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WHITE PAPER DISCUSSING **THE NONADMITTED AND REINSURANCE REFORM ACT OF 2010 AND** **ITS POTENTIAL APPLICATION TO CAPTIVE INSURANCE**

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The Nonadmitted and Reinsurance Reform Act (NRRA) was enacted in July 2010 as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act.¹ The NRRA provides that only an insured's "home state" may collect premium taxes on "nonadmitted insurance," and in that regard, restricts the ability of other states to directly collect premium taxes on nonadmitted insurance covering risk in their states. The NRRA encourages, but does not require, states to enter into an interstate agreement or compact that provides for the allocation of nonadmitted insurance premium taxes from the home state to other states based on a formula that considers the location of the property, risks and exposures covered. The NRRA also provides that only the insured's "home state" rules are applicable to the "placement of nonadmitted insurance," effectively preempting the placement rules of non-home states.

The NRRA primarily applies to the streamlined taxation and regulation of nonadmitted insurance and does not purport to grant the states any new authority to impose taxes. But its text and legislative history contain some ambiguities as to whether independently procured insurance and insurance transactions conducted beyond the jurisdiction of a state are included in the definition of nonadmitted insurance. This is problematic because constitutional due process protections are at risk where the NRRA appears to promote the distribution of tax proceeds, both to the home state and under an interstate compact, to states that do not have the proper jurisdiction to impose a tax.

Concerns have been raised in the captive community about whether the NRRA's taxation and regulation provisions affect captive insurance. These concerns raise two separate issues about the possible application of the NRRA to captive insurance. First, does the broad definition of nonadmitted insurance include insurance provided by captives, and if so, what would be the implications for captive insurers? Second, do the provisions related to independently procured insurance apply to insurance purchased from captive insurers and if so, how does the NRRA affect such independently procured insurance? This paper

¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203 (July 21, 2010).

explores these issues and the background for state taxation of captive insurance companies. It examines legislative history of the NRRA to expose its intent and analyzes the NRRA's practical impact on the existing state taxation and regulation of captive insurance.

I. BACKGROUND

A. State Authority to Tax and Regulate the Business of Insurance

Regulation of the business of insurance has been reserved for the states for over a century. However, the ability of states to tax and regulate insurance is *limited* by constitutional restrictions.

Due Process

The power of states to regulate and tax transactions of insurance that take place *within* their borders is generally accepted. Recognizing the “vital distinction between acts done within and acts done beyond a State’s jurisdiction,” the Supreme Court recognized as far back as 1897 that a state could not impinge on a citizen’s Fourteenth Amendment Due Process right to purchase insurance outside its confines, even if that insurance covered property within the state.²

Questions about the ability of states to tax insurance premiums continued over time and the Supreme Court solidified what is now a clear limitation on a state’s ability to tax: “As a matter of convenience and certainty, and to secure a practically just operation of the constitutional prohibition, we look to the state power to control the objects of the tax as marking the boundaries of the power to lay it.”³ It follows that where an insurance company carries out insurance transactions within a state, the insurance may be taxed. And the inverse holds true: “The due process clause denies the state power to tax or regulate the corporation’s property and activities elsewhere.”⁴

The inquiry of *when* a state may properly impose taxes on insurance looks to the “objects of the tax:” the business entities involved and the transaction.⁵ The Supreme Court held that a registered foreign corporation may not be taxed on the reinsurance of risk in a state, where the insurance does not run to the “original insured” within the state and is transacted entirely outside the state, because no part of that transaction was “embraced in any privilege granted by that state.”⁶

Legislative history of the McCarran-Ferguson Act, which explicitly preserves the regulation of insurance for the states unless a federal law specifically addresses the

² See *Allgeyer v. Louisiana*, 165 U.S. 578 (1897). See also *St. Louis Cotton Compress Company v. State of Arkansas*, 260 U.S. 346 (1922) (“The State may regulate the activities of foreign corporations within the State but it cannot regulate or interfere with what they do outside.”)

³ *Connecticut General Life Insurance Co. v. Johnson, Treasurer of California*, 303 U.S. 77, 80 (1938). Justice Black’s dissent to this opinion is based on the premise that the Due Process Clause should not apply to corporations. That view has not prevailed.

⁴ *Id.*

⁵ *Id.*

⁶ *Id.* at 82.

business of insurance, indicates that these Supreme Court decisions were embraced by Congress and given lasting power. A House Report indicates that the intent of the McCarran-Ferguson Act was to “provide for the continued regulation and taxation of insurance by the States, subject always, however, to the limitations set out in the controlling decisions of the United States Supreme Court [discussed above], which hold, inter alia, that a State does not have power to tax contracts of insurance or reinsurance entered into outside its jurisdiction by individuals or corporations resident or domiciled therein covering risks within the State or to regulate such transactions in any way.”⁷ In the seminal 1962 case, *Texas State Board of Insurance et al. v. Todd Shipyards Corp*, Texas’s effort to impose a tax on insurance purchased outside the state by an insured without a place of business in Texas and without the use of a Texas insurance agent was rejected.⁸ The Supreme Court firmly established that its prior decisions setting limitations on the right of states to tax insurance transactions, “which the industry has reason to rely since 1897,” would not be changed.⁹

B. State Insurance Regulation and Licensing

Insurers and Insurance Policies

States have a substantial interest in regulating insurance companies to ensure they possess sound financial and management structures to meet their future obligations related to the various coverages provided in their state. As a result, states require insurers selling insurance in their state to become “admitted” to conduct insurance business in the state. By becoming admitted, an insurer submits itself to taxation, as well as complex requirements that seek to ensure its solvency and the safety of its funds, such as minimum capital and surplus standards, consumer protections, and investment guidelines. Generally, each of an insurer’s insurance policies must also be approved by the state’s insurance department to be permitted for sale within the state’s borders.

All domestic insurers are domiciled in one state. Insurers are licensed by their domiciliary state to sell certain lines of insurance, such as property, life, or disability insurance. Insurers may apply to other states to become admitted insurers capable of selling certain lines of insurance within those states. Once domiciled or licensed in a state, an “admitted” insurer becomes subject to that state’s taxes and regulations.

On the other hand, insurers and insurance policies that are not approved in a state, but exist in another state or another country, are considered “nonadmitted.” Insurers are not directly subject to taxation or regulation in states where they are nonadmitted. Within nonadmitted insurance are three important, distinct classifications:

⁷ H. R. Rep. No. 173, 79th Cong., 1st Sess., p. 3.

⁸ 370 U.S. 451.

⁹ *Id.* at 457. Subsequent lower court decisions have limited the holding of the Todd Shipyards case by declaring certain acts within the state sufficient to warrant taxation or regulation. *See Associated Elec. & Gas Ins. Servs. v. Clark*, 676 A.2d 1357, 1361 (R.I. 1996) (Relying on the principle that “the maintenance of an office or agents within the state is not a necessary prerequisite to the exercise of the power of taxation,” Rhode Island’s highest court permitted state taxation of a nonadmitted insurer whose only activity within Rhode Island was the sending of mail to insureds in the state.)

- 1) **Surplus lines insurance.** Surplus lines insurance is sold by insurance companies that, though nonadmitted in a certain state, meet sufficient standards to be considered an “eligible” insurer and to have its policies sold by a *state licensed surplus lines producer*.¹⁰
- 2) **Exempt insurance.** Exempt insurance covers lines of insurance that are specifically excluded from a state’s insurance code requirements. For example, commercial aviation, ocean marine, railroad and other transportation risks are often exempted insurance coverages.
- 3) **Insurance conducted beyond the regulatory jurisdiction of a state.** Activity conducted beyond a state’s regulatory jurisdiction includes all the business of insurance transactions conducted entirely outside a state’s borders, even if some or all of the covered risk is within the state.¹¹

Producer Licensing and Surplus Lines

Insurance producers (also termed agents or brokers) are typically licensed in a state to sell particular lines of insurance, such as property, life, or disability insurance. A producer may also obtain a surplus lines license to sell certain insurance policies that are underwritten by an insurer that is not admitted in the state.

Contrary to admitted insurers and their approved policies, surplus lines insurers and their policies are not individually approved by the state because they exist beyond the state’s jurisdiction. To compensate for the additional risk these policies impose on the state, surplus lines *producers* that sell foreign policies within the state are regulated, as opposed to the individual insurer and the terms of its policies. As a result, surplus lines producers are typically required to have one or more years of experience as a producer before applying for a surplus lines license, and must: a) qualify the business for export by demonstrating that coverage from an admitted company is not readily available; b) determine the insurer is fiscally stable and is an *eligible* surplus lines insurance company;¹² and c) file appropriate forms with the state.

Importantly, “Because surplus lines companies are not subject to state regulation, the insurance departments [of the several states] have no way of effectively collecting

¹⁰ Surplus lines are defined by the National Association of Insurance Commissioners as “any property and casualty insurance . . . on properties, risks or exposures, located or to be performed in [a] state, permitted to be placed through a surplus lines licensee with a nonadmitted insurer eligible to accept such insurance” Nonadmitted Insurance Model Act, NAIC Model Laws, Regulation and Guidelines 870-1, §3 (N). So, identifying what insurance is surplus lines insurance requires four factors to exist: 1) the covered property must be within the state; 2) the insurance must be placed through a surplus lines producer licensed in the state; 3) the insurer must not be licensed to do business in the state; and 4) the insurer must be considered “eligible” to sell insurance in the state.

¹¹ These circumstances are discussed in the Todd Shipyards case. *See* Note 8, *supra*.

¹² For example, Louisiana publishes an “Approved Unauthorized Insurer List -- Surplus Lines (White List)” that indicates which nonadmitted insurers Louisiana licensed surplus lines producers may place surplus lines policies with. *See* Louisiana Department of Insurance, available at: http://www.lidi.state.la.us/search_forms/white_list/white_list.aspx.

premium taxes from them.”¹³ However, the surplus lines *producers* selling the insurance are usually required to collect and remit a tax on the premiums paid by the insured because the producer is able to engage in that transaction by virtue of a state granted license, and as a result, that transaction takes place pursuant to the laws of the state.

C. Independently Procured Insurance

Insurance purchased directly from a nonadmitted insurer by an insured is “independently procured insurance.” Some states permit exempted commercial entities to procure insurance independently without complying with the full extent of the insurance laws. But perhaps more importantly, most states impose a premium tax on the resident purchaser of independently procured insurance.¹⁴

Where insurance is procured independently (without a broker) *outside* of a state’s borders, and neither the insurer nor the insured conducts business within the state where the risk is located, the insurance department of such a state would have no jurisdiction over the parties or the transaction and no ability to regulate its terms or to impose a tax. But, in this situation, any state with proper jurisdiction over the insured or insurer as a business entity could impose a tax on the payments made or received.

While independently procured insurance can be considered “nonadmitted” insurance, its characteristics are very different from other nonadmitted insurance, such as surplus lines insurance.¹⁵

D. Captive Insurance

Corporations or associations may create wholly owned insurance companies, called captive insurers, from which to purchase insurance for the parent company and its affiliates.¹⁶ A company may decide to form a wholly owned insurance subsidiary to decrease costs, obtain broader coverage than is otherwise available, earn income from investments of the captive’s reserves, avoid brokerage fees, expedite claims processing, improve risk management, access the reinsurance market, and for other purposes. The concept of a wholly owned insurance subsidiary was established in the 1950s and has grown considerably given these benefits.

¹³ Licensing & Surplus Lines Laws, Susan Maloney (2009).

¹⁴ New York appears to impose a premium tax on all independently procured insurance, regardless of where it is purchased, *for New York companies*. See Permissibility of Self-Procurement of Property Insurance from Parent’s Captive Located and Regulated in Foreign Country, New York General Counsel Opinion (October 30, 2002). Roughly 39 states impose similar independently procured insurance premium taxes on insureds in their states.

¹⁵ Because the nonadmitted market is composed of several different markets, it may not be appropriate, or legally possible, to treat its individual components the same.

¹⁶ A distinction exists between a “pure captive,” that only insures its parents and affiliates, and “insurance subsidiaries” that issue policies to unaffiliated parties, though their legal treatment may not be different. Where a pure captive “represents little more than self-insurance” of little concern to states, the regulatory interests increase as a captive makes insurance available to other members of the public.

Captive insurers are typically domiciled in a state or foreign country that has advanced or favorable captive laws.¹⁷ Within their domicile, captives act as admitted insurers subject to regulation and taxation. Captives will conduct activities that constitute the business of insurance only within their domicile to avoid regulatory compliance costs and taxes related to conducting the business of insurance in other states. This structure has ensured, for as long as captives have existed, that only a captive's domicile may tax and regulate its insurance business. Indeed, captive insurers generally pay premium taxes to their domiciliary state as admitted insurers.

A large number of states require insureds to pay taxes on independently procured insurance premiums paid to an insurer outside the state. That tax on a corporate entity's insurance premium payments appears to be permissible under the Constitutional limitations on state taxation because the state has proper jurisdiction over a business entity operating, and making premium payments from, within its borders.¹⁸

II. DOES THE NRRA APPLY TO CAPTIVES?

The NRRA applies to the payment of premium taxes on "nonadmitted insurance" placed with a "nonadmitted insurer." "Nonadmitted insurance" is defined by the NRRA 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."¹⁹ A "nonadmitted insurer" is "with respect to a State, an insurer not licensed to engage in the business of insurance."²⁰ Separately, "independently procured insurance" is defined by the NRRA as "insurance procured directly by an insured from a nonadmitted insurer."

A cursory reading of the statute might lead one to conclude that captive insurance purchased by the insurer's parent could be considered insurance "placed directly" with a nonadmitted insurer, bringing it into the purview of the NRRA's terms as "nonadmitted insurance." But captive insurance may not fall within the definition of "nonadmitted insurance" and thus may not be covered by the key features of the NRRA. On the other hand, captive insurance is likely subject to the requirements imposed on independently procured insurance, which should be considered distinct from those applied to nonadmitted insurance.

Our analysis of the NRRA's tax allocation and regulation provisions, as they would apply to captive insurers, reveals conflicts with A) the definition of "nonadmitted insurance"; B) the legislative intent expressed by the law's sponsors; C) its interpretation by the implementing bodies; D) the independently procured insurance provisions; and E) the

¹⁷ Aspects to consider when selecting a captive domicile include: reserves required, legal insurance restrictions, investment restrictions on reserves, accounting procedures, taxes, control of premiums, reinsurance penalties, limits on maximum premium and exposure levels, regulatory environment and formation time and paperwork.

¹⁸ See note 2, *supra*.

¹⁹ See note 1, *supra*, at § 527 (9) (Definitions).

²⁰ By referring to the business of insurance "with respect to a state," the NRRA preserves state law definitions of the business of insurance. Also, risk retention groups were specifically excluded from the definition of a nonadmitted insurer. See note 1, *supra*, § 527 (11)(B).

practicality of its implementation; all of which are exacerbated by F) unclear and inconsistent text.

A. Legislative Intent

The NRRA’s legislative history provides a clear indication that its sponsors intended for its “nonadmitted insurance” provisions only to apply to surplus lines insurance. On September 9, 2009, a predecessor to the version of the NRRA adopted in the Dodd-Frank Act was discussed on the House floor by three of its sponsors. All three described the bill as a resolution to improve surplus lines insurance laws:

Rep. Moore of Kansas, Chief Sponsor: “Under today’s laws, the regulation of the surplus lines market is, unfortunately, fragmented and cumbersome Accordingly, *H.R. 2571 specifies that only the tax policies, licensing and other regulatory requirements of the home State of the policyholder govern a surplus lines transaction* [and] it allows sophisticated commercial entities direct access to the surplus lines market”

Rep. Garrett of New Jersey, Sponsor: “H.R. 2571, the Nonadmitted and Reinsurance Reform Act of 2009, *will reform and will streamline the regulation of the nonadmitted—that’s surplus lines—insurance market* as well as the reinsurance market. *Title I, which addresses the surplus lines market, will reduce regulatory overlap, and will clarify where the appropriate taxing authority really should lie with each market transaction.*”

Rep. Bachus of Alabama, Sponsor and Ranking Member of the Financial Services Committee: “Today we are seeking to advance a modest but long-overdue *measure to streamline the current system for surplus lines insurance* and for reinsurance. *Surplus lines insurance, also known as ‘nonadmitted’ insurance,* is highly specialized property and casualty insurance for exceptional risks, such as hazardous materials or amusement parks. [The bill] would adopt a ‘home state’ approach to address inconsistencies in state regulation of the surplus lines insurance market.”²¹

That bill was later included in the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was signed into law ten months after those statements were made, on July 21, 2010. One day later, Rep. Moore spoke on the House floor “to make one important clarification of intent Section 521(a) [the operative tax provision] is intended to require the broker to pay or remit all tax in a *surplus lines transaction* to the ‘Home State’ of the insured”²²

Again, on December 15, 2010, Rep. Moore clarified on the House floor that “The goal of NRRA was to . . . streamline the regulatory regime to enable insurers and brokers to more easily and efficiently comply with state rules The law accomplishes this by *giving sole regulatory authority over surplus lines transaction* [sic]—including the authority to

²¹ 155 Cong. Rec. H9362 (2009).

²² 156 Cong. Rec. E1407 (2010).

collect premium taxes—to the home state of the insured.”²³ This clarification came at a time when the National Association of Insurance Commissioners (NAIC) was in the initial stages of preparing their interstate compact for implementation of the NRRA. To which Rep. Moore states that:

. . . the [NAIC] is moving swiftly to draft a model agreement and statutory language to *enable the states to collect and share surplus lines premium taxes* . . . [Beyond taxes, 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* . . . the states need to take this opportunity to adopt a single set of *uniform surplus lines regulatory requirements*.

In sum, the legislative history conveys a clear intent for the NRRA to apply only to surplus lines and not to all types of nonadmitted insurance. In addition, industry supporters of the legislation have indicated that the legislation was intended to reform surplus lines insurance regulation and the collection and allocation of premium taxes.

B. Definition of “Nonadmitted Insurance”

Captive insurance is not likely to fall within the definition of nonadmitted insurance. 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*.²⁴

First, note that “nonadmitted insurance” only applies to property and casualty insurance. All other types of coverage, such as health or life insurance, are not considered nonadmitted insurance.

Second, the definition of “nonadmitted insurance” is derived from the NAIC Nonadmitted Insurance Model Act’s definition of “*surplus lines insurance*” as:

Any property and casualty insurance in this state on properties, risks or exposures, located or to be performed in this state, permitted to be placed through a surplus lines licensee with a nonadmitted insurer eligible to accept such insurance. . . .²⁵

The NRRA’s definition of nonadmitted insurance is identical to the NAIC Model Act’s definition of surplus lines, except that it omits certain state jurisdictional limitations and inserts “directly or” after the phrase “permitted to be placed.”²⁶ So the determinative

²³ 156 Cong. Rec. E2144 (2010).

²⁴ See note 19, *supra* (emphasis added).

²⁵ See note 10, *supra*.

²⁶ The omission of language referring to “this state” is appropriate because NRRA is federal law. But molding a state law definition for federal use has created ambiguities. For example, under what authority does the Act intend directly placed insurance to be “permitted to be placed?” State laws typically grant authority to place insurance, but the act is ambiguous as to which state or federal law should be referenced for that determination.

issue is whether the insertion of “directly or” in NRRA’s definition expands it to encompass captive insurance. Several factors indicate that should not be the case.

The definition of nonadmitted insurance, with respect to insurance “placed directly,” should not be read in isolation but in connection with the accompanying text from the NAIC’s definition of surplus lines insurance, which provides insight to its meaning. Insurance is only “*permitted* to be placed,” in the context of surplus lines insurance, with “eligible insurers,” so those two clauses should be read together. As a result, surplus lines policies are typically only “permitted” to be placed, either directly or through a broker, with insurers that are deemed “eligible” by a state after meeting certain regulatory requirements.²⁷ Those requirements do not apply to insurance that is conducted beyond the regulatory jurisdiction of a state, which is how captive insurance is typically transacted.

Nonadmitted insurance includes insurance that is “permitted to be placed directly” with an eligible insurer but does *not* include “independently procured insurance,” which is “procured directly . . . from a nonadmitted insurer.” The distinction between permitted or eligible insurance that is placed directly and independently procured insurance is significant. Insurance that is *permitted* to be placed directly with an *eligible* insurer will be constrained to certain lines of insurance and certain insurers on a state’s white list. As stated above, state white lists typically relate to surplus lines insurers and surplus lines insurance. On the other hand, independently procured insurance includes insurance that is purchased from an insurer that is not an *eligible* insurer under a state’s laws.²⁸

Following this analysis, “independently procured insurance” is not encompassed in the definition of “nonadmitted insurance,” so the requirement that nonadmitted insurance premium taxes may only be collected by the insured’s home state should not apply to independently procured insurance.

In sum, captive insurance is not “*permitted* to be placed directly . . . with a nonadmitted insurer *eligible* to accept such insurance.”²⁹ Although captive insurance may be procured “directly” by an insured from a captive insurer, the captive insurance that is procured beyond the borders of a state is not “permitted to be placed directly” by any state but the insurer’s domicile, nor are captive insurer’s typically “eligible” insurers, which refers to the list published by individual states of eligible *surplus lines* insurers (white list).

The use of the phrase “insurance permitted to be placed” indicates that “nonadmitted insurance” should apply to surplus lines insurance that is permitted to be placed in a state by virtue of a surplus lines insurer’s eligibility, as determined by the insurer’s inclusion in a state’s white list of approved unauthorized insurers. Captive insurance is not considered surplus lines insurance placed by an eligible nonadmitted insurer, nor do

²⁷ See note 12, *supra*.

²⁸ Nor would the insurance policy be “permitted to be placed” by a state.

²⁹ A narrower interpretation of this definition could encompass all “property and casualty insurance permitted to be placed directly” without further limitations, but that view neglects the definition’s lineage and a substantial amount of its text.

captives seek to be surplus lines insurers, so captive insurance should not be considered within the definition of nonadmitted insurance. Reading the statute broadly, to include independently procured insurance as “nonadmitted insurance,,” is contrary to the legislative intent of the NRRA, its statutory construction, and the history of its language.

C. Implementing Bodies

The NRRA encourages, but does not require, states to adopt, by way of an interstate compact or a similar agreement, uniform “requirements, forms, and procedures . . . that provide for the reporting, payment, collection, and allocation of premium taxes” on nonadmitted insurance.

The NAIC’s Surplus Lines Implementation Task Force has developed an interstate agreement, called the Nonadmitted Insurance Multi-State Agreement (NIMA), that has been signed by 12 states and authorized by several others.³⁰ Though the NIMA retains the NRRA’s definitions that, if interpreted literally, could be read to include captive insurers, several factors indicate its target is surplus lines insurance:

- 1) NAIC staff stated they have not heard any insurance commissioners suggest that the NRRA extends to captive insurance;
- 2) The NIMA’s definition of “nonadmitted insurance” replicates the NRRA’s, but clarifies that it does “not require a State to treat any property and casualty insurance as Non-Admitted Insurance where the laws of the state do not provide such treatment”;³¹
- 3) The NAIC *Surplus Lines* Implementation Task Force has handled the creation of the NIMA; and
- 4) The tax allocation formula is titled: *Surplus Lines* Premium Tax Allocation Formula.

The National Conference of Insurance Legislators’ (NCOIL) Surplus Lines Insurance Multi-State Compliance Compact (SLIMPACT) has been adopted by nine states.³² Nonadmitted insurance is defined in the SLIMPACT differently than in the NRRA to only include surplus lines insurance and independently procured insurance (which is insurance procured by an insured directly from a surplus lines insurer or other nonadmitted insurer *as permitted by the laws of the home state*), effectively excluding insurance conducted beyond a state’s jurisdiction.

³⁰ As of September 1, 2011, 12 states have signed the NIMA: Arkansas, Connecticut, Florida, Hawaii, Louisiana, Mississippi, Nebraska, Nevada, Puerto Rico, South Dakota, Utah, and Wyoming. 19 states have approved legislation permitting the insurance commissioner to enter into NIMA or an interstate compact: Alaska, Arizona, Georgia, Maine, Montana, New Hampshire, Oklahoma, and West Virginia. Similar legislation has passed the legislature, and is waiting for the governor’s signature, in four states: Delaware, New Jersey, Oregon, and Texas. Similar legislation is pending in Massachusetts and Illinois.

³¹ Nonadmitted Insurance Multi-State Agreement, National Association of Insurance Commissioners, § 5 (f). This definition appears to exclude insurance that is conducted beyond the tax and regulatory jurisdiction of a state.

³² As of September 1, 2011, five states have passed legislation to enter SLIMPACT: Alabama, Kansas, Kentucky, New Mexico, and North Dakota. Four states passed SLIMPACT with additional provisions should SLIMPACT not be adopted by enough states to become operative: Indiana, Rhode Island, Tennessee and Vermont.

The implementing bodies and the interstate agreements they have created largely support the exclusion of captives from the NRRA's taxation and regulation provisions.

D. Independently Procured Insurance

The NRRA grants "home states" the power to require tax allocation reports from insureds that have independently procured insurance (along with surplus lines brokers) to "facilitate the payment of premium taxes among the states." The direct impact of this provision should be minimal since it is limited to tax allocation reports.

But the reporting requirements have tempted at least one state to impose additional taxes on independently procured insurance: New York has increased its independently procured insurance tax basis from only premiums allocated to risks in the state to all premiums paid regardless of where the risk resides.³³ Note that the NRRA does not change the fundamental jurisdictional requirements needed to impose and collect a tax on independently procured insurance.

E. Application to Captives

Practical ambiguities exist when applying the NRRA to captive insurance. The NRRA only permits an insured's home state to collect nonadmitted insurance premium taxes and encourages states to adopt an interstate compact or other agreement to distribute those tax proceeds according to where the "properties, risks, or exposures" are located.³⁴ Assuming the NRRA would apply to captives, an insured parent would be required to pay any nonadmitted insurance premium taxes to the insured parent's "home state."³⁵ Also, the home state's laws generally would apply to the placement of nonadmitted insurance.

Admitted Insurance Taxes

Taxes imposed by a domiciliary state on an admitted insurer that is selling what *other* states may consider to be "nonadmitted insurance" are, in fact, taxes on admitted insurance in the domiciliary state. So, taxes imposed on a captive insurer by its domiciliary state are taxes on an entity within that state and are not affected by the nonadmitted premium tax provisions of the NRRA.

Payment of Taxes Beyond Proper Jurisdiction

The NRRA's contemplated tax allocation and distribution scheme *does not grant states any new powers to tax nonadmitted insurance*. The existing limitations on a state's power

³³ We do not address the propriety of that law.

³⁴ Sharing premium taxes with other states is not required. Ten states (California, Idaho, Maryland, Minnesota, Missouri, North Carolina, New York, Pennsylvania, Virginia, and Washington) have enacted NRRA implementing legislation that permits the state to keep all of the nonadmitted premium taxes it collects as a home state, without any provision for allocating premiums to other states pursuant to an interstate compact or agreement, as encouraged by the law. By taking this approach, the states will not receive nonadmitted insurance premiums on risks in its state from other states that do enter an interstate compact or agreement.

³⁵ "Home state" is defined as either the insured's principal place of business or, if none of the risk is there, the state where the greatest amount of risk for a particular insurance contract is located. See note 1, *supra*, at § 527 (6) (Definitions).

to tax insurance are neither explicitly nor implicitly modified by the text of the law and were not mentioned in its legislative history. Several aspects of the NRRA challenge the constitutional precedent requiring proper jurisdiction for state taxation.

First, the NRRA's determination of the insured's "home state" is problematic. An insured's home state will be its principal place of business³⁶ unless none of the risk is located in that state, in which case, the home state becomes the state where the "greatest percentage of the insured's taxable premium for that insurance contract is allocated."³⁷ If the home state is declared to be a state that neither the insurance company nor the insured have transacted insurance business in, a required payment of tax to the home state could violate established judicial precedent requiring proper jurisdiction to impose a tax.

Second, if the home state has adopted an interstate compact as contemplated by the NRRA, the premiums would then be allocated to other states, ideally based on the amount of risk covered by the policy in each state (but depending on the specific formula in the interstate compact adopted by the home state). Where the home state has elected not to participate in an interstate compact, it may retain 100% of the premium tax, as long as some portion of the risk is covered in that state. Where the payment of captive premium taxes to a home state, and/or to another state through a tax allocation scheme, spreads taxes to a state that does not have the authority to impose a tax on the insurance, the principles established in the Todd Shipyards case could be violated.³⁸

Finally, at least one state, Maryland, has included in its NRRA implementing legislation an additional extra-territorial provision that would tax "unauthorized insurers" (other than surplus lines and independently procured insurance) based solely on the fact that the insurance's subject is located in the state.³⁹ Although the NRRA's tax allocation scheme may indirectly encourage extra-territorial taxes, such legislative action is inconsistent with the NRRA's purpose of streamlining surplus lines tax payments and regulations. Perhaps more importantly, it conflicts with the progeny of insurance tax law that requires some jurisdictional authority before a state may impose and collect a tax. While this activity does not appear currently to be widespread among the states, if enforced, it represents a significant risk of increased tax costs for captive insurers and their parent companies.

F. Unclear and Inconsistent Text

The following portions of the NRRA are unclear or inconsistent, making its meaning difficult to interpret with certainty:

³⁶ NRRA does not define "principal place of business," but the implementing acts, NIMA and SLIMPACT, define it almost identically as where the insured maintains its headquarters and where the insured's high-level officers direct, control, and coordinate the business activities of the insured.

³⁷ See note 1, *supra*, § 527 (6)(A).

³⁸ Although the holding of Todd-Shipyards was limited to the specific facts of that case, its structure is preserved in our analysis. Where *no* contact exists within a state, constitutional restrictions on state taxation should apply.

³⁹ See MD House Bill 969 § 4-209(b) (2011).

- 1) A “premium tax” is defined to include taxes imposed as consideration for insurance on surplus lines and independently procured insurance, but *not* on all “nonadmitted insurance.” As a result, this definition appears to exclude some forms of nonadmitted insurance from being considered for the “premium tax” provisions. This could represent the drafter’s intent to omit some insurance activities conducted beyond a state’s regulatory jurisdiction from the premium tax provisions of the NRRA, which is a significant issue for captives. If that was the objective of this statutory scheme, such an interpretation may need to be affirmed or clarified.
- 2) The NRRA provides that the “*placement* of nonadmitted insurance shall be subject to the statutory and regulatory requirements solely of the insured’s home state.” Because the term “placement” is not defined, it is difficult to determine exactly what provisions of a home state’s laws would apply to the nonadmitted insurance.

A related section indicates that the home state has the sole authority to require licensure for the sale, solicitation or negotiation of nonadmitted insurance to an insured, so it is unclear if the earlier regulation of “placement” expands beyond these powers.

- 3) The NRRA establishes “uniform standards for surplus lines [insurer] eligibility,” but applies some aspects of that surplus lines uniformity to all nonadmitted insurers domiciled in the United States.⁴⁰ An exception is provided that would permit a state to impose eligibility standards on all nonadmitted insurers, but it refers to two sections of the NAIC’s Nonadmitted Insurance Model Act that are only applicable to surplus lines insurers.⁴¹ Since the insurer eligibility exceptions would only apply to surplus lines, the use of nonadmitted insurance elsewhere in that section appears over inclusive, both complicating its meaning and hinting that these terms were intended to only effect surplus lines insurance.

III. CONCLUSION

In sum, the drafters, legislative sponsors, industry supporters of the legislation, and implementing actors at the NAIC and the NCOIL have indicated that the intent of the Nonadmitted and Reinsurance Reform Act was to reform the regulation of and collection of premium taxes on surplus lines insurance. But the definition of “nonadmitted insurer” is so broad that, when read literally, it raises a question of whether captive insurance could be covered. However, when read in context of the definition of “nonadmitted insurance,” captive insurers are not likely subject to the NRRA’s nonadmitted insurance provisions because they are not placing nonadmitted insurance.

The NRRA does not purport to change the fundamental law surrounding the taxation of insurance that insulates captives from taxation and regulation beyond the states where

⁴⁰ See note 1, *supra*, at § 524 (1).

⁴¹ See note 10, *supra*, at §§ 5A (2) and 5C (2)(a).

they conduct the business of insurance. Instead, the NRRA provides a mechanism for state-authorized nonadmitted insurance premium taxes to be collected and allocated to states that can legally receive those funds. So even if captives could be considered nonadmitted insurers, only the states that are exposed to some aspect of a captive insurance transaction may impose a tax, and the tax would have to be imposed by a separate law of the state, not merely by adoption of a NRRA-related interstate compact.

With respect to independently procured insurance regulation and taxation, the NRRA did not change the application of these state laws to insureds. Nor should it restrict the collection of premium taxes paid for independently procured insurance to the “home state” of the insured, as it does for nonadmitted insurance. The captive industry should be aware that some states may attempt to overreach their taxing authority, and some may become more aggressive in pursuing and collecting the taxes on premiums paid for independently procured insurance as a result of the visibility provided by the NRRA and their increased need for revenue.

Despite the large number (44) of states that have passed NRRA-implementing legislation, the result for insurers and insurance brokers attempting to comply with the various approaches taken by the states remains duplicative and burdensome. Moreover, the significant number of states that have contravened Congressional intent by adopting legislation that increases nonadmitted insurance taxes without entering into an interstate compact to properly allocate those premiums among the states, indicates that additional federal action may be necessary.