MULTI-STATE SURPLUS LINES RISKS: WILL THERE BE MEANINGFUL TAX-SHARING AMONG THE STATES?

by

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The Nonadmitted and Reinsurance Reform Act (the "NRRA"), signed into law in 2010 as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), prohibits states other than the home state of an insured from imposing a premium tax on surplus lines insurance, effective July 21, 2011.[1] In other words, the NRRA establishes a single-state taxation system for multi-state surplus lines risks. It allows the home state to retain one hundred percent (100%) of the tax received on gross premiums, assuming the state's laws have been amended to allow taxation of the entire premium.[2] The NRRA suggested that states might enter into tax sharing agreements or a compact to facilitate the equitable distribution of premium tax revenues in accordance with the location of insured risks. As this article demonstrates, the prospects for such a tax sharing structure are largely unfulfilled one year later.

Home State Taxation

Under the NRRA, the "home state" is generally the state of the insured's principal place of business or, in the case of an individual, principal residence.[3] However, if one hundred percent (100%) of the insured risk is located somewhere other than the insured's principal place of business or principal residence, then the home state is the state to which the greatest percentage of the insured's taxable premium for that insurance contract is allocated.[4] Also, if more than one insured from an affiliate group are named insureds on a single non-admitted insurance contract, then the

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[1] 15 USC § 8201(a). The NRRA specifically preempts the application of premium tax laws and regulations by any other state. 15 USC § 8202(c).

[2] A number of states have signed into law conforming NRRA legislation. *See* National Association of Professional Surplus Lines Offices, Ltd., available at: http://www.napslo.org/imispublic/AM/Template.cfm?Section=State_Update_Review&Template=/CM/HTMLDisplay.cfm&ContentID=7295.

[3] 15 USC § 8206(6)(A)(i).

[4] 15 USC § 8206(6)(A)(ii).

home state for that contract will be the state of the member of the affiliated group that has the largest percentage of premium attributed to it under such insurance contract.[5]

While not required, the NRRA empowers the states to enter into a compact or other agreement for the purpose of creating national or uniform standards regarding the collection, allocation and distribution of taxes among the states involving multi-state surplus lines risks.[6] Thus, it is up to the insured's home state whether to share the tax that it collects with other states.

States that fail to adopt some method of tax allocation will be subject to single-state taxation, which may cause some states to lose premium tax revenue. For example, assume a company headquartered in North Carolina with offices in Florida and Georgia is seeking insurance coverage for all three offices. Under the NRRA, North Carolina (*i.e.*, the state of the insured's principal place of business) would be considered the home state for purposes of collecting premium tax. Without a tax sharing agreement, Florida and Georgia could stand to lose the apportioned amount of the premium tax that they would be expected to receive under the NRRA.

Tax-Sharing Proposals

Currently, there are two competing tax sharing proposals being considered by the states in response to the NRRA. One proposal is the Non-Admitted Insurance Multi-State Agreement ("NIMA"), which is supported by the National Association of Insurance Commissioners ("NAIC").[7] The other proposal is the Surplus Lines Multi-State Compliance Compact Lite ("SLIMPACT"), which is supported by the National Conference of Insurance Legislators ("NCOIL") and endorsed by the Council of State Governments and the National Conference of State Legislators.[8]

NIMA is basically limited to the allocation of premium taxes for non-admitted insurance for multistate risks, whereas SLIMPACT takes a broader approach to the modernization of surplus lines regulation. NIMA becomes effective upon execution by two or more participating states. SLIMPACT also becomes effective when two states adopt enabling legislation, but it does not become operational until 10 states, or states representing greater than forty (40%) of the surplus lines insurance premium, have joined the compact.

Until now, the states have failed to reach consensus on a premium tax allocation method – whether that be NIMA, SLIMPACT, or something else. Part of the discord among states seems to stem from the fact that they are uncertain about how the NRRA will impact their premium tax revenues.

[5] 15 USC § 8206(6)(B).

[6] 15 USC § 8201(b)(1).

[7] A copy of NIMA is available at: http://www.naic.org/documents/committees_ex_slitf_nima_execution_copy.pdf.

[8] A copy of SLIMPACT is available at: http://www.csg.org/programs/policyprograms/NCIC/documents/finalcompactlanguage-slimpact.pdf.

With that unanswered question hanging for many states, some have mandated specifically in the legislation that a fiscal analysis be performed before entering into a tax sharing arrangement. For example, Ohio requires the Superintendent of Insurance to conduct a fiscal analysis of the impact of entering into a tax sharing arrangement, and authorizes the Superintendent to enter into SLIMPACT if the required fiscal analysis indicates that entering into a tax sharing arrangement is advantageous to Ohio.[9] Other states, such as Indiana and Rhode Island, authorize the state insurance regulator to enter into a different tax sharing arrangement if SLIMPACT does not take effect or becomes ineffective, provided the regulator performs a fiscal analysis of the impact of such arrangement and concludes it is in the state's financial best interest.[10]

Depending on the state, some states may find sharing taxes is in the "financial best interest" of the state while others may find that it is not. Each state will need to do an analysis of how often risks underwritten on a surplus lines basis in the particular state would constitute the "home state" in the case of multi-state risks.

Florida appears to have already done such an analysis. Representatives from the Florida Surplus Lines Service Office ("FSLSO")[11] estimate that approximately 10 percent of surplus lines premium tax revenue in Florida is attributable to taxes on multi-state risks.[12] As illustrated above, if Florida is not considered the "home state" for purposes of the multi-state policy, the state will not be able to collect premium taxes on the Florida portion of the risk, absent a tax-sharing agreement. According to Florida's Office of Insurance Regulation and FSLSO, representatives indicated that Florida may lose $15 to $20 million in tax revenue if the state is unable to collect surplus lines premium taxes on multi-state risks.[13] So, in Florida's case, it appears that tax sharing would benefit the state. However, Florida does not control its own fate in this regard, because the home states for such risks must also enter into such a tax-sharing agreement in order for Florida to benefit.

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[9] *See* Ohio House Bill No. 122, available at: http://www.legislature.state.oh.us/bills.cfm?ID=129_HB_122. Ohio also requires the Superintendent to request that the General Assembly authorize the Superintendent to enter into a different tax sharing arrangement if it is found to be in Ohio's financial best interest. *See id.*

[10] *See* Indiana Senate Bill 579, available at: http://www.in.gov/legislative/bills/2011/SE/SE0578.1.html; Rhode Island House Bill 5110, available at: http://www.rilin.state.ri.us/billtext11/housetext11/h5110aaa.pdf.

[11] FSLSO is a statutorily mandated, not-for-profit association of all Florida surplus lines agents.

[12] *See* Florida Senate Bill Analysis and Fiscal Impact Statement, Senate Bill 1816 (Mar. 28, 2011), available at: http://www.flsenate.gov/Session/Bill/2011/1816/Analyses/WGGDsIMdULVlJ8kjnT9JaPW47g4=%7C7/Public/Bills/1800-1899/1816/Analysis/2011s1816.pre.bft.PDF.

[13] *Id. See* Florida Office of Insurance Regulation, Press Release: Office Announces Multi-State Agreement to Implement Dodd-Frank Wall Street Reform and Streamline Surplus Lines Reporting (June 16, 2011), available at: http://www.floir.com/PressReleases/viewmediarelease.aspx?ID=3902.

Status of the States

Based on the "Surplus Lines Insurance Premiums by State" data set forth in Appendix A of SLIMPACT,[14] the top-ten surplus lines premium states appear to be:

• California^	• New Jersey^
• Florida*	• New York^
• Georgia^	• Pennsylvania^
• Illinois^	• Texas^
• Louisiana*	• Washington^

*Signed NIMA
^Has not joined NIMA or SLIMPACT

As reflected above, eight of the top ten surplus lines premium states have yet to join a tax sharing agreement or compact with one or more other states. In 2005, these states comprised approximately 52.5% of the nation's non-admitted premiums.[15] **Assuming these states still comprise 50% or more of the nation's non-admitted premiums, query whether there can be any meaningful tax sharing if the other states join NIMA or SLIMPACT.**

So far, at least eleven states and one territory have joined NIMA. These states are: Alaska, Connecticut, Florida, Hawaii, Louisiana, Mississippi, Nebraska, Nevada, Puerto Rico, South Dakota, Utah, and Wyoming.[16] Based on Appendix A of SLIMPACT, these states (excluding Puerto Rico) comprised approximately 17% of the nation's non-admitted premiums in 2005.[17]

Meanwhile, at least nine states have joined SLIMPACT. These states are: Alabama, Indiana, Kansas Kentucky, North Dakota, New Mexico, Rhode Island, Tennessee, and Vermont.[18]

[14] This data is 2005 calendar year data excerpted from a study dated February 27, 2007 by Mackin & Company. *See* Appendix A of SLIMPACT.

[15] Based on the 2005 data contained in Appendix A of SLIMPACT, the percentage of total surplus line insurance premiums for the following states were: California (18.49%), Georgia (2.95%), Illinois (3.34%), New Jersey (3.58%), New York (9.11%), Pennsylvania (2.57%), Texas (10.06%), and Washington (2.43%).

[16] *See* NIMA's website, available at: http://www.floir.com/Sections/PandC/NIMA.aspx.

[17] According to NIMA's website, states that have joined NIMA currently represent 22% of the surplus lines marketplace based on 2009 data.

[18] *See* Council of State Governments website, available at: http://www.csg.org/programs/policyprograms/NCIC/SLIMPACT.aspx.

Based on Appendix A of SLIMPACT, these states comprised approximately 6% of the nation's non-admitted premiums in 2005.

Outlook for States

Based on the state breakdown of non-admitted premiums above, with only roughly a quarter of such premiums to be shared among states, we are likely to see a significant shift in where surplus lines premium tax is distributed among the states. Almost certainly under the present situation there will be winners and losers so long as the states with the largest share of non-admitted premiums choose not to participate in a tax sharing arrangement. At this point, we will have to wait and see how this redistribution will play out and who will be on the winning and who will find themselves on the losing side. Of course this assumes Congress will not intervene in the interim, which is another topic for discussion.[19]

Will NIMA and SLIMPACT Merge?

As this article was being finalized, it was reported in the trade press that at a hearing of the Subcommittee on Insurance, Housing and Community Opportunity of the House Financial Services Committee, representatives of the NAIC and NCOIL stated that they were working on merging NIMA and SLIMPACT. It of course remains to be seen whether such efforts will be successful, and if so, what form the merged entity will take. If the merged entity encompasses only the states currently signed on to NIMA and SLIMPACT, the resulting entity still would account for less than 25% of the nation's non-admitted premiums in 2005. The effectiveness of a tax-sharing agreement encompassing even that share of the non-admitted premiums would be open to question.

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This article does not constitute legal or other professional advice or service by JORDEN BURT LLP and/or its attorneys.

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[19] Given the current implementation landscape of the NRRA, lawmakers have raised concern about whether or not Congress will intervene in surplus lines regulation. *See* July 1, 2011 Letter from NCOIL to SLIMPACT Commission Representatives Re: Surplus Lines Insurance Multi-State Compliance Compact (SLIMPACT) Allocation Formula Methodology, available at: http://www.napslo.org/imispublic/pdf/legreg/NCOILCompact7111.pdf.