

## FREQUENTLY ASKED QUESTIONS ABOUT THE IMPLEMENTATION OF THE SURPLUS LINES PART PROVISIONS IN THE NONADMITTED AND REINSURANCE REFORM ACT

### 1. What will the NRRA mean for surplus lines regulation?

The Nonadmitted and Reinsurance Reform Act (NRRA) finally is expected to become law after more than 4 years of being bounced around as a bill in Congress. The nonadmitted and reinsurance reform act ushers in a new era of surplus lines regulation by implementing a home-state tax and compliance system. The NRRA closes the chapter on multi-state tax allocation problems that have plagued brokers since the mid 1980's. The problems with multi-state compliance and multi-state licensing for the placement of a single policy will also become a thing of the past. Below are frequently asked questions that have been raised in connection with the upcoming implementation of the NRRA reforms and NAPSLO's comments about the FAQ's.

### 2. What reforms in the NRRA impact surplus lines insurance?

The most significant provisions implement single-state tax collection by the insured's home state, single-state placement regulation by the insured's home state and require only one license from the insured's home state for a multi-state surplus lines placement. The specific NRRA reform provisions are as follows:

(a) Home State's Exclusive Authority—No State other than the home State of an insured may require any premium tax payment for nonadmitted insurance.

a) Home State Authority—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.

(b) Broker Licensing—No State other than an insured's home State may require a surplus lines broker to be licensed in order to sell, solicit, or negotiate nonadmitted insurance with respect to such insured.

### 3. What insurance is impacted by the NRRA?

The NRRA implements reforms for surplus lines insurance, independently procured insurance and reinsurance. This paper will only discuss surplus lines insurance. The surplus lines provisions of the NRRA apply to "non admitted insurance" which means insurance transacted with a nonadmitted insurer by a surplus lines broker. The specific definitions are as follows:

(9) Nonadmitted Insurance—The term "nonadmitted insurance" means 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.

(11) Nonadmitted Insurer—The term "nonadmitted insurer" means, with respect to a State, an insurer not licensed to engage in the business of insurance in such State.

(14) Surplus Lines Broker—The term "surplus lines broker" means an individual, firm, or corporation which is licensed in a State to sell, solicit, or negotiate insurance on properties, risks, or exposures located or to be performed in a State with nonadmitted insurers.

(15) STATE—The term "State" includes any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, Guam, the Northern Mariana Islands, the Virgin Islands, and American Samoa.

### 4. When do surplus lines provisions become effective?

Section 2 of the NRRA specifically provides that "except as otherwise specifically provided in this Act, this Act shall take effect upon the expiration of the 12-month period beginning on the date of the

enactment of this Act.” The bill provides additional detail for the effective date of the interstate compact, or other tax allocation system, if one is adopted. If the states fail to implement a tax allocation system within 330 days after the adoption of the NRRRA, then a single-state taxation system will become effective on the effective date of the NRRRA. If the states implement a tax allocation system after the effective date of the NRRRA, the allocation system will become effective on the Jan 1, after the allocation system is adopted. The specific effective date for the implementation of the multi-state tax allocation system, if one is adopted, are as follows:

(2) EFFECTIVE DATE- Except as expressly otherwise provided in such compact or other procedures, any such compact or other procedures—

(A) If adopted on or before the expiration of the 330-day period that begins on the date of the enactment of this Act, shall apply to any premium taxes that, on or after such date of enactment, are required to be paid to any State that is subject to such compact or procedures; and

(B) If adopted after the expiration of such 330-day period, shall apply to any premium taxes that, on or after January 1 of the first calendar year that begins after the expiration of such 330-day period, are required to be paid to any State that is subject to such compact or procedures.

5. What will the NRRRA reforms mean for surplus lines brokers?

Surplus lines brokers will return to a single-state tax payment system that existed across the country until multi-state tax requirements started to appear in the mid 1980”s and multi-state compliance requirements were imposed following the adoption of Gramm, Leach, Bliley in the early 2000”s. The reforms are summarized as follows:

- a. Brokers will no longer have to comply with the tax provision of all states where portions of the risk reside. They will make a single tax payment to the home state of the insured.
- b. Brokers will also be required to comply with the placement laws of the insured’s home state exclusively. Other multi-state compliance obligations such as multi-state policyholder notices, diligent searches, export list searches, policy fee rules, exempt commercial purchaser rules and eligibility list searches for a single policy placement would no longer apply.
- c. A broker would need one producer’s license from the insured’s home state to write a multi-state risk.
- d. A national insurance producer registry will be implemented for surplus lines brokers so the licensing burden will be further alleviated.
- e. Insurance for exempt commercial purchasers would be streamlined by the adoption of a nationwide exemption from the state diligent search laws.
- f. Uniform tax forms and tax procedures are to be implemented.

6. What will NRRRA reforms mean for surplus lines insurance companies?

Surplus lines companies have a couple of significant benefits. First the companies get the advantage of a uniform eligibility provisions. The NRRRA provides that:

No state can 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 101(b) of this Act that include alternative nationwide uniform eligibility requirements;

Section 5A(2) requires that to be eligible in a state an insurers must be “authorized to write in its domiciliary jurisdiction.”

5c(2)(a) provides and insurer must qualify under one of the following subparagraphs:

a) has capital and surplus or its equivalent under the laws of its domiciliary jurisdiction which equals the greater of:

i)

- a. The minimum capital and surplus requirements under the law of this state; or
- b. \$15,000,000

ii) The requirements of subparagraph (a)(i) may be satisfied by an insurers possessing less than the minimum capital and surplus upon an affirmative finding of acceptability by the commissioner. The finding shall be based upon such factors as quality of management, capital and surplus of any parent company, company underwriting profit and investment income trends, market availability and company record and reputation within the industry, in no event shall the commissioner make an affirmative finding of acceptability when the nonadmitted insurer's capital and surplus is less than \$4,500,000.

The NRRA definition of the nonadmitted model act is as follows: the Non-Admitted Insurance Model Act, as adopted by the NAIC on August 3, 1994, and amended on September 30, 1996, December 6, 1997, October 2, 1999, and June 8, 2002.”

The rules would allow the domiciliary state to set a ceiling for capital and surplus under paragraph a. There is a floor under paragraph b of \$15,000,000. The floor can be lowered to as little as \$4,500,000 if there is a finding by the Commissioner that it is acceptable. Non-domiciliary States cannot impose eligibility requirements except in conformance with these provisions.

The international insurers also benefit in that no state can “prohibit a surplus lines broker from placing nonadmitted insurance with, or procuring nonadmitted insurance from, a nonadmitted insurer domiciled outside the United States that is listed on the Quarterly Listing of Alien Insurers maintained by the International Insurers Department of the NAIC.”

There is a significant benefit for international insurers in that once the NAIC approves the international insurer it is approved in all states. This is a significant improvement over the existing process.

The tax audits and data reporting obligations for surplus lines insurers should also be reduced. If the broker is no longer allocating the tax to all states where there is an exposure, there is less of a need to audit the companies. In the area of casualty insurance, the audits were particularly burdensome because the allocation rules ranged from non-existent to impossibly complex.

7. What will NRRA mean for exempt commercial purchasers of surplus lines insurance?

The uniform nationwide definition of exempt commercial purchaser in the NRRA is a significant improvement over the existing process. Many states expected the broker to verify that the insured qualifies as an exempt commercial purchaser for every state where any portion of the risk resided. If the insured did not qualify in some of the exposure states, the broker would need to complete a diligent search to access the surplus lines market for the portion of the exposures in those particular states. This confusing regulatory environment caused significant problems for the surplus lines brokers with multi-state risks that qualified as exempt commercial purchasers in a portion of the exposure states. The nationwide uniform definition should eliminate the problems caused by conflicting or non-existent definitions of exempt commercial purchasers with multi-state exposures.

Section 105 of the NRRA provides as follows:

A surplus lines broker seeking to procure or place nonadmitted insurance in a State for an exempt commercial purchaser shall not be required to satisfy any State requirement to make a

due diligence search to determine whether the full amount or type of insurance sought by such exempt commercial purchaser can be obtained from admitted insurers if—

- (1) The broker procuring or placing the surplus lines insurance has disclosed to the exempt commercial purchaser that such insurance may or may not be available from the admitted market that may provide greater protection with more regulatory oversight; and
- (2) The exempt commercial purchaser has subsequently requested in writing the broker to procure or place such insurance from a nonadmitted insurer.

8. What is the NRRA's definition of an exempt commercial purchaser?

The term "exempt commercial purchaser" means any person purchasing commercial insurance that, at the time of placement, meets the following requirements:

- (A) The person employs or retains a qualified risk manager to negotiate insurance coverage.
- (B) The person has paid aggregate nationwide commercial property and casualty insurance premiums in excess of \$100,000 in the immediately preceding 12 months.
- (C)(i) The person meets at least one of the following criteria:

- (I) The person possesses a net worth in excess of \$20,000,000, as such amount is adjusted pursuant to Clause (ii).
- (II) The person generates annual revenues in excess of \$50,000,000, as such amount is adjusted pursuant to Clause (ii).
- (III) The person employs more than 500 full time or full time equivalent employees per individual insured or is a member of an affiliated group employing more than 1,000 employees in the aggregate.
- (IV) The person is a not-for-profit organization or public entity generating annual budgeted expenditures of at least \$30,000,000, as such amount is adjusted pursuant to Clause (ii).
- (V) The person is a municipality with a population in excess of 50,000 persons.

(ii) Effective on the fifth January 1 occurring after the date of the enactment of this Act and each fifth January 1 occurring thereafter, the amounts in subclauses (I), (II), and (IV) of clause (i) shall be adjusted to reflect the percentage change for such five-year period in the Consumer Price Index for All Urban Consumers published by the Bureau of Labor Statistics of the Department of Labor.

9. What is the NRRA's definition of a qualified risk manager?

The term "qualified risk manager" means, with respect to a policyholder of commercial insurance, a person who meets all of the following requirements:

- (A) The person is an employee of, or third party consultant retained by, the commercial policyholder.
- (B) The person provides skilled services in loss prevention, loss reduction, or risk and insurance coverage analysis, and purchase of insurance.
- (C) The person—

(i)(I) Has a bachelor's degree or higher from an accredited college or university in risk management, business administration, finance, economics, or any other field determined by a State insurance commissioner or other State regulatory official or entity to demonstrate minimum competence in risk management; and

(II)(aa) Has three years of experience in risk financing, claims administration, loss prevention, risk and insurance analysis, or purchasing commercial lines of insurance; or

(bb) Has one of the following designations:

- (AA) A designation as a Chartered Property and Casualty Underwriter (in this subparagraph referred to as "CPCU") issued by the American Institute for CPCU/Insurance Institute of America;
- (BB) A designation as an Associate in Risk Management (ARM) issued by the American Institute for CPCU/Insurance Institute of America;
- (CC) A designation as Certified Risk Manager (CRM) issued by the National Alliance for Insurance Education & Research;
- (DD) A designation as a RIMS Fellow (RF) issued by the Global Risk Management Institute; or
- (EE) Any other designation, certification, or license determined by a State insurance commissioner or other State insurance regulatory official or entity to demonstrate minimum competency in risk management;

(ii)(I) has at least seven years of experience in risk financing, claims administration, loss prevention, risk and insurance coverage analysis, or purchasing commercial lines of insurance; and (II) has any one of the designations specified in subitems (AA) through (EE) of clause (i)(II)(bb);

(iii) has at least 10 years of experience in risk financing, claims administration, loss prevention, risk and insurance coverage analysis, or purchasing commercial lines of insurance; or

(iv) has a graduate degree from an accredited college or university in risk management, business administration, finance, economics, or any other field determined by a State insurance commissioner or other State regulatory official or entity to demonstrate minimum competence in risk management.

Could a state come up with a stricter or more lenient definition of exempt commercial purchaser for single state risks? If the state is dealing with the same issue, it does not appear as though the language allows the states have discretion to change the requirements. The NRRRA appears to provide a nationwide system without exceptions. If a state statute was dealing with a different type of diligent search exemption, then it is possible that a state's requirements would not be considered to be preempted.

#### 10. What will NRRRA change for regulators and legislators?

Legislators have a high level decision to make. They can opt for a tax allocation procedure consistent with the Congressional statement of intent, such as a compact, or they can allow the single state tax system to become effective on the effective date of the NRRRA. This is a significant policy decision that needs to be made by the legislators. NCOIL has endorsed the interstate compact as a solution for the allocation of a multi-state tax system, but the endorsement is only a first step. To implement a multi-state tax allocation system would require a change of the laws of many states. The majority of state statutes tax only the in-state exposures so there would be no tax to allocate to the other states.

NAPSLO also believes that the NRRRA requires a uniform taxation system regardless of whether an allocation system is implemented. In many states this will require a change of the laws. For example, the laws would need to be amended to create uniform requirements, forms and procedures for the reporting, payment and collection of tax semi-annually.

Below is a summary of the changes that would need to be implemented by the states to comply with the NRRRA.

**a) States would need to add surplus lines brokers to the NIPR system if they have not already done so. Section 103 requires the state to include surplus lines brokers within the NIPR. This is something that can be done without legislation since NIPR is already in use for admitted agents. Several states have added surplus lines brokers to the NIPR system already. Below is the NIPR requirement from the NRRRA:**

## SEC. 103. PARTICIPATION IN NATIONAL PRODUCER DATABASE.

After the expiration of the 2-year period beginning on the date of the enactment of this Act, a State may not collect any fees relating to licensing of an individual or entity as a surplus lines broker in the State unless the State has in effect at such time laws or regulations that provide for participation by the State in the national insurance producer database of the NAIC, or any other equivalent uniform national database, for the licensure of surplus lines brokers and the renewal of such licenses.

**b) States would need to validate compliance with the insurer eligibility standards. A domiciliary State would either need to make sure they require the minimum capital and surplus or that there has been a finding by the Commissioner that a lesser amount of capital and surplus is acceptable, but it must be at least \$4,500,000. Non-domiciliary states may need to revise their eligibility criteria. The states must also recognize the decision by the NAIC International Insurers Department regarding the eligibility of international insurer is binding upon the state. Many states have already established laws that grant international insurers eligibility if they have been approved by the NAIC's international insurers department. The specific provisions are below:**

## SEC. 104. UNIFORM STANDARDS FOR SURPLUS LINES ELIGIBILITY.

A State may not—

- (1) 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 Nonadmitted Insurance Model Act, unless the State has adopted nationwide uniform requirements, forms, and procedures developed in accordance with section 101(b) of this Act that include alternative nationwide uniform eligibility requirements; and
- (2) prohibit a surplus lines broker from placing nonadmitted insurance with, or procuring nonadmitted insurance from, a nonadmitted insurer domiciled outside the United States that is listed on the Quarterly Listing of Alien Insurers maintained by the International Insurers Department of the NAIC.

The Nonadmitted Model act Section 5A(2) provides that to be eligible each insurer must be “authorized to write in its domiciliary jurisdiction.”

5c(2)(a) provides that an insurer must qualify under one of the following subparagraphs:

b) has capital and surplus or its equivalent under the laws of its domiciliary jurisdiction which equals the greater of:

- a. the minimum capital and surplus requirements under the law of this state; or
- b. \$15,000,000

b) the requirements of subparagraph (a)(i) may be satisfied by an insurers possessing less than the minimum capital and surplus upon an affirmative finding of acceptability by the commissioner. The finding shall be based upon such factors as quality of management, capital and surplus of any parent company, company underwriting profit and investment income trends, market availability and company record and reputation within the industry, in no event shall the commissioner make an affirmative finding of acceptability when the nonadmitted insurer's capital and surplus is less than \$4,500,000.

The definition of the nonadmitted model act is as follows: the Non-Admitted Insurance Model Act, as adopted by the NAIC on August 3, 1994, and amended on September 30, 1996, December 6, 1997, October 2, 1999, and June 8, 2002.”

A state could apparently set a ceiling for capital and surplus under paragraph (a) for its domestic insurers. There is a floor under (b) of \$15,000,000. The floor can be lowered to as little as \$4,500,000 but that it requires a finding by the Commissioner.

The international insurers also benefit in that no state can “prohibit a surplus lines broker from placing nonadmitted insurance with, or procuring nonadmitted insurance from, a nonadmitted insurer domiciled outside the United States that is listed on the Quarterly Listing of Alien Insurers maintained by the International Insurers Department of the NAIC.”

**c) States would need to adopt an exception to the diligent search rules for exempt commercial purchasers consistent with the exceptions in the NRRRA. The states would also need to adopt the definition of exempt commercial purchaser and qualified risk manager. States may also want to come up with a policyholder notice to meet the NRRRA requirements for exempt commercial purchasers. The NRRRA provisions are below.**

#### **SEC. 105. STREAMLINED APPLICATION FOR COMMERCIAL PURCHASERS.**

A surplus lines broker seeking to procure or place nonadmitted insurance in a State for an exempt commercial purchaser shall not be required to satisfy any State requirement to make a due diligence search to determine whether the full amount or type of insurance sought by such exempt commercial purchaser can be obtained from admitted insurers if—

- (1) the broker procuring or placing the surplus lines insurance has disclosed to the exempt commercial purchaser that such insurance may or may not be available from the admitted market that may provide greater protection with more regulatory oversight; and
- (2) the exempt commercial purchaser has subsequently requested in writing the broker to procure or place such insurance from a nonadmitted insurer.

The definitions of exempt commercial purchaser and qualified risk manager are as follows:

(5) EXEMPT COMMERCIAL PURCHASER- The term “exempt commercial purchaser” means any person purchasing commercial insurance that, at the time of placement, meets the following requirements:

- (A) The person employs or retains a qualified risk manager to negotiate insurance coverage.
- (B) The person has paid aggregate nationwide commercial property and casualty insurance premiums in excess of \$100,000 in the immediately preceding 12 months.
- (C)(i) The person meets at least one of the following criteria:
  - (I) The person possesses a net worth in excess of \$20,000,000, as such amount is adjusted pursuant to clause (ii).
  - (II) The person generates annual revenues in excess of \$50,000,000, as such amount is adjusted pursuant to clause (ii).
  - (III) The person employs more than 500 full time or full time equivalent employees per individual insured or is a member of an affiliated group employing more than 1,000 employees in the aggregate.
  - (IV) The person is a not-for-profit organization or public entity generating annual budgeted expenditures of at least \$30,000,000, as such amount is adjusted pursuant to clause (ii).
  - (V) The person is a municipality with a population in excess of 50,000 persons.

(ii) Effective on the fifth January 1 occurring after the date of the enactment of this Act and each fifth January 1 occurring thereafter, the amounts in subclauses

(I), (II), and (IV) of clause (i) shall be adjusted to reflect the percentage change for such five-year period in the Consumer Price Index for All Urban Consumers published by the Bureau of Labor Statistics of the Department of Labor.

(12) QUALIFIED RISK MANAGER- The term “qualified risk manager” means, with respect to a policyholder of commercial insurance, a person who meets all of the following requirements:

- (A) The person is an employee of, or third party consultant retained by, the commercial policyholder.
- (B) The person provides skilled services in loss prevention, loss reduction, or risk and insurance coverage analysis, and purchase of insurance.
- (C) The person—

- (i)(I) has a bachelor’s degree or higher from an accredited college or university in risk management, business administration, finance, economics, or any other field determined by a State insurance commissioner or other State regulatory official or entity to demonstrate minimum competence in risk management; and

- (II)(aa) has three years of experience in risk financing, claims administration, loss prevention, risk and insurance analysis, or purchasing commercial lines of insurance; or

- (bb) has one of the following designations:

- (AA) a designation as a Chartered Property and Casualty Underwriter (in this subparagraph referred to as “CPCU”) issued by the American Institute for CPCU/Insurance Institute of America;

- (BB) a designation as an Associate in Risk Management (ARM) issued by the American Institute for CPCU/Insurance Institute of America;

- (CC) a designation as Certified Risk Manager (CRM) issued by the National Alliance for Insurance Education & Research;

- (DD) a designation as a RIMS Fellow (RF) issued by the Global Risk Management Institute; or

- (EE) any other designation, certification, or license determined by a State insurance commissioner or other State insurance regulatory official or entity to demonstrate minimum competency in risk management;

- (ii)(I) has at least seven years of experience in risk financing, claims administration, loss prevention, risk and insurance coverage analysis, or purchasing commercial lines of insurance; and

- (II) has any one of the designations specified in subitems (AA) through (EE) of clause (i)(II)(bb);

- (iii) has at least 10 years of experience in risk financing, claims administration, loss prevention, risk and insurance coverage analysis, or purchasing commercial lines of insurance; or

- (iv) has a graduate degree from an accredited college or university in risk management, business administration, finance, economics, or any other field determined by a State insurance commissioner or other State regulatory official or entity to demonstrate minimum competence in risk management.

**d) A state would need to verify that its laws are consistent with the home-state regulation requirements of the NRRA. Many state laws will not need to be modified to implement a single-state compliance system because the state laws were originally written to authorize single state placement compliance, and to require broker licensing only in the home state of the insured. State laws would need to be modified to implement the modification of home state rules “if 100% of the insured risk is located out of the state.” The rule for affiliated groups is also new and would need to be added to state codes. The definitions of “affiliated group,” “affiliate” “home state” and “control” should be added to the surplus lines codes. Below is the language from the NRRA.**

## **SEC. 102. REGULATION OF NONADMITTED INSURANCE BY INSURED’S HOME STATE.**

(a) Home State Authority—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.

(b) Broker Licensing- No State other than an insured’s home State may require a surplus lines broker to be licensed in order to sell, solicit, or negotiate nonadmitted insurance with respect to such insured.

### **(6) HOME STATE-**

(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 subparagraph (A), the State to which the greatest percentage of the insured’s taxable premium for that insurance contract is allocated.

(B) AFFILIATED GROUPS—If more than one 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.

(2) AFFILIATE—The term “affiliate” means, with respect to an insured, any entity that controls, is controlled by, or is under common control with the insured.

(3) AFFILIATED GROUP—The term “affiliated group” means any group of entities that are all affiliated.

(4) CONTROL—An entity has “control” over another entity if—

(A) the entity directly or indirectly or acting through one 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.

**e) States would need to create uniform tax forms, uniform requirements and uniform procedures for the collection of surplus lines tax to comply with the NRRA. The NRRA contains an expression of congressional intent to require “nationwide uniform requirements, forms and procedures” for the reporting payment and collection of premium tax. A state would need to adopt uniform requirements, uniform forms and payment dates would be needed, but states could implement whatever tax rates and assessments that currently exist under the home state law.**

**States would need to create a uniform “tax allocation report” to facilitate allocation of the tax, if the states elect to adopt an allocation mechanism. State tax allocation laws and allocation regulations would need to be repealed or modified because they are not consistent from state to state. To comply with the NRRRA the tax allocation system must be uniform and must be based upon a system where the tax is remitted to the home state of the insured. To the extent that allocation laws exist today, they are not uniform, not based upon a home state system, and are therefore not compliant with NRRRA requirements.**

**To comply with the congressional statement of intent, the states would also need to implement an interstate compact or other procedure for the allocation of surplus lines tax. A draft compact was created by a group of industry volunteers. The NAIC’s Surplus Lines Task Force is currently studying an interstate compact for the allocation of surplus lines tax. If the interstate compact is adopted the compact commission would adopt a uniform allocation formula. The pertinent provisions are below.**

#### **SEC. 101. REPORTING, PAYMENT, AND ALLOCATION OF PREMIUM TAXES.**

(a) Home State’s Exclusive Authority- No State other than the home State of an insured may require any premium tax payment for nonadmitted insurance.

(b) Allocation of Nonadmitted Premium Taxes—

(1) IN GENERAL—The States may enter into a compact or otherwise establish procedures to allocate among the States the premium taxes paid to an insured’s home State described in subsection (a). . .

(4) NATIONWIDE SYSTEM—The Congress intends that each State adopt nationwide uniform requirements, forms, and procedures, such as an interstate compact, that provides for the reporting, payment, collection, and allocation of premium taxes for nonadmitted insurance consistent with this section.

(c) Allocation Based on Tax Allocation Report—To facilitate the payment of premium taxes among the States, an insured’s home State may require surplus lines brokers and insureds who have independently procured insurance to annually file tax allocation reports with the insured’s home State detailing the portion of the nonadmitted insurance policy premium or premiums attributable to properties, risks or exposures located in each State. The filing of a nonadmitted insurance tax allocation report and the payment of tax may be made by a person authorized by the insured to act as its agent.

(13) PREMIUM TAX- 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.

A draft bill incorporating the changes necessary for a state to comply with the NRRRA is attached.

11. Is there any way to know if the states are going to allocate taxes among the exposure states or implement a single-state tax system?

This is the biggest unanswered question following adoption of the NRRRA. The NRRRA contains an express statement of Congressional intent for the states to adopt an allocation system. Congress did not compel the states to implement an allocation system, but if the states fail to do so, a single state tax system will become the law one year after the adoption of the NRRRA.

12. How would the proposed interstate compact function as the mechanism to allocate taxes?

An interstate compact is contract between the states. It would create a compact commission with a representative from each state to set uniform tax allocation formulas, uniform payment dates, and uniform data elements for the remittance of surplus lines tax. It would also operate as a data clearinghouse for surplus lines risks. The idea was that the broker would input the risk characteristics into a web based system. The system would calculate the tax and store the data for submission to the states at the end of the accounting period. The states would be given a report showing the risks, the tax due, and the allocated portion to the state. A draft compact was created by a group of industry volunteers. The NAIC is presently studying the feasibility of a proposed compact.

13. Is there a procedure to allocate taxes without an interstate compact that would be enforceable?

It is not clear if there is anything other than a compact that would be able to legally facilitate the allocation of the tax following the NRRA adoption. There is at least one opinion that the tax must be remitted to the home state. Once the tax is collected by the home state, it is not clear if there is any way to allocate the tax to the other states, short of an interstate compact. Others have asked if the NRRA would allow a state to require that a tax payment must be remitted to the compact clearinghouse for processing and allocation. This may be a determination that needs to be made by the individual states, based upon an interpretation of state law. If state law permits a tax to be remitted to a compact clearinghouse this may be an option. If there is no prohibition in a particular state, it is possible that the compact could contractually provide clearinghouse services to non-member states. The scope of the services would need to be detailed in a contract between the state and the compact. Each state would need to determine if this is feasible for their particular state. If there is a way for states to participate without legislatively adopting the compact, at least some states would consider that option. The NRRA provides that:

“The States may enter into a compact or otherwise establish procedures to allocate among the States the premium taxes paid to an insured’s home State described in subsection (a).”

Although the NRRA is authorizing “other procedures” for tax allocation, the states can obviously only implement a system that is consistent with state law. It is not clear whether any system could allow the states to collect the tax and allocate it to the other exposure states except an interstate compact.

NRRA authorizes allocation of taxes “paid to the home state” so it appears clear that the existing tax system could not meet the requirements of the NRRA. On the effective date of the NRRA, the broker will no longer be required to allocate the tax to more than one state for a single policy placement.

The NRRA’s preemption provisions were clearly intended to bring about the end of the existing tax system. The preemption provisions in section 102 are as follows:

- c) Enforcement Provision- With respect to section 101 and subsections (a) and (b) of this section, any law, regulation, provision, or action of any State that applies or purports to apply to nonadmitted insurance sold to, solicited by, or negotiated with an insured whose home State is another State shall be preempted with respect to such application.

Section 101 contains the single-state tax remittance provisions. Section 102 (a) provides for single state statutory and regulatory compliance. Section 102 (b) provides for a single producer licensing requirement in the insured’s home state.

14. If the states elect to allow the single state tax system to be implemented, how will a single-state tax system work?

The broker would need to determine which state is the home state and then comply with the home state laws applicable to surplus lines tax. No longer would it be necessary for the broker to divide the taxes among the states where the exposure resides. Brokers would pay the assessments and fees required by the insured’s home state. Section 103 provides that congress intends that each state adopt nationwide uniform requirements, forms and procedures...that provides for the reporting payment, collection and

allocation of premium taxes for nonadmitted insurance.” The clear expression of congressional intent was to require a nationwide uniform system for remittance of the taxes.

15. What does the term “principal place of business” mean?

The NRRA defines home state to mean the principal place of business of the insured:

(6) HOME STATE—

(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

The term “principal place of business” was recently interpreted by the U.S. Supreme Court in *Hertz v. Friend* No. 08-1107 decided Feb 23, 2010. The Court concluded that the phrase “principal place of business” refers to the place where a corporation’s high level officers direct, control, and coordinate the corporation’s activities, i.e. its “nerve center” which will typically be found at its corporate headquarters. The court acknowledged no system was perfect but went on to explain “if the record reveals attempts at jurisdictional manipulation, for example, that the alleged nerve center is nothing more than a mail drop box, a bare office with a computer, or the location of an annual executive retreat- the courts should instead take as the “nerve center” the place of actual direction, control, and coordination, in the absence of such manipulation.” In the *Hertz* case, New Jersey was the location of the corporate headquarters and was therefore deemed to be the “principal place of business” notwithstanding the fact that *Hertz* generated more business activity in California than any other state.

Although the *Hertz* case was not interpreting the NRRA, it was interpreting the exact same phrase used in the NRRA – “principal place of business.” It is possible that a court interpreting the NRRA would not follow the *Hertz* decision, but it is unlikely because *Hertz* is a U.S. Supreme Court case interpreting the exact same phrase used in the NRRA. Texas adopted a statute that would change the definition of home state, but it is not likely to change this analysis because federal law preempts state law.

16. Does the principal place of business change if 100% of insured risk is outside of home state?

The NRRA alters the definition of “Home State” if 100% of the insured exposures were outside of the home state. The NRRA provides:

(ii) if 100 percent of the insured risk is located out of the State referred to in subparagraph (A), the State to which the greatest percentage of the insured’s taxable premium for that insurance contract is allocated.

If 100% of the insured risk is outside of the home state then the home state is deemed to be the state where the largest portion of the insured risks resides. If a corporate headquarters (nerve center) is in one state, but none of the insured risk is in that state then the home state becomes the state where the largest percentage of insured risk resides.

17. How does the NRRA deal with affiliated groups insured under one policy?

The NRRA sought to clarify the location of the home state when affiliated groups are insured under a single policy. Specifically, the insured entity with the largest percentage of the insured risk would be the company that would control the determination of home state. The NRRA provides:

(B) AFFILIATED GROUPS—If more than one 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.

(2) AFFILIATE—The term “affiliate” means, with respect to an insured, any entity that controls, is controlled by, or is under common control with the insured.

(3) AFFILIATED GROUP—The term “affiliated group” means any group of entities that are all affiliated.

(4) CONTROL—An entity has “control” over another entity if—

(A) the entity directly or indirectly or acting through one 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.

In other words, if there is more than one insured under a single policy, the insured with the largest percentage of premium under that policy becomes the controlling insured. After the broker identifies the controlling insured, the broker would go through the same analysis. First the broker would determine the nerve center for that company. Second, if there is any insured exposures in that state where the “nerve center” resides, then that becomes the home state. If 100% of the insured exposures are outside of the state where the nerve center resides, then you would look at the state with the largest amount of exposures for the insured that is deemed the controlling insured member of the affiliated group.

18. What does the term “principle residence” mean?

The NRRRA taxes an individual based upon the principal residence of the insured. It is possible that an individual would have more than one dwelling that is considered a “residence.” In such cases the broker would need to determine which is the “principal residence” of the insured. The NRRRA provides the following definition of home state:

(6) HOME STATE—

(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

Both the tax code and the bankruptcy code use the term “principal residence.” The question of which state is a principal residence has been litigated many times. It is likely any court trying to construe the term would look at the existing case law. Obviously, a person would have to have a “residence” in more than one state for there to be a question as to which was the “principal residence.” When the question has come up, courts have looked at things such as the dictionary definitions:

“The ordinary meaning of . . . “principle”, and “residence” are clear and well understood, but if dictionary definitions are helpful in recalling the common meanings (see \*386 Webster’s Unabridged Third New International Dictionary), . . . principal means “chief or main”; and residence means “the place where one actually lives or has his home.”

U.S. v. Sheahan, 323 F2d 383, C.A. GA 1963

Courts also have looked at items such as tax returns, voting records, driver’s licenses, physical occupancy and good faith of the party claiming “principal residence”. In general, courts have used an “all facts and circumstances” test to determine the principal residence of an individual.

19. Will there be disputes over which state is the home state?

Some states have been aggressive in collecting the surplus lines tax. It is possible that some states will continue to be aggressive, so there could be disputes over which state is the home state. Because the NRRA does not establish a federal regulator, there is the possibility that states will disagree over which is the home state. If there is an interstate compact there would be a compact commission that could help resolve these kinds of disputes. Given the fact that the term “principal residence” and “principal place of business” have been extensively construed by the courts the number of disputes should be relatively small.

20. What happens if the states don't do what Congress “intends” and fail to implement a system to allocate taxes?

The NRRA provides an express statement of congressional intent:

(4) NATIONWIDE SYSTEM—The Congress intends that each State adopt nationwide uniform requirements, forms, and procedures, such as an interstate compact, that provides for the reporting, payment, collection, and allocation of premium taxes for nonadmitted insurance consistent with this section.

If the states fail to implement nationwide uniform requirements, forms and procedures that provide for the reporting, payment and collection of premium tax, will there be additional Congressional action? Again, there is no federal regulator to implement this regulatory system. If a state is bringing an enforcement action against a broker or company that is contrary to the NRRA, the broker or company could resist it in court. The bill itself authorizes studies of the nonadmitted market which would likely address the issue if the states have not complied with the congressional intent to allocate taxes. It is also possible that a state or group of states would complain about the lack of an allocation system and begin pushing for additional congressional measures to enforce the intent. There is no express penalty for failing to comply with the congressional intent, but one obvious possible repercussion is additional Congressional action.

21. Is there a way to settle disputes over which state is the home state?

Section 102 contains an enforcement provision:

d) Enforcement Provision- With respect to section 101 and subsections (a) and (b) of this section, any law, regulation, provision, or action of any State that applies or purports to apply to nonadmitted insurance sold to, solicited by, or negotiated with an insured whose home State is another State shall be preempted with respect to such application.

Section 102 a) provides that the home-state regulations shall apply. Section 102 b) provides that one producer's license in the insureds home state is all that is required for a multi-state placement. Section 101 is the provision provides for taxation exclusively by the home state. There is an enforcement provision built in to the bill, but there are no other provisions that would settle disputes about the home state. Since there is no federal regulator created by the NRRA, the enforcement of the reforms will have to be by other means.

A broker can make a good faith evaluation of the insured's home state, but this does not mean that a state would not second guess the decision on which state is the home state. There is no federal regulator created by the NRRA so there is no mechanism in the NRRA to resolve these disputes, short of litigation. If an interstate compact were to be implemented, then there would be a compact commission that could help resolve disputes over the location of the insured's home state. If the compact were enacted or other allocation procedure were implemented, the taxes would be allocated so there would be less of a reason to second guess the determination made by the broker. The states would get their share of the money under the compact so there would be little reason to second guess the home state determination.

22. What is the purpose of the NAIC report to congress and GAO study?

The NRRRA authorizes two different reports. One from the NAIC and one from the GAO. The NAIC study is for the purpose of “identifying and describing any compact or other procedure for allocation among the states of premium taxes that have been adopted during such period by any states.” The NRRRA authorizes the NAIC report but does not require it. The NAIC report provisions are as follows:

(3) REPORT—Upon the expiration of the 330-day period referred to in paragraph (2), the NAIC may submit a report to the Committee on Financial Services and Committee on the Judiciary of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate identifying and describing any compact or other procedures for allocation among the States of premium taxes that have been adopted during such period by any States.

The second report, from the GAO, is mandatory and is “to determine the effect of the enactment of this title on the size and market share of the market.” It is also to study the differences in price and availability of coverages in both the admitted and nonadmitted markets. Finally, the report is also to study the extent to which there has been a change of individuals who have nonadmitted insurance policies. The NRRRA language on the GAO study is as follows:

#### **SEC. 106. GAO STUDY OF NONADMITTED INSURANCE MARKET.**

(a) In General—The Comptroller General of the United States shall conduct a study of the nonadmitted insurance market to determine the effect of the enactment of this title on the size and market share of the nonadmitted insurance market for providing coverage typically provided by the admitted insurance market.

(b) Contents- The study shall determine and analyze--

- (1) the change in the size and market share of the nonadmitted insurance market and in the number of insurance companies and insurance holding companies providing such business in the 18-month period that begins upon the effective date of this Act;
- (2) the extent to which insurance coverage typically provided by the admitted insurance market has shifted to the nonadmitted insurance market;
- (3) the consequences of any change in the size and market share of the nonadmitted insurance market, including differences in the price and availability of coverage available in both the admitted and nonadmitted insurance markets;
- (4) the extent to which insurance companies and insurance holding companies that provide both admitted and nonadmitted insurance have experienced shifts in the volume of business between admitted and nonadmitted insurance; and
- (5) the extent to which there has been a change in the number of individuals who have nonadmitted insurance policies, the type of coverage provided under such policies, and whether such coverage is available in the admitted insurance market.

(c) Consultation With NAIC—In conducting the study under this section, the Comptroller General shall consult with the NAIC.

(d) Report—The Comptroller General shall complete the study under this section and submit a report to the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate regarding the findings of the study not later than 30 months after the effective date of this Act.

23. Will the brokers have to file tax allocation reports even if the states fail to implement a tax allocation system?

The idea of the tax allocation report was to facilitate allocation of taxes. If the state requiring the report does not intend to allocate taxes, it is not clear why the report would be required. To require the broker to complete a burdensome allocation report, if the state is not going to allocate the taxes would be unnecessary. The specific language regarding the allocation is as follows:

(c) Allocation Based on Tax Allocation Report—To facilitate the payment of premium taxes among the States, an insured's home State may require surplus lines brokers and insureds who have independently procured insurance to annually file tax allocation reports with the insured's home State detailing the portion of the nonadmitted insurance policy premium or premiums attributable to properties, risks or exposures located in each State. The filing of a nonadmitted insurance tax allocation report and the payment of tax may be made by a person authorized by the insured to act as its agent.

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