750,000	NA
Projected Year 1	1,500,000	1,275,000	2,000,000	2,200,000	2,600,000	NA	NA	1,750,000	1,925,000	2,275,000
Premium Projection Assumptions	25% of 2019	25% of 2019	see below	see below	see below	NA	NA	see below	see below	see below

NRRA – apply NRRA “home state” rule, which allows taxation of premiums for risks located anywhere
in the US if Washington is the “home state” of the insured
WA Only (Broad) – defines Washington risks to include all premiums in “reimbursement policies"
WA Only (Narrow) – only tax premiums allocable to risks located in Washington
2.00% tax rate assumption provided by OIC; 1.75% tax rate assumption provided by DOR
** Based on survey results and publicly available data*
*** Judgementally selected based on our research, including but not limited to:*
- *Large captive insurance company owners ($25 million or more) will have most impact*
- *Large captive insurance company owners cost to operate captives is generally 1% of premium or less*
- *Large captive insurance company owners federal tax benefit generally averages 2.5% of reimbursement policy premiums*
- *Large captive insurance company owners may exit the market or restructure policies to legally avoid the new tax*
- *Several large captive insurance company owners supported the WA Only (Narrow) base and tax rate, resulting in estimates equal to or higher than 2019*

The table above is based on Appendices B11 and D, Milliman Captive Insurance Study, prepared for Washington State Department of Revenue and Office of Insurance Commissioner, January 2021

Premium and Tax Revenue Forecasts
Assumes Tax Does Not Apply to WA WC Risks

Appendix D
Exhibit 1
Sheet 2

Taxing Entity:	OIC			DOR		
Tax Rate:	2.00%			1.75%		
Taxable Base:	NRRA	WA Only (Broad)	WA Only (Narrow)	NRRA		WA Only (Narrow)
SURVEY RESULTS - DIRECT WRITTEN PREMIUM						
2018	513,653,408	437,000,000	69,383,884	NA		69,383,884
2019	134,398,560	114,000,000	39,508,462	NA		39,508,462
ESTIMATED DIRECT WRITTEN PREMIUM						
2018*	800,000,000	665,000,000	100,000,000	NA		100,000,000
2019*	240,000,000	195,000,000	40,000,000	NA		40,000,000
Projected Year 1**	60,000,000	48,750,000	50,000,000	NA		50,000,000
ESTIMATED TAX REVENUE						
2018	16,000,000	13,300,000	2,000,000	NA		1,750,000
2019	4,800,000	3,900,000	800,000	NA		700,000
Projected Year 1	1,200,000	975,000	1,000,000	NA		875,000
Premium Projection Assumptions	25% of 2019	25% of 2019	see below	NA		see below

NRRA – apply NRRA "home state" rule, which allows taxation of premiums for risks located anywhere in the US if Washington is the "home state" of the insured
WA Only (Broad) – defines Washington risks to include all premiums in "reimbursement policies"
WA Only (Narrow) – only tax premiums allocable to risks located in Washington
Estimated Direct Written Premium values = Estimated Direct Written Premium values from Appendix D, Exhibit 1, Sheet 1, less $100M in 2018 and $60M in 2019. $100M and $60M represent our estimate of WA WC premiums, based on our survey results.
2.00% tax rate assumption provided by OIC; 1.75% tax rate assumption provided by DOR
** Based on survey results and publicly available data*
*** Judgementally selected based on our research, including but not limited to:*
- *Large captive insurance company owners ($25 million or more) will have most impact*
- *Large captive insurance company owners cost to operate captives is generally 1% of premium or less*
- *Large captive insurance company owners federal tax benefit generally averages 2.5% of reimbursement policy premiums*
- *Large captive insurance company owners may exit the market or restructure policies to legally avoid the new tax*
- *Several large captive insurance company owners supported the WA Only (Narrow) base and tax rate, resulting in estimates equal to or higher than 2019*

The table above is based on Appendices B11 and D, Milliman Captive Insurance Study, prepared for Washington State Department of Revenue and Office of Insurance Commissioner, January 2021

Captives #s and Direct Written Premium (DWP) Volume for Washington-Headquartered Entities

Appendix D
Exhibit 2
Sheet 1

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
					Estimated number of captives insuring risk directly in WA state			Estimated DWP written by captives insuring risk in WA state		
Year	# of active captives (non-$0 GWP)	# of captives identified in study with $0 DWP but non-$0 GWP	# of captives identified in study with non-$0 DWP	Direct written premiums based on data provided by identified captives	Low	Medium	High	Low	Medium	High
2010	15	4	11	255,212,586	16	22	35	369,000,000	418,000,000	517,000,000
2011	17	5	12	302,313,454	18	25	40	438,000,000	496,000,000	614,000,000
2012	18	5	13	329,194,397	19	26	42	477,000,000	540,000,000	668,000,000
2013	19	5	14	405,222,540	20	28	45	586,000,000	664,000,000	822,000,000
2014	21	6	15	472,248,632	22	31	49	683,000,000	774,000,000	958,000,000
2015	23	7	16	461,826,570	24	34	54	668,000,000	757,000,000	937,000,000
2016	26	6	20	485,661,272	27	38	61	703,000,000	796,000,000	985,000,000
2017	29	7	22	499,744,075	30	43	68	723,000,000	819,000,000	1,013,000,000
2018	33	9	24	547,390,798	34	48	78	795,000,000	900,000,000	1,114,000,000
2019	35	12	23	156,889,107	36	51	82	264,896,706	300,000,000	371,217,080

(2) # of captives with no direct transactions between the captive owner and captive insurance company (i.e., no direct procurement)
(3),(5),(6),(7) # of captives with direct transactions between the captive owner and captive insurance company
(8), (10) for 2019 selected based on distribution of # of captives by type and average premium size; prior years selected based on implied 2019 range

The table above is based on Appendices B11 and D, Milliman Captive Insurance Study, prepared for Washington State Department of Revenue and Office of Insurance Commissioner, January 2021

Taxable Base - Range of Estimates
Assumes Tax Applies to All Coverages

Appendix D
Exhibit 2
Sheet 2

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
	Survey Results		Estimated								
			NRRA			WA Only (Broad)			WA Only (Narrow)		
Year	Direct Written Premium	WA Only (Narrow) Direct Written Premium	Low	Medium	High	Low	Medium	High	Low	Medium	High
2018	547,390,798	103,121,275	795,000,000	900,000,000	1,114,000,000	676,000,000	765,000,000	100,000,000	177,000,000	200,000,000	248,000,000
2019	156,889,107	61,999,009	264,896,706	300,000,000	371,217,080	225,000,000	255,000,000	316,000,000	88,000,000	100,000,000	124,000,000

(3), (5) from Exhibit 2, Sheet 1
(4), (10) based on direct written premium amounts from survey results and publicly available data
(6) - (8) based on NRRA figures in (3) - (5) and selected percentage of reimbursement policies from survey data
(9) = [(10) / (4)] x (3)
(11) = [(10) / (4)] x (5)

The table above is based on Appendices B11 and D, Milliman Captive Insurance Study, prepared for Washington State Department of Revenue and Office of Insurance Commissioner, January 2021

Estimated # of Captives Operating in Washington in 2019
Reflects all captives

	Low Estimate	*Medium Estimate*	*High Estimate*
Washington Headquartered Companies			
Direct Writers	36	51	82
Non-Direct Writers	19	27	43
Subtotal	55	78	125
Non-Washington Headquartered Companies			
Direct Writers	77	103	128
Non-Direct Writers	40	53	67
Subtotal	117	156	195
All Companies			
Direct Writers	113	154	211
Non-Direct Writers	59	80	110
Subtotal	172	234	320

Estimates for non-Washington headquartered companies are based on summary of data on the top 100 B&O taxpayers in the state split between Washington and non-Washington headquartered companies

The table above is based on Appendices B11 and D, Milliman Captive Insurance Study, prepared for Washington State Department of Revenue and Office of Insurance Commissioner, January 2021

2019 Captives #s and Direct Written Premium (DWP) Volume for Washington-Headquartered Entities (By Type)
Medium Estimate

Appendix D
Exhibit 3
Sheet 1

Captive Type	Estimated					Survey Results		
	Captives Insuring Direct WA Risk	Total DWP	Average DWP	% of Number of Captives	% of Total DWP	Captives Insuring Direct WA Risk	Total DWP	Average DWP
Single Parent	NUMBER OF LARGE SINGLE-PARENT CAPTIVES SELECTED REMAINDER ALLOCATED BASED ON SURVEY RESULTS							
Cells								
1. Non-831(b)/Micro	3	160,385	53,462	5.8%	0.1%	1	53,462	53,462
2. 831(b)/Micro	10	8,279,875	827,988	19.5%	2.8%	4	3,311,950	827,988
Non-Cells								
1. Large (Over $5M DWP)	11	269,340,578	24,485,507	21.4%	89.8%	7	144,432,841	20,633,263
2. Small / Non-831(b)/Micro (Under $5M DWP)	16	14,707,835	919,240	31.2%	4.9%	7	6,434,678	919,240
3. 831(b)/Micro	3	3,853,692	1,284,564	5.8%	1.3%	1	1,284,564	1,284,564
Group	8	3,657,635	457,204	15.6%	1.2%	3	1,371,613	457,204
Total	51	300,000,000	5,844,156	100.0%	100.0%	23	156,889,107	6,821,266

The table above is based on Appendices B11 and D, Milliman Captive Insurance Study, prepared for Washington State Department of Revenue and Office of Insurance Commissioner, January 2021

2019 Captives #s and Direct Written Premium (DWP) Volume for Washington-Headquartered Entities (By Type)
Low Estimate

Captive Type	Estimated Captives Insuring Direct WA Risk	Total DWP	Average DWP	% of Number of Captives	% of Total DWP
Single Parent	**NUMBER OF LARGE SINGLE-PARENT CAPTIVES SELECTED REMAINDER ALLOCATED BASED ON MEDIUM ESTIMATES**				
Cells					
1. Non-831(b)/Micro	2	106,923	53,462	5.5%	0.0%
2. 831(b)/Micro	6	4,967,925	827,988	16.6%	1.9%
Non-Cells					
1. Large (Over $5M DWP)	10	244,855,071	24,485,507	27.6%	92.4%
2. Small / Non-831(b)/Micro (Under $5M DWP)	11	10,111,637	919,240	30.4%	3.8%
3. 831(b)/Micro	2	2,569,128	1,284,564	5.5%	1.0%
Group	5	2,286,022	457,204	13.8%	0.9%
Total	36	264,896,706	7,318,280	100.0%	100.0%

The table above is based on Appendices B11 and D, Milliman Captive Insurance Study, prepared for Washington State Department of Revenue and Office of Insurance Commissioner, January 2021

2019 Captives #s and Direct Written Premium (DWP) Volume for Washington-Headquartered Entities (By Type)
High Estimate

Captive Type	Estimated Captives Insuring Direct WA Risk	Total DWP	Average DWP	% of Number of Captives	% of Total DWP
Single Parent	NUMBER OF LARGE SINGLE-PARENT CAPTIVES SELECTED REMAINDER ALLOCATED BASED ON MEDIUM ESTIMATES				
Cells					
1. Non-831(b)/Micro	5	267,308	53,462	6.1%	0.1%
2. 831(b)/Micro	17	14,075,788	827,988	20.7%	3.8%
Non-Cells					
1. Large (Over $5M DWP)	13	318,311,593	24,485,507	15.8%	85.7%
2. Small / Non-831(b)/Micro (Under $5M DWP)	28	25,738,712	919,240	34.0%	6.9%
3. 831(b)/Micro	5	6,422,820	1,284,564	6.1%	1.7%
Group	14	6,400,861	457,204	17.0%	1.7%
Total	82	371,217,080	4,512,457	100.0%	100.0%

The table above is based on Appendices B11 and D, Milliman Captive Insurance Study, prepared for Washington State Department of Revenue and Office of Insurance Commissioner, January 2021

Estimated Unpaid Taxes, Penalties, and Interest
Medium Estimates

Appendix D
Exhibit 4
Sheet 1

	OIC as Collecting Authority						DOR as Collecting Authority	
	Taxable Base	Potential Unpaid Taxes, Interest, and Penalties					Taxable Base	Potential Unpaid Taxes
Year	WA Only (Broad)	Tax @ 2.0%	Penalty @ 20.0%	Interest @ 12.0% per Annum	Total		WA Only (Narrow)	DOR @ 1.50%
2010	355,300,000	7,106,000	1,421,200	8,527,200	17,054,400		NA	NA
2011	421,600,000	8,432,000	1,686,400	9,106,560	19,224,960		NA	NA
2012	459,000,000	9,180,000	1,836,000	8,812,800	19,828,800		NA	NA
2013	564,400,000	11,288,000	2,257,600	9,481,920	23,027,520		NA	NA
2014	657,900,000	13,158,000	2,631,600	9,473,760	25,263,360		NA	NA
2015	643,450,000	12,869,000	2,573,800	7,721,400	23,164,200		NA	NA
2016	676,600,000	13,532,000	2,706,400	6,495,360	22,733,760		177,000,000	2,655,000
2017	696,150,000	13,923,000	2,784,600	5,012,280	21,719,880		182,000,000	2,730,000
2018	765,000,000	15,300,000	3,060,000	3,672,000	22,032,000		200,000,000	3,000,000
2019	255,000,000	5,100,000	1,020,000	612,000	6,732,000		100,000,000	1,500,000
Total - 10 Year	5,494,400,000	109,888,000	21,977,600	68,915,280	200,780,880		NA	NA
Total - 4 Year	2,392,750,000	47,855,000	9,571,000	15,791,640	73,217,640		659,000,000	9,885,000

Figures are not reduced to reflect settlements already made by two captive owners
Statute of limitations prohibits DOR from collecting more than four years of historical taxes
WA Only (Broad) is lilkely maximum base; policies written to individual non-WA subsidiaries (if any) would be excluded
Based on our understanding of relevant statutes, interest applies only to unpaid tax amount
Estimated premium base is based on survey results and the OIC definition of which premiums are subject to taxation
1.50% and 2.00% tax rate assumptions provided by the DOR and OIC, respectively
20.0% penalty and 12.0% interest rate assumptions provided by the OIC

The table above is based on Appendices B11 and D, Milliman Captive Insurance Study, prepared for Washington State Department of Revenue and Office of Insurance Commissioner, January 2021

Estimated Unpaid Taxes, Penalties, and Interest

Low Estimates

Appendix D
Exhibit 4
Sheet 2

	OIC as Collecting Authority					DOR as Collecting Authority	
	Taxable Base	Potential Unpaid Taxes, Interest, and Penalties				Taxable Base	Potential Unpaid Taxes
Year	WA Only (Broad)	Tax @ 2.0%	Penalty @ 20.0%	Interest @ 12.0% per Annum	Total	WA Only (Narrow)	DOR @ 1.50%
2010	314,000,000	6,280,000	1,256,000	7,536,000	15,072,000	NA	NA
2011	372,000,000	7,440,000	1,488,000	8,035,200	16,963,200	NA	NA
2012	405,000,000	8,100,000	1,620,000	7,776,000	17,496,000	NA	NA
2013	498,000,000	9,960,000	1,992,000	8,366,400	20,318,400	NA	NA
2014	581,000,000	11,620,000	2,324,000	8,366,400	22,310,400	NA	NA
2015	568,000,000	11,360,000	2,272,000	6,816,000	20,448,000	NA	NA
2016	598,000,000	11,960,000	2,392,000	5,740,800	20,092,800	156,000,000	2,340,000
2017	615,000,000	12,300,000	2,460,000	4,428,000	19,188,000	161,000,000	2,415,000
2018	676,000,000	13,520,000	2,704,000	3,244,800	19,468,800	177,000,000	2,655,000
2019	225,000,000	4,500,000	900,000	540,000	5,940,000	88,000,000	1,320,000
Total - 10 Year	4,852,000,000	97,040,000	19,408,000	60,849,600	177,297,600	NA	NA
Total - 4 Year	2,114,000,000	42,280,000	8,456,000	13,953,600	64,689,600	582,000,000	8,730,000

Figures are not reduced to reflect settlements already made by two captive owners
Statute of limitations prohibits DOR from collecting more than four years of historical taxes
WA Only (Broad) is lilkely maximum base; policies written to individual non-WA subsidiaries (if any) would be excluded
Based on our understanding of relevant statutes, interest applies only to unpaid tax amount
Estimated premium base is based on survey results and the OIC definition of which premiums are subject to taxation
1.50% and 2.00% tax rate assumptions provided by the DOR and OIC, respectively
20.0% penalty and 12.0% interest rate assumptions provided by the OIC

The table above is based on Appendices B11 and D, Milliman Captive Insurance Study, prepared for Washington State Department of Revenue and Office of Insurance Commissioner, January 2021

Estimated Unpaid Taxes, Penalties, and Interest
High Estimates

Appendix D
Exhibit 4
Sheet 3

	OIC as Collecting Authority						DOR as Collecting Authority	
	Taxable Base	Potential Unpaid Taxes, Interest, and Penalties					Taxable Base	Potential Unpaid Taxes
Year	**WA Only (Broad)**	**Tax @ 2.0%**	**Penalty @ 20.0%**	**Interest @ 12.0% per Annum**	**Total**		**WA Only (Narrow)**	**DOR @ 1.50%**
2010	439,000,000	8,780,000	1,756,000	10,536,000	21,072,000		NA	NA
2011	522,000,000	10,440,000	2,088,000	11,275,200	23,803,200		NA	NA
2012	568,000,000	11,360,000	2,272,000	10,905,600	24,537,600		NA	NA
2013	699,000,000	13,980,000	2,796,000	11,743,200	28,519,200		NA	NA
2014	814,000,000	16,280,000	3,256,000	11,721,600	31,257,600		NA	NA
2015	796,000,000	15,920,000	3,184,000	9,552,000	28,656,000		NA	NA
2016	837,000,000	16,740,000	3,348,000	8,035,200	28,123,200		219,000,000	3,285,000
2017	861,000,000	17,220,000	3,444,000	6,199,200	26,863,200		225,000,000	3,375,000
2018	100,000,000	2,000,000	400,000	480,000	2,880,000		248,000,000	3,720,000
2019	316,000,000	6,320,000	1,264,000	758,400	8,342,400		124,000,000	1,860,000
Total - 10 Year	5,952,000,000	119,040,000	23,808,000	81,206,400	224,054,400		NA	NA
Total - 4 Year	2,114,000,000	42,280,000	8,456,000	15,472,800	66,208,800		816,000,000	12,240,000

Figures are not reduced to reflect settlements already made by two captive owners
Statute of limitations prohibits DOR from collecting more than four years of historical taxes
WA Only (Broad) is lilkely maximum base; policies written to individual non-WA subsidiaries (if any) would be excluded
Based on our understanding of relevant statutes, interest applies only to unpaid tax amount
Estimated premium base is based on survey results and the OIC definition of which premiums are subject to taxation
1.50% and 2.00% tax rate assumptions provided by the DOR and OIC, respectively
20.0% penalty and 12.0% interest rate assumptions provided by the OIC

The table above is based on Appendices B11 and D, Milliman Captive Insurance Study, prepared for Washington State Department of Revenue and Office of Insurance Commissioner, January 2021

	OIC as Collecting Authority				
	Taxable Base	**Potential Unpaid Taxes, Interest, and Penalties**			
Year	**WA Only (Narrow)**	**Tax @ 2.0%**	**Penalty @ 20.0%**	**Interest @ 12.0% per Annum**	**Total**
2010	93,000,000	1,860,000	372,000	2,232,000	4,464,000
2011	110,000,000	2,200,000	440,000	2,376,000	5,016,000
2012	120,000,000	2,400,000	480,000	2,304,000	5,184,000
2013	148,000,000	2,960,000	592,000	2,486,400	6,038,400
2014	172,000,000	3,440,000	688,000	2,476,800	6,604,800
2015	168,000,000	3,360,000	672,000	2,016,000	6,048,000
2016	177,000,000	3,540,000	708,000	1,699,200	5,947,200
2017	182,000,000	3,640,000	728,000	1,310,400	5,678,400
2018	200,000,000	4,000,000	800,000	960,000	5,760,000
2019	100,000,000	2,000,000	400,000	240,000	2,640,000
Total - 10 Year	1,470,000,000	29,400,000	5,880,000	18,100,800	53,380,800
Total - 5 Year	827,000,000	16,540,000	3,308,000	6,225,600	26,073,600

Figures are not reduced to reflect settlements already made by two captive owners
Based on our understanding of relevant statutes, interest applies only to unpaid tax amount
Estimated premium base is based on survey results and the OIC definition of which premiums are subject to taxation
2.00% tax rate assumptions provided by the OIC
20.0% penalty and 12.0% interest rate assumptions provided by the OIC

The table above is based on Appendices B11 and D, Milliman Captive Insurance Study, prepared for Washington State Department of Revenue and Office of Insurance Commissioner, January 2021

Appendix E
Results of Tax Savings Model

The following exhibits provide support for one entry in Table 24. The associated entries are in the “IRS” payment pattern column and the “3%” interest rate row. Support for additional entries is available upon request.

Captive Insurance Company **Exhibit 1**
Total Insurance Program

Captive Tax Benefit: Before and After Premium Tax

Inputs	
Premium:	10,000,000
Loss Ratio	100.0%
Ultimate Losses:	10,000,000
Payment Pattern:	IRS
Interest Rate:	3.0%
Expenses:	200,000

		Dollars ($)	% of Ultimate Losses
(1)	Estimated Tax Benefit	195,197	1.95%
(2)	Annual Captive Expenses	200,000	2.00%
(3)	Annual Captive Expenses (After Federal Tax)	158,000	1.58%
(4)	"Net" Estimated Tax Benefit	37,197	0.37%
(5)	State of WA Premium Tax of 2.0%	200,000	2.00%
(6)	State of WA Premium Tax of 2.0% (After Federal Tax)	158,000	1.58%
(7)	Benefit Net of Premium Tax	(120,803)	(1.21%)

Notes:
(1): From Exhibit 2
(2): Judgmentally selected
(3): = (2) x (1.0 minus Marginal Tax Rate of 21.0%)
(4): = (1) - (3)
(5): = Premium x Premium Tax of 2.0%
(6): = (5) x (1.0 minus Marginal Tax Rate of 21.0%)
(7): = (4) - (6)

Captive Insurance Company **Exhibit 2**
Total Insurance Program

Estimated Tax Benefit

Inputs	
Premium:	10,000,000
Loss Ratio	100.0%
Ultimate Losses:	10,000,000
Payment Pattern:	IRS
Interest Rate:	3.0%

(1)	(2)	(3)	(4)	(5)	(6)	(7)
Calendar Year	Discounted Incurred Losses	Paid Losses	Difference (2) - (3)	Time (Years)	Present Value of (4)	Estimated Tax Benefit
2020	8,994,419	1,650,507	7,343,911	0.5	7,236,171	1,519,596
2021	197,909	1,991,473	(1,793,564)	1.5	(1,715,778)	(360,313)
2022	151,473	1,382,231	(1,230,758)	2.5	(1,143,088)	(240,048)
2023	116,602	1,158,889	(1,042,286)	3.5	(939,846)	(197,368)
2024	89,942	783,762	(693,820)	4.5	(607,406)	(127,555)
2025	71,621	571,272	(499,651)	5.5	(424,681)	(89,183)
2026	58,961	383,629	(324,668)	6.5	(267,915)	(56,262)
2027	51,232	229,506	(178,274)	7.5	(142,826)	(29,994)
2028	45,112	266,286	(221,174)	8.5	(172,035)	(36,127)
2029	40,842	96,963	(56,121)	9.5	(42,381)	(8,900)
2030	80,866	197,585	(116,719)	10.5	(85,576)	(17,971)
2031	12,992	197,585	(184,593)	11.5	(131,397)	(27,593)
2032	12,992	197,585	(184,593)	12.5	(127,570)	(26,790)
2033	12,683	188,425	(175,742)	13.5	(117,916)	(24,762)
2034	10,220	115,441	(105,220)	14.5	(68,542)	(14,394)
2035	10,220	115,441	(105,220)	15.5	(66,546)	(13,975)
2036	10,220	115,441	(105,220)	16.5	(64,608)	(13,568)
2037	10,220	115,441	(105,220)	17.5	(62,726)	(13,172)
2038	10,220	115,441	(105,220)	18.5	(60,899)	(12,789)
2039	10,220	115,441	(105,220)	19.5	(59,125)	(12,416)
2040	1,032	11,659	(10,627)	20.5	(5,798)	(1,218)
Total	10,000,000	10,000,000	0		929,511	195,197

Notes:
(2),(3): Sum of Exhibits 3-4, Sheet 1
(5): Assumed timing for present value calculations
(6): Based on (4), (5), and an interest rate of 3.0%
(7): = (6) x a marginal tax rate of 21.0%

Captive Insurance Company
Workers Compensation

Exhibit 3
Sheet 1

Estimated Tax Benefit

Inputs	
Premium:	7,000,000
Loss Ratio	100.0%
Ultimate Losses:	7,000,000
Payment Pattern:	IRS
Interest Rate:	3.0%

(1)	(2)	(3)	(4)	(5)	(6)	(7)
Calendar Year	Discounted Incurred Losses	Paid Losses	Difference (2) - (3)	Time (Years)	Present Value of (4)	Estimated Tax Benefit
2020	6,291,483	1,322,192	4,969,292	0.5	4,896,389	1,028,242
2021	130,598	1,562,251	(1,431,653)	1.5	(1,369,563)	(287,608)
2022	95,666	937,926	(842,260)	2.5	(782,264)	(164,275)
2023	72,667	729,108	(656,441)	3.5	(591,924)	(124,304)
2024	57,120	412,217	(355,097)	4.5	(310,870)	(65,283)
2025	47,366	328,006	(280,641)	5.5	(238,532)	(50,092)
2026	40,667	195,912	(155,245)	6.5	(128,108)	(26,903)
2027	36,682	140,978	(104,296)	7.5	(83,558)	(17,547)
2028	33,235	153,831	(120,596)	8.5	(93,803)	(19,699)
2029	31,061	51,513	(20,452)	9.5	(15,445)	(3,243)
2030	70,440	115,441	(45,001)	10.5	(32,994)	(6,929)
2031	10,220	115,441	(105,220)	11.5	(74,898)	(15,729)
2032	10,220	115,441	(105,220)	12.5	(72,717)	(15,270)
2033	10,220	115,441	(105,220)	13.5	(70,599)	(14,826)
2034	10,220	115,441	(105,220)	14.5	(68,542)	(14,394)
2035	10,220	115,441	(105,220)	15.5	(66,546)	(13,975)
2036	10,220	115,441	(105,220)	16.5	(64,608)	(13,568)
2037	10,220	115,441	(105,220)	17.5	(62,726)	(13,172)
2038	10,220	115,441	(105,220)	18.5	(60,899)	(12,789)
2039	10,220	115,441	(105,220)	19.5	(59,125)	(12,416)
2040	1,032	11,659	(10,627)	20.5	(5,798)	(1,218)
Total	7,000,000	7,000,000	(0)		642,871	135,003

Notes:
(2),(3): Exhibit 3, Sheet 2
(5): Assumed timing for present value calculations
(6): Based on (4), (5), and an interest rate of 3.0%
(7): = (6) x a marginal tax rate of 21.0%

Captive Insurance Company **Exhibit 3**
Workers Compensation **Sheet 2**

Derivation of Discounted Incurred Losses

Inputs	
Premium:	7,000,000
Loss Ratio	100.0%
Ultimate Losses:	7,000,000
Payment Pattern:	IRS
Interest Rate:	3.0%

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Calendar Year	Payout Pattern	Incremental Paid Losses	Cumulative Paid Losses	Undiscounted Reserves	IRS Discount Factors	Discounted Reserves	Discounted Incurred Losses
2020	18.9%	1,322,192	1,322,192	5,677,808	87.5213%	4,969,292	6,291,483
2021	22.3%	1,562,251	2,884,442	4,115,558	85.9577%	3,537,639	130,598
2022	13.4%	937,926	3,822,368	3,177,632	84.8235%	2,695,379	95,666
2023	10.4%	729,108	4,551,476	2,448,524	83.2721%	2,038,937	72,667
2024	5.9%	412,217	4,963,693	2,036,307	82.6909%	1,683,840	57,120
2025	4.7%	328,006	5,291,700	1,708,300	82.1401%	1,403,200	47,366
2026	2.8%	195,912	5,487,612	1,512,388	82.5155%	1,247,954	40,667
2027	2.0%	140,978	5,628,590	1,371,410	83.3929%	1,143,658	36,682
2028	2.2%	153,831	5,782,421	1,217,579	84.0243%	1,023,062	33,235
2029	0.7%	51,513	5,833,934	1,166,066	85.9823%	1,002,610	31,061
2030	1.6%	115,441	5,949,375	1,050,625	91.1466%	957,609	70,440
2031	1.6%	115,441	6,064,815	935,185	91.1466%	852,389	10,220
2032	1.6%	115,441	6,180,256	819,744	91.1466%	747,169	10,220
2033	1.6%	115,441	6,295,697	704,303	91.1466%	641,949	10,220
2034	1.6%	115,441	6,411,137	588,863	91.1466%	536,728	10,220
2035	1.6%	115,441	6,526,578	473,422	91.1466%	431,508	10,220
2036	1.6%	115,441	6,642,019	357,981	91.1466%	326,288	10,220
2037	1.6%	115,441	6,757,459	242,541	91.1466%	221,068	10,220
2038	1.6%	115,441	6,872,900	127,100	91.1466%	115,847	10,220
2039	1.6%	115,441	6,988,341	11,659	91.1466%	10,627	10,220
2040	0.2%	11,659	7,000,000	-	91.1466%	-	1,032

Notes:
(2): Based on discount factors promulgated by the IRS
(3): = ultimate losses x (2)
(4): = cumulative sum of (3)
(5): = ultimate losses - (4)
(6): From IRS Rev. Proc. 2019-31 for Accident Year 2019 and subsequent
(7): = (5) x (6)
(8): = (3) + change in discounted reserves in (7)

Captive Insurance Company
General Liability

Exhibit 4
Sheet 1

Estimated Tax Benefit

Inputs	
Premium:	3,000,000
Loss Ratio	100.0%
Ultimate Losses:	3,000,000
Payment Pattern:	IRS
Interest Rate:	3.0%

(1) Calendar Year	(2) Discounted Incurred Losses	(3) Paid Losses	(4) Difference (2) - (3)	(5) Time (Years)	(6) Present Value of (4)	(7) Estimated Tax Benefit
2020	2,702,935	328,316	2,374,620	0.5	2,339,782	491,354
2021	67,311	429,222	(361,911)	1.5	(346,215)	(72,705)
2022	55,807	444,305	(388,498)	2.5	(360,824)	(75,773)
2023	43,936	429,781	(385,845)	3.5	(347,923)	(73,064)
2024	32,822	371,544	(338,723)	4.5	(296,536)	(62,272)
2025	24,255	243,266	(219,011)	5.5	(186,149)	(39,091)
2026	18,294	187,716	(169,422)	6.5	(139,807)	(29,359)
2027	14,550	88,528	(73,978)	7.5	(59,268)	(12,446)
2028	11,878	112,455	(100,578)	8.5	(78,232)	(16,429)
2029	9,781	45,450	(35,669)	9.5	(26,936)	(5,657)
2030	10,426	82,144	(71,718)	10.5	(52,582)	(11,042)
2031	2,772	82,144	(79,373)	11.5	(56,499)	(11,865)
2032	2,772	82,144	(79,373)	12.5	(54,854)	(11,519)
2033	2,463	72,985	(70,522)	13.5	(47,318)	(9,937)
2034	0	0	0	14.5	0	0
2035	0	0	0	15.5	0	0
2036	0	0	0	16.5	0	0
2037	0	0	0	17.5	0	0
2038	0	0	0	18.5	0	0
2039	0	0	0	19.5	0	0
2040	0	0	0	20.5	0	0
Total	3,000,000	3,000,000	0		286,640	60,194

Notes:
(2),(3): Exhibit 4, Sheet 2
(5): Assumed timing for present value calculations
(6): Based on (4), (5), and an interest rate of 3.0%
(7): = (6) x a marginal tax rate of 21.0%

Derivation of Discounted Incurred Losses

Inputs	
Premium:	3,000,000
Loss Ratio	100.0%
Ultimate Losses:	3,000,000
Payment Pattern:	IRS
Interest Rate:	3.0%

(1) Calendar Year	(2) Payout Pattern	(3) Incremental Paid Losses	(4) Cumulative Paid Losses	(5) Undiscounted Reserves	(6) IRS Discount Factors	(7) Discounted Reserves	(8) Discounted Incurred Losses
2020	10.9%	328,316	328,316	2,671,684	88.8810%	2,374,620	2,702,935
2021	14.3%	429,222	757,538	2,242,462	89.7544%	2,012,708	67,311
2022	14.8%	444,305	1,201,843	1,798,157	90.3264%	1,624,211	55,807
2023	14.3%	429,781	1,631,624	1,368,376	90.4989%	1,238,366	43,936
2024	12.4%	371,544	2,003,168	996,832	90.2502%	899,643	32,822
2025	8.1%	243,266	2,246,434	753,566	90.3215%	680,632	24,255
2026	6.3%	187,716	2,434,150	565,850	90.3437%	511,210	18,294
2027	3.0%	88,528	2,522,678	477,322	91.6011%	437,232	14,550
2028	3.7%	112,455	2,635,133	364,867	92.2678%	336,655	11,878
2029	1.5%	45,450	2,680,583	319,417	94.2296%	300,986	9,781
2030	2.7%	82,144	2,762,727	237,273	96.6260%	229,268	10,426
2031	2.7%	82,144	2,844,871	155,129	96.6260%	149,895	2,772
2032	2.7%	82,144	2,927,015	72,985	96.6260%	70,522	2,772
2033	2.4%	72,985	3,000,000	-	96.6260%	-	2,463
2034	0.0%	-	3,000,000	-	96.6260%	-	-
2035	0.0%	-	3,000,000	-	96.6260%	-	-
2036	0.0%	-	3,000,000	-	96.6260%	-	-
2037	0.0%	-	3,000,000	-	96.6260%	-	-
2038	0.0%	-	3,000,000	-	96.6260%	-	-
2039	0.0%	-	3,000,000	-	96.6260%	-	-
2040	0.0%	-	3,000,000	-	96.6260%	-	-

Notes:
(2): Based on discount factors promulgated by the IRS
(3): = ultimate losses x (2)
(4): = cumulative sum of (3)
(5): = ultimate losses - (4)
(6): From IRS Rev. Proc. 2019-31 for Accident Year 2019 and subsequent
(7): = (5) x (6)
(8): = (3) + change in discounted reserves in (7)

Appendix F
Captive Insurance Survey Questions

Initial Captives Survey

The initial captive survey is available online through Survey Monkey. This survey was sent to companies through the following email:

From: samantha.poulin@milliman.com via SurveyMonkey <member@surveymonkeyuser.com>
Sent: Thursday, August 27, 2020 9:17 AM
To: *Company Email*
Subject: Washington OIC Survey on Captive Insurance

Washington OIC Survey on Captive Insurance

To: *Company Name*

The Office of the Insurance Commissioner (OIC) in partnership with the Department of Revenue (DOR), has been requested by the Washington State Legislature and the Office of the Governor, to engage in a study to understand the extent of the use of captive insurance in Washington State. To accomplish this, OIC and DOR have contracted with Milliman Inc. to perform a survey to collect detailed information about captive insurance. Milliman Inc. is a Washington State headquartered independent consulting firm with experience in insurance, collecting confidential information, analyzing data, and writing reports.

This short, three (3) question survey seeks to identify companies that currently use captive insurance or have used captive insurance in the last ten (10) years. A "captive insurer" is generally defined as an insurance company that is controlled by its insureds. A captive insurer's primary purpose is insuring the risks of its owners or members. Forms of captive insurance include pure captives (owned by a single entity, including micro captives), group captives (owned by a group of entities), sponsored captives, and agency captives.

If you **have not** made use of a captive insurance company in the last 10 years, please respond to questions 1 and 2 only. No further action is required.

If you **have** made use of a captive insurance company in the last 10 years, please respond to all 3 questions and a Milliman representative will be in touch regarding additional information requested.

Please respond to this survey request no later than **Friday, August 28, 2020**. If you do not respond to the survey further investigation and enforcement will be pursued.

Begin Survey

Initial Survey Questions

1. Company Name

2. Does your company currently (or has your company in the last ten years) made use of a captive insurance company?

   If the survey respondent answers “no” and clicks submit, the survey ends

   If the survey respondent answers “yes” and clicks submit, the receive the following question

3. Please provide the name and email address of the company representative that can be contacted for more information.

*A more detailed survey will be sent to those companies using captive insurers.

Captives Insurance Survey

This document is to be used only as a reference and should not be used as a response to the survey. **Any responses received through this document will not be counted.**

Company Information

1. Name of company: _________
2. Type of company, select one:
    a. *Corporation*
    b. *S. Corporation*
    c. *Limited Liability Corporation*
    d. *Partnership*
    e. *Sole Proprietorship*
3. Principal place of business: _________
4. Industry: _________

Captive Information

1. Name of captive: _________
2. Year of incorporation: _________
3. Type of captive, select one:
    a. *Pure / Single Parent*
    b. *Group / Association / Industrial*
    c. *Cell / Sponsored / Rent-A-Captive*
    d. *Agency*
    e. *Microcaptive*
    f. *Other*
4. Domicile: _________
5. Is the captive treated as an insurance company for federal income tax purposes? *Yes / No*

6. Does the captive make the 831(b) election? *Yes / No*

Insured Risks

1. Provide written premium by coverage and policy year in separate tabs

	Written Premium Allocable to Washington Risks				Written Premium Allocable to Non-Washington Risks				
Coverage	Direct	Assumed	Ceded	Net	Direct	Assumed	Ceded	Net	Format of Policy
Workers Compensation	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	SELECT...
General Liability	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	SELECT...
Auto Liability	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	SELECT...
Professional Liability	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	SELECT...
Property	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	SELECT...
Medical Stop Loss	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	SELECT...
Other Liability *	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	SELECT...
Terrorism	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	SELECT...
NBCR **	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	SELECT...
All Other	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	SELECT...
Total	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	

** Including Directors & Officers, Employment Practices Liability, Cyber, etc.*
*** Nuclear Biological Chemical Radiological*

2. Does the captive cover third party (unrelated) risks? *Yes / No*
3. What types of third party (unrelated) risks are covered by the captive?
   a. Employee Benefits, select one:
      US benefits only / international benefits only / US and international benefits / None
   b. Pooling or Reinsurance Arrangements with Captive Peers: *Yes / No*
   c. Insurance to Employees (personal lines, etc.): *Yes / No*
   d. Insurance to Customers (warranty, etc.): *Yes / No*
   e. Insurance to Contractors (OCIP, etc.): *Yes / No*
   f. Other: *Yes / No*

Captive Expense

1. What were the 2019 captive operating costs in the following areas:
   a. Captive Management: $_________
   b. Audit, Legal, Actuarial: $_________
   c. Board Meetings: $_________
   d. Other General & Administrative Expenses: $_________
   e. Commission & Brokerage: $_________
   f. Other Underwriting Expenses: $_________

Taxation & Fees

2. What are the annual premium taxes paid to domiciliary state? $_________

3. What are the annual premium taxes paid to non-domiciliary states? *$_________ This amount should include any taxes paid by the parent company as a result of utilizing the captive*

4. What are the other annual fees are paid to domiciliary state? *$_________*

Captive Benefits

1. In management's opinion, what are the economic and non-economic benefits provided by the captive?

   ____

   ____

Document List

1. Please provide the following documents:
   a. Captive annual reports (as filed with domicile) for 2017, 2018 and 2019
   b. 2019 captive policy list (separately for direct, assumed, and ceded policies)

Appendix G
Captive Insurance Study Report Excerpts

Captive Insurance Company Counts and Direct Written Premium By Year **Appendix G**

Survey Results **Exhibit 1**

	Single Parent Captive Insurers			Group Captive Insurers		
Year	**# of Active Captive Insurers with Gross Written Premium > $0**	**# of Active Captive Insurers with Direct Written Premium > $0**	**Direct Written Premium**	**# of Active Captive Insurers with Gross Written Premium > $0**	**# of Active Captive Insurers with Direct Written Premium > $0**	**Direct Written Premium**
2010	12	10	254,940,119	3	1	272,467
2011	14	11	302,192,586	3	1	120,868
2012	15	12	329,084,625	3	1	109,772
2013	16	13	405,107,883	3	1	114,657
2014	19	15	472,248,632	2	0	0
2015	20	15	461,698,818	3	1	127,752
2016	23	18	485,440,598	3	2	220,674
2017	25	20	499,502,064	4	2	242,011
2018	28	21	545,820,569	5	3	1,570,229
2019	28	20	155,517,494	7	3	1,371,613

The table above is based on Appendices B11 and D, Milliman Captive Insurance Study, prepared for Washington State Department of Revenue and Office of Insurance Commissioner, January 2021

Estimated Unpaid Taxes, Penalties, and Interest

Appendix G
Exhibit 2

Collecting Authority	Tax Base	Time Frame	Taxable Base	Tax Rate *	Unpaid Tax	Penalties @ 20.0% *	Interest @ 12.0% *	Total
OIC	WA Only (Broad)	10 Years	5,494,400,000	2.0%	109,888,000	21,977,600	68,915,280	200,780,880
OIC	WA Only (Broad)	4 Years	2,392,750,000	2.0%	47,855,000	9,571,000	15,791,640	73,217,640
OIC	WA Only (Narrow)	10 Years	1,470,000,000	2.0%	29,400,000	5,880,000	18,100,800	53,380,800
OIC	WA Only (Narrow)	5 Years	827,000,000	2.0%	16,540,000	3,308,000	6,225,600	26,073,600

** Tax, penalty, and interest rate assumptions provided by OIC*
The "WA Only (Broad)" tax base is based on the OIC definition of which premiums are subject to taxation;
this includes all premiums from reimbursement policies based on the location of the insured's principal place of business.
Taxable base is estimated by Milliman based on survey results and the OIC's definition for the Tax Base.

The table above is based on Appendices B12 and D, and Section VIII, Policy Considerations and Revenue Forecasts, Milliman Captive Insurance Study, prepared for Washington State Department of Revenue and Office of Insurance Commissioner, January 2021

State	Authorized Premium Tax Rate	Excess/ Surplus Lines Premium Tax Rate	Independent Procurement Premium Tax Rate	State	Authorized Premium Tax Rate	Excess/ Surplus Lines Premium Tax Rate	Independent Procurement Premium Tax Rate
AK	2.700%	2.700%	3.700%	NC	1.900%	5.000%	5.000%
AL	3.600%	6.000%	4.000%	ND	1.750%	1.750%	1.750%
AR	2.500%	4.000%	2.000%	NE	1.000%	3.000%	3.000%
AZ	1.750%	3.000%	3.000%	NH	1.250%	3.000%	4.000%
CA	2.350%	3.000%	3.000%	NJ	2.100%	5.000%	5.000%
CO	2.000%	3.000%	3.000%	NM	3.003%	3.003%	3.003%
CT	1.500%	4.000%	4.000%	NV	3.500%	3.500%	3.500%
DC	1.700%	2.000%	N/A	NY	2.000%	3.600%	3.600%
DE	2.000%	3.000%	3.000%	OH	1.400%	5.000%	5.000%
FL	1.750%	5.000%	5.000%	OK	2.250%	6.000%	6.000%
GA	2.250%	4.000%	4.000%	OR	N/A	2.300%	2.300%
HI	4.265%	4.680%	4.680%	PA	2.000%	3.000%	3.000%
IA	1.000%	1.000%	1.000%	RI	2.000%	4.000%	4.000%
ID	1.500%	1.500%	1.500%	SC	1.250%	6.000%	N/A
IL	0.500%	3.500%	0.500%	SD	2.500%	2.500%	2.500%
IN	1.300%	2.500%	N/A	TN	2.500%	5.000%	5.000%
KS	2.000%	6.000%	6.000%	TX	1.600%	4.850%	4.850%
KY	2.000%	3.000%	2.000%	UT	2.250%	4.250%	4.250%
LA	N/A	4.850%	4.850%	VA	2.250%	2.250%	N/A
MA	2.280%	4.000%	N/A	VT	2.000%	3.000%	3.000%
MD	2.000%	3.000%	3.000%	WA	2.000%	2.000%	N/A
ME	2.000%	3.000%	3.000%	WI	2.000%	3.000%	3.000%
MI	N/A	2.500%	2.500%	WV	3.000%	4.550%	N/A
MN	2.000%	3.000%	2.000%	WY	0.750%	3.000%	3.000%
MO	2.000%	5.000%	5.000%	GU	4.000%	4.000%	N/A
MS	3.000%	4.000%	7.000%	PR	N/A	9.000%	15.000%
MT	2.750%	2.750%	2.750%	VI	5.000%	5.000%	5.000%

The table above is based on Section III, Insurance Regulation and Taxation, Milliman Captive Insurance Study, prepared for Washington State Department of Revenue and Office of Insurance Commissioner, January 2021

Projection of Potential Year 1 Subject Premium and Tax Revenue
Assumes Premium Tax Applies to All Coverages
@ 1.75% and 2.00% Tax Rates

A. Projection of Year 1 Subject Premium

	Taxable Base				
Item	**NRRA**	**WA Only (Broad)**	**WA Only (Narrow) Low Estimate**	**WA Only (Narrow) Medium Estimate**	**WA Only (Narrow) High Estimate**
Estimated 2018 Premium**	900,000,000	765,000,000		200,000,000	
Estimated 2019 Premium**	300,000,000	255,000,000		100,000,000	
Estimated Year 1 Premium	75,000,000	63,750,000	100,000,000	110,000,000	130,000,000
Derivation of Estimated Year 1 Premium***	25% of 2019	25% of 2019	see below	see below	see below

B. Projection of Year 1 Tax Revenue

	Taxable Base				
Tax Rate	**NRRA**	**WA Only (Broad)**	**WA Only (Narrow) Low Estimate**	**WA Only (Narrow) Medium Estimate**	**WA Only (Narrow) High Estimate**
Estimated Year 1 Premium	75,000,000	63,750,000	100,000,000	110,000,000	130,000,000
Premium Tax at 2.00% Rate	1,500,000	1,275,000	2,000,000	2,200,000	2,600,000
Premium Tax at 1.75% Rate	NA	NA	1,750,000	1,925,000	2,275,000

1.75% tax rate assumption provided by DOR; 2.00% tax rate assumption provided by OIC
* Based on survey results and publicly available data
** Judgementally selected based on our research, including but not limited to:
- Large captive insurance company owners ($25 million or more) will have most impact
- Large captive insurance company owners cost to operate captives is generally 1% of premium or less
- Large captive insurance company owners federal tax benefit generally averages 2.5% of reimbursement policy premiums
- Large captive insurance company owners may exit the market or restructure policies to legally avoid the new tax
- Several large captive insurance company owners supported the WA Only (Narrow) base and tax rate, resulting in estimates equal to or higher than 2019

The table above is based on Appendices B12 and D, Milliman Captive Insurance Study, prepared for Washington State Department of Revenue and Office of Insurance Commissioner, January 2021

	Authorized Insurers	**Surplus Lines**	**Risk Retention Groups**	**Captive Insurance**
Description	Traditional Insurance	Coverage unavailable from authorized insurers or purchased by large, sophisticated companies.	Insurer owned by policyholders, who pool risk; limited to commercial liability insurance; most RRGs are licensed by their domiciliary state as captive insurers.	Insurer that insures its owners and/or affiliates; organized for the main purpose of funding the owners' risks; owners actively participate in underwriting, operations, and investments
Regulatory Framework	Insurer must be “authorized”—i.e., have certificate of authority to do business in Washington State. RCW 48.05.030. See also RCW 48.15.020. ***Subject to solvency and market conduct regulation.*** 48.03 RCW; 48.05 RCW; 48.37 RCW. ***Producers*** (agents) that are involved must be licensed in Washington State. RCW 48.17.060.	Insurance purchased in the surplus lines market must be ***unavailable*** from authorized insurer, ***except*** when purchaser is a large company with an in-house risk manager RCW 48.15.040; RCW 48.15.043. Surplus lines **broker** licensed in WA state must be used to procure the insurance. RCW 48.15.040. Insurers providing surplus lines insurance are not directly regulated by Washington State, but ***surplus lines brokers are regulated by the state***. RCW 48.15.070. Surplus lines brokers must not knowingly place insurance with insurers that are financially unsound. RCW 48.15.090. Under NRRA, only “home state” of insured (generally where insured is headquartered) may regulate placement of surplus lines. 15 USC 8202.	In-state: chartered and licensed under RCW 48.92.030. Out-of-state: registered under RCW 48.92.040. ***Subject to solvency and market conduct regulation, but authority to regulate out-of-state RRGs is limited by federal law***. Instead, out-of-state RRGs are regulated primarily by state of domicile. RCW 48.92.030 (in-state) and RCW 48.92.040 (out-of-state); 15 USC 3902, 3905. ***Producers*** (agents) that are involved must be licensed in Washington State. RCW 48.92.120.	No regulatory framework in Washington State. Captive insurance is a form of unauthorized insurance not permitted under Washington law. RCW 48.15.020; RCW 48.05.030.[1] Unauthorized insurance is subject to a 2% premium tax even when not permitted by law. RCW 48.14.095. .
Premium tax base	Premium taxes are assessed on premiums allocated to ***risks located in Washington State***. RCW 48.14.020.	“Home state” rule: Premium taxes are ***assessed on 100% of the premium covering US risks*** if the insured is headquartered in WA, unless the policy covers no risk in WA, then it is paid to whatever state has the most risk. If policy covers multiple affiliated companies as named insureds, home state is state in which affiliate to which greatest percentage of premium is attributed has its headquarters. RCW 48.15.010(5) (adopting NRRA definition of “home state”); RCW 48.15.120; 15 USC 8201.[2]	Premium taxes are assessed on premiums allocated to ***risks located in Washington State***. RCW 48.92.040(3)(a).	Premium taxes for unauthorized insurance are assessed on premiums allocated to ***risks located in Washington State***. RCW 48.14.095.
Who pays tax	***Insurer*** pays the taxes to OIC	***Broker***, not the insurer, pays the taxes to OIC	***Insurer*** pays the taxes to OIC	The ***insurer*** pays the taxes to OIC.
Tax rate	2.00%	2.00%	2.00%	2.00%

[1] Two Washington companies in litigation with OIC have disputed this characterization of their captive insurers. This litigation is currently suspended.

[2] This is a simplified presentation of the "home state" rule. See Appendix B4 of the Milliman Captive Insurance Study for a comprehensive discussion of the rule.

The table above is based on Section III, Insurance Regulation and Taxation, Milliman Captive Insurance Study, prepared for Washington State Department of Revenue and Office of Insurance Commissioner, January 2021