CAPTIVE DEVELOPMENTS IN 2020 REFLECTS A CHANGING MARKETPLACE

Written By Karrie Hyatt

Despite indications that captives would see a banner year in growth in 2020, the reported number of formations was only slightly higher than 2019. The reason there weren't larger gains was likely due to businesses being shut down for several months and the resulting slowed economy.

However, captive managers and regulators have indicated that interest in captives is very high which suggests that captive formations this year will be much higher.

There was very little activity in captive legislation among U.S. domiciles. Only two states managed to pass legislation to update their captive laws. Other domiciles were thwarted from making planned updates by the pandemic shutdown.

The number of captive formations in 2020 was higher than 2019, but not excessively so. While many U.S. domiciles saw increased numbers of formations last year, other domiciles saw fewer captives formed.

Larger number of formations played out for Hawaii, North Carolina, and Vermont, but other states only saw a slight uptick in formations. States, such as South Carolina and Montana, had lower formations than the previous year.

North Carolina had the most formations in 2020 with 47 captives and 126 cell or series captives licensed. Utah and Vermont tied for second with 38 captives each. Utah's numbers also include any cells licensed.

Montana and Nevada tied for third with 23 new captives. Montana's number was down from the domicile's 2019 40 formations. Following close in fourth place is Hawaii with 21 formations, which showed a 50% increase over 2019's 11 formations.

Of the other domiciles that have reported formation numbers for 2020 are as follows; District of Columbia (18); Tennessee (18 and 41 cells); Texas (14); Arizona (12); South Carolina (9); Connecticut (6); and Missouri (2).

The outlier is Delaware with a reported 70 formations in 2020. While this ostensibly would put the domicile in first place for formations, far outpacing its competitors, 67 of those licenses were provisional. Six-month provisional licenses are unique to Delaware.

Added to the state's captive law in late 2018, provisional licenses allow captive applicants to begin operations while their application is being processed by regulators. As captives operating under a provisional license are not fully licensed captives, it is not appropriate to compare them with other domiciles.

The two largest risk-regulating domiciles in the United States are North Carolina and Tennessee with 795 and 720 captive entities. However, for both domiciles, the bulk of their risk-bearing entities are cell or series captives.

North Carolina reports 545 cells/series and Tennessee reports 460. Looking beyond those two domiciles, Vermont is still the leading captive domicile with 589 operating captives. Delaware reports more than 500 captives. Utah (396), Nevada (296), Montana (270), and Hawaii (242) make up the list of U.S. domiciles with more than 200 captives.

Across the board, captive managers have reported an increase in interest in captives due to market conditions and coverage gaps highlighted by the pandemic which should make 2021 a dynamic year in captive formations.

BY THE LEGISLATION

After the rapid additions and changes to captive law in dozens of states during the 2010s, captive law revisions seem to have slowed down considerably. There hasn't been a state passing new captive law since North Carolina in 2013 and Ohio in 2014.

Many years in the last decade saw five or more domiciles revise their captive law. Last year, there were only two states that pushed through new legislation. Several other states had the intention of passing new captive insurance legislation but were impeded by the pandemic.

One of the two domiciles that revised their law last year was Oklahoma. The revision was signed into law in May 2020. It changes how premium taxes collected from captive insurers are distributed within the state which offers transparency in how taxes collected from captives are used.

As it does nearly every year, Vermont tweaked its captive law again in 2020. In June, the governor signed the latest series of changes into law. Some of the many changes include new policies for protected cells; changes to capital requirements for dormant captives and for sponsored cell captives; changes to regulation of cell captives to reflect the regulation of standalone captives; and changes to align with NAIC accreditation standards. At this time, Vermont hasn't announced any changes to their captive law for 2021.

Last year, prior to the state legislature closing due to the pandemic, the Alabama House of Representatives unanimously passed a law to update the state's captive law. The bill did not have a chance to be voted on in the senate, so languished for the rest of 2020. However, that update has again been presented, along with further updates, to the state legislature.

Last year's changes included revising requirements for branch captives that would more closely match those of pure captives, removing the requirement that coastal homeowner captives have fronting carriers, clarifying how domestic captives can insure risks in foreign jurisdictions, and codifying a formal dormancy statute. The additions this year to the bill will create a new redomestication process, allow for risk retention groups, reduce minimum capital requirements, and offer three new alternative risk transfer entities.

In February, Delaware State Senate passed HB 36 that will update the domicile's captive law. Similar to Vermont, the new amendments are meant to help clarify the existing law while making small, but important, improvements.

The new law makes some technical corrections to align better with Delaware law standards; it defines "policy" and "premium" and revises the definition of a pure captive; it expands the licensing authority for series captives to be licensed as an agency, branch, or reciprocal captive insurance company; and includes other small changes.

OUTLOOK

The conditions last year that made forming a captive appealing in 2020 will continue through 2021. The insurance marketplace will remain hard, which historically has seen a rise in captive formations. Additionally, gaps in commercial coverage that, for many businesses, was brought to the forefront during the COVID-19 shutdown will have businesses looking for alternative ways to finance that risk. 2021 should be a banner year for the captive industry.

However, there are several challenges on the horizon. The IRS increased its hostility towards enterprise risk captives (ERCs) in 2020 and that is not likely to change for the better in 2021. Especially, since the Service recently garnered its fourth tax court win against what it calls "microcaptives," small captives that take the 831(b) tax deduction. In a decision handed down on March 10, the judge found in the case of Caylor Land & Development v. Commissioner that the "microcaptive" was not an insurance company because it didn't have proper risk distribution.

This summer, the U.S. Supreme Court is due to hand down a decision in CIC Services v. IRS. This will be the first time that the highest court in the U.S. will decide a case involving captives. In 2016, when the IRS issued Notice 2016-66, CIC Services, a Tennessee-based captive manager, filed a lawsuit against the IRS and Treasury Department arguing that notice was unlawfully issued and did not meet the authority or "reasoned analysis" requirements of the Administrative Procedure Act. The decision, whether in favor of CIC Services or not, will have far reaching implications for all types of captives and how the IRS approaches their taxation. ■

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