

FAQs Surplus Lines Insurance Multi-State Compliance Compact

1. Why is the surplus lines interstate compact needed?

Surplus lines brokers have faced multi-state tax problems for years, and in recent years the multi-state compliance problems have become progressively worse. The compliance problems were exacerbated by the passage of Gramm Leach Bliley which compelled the states to license non-resident surplus lines brokers. The non-resident surplus lines licenses resulted in some states expecting compliance in every state where any portion of the risk exposures were located. Obviously it is impractical, for example, to conduct a diligent search in numerous states, file affidavits in numerous states, and maintain bank accounts and placement records in numerous states. With respect to taxes, the state laws are sometimes conflicting in that some states claim 100% of the surplus lines tax is due if they are considered to be the “home state.” Obviously there is nothing left to allocate to the other states that require an allocated share. The tax allocation laws are also inconsistent and the broker is left making a judgment call how to allocate the taxes. For example the nature of the risk makes it difficult to allocate the taxes. A few of the types of risks presenting allocation problems include D&O, surety, umbrella policies, and products and completed operations.

2. How would the compact solve the multi-state tax and compliance problems facing the surplus lines industry?

The compact would require single state compliance in the home state for surplus lines placements and mandate a uniform tax allocation formula for all compacting states. The compact commission could also adopt uniform surplus lines compliance standards if 2/3 of the compact commissioners approve them. The states have the option of “opting out” of the uniform compliance standards.

3. Why are the compliance laws so confusing when applied to a multi-state risk?

The laws were written at a time when the broker had a license only from his or her state of residence so the laws assumed that compliance in the state of residence would occur. It was not necessary to specify single-state compliance or identify a home state because the broker had only one license from his or her state of residency. Because the laws failed to explicitly mandate single state compliance, the states could interpret the laws to require multi-state compliance, even though such laws had never been construed previously to require multi-state compliance. After multi-state licenses became available, the laws that were written with the understanding that single-state compliance was acceptable (but failed to explicitly mandate single-state compliance) now for the first time were construed to require multi-state compliance.

4. Why are the tax allocation laws so confusing when applied to a multi-state risk?

Even among the states that require allocation of premium taxes, the laws are not consistent and frequently the language is overly simplistic in mandating an allocation of taxes based on the portion of the risk exposures located in the state. Unfortunately, the state laws fail to specify precisely how the tax was to be allocated. As a result, allocating the tax based on the portion of risk exposures in each state is easier said than done. Risk exposures in each state cannot be easily calculated for most multi-state casualty or surety policies. The method of allocation could include, among others, revenue, payroll, square feet, number of employees and receipts, but there is little guidance regarding which methodology to use. Worse, package policies, umbrella policies and others may require more than one allocation methodology for each policy.

5. How does the compact solve the multi-state tax problem?

Each state would continue to use its own tax rate and collect its own taxes, but the compact mandates a uniform tax allocation formula to be used by all compacting states. The formula is to be adopted by the compact commission. The compact also mandates that each state use one or more of the uniform tax payment dates, and a single composite tax rate for each state. The broker would no longer have to try to figure out what municipal taxes, fire district charges, and other assessments apply because the various taxes and assessments would be built in to the state's composite tax rate. It would be easy to calculate the tax amount, determine where the tax forms should be filed, and how the tax should be allocated.

6. How does the compact solve the multi-state compliance problem?

The compact mandates single-state compliance with the laws of the home state of the insured. For example, the broker would comply exclusively with the home state laws of the insured regarding diligent searches, affidavits, policyholder notices, producer licensing, bank accounts, bond requirements, and record keeping. The compact commission can adopt uniform compliance standards if they are approved by two-thirds of the compacting states. The states can opt out of the uniform compliance standards adopted by the commission.

7. If the compact is enacted, will the tax revenues of the states decline?

It is unlikely that tax revenues of any state would decline because the tax rates of the states would remain the same. Most observers think the tax revenues will increase. A uniform allocation formula used by all states would make the tax payment much simpler. In addition, because the compact would apply a uniform definition of surplus lines insurance, it would eliminate the situation where the insured deems the placement to be surplus lines insurance in the home state and

independently procured (IP) insurance in the other states. The compact closes the loophole caused by the independent procurement laws and the Todd Shipyards decision because the entire transaction would be taxed as surplus lines. Without the compact there could be insureds that are not paying the out-of-state portions of the IP tax because there is a credible legal defense to payment based on the Todd Shipyards case.

8. Would the compact clearinghouse help calculate the tax due on surplus lines placements?

Ideally, the compact clearinghouse would develop software to calculate the tax due on each placement and the data would be stored in an electronic clearinghouse. The clearinghouse would allow transparency into the surplus lines (and IP) tax system that was not possible without the compact. The clearinghouse could make it easier for the broker to calculate the tax and remit tax payments. The transparency resulting from the implementation of a clearinghouse could result in increased tax revenues.

9. Is this compact required by the Non admitted and Reinsurance Reform Act (NRRA)?

No. Although the language of the NRRA encourages the states to enter into a compact for allocation of taxes, Congress did not compel the states to do so. With a few exceptions, the states also expect the taxes to be allocated. The compact is an obvious mechanism to deliver a fair and uniform tax allocation system.

10. How does the compact determine which state will regulate a multi-state surplus lines placement?

The compact provides that the home state of the insured will exclusively regulate a multi-state surplus lines placement. The definition of home state in the compact is the state that satisfies at least two of the following criteria:

1. The state where negotiations by the insured took place.
2. The state where the policy was delivered to the insured.
3. The state where the principal office of the insured is located.

If no state meets two of the criteria then the home state is the state where the largest portion of the insured risk is located based on the premium tax allocation formula.

11. Will the compact make it easier for a broker to determine which surplus lines carriers are approved in which states?

The compact commission would be responsible for adopting uniform compliance standards. It is possible that the process of checking eligibility list could be streamlined in a couple of different ways. One is the compact could adopt uniform standards for company eligibility. The other is that the compact commission could create an electronic web based system to check company eligibility lists in all compacting states.

12. Does the compact alleviate the tax-reconciliation burden imposed on surplus lines companies?

The compact clearinghouse should make it obvious what tax was collected in connection with a placement and how the tax was allocated. The compact clearinghouse should be gathering data regarding both surplus lines and independently procured insurance. There should be no reason for a compacting state to require additional data from a surplus lines company to reconcile the broker filings with company data.

Note that the compact draft does not presently require data for a single state risk. It is possible that the commission would adopt a rule requiring data for a single state risk in the future. If the clearinghouse contained data for single state risks there should be enhanced transparency and the need to gather data from a surplus lines insurer should be minimized.

13. Are there limitations on the regulatory compliance rules that can be adopted by the compact commission?

Yes. First, it takes a 2/3 vote of the compact commissioners to adopt a standard. Second a state can opt out of standards adopted by the commission. Third, the compact draft authorizes the compact commission to adopt compliance standards only with respect to the following issues:

- a. Surplus lines and independently procured insurance filings.
- b. Surplus lines banking, bond and record keeping obligations.
- c. Surplus lines diligent search requirements and exceptions.
- d. Surplus lines policyholder notices.
- e. Surplus lines insurer eligibility.

14. Is the compact separate from the Non admitted and Reinsurance Reform Act of 2007 (NRRA) or does the compact work in conjunction with the NRRA?

A surplus lines multi-state compliance compact could be drafted in a couple of different ways. One is a compact that provides a complete solution, including a solution to the same problems that would be addressed by the NRRA. The other is a compact that works in conjunction with the NRRA by regulating matters not otherwise within the scope of the NRRA. For example a compact designed for the limited purpose of allocating taxes would work in conjunction with the NRRA because the NRRA has no tax allocation provisions. The current draft compact was created as a complete solution for a number of reasons including the compact project was initiated prior to the introduction of the NRRA. If a compact (complete solution) was passed by the states and the NRRA was passed by the federal government, then the provisions of the NRRA would preempt any inconsistent provisions of the interstate compact.

14. How is the compact governed?

The compact is governed by compact commissioners. Each compacting state may select one compact commissioner. The compact commissioners are required to adopt mandatory rules regarding a tax allocation formula, data reporting requirements, single state regulatory compliance rules, and a method for the compact to report to the surplus lines licensees and compacting states all taxes owed to each state. The commission shall also have authority to adopt optional uniform compliance rules. A compact management committee shall be established which shall include 6 members from the largest surplus lines states, 5 members from states with at least 2% of the market and 4 members from state with less than 2% of the market. The management committee may appoint an executive director.

15. How would the stamping offices be affected if the states adopt an interstate compact?

It is anticipated the stamping offices would continue to perform essentially the same function they do today. The stamping offices would have the ability to report data into the clearinghouse for risks in their respective states. It may be necessary for the stamping offices to develop software that interfaces with the clearinghouse.