

REPORT

DATE: FEBRUARY 27, 2007

TO: DAN MAHER
EXECUTIVE DIRECTOR
EXCESS LINE ASSOCIATION OF NEW YORK

FROM: MACKIN & COMPANY

RE: TAXATION OF MULTISTATE E&S PLACEMENTS: A QUANTITATIVE
AND QUALITATIVE ANALYSIS

INTRODUCTION AND SUMMARY OF FINDINGS

In 1963, Julius S. Wikler said that surplus lines regulation “is the Achilles’ heel of state regulation, and will constitute a wedge with which proponents of federal regulation may open up the entire field unless the states commence to evince a real interest in the matter.”¹ In 2006, the U.S. House of Representatives unanimously passed H.R. 5637, “The Non-admitted and Reinsurance Reform Act of 2006,” and more could happen in 2007.

It is in this public policy context that ELANY is working toward development of an interstate compact as a means of addressing the present untenable situation for brokers and other participants in the non-admitted market when it comes to taxation of multistate excess and surplus lines (E&S) placements. Such a compact could help preserve state-based regulation, and create a fair, efficient, cost-effective means of complying with appropriate rules and paying appropriate taxes on multistate placements in the non-admitted market. It would also provide brokers with needed confirmation that their multistate placements are in compliance with applicable tax and other rules. A contemplated compact could create a mechanism for defining which state would be the “home state” whose rules would prevail, or by creating a clearinghouse which could process all multistate placements. Either method would apply uniform allocation methods for taxing purposes.

The Gramm Leach Bliley Act (GLB) ushered in welcome reforms, specifically nonresident licensing for E&S brokers. At the same time, it compounded and expanded problems for brokers trying to comply with laws and a regulatory framework left over from the resident-only licensing days. That regulatory framework worked well in governing E&S placements on a single-state compliance basis. Under resident-only licensing, a broker would generally comply with rules and file and pay taxes in only one state – generally the state where the broker held a license. Since the enactment of GLB, brokers placing multistate risks have faced a formidable tangle of different and often conflicting state rules, and no guidance on which

¹ Wikler, p. 539, cited in Weese, p. 192.

state's or states' rules apply to those placements. This is particularly problematic when it comes to paying premium taxes on such placements.

State officials have expressed concern about the revenue implications of a coordinated multistate tax and regulatory system like a compact, with many perceiving that it would lead some states to gain and others to lose revenues, the so-called "winners and losers" question.

Against this general background, you have asked that we undertake a study to find out whether the winners and losers question can be quantifiably answered. You have also asked that we review more qualitative elements of the present situation.

We have found -- as many surplus lines professionals but few others already know -- that today's system is uneven, incongruous, and confusing, and that it raises serious issues of fairness, cost-effectiveness, and compliance. We have gathered information that points to the need for reform of regulation and taxation of multistate E&S placements, and suggest that such reforms, possibly in the form of an interstate compact, could lead to increased tax revenues on those placements in most, if not all, states. Our research tells us that data is not available that can point with certainty to an answer to the winners and losers question. Most states do not collect data on the premium that they do not tax, and states vary widely in terms of the data they capture on premium they do tax. Those facts of life make it nearly impossible to determine accurately the amount of gross E&S premium written in the U.S., or even on a state-by-state basis, which would be key to determining whether states would gain or lose revenues under a coordinated regulatory and taxation system for multistate E&S placements. It is likely that establishment of a coordinated state system of tax collection and reporting would fill this gap in our present understanding of premium levels on a state-by-state and on a national basis.

Notwithstanding the above statement that the data does not exist to answer the winners and losers question, we think it's fair and appropriate to point out that, under a state-based system like a compact, if a state found that its revenue levels decreased, it would retain the ability to adjust its E&S tax rates to compensate for part or all of the loss.

Our research tells us that coordinated regulation of multistate E&S placements:

- is essential post-GLB,
- would lead to fair and equitable distribution of tax revenues, and
- could very well lead to increased tax revenue in most, if not all states.

This paper is in two parts. Part One covers the qualitative aspects of our study and our conclusions. Part Two reports on the methodology and data analysis that contributed to the conclusions presented in Part One.

Part One of this paper will:

- describe the essential characteristics of the present situation regarding tax collections on multistate E&S placements, including two large brokers' estimates of costs that could be saved under a coordinated system;
- identify key historical developments that have led to the present situation; and
- discuss the qualitative results of our study, including our conclusions regarding specific ways that states could gain or lose revenues under a compact or a similar coordinated taxation system for multistate E&S placements.

Part Two of this paper will present the specific results of the quantitative aspects of our study. It will:

- describe our methodology;
- describe our data analysis, including validation of the data we received and calculations we performed on that data; and
- present selected tax and premium data that we collected and the results of our calculations.

Also, attached as an appendix, is a glossary of certain terms used in the paper that may not be familiar to public policy makers and those outside the E&S industry.

PART ONE: QUALITATIVE ANALYSIS

THE PRESENT SITUATION

E&S brokers presently face an untenable situation in which there is no guidance as to which states' laws apply to multistate placements. In an effort to comply with multiple states' rules, even when it's not clear that they must do so, brokers are incurring enormous costs which are shifted back to insureds, and ultimately to the consumers of those insureds' goods and services. This is in contrast to state laws governing admitted insurance business, which "typically do specify which laws apply to in-state activities involving multistate risks."² Challenges relating to determining which states' laws might govern multistate E&S placements apply to premium tax payments, as well as to related E&S filings and other aspects of regulation.

To illustrate the issue, we will briefly discuss the straightforward tax and regulatory compliance obligations that come with a simple single-state placement. In such a placement, the insured and the risk are in the same state, the broker is licensed and based in that state, and the policy is negotiated and delivered there. It is clear in such a situation that the broker must

² National Association of Professional Surplus Lines Offices (NAPSLO): *Multistate Compliance Problems in the Surplus Lines Industry*, p. 2.

comply with the state's laws and regulations. The broker would file all the appropriate documentation and pay tax on the premium to that state. There is no question as to what is the "home state" of the placement.

But when it comes to E&S placements involving multiple states, questions regarding tax and regulatory compliance for brokers and other market participants are innumerable.

Let's start with a few examples of the myriad possible configurations of multistate placements. A placement could feature a broker that is licensed and located in the state where the insured has its headquarters but with insured risks located in several other states. Or, a placement could have a broker with a nonresident license in the state where the insured has its headquarters, and insured risks located elsewhere. In such multistate placements there is virtually no guidance as to which state's or states' rules apply.

E&S insurers are, by definition, non-admitted, and therefore, by and large, beyond the reach of state insurance regulators.³ This leaves state licensed E&S brokers, who do answer to state regulators and taxing authorities, responsible for paying premium taxes, filing appropriate documentation with regulators, and generally ensuring compliance with the laws of the states where they are licensed.

However, in multistate placements, brokers have no guidance regarding which state laws apply. The unhappy result is duplicate regulation and compliance efforts. Also, state laws often conflict, which is particularly problematic where states have taken the position that multistate transactions must comply with the rules of each state with any stake in the transaction.⁴

Three main differences among states' tax rules relate to:

- whether states tax multistate placements on a gross basis, i.e., they tax all of the premium on a transaction regardless of how much risk is located in that state, or whether they tax-allocate, i.e., they tax multistate transactions based on a proportion of premium that derives from risk located in the state;
- the methods for allocating premium on multistate risks, which vary widely among states; and
- the existence and interpretation of direct or independent procurement taxes.

Taxes on multistate placements are generally paid in two ways. A broker usually pays E&S premium tax in the state of their license, and the insured could pay direct procurement or

³ E&S insurers operate outside the "normal" regulatory framework, which enhances their flexibility to handle extraordinary risks. The E&S market serves as a supplemental, rather than an alternative market. This does not mean that E&S insurers are unregulated. State rules generally require that non-admitted insurers be recognized as eligible to provide coverages not available in the admitted market. Eligibility requirements vary by state but generally are aimed at ensuring that non-admitted insurers are financially secure, and adhere to certain underwriting disciplines. (Westphalen, Weese)

⁴ NAPSLO: *Multistate Compliance Problems of the Surplus Lines Industry*, p. 2.

independent procurement taxes that may be due to other states. Direct or independent procurement taxes serve, in many states, as a way to collect tax on a placement in which a portion of the risk is located in the state, but the placement's broker is not licensed there, and the broker has complied with E&S laws in a different state.

Although states generally first adopted direct or independent procurement taxes as a way to tax E&S placements that an insured procured directly from a carrier without the assistance of a broker, E&S market participants have used those tax laws to pay taxes on multistate placements. In such placements, a broker generally informs the insured that it may have a direct or independent procurement tax liability in states where the broker is not licensed. It would then be up to the insured to pay the direct or independent procurement taxes.⁵ This process is, in itself, problematic, because it depends on insureds' risk management staff conveying the appropriate tax liability information to colleagues who may be completely unfamiliar with the concept, or even the terms, "unauthorized" or "non-admitted" insurance.

Since GLB, these problems are exacerbated because a broker may be licensed in several or even all states involved in a multistate placement. That compounds confusion regarding whether taxes are due and to what states, and whether such taxes should be in the form of E&S premium tax or direct or independent procurement tax. Also, brokers may be exposed on the compliance side if they hold a license in a state, but are making and filing a placement under the laws of another state, where they also hold a license, and which has a stronger relationship with the placement, e.g. because most of the insured risk is located there. It is unclear whether the laws of the state with the smaller portion of the risk apply.

As referenced above, the lack of clarity in the present system exacts a significant toll on E&S brokers and their clients. Two large E&S brokers have provided estimates of the amount they could save on an annual basis if a coordinated multistate regulatory system, such as the one envisioned under the Smart Act, were enacted. Each broker's estimate follows.

Broker One estimates that it would realize savings of \$10,075,000 per year as follows:

- \$1,275,000 in processing of broker/client affidavits,
- \$3,000,000 in E&S tax filings,
- \$4,800,000 in simplified marketing, and
- \$1,000,000 in licensing costs.

⁵ It should be noted that there is a body of case law challenging the validity of direct or independent procurement taxes.

Broker Two estimates that it would realize savings of \$13,712,004 per year as follows:

- \$7,778,265 in administrative costs including, for example, affidavit preparation, signature follow-up, exposure allocations, and state filings, payments, and reporting;
- \$3,600,000 in diligent search/declination costs; and
- \$2,333,739 in compliance costs, including audits and fines and interest.

The last bullet above, which projects savings of over \$2.33 million in compliance costs under a coordinated system, underscores the risk that brokers now bear. It is virtually if not absolutely impossible to comply with all states' rules when those rules conflict, and those compliance challenges ultimately cost consumers money.

HOW WE GOT HERE

It is helpful to know key regulatory developments in the history of the E&S market. The following will show how we got to the present regulatory mismatch between laws that, on the one hand, facilitate nonresident broker licensing but, on the other hand, still don't adequately address compliance and tax issues relative to multistate transactions.

Most recently, enactment of GLB established full nonresident licensing for E&S brokers. This brought many benefits to brokers, but it also brought a major problem because it only changed licensing rules, leaving in place a legal and regulatory framework that reflected the old reality of resident-only licensing.⁶

In the preceding period of strictly resident E&S broker licensing, brokers typically complied with the laws of, and paid premium taxes to, only their home state, where they held their resident license. As referenced above, when it came to multistate transactions, brokers would typically inform insureds of those insureds' potential liabilities under other states' direct or independent procurement taxes, and the insureds would pay those taxes. During this time period, brokers tried to pay taxes on multistate risks in several ways. Following are examples of those efforts and how they have fared.

- Some brokers have attempted to file documents and pay premium taxes in states where they were not licensed and received letters from regulators informing them that they had illegally transacted insurance without a license.⁷
- Some brokers have paid surplus lines premium taxes to their own state on the full premium amount of a multistate placement. If another state contacted the broker regarding its share of the tax, the broker would direct that state to the broker's

⁶ NAPSLO: *Multistate Compliance Problems of the Surplus Lines Industry*, p. 1.

⁷ Bouhan 1994.

home state which had collected the tax.⁸ This method was not especially efficient for those other states, though it would have benefited the brokers' home states.

- Some brokers made payments to other states by engaging the services of locally licensed brokers, who would make “accommodation filings” or “courtesy filings” on their behalf. This was deemed illegal in several states, on the grounds that an insurance transaction is generally only considered an E&S placement in a single state, and using brokers to file E&S placements in other states effectively made them E&S transactions strictly for tax purposes.⁹ Also, the brokers making such courtesy filings may have had no genuine involvement in the placement.

Prior to GLB, the most significant industry-wide legislative overhaul was the shift to tax allocation in most states in the 1980s. Before that, states taxed multistate insurance transactions based on the policy's gross premium, regardless of how much risk was located in each state. In other words, if five percent of a placement's premium derived from risk located in a state, the state would still tax 100 percent of the premium on the whole placement. This led to multiple taxation of the same premium dollars and, in some cases, to premium taxes that equaled or even exceeded the premium amount in a placement.¹⁰

Even now, beyond tax-allocation as referenced above, most state laws governing E&S insurance largely contemplate insurance policies covering risks in only one state. In fact, most laws are based on New York's original statute, enacted in 1890.¹¹

THE WINNERS AND LOSERS QUESTION

As referenced above, we are unable to determine conclusively whether or not a coordinated system would create winners and losers when it comes to state tax revenue. We do know that brokers need a new way to file and comply with state tax laws when it comes to multistate placements. The present system is fractured and was not designed to regulate and tax multistate placements. On the tax side, this is particularly important because, relative to their number, multistate placements generate a large amount of premium. We believe that most states will be “winners” under a coordinated system of regulation and taxation. In fact, we can only identify two ways that states could possibly lose revenue under such a system.

This section will discuss

- public policies and methods of implementing those policies, which, if replaced under a coordinated system like a compact, would likely lead to more revenues for states; and
- two ways some states could possibly lose revenue under a coordinated system like a compact.

⁸ *ibid.*

⁹ Bouhan 1994, 1999.

¹⁰ NAPSLO 2006, p. 3.

¹¹ NAPSLO: *Multistate Compliance Problems of the Surplus Lines Industry*, p 1; Brockett, p. 236.

WAYS STATES COULD WIN

Here are examples of state public policies whose repeal, through a compact, would likely result in increased state revenue.

- Taxation of multistate transactions on a gross basis provides a disincentive for brokers to file there, particularly if a small portion of a transaction's premium derives from risk in that state. A compact could address this by ensuring fair and complete tax collection.¹²
- States that do not have direct or independent procurement tax, or that have the tax but do not use it to tax multistate placements where a broker is involved, would stand to gain under a compact that allocated tax payments in accordance with risk locations.¹³

On the implementation side, a compact could provide a simple, accurate way to tax premium that is currently taxed under direct or independent procurement laws. These premiums are difficult to track. Insureds generally remit direct and independent procurement taxes to states' revenue divisions, rather than insurance regulators, who generally (though not always) collect E&S premium taxes. We have found that states do not always track their direct or independent procurement tax collections. Specifically,

- three states do not track their direct and independent procurement tax collections separately from their E&S premium tax collections - they reported to us a single figure covering both categories of tax collection¹⁴; and
- five states say they collect direct or independent procurement tax, but they don't track the collections at all.¹⁵

WAYS STATES COULD LOSE

As referenced above, our analysis identified only two ways in which states, either individually or together, could lose revenues under a coordinated multistate taxation system. They follow.

¹² Our research only concretely identifies two states that tax this way, Virginia and Texas. Texas employs a variation known as the "orphan tax," under which it taxes premium allocable to other states only if those other states are not collecting tax on the same premium.

¹³ Our research shows that the following ten states do not have a direct or independent procurement tax: Delaware, Illinois, Massachusetts, Montana, Nebraska, North Dakota, Oregon, Washington, West Virginia, and Wyoming. South Carolina reported to us that, although they do not have a specific direct procurement tax, they track E&S premium tax paid on brokerless placements.

¹⁴ States that reported to us that they do not track direct or independent procurement tax separately from E&S premium tax collections are Alabama, Delaware (which has no statutory provision for direct procurement, so when insureds pay such tax, it's recorded as E&S premium tax), and Georgia.

¹⁵ The states that reported to us that they collect direct or independent procurement taxes but do not track those collections at all are Connecticut, Iowa, Kentucky, Oklahoma, and Virginia.

- First, as indicated above, a tax-allocating state could lose revenue if a large number of its brokers have been inappropriately paying premium tax on gross premium on multistate placements. Under a multistate agreement, the brokers would likely allocate such revenues, as appropriate, to other states, which would reduce revenue to the brokers' home states. The data we have gathered does not show -- and cannot show -- the amount of tax that may be inappropriately paid in this way to brokers' home states.
- Second, if a gross-taxing state is presently getting all of the premium tax it deserves and shifts to a tax-allocation method under a multistate agreement, it would obviously lose revenue. It is impossible to tell whether such states are collecting all the premium tax they are due. And our research only firmly identifies Virginia and Texas¹⁶ as gross-taxing states.¹⁷ And mitigating the possibility that those states could lose tax revenue is the idea referenced in the previous section, i.e., gross-taxing states could gain revenue by collecting tax on multistate transactions that may not presently be filed there.

CONCLUSION

A coordinated tax system for multistate E&S placements would not only enhance consumer value by providing clear guidance regarding compliance issues on those placements, it would also ensure fair and equitable distribution of tax revenues among the states. A clear and simple means of compliance with tax rules and other regulations are also likely to increase compliance, boosting overall tax collections. At the same time, under such a collection system, any state would retain its inherent ability to adjust its E&S tax rates and make up for any shortfall.

As Congress and the states contemplate regulatory modernization and more coordinated regulation of insurance, through optional federal chartering, the Smart Act, and state by state initiatives, a compact for E&S regulation and taxation merits consideration by federal and state policymakers.

¹⁶ As referenced in a previous footnote, Texas' variant on gross-taxation has it collect tax on premium derived from risk in other states only if those states are not collecting tax on the same premium.

¹⁷ Hawaii, New Mexico, Rhode Island, and Vermont did not respond to either of our surveys, so we could not determine whether or not they are gross-taxing states.

PART TWO: METHODOLOGY AND QUANTITATIVE ANALYSIS

As referenced above, Part Two of this paper will address the quantitative portion of our research. It will:

- describe our survey-based methodology;
- describe our data analysis, including validation of the data we received and calculations we performed on that data; and
- present selected tax data that we collected and the results of our calculations.

METHODOLOGY

Our methodology included a review of existing literature, two 50-state surveys of regulators, and one survey of E&S stamping offices. We designed the surveys to collect premium and tax revenue data for 2004 and 2005, and to confirm information we had regarding tax rates in the states. We also compared the data we collected from regulators and stamping offices with information reported in other published and unpublished sources.

Specifically, we surveyed

- stamping offices of the 15 states that have such offices, seeking the gross policy premiums written in those states each year; and
- insurance regulatory professionals in charge of surplus lines in State Insurance Departments, regarding
 - how much E&S lines premium tax each state collected in 2004 and 2005;
 - how much direct/independent procurement tax each state collected on E&S lines business in 2004 and 2005;
 - whether the tax rates applied to an allocated portion of risks located in the state, or to 100 percent of policy premium;
 - whether each state's E&S lines premium tax rate had changed since the beginning of 2004;¹⁸ and
 - whether each state's direct/independent procurement tax rate on E&S lines of business had changed since the beginning of 2004.¹⁹

¹⁸ The purpose of this question was to verify tax rates reported in the A.M. Best/NAPSLO 2005 special report.

¹⁹ The purpose of this question was to verify tax rates supplied by LeBoeuf Lamb Greene & MacRae.

Other data sources we reviewed included

- a *Business Insurance* special report plus unpublished data collected in conjunction with that report,
- A.M. Best/NAPSLO special reports on the industry for 2004 and 2005, and
- Schedule T data from 25 of the top 26 E&S insurers (excluding Lloyd's, which does not file a Schedule T).

Following our review of all of the above information, we decided to conduct a follow-up survey of Insurance Department personnel because we determined that

- several Insurance Department respondents had not interpreted correctly our question regarding whether they tax-allocate, and
- responses relative to “gross premiums” did not necessarily include premiums on multistate transactions.

Our follow-up survey addressed the two issues identified immediately above, and attempted to clarify other questions that arose in our data analysis. The follow-up survey

- asked more clearly whether states tax-allocate on multistate transactions or tax the full premium amount,
- asked whether tax allocating states collect data on portions of multistate transactions they don't tax, i.e. gross premium on multistate placements including the out-of-state portion,
- asked how much taxable premium was written in each state in 2004 and 2005,
- sought information regarding dates of tax years, and
- sought information regarding applicability of different tax rates to different categories of risk and premium amounts taxed at those rates.

DATA REVIEW AND ANALYSIS VALIDATION

We began our data analysis with an effort to validate data we collected in our surveys by comparing it with published data. We found that, in most cases, the data we collected was broadly similar to data published. However, the comparison helped us identify certain errors in our data that resulted from respondents' incorrect answers, which we were able to correct. We also identified several inconsistencies in published data, which illustrate the potential for confusion when discussing E&S premium and tax amounts. It is not the purpose of this paper to analyze or critique survey data published elsewhere, but we discovered, for example, that several

states reported E&S premium tax numbers to *Business Insurance* that included direct or independent procurement tax, with no notation to that effect.

CALCULATIONS

As referenced above, this study was aimed at providing a quantitative response to the argument that a coordinated system of taxation and regulation like a compact would produce state revenue winners and losers. The hypothesis underlying our calculations was that many states were collecting less than they could have been entitled to collect.

In our effort to determine whether states were definitively under-collecting taxes on E&S transactions, we performed three sets of calculations, which we have identified below. None of the calculations proved that states were, or were not, under-collecting taxes.

Specifically, the three sets of calculations

- compared NAIC Schedule T data for 25 of the top 26 non-admitted insurers²⁰ in the U.S. market with premium tax collections in the states,
- compared premium tax data that we collected in our surveys with published premium numbers, and
- attempted to determine how much revenue states “lost” by tax-allocating that they did not “make back” in the form of direct or independent procurement taxes.

The calculations are presented in more detail below, along with tables showing selected data.

SCHEDULE T CALCULATION AND ANALYSIS

The hypothesis we tested with the Schedule T analysis was that most states did not collect as much premium tax as “should have” been generated by the amounts of premium reported on the largest insurers’ Schedule T filings with the NAIC. According to its instruction document, the Schedule T “is intended to exhibit the amount of premiums allocated to each state and it should be the basis of premium tax calculations.”

Our analysis did not show any broad or significant under-collection of premium taxes based on Schedule Ts.

More important, closer examination of the issue, including conversations with industry representatives, has convinced us that non-admitted carriers’ Schedule T filings are not a reliable means of determining whether specific states have collected all the premium taxes to which they are entitled. The biggest reason for the unsuitability of Schedule T data for use in collecting E&S premium tax is that E&S brokers file and pay premium tax and carriers file Schedule Ts for other purposes.

²⁰ As referenced above, Lloyd’s, the second largest E&S insurer in the U.S. market, could not provide state by state premium data.

Brokers' and carriers' filings will always vary for a variety of reasons, including the following.

- Brokers and carriers have different filing schedules.
- Brokers and carriers must treat direct and independent procurement taxes differently. While carriers would report premium generated without a broker, no broker can report this premium.²¹

Finally, allocation methods vary widely between brokers and carriers, as they must under the present system. For example, if a multistate placement involves a gross-taxing state and an allocating state

- the premium derived from risk located in the allocating state would be taxed twice,
- the broker would file documents showing that tax was paid on more than 100 percent of the premium on the placement, and
- the carrier would allocate the amount of the actual premium, because its Schedule T filings must tie to its financial statements.

In other words, the broker's filings are tied to premium taxes paid, while the carrier's Schedule T filings only show premium written. In the case described above, the carrier would report a lower premium amount than the broker would report.

Additionally, even if this fundamental difference between the two reporting systems did not exist, carriers would face the same challenges that brokers now face regarding the vagaries of allocating risk in multistate policies under the present uncoordinated system of different, and often conflicting, state laws.²²

This issue is particularly important in light of recent efforts by several states, and now the NAIC, to use Schedule T filings to confirm that they have collected all the E&S premium taxes they are due. We have identified just a few of many reasons that such efforts will not garner the desired result.

CALCULATIONS BASED ON PREMIUM AND TAX DATA

The second theory we tested was that, on a national and on a state by state basis, states were not collecting tax on all taxable premium. To check this theory, we calculated the amount of premium that was taxed in each state and compared it to unpublished data on taxable premium that *Business Insurance* collected and supplied to us. We did this by

²¹ Bouhan 1994.

²² Undated NAPSLO Manuscript

- dividing the surplus lines premium tax collected in each state by the tax rate to calculate how much premium was taxed this way,
- dividing the direct or independent procurement tax collected in each state by that tax rate to calculate how much premium was taxed this way,
- adding the two calculated premium figures to determine how much premium was taxed in each state for each of the years in question, and
- comparing this number with the premium written figures reported in *Business Insurance's* "Spotlight Report: Surplus Lines Premiums and Taxes by State," published September 11, 2006.

We found that the amount of premium taxed broadly matched the amount of premium reported to *Business Insurance*, and did not indicate any widespread or significant under-collection of taxes. In fact, when we compared the amount of premium taxed on a nationwide basis, and compared it with published figures reporting total E&S premium written on a national basis, our figures showed that in 2004, 95 percent of premium written was taxed, and in 2005, 94 to 99 percent was taxed (there is a range for 2005 due to the different premium figures reported by A.M. Best and *Business Insurance*, as discussed below). Table One below shows the state by state analysis, and Table Two shows the aggregated national figures.

It is appropriate here to note that accurate premium numbers are very difficult to ascertain, both on a state by state and on a national basis.²³ Table Two below shows significant differences between gross premium written figures reported by *Business Insurance* and by A.M. Best. Specifically, A.M. Best's figures for 2005 are 4.44 percent lower than *Business Insurance*.

CALCULATIONS BASED ON MULTISTATE GROSS PREMIUM DATA

The third theory we tested was that, for tax-allocating states, the amount they collect in direct and independent procurement taxes did not "make up for" tax "lost" on multistate premium they did not tax.

We were unable to perform this calculation in a meaningful way because, of the 38 states that responded to our second survey, which was aimed at gathering data on premiums on multistate transactions, we found that only one, New York, was a tax-allocating state that collected data on premium it does not tax because of its multistate nature. Several states reported premium that was not taxed because the type of risk or the type of insured are exempt from such taxes.

The lack of data at the state level on premium derived from risks located in other states points out the difficulty in ascertaining how much premium is actually written in the U.S. E&S market. Establishment of clear and uniform tax payment and premium allocation through a coordinated state system like a compact could fill this void in our present knowledge of E&S premium amounts on a state and national basis.

²³ Brockett p. 244.

TABLE ONE – PREMIUM AND TAX CALCULATIONS

Note that, in the last column, positive values for several states, which could, at first glance, suggest over-collection of taxes, are explained largely, if not completely, by direct or independent procurement taxes in the same amounts.

2004					
States	Calculated Premium on which Procurement Taxes were paid	Calculated Premium on which Premium Taxes were paid	Total Calculated Premium	Taxable Premium as Reported to Business Insurance (supplemented by our calculations - see note below)	Difference Between Calculated Premium and BI Taxable Premium
	<i>Direct/Independent Procurement Tax Collected divided by Direct/Independent Procurement Tax Rate</i>	<i>E&S Premium Tax Collected divided by E&S Tax Rate²⁴</i>	<i>Calculated Premium on which Premium Tax was paid Plus Calculated Premium on which Procurement Tax was Paid</i>	<i>Where BI had no data, we have entered our calculated premium on which PT was paid. Noted with bold numbers.</i>	<i>Calculated Premium minus BI-reported Taxable Premium (negative suggests premium amounts possibly untaxed)</i>
Alabama	0	407,736,700	407,736,700	406,991,433	745,267
Alaska	14,533,333	81,370,370	95,903,704	64,685,222	31,218,482
Arizona	18,859,400	528,067,100	546,926,500	528,067,100	18,859,400
Arkansas	18,825,500	184,392,325	203,217,825	184,392,693	18,825,132
California	620,586,733	5,572,769,167	6,193,355,900	5,572,768,644	620,587,256
Colorado	364,756	461,452,700	461,817,456	461,452,700	364,756
Connecticut	0	300,753,350	300,753,350	300,753,350	0
Delaware	0	73,810,000	73,810,000	73,810,093	(93)
Florida	417,564,180	2,232,627,720	2,650,191,900	2,508,508,400	141,683,500
Georgia	0	852,746,750	852,746,750	852,746,750	0
Hawaii²⁵	0	197,744,851	197,744,851	198,509,751	(764,900)
Idaho	94,982	66,246,655	66,341,636	66,245,757	95,879
Illinois	0	818,937,057	818,937,057	1,012,483,750	(193,546,693)
Indiana	5,819,926	375,323,160	381,143,086	375,323,146	5,819,940
Iowa	0	131,528,629	131,528,629	131,528,643	(14)
Kansas	10,844,139	148,701,300	159,545,439	152,743,375	6,802,064
Kentucky	0	151,349,200	151,349,200	152,515,154	(1,165,954)
Louisiana	10,757,780	829,719,940	840,477,720	837,300,751	3,176,969
Maine	5,117,667	67,448,833	72,566,500	62,986,560	9,579,940

²⁴ In some cases, states have different rates for different categories of risk including, for example, marine or fire risk. In these cases we used the “Surplus Lines” rate.

²⁵ Data for this state is from September 11, 2006, Business Insurance Spotlight Report because the state did not respond to our survey.

2004					
States	Calculated Premium on which Procurement Taxes were paid	Calculated Premium on which Premium Taxes were paid	Total Calculated Premium	Taxable Premium as Reported to Business Insurance (supplemented by our calculations - see note below)	Difference Between Calculated Premium and BI Taxable Premium
	<i>Direct/Independent Procurement Tax Collected divided by Direct/Independent Procurement Tax Rate</i>	<i>E&S Premium Tax Collected divided by E&S Tax Rate²⁶</i>	<i>Calculated Premium on which Premium Tax was paid Plus Calculated Premium on which Procurement Tax was Paid</i>	<i>Where BI had no data, we have entered our calculated premium on which PT was paid. Noted with bold numbers.</i>	<i>Calculated Premium minus BI-reported Taxable Premium (negative suggests premium amounts possibly untaxed)</i>
Maryland	16,191,000	395,932,833	412,123,833	395,781,933	16,341,900
Massachusetts	0	629,166,875	629,166,875	708,640,237	(79,473,362)
Michigan	145,505,720	725,763,840	871,269,560	725,763,840	145,505,720
Minnesota	13,672,750	376,346,833	390,019,583	377,566,333	12,453,250
Mississippi	7,558,833	264,172,200	271,731,033	264,177,156	7,553,877
Missouri	44,907,340	444,408,560	489,315,900	489,315,902	(2)
Montana	0	45,425,018	45,425,018	45,425,018	0
Nebraska	0	92,163,633	92,163,633	92,163,633	0
Nevada	20,943,343	278,287,857	299,231,200	336,217,740	(36,986,540)
New Hampshire	10,485,900	80,254,900	90,740,800	80,254,867	10,485,933
New Jersey	112,038,467	1,055,349,500	1,167,387,967	1,055,349,500	112,038,467
New Mexico²⁷	0	63,126,474	63,126,474	63,126,474	0
New York	339,444,444	2,609,827,000	2,949,271,444	2,609,826,997	339,444,447
North Carolina	3,393,640	493,665,120	497,058,760	496,474,709	584,051
North Dakota	0	30,846,400	30,846,400	30,843,557	2,843
Ohio	1,362,220	246,000,000	247,362,220	157,234,516	90,127,704
Oklahoma	0	304,276,600	304,276,600	304,276,600	0
Oregon	0	282,675,850	282,675,850	257,090,552	25,585,298
Pennsylvania	193,500,000	770,100,000	963,600,000	865,603,000	97,997,000
Rhode Island²⁷	0	76,957,533	76,957,533	2,308,726	74,648,807
South Carolina	69,450	389,463,625	389,533,075	389,533,050	25
South Dakota	967,480	45,127,680	46,095,160	45,127,696	967,464

²⁶ In some cases, states have different rates for different categories of risk including, for example, marine or fire risk. In these cases we used the "Surplus Lines" rate.

²⁷ Data for this state is from September 11, 2006, Business Insurance Spotlight Report because the state did not respond to our survey.

2004					
States	Calculated Premium on which Procurement Taxes were paid	Calculated Premium on which Premium Taxes were paid	Total Calculated Premium	Taxable Premium as Reported to Business Insurance (supplemented by our calculations - see note below)	Difference Between Calculated Premium and BI Taxable Premium
	<i>Direct/Independent Procurement Tax Collected divided by Direct/Independent Procurement Tax Rate</i>	<i>E&S Premium Tax Collected divided by E&S Tax Rate²⁸</i>	<i>Calculated Premium on which Premium Tax was paid Plus Calculated Premium on which Procurement Tax was Paid</i>	<i>Where BI had no data, we have entered our calculated premium on which PT was paid. Noted with bold numbers.</i>	<i>Calculated Premium minus BI-reported Taxable Premium (negative suggests premium amounts possibly untaxed)</i>
Tennessee	7,596,440	473,107,960	480,704,400	473,107,960	7,596,440
Texas	253,010,206	3,221,598,598	3,474,608,804	3,321,116,492	153,492,312
Utah	20,625,200	143,018,565	163,643,765	146,245,111	17,398,654
Vermont²⁹	0	38,173,700	38,173,700	38,173,700	0
Virginia	0	633,603,289	633,603,289	679,051,028	(45,447,739)
Washington	0	712,362,250	712,362,250	712,362,142	108
West Virginia	0	128,384,375	128,384,375	128,061,144	323,231
Wisconsin	66,983,133	328,196,367	395,179,500	328,196,368	66,983,132
Wyoming	0	33,122,600	33,122,600	33,122,878	(278)
Totals:	2,381,623,962	28,893,631,842	31,275,255,804	29,595,352,131	1,679,903,673

²⁸ In some cases, states have different rates for different categories of risk including, for example, marine or fire risk. In these cases we used the “Surplus Lines” rate.

²⁹ Data for this state is from September 11, 2006, Business Insurance Spotlight Report because the state did not respond to our survey.

TABLE ONE CONTINUED – PREMIUM AND TAX CALCULATIONS

Note that, in the last column, positive values for several states, which could, at first glance, suggest over-collection of taxes, are explained largely, if not completely, by direct or independent procurement taxes in the same amounts.

2005					
States	Calculated Premium on which Procurement Taxes were paid	Calculated Premium on which Premium Taxes were paid	Total Calculated Premium	Taxable Premium as Reported to Business Insurance (supplemented by our calculations - see note below)	Difference Between Calculated Premium and BI Taxable Premium
	<i>Direct/Independent Procurement Tax Collected divided by Direct/Independent Procurement Tax Rate</i>	<i>E&S Premium Tax Collected divided by E&S Tax Rate³⁰</i>	<i>Calculated Premium on which Premium Tax was paid Plus Calculated Premium on which Procurement Tax was Paid</i>	<i>Where BI had no data, we have entered our calculated premium on which PT was paid. Noted with bold numbers.</i>	<i>Calculated Premium minus BI-reported Taxable Premium (negative suggests premium amounts possibly untaxed)</i>
Alabama	0	445,746,000	445,746,000	445,746,000	0
Alaska	16,825,033	89,453,519	106,278,552	89,377,259	16,901,293
Arizona	19,708,233	663,703,267	683,411,500	663,703,267	19,708,233
Arkansas	17,037,200	201,859,750	218,896,950	201,859,745	17,037,205
California	442,349,233	5,622,450,467	6,064,799,700	5,622,450,389	442,349,311
Colorado	2,860,889	543,781,333	546,642,222	503,030,140	43,612,082
Connecticut	0	329,358,800	329,358,800	329,358,800	0
Delaware	0	92,835,950	92,835,950	92,689,683	146,267
Florida	551,294,600	2,660,908,760	3,212,203,360	3,221,704,536	(9,501,176)
Georgia	0	895,643,150	895,643,150	895,643,175	(25)
Hawaii³¹	0	232,951,489	232,951,489	233,981,170	(1,029,681)
Idaho	7,491	74,202,255	74,209,745	74,201,272	8,473
Illinois	0	1,016,504,629	1,016,504,629	1,016,395,632	108,997
Indiana	8,481,865	412,265,320	420,747,185	409,581,452	11,165,733
Iowa	0	135,130,933	135,130,933	134,327,940	802,993
Kansas	7,209,230	160,279,300	167,488,530	170,585,763	(3,097,234)
Kentucky	0	167,996,133	167,996,133	165,200,696	2,795,437
Louisiana	29,017,240	853,173,280	882,190,520	853,173,280	29,017,240
Maine	2,454,000	60,111,200	62,565,200	66,766,454	(4,201,254)

³⁰ In some cases, states have different rates for different categories of risk including, for example, marine or fire risk. In these cases we used the “Surplus Lines” rate.

³¹ Data for this state is from September 11, 2006, Business Insurance Spotlight Report because the state did not respond to our survey.

2005					
States	Calculated Premium on which Procurement Taxes were paid	Calculated Premium on which Premium Taxes were paid	Total Calculated Premium	Taxable Premium as Reported to Business Insurance (supplemented by our calculations - see note below)	Difference Between Calculated Premium and BI Taxable Premium
	<i>Direct/Independent Procurement Tax Collected divided by Direct/Independent Procurement Tax Rate</i>	<i>E&S Premium Tax Collected divided by E&S Tax Rate³²</i>	<i>Calculated Premium on which Premium Tax was paid Plus Calculated Premium on which Procurement Tax was Paid</i>	<i>Where BI had no data, we have entered our calculated premium on which PT was paid. Noted with bold numbers.</i>	<i>Calculated Premium minus BI-reported Taxable Premium (negative suggests premium amounts possibly untaxed)</i>
Maryland	20,321,933	434,887,600	455,209,533	434,889,000	20,320,533
Massachusetts	0	708,640,225	708,640,225	702,878,772	5,761,453
Michigan	109,586,640	703,357,040	812,943,680	703,357,040	109,586,640
Minnesota	32,890,050	393,128,400	426,018,450	392,730,267	33,288,183
Mississippi	8,040,533	263,313,175	271,353,708	263,329,614	8,024,094
Missouri	32,249,760	404,489,860	436,739,620	436,739,610	10
Montana	0	64,692,873	64,692,873	64,692,873	0
Nebraska	0	92,141,167	92,141,167	92,141,171	(4)
Nevada	24,099,514	354,271,514	378,371,029	370,018,174	8,352,855
New Hampshire	13,524,475	102,946,250	116,470,725	102,917,482	13,553,243
New Jersey	82,831,967	1,087,994,033	1,170,826,000	1,087,994,033	82,831,967
New Mexico³³	0	67,608,458	67,608,458	67,608,458	0
New York	427,777,778	2,768,618,083	3,196,395,861	2,768,618,072	427,777,789
North Carolina	1,888,660	514,965,060	516,853,720	516,807,631	46,089
North Dakota	0	36,223,943	36,223,943	36,222,949	994
Ohio	3,420,240	342,000,000	345,420,240	241,263,107	104,157,133
Oklahoma	0	319,526,400	319,526,400	319,526,400	0
Oregon	0	312,702,150	312,702,150	312,702,150	0
Pennsylvania	236,900,000	780,666,667	1,017,566,667	780,666,667	236,900,000
Rhode Island³³	0	71,794,067	71,794,067	2,153,822	69,640,245
South Carolina	191,025	412,489,825	412,680,850	412,680,977	(127)
South Dakota	1,862,240	38,702,120	40,564,360	38,702,132	1,862,228
Tennessee	7,960,040	451,775,240	459,735,280	451,775,240	7,960,040

³² In some cases, states have different rates for different categories of risk including, for example, marine or fire risk. In these cases we used the "Surplus Lines" rate.

³³ Data for this state is from September 11, 2006, Business Insurance Spotlight Report because the state did not respond to our survey.

2005					
States	Calculated Premium on which Procurement Taxes were paid	Calculated Premium on which Premium Taxes were paid	Total Calculated Premium	Taxable Premium as Reported to Business Insurance (supplemented by our calculations - see note below)	Difference Between Calculated Premium and BI Taxable Premium
	<i>Direct/Independent Procurement Tax Collected divided by Direct/Independent Procurement Tax Rate</i>	<i>E&S Premium Tax Collected divided by E&S Tax Rate³⁴</i>	<i>Calculated Premium on which Premium Tax was paid Plus Calculated Premium on which Procurement Tax was Paid</i>	<i>Where BI had no data, we have entered our calculated premium on which PT was paid. Noted with bold numbers.</i>	<i>Calculated Premium minus BI-reported Taxable Premium (negative suggests premium amounts possibly untaxed)</i>
Texas	239,839,938	3,059,170,454	3,299,010,392	3,046,363,903	252,646,489
Utah	14,043,506	142,593,412	156,636,918	147,809,055	8,827,863
Vermont³⁵	0	41,919,433	41,919,433	41,919,438	(5)
Virginia	0	611,530,667	611,530,667	642,889,272	(31,358,605)
Washington	0	739,932,050	739,932,050	739,930,065	1,985
West Virginia	0	130,476,250	130,476,250	128,356,483	2,119,767
Wisconsin	31,605,533	248,758,333	280,363,867	248,758,333	31,605,534
Wyoming	0	40,526,967	40,526,967	40,526,980	(13)
Totals:	<i>2,386,278,847</i>	<i>30,400,197,249</i>	<i>32,786,476,096</i>	<i>30,826,745,823</i>	<i>1,959,730,273</i>

³⁴ In some cases, states have different rates for different categories of risk including, for example, marine or fire risk. In these cases we used the "Surplus Lines" rate.

³⁵ Data for this state is from September 11, 2006, Business Insurance Spotlight Report because the state did not respond to our survey.

TABLE 2 - NATIONAL DATA

	2004	2005
AS REPORTED TO BUSINESS INSURANCE:		
GROSS PREMIUM WRITTEN US ³⁶	32,983,618,705	34,749,265,476
TAX COLLECTED NATIONWIDE (INCLUDES SOME DIRECT AND INDEPENDENT PROCUREMENT TAX) ³⁶	1,094,850,585	1,145,836,004
AS REPORTED IN AM BEST: GROSS PREMIUM WRITTEN US³⁷	33,011,955,000	33,280,702,000
AS REPORTED TO US:		
TOTAL E&S PREMIUM TAX COLLECTED	1,064,052,918	1,122,309,379
TOTAL DIRECT/INDEPENDENT PROCUREMENT TAX COLLECTED	87,321,944	90,336,970
TOTAL TAX COLLECTED ON E&S BUSINESS	1,151,374,862	1,212,646,349
CALCULATIONS BASED ON OUR DATA:		
CALCULATED PREMIUM ON WHICH PREMIUM TAX WAS PAID	28,893,631,842	30,400,197,249
CALCULATED PREMIUM ON WHICH D/I PROCUREMENT TAX WAS PAID	2,381,623,962	2,386,278,847
TOTAL CALCULATED PREMIUM ON WHICH TAX WAS PAID	31,275,255,804	32,786,476,096
OUR CALCULATED TAXED PREMIUM AS A PERCENTAGE OF GROSS PREMIUM WRITTEN AS REPORTED TO BUSINESS INSURANCE	94.82%	94.35%
OUR CALCULATED PREMIUM AS PERCENTAGE OF GROSS PREMIUM WRITTEN AS REPORTED BY AM BEST	94.74%	98.51%

³⁶ We have excluded the District of Columbia from the *Business Insurance* Gross Premium Written and Tax Collected figures because our survey did not include the District.

³⁷ AM Best data includes the District of Columbia because AM Best did not provide premium numbers on a jurisdiction by jurisdiction basis.

APPENDIX A: DEFINITION OF TERMS

Following are several terms used in this report and the meanings with which they are used.

- allocated premium: The portion of a premium in a multistate transaction that is allocated to risk(s) in a particular state for tax and regulatory purposes. Brokers generally make these allocations.
- broker: An intermediary between a customer and an insurance company. Brokers typically search the market for coverage appropriate to their clients. They work on commission and usually sell commercial, not personal, insurance.³⁸
- direct procurement: Procurement of an insurance policy from a non-admitted insurance carrier without use of a broker licensed in a particular state. A broker licensed in another state or states might be involved.
- direct procurement tax: Premium tax charged by several states on insureds that have directly procured an insurance policy from a non-admitted insurance carrier.
- excess lines insurers: Non-admitted insurer.
- gross premium: Total premium amount on a multistate transaction.
- gross-basis taxation: A premium taxation method under which a state taxes 100 percent of the policy premium on a multistate transaction, regardless of how much premium derives from risk(s) located in the state.
- independent procurement: Same as Direct Procurement, defined above.
- independent procurement tax: Same as Direct Procurement Tax, defined above.
- multistate placement: A transaction relating to the purchase of insurance covering risks located in more than one state.
- non-admitted insurer: Insurer licensed in its domiciliary state, which is not licensed, but is eligible to sell E&S insurance in other states. They sell coverage that is unavailable from licensed insurers within the state.
- premium tax: Tax paid on insurance premiums. In non-admitted markets, such taxes are generally paid by brokers.
- single state transaction: A transaction relating to the purchase of insurance covering risks located within a single state.

³⁸ Insurance Information Institute Glossary of Insurance Terms (www.iii.org)

- surplus lines insurer: Non-admitted insurer.
- tax allocation: A premium taxation method under which a state taxes only the portion of a multistate policy premium that derives from risk(s) located in the state.
- taxable premium: Premium that is taxable under a state's laws.
- tax-exempt premium: Premium that is exempt from tax under a state's laws, often because of the nature of the risk (e.g. several states exempt aviation risks from premium tax), or the nature of the insured (e.g. a government or other tax-exempt entity).

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