REPORT OF THE
SECRETARY OF FINANCE

The Taxation of Insurance Companies in Virginia

TO THE GOVERNOR AND
THE GENERAL ASSEMBLY OF VIRGINIA

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COMMONWEALTH of VIRGINIA

Stuart W. Connock
Secretary of Finance

Office of the Governor
Richmond 23219

January 10, 1986

TO: The Honorable Charles S. Robb
Governor of Virginia

and

The General Assembly of Virginia

As you know, the 1985 General Assembly passed House Joint Resolution 311, requesting that the Secretary of Finance study the taxation of insurance companies in Virginia. Enclosed for your review and consideration is the report prepared in response to this resolution.

Sincerely,

Stuart W. Connock

Executive Summary

Virginia levies a gross premium tax on the insurance industry. In fiscal year 1985, this tax generated $108.6 million, making it the fifth largest source of revenue in the Commonwealth's General Fund. Although the characteristics of the insurance industry have changed dramatically over the years, the rate structure has not changed from the original form recommended to the General Assembly in the 1914 Report of the Joint Committee on Tax Revision.

House Joint Resolution 311 passed by the 1985 General Assembly requested the Secretary of Finance to study the taxation of insurance companies in Virginia. The objectives of the study were:

1. To examine the philosophy and derivation of the gross premium tax;
2. To evaluate the rationale for applying different tax rates to gross premium income;
3. To assess the tax burden and equity of taxing gross premium income; and
4. To evaluate the criteria for exempting certain types of insurers from the gross premium tax.

The gross premium tax is the most prevalent form of insurance taxation nationwide. However, Virginia's tax structure is more complex than that of most other states. The complexity is due primarily to Virginia's three different rates and numerous fees and special assessments. The overall tax structure is comprised of these basic components:

- the gross premium tax ranging from 1% to 2.75%;
- a corporate income tax that is applied to for-profit health maintenance organizations;
- six different license fees ranging from $20 to $200;
- two assessments to offset the costs of regulatory agencies, and
- a fire programs tax of .8%.

Present law also provides for several exclusions and deductions from the premium tax base.

Certain types of insurers are exempt by law from paying the gross premium tax in Virginia. These include: mutual assessment fire companies serving four counties or less; prepaid hospital, medical, surgical, dental, and optometric plans; and fraternal benefit societies. Because health maintenance organizations (HMOs) are not legally defined as insurance companies, they also are not subject to the premium tax.

Virginia's tax structure appears to have rates that are higher than most states. The 2.75 percent rate on property and casualty companies is especially high, and the addition of the .8 percent fire programs tax results in greater retaliatory taxes paid by Virginia-domiciled companies to other states where they do business. This comparatively high rate is viewed by industry representatives as one reason why the domestic insurance industry is relatively small in Virginia.

Nominal rankings of premium tax rates are one way of comparing tax burdens on insurance companies in Virginia with those in other states. Another way of measuring relative tax burden is to examine how Virginia's taxes are distributed among types of insurance companies. This type of analysis is essentially the same as that conducted in 1914. In order to perform this analysis, a comparable income figure was calculated for the different lines of insurance, and total revenue collected from taxes, fees, and assessments was determined. The percentage of income that goes to pay taxes, fees, and other assessments provides an indicator of relative tax burden.

The analysis of tax burden showed that among domestic insurers, the highest relative tax burden is on the property and casualty companies, mutual assessment fire companies, and the workers' compensation self-insured groups. This finding is essentially the same as the key finding in the 1914 study. At that time, the rate structure was adjusted to reduce the burden on property and casualty companies.

The fact that Blue Cross/Blue Shield (BC/BS) plans, HMOs, and fraternal benefit societies are not subject to the gross premium tax is viewed by many commercial insurers as another inequity in Virginia's tax structure. They believe that these organizations provide insurance protection that is largely indistinguishable from that sold by companies that are subject to the tax. According to commercial insurers, this preferential tax status gives these organizations a competitive edge in the market.

The tax-exempt groups counter that they provide certain public benefits and charitable work that they would have to reduce or eliminate if they were subject to the tax. Furthermore, the BC/BS plans and HMOs indicate that if they eliminated the open enrollment and unrestricted conversion provisions in their contracts, the state would have to assume the risk for large numbers of individuals who would not be able to get affordable insurance coverage.

The long-standing tax-exempt status of these organizations is currently being considered in a number of forums. Not only are other states reassessing their tax treatment, but Congress will likely be addressing this issue over the next few years.

Several alternatives exist for addressing tax inequities while maintaining current levels of revenue. The options are not mutually exclusive and are open to combination and refinement. The present system could be restructured in the following ways:

- Equalize the base of taxation. The major inequity here is the inability of property and casualty companies to deduct assessments paid to guaranty associations, whereas life companies are permitted this deduction. To remedy this situation, either eliminate or permit this deduction for all companies. If the status quo is maintained, a deduction for annuity claims should be disallowed.

- Equalize license fees. There is no justification for the variation in amounts or application of annual license fees. They should either be repealed, equalized, or, if different, tied to a defensible rationale.

- Require all companies to equitably bear the cost of regulation. Self-insured workers' compensation groups pay administrative assessments to both the Bureau of Insurance and the Industrial Commission. Fraternal benefit societies pay no administrative assessments.

- Reduce the tax burden for property and casualty companies. These companies bear a far greater tax burden than other lines of insurance. Ways to reduce the burden include decreasing the premium tax rate and eliminating or crediting the fire programs tax.

- Move toward a simplified rate structure. Virginia's multi-tiered structure can be simplified without a major loss in revenue. A single or two-tiered structure should be considered.

A major issue that should be addressed definitively is the tax-exempt status of BC/BS plans and HMOs. Much of the information necessary to make a decision to maintain or alter the status does not now exist, but should be collected in a subsequent study. Based on the results of that study, the tax structure should be addressed in one of the following ways:

1. eliminate the tax on all health insurance;

2. tax all health insurance at one rate, or;

3. establish a rate differential based on criteria that are regulated by the State Corporation Commission.

Most alternatives result in revenue adjustments. In addition to revenue impacts, changes in the current system can have other unanticipated impacts, especially in the area of retaliatory taxes, self-insurance, costs to consumers, uninsured risks, and availability of care.

- Retaliatory Taxes: Any increase in the effective rate of taxation in Virginia (through increased premium tax rate, fees, licenses, and special taxes) can result in higher retaliatory taxes for Virginia-domiciled companies that do business in other states.

- Self-Insurance: As the costs of coverage increase (especially for health and liability coverage), many employers may turn to methods of self-insuring. Under federal, law it is not clear whether self-insurance can be taxed by the states.

- Costs to Consumers: If higher tax rates are levied on insurance and if tax-exempt companies lose their preferential status, consumers may bear a share of the rate increase in higher premiums. However, if rates are reduced, there is no guarantee that consumers will benefit from the savings.

- Uninsured Risks: If tax-exempt health insurance is taxed and open enrollment and conversion policies are no longer available, the government may be faced with a greater need for charity or subsidized care.

- Availability of Care: If all health insurance is taxed, BC/BS plans might eliminate "charity care allowances" which could place a severe financial burden on certain hospitals. Also, the availability of health insurance might be concentrated in the highly profitable metropolitan areas at the expense of rural areas.

This study should be continued in 1986 to respond to the following recommendations:

Recommendation 1: The inequities in the tax structure identified in this report should be addressed by the Governor and the General Assembly in the following manner:

- The continued study should propose specific revisions of the tax structure to bring about equity between life and casualty companies and rectify other inequities in the structure.

- Legislation should be recommended to the 1987 Session of the General Assembly to effect those changes for tax years beginning on and after January 1, 1988.

- Anticipated revenue adjustments should be incorporated in the general fund revenue forecast for the 1988-90 biennium and beyond.

Recommendation 2: The study should document the possible ramifications of taxing exempt organizations such as escalating hospital costs and increasing numbers of high risk and uninsurable individuals whose health care coverage would be jeopardized if open enrollment periods were no longer available.

Recommendation 3: The study should include the views of the Attorney General regarding the Commonwealth's authority to tax self-insured groups under federal law.

Recommendation 4: If federal tax reform results in eliminating the tax-exempt status of BC/BS plans, HMOs and fraternal benefit organizations, consideration should be given by the Governor and the General Assembly to imposing the gross premium tax on these entities.

ACKNOWLEDGEMENTS

This report was prepared for the Secretary of Finance by staff from the Department of Planning and Budget. Principal contributors were Richard D. Brown (Project Director), Lois S. Lindsay, and Billie K. Payne.

The team would like to acknowledge the assistance and information provided by numerous people during the conduct of the study.

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The study team met with representatives of the insurance industry throughout the conduct of the study. They are listed by name and organization in Appendix D.

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I Overview

Background and Objectives of HJR 311

The tax levied on the gross premiums of insurance companies is the fifth largest source of revenue for the Commonwealth's General Fund. In fiscal year 1985, this tax generated $108.6 million. Although the characteristics of the insurance industry have changed markedly over the years, no broad examination of the tax has been undertaken since the current structure was established in 1914.

House Joint Resolution 311 passed by the 1985 session of the General Assembly (see Appendix A), requested the Secretary of Finance to study the taxation of insurance companies in Virginia. The study was conducted by staff from the Department of Planning and Budget, with assistance from the State Corporation Commission and the Department of Taxation. During the course of the study, representatives from the insurance industry provided information and assistance.

The objectives of the study are:

1. To examine the philosophy and derivation of the gross premium tax;

2. To evaluate the rationale for applying different tax rates to gross premium income;

3. To assess the tax burden and equity of taxing gross premium income; and

4. To evaluate the criteria for exempting certain types of insurers from the gross premium tax.

Provisions governing the taxation of insurance companies are included in Title 58.1 of the Code of Virginia. Other license fees and regulatory assessments are contained in Titles 38.1 and 65.1 of the Code. Although some health care providers are not legally defined as insurance companies, for purposes of this report, all health care providers who agree to protect an individual against medical costs and collect fees in advance to provide that coverage shall be referred to as insurance companies.

Current Rate Structure

Virginia levies a gross premium tax on the insurance industry. This type of tax is used in all states because it is relatively simple to administer by both the state and the industry. In contrast to most states, however, Virginia has a differentiated rate structure ranging from 1 percent to 2.75 percent. The overall tax structure is made up of four basic components. These include two general revenue taxes (premium and corporate income), six separate annual license fees, two different assessments to offset the costs of regulatory agencies, and a dedicated tax for fire services programs. Each of these items is discussed in more detail in the following sections.

Three-tiered Structure: Table I-1 on page 3 presents an overview of the tax and fee structure. Virginia's premium tax structure has three different rates which are applied to the various types of insurance. Property and casualty, accident and sickness, disability, title, prepaid legal, and home protection premiums are assessed the highest rate of 2.75 percent; life insurance pays at a 2.25 percent rate; and small cooperative companies and mutual assessment fire companies pay at 1 percent. The total tax revenue from each type of insurer is shown below.

TABLE I-2

PREMIUM TAX REVENUE BY MAJOR LINES OF INSURANCE
1984

Type of Insurance	Premium Tax Collected
Life, Accident and Sickness, Annuities Companies	$47,136,231
Property and Casualty Companies	56,275,637
Cooperative Non-Profit Life Benefit Companies	1,447
Cooperative or Assessment Life and Casualty Companies	4,566
Burial Societies	133,317
Title Insurance Companies	939,904
Fraternal Benefit Societies	0
Mutual Assessment Fire Companies	218,049
Home Protection	9,610
Prepaid Hospital, Medical, Surgical, Dental, Optometric Services	0
Prepaid Legal Plans	0
Workers Compensation Self-Insured Groups	0
Health Maintenance Organizations	0
TOTAL	$104,718,761

SOURCE: State Corporation Commission, Bureau of Insurance.

TABLE I-1

TAX AND FEE STRUCTURE FOR INSURANCE COMPANIES IN VIRGINIA
1984

Classes of Insurance	Gross Premium Tax	Other License Fees	Insurance Bureau Assessment	Industrial Commission	Fire Programs	Corporate Income Tax
Life	(2.25%)	-	(.06%)	-	-	-
Accident & Sickness	(2.75%)	-	(.06%)	-	-	-
Property & Casualty[a/]	(2.75%)	-	(.06%)	(1.0%)	(.8%)	-
Cooperative Nonprofit Life Benefit	(1.0%)	$25	(.06%)	-	-	-
Cooperative or Assessment Life and Casualty	(1.0%)	-	(.06%)	-	-	-
Burial Societies	(1.0%)	-	(.06%)	-	-	-
Title Insurance	(2.75%)	-	(.06%)	-	-	-
Mutual Assessment Fire (4 counties or less)	-	-	(.06%)	-	(.8%)	-
Mutual Assessment Fire (More than 4 counties)	(1.0%)	-	(.06%)	-	(.8%)	-
Home Protection	(2.75%)	-	(.06%)	-	(.8%)	-
Prepaid Legal	(2.75%)	$50-200	(.06%)	-	-	-
Prepaid Hospital, Medical, Surgical, Dental, Optometric	-	$50-200	(.06%)	-	-	-
HMOs	-	$100	(.06%)	-	-	(6.0%)
Fraternal Benefit Societies	-	$20	-	-	-	-
Workers' Compensation - Self-Insured Groups	-	-	(.06%)	(1.1%)	-	-

[a/] Property and casualty tax and assessment excludes workers' compensation premiums.

SOURCE: State Corporation Commission, Bureau of Insurance.

The State Corporation Commission's Bureau of Insurance is responsible for collecting the tax and auditing tax returns. Each company that is subject to the gross premium tax computes its tax liability on a calendar year basis and submits a tax form to the Bureau by March of the year following the taxable period. The following method is used to compute the tax:

- Step I: Total dollar premiums written, minus allowable deductions = premium tax base.

- Step II: Premium tax base, multiplied by applicable rate = premium tax due.

A detailed assessment of the current structure is found in Chapters II, III, and IV.

Exemptions from Premium Tax: Certain types of insurers are exempt by law from paying the gross premium tax in Virginia. These include the following:

- Mutual assessment fire companies serving four counties or less (county mutuals);

- Prepaid hospital, medical, surgical, dental, and optometric plans; and

- Fraternal benefit societies (fraternals).

The premium tax does not apply to health maintenance organizations (HMOs) because the organizations are not included in the statutory definition of insurance. HMOs that are organized for profit must pay corporate income tax (see Table I-1); however, no HMO has yet shown profits that would be subject to taxation.

Other Fees and Assessments: Insurance companies are subject to other fees and assessments in addition to the gross premium tax. Cooperative nonprofit life benefit companies, prepaid legal, fraternals, HMOs, and prepaid health plans pay an annual license fee. These fees range from $20 to $200. County mutuals pay no license fee but are assessed the Bureau's fee and the fire programs tax. Fraternals pay only a $20 per year license fee. For the most part, license fees represent relatively minor charges which are applied only to those classes of insurance which are exempt from the gross premium tax. There are two exceptions, however. Prepaid legal plans and cooperative benefit companies are required to pay annual license fees of $50 and $25, respectively, in addition to their tax liabilities. In 1984, Virginia collected slightly less than $4,000 from license fees.

Insurance companies in Virginia are also required to pay assessments to offset the costs incurred by certain state regulatory bodies. There are two kinds of assessments for this purpose. The first is a levy on premium income of up to .1 percent for the maintenance of the State Bureau of Insurance. In 1984, this assessment was fixed at 6/100 of 1 percent and is applicable to all classes of insurers in Virginia except fraternal benefit societies. The second assessment is for maintenance of the Industrial Commission of Virginia. This assessment is set annually within prescribed ranges. For property and casualty companies, the rate was 1 percent of 1984 premium income on workers' compensation insurance written in the state. For workers'

compensation self-insured groups, the rate was 1 percent of 1984 premiums for the Administrative Fund and 1/8 of 1 percent of premiums for the Uninsured Employers Fund. Virginia collected approximately $9 million from all regulatory assessments in 1984.

A fourth kind of levy on insurance companies in Virginia is the fire programs' tax. This tax was passed by the 1985 General Assembly and became effective July 1, 1985. It applies a rate of .8 percent to premium income of fire, allied lines, multi-peril, ocean marine and inland marine insurance. Revenues collected from the tax are earmarked for purchases of fire service training facilities and firefighting equipment and for underwriting the costs of the Department of Fire Programs. It is estimated that Virginia would have collected $5 million if this tax had been in effect during 1984.

Methods

A number of data collection activities were conducted during the course of this review. Historic and current literature on the taxation of insurance companies in Virginia and nationwide was reviewed. Annual reports and financial statements of insurance companies doing business in Virginia were analyzed. A telephone survey of every state was conducted to compare other tax structures to Virginia's. Interviews were conducted with representatives of each line of insurance subject to and exempt from the gross premium tax.

Organization of This Report

This chapter has presented a brief overview of HJR 311 and Virginia's current rate structure. The next chapter presents the history of the gross premium tax and trends that are affecting the insurance industry. Chapter III assesses the current structure in terms of relative tax burden and equity considerations. Chapter IV discusses the insurers who are exempt from taxation. The final chapter presents alternatives to the current tax structure and recommendations. Supplemental information is found in appendices to this report.

II The History of Virginia's Gross Premium Tax

Overview

Since the early 1800s, insurance companies in Virginia have been taxed in some form either by the Commonwealth or its localities. The first known state tax on the industry was in 1842, when each insurance office was taxed $100 annually. After 1842, several state and local taxes were levied on the industry in the form of license fees and property and capital stock taxes.

The first state tax on gross premiums was enacted in 1856. This equalled .5 percent on gross premiums received by "foreign" companies (those chartered outside of Virginia). This premium tax was in addition to all other applicable taxes and fees that were in effect at the time.

In 1873, the state tax rate for foreign and "domestic" (those chartered in Virginia) companies became the same. Each company doing business in Virginia paid a $200 annual license fee plus a 1.5 percent tax on premiums. This tax was in lieu of all other state taxes. However, each company continued to pay local real estate and tangible personal property taxes and a license tax to each municipality in which it conducted business.

The rate on premiums was reduced to 1 percent in 1874, when retaliatory tax laws were enacted. Retaliatory provisions attempted to equalize the different tax treatments among the states. For example, if New York-based companies paid a higher rate in Virginia than in New York, then New York state imposed an additional tax on Virginia-domiciled companies doing business there to equal the difference in rates.

In 1914, a broad study was undertaken to examine Virginia's total tax structure. While only a small portion of the study was devoted to the insurance industry, it recommended major changes which were adopted in 1915. The only major change that has occurred since the 1914 study is a fire programs tax levied on fire insurance premiums that took effect in July 1985.

This chapter will take a close look at the historical rationale for the present structure. Trends in the insurance industry which can have significant impacts on tax revenues will also be examined.

1914 Report of the Joint Committee on Tax Revision

The logic and structure of the present system for classifying and taxing insurance is described in the 1914 Report of the Joint Committee on Tax Revision. The report recommended a major restructuring of most of the Commonwealth's tax laws. These recommendations were adopted by a special session of the General Assembly in 1915.

In the section dealing with the taxation of insurance companies, the report stated: "There is confusion and difficulty in ascertaining precisely what the tax burden really is." At least nine state and local taxes and fees were identified. These included: charter fees, a $200 license tax to the state, treasurer deposit security fees, license certificate fees, license payments to each municipality, franchise and registration charges, capital tax to state and localities, real estate and tangible property taxes, and assessments to the Bureau of Insurance.

The report noted that Virginia was one of the few states that still imposed these other taxes in addition to the gross premium tax. It recommended that a majority of the other taxes and fees be eliminated and replaced with a tax paid directly to the Commonwealth, and that a portion of the tax be returned to the localities where the premiums were collected. But, the report also stated: "[I]f a system of partial segregation be adopted, we regard the tax on insurance companies as perhaps better adapted than any other to the exclusive use of the State."

The 1914 report identified several inequities caused by multiple municipal taxes and the single tax rate applied to all classes of insurance. Table II-1 presents information in the 1914 report from which the authors drew several major conclusions about the tax structure. First, small companies with relatively little business (those with annual business under $10,000) bore a much greater tax burden than larger companies with more business. This was primarily because the taxes and fees were levied at a fixed amount, regardless of the size of the company or its profitability. Second, the report concluded that property and casualty companies carried the greatest burden among the different classes of insurance.

It appears that much of the insurance business in 1914 was transacted by company agents who operated out of small local offices or their homes. The premiums these agents collected for selling insurance comprised the major portion of income the companies earned in Virginia. Therefore, a tax on gross premiums adequately taxed the revenues generated in Virginia. Also, the tax was easy for these independent businessmen to administer. Each agent was responsible for reporting to the State Corporation Commission the amount of premiums collected annually from Virginia citizens.

To address the problems of the tax burden and the inequities in the system, the report made two major recommendations:

1. That the gross premium tax on insurance companies be in lieu of all other state and local taxes except charter, franchise and registration charges; local property taxes; and the assessment fee paid to the Bureau of Insurance and the Treasurer.

2. That insurance companies should be grouped into four classes and a rate applied to each class to evenly distribute the tax burden.

TABLE II-1

Report of the Joint Committee on Tax Revision, 1914
Insurance Companies Classified to Show Relative Burden of Virginia Taxes on
Large and Small Companies

Classified by Amount of Virginia Premium Income	FIRE AND MARINE				LIFE			
	No.	Virginia Premium Income	Virginia Taxes	Percentage of Taxes to Income	No.	Virginia Premium Income	Virginia Taxes	Percentage of Taxes to Income
Total All Classes	94	$4,984,484	$211,484	4.27	36	$9,026,399	$169,793	1.88
Under $10,000	8	48,736	4,687	9.61	2	3,345	856	25.62
10,000 - 24,999	20	3,311,914	19,889	6.42	4	81,359	2,365	2.91
25,000 - 49,999	32	1,160,673	59,308	5.12	9	344,928	8,777	2.54
50,000 - 99,999	23	1,500,231	63,175	4.21	4	324,985	6,785	2.04
100,000 - 199,999	6	787,133	25,274	3.21	5	615,576	11,652	1.89
200,000 - 299,999	5	1,176,117	39,148	3.33	2	511,023	9,530	1.87
300,000 - 499,999	-	-	-	-	3	1,203,384	23,701	1.97
500,000 - and over	-	-	-	-	7	5,941,826	106,123	1.79
	CASUALTY AND MISCELLANEOUS				INDUSTRIAL AND SICK BENEFIT			
Total All Classes	32	$1,574,649	$ 40,257	2.56	11	$2,256,688	$ 19,249	.85
Under $10,000	10	51,797	3,233	6.25				
10,000 - 24,999	6	106,770	3,982	3.73				
25,000 - 49,999	6	210,661	6,467	3.07	1	28,219	581	2.06
50,000 - 99,999	5	386,050	9,567	2.48	3	225,178	1,979	.88
100,000 - 199,999	4	472,624	10,303	2.18	2	244,901	1,768	.72
200,000 - 299,999	-	-	-	-	3	721,437	4,189	.38
300,000 - 499,999	1	346,747	6,703	1.93	1	317,041	1,923	.61
500,000 - and over					1	718,912	8,805	1.23
					TOTAL OF ALL COMPANIES			
Total All Classes					173	$17,841,560	$440,784	2.47
Under $10,000					20	103,898	8,777	8.45
10,000 - 24,999					30	500,043	26,236	5.25
25,000 - 49,999					48	1,744,481	75,135	4.31
50,000 - 99,999					35	2,136,417	81,508	3.35
100,000 - 199,999					17	2,120,234	49,000	2.31
200,000 - 299,999					10	2,408,577	52,800	2.19
300,000 - 499,999					5	1,867,172	32,328	1.73
500,000 - and over					8	6,060,738	114,028	1.72

SOURCE: Report of the Joint Committee on Tax Revision, 1914.

The four classes of insurance and the tax rate that was applied to the gross premiums of each class are as follows:

1. Fraternal Orders with no capital stock and no profit that conduct their work through local lodges--------------------0%

2. Sick benefit companies organized for profit. (The low rate applied only to companies issuing policies for no more than $250 and paying sick benefits of no more than $10 per week)---------------------------------------1%

3. Life insurance companies---------------------------------------2.25%

4. Fire and marine, surety, health and accident and all others not not previously enumerated--------------------------------------2.75%

The 1914 report concluded with a table that compared the existing rate at the time ("Present Taxes, State and Municipal") to the three-tiered structure proposed (See Table II-2). The table shows that the "Proposed Tax" more fairly distributed the tax burden between life insurance companies and fire and marine companies. The report's recommendations were adopted by the 1915 General Assembly, and tax rates have remained in force since that time.

TABLE II-2

REPORT OF THE JOINT COMMITTEE ON TAX REVISION, 1914
PRESENT AND PROPOSED TAXES ON INSURANCE COMPANIES

	Present Taxes, State and Municipal	PROPOSED TAX						
		On Premiums		Tax for the Insurance Bureau	Charges for the State Treasurer	Total Taxes and Charges	Changes Over Present Tax	
		Rate	Amounts				Increases	Decreases
Fire and Marine Companies	$211,484	2.75	$137,082	$ 7,082	$1,177	$145,532	$	$65,952
Sick Benefit Companies	19,249	1.00	22,556	1,330	58	23,946	4,697	—
Life Companies	169,793	2.25	203,093	5,603	522	209,220	39,426	—
Casualty, Fidelity and Miscellaneous	40,257	2.75	43,302	2,606	217	46,126	5,868	—
	$440,783	—	$406,033	$16,621	$1,974	$424,824	—	$15,959

SOURCE: Report of the Joint Committee on Tax Revision, 1914

Since 1914, several new lines of insurance have been included within the rate structure. However, the major emphasis of studies on insurance taxation has been on tax-exempt insurers in the health area. Most of these studies were undertaken to determine if exempt insurers continued to meet the original criteria for tax exemption.

Trends in the Insurance Industry

Until the 1970s, the insurance products for sale in the three major categories of life, health, and property and casualty were fairly limited in scope and were similar from company to company. During the last fifteen years, however, each of these lines of insurance has undergone major changes in the range of products and type of coverage provided. The way the insurance industry conducts business and the types of products it sells have been reshaped by the following recent events:

- Significant increases in liability awards;
- Skyrocketing health care costs;
- More knowledgable consumers who "shop around" for insurance and demand more for their insurance dollar; and
- Increased competition through industry deregulation.

This section describes the major trends in the life and property and casualty industries that do have or may have an impact on the gross premium tax in Virginia. A corresponding section on health insurance is found in Chapter IV.

Property and Casualty Trends: About 3,500 companies nationwide sell some form of property and casualty insurance. In 1984, these companies sold more than $118 billion of property and casualty coverage. Over 50 percent of all the insurance written was for individuals. The largest proportion was for individual automobile coverage. The second and third highest were workers' compensation and homeowners' coverage.

Property and casualty lines have historically been cyclical in nature, but over the past six years the property and casualty business has suffered major financial setbacks. Since 1978, premiums have failed to cover claims and operating expenses. As the cost of houses, automobiles, and property increased because of inflation, the amount required to cover such losses soared. However, fierce competition among carriers kept premium rates unreasonably low and high interest rates allowed the companies to use their investment income to make up the difference. By 1984, the industry experienced a record underwriting loss of $22 billion. Last year also marked the first year that investment income no longer bridged the gap between low premium rates and high losses, and combined net income before taxes showed a loss of $3.5 billion.

Although carriers knew their premiums were too low, changing their course proved nearly impossible as clients jumped from one carrier to another to get cheaper rates. Since the summer of 1985, the property and casualty business has shown signs of stabilization. Industry analysts believe that the price wars may be over for the time being.

Municipal and state governments were hit hard by the recent rate increases. As their immunity from liability suits decreased, the cost for insurance grew. Many municipalities either cannot afford the coverage or cannot find a carrier willing to provide coverage. Many corporations are

unable to get coverage for certain lines, such as directors' and officers' liability. Reinsurers, which are used by primary carriers to spread their risks, refused to accept many types of coverage because of high-risk areas of environmental pollution and health and safety liability.

One result of higher premiums and unavailable coverage is that more companies and municipal governments are turning to self-insurance. Under a self-insurance arrangement, these organizations actually assume a sufficient portion of the risks formerly borne by an insurance company. If the number of entities turning to self-insurance continues to grow, it could have a negative impact on premium tax revenues because no type of tax is levied on funds reserved or earmarked for self-insurance in Virginia. While self-insured groups are immune from state regulation by federal law, it is not clear whether such prohibition applies to state taxation of these groups. A legal assessment of this issue is needed.

A positive revenue impact results from recent industry actions to raise premium rates. Higher premiums are increasing the base to which the 2.75 percent tax is applied.

Life Insurance Trends: About 2,125 life insurance companies operate in the United States. At the end of 1984, almost $7 trillion of life insurance was in force nationwide. Over 73 percent of all life insurance written is for ordinary life coverage to individuals.

Unlike the property and casualty business, the life insurance business is relatively predictable and generally escapes cyclical market trends. It has enjoyed steady earnings over the years, and was a big benefactor of the World War II baby boom that matured in the late 1960s and early 1970s. The industry was relatively passive until the late 1970s when it got caught in the soaring interest rate and inflation spiral. Its major product, whole life, was providing a return on the savings portion of 3 to 5 percent which was unappealing to the public.

With deregulation of the financial service industries in 1981, banks and brokerage firms became major competitors of the life insurance industry. In order to regain its share of the market, the industry had to change its approach and offer products that were "interest sensitive" such as variable and universal life policies. These products were well-received by the public. In 1984, sales of variable life increased by 50 percent over the previous year, and universal life more than doubled.

Premium receipts represent the major source of income for the industry. In the late 1960s, life insurance policies represented two-thirds of all coverage sold by life companies. Today, life insurance is only slightly over one-third of all sales, with health insurance and annuity coverage even at about 30 percent each. Sales of annuities as a percent of total sales jumped from 9.6 percent in 1968 to 30.2 percent in 1984. Within the next two years, the sale of annuities and retirement plans is expected to exceed the sale of traditional life insurance products.

These changes should be monitored closely to see what impacts, if any, they have on premium tax revenues. Because Virginia does not tax annuity premiums, if increased sales of annuities are made at the expense of life policies, there will be a negative revenue impact to the state. The rapid diversification of life insurance companies into financial planning areas will further complicate the tax structure, and may result in package policies that are difficult to unravel for the sake of applying several different tax rates to various classes of insurance.

Conclusion

In 1914, when Virginia's tax structure for insurance companies was established, the industry offered a limited number of products and derived nearly all of its income from premiums. The insurance industry has changed significantly since that time. Not only have companies diversified their products, but new types of insurance--Blue Cross and Blue Shield plans and HMOs--have staked out a major share of the health insurance market. These changes can affect revenues collected through the gross premium tax. They also signal a need to reevaluate whether the gross premium tax is the most appropriate tax for insurance companies.

The next chapter examines the current tax structure from the standpoint of tax equity and tax burden. In this analysis, the rationale for the 1914 structure is tested against today's industry climate.

III The Premium Tax Burden in Virginia

Overview

The premium tax is the most prevalent method used by states to tax insurance companies. In its simplest form, this tax is computed by applying a percentage rate to the premium income received by insurance companies from policies written to cover risks in a particular state during the preceding calendar year. For purposes of this calculation, premium income is usually defined to exclude certain receipts from taxation. The kinds of deductions and exemptions most frequently allowed by the states include: returned premiums and cancellations, annuity considerations, dividends paid or credited to policyholders, and premiums received for reinsurance.

Although all states and the District of Columbia levy a premium tax, the structure of the tax varies considerably among the states. In just over half of the states, the tax is imposed at a single rate which is applied to all lines of insurance and all types of companies. In the remainder of the states, the imposition of the tax involves a multiple rate structure. Virginia is one of only nine states that have a tax structure with more than two tax rates.

In addition to the premium tax, several states subject insurance companies to special purpose taxes, license fees, corporate or business income taxes, and franchise taxes. The impact of these supplemental taxes, however, may not be additive in terms of revenue yield. Allowable deductions and credits offered by many of the states often negate a company's tax liability under any one type of tax.

Because of the diversity of tax treatment by states, effective tax rates and tax burdens are difficult to measure. This chapter will examine the issue of tax burden from two perspectives:

- a comparison of Virginia's premium tax rates to those of other states, and
- a comparison of the amount of taxes and fees paid to Virginia relative to the operating income received by different types of insurance companies.

The analysis will also examine the present exclusions and deductions from the Virginia premium tax base and focus on areas where there is a difference in tax treatment among the various classes of insurers. The chapter will conclude with an assessment of the revenue impact of alternative forms of taxation on insurance companies.

Comparison Of Virginia To Other States

In order to assess Virginia's position relative to other states, a literature search and telephone survey were conducted to obtain information on how other states tax insurance companies. The results of this effort indicate that all fifty states and the District of Columbia impose a premium tax on insurance companies (see Appendix B). However, in Indiana, domestic companies may opt to pay a state income tax in lieu of the gross premium tax. In North Carolina, domestic property and casualty companies pay a gross premium tax or an income tax, whichever is greater.

Comparison of Rates: Across the nation, premium tax rates range from a high of more than 4 percent on property/casualty and accident/sickness policies in Hawaii to no tax for certain types of domestic companies in the states of Michigan, Ohio, Oklahoma, Oregon, and Wisconsin. The majority of states have premium tax rates between 1 percent and 2 percent. As shown in Table III-1, Virginia's tax rates of 2.75 percent on property and casualty companies and 2.25 percent on life policies place the Commonwealth in the upper quartile of states in terms of premium tax rates. It should be noted that several states provide for credits which could reduce or eliminate a company's tax liability under the premium tax. As a result, Virginia's ranking may be higher in terms of effective tax rates.

In addition, the recent U.S. Supreme Court decision in Metropolitan Life Insurance Company versus W.G. Ward could have an effect on the relative ranking of states. In that case the Court struck down Alabama's practice of imposing higher premium taxes on foreign insurance companies than on domestic companies but allowing foreign companies to reduce, but not eliminate, the tax differential by investing certain amounts in state-approved investments. The Court held that this practice was discriminatory and without legitimate state purpose. Because of this ruling, many states are in the process of reexamining their tax laws.

Table III-1

Range of Premium Tax Rates in Other States
as of September 1985

	Number of States			
Tax Rate	Life and Health		Property and Casualty	
(Percent)	Domestic	Foreign	Domestic	Foreign
0	5		5	
.1 - 1	7	1	8	2
1.1 - 2	26	27	23	24
2.1 - 3	13*	21*	14*	21*
3.1 - 4		2	1	3
4.1 +				1

*Virginia

SOURCE: Department of Planning and Budget.

Because of the wide variation in tax structures, it is difficult to determine a national standard for comparison purposes. States appear to set tax rates to meet revenue needs and to complement overall state tax policy. The variation can best be illustrated by examining the structures of Virginia's neighboring states as shown in Table III-2.

Differences among these states include the complexity of the tax structure, the amount of the premium tax rate, and the types of other taxes imposed. Maryland and the District of Columbia have a uniform premium tax rate of 2 percent on all lines of insurance. Kentucky has an equivalent tax rate but adds two additional taxes on fire policies. North Carolina's tax scheme is more complex because it requires a premium tax or income tax on domestic property and casualty companies but imposes only a premium tax on life and foreign insurance companies. West Virginia adds to the complexity by imposing a business and occupational tax in addition to a premium tax. Finally, the situation in Tennessee is the most involved with a multi-tiered premium tax, a franchise tax, an income tax, and a stock and bond tax.

Table III-2

Insurance Taxes in Neighboring States

	Premium Tax Rates(%)				Other Taxes		
	Life and Health		Property & Casualty		Fire	Income	Franchise
State	Domestic	Foreign	Domestic	Foreign			
District of Columbia	2	2	2	2			
Kentucky	2	2	2	2	x		
Maryland	2	2	2	2			
North Carolina	1.50	2.50	1	2.50	x	x[a]	
Tennessee	1.75	2	2.50	2.50	x	x[b]	x
West Virginia	2+1	2+1	2+2	2+2	x	x[c]	
Virginia	2.25 & 2.75	2.25 & 2.75	2.75	2.75	x		

a/ Domestic property and casualty companies only if greater than premium tax.
b/ Premium tax credited.
c/ Business and Occupation Tax (Rental Income).

SOURCE: Department of Planning and Budget.

Of the surrounding states, only West Virginia and North Carolina appear to have higher premium tax rates on life insurance than Virginia. Virginia's 2.25 percent rate on life policies and 2.75 percent on disability, double indemnity, and accident and sickness policies exceeds West Virginia's 2 percent base rate but the latter state allows an additional 1 percent tax to be applied to certain life companies. North Carolina has a lower 1.5 percent rate on domestic life companies but foreign companies must pay a premium tax of 2.5 percent. The remaining states have tax rates of 2 percent or less on life policies.

A similar situation exists in property and casualty lines. Of the six contiguous states, only West Virginia appears to have a higher tax rate than Virginia's 2.75 percent. Again, West Virginia has a base rate of 2 percent but it allows the 1 percent additional tax to be added. All of the remaining states have tax rates which range between 1 and 2.5 percent.

Twenty-five percent of the foreign insurance companies operating in Virginia are chartered in five states: Illinois, New York, Pennsylvania, Delaware and Ohio. All of these states have lower premium tax rates than Virginia; however, with the exception of Pennsylvania, they also impose income or franchise taxes. New York, for example, has a premium tax of 1 percent on life companies and 1.2 percent on property and casualty companies plus a tax on income or capital apportioned to the state. This tax structure weighs heavily against domestic companies but reduces the amount of retaliatory taxes that New York companies would otherwise have to pay other states.

Similarly, Illinois levies a 4 percent income tax on all insurance companies doing business in the state in addition to its 2 percent premium tax. Delaware and Ohio, on the other hand, limit additional taxes to domestic companies. Delaware applies a franchise tax based on a sliding scale to capital of domestic companies only. Ohio allows domestic companies to chose between its premium tax on foreign companies (2.5%) or a .6 percent franchise tax. In some cases, however, Ohio companies must pay the premium tax applicable to foreign companies if they do not meet certain criteria.

Special Taxes: Besides premium taxes, insurance companies nationwide are subject to a variety of special taxes in their home states and to retaliatory taxes imposed by states in which they operate as foreign corporations.

The most common special taxes are those on fire insurance and ocean marine insurance. Although these taxes are relatively small producers of revenue in comparison to the broader-based premium taxes, they receive a lot of attention from industry and government officials because they represent a departure from the general scheme of taxation. In the case of fire insurance taxes, the revenue is often earmarked to fund selected programs or services, such as fire marshall offices, fire training programs, and fire fighters retirement. Opponents of such taxes argue they discriminate against particular lines of insurance and that, in most cases, these taxes are unrelated to the special purpose programs which they fund. Insurance industry representatives also fear that these taxes open the way for the growth of a number of dedicated funds which will increase the tax burden on insurance companies without the level of review and consideration that would be given to general tax increases through the normal budget and appropriation process.

Fire program taxes apply specifically to fire or lightning policies and the specified portion of other policies which the state defines as the fire portion (homeowners, auto, etc.). In Virginia, the tax base is broadened to include total premium income of these policies and allied lines, multi-peril and marine insurance. Twenty-six states have some type of tax on fire-related insurance policies in addition to their premium tax. Twelve of these states, including Virginia, impose a rate of one percent or less. Other states levy more than one additional tax and the cumulative rate goes as high as 3.75 percent.

Among surrounding states, Kentucky, North Carolina, Tennessee, and West Virginia impose additional fire insurance taxes. Tennessee's tax of .75 percent is similar to Virginia's (.8%). North Carolina and West Virginia have multiple taxes with a cumulative rate of 1.5 percent. Kentucky has the highest fire tax in the region with a total of 2.25 percent of the fire-related portions of property and casualty premiums.

Ocean marine taxes are applied to the gross underwriting profit or net/taxable underwriting profit (a portion of the average profit from the three preceding years) of ocean or wet marine and transportation insurance. Nationwide, twenty states have this type of tax on ocean marine coverage. None of Virginia's neighboring states impose this tax. While Virginia does not levy this type of tax, these policies are included under the fire programs tax.

Retaliatory Taxes: Virginia is one of 47 states that have a retaliatory law for insurance companies. These laws allow a state to tax a foreign insurance company at a higher than normal rate if the state's domestic companies are taxed at a higher rate by the foreign company's home state. Most states, including Virginia, use an aggregate basis for computing retaliatory taxes. The total burden is calculated by adding the premium tax, license fee, and other special fees that are imposed by other states on domestic companies.

When retaliatory taxes were first enacted, the states involved were primarily interested not in revenue production but in protecting domestic companies by keeping the tax rates imposed by other states as low as possible. Industry experts attribute the current average maximum rate of 2 percent to states' concerns about the effects of retaliation.

The basic concept of retaliatory taxation is that if Virginia tax rates were increased above their already relatively high rate, other states would impose higher retaliatory rates on Virginia companies doing business in those states. The taxes become, in effect, an additional cost to companies which are chartered in Virginia. Therefore, retaliation must be considered in any insurance tax law revision.

Retaliatory taxes are not an issue if a state's domestic companies do not have a significant amount of foreign business. However, if domestic companies have a sizeable national operation, there are several ways to reduce the effects of retaliation. One method is to place a higher aggregate tax burden on domestic companies than on foreign companies. For instance, New York levies a premium tax of 1 percent on life and 1.2 percent on domestic property and casualty companies but adds a tax on income or capital apportioned to the state. This tax structure places a greater tax burden on domestic companies but reduces the amount of retaliatory taxes that large New York-based companies -- like Metropolitan and Mutual of New York -- would otherwise have to pay.

Another approach is to impose a higher premium tax rate on domestic than on foreign companies. Depending on the amount of out-of-state business a domestic company writes, this option may actually cost the company less than if a much lower rate were imposed on domestic companies. A final consideration is to allow domestic companies a tax credit for all or a portion of retaliatory taxes.

There is not much that one state can do unilaterally to eradicate retaliatory laws. A few states have established policies of reciprocal nonretaliation with specific states. Both the Council of State Governments and the National Association of Tax Administrators support an end to retaliation through state legislation on reciprocal nonretaliation.

Tax Burdens In Virginia

Nominal rankings of premium tax rates, as discussed earlier in this chapter, provide one way of comparing tax burdens on insurance companies in Virginia with those in other states. Another way of measuring relative tax burdens is to look at how Virginia's taxes are distributed among types of insurance companies. This type of analysis is essentially the same as that conducted in 1914. In order to conduct this analysis, two types of data are needed. The first is a comparable statement of operating income for the different lines of insurance. The second is an accounting of the total revenue collected by Virginia from the various taxes, fees, and assessments placed on insurance companies.

Methodology: The necessary data to complete the first part of this analysis are contained in the annual reports that each insurance company doing business in Virginia must submit to the State Corporation Commission. Although these reports vary somewhat, it is possible to disaggregate the financial information presented and organize it in a format that can be compared among lines of insurance. Table III-3 presents the various types of operating income considered in this analysis. As shown in Table III-3, there are three categories of income:

1. Premiums earned and other considerations,
2. Net investment gain, and
3. Miscellaneous and other income.

These categories can be totaled to arrive at a comparable income figure for the several types of insurance companies.

As for data on revenue collections, the Virginia tax structure is made up of four basic components. These include two taxes of a general revenue producing nature (the premium tax and corporate income tax for profit-making HMOs), six separate annual license fees, two different assessments to offset the costs of regulatory agencies, and a dedicated tax for fire services programs.

Aside from the major taxes, fees, and assessments, there are other types of charges on insurance companies which result from the operation of the auto assigned risk plan, the medical malpractice joint underwriting association, the guaranty associations and the fair access to insurance requirements plan. These supplemental costs are not considered in this analysis because they are regulatory burdens which are not a part of Virginia's tax structure per se. It should be noted, however, that these regulatory requirements particularly affect the property and casualty industry.

TABLE III-3

COMPARABLE INCOME DATA FROM INSURANCE COMPANIES' ANNUAL STATEMENTS BY TYPE OF INSURANCE COMPANY

Type of Insurance Company

Type of Income	Life, Accident and Health	Property a/ and Casualty	Cooperative Nonprofit Life Benefit, Life and Casualty Cooperative, Assessment Burial Societies	Mutual Assessment Fire	Workers' Compensation Self Insured Groups	Prepaid Health Plans	Health Maintenance Organizations b/	Fraternal Benefit Societies
Premiums Earned And Other Considerations	Premiums Earned Annuity Considerations Annuity And Other Fund Deposits Supplemental Contracts and Dividend Accumulations	Premiums Earned	Total Received From Applicants And Members	Net Assessments Received	Premiums Earned	Premiums Earned	Net Earned Subscriptions Co-Payment And Other Subscriber Income	Premiums And Annui Considerations Admission Certificate Fees
Net Investment Gain Or (Loss)	Net Investment Income Net Realized Capital Gains (Losses)	Net Investment Income Net Realized Capital Gains (Losses)	Gross Investment Income c/ Less: Gross Increase By Adjustment, In Book Value Of Ledger Assets Less: Gross Loss On Sale Or Maturity Of Ledger Assets	Total Investment c/ Income Less: Loss On Disposal Of Investments	Net Investment Income Net Realized Capital Gains (Losses)	Net Investment Income Net Realized Capital Gains (Losses)	Interest Dividend d/ And Rental Income	Net Investment Inc Net Realized Capit Gains (Losses)
Other Income	Commission And Expense Allowances On Insurance Ceded Reserve Adjustments On Insurance Ceded Other Income	Net Gain Or (Loss) From Agents' Or Premium Balances Charged Off Finance And Service Charges Not Included In Premiums Other Income	Other Income	Other Income	Other Income	Other Income	Non-Subscriber Health Care Income Reinsurance Recoveries Other Income	Late Charges-Mortg Loans Reinvestment Incom Miscellaneous Inco

a/ Includes Home Protection, Prepaid Legal, and Title Insurance Companies.
b/ Exact sources of income will vary depending on organizational structure.
c/ Gross or total investment income makes no allowance for investment expenses or capital losses. Therefore, certain deductions are applied to total or gross income to make it more comparable with net investment gain or (loss). Even with these deductions, investment income for these companies is somewhat overstated as compared to net investment gain or loss because complete data on investment expenses are not available from data presented in the Annual Statements.
d/ Data on investment expenses is not itemized in the Annual Statements of Health Maintenance Organizations.

SOURCE: Department of Planning and Budget - Based on Annual Statements of Insurance Companies To The State Corporation Commission.

Given the income and revenue data outlined above, the relative tax burdens for different types of insurance companies can be calculated. For purposes of this analysis, it would be preferable to compare total taxes with only that portion of total operating income which is allocable to Virginia. This adjustment would require the development of some mechanism to apportion income among the states. Under corporate income tax laws, such an apportionment is made on the basis of the percentage of a company's total sales, real and personal property, and payroll in Virginia. Because these data are not readily available for all insurance companies doing business in Virginia, the analysis necessitated another approach.

The alternative methodology computes separate tax burden measures for foreign and domestic companies and divides total taxes and fees by the total income. This approach understates tax burdens on foreign companies because all of their income would not be attributable to Virginia for taxation. The relative distribution of tax burdens among domestic insurers, however, should be comparable since most do business exclusively in Virginia and their income would be allocable to the state under an apportionment procedure.

Comparison of Burdens: Table III-4 illustrates the analysis of comparable income and tax burden. The last column on the table presents a summary of the relative tax burden on different kinds of insurance companies. Among the domestic insurers, the highest relative tax burdens are on the workers' compensation self-insured groups, the mutual assessment fire companies, and the property and casualty companies. Within this group, it is significant that two types of insurers (small mutual assessment fire companies and self-insured workers' compensation plans) are exempt from the premium tax and the larger mutual assessment fire companies are taxed at the lowest premium tax rate (1 percent). Despite their favored tax treatment, these companies bear the highest burdens because they are subject to other levies which offset their premium tax status. For example, the imposition of the newly-enacted fire programs tax increases the relative tax burden of the mutual assessment fire companies to a level which is commensurate with property and casualty companies even though the latter companies pay the bulk of the premium tax.

As Table III-4 also shows, domestic life insurance companies have relative tax burdens that are significantly less than property and casualty companies. There are four major reasons for this outcome. First, as outlined in Chapter I, life insurance premiums are taxed at a rate which is .50 percent lower than property and casualty premiums (2.25 percent versus 2.75 percent). Second, life insurance companies derive a good portion of their income from annuity contracts which are exempt from taxation. (In Virginia, annuity income constitutes about 11 percent of the premium income of domestic life insurance companies.) Third, unlike domestic property and casualty companies, Virginia life insurance companies write a substantial amount of insurance in other states. These premiums are taxable in the state where they are earned. Finally, domestic life companies are subject to only the assessment for the Bureau of Insurance in addition to the premium tax whereas property and casualty companies pay at least four different levies in Virginia.

TABLE III-4

RELATIONSHIP OF LICENSE TAXES, LICENSE FEES AND ASSESSMENTS
TO COMPARABLE INCOME OF DIFFERENT TYPES OF INSURANCE COMPANIES
OPERATING IN VIRGINIA DURING CALENDAR YEAR 1984
(Thousands of Dollars)

		Applicable Taxes, Fees and Assessments						
Type of Insurance Company	Comparable Income	Premium License Tax	Other License Fees	Assessment for Bureau of Insurance	Assessment for Industrial Commission	Assessment for Fire Program Fund a/	Total	Percent Taxes, Fees and Assessments of Comparable Income
Life, Accident, and Health Companies:								
Foreign Companies	$185,548,109	$ 43,679	$ ...	$1,233	$ ...	$ ...	$ 44,912	.02%
Domestic Companies	1,337,151	3,532	...	101	...	...	3,633	.27
Total	186,885,260	47,211	...	1,334	...	...	48,545	.03
Property and Casualty Companies: b/								
Foreign Companies	111,976,530	54,788	... c/	1,363	3,528	4,326	64,005	.06
Domestic Companies	295,348	2,540	... c/	57	51	183	2,831	.96
Total	112,271,878	57,328	...	1,420	3,579	4,509	66,836	.06
Cooperative Non-Profit Life Benefit Companies Cooperative or Assessment Life & Casualty Companies Burial Societies d/	23,104	139	... c/	12	...	...	151	.65
Mutual Assessment Fire Companies: d/								
Serving more than four counties	31,534	218	...	15	...	172	405	1.28
Serving four counties or less	2,202	...	...	5	...	18	23	1.04
Total	33,736	218	...	20	...	190	428	1.27
Workers' Compensation Self-Insured Groups: d/	22,564	...	...	14	1,408	...	1,422	6.30
Prepaid Hospital, Medical, Surgical, Dental, Optometric Plans:								
Foreign Plans	774,355	...	1	65	...	...	66	.01
Domestic Plans	1,044,680	...	1	625	...	...	626	.06
Total	1,819,035	...	2	690	...	...	692	.04
Health Maintenance Organizations:								
Foreign Organizations	461,810	...	1	40	...	...	41	.01
Domestic Organizations	10,555	...	1	6	...	...	7	.07
Total	472,365	...	2	46	...	...	48	.01
Fraternal Benefit Societies:								
Foreign Societies	3,050,485	...	1	...	...	...	1	... e/
Domestic Societies	112	...	... c/	...	...	...	...	...
Total	3,050,597	...	1	...	...	...	1	...
Total Foreign Companies	301,811,289	98,467	3	2,701	3,528	4,326	109,025	.04
Total Domestic Companies	2,767,250	6,429	2	835	1,459	373	9,098	.33
Grand Total All Companies	$304,578,539	$104,896	$5	$3,536	$4,987	$4,699	$118,123	.04

a/ An assessment of eight-tenths of one percent on the gross premium income from insurance policies providing fire protection was enacted by the 1985 General Assembly to establish a Fire Programs Fund. The amounts shown are estimated by applying this assessment to 1984 data.

b/ For purposes of this table, property and casualty companies include title insurance, home protection and prepaid legal companies.

c/ Less than $500.

d/ All companies in this category are domestic companies.

e/ Less than .005%.

SOURCES: Department of Planning and Budget - Based on Annual Statements of Insurance Companies and unpublished data.

A final point to be drawn from Table III-4 concerns the tax burdens exhibited by prepaid health plans, health maintenance organizations, and fraternal benefit societies. The comparatively low tax burden displayed for these entities is not surprising since they pay relatively minor license fees instead of a premium tax. As a matter of tax policy, however, it should be noted that the current parity in tax burdens between prepaid health plans and health maintenance organizations is not by design but results from the recent entrance of HMOs in Virginia. It is expected that tax burdens for the health maintenance organizations will increase over time as some of these ventures become profitable and begin to pay corporate income taxes. Table III-4 includes no entry for corporate income taxes because there is no evidence that any HMO to date has realized profits that would be subject to income taxation. This may not be the case in the future.

Premium Tax Exclusions and Deductions

There are certain exclusions and deductions which are applicable to the Virginia premium tax. The exclusions are generally contained in the statutory definition of gross premiums subject to taxation while the deductions may be found in separate sections of the Code. Table III-5 presents a summary of the various exclusions and deductions under current tax law. Since these adjustments can affect individual types of insurance companies differently, each will be examined in more detail below.

Assumed Reinsurance: Assumed reinsurance is not included in the gross premium tax base of any insurance company in Virginia. The reason for this exclusion is to avoid double taxation of a single premium. Insurance written by a company and reinsured with another company is part of the taxable premiums for the first company. Therefore, the premiums on the insurance assumed by the second company must be excluded from the tax base to prevent the same premiums from being taxed twice.

Returned Premiums: All insurance companies in Virginia are allowed to exclude amounts returned on policies cancelled or not taken. Since returned premiums do not constitute receipts for the insurance company, they are excluded from taxation.

Insurance on Own Employees: Virginia also allows insurance companies to exclude from taxable income those premiums received or derived from group life or accident and sickness policies which are issued to insure an insurance company's own employees, agents and representatives. While the scope of this exclusion is not limited by statute to any particular type of insurance company, only certain kinds of companies write life or accident and sickness insurance on a group basis. The companies able to take advantage of this exclusion include life, property and casualty, burial societies, cooperative nonprofit life benefit, and cooperative or assessment life and casualty companies.

The logic behind exempting the premiums on employee insurance is twofold. First, all premiums derived from these policies may not be income to the insurance company in a strict accounting sense. All or a portion of these receipts may be traced to an internal transfer of funds which the insurance

TABLE III-5

SUMMARY OF EXCLUSIONS AND DEDUCTIONS FROM GROSS PREMIUM TAX

Classes of Insurance	Subject to Premium Tax	Assumed Reinsurance	Returned Premiums	Insurance on own Employees	Dividends	Workers' Comp	Other Than Legal Reserve Policies	Annuities	Guaranty Assoc. Assessments	Neighborhood Assistance Act	Urban Enterprise Zone Act
Life[a]	x (2 1/4%)	x	x	x				x	x	x	x
Accident & Sickness[b]	x (2 3/4%)	x	x	x					x	x	x
Property & Casualty	x (2 3/4%)[c]	x	x	x	x[d]	x [c]				x[e]	x[e]
Cooperative Nonprofit Life Benefit	x (1%)	x	x	x			x			x	x
Cooperative or Assessment Life and Casualty	x (1%)	x	x	x						x	x
Burial Societies	x (1%)	x	x	x						x	x
Title Insurance	x (2 3/4%)	x	x							x	x
Mutual Assessment Fire	x (1%)[f]	x	x							x	x
Home Protection	x (2 3/4%)	x	x							x	x
Prepaid Legal	x (2 3/4%)	x	x							x	x
Prepaid Hospital, Medical, Surgical, Dental, Optometric											
HMO's											
Fraternals											

a/ Accidental death, dismemberment, disability, and double indemnity are taxed at 2 3/4%.
b/ Industrial sick benefit policies for no more than $250 and providing sick benefits of no more than $10 per week are taxed at 1%.
c/ Premium tax does not apply to workers' compensation. Property and casualty pay assessments to the Industrial Commission for workers' compensation.
d/ Mutual companies only.
e/ Excludes foreign companies.
f/ Taxed only if in more than four contiguous counties or in cities of certain population size.

SOURCE: Department of Planning and Budget.

company uses to pay itself for the contractual obligations it has to its employees. Secondly, most insurance companies could easily turn to self-insurance to provide life and accident and sickness coverage to their employees. Under these conditions, no tax would be collected because the premium tax is not applicable to self-insurance.

Dividends: Many insurance companies are mutual organizations which credit dividends to their policyholders when there is a year-end surplus. In Virginia, these dividends are deductible from the premium tax base for mutual property and casualty companies but not for mutual life insurance companies. While on the surface this would appear to be an inequity, the difference in tax treatment may be justified due to the nature of dividends between the two types of companies. For example, the dividends declared by mutual property and casualty companies usually result from the fact that premium rates were initially set too high based on actual claims experience during the year. Consequently, such dividends are similar in nature to returned premiums which are properly excluded from taxation. For life insurance companies, however, dividends paid to policy owners may not reflect premium rates as much as they do investment performance. Under these circumstances such dividends are mainly attributable to investment income which is not included in the premium base. Therefore, no adjustment in taxes is warranted, albeit some states permit mutual life insurance companies to take this deduction.

Workers' Compensation Insurance: Another exemption from premium taxes involves workers' compensation insurance written by property and casualty companies. Premium taxes are not imposed on these policies because workers' compensation insurance is subject to a special assessment for purposes of operating the Industrial Commission of Virginia. This difference in tax treatment is not unique. Many states apply alternative taxes on this type of insurance to administer their workers' compensation laws. In Virginia, the self-insured groups pay regulatory assessments to both the State Corporation Commission and the Industrial Commission.

Other Than Legal Reserve Policies: When the present insurance Code was enacted in 1952, cooperative non-profit life benefit companies were allowed to retain certain types of insurance which did not have to comply with standard reserve requirements. The premiums associated with these policies were also exempted from taxation. Although it is not clear why this action occurred, the preferential treatment afforded these companies appears to be related to their historical nature. Originally, cooperative non-profit benefit life companies were similar to fraternal benefit societies in that they were non-profit entities without capital stock, which conducted business for the sole benefit of their members.

Regardless of its purpose, the impact of this exemption is of diminishing importance because no new cooperative non-profit life benefit companies can be established under existing law. Moreover, the trend over recent years has been for these companies to be absorbed or reorganized into modern corporate structures. Today, there are only two of these companies remaining in Virginia. If current trends continue, the tax exempt status of "other than legal reserve policies" will have little practical meaning in the years ahead.

<u>Annuities</u>: Annuities are one of the principal means by which people provide for their retirement. There are two basic types:

1. Annuities purchased by individuals, called individual annuities; and

2. Annuities purchased in connection with employment, including those under a master pension contract covering a group of employees, called group annuities.

It is estimated that about 50 million persons were covered by some type of annuity pension plan in 1980.

Like Virginia, most states have opted to exempt annuity considerations from taxation although this was not always the case. After the depression, efforts to tax annuities increased greatly as states looked for new sources of revenue. By 1950, only 17 states did not tax annuities, and 31 states imposed their full premium tax rate on annuity considerations. Since that time, however, the taxation of annuities has fallen out of favor. In fact, no state has imposed a new tax on any kind of annuity during the last eighteen years.

Today, sixteen states levy a tax on some form of annuity. Kentucky and the District of Columbia tax annuities at the full premium tax rate, while five states tax them at reduced rates. Nine states exempt annuities issued under pension plans qualified under the U.S. Internal Revenue Code, while California taxes these plans at a reduced rate, and Mississippi taxes them on a reciprocal basis. The state of Tennessee plans to phase out its tax on annuities by January, 1987.

The arguments against taxing annuities raise several social and economic issues. To some, such a tax would be comparable to levying a tax on each deposit made to a savings account. A capital levy of this nature could result in inequities between non-taxed entities such as banks and trust companies and insurance companies. It would also run counter to prevailing efforts encouraging people to provide for their own retirement. In addition, annuities issued in past years would be subject to taxes which were not contemplated at the time they were issued. This could place a great tax burden on insurance companies given the long-term, fixed-price nature of these contracts.

Of particular concern to insurance companies is the fact that group annuities are in direct competition with trust funds which have been established by employers and unions. The funds are usually administered by banks or trust companies. For this reason, a tax on annuities could give the latter financial institutions an unfair advantage over insurance companies. Industry representatives point out that during the 1950s when taxation of annuities was at its height, an increasing number of pension plans converted from insurance companies to an non-insured status primarily because of state tax policies which taxed annuities but exempted uninsured pension plans.

In addition to these concerns, there are at least three other negative impacts that could result from the taxation of annuities. The first would be discrimination against small employers. The establishment of a trust plan by a small employer to avoid tax liability is impractical due to the high administrative costs related to benefits under a small scale trust plan, the inability to spread mortality risk, and the inability to diversify investments. Therefore, small employers would be particularly affected by the burden of a tax on annuities.

Another outcome might be the potential loss of revenues to the state. This would result from a change to tax free, non-insured plans to avoid tax liability. In this respect, it should be noted that employee benefit plans are usually made up of three parts--life insurance, accident and sickness insurance, and retirement benefits. A switch to avoid taxes on the retirement portion of this package might also involve a similar conversion of the other two parts with a loss of premium tax revenue to the state.

A final impact of annuity taxation might be to hamper the growth and development of Virginia's domestic insurance companies. A tax on annuity considerations effectively raises the tax liability of domestic companies and could place them at a competitive disadvantage with respect to foreign companies due to retaliatory tax laws in most other states. This could be a substantial impact, because Virginia is already considered to be a high tax state and is subject to much retaliation.

If the decision to exempt annuities from taxation is based on the above considerations, it should be pointed out that the exemption does not eliminate all equity concerns. This is because annuities represent a substantial source of income which can be invested to produce a profit for the insurance company. Since insurance companies are mainly subject to premium taxes, this means that the income generated from annuity deposits will escape taxation. For other financial institutions which are subject to other types of taxes, such gains would normally be included in the income stream for taxation. The exemption of annuities entirely from premium taxes causes an inequity in tax treatment among various financial institutions. This inequity may be small versus the consequences of taxing annuities, but it still exists.

<u>Guaranty Association Assessments</u>: There are two guaranty associations in Virginia; one for insurers who write life insurance, accident and sickness policies, and annuity contracts, and the other for insurers who write all other kinds of direct insurance except title, fidelity and surety and ocean marine insurance. These two associations were established in 1976 and 1972, respectively. Their purpose is to provide a means for payment of insured claims, to mitigate financial loss to policyholders because of insolvencies, and to make assessments for the cost of such protection among insurers.

When a member insurance company becomes insolvent, these two associations are obligated to cover claims of that company within certain limits. For this purpose, assessments are levied against the remaining member companies as prescribed by law. The amount of any assessment on a life insurance company may be written off against premium taxes over a five-year period. There is no provision, however, for any tax write-off with respect to assessments imposed on property and casualty companies.

The tax treatment of guaranty association assessments in Virginia raises two fundamental equity issues. The first involves whether these assessments should be tax deductible. The second deals with whether the current deduction for assessments made to cover annuity claims should be allowed if annuities are not taxed.

Proponents of deducting guaranty association assessments from premium taxes argue that the nature of these assessments renders them a legitimate tax deduction. They point out that such assessments are a levy against a well-managed insurance company to offset liabilities of an insolvent one. Moreover, since insurance companies are regulated and licensed by the state, the state should be responsible for the burden if an insurance company fails. Accordingly, a tax deduction for guaranty associations should be granted to property and casualty companies.

Opponents of such a deduction counter that it may be very risky for a state to assume responsibility for these assessments through its tax policies. While some states like Virginia have had few insurance company failures, the potential for a sizable bankruptcy or multiple insolvencies exists. Should this happen, state revenues from premium taxes could be depressed for a long period as the result of large tax deductions. This situation is even more probable if such deductions are extended to the property and casualty companies because of current economic conditions. At a minimum, there should be some cap on the total amount of these assessments that could be deducted in any given year.

Some insurance industry officials believe that the inconsistent treatment of guaranty association fees in Virginia is due to an oversight which occurred because the guaranty association for property and casualty companies was established before the association for life insurance companies. Although this may be one explanation, another is that the frequency of insolvencies has been greater for property and casualty companies in Virginia. Also, property and casualty contracts are short-term and their rates can be adjusted to recoup this loss. Thus, it is not clear whether the difference in tax treatment of guaranty association assessments resulted from a conscious policy decision or by accident.

It would appear, however, that the five-year deduction period offered life insurance companies represents a compromise between the two extremes. Under this arrangement, the initial impact of any assessment falls on the insurance company which continues to lose the time value of money over five years until the assessment is completely written off. The state, in turn, is protected from sudden losses in revenue but gradually assumes the full cost of these assessments.

The other issue with respect to guaranty association assessments concerns annuities. Pursuant to Section 38.1-482.23(B) of the Code, the Virginia Life, Accident and Sickness Insurance Guaranty Association is required to maintain three separate accounts. These include a life insurance account, an accident and sickness account, and an annuity account. Assessments may be made for each account against member insurance companies to pay necessary obligations

associated with an insolvency. As a result, any assessment on behalf of the annuity account may be deducted by a member company from its premium tax liability even though annuities are not taxed in Virginia. This would not be a problem if one assumes that all guaranty association assessments are costs which should be borne by the state through tax deductions. Otherwise, this deduction would seem to be inconsistent with implied tax policy.

The tax issues surrounding guaranty association assessments are not unique to Virginia. The National Association of Insurance Companies is currently preparing model legislation concerning these charges.

Neighborhood Assistance/Urban Enterprise Zones: A final adjustment made to premium taxes is a partial tax credit which is allowed for approved investments in or contributions to a neighborhood assistance program or an urban enterprise zone. These programs raise no particular equity concerns because they are broad-based credits which affect taxation for most businesses in Virginia. The only apparent issue is that foreign fire or casualty insurance companies are not eligible for these credits. While this limitation plainly discriminates against foreign insurance companies, there is no evidence that any insurance company has ever taken advantage of these credits in Virginia.

Other Forms of Taxation

Because of the select nature of premium taxes, some states have moved to apply alternative types of taxes on insurance companies which are more compatible with the general scheme of business taxation. The two taxes most commonly used by other states are corporate income taxes and franchise taxes.

Corporate Income Taxes: Corporate income taxes are levied on insurance companies in twenty states. Tax regulations in these states are fairly evenly divided between those states that apply the tax to foreign and domestic companies and those that apply the tax to domestic companies only. There are often other restrictions that affect tax liability. Michigan and New Hampshire, for example, tax only those companies which have gross income in excess of $40,000 and $12,000 respectively. All companies are subject to an excise tax in Tennessee, but domestic companies must pay an additional tax on income derived on stocks and bonds. Indiana and North Dakota levy an income tax only on those domestic companies that do not pay the state premium tax.

There is also variation among the states in the definition of taxable income. Six states utilize adjusted federal income (plus or minus specific deductions) as their tax base. Eleven other states use their equivalent of net income. Indiana is in the process of converting from a gross income base to an adjusted gross income base. Massachusetts taxes gross investment income similar to Tennessee's stock and bond interest tax.

In order to assess the revenue impact of a corporate income tax in Virginia, the Secretary of Finance requested an illustrative group of 13 companies to submit their 1984 federal corporate income tax returns for examination. Eleven companies complied. Because Virginia conforms to federal income tax laws, this information provided a base from which Virginia income tax collections could be estimated.

To arrive at Virginia taxable income, several adjustments were made to federal taxable income to reflect the additions and substractions required of all corporate income taxpayers. The major adjustments were:

° An addition to income for interest received from obligations of other states.

° A subtraction from income for interest received from obligations of the United States.

° An addition for excess cost recovery (depreciation) claimed under the federal Accelerated Cost Recovery Sytem, which is deferred for purposes of Virginia taxation for up to seven years. The addition was offset by a subtraction for previous additions which would have been allowed if the insurance company had been subject to the income tax in 1982 and 1983.

Once these additions and subtractions were made, the adjusted income figure for each company was allocated and apportioned to Virginia. Some companies did not appear to be doing business in any state other than Virginia. Therefore, 100 percent of their adjusted income was subjected to Virginia's 6 percent corporate income tax rate for purposes of estimating corporate income tax collections.

For companies with multi-state operations, however, dividend income was allocated to Virginia if the corporate headquarters was located in Virginia and all other income was apportioned to Virginia on the basis of the percentage of total premium income and annuity considerations earned in Virginia The sum of any dividend income allocated to Virginia and the other income apportioned to Virginia yielded the Virginia taxable income upon which corporate income tax collections were estimated.

The results of this analysis indicate that revenue collections from this group of companies would fall by approximately 82 percent if the current premium tax were replaced by a corporate income tax. The total difference in 1984 tax liabilities for the eleven companies examined is shown below.

1984 Premium Tax Liability	1984 Estimated Corporate Income Tax Liability	Difference	
		Amount	Percent
$3,520,000	$650,000	-$2,870,000	-81.5%

There are a number of factors which influence the dramatic difference in revenue collections between these two types of taxes. First, as mentioned earlier, 1984 was a difficult year for the insurance industry. Five of the eleven companies had losses on federal income tax returns which carried over to Virginia. Second, most companies had sizeable investments in U.S. securities, and the interest on these obligations is exempt from Virginia income taxation. Two companies which showed gains on their federal returns had a loss after this subtraction . Third, one company which is subject to premium taxes is organized in such a fashion as to be exempt from federal

income taxes. It was assumed that this exemption would also apply to Virginia income taxes under conformity provisions. Finally, recent changes in federal tax laws that will increase future tax liabilities for insurance companies were not in effect during 1984.

Given the small number of insurance companies analyzed, it is statistically not possible to generalize about how total revenue collections in Virginia would be affected by a switch from premium to corporate income taxes. It is significant, however, that a much more comprehensive analysis prepared for Pennsylvania in 1981 showed similar results. The estimated tax loss to Pennsylvania of replacing its 2 percent premium tax on insurance companies with a corporate income tax was $130 million, or 81.1 percent of premium tax receipts.

The difference in tax receipts between corporate income and premium taxes may indicate that premium taxes have placed a heavier burden on insurance companies than taxes levied on other corporations. On the other hand, it should be pointed out that efforts to equitably define net income for insurance companies are very complex. While the net income flows of property and casualty companies and short-term life insurance plans may not be difficult to determine, the net income of other forms of life insurance, annuities, and accident and sickness insurance is not easy to measure. It is not clear, for example, what portion of investment income for a life insurance company is attributable to the company's earning capacity or to policyholders' savings. The federal government has been wrestling with these issues for years, and it appears that federal tax laws for insurance companies are now changing more frequently. Given these problems, it is very difficult to ascertain whether the income tax base for all insurance companies is comparable to that of other corporations. Therefore, caution must be exercised in any attempt to compare burdens among alternative forms of taxation.

Franchise Taxes: For the purpose of this study, a franchise tax is considered to be a tax on capital, however measured. The structure of franchise taxes varies greatly among the five states that impose them. Alabama has a two-tiered rate structure of ten dollars per one thousand dollars of capital for domestic companies and three dollars per one thousand dollars of capital for foreign companies. Delaware and Ohio apply their franchise taxes only to domestic companies. Delaware has a sliding scale based on authorized capital. Ohio allows companies to pay the smaller of two rates: .6 percent of the value of capital and surplus of a company having capital divided into shares or 2.5 percent of the gross amount of premiums received.

Arkansas and Tennessee tax foreign and domestic companies at the same rate. Arkansas charges a two-tiered fee of one hundred dollars if outstanding capital stock is less than $500,000 and two hundred dollars if capital stock is equal to or higher than $500,000. Tennessee levies a rate of 25 cents per $100 of outstanding stock, surplus, undivided profits, and reserves which do not represent definite legal liabilities. The market value of stock held in Tennessee corporations may be deducted from net worth.

The logic for imposing a franchise tax on insurance companies is twofold. First, this form of taxation uses a broader measure of a company's economic performance for calculating tax liability than does a tax based solely on premium income. The equity considerations involved in this approach are readily apparent from the preceding analysis on corporate income taxes. In that comparison, it was shown that gross premiums may be a poor indication of a company's ability to pay taxes because a company could experience a loss in terms of net income regardless of the level of its premium receipts. A franchise tax placed on asset value accounts for this discrepancy since such losses would automatically reduce the net worth of a company and, thus, lower its basis for taxation.

Secondly, a franchise tax circumvents many of the problems inherent in corporate income taxes. For example, under corporate tax laws, states cannot tax income derived from U.S. government obligations. Because insurance companies could easily adjust their investments to include more federal securities in their portfolios, the exclusion of such income from the corporate tax base allows them wider latitude to reduce their income tax liabilities. Under a franchise tax, however, the value of tax exempt obligations and the interest thereon may be charged with a share of the insurance company's expenses or liabilities. Thus, only a pro-rata deduction for net worth attributable to U.S. obligations is required.

The revenue impact of a franchise tax on insurance companies in Virginia would depend on the exact definition selected to determine the tax base and the tax rate to be applied. An indication of how tax collections would change, however, can be illustrated by applying a tax similar to the one in Tennessee to the capital and surplus accounts of domestic insurance companies in Virginia. The following shows the estimated revenue impact of a franchise tax levied at 25 cents per $100 of capital and surplus on domestic life and property and casualty companies.

1984 Premium Tax Liability	Estimated Franchise Tax Liability	Difference	
		Amount	Percent
$5,747,000	$2,012,000	-$3,735,000	-65.0%

While a franchise tax has some advantages over a premium tax, any move to implement it could be criticized as being a departure from generally accepted business taxes. In effect, the imposition of a franchise tax on insurance companies would only substitute one special business tax for another. In addition, it is likely that a franchise tax would be more difficult to administer than traditional premium taxes. Because of these considerations and the potential revenue loss associated with replacing premium taxes with a franchise tax, most states have avoided this form of taxation.

Conclusion

Like other states, Virginia applies a premium tax to insurance companies. The structure of the Virginia tax, however, appears to be more complex than other states, and nominal tax rates seem high by national standards. This situation may have hindered economic development because domestic companies must pay retaliatory taxes to other states.

Among the different classes of insurers, property and casualty, self-insured workers' compensation groups and county mutual companies bear a greater tax burden in Virginia. The relative measures of tax burden are influenced by the fact that the tax structure consists of several components. In addition to a premium tax, Virginia has annual license fees, regulatory assessments, a fire program tax and, in the case of HMOs, a corporate income tax.

Present law provides for several exclusions and deductions from the premium tax base. With few exceptions, these resemble the adjustments made by other states. However, some inequities do exist. For example, it is not clear why "other than legal reserve" policies issued by cooperative nonprofit benefit life companies are not taxed. In addition, the present deduction for guaranty association assessments discriminates against property and casualty companies.

Although the premium tax in Virginia is in lieu of all other taxes, some states impose a corporate income and/or franchise tax on insurance companies. These types of taxes would produce less revenue than premium taxes in Virginia but would be more in line with other business taxation. Comparisons of tax burdens among alternative forms of taxation are difficult to make, however, because taxable income for insurance companies is not easily determined.

This chapter has assessed tax burdens and equity issues associated with Virginia's current tax structure. The next chapter will examine the equity of exempting certain types of insurers from taxation.

IV Exemptions from the Gross Premium Tax

Overview

There are four types of insurers that are exempt from the gross premium tax in Virginia: fraternal benefit organizations, county mutual assessment fire organizations, prepaid health plans, and health maintenance organizations. This chapter examines the rationale for the exemptions and the current justification for retaining the tax-exempt status for these insurers.

Fraternal Benefit Societies and Small Mutual Assessment Companies

Fraternal benefit societies (known as "fraternals") and small mutual assessment companies ("county mutuals") are exempt from Virginia's gross premium tax. The 1914 rationale for this preferential tax treatment was that these were small, non-profit, non-stock companies that met a public need for low cost insurance protection.

Fraternals: Fraternal benefit societies are non-profit organizations without capital stock, carried on solely for the mutual benefit of their members and members' dependents. Fraternals have a representative form of government, a lodge system to which members belong, and a set of defined charitable or social purposes for which the society is formed. Fraternals are generally categorized into four groups with common interests:

1. Religious: examples are Knights of Columbus, Lutheran Brotherhood, Baptist Life Association;

2. Ethnic: examples are Polish National Alliance, Sons of Norway;

3. Occupational: examples are Police and Firemen's Insurance, Order of United Commercial Travelers; and

4. General Purpose: examples are Woodmen of the World, Royal Neighbors.

The "general purpose" societies usually have a patriotic or moral creed to which the membership subscribes.

The first successful fraternal society in America was the "Ancient Order of United Workmen" which was created in 1868. At the time of its formation, there was general distrust and confusion about commercial life insurance. Furthermore, the policies sold by commercial companies were too expensive for the average citizen to afford. The insurance offered by the "Workmen" soon gained popularity nationwide because it was targeted toward working classes at rates they could afford. Today there are approximately 200 fraternals nationwide with total insurance in force of over $68.4 billion.

A majority of fraternals provide life, health, and accident insurance. In order to remain competitive, many of them now offer "interest sensitive" policies such as variable and universal life, as well as annuities. They

write life insurance on a legal reserve basis as do commercial companies, and they are required to meet the same tests of solvency. Unlike other insurance companies, laws restrict those who may be named as beneficiaries on these policies.

There are presently 26 foreign societies and 1 domestic society licensed in the Commonwealth. Table IV-1 summarizes the current scope of insurance sold by fraternals. During 1984, the societies collected premiums totalling $18.8 million and paid out benefits of $5 million.

TABLE IV-1
Fraternal Benefit Societies
Scope of Activity in Virginia
Calendar Year 1984

	Life	Accident & Sickness	Total
Premiums Collected	$16,600,000	$2,230,000	$18,830,000
Benefits Paid	3,499,000	1,503,000	5,002,000

SOURCE: State Corporation Commission, 1984 Insurance Company Statistical Report.

Although several states have considered taxing fraternals, all 50 states exempt them from state and local taxes. Virginia, however, is one of the few states that does not levy a regulatory administrative fee. The only fee that fraternals pay in Virginia is the annual license fee of $20.

Fraternal benefit societies are exempt from federal taxation under Section 501(c)(8) of the Internal Revenue Code. The federal exemption has been under close scrutiny as part of the President's tax reform proposal and the House Ways and Means Committee's proposal. Although both proposals concluded that tax exemption should continue for the present, the Ways and Means Committee requires that the Treasury Department conduct a special audit and study of fraternals whose gross premiums in 1984 exceeded $25 million. The report is due by January 1, 1988, at which time Congress will take action regarding the tax treatment of fraternals engaged in the sale of insurance.

Although fraternals are not taxed, they calculate their rates by including a tax "factor." The funds that would normally go to taxes are set aside for charitable contributions. Last year fraternal organizations nationwide contributed about $230 million to charitable causes such as orphanages, homes for the aged, and welfare services for the indigent.

County Mutuals: There are 30 county mutual companies located in Virginia, all of which are domestic. County mutuals were created in the early 1900s in sparsely-populated, rural areas because fire insurance was either unavailable or too expensive for local citizens. Initially, a group of citizens got together and agreed that if a member of the group suffered a loss from fire or other casualties, they would collect money among themselves to help pay the loss. Gradually, the citizens began to form companies to collect the fees. Later, the companies began to collect fees in advance to cover anticipated losses. However, the fees were generally very low and often did not cover the full cost of a loss. In those cases, the group members would be reassessed for additional fees to cover losses.

In recent years, the companies have improved their administrative operations and their rates have increased to more adequately cover losses. However, the companies are not required to maintain surpluses to cover losses. This issue is being considered by the current study to recodify Virginia's insurance laws.

Fourteen of the 30 companies in Virginia serve more than four contiguous counties or other areas where the population exceeds 100,000. They are subject to a 1 percent gross premium tax. Sixteen companies serve four or fewer contiguous counties with a population of less than 100,000. These companies are exempt from the premium tax. All of the companies pay the annual 0.06 percent assessment fee to the Bureau of Insurance.

Table IV-2 presents the premium income of these companies and the claims paid in 1984.

TABLE IV-2
County Mutual Companies
Scope of Activity in Virginia
Calendar Year 1984

	Premium Income	Losses Paid
16 tax-exempt companies	$ 2,333,000	$ 1,153,000
14 companies taxed at 1%	21,810,000	11,981,000
Total	$24,143,000	$13,134,000

SOURCE: State Corporation Commission, 1984 Insurance Company Statistical Report.

County mutuals in one form or another exist across the country. Virginia's tax treatment of county mutuals mirrors the practice of other states. These companies enjoy a favored tax status nationwide, with most states granting them full exemptions.

Effects of Taxation: Removing the tax exemption would have diverse effects on fraternals and county mutuals. Officials of fraternals would have to decide either to reduce charitable contributions or raise premiums so that present levels of charitable contributions could be maintained. The effects would be much more severe on county mutuals. Some of these companies are expanding and converting to mutual insurance companies. Others are being bought out by larger property and casualty insurers. These companies could survive by passing on the cost of the tax to policyholders. However, some county mutuals still serve the purpose for which they were created--providing affordable insurance to rural areas where none is available. For these companies to continue in operation, rates would likely be so high that they would be beyond the reach of those who needed coverage. The 1982 amendment allowing the Virginia Property Insurance Association to insure farm property could partially address this problem.

Prepaid Health Plans and Health Maintenance Organizations

The major types of insurers exempt from the gross premium tax in Virginia are the prepaid health plans which include Blue Cross/Blue Shield plans (hereafter called "BC/BS plans"), and prepaid dental and optometric plans. Because Health Maintenance Organizations (HMOs) are not legally defined as insurance companies, the gross premium tax does not apply to them. For purposes of this report, however, HMOs will be included in the analysis since they are considered competitors in the health insurance industry.

As Table IV-3 shows, in 1984 these organizations collected premiums in excess of $1.2 billion from Virginia subscribers. Because the three prepaid dental and optometric plans comprised less than 0.5 percent of the total premium income for these companies, this section will concentrate on the BC/BS plans and HMOs. Neither of these types of insurers was in existence, nor envisioned, when the 1914 study was undertaken. The concept of prepaid health coverage is relatively new to the insurance industry and the original rationale for a favored tax status and the current justification for tax-exemption appear to overlap.

The BC/BS plans, prepaid dental and optometric plans, and HMOs are required to pay an annual license fee to the Bureau of Insurance. The annual fee for the prepaid plans ranges from $50-200 based on the number of Virginia subscribers; HMOs pay a flat fee of $100 per year. Prepaid plans and HMOs also pay the .06 percent assessment that supports the operation of the Bureau of Insurance. For-profit HMOs are subject to corporate tax in Virginia; however, in 1984 no HMOs had realized profits that would be subject to taxation.

TABLE IV-3
Scope of Exempt Health Insurers in Virginia
Calendar Year 1984
($ in thousands)

Type of Plan	Number of Plans	Total Income	Virginia Subscriber Income
BC/BS Plans	4	$1,811,528	$1,141,406
Prepaid Dental	2	5,860	5,871
Prepaid Optometric	1	1,617	35
HMO	12	472,371	75,526
Total	19	$2,291,376	$1,222,838

SOURCE: Department of Planning and Budget.

Prepaid Health Plans: Blue Cross/Blue Shield plans are typically independent, nonprofit corporations that make payments to providers on a service basis for surgical, medical, and hospital care. BC/BS plans got their start in Virginia in the 1930s. They were originally established in response to two factors--the economic conditions of the 1930s and the growth of organized labor. During the Depression, many people were unable to pay their hospital bills. As a result, many hospitals were in a state of financial crisis. At the same time, employers unable to meet the demands for increased wages from labor organizations were offering fringe benefits as concessions. The eventual outcome was prepaid hospital plans.

The first major study of the tax status of BC/BS plans was conducted by the Virginia Advisory Legislative Council (VALC) in 1949. As a result of the study, the plans were declared exempt from the gross premium tax and all other state taxes. The major reasons for exemption cited in the study include the following:

- The plans offered a means of providing hospital care for those who could not otherwise afford it;
- The plans were considered collecting and dispersing agencies for participants--not insurance companies;
- There were no profits to the association or its subscribers;
- The plans offered a viable alternative to the nationwide pressure for adoption of socialized medicine; and
- The plans attempted to balance income and outgo, and VALC believed that any tax would diminish reserves, decrease services, or increase rates.

The only other major study to consider the plans' tax status was conducted in 1978 by the State Corporation Commission as part of its involvement in the Health Care Cost Study Commission. The report concluded that a new regulatory approach might be appropriate in light of changes in the health insurance market, the operations of prepaid health plans, and the public services provided by the plans. The report identified three regulatory alternatives:

1. Regulate and tax the plans in the same way as commercial insurers;

2. Regulate and tax the plans as public service corporations; and

3. Maintain the status quo.

No changes in tax or regulatory structure were made as a result of the study.

Since the 1940s, there have been several attempts to adjust the tax differential between commercial health insurers and BC/BS plans. In 1970, Senate Bill 351 proposed taxing the BC/BS plans at the same rate as accident and sickness insurance--2.75 percent. The bill did not pass. In 1980 and 1981, legislation was introduced, but did not pass, to reduce the tax rate applied to commercial accident and sickness insurance.

Health Maintenance Organizations: The HMO concept has been in existence in the United States since the 1920s. An HMO is an organization that provides a wide range of health care services for a fixed periodic payment. HMOs generally enroll groups only--no individual subscribers--and most preventive and corrective services are provided. The major distinctions between an HMO and a BC/BS plan are the breadth of benefits and choice of provider. HMOs offer a broader range of benefits in that the preventive care provided to subscribers is generally not available under BC/BS contracts. BC/BS plans give subscribers broad flexibility in choosing their physicians and hospitals, while HMOs require subscribers to utilize specific providers. Industry officials indicate, however, that these distinctions are not as sharp as they once were.

HMOs can be sponsored by the government, medical schools, hospitals, employers, labor unions, commercial insurers, and BC/BS plans. HMOs are typically organized in one of four ways:

- Staff Model: Physicians are hired and employed by the HMO;

- Group Model: The HMO contracts with a group of physicians and other providers (such as pharmacies) for delivery of care;

- Network Model: The HMO contracts with a number of groups in a given area; and

- Independent Provider Association (IPA): The HMO contracts with numbers of individual providers who continue to practice in their own offices and serve non-HMO patients as well.

Currently there are two group models, four staff models, and 13 IPAs in the state. One organization functions as both an IPA and a group model in different locations. Nine HMOs have operations in Northern Virginia, six in Richmond and six in the Tidewater area. Three organizations have facilities in two major metropolitan areas.

Of the 18 HMOs licensed in the state, five are non-profit organizations and the remainder are for-profit. Due to the recent establishment of HMOs in Virginia, none of the for-profit organizations has realized any profits that are subject to taxation. According to HMO officials, it is likely that several will show profits in calendar year 1986.

Taxation of BC/BS Plans

At the federal level, the long-standing tax exemption of the BC/BS plans has undergone scrutiny in both the President's proposal on tax reform and the proposal of the House Ways and Means Committee. At the state level, approaches to taxation and regulation of BC/BS plans vary significantly across the country.

Federal Actions: BC/BS plans are currently exempt from federal taxes under Sections 501(c)(3) and (4) of the Internal Revenue Code which address charitable and social welfare organizations that serve a public rather than a private purpose.

The House Ways and Means Committee's bill in December 1985 addressed the issue of the plans' tax exempt status. According to the Committee report, there is concern that exempt charitable and welfare organizations such as BC/BS plans are engaged in insurance activities that are "so inherently commercial that tax-exempt status is inappropriate."

The report points out that the availability of tax-exempt status under present law has allowed some large insurance entities to compete directly with commercial insurers, and that the group of BC/BS plans is now among the largest health care insurers in the nation. Additional points raised in the report are noted later in this chapter.

Other States' Taxation of BC/BS Plans: In order to assess other states' approaches to regulation and taxation of the health care industry, telephone interviews were conducted with the fifty states and the District of Columbia. Initial contacts were made with individuals in state insurance departments and followed up, when necessary, with contacts in state departments of taxation, revenue, health, and corporations. Where possible, data was verified through multiple sources.

The survey's primary focus was to determine whether or not a state applied a premium tax to BC/BS plans or HMOs and the rationale behind the tax status. The survey did not examine other types of taxes applied to these insurers. Summary information on each state's tax treatment of BC/BS plans and HMOs as of September 30, 1985, is presented in Appendix C.

Of the 25 states that impose a premium tax on BC/BS plans, 21 view the plans as insurance companies and subject them to the same taxation as a commercial insurer. In five states, the BC/BS plans have converted from non-profit organizations to mutual insurance companies. These plans have agreed to be subject to the premium tax in exchange for release from cost containment requirements, and subsidiary and other restrictions mandated by the non-profit, tax-exempt status. Examples of states in which BC/BS plans have converted to mutual insurance companies are discussed below.

* * *

In Connecticut and Louisiana, the BC/BS plans wanted to purchase life insurance companies to help them maintain their competitive posture in the health care industry. The regulatory agencies determined that this would violate state laws restricting the activities of these organizations. In both states, the BC/BS plans volunteered to convert to mutual insurance companies and pay a premium tax rather than remain tax-exempt and subject to the law's limitations.

* * *

Several Ohio BC/BS plans opted to convert to mutual insurance companies to escape the cost containment restrictions attached to the non-profit status. Other BC/BS plans in Ohio have remained non-profit organizations and retain their tax exempt status.

* * *

Tax rates for BC/BS plans among the states range from .044 percent to 6 percent, with fourteen of the 25 states allowing some type of credit or deduction. Of the 25 states that tax the plans, twelve states have a tax rate greater than 2 percent and seven of the twelve allow credits for in-state assets. The higher the tax rate, the more likely the state will allow some type of credit.

Those states that currently impose a tax on BC/BS plans expect no changes in their tax laws in the near future. Several states noted that they would be adjusting their rates, either by imposing a uniform rate on all health insurers or by reducing the differential between foreign and domestic rates as a result of the U. S. Supreme Court decision in Metropolitan Life Insurance Company versus W. G. Ward.

Utah is one state that is going against the trend to tax all health insurance. BC/BS plans in Utah are currently taxed at 2.25 percent. A recent study by that state determined that since HMOs were exempt, all health care coverage should be exempt -- including the health portion of life insurance policies. A law has since been passed, effective July 1, 1986, that exempts all forms of health insurance from taxation.

During the survey, states were asked to describe the effect of taxing BC/BS plans. In general, the observable impact to date has been minimal.

- Arizona reported that there were no negative effects when a 1 percent tax was added in that state.

- Alabama responded that BC/BS had 50 percent of the state health insurance business when the 1 percent tax was imposed in that state. The impact on rates was minor due to the plan's large surplus at the time.

- A recent study conducted in Idaho concluded that the BC/BS surplus was so large that imposing a premium tax would have no effect on rates.

- Louisiana reported that levying a tax of approximately 2 percent on BC/BS plans resulted in an annual rate increase of twenty cents per subscriber.

BC/BS plans are not taxed in 26 of the 51 jurisdictions surveyed. Twenty-two of those states consider BC/BS plans non-profit, tax-exempt organizations. Three states, Delaware, Missouri and Wisconsin have a state policy that health insurance in any form will not be taxed. Missouri exempts non-profit and for-profit plans. BC/BS plans are exempt in Oregon because all domestic companies--regardless of the type of insurance-- are exempt from premium taxes.

Overall, eighteen of the states that do not tax the plans anticipate no change in their BC/BS statutes. Five states intend to introduce legislation to tax BC/BS plans in the near future. Several of these states have attempted to enact a premium tax in recent years but were unsuccessful. The BC/BS plan in Michigan, however, is considering a voluntary conversion to a mutual company. Recent changes in Michigan law have given the Bureau of Insurance increased regulatory authority over the state's BC/BS plan. The plan has estimated that premium taxes will cost between $4-5 million annually but the expense will be offset by the freedom of fewer regulations.

Taxation of HMOs

In addition to examining BC/BS plans, the federal government is also reviewing the tax exempt status of certain HMOs. This is occurring at a time when many states are examining their own regulatory requirements and tax policies pertaining to HMOs.

Federal Actions: Federal taxation of HMOs is based on their profit/non-profit status. This treatment is changed in the tax legislation passed by the House Ways and Means Committee last December. The bill removes the tax-exempt status of a non-profit HMO, unless it provides "health care to its members predominently at its own facility through the use of health care professionals and other workers employed by the organization."

Other States' Taxation of HMOs: HMOs are relatively new organizations. A few states do not have any HMOs and several states are just now developing enabling legislation to regulate their operations. Approaches to taxation vary across the nation:

- Of the sixteen states that tax HMOs, twelve of those states treat HMOs as insurance companies and subject them to a premium tax.

- Indiana, Massachusetts and New Hampshire apply the premium tax to for-profit HMOs only.

- Oregon taxes foreign, for-profit HMOs only.

- Iowa allows a five-year grace period before the 2 percent premium tax is imposed on HMOs. This delay is in place to provide sufficient start-up and development time for the organizations.

- Kansas levies a staggered tax rate -- no premium tax for the first two years, .5 percent for years three through five, and 1 percent after five years.

The tax rates for HMOs range from .044 percent to 3.0 percent, with rates for thirteen states falling in the 2 to 3 percent grouping. All five of the states that allow credits for in-state assets have tax rates of 2 percent or more.

The states that tax HMOs generally expect no changes to their HMO statutes. Louisiana, however, is currently taxing HMOs without any state legislation pertaining to HMOs. HMOs operate in Louisiana under the State Attorney General's ruling that federal law supercedes state law. The state is in the process of implementing legislation that would allow continuation of the current methods of operation for HMOs.

There are several reasons why 36 states do not tax HMOs. The most prevalent reason is that some states consider HMOs non-profit, tax-exempt organizations. Others do not tax HMOs in an attempt to encourage their development within the state. In four states, HMOs are not viewed as insurance companies and, therefore, are not subject to a premium tax. Missouri, Utah and Wisconsin have state policies to not tax health care coverage.

The taxation of HMOs is being reexamined by many of those states that do not currently impose a tax. In the states that now consider HMOs to be non-profit companies, three expect legislation to be introduced in the near future to propose a tax. Two of those states, Maryland and New York, plan to tax for-profit HMOs only. One of the states that is currently attempting to encourage development of HMOs (Connecticut) is also considering levying a tax. In Missouri, which presently does not tax health care coverage, the insurance department plans to repeat its efforts to remove the health care exemption.

Changes in the Health Care Industry

Like other segments of the insurance industry, the health insurance picture is changing rapidly. The changes are more profound in this area, however, because health insurance coverage is becoming more tightly linked with the actual provision of health care. This means that states that are considering a tax on health insurance need to also consider the potential effects of a tax on the availability and costs of health care.

Most observers of the health care industry agree that until a few years ago, the financial incentives in health care delivery were a major cause of the rising costs of care. Until the late 1970s, the health care delivery system was characterized primarily by physicians and hospitals who were providers of care, and commercial insurers and BC/BS plans who reimbursed providers based on provisions in subscriber agreements. Most hospitals were paid for services on a cost-plus basis. This meant that there was an implicit financial incentive for a hospital to provide a broad array of services whether they were necessary or not. Physicians were paid on a fee-for-service basis that did not question the need for a service or the setting in which it was delivered. Finally, patients themselves rarely had to make out-of-pocket payments for medical care because third-party insurance paid most, if not all, of the incurred expenses.

As the costs of health care skyrocketed during the 1970s, private employers and federal and state governments sought ways to contain costs. Their efforts generally fell in one of two categories: increased regulation or increased competition. The advocates for greater regulation assumed that rising costs were largely a result of the proliferation of hospitals and physicians and the duplication of expensive medical technology. They believed that costs could be reduced by limiting supplies. The outgrowths of the proregulatory movement were "certificate of need" laws, networks of local health systems planning agencies, and professional standards review organizations.

By the late 1970s, cost containment proponents acknowledged that tight regulation was not having the desired impact on the nation's health bill. Many proponents turned to competition as the way to keep costs in check, theorizing that once doctors and hospitals have to compete in the free market, they will have to constantly reassess their prices and services to remain in business.

In response to this shift toward competition, the health care industry is exhibiting new characteristics that were not present ten years ago. The most significant changes include:

- Prospective Payments to Hospitals: Spear-headed by the federal government in response to escalating Medicare costs, this system pays a flat rate for hospital care based on a patient's diagnosis rather than the hospital's costs. A recent study of this new system reported that hospitals are holding the line on costs and, in some cases, are experiencing substantial profits.

- Physicians' Acceptance of Alternative Delivery Systems: After initial resistance to the new systems such as HMOs, Preferred Provider Organizations (PPOs), and others, physicians themselves are taking an active role in developing innovative, cost-conscious delivery and reimbursement systems.

- Increased Expenses Borne by Patients: Most commercial insurers and BC/BS plans now require deductibles and co-payments from consumers. The federal government is considering tax reform that would limit tax-free insurance benefits for employees. These actions will encourage subscribers to carefully weigh the need for care against the costs they must bear.

- <u>Removal of Regulatory Restrictions to Foster Innovation</u>: At the federal and state levels, regulations are being lifted that would hamper the growth of competition and stifle the development of new types of delivery systems. The phased tax rate imposed by some states is one way of ensuring that new organizations are given a grace period in which to get a foothold in the market and stabilize operations.

- <u>Emergence of Industry "Giants"</u>: The concepts of the "family doctor" and the "community hospital" are rapidly fading. In their place are a small number of large corporations that can provide total care--physicians, laboratory and pharmacy services, and hospital care, as well as insurance. These corporations are organizationally characterized by a parent company and multiple subsidiaries, each engaged in a specific activity. Subsidiaries may be subject to taxation depending on the nature of the activity.

- <u>Increased Reliance on Self-Insurance</u>: Nationally, approximately one-half of all businesses with more than 500 employees now fully or partially self-fund their health benefits to improve cash flow and investment opportunities and save the relatively high administrative costs of private insurers. Self-insurance programs are not taxed; therefore, states lose revenue that would otherwise be collected if employees purchased insurance coverage from traditional carriers. Another issue surrounding the proliferation of self-insured entities is the lack of oversight by regulatory agencies to ensure fund solvency.

- <u>Prospective Payment for Medicare and Other Entitlement Programs</u>: The federal government is examining the possibility of replacing the current Medicare system with prepaid voucher arrangements with third-party insurers. The government would provide vouchers to the insurers (HMOs, BC/BS, commercial insurers) in exchange for the insurer assuming all risks for health care claims. If successful, it is expected that the program could expand to other federal entitlement programs.

Experts predict that by 1995, the delivery of health care in the United States will be dominated by as few as twenty national or regional medical care corporations, each responsible for the health of three to ten million people. These "Supermed" outfits will combine services of physicians, hospitals, and insurers into one organization, and their development will force other competitors to continue the integration of formerly distinct components of the health industry.

It is possible to see the industry positioning itself now for this future competitive environment. Many commercial insurers and BC/BS plans are diversifying into other segments of the health care field and are merging with other companies in an effort to ensure their long-term survival.

Reassessing Tax-Exempt Status

The changing landscape of the health insurance industry is the major reason for the reexamination of tax exemption. The Report of the House Ways and Means Committee referenced earlier in this chapter raises two major issues that are linked to this evolution within the industry:

(1) Tax exemption gives the BC/BS plans an unfair competitive edge over commercial insurers, and

(2) The plans' insurance activities have become so like those of commercial companies that tax exemption is no longer appropriate.

These issues were echoed by commercial health insurers in Virginia who were interviewed as part of this study.

In a position paper prepared by the national BC/BS association in response to the Ways and Means proposal, arguments are presented in support of the tax-exempt status. BC/BS plans in Virginia have stated similar positions in the course of this review.

Social Benefits: The principal argument advanced by the national BC/BS association is that plans should retain their tax-exempt status because they provide a significant social benefit that commercial insurers do not. Specifically, this benefit is the plans' open enrollment policy whereby applicants cannot be denied coverage for health reasons, and once enrolled cannot lose coverage due to a high utilization of medical service. In addition, group members are entitled to convert their coverage when they leave their group. The plans state that this policy serves the public because the responsibility of providing coverage to high risk and uninsurable individuals does not fall on the government. According to BC/BS officials, it is these open enrollment and conversion policies that make the plans "the insurer of last resort" and justify their preferential tax treatment. If tax exemption is revoked, the plans indicate they may have to curtail or eliminate these policies.

While the open enrollment policy for individuals is a unique practice of BC/BS plans, commercial health insurers claim that the actual impacts of the policy are not significant enough to warrant preferential tax treatment. Unfortunately, it is not possible to pin down the true effects of open enrollment in Virginia or nationwide. Although estimates have been developed on the number of people in the United States without private or public insurance, there has been little research on the number of these uninsured individuals who tried to get insurance through commercial carriers but were turned down because they did not meet underwriting requirements. There is also no quantitative data on the number of BC/BS subscribers who bought plan coverage because they were, or assumed they were, uninsurable by commercial carriers. In the absence of data on uninsurables, the question of the impact of taxation on this public service activity--which is fundamental to the development of tax policy--cannot be answered.

In addition to the open enrollment policy, the plans put forth other arguments in favor of the present exemption. First, almost all of their premium income is paid out in claims. Further, because a far greater portion of the plans' total income is from premiums as compared to commercial insurance companies, special tax treatment is warranted. Plans also sponsor or provide public education programs, university courses, scholarships, and cost containment seminars for subscribers and health care providers.

The Report of the Ways and Means Committee points out that many of the historical distinctions between the plans and commercial companies have disappeared. For example, similar levels of covered services, co-payments, and deductibles are available through commercial insurance companies. Individuals subscribe to BC/BS plans not because it is the only affordable option but because they prefer the convenience and package of services offered by the plans. Organizationally, many of the plans resemble mutual companies that are subject to the gross premium tax.

Based on this conclusion, the Ways and Means proposal recommends that no organization should remain exempt from taxation under Sections 501(c)(3) and (4) of the Internal Revenue Code if a substantial part of the organization's activities consists of providing "commercial-type insurance". The bill states that commercial-type insurance does not apply to health insurance provided by an HMO if the insurance is incidental to the organization's principal activity of providing health care.

The bill proposes that the Treasury Department issue regulations providing "special tax treatment" (but not tax exemption _per se_) to BC/BS plans that engage in public benefit activities such as open enrollment if the benefit is not already required under law. This means that if a law requires _all_ companies that issue health policies to provide a specified coverage, the plans would not be afforded special tax treatment for providing that coverage.

The Committee's proposal appears to put limits on the types of activities that the plans can claim as public benefits. It also leaves the door open for taxing the plans, albeit at a lower rate, if they meet federal requirements for public service activities. The Committee's proposal will likely be debated in many forums over the next several months. States that are considering taxation of the plans will be following these deliberations closely.

Potential Effects of Taxing the Plans and HMOs: The national BC/BS association's position paper outlines the likely consequences of taxing the plans:

- They will be forced to adopt more stringent underwriting practices;
- They will have to lower payouts, increase premiums, or discontinue coverage for high risk classes;
- Hospitals' bad debts for uncompensated care will increase;

- The number of state Medicaid eligibles will increase; and
- The State will need to sponsor risk pools or other methods to provide for the increased costs of treating high risk individuals.

The plans contend that such a change should not be made without a careful evaluation of its potential effect on the availability of adequate health care.

In a position paper presented to the Secretary of Finance by Blue Cross and Blue Shield of Virginia, the following points are made about the impact of taxation on costs of health care in the Commonwealth:

- By exempting the plans and HMOs from taxation, the Virginia General Assembly has put in place a program designed to control medical care costs by fostering price competition among providers;
- The tax-exempt environment in Virginia makes it attractive to HMOs to locate in the state, thereby injecting additional competition--and cost containment--into the market;
- A premium tax would be passed on to subscribers, many of whom are employed by local and state governments; these employers would have to bear the burden of the tax;
- Revenue generated by the tax would be offset by the cost to the Commonwealth to replace social service and hospital subsidies now provided by BC/BS plans.

Commercial health insurers in Virginia who view tax exemption as a distinct competitive advantage for the plans, state that they would offer coverage to high risk individuals if they were tax exempt. Commercial insurers also point out that taxing BC/BS plans and HMOs need not be an "all-or-nothing" proposition where they are taxed at the highest rate and are forced to eliminate open enrollment, public service, and charity care programs. It is possible to phase in taxation over several years, or to tax at a lower rate in recognition of their social benefits.

In the course of this review, representatives of the HMOs in Virginia were contacted to determine the potential effects of levying the gross premium tax on HMOs. As mentioned earlier in this report, Virginia law requires that all for-profit HMOs pay corporate tax. Although none of Virginia's 13 for-profit HMOs realized profits in 1984, is is likely that some will pay corporate taxes on 1985 income.

HMO officials point out the current tax treatment is appropriate for HMOs because of the very young nature of this segment of the health industry in Virginia. Very few HMOs are more than a year old, and their combined enrollment in November 1985 was approximately 250,000 individuals. Officials state that although the membership has grown rapidly over the past year, it is still a very small share of the total market. Moreover, HMOs do not have the level of reserves of BC/BS plans and other insurers. It appears that the General Assembly's decision to impose a corporate rather than a premium tax on for-profit HMOs was one way of acknowledging the vulnerability of this young industry and giving it a boost in its early years.

While it is true that HMOs are relatively new, they are being readily accepted in Virginia, as evidenced by the 63 percent growth in premium income and 56 percent growth in membership since 1984. Moreover, the five year start-up period used by the industry to predict when an HMO will break even has been reduced in practice to 2 or 3 years in some cases.

HMO officials also point out that benefits mandated for federal qualification as an HMO (which all but one of Virginia's HMOs are or will be) and presently being proposed by the Bureau of Insurance, are broader than those offered by BC/BS plans and commercial insurers.

HMOs, unlike BC/BS plans, do not have any waiting periods for preexisting conditions. Individuals are eligible for total coverage the day that they enroll. HMOs officials contend that this provision makes HMOs more attractive than BC/BS plans for sicker individuals.

Another concern is that federally qualified HMOs are required to apply one fee structure to all group policies. This could force these organizations to be lowest bidder for high-risk, high-cost contracts because other insurers can raise their fees to price themselves out of the market.

Finally, the combination of unavoidable high-cost contracts and a premium tax could result in HMOs being forced to raise rates and employers turning to self-insurance or contracting directly with providers to get coverage at a lower cost. Not only would these types of arrangements be exempt from any tax, they would also be outside of the scope of regulation in Virginia.

Conclusion

The long-standing tax-exempt status of certain insurers is being reconsidered in a variety of forums. Not only are other states reassessing the tax treatment of BC/BS plans and HMOs, but Congress will likely be addressing this issue and the taxation of fraternal benefit societies over the next few years.

Fraternals and county mutuals have enjoyed special tax treatment primarily because of their charitable, non-profit nature. Since the current tax structure was established in 1914, the insurance products that these organizations offer have become increasingly competitive--both in coverage and costs--with products offered by commercial companies that are subject to taxation. This raises questions about tax equity within the current tax structure.

The current restructuring of the health care industry due to market forces is clouding the distinction between the business of medical care and the business of health insurance. More providers are accepting combinations of fee-for-service, prepayments, and prospective payments. Hybrid organizations such as HMOs are taking a greater share of the market. The products offered by BC/BS plans, HMOs and commercial insurers have few distinctions.

The variety of organizational structures and product lines in the health care and health insurance industries are providing a backdrop for the reassessment of tax policy that is going on in many states. Serious questions remain unanswered. Public officials are concerned about predictions of higher premium costs and increased numbers of uninsured individuals if tax exemption is revoked for BC/BS plans and HMOs. Commercial insurers are raising questions about the tax equity of these exemptions.

There are a number of ways to address the issue of tax equity in the health insurance industry. The following chapter presents several alternatives for health as well as other lines of insurance.

V Modifying the Tax Structure: Alternatives and Recommendations

Overview

The gross premium tax is the most common tax levied on insurance companies nationwide. The tax is simple to calculate and administer. In most cases, it generates greater revenue than the corporate or franchise tax. However, as this report has shown, inequities exist in Virginia's current system. Furthermore, the report has identified data that needs to be collected and analyzed before responsible decisions can be made about the tax status of health insurers.

This chapter summarizes the inequities and data needs and presents approaches for addressing them. Where applicable, the potential revenue impact of alternatives is given. The chapter concludes with recommendations.

Alternatives

Several alternatives exist for addressing tax inequities while maintaining current levels of revenue. The options are not mutually exclusive and are open to combination and refinement. The present system could be restructured in the following ways:

- Equalize the base of taxation. The major inequity here is the inability of property and casualty companies to deduct assessments paid to guaranty associations, whereas life companies are permitted this deduction. To remedy this situation, either eliminate or permit this deduction for all companies. If the status quo is maintained, a deduction for annuity claims should be disallowed.

- Equalize license fees. There is no justification for the variation in amounts or application of annual license fees. They should either be repealed, equalized, or, if different, tied to a defensible rationale.

- Require all companies to equitably bear the cost of regulation. Self-insured workers' compensation groups pay administrative assessments to both the Bureau of Insurance and the Industrial Commission. Fraternal benefit societies pay no administrative assessments.

- Reduce the tax burden for property and casualty companies. These companies bear a far greater tax burden than other lines of insurance. Ways to reduce the burden include decreasing the premium tax rate and eliminating or crediting the fire programs tax.

- Move toward a simplified rate structure. Virginia's multi-tiered structure can be simplified without a major loss in revenue. A single or two-tiered structure should be considered.

A major issue that should be addressed definitively is the tax-exempt status of BC/BS plans and HMOs. Much of the information necessary to make a decision to maintain or alter the status does not now exist, but should be collected in a subsequent study. Based on the results of that study, the tax structure should be addressed in one of the following ways:

1. eliminate the tax on all health insurance;

2. tax all health insurance at one rate, or;

3. establish a rate differential based on designated characteristics that are regulated by the State Corporation Commission.

Impacts of Alternatives

Most options result in revenue adjustments. Table V-1 shows the revenue impact of adjusting the rate of taxation by line of insurance. These values were computed from 1984 premiums subject to taxation. For annuities and companies currently exempt from taxation, premium values that would be subject to taxation are included. By using the table, it is possible to determine the approximate revenue losses and gains within and among lines of insurance. The table reflects the current base and does not show the revenue effects of broadening the base to include items omitted by exemption, deduction, or credit.

In addition to revenue impacts, changes in the current system can have other, unanticipated impacts, especially in the areas of retaliatory taxes, self-insurance, costs to consumers, uninsured risks, and availability of care.

- Retaliatory Taxes: Any increase in the effective rate of taxation in Virginia (through increased premium tax rate, fees, licenses, and special taxes) can result in higher retaliatory taxes for Virginia-domiciled companies that do business in other states.

- Self-Insurance: As the costs of coverage increase (especially for health and liability coverage), many employers may turn to methods of self-insuring. Under federal law it is not clear whether self-insurance can be taxed. Currently, Virginia does not levy a premium tax on self-insured groups.

- Costs to Consumers: If higher tax rates are levied on insurance and if tax-exempt companies lose their preferential status, consumers may bear a share of the rate increase in higher premiums. On the other hand, if rates are reduced, there is no guarantee that consumers will benefit from the savings.

- Uninsured Risks: If tax-exempt health insurance is taxed and BC/BS plans no longer have open enrollment and conversion policies, the government may be faced with a greater need for charity or subsidized care.

- Availability of Care: If all health insurance is taxed, BC/BS plans might eliminate "charity care allowances" which could place a severe financial burden on certain hospitals. Also, the availability of health insurance might be concentrated in the highly profitable metropolitan areas at the expense of rural areas.

TABLE V-1

Effect of Potential Change in Taxes on Gross Premiums[a]
(Thousands of Dollars)

Percent of Change Over Current Rate	Property & Casualty b/	Life	Accident & Sickness	Prepaid Health	HMO c/	Annuity	Title	Other Life & Casualty & Burial d/	Fraternal Benefit	Mutual Assessment Fire e/
.25	4,938	2,862	1,947	2,868	191	685	84	49	47	60
.50	9,876	5,725	3,893	5,737	383	1,370	168	98	94	121
.75	14,815	8,587	5,840	8,605	574	2,054	252	147	141	181
1.00	19,753	11,450	7,787	11,473	765	2,739	336	196	188	241
1.25	24,691	14,312	9,733	14,341	957	3,424	420	244	235	302
1.50	29,629	17,175	11,680	17,210	1,148	4,109	504	293	282	362
1.75	34,567	20,037	13,627	20,078	1,339	4,794	588	342	328	423
2.00	39,505	22,899	15,573	22,946	1,531	5,479	672	391	375	483
2.25	44,444	25,762	17,520	25,815	1,722	6,163	756	440	422	543
2.50	49,382	28,624	19,467	28,683	1,913	6,848	840	489	469	604
2.75	54,320	31,487	21,413	31,551	2,104	7,533	924	538	516	664
3.00	59,258	34,349	23,360	34,420	2,296	8,218	1,008	587	563	724

NOTE: Figures in boxes depict current rates and revenue collections.

a/ Amount of revenue gain or loss for each .25 percent change.
Calculations based on 1984 gross premium income which may not include all deductions, exemptions, etc.

b/ Includes prepaid legal plans and home protection companies.

c/ 1985 HMO premium income has increased more than sixty percent over 1984 levels.

d/ Includes Cooperative Non-profit Life Benefit, Cooperative or Assessment Life and Casualty, and Burial Societies.

e/ Figures include premium income for those mutual assessment fire companies that are taxed at one percent and those that are exempt from taxation.

SOURCE: Department of Planning and Budget, based on 1984 Insurance Company Statistical Report.

These potential outcomes of changing the current structure need to be considered beside any rate revision. One way to mitigate the effects of changing tax rates is to phase in the adjustments gradually over two or three biennia. This means that a reduction in rates could be absorbed within the General Fund and an increase in rates could be anticipated by companies and factored into their long-range plans.

Summary of Approaches

Table V-2 presents a variety of approaches that can be considered to address inequities. Each approach is followed by the advantages, disadvantages, and revenue impact of such action. The revenue impact of additional alternatives can be determined by using the information in Table V-1.

By using this revenue data in connection with the alternatives, many different scenarios are possible. For example: If policy makers wanted a uniform rate of 2 percent on all major lines of insurance (Alternatives #V-A and #VII-B on Table V-2), and wanted to achieve this uniformity over a period of years so the burden on BC/BS plans and HMOs would not be severe, a phased implementation could occur over three biennia. The example below indicates how this could be done with minimal net changes in state revenue (+$2.3 million) over the six-year period.

	Rates				Revenue	
	P&C Title	Accident/ Sickness	Life	BC/BS HMOs	Amount ($ Millions)	Change From 1985
1985	2.75%	2.75%	2.25%	.00%	$102.4	...
Year 1	2.50	2.75	2.25	.25	100.5	-$1.9
Year 2	2.50	2.50	2.25	.75	104.6	+ 2.2
Year 3	2.25	2.50	2.25	1.00	102.7	+ .3
Year 4	2.25	2.25	2.25	1.25	103.8	+ 1.4
Year 5	2.00	2.25	2.00	1.75	102.0	- .4
Year 6	2.00	2.00	2.00	2.00	103.1	+ .7

The revenue impact for other rates on lines of insurance can be found by using Table V-1.

TABLE V-2

ALTERNATIVES TO THE CURRENT TAX STRUCTURE

ALTERNATIVES	ADVANTAGES	DISADVANTAGES	ANNUAL REVENUE IMPACTS
I. Tax Base:			
A. Allow property & casualty (P&C) to deduct guaranty association fees.	Equalizes treatment for life and P&C.	Creates need to establish a cap on amount that can be deducted.	Slight loss
B. Eliminate life company deductions for guaranty association fees.	Equalizes treatment for life and P&C.	Creates additional tax burden on life companies.	Slight increase
C. Tax "other than legal reserve" policies.	Equalizes tax treatment on all life policies. Eliminates questionable exemption from the tax base. Reduces effort to administer tax policy.	Creates additional tax burden on non-profit life benefit companies.	Slight increase
II. License Fees:			
A. Eliminate all license fees.	Creates equity in fees. Reduces administrative requirements.	Eliminates all general tax from certain companies.	-$3,600
B. Charge fixed fee to those companies exempt from premium tax.	Creates consistency in fee structure. Eliminates discrepancy with current law that premium taxes shall be in lieu of all other taxes.	Could create unequal burden on small companies.	Depends on fee
C. Charge a license fee that relates to premium income.	Gives logic and equity to license fee structure. Helps equalize tax burden.	Could be more difficult to administer.	Depends on fee

TABLE V-2 (continued)

ALTERNATIVES	ADVANTAGES	DISADVANTAGES	ANNUAL REVENUE IMPACTS
III. Administrative Assessment Fees:			
A. Eliminate fee paid to Bureau of Insurance by self-insured workers' compensation groups.	Eliminates double fee paid by self-insured workers' compensation groups.	Reduces operating revenue to SCC.	-$14,400
B. Require Fraternal Benefit Societies to pay assessment fee.	All companies would bear the costs of regulation.	Places fee on companies that previously had none.	+$11,300
IV. Tax Burden on P&C Companies:			
A. Reduce 2.75% tax on P&C companies.	Creates greater equity in tax burden. Could stimulate growth in domestic industry. Reduces retaliatory taxes.		-$9.9 million at 2.25%
B. Eliminate fire programs tax.	Reduces taxes on companies with highest tax burden. Reduces retaliatory taxes. Creates consistency in tax structure. Could stimulate growth in domestic industry.	Eliminates a source of aid for localities. Creates expenditure demands on General Fund.	-$5 million (Nongeneral Fund)
C. Allow a credit for the fire programs tax.	Maintains a dedicated fund for localities. Reduces taxes on companies with highest tax burden. Reduces retaliatory taxes. Could stimulate growth in domestic industry.	Adds new administrative requirements.	-$5 million (General Fund)

TABLE V-2 (continued)

ALTERNATIVES	ADVANTAGES	DISADVANTAGES	ANNUAL REVENUE IMPACTS
V. Rate Structure:			
A. Apply premium tax of 2% to all lines of insurance.	Simple to administer. Makes tax structure comparable to other states. Distributes tax burden more evenly. Reduces retaliatory taxes. Stimulates growth in domestic industry.	Places tax on companies that previously had none. Increases tax burden on companies currently taxed at 1%. May require revision of open enrollment statutes. May reduce charitable contributions of fraternals. Requires mandatory public service policy for high risk health insurance or additional state support for indigent care.	+$1.5 million
B. Set up two-tier structure: 2.25%: Life, Sickness & Accident, Property, & Casualty, Title. 1% Prepaid Health HMOs, Fraternals County Mutuals Burial, Non-profit Life, Assessment Life & Casualty.	Distributes tax burden more evenly. Simple to administer. Stimulates domestic industry growth. Reduces retaliatory taxes. Could enhance competitive environment in health insurance industry.	Results in some inequities in tax burden. Places tax on companies that previously had none. May require revision of open enrollment statutes. May reduce charitable contributions of fraternals.	-$1.5 million
C. Replace premium tax with corporate income tax.	Taxes income for insurance companies like income for other corporation. Links taxes to profitability. Lowers tax burden for most companies. Reduces retaliatory taxes.	Requires involvement of SCC and Department of Taxation. Separates taxation from regulatory control. Increases reporting requirements on insurance companies. Subjects revenues to cyclical swings in the insurance industry.	Substantial (-$86 million based on limited sample)

TABLE V-2 (continued)

ALTERNATIVES	ADVANTAGES	DISADVANTAGES	ANNUAL REVENUE IMPACTS
I. Annuities:			
A. Apply premium tax to annuities.	Acknowledges that annuities generate income for insurance companies.	Runs counter to current social policy encouraging people to provide for their own retirement. May result in a competitive advantage for non-insurance annuity providers. Would increase retaliatory taxes.	+$1.4 million at .5 percent
II. Tax Treatment for Health Insurance Companies:			
A. Eliminate tax on all health insurance.	Creates equity in tax treatment of health insurance. Could enhance competitive environment. Eliminates retaliatory taxes for commercial companies. Increases options for mandating health insurance benefits. Could stimulate growth in domestic industry. Eliminates the advantage for self-insured health care.	Establishes social policy by designating health insurance for preferential tax treatment. Could require additional administrative and regulatory burdens on SCC for mandatory high risk health insurance.	-$21 million
B. Tax all health insurance at one rate.	Creates equity in tax treatment of health insurance. Could enhance competitive environment. Increases options for mandating health insurance benefits.	Places tax on companies that previously had none. Requires mandatory public service policy for high risk health insurance or additional state support for indigent care.	-$1.4 million at 1%
C. Tax all companies and allow credits or lower tax rate to companies that provide social benefits.	Could enhance competitive environment. Provides incentive for more companies to provide social benefits.	Requires additional administrative and regulatory burdens on SCC.	Revenue increase depends on rate

Recommendations

This study should be continued in 1986 to respond to the following recommendations:

Recommendation 1: The inequities in the tax structure identified in this report should be addressed by the Governor and the General Assembly in the following manner:

- The continued study should propose specific revisions of the tax structure to bring about equity between life and casualty companies and rectify other inequities in the structure.
- Legislation should be recommended to the 1987 Session of the General Assembly to effect those changes for tax years beginning on and after January 1, 1988.
- Anticipated revenue adjustments should be incorporated in the general fund revenue forecast for the 1988-90 biennium and beyond.

Recommendation 2: The study should document the possible ramifications of taxing exempt health care organizations, such as escalating hospital costs and increasing numbers of high risk and uninsurable individuals whose health care coverage would be jeopardized if open enrollment periods were no longer available.

At a minimum, the study should present:

1. The number and medical characteristics of applicants for insurance from commercial health companies who are denied coverage through failure to meet medical underwriting criteria;
2. The number and medical characteristics of individuals who have been cancelled by commercial health insurers;
3. The number and medical characteristics of "high risk" or "uninsurable" individuals who are covered by Blue Cross and Blue Shield (BC/BS) plans' open enrollment policy;
4. The number and medical characteristics of group subscribers who convert to individual coverage under the BC/BS plans and HMOs;
5. Quantifiable information on the cost savings afforded particular hospitals through both the policies and the business practices of the BC/BS plans;
6. A detailed assessment of the extent to which other states regulate the fee structures and minimum benefit levels of health insurers and the impact of these actions on consumers;
7. A description of the legal and regulatory steps needed to protect subscribers and the industry if a change in the tax status of BC/BS plans and HMOs is effected.

The study should involve the State Corporation Commission, the Secretary of Finance, other state agencies as appropriate and industry representatives.

Recommendation 3: The study should include the views of the Attorney General regarding the Commonwealth's authority to tax self-insured groups under federal law.

Recommendation 4: If federal tax reform results in eliminating the tax-exempt status of BC/BS plans, HMOs and fraternal benefit organizations, consideration should be given by the Governor and the General Assembly to imposing the gross premium tax on these entities.

Appendices

APPENDIX A

1985 SESSION

HOUSE JOINT RESOLUTION NO. 311

Requesting the Secretary of Finance to study the taxation of insurance companies in Virginia

WHEREAS, the tax structure and rates imposed on insurance companies in the Commonwealth have remained unchanged for the past sixty-nine years; and

WHEREAS, in recent years insurance companies have developed and are now marketing a wide array of products and services in addition to insurance; and

WHEREAS, the current gross receipts tax on insurance companies in the Commonwealth is based solely upon gross premium income and is in lieu of all other taxes; and

WHEREAS, the rate of tax imposed on insurance companies in the Commonwealth ranges from 1 percent to 2 3/4 percent, depending on the type of insurance provided; and

WHEREAS, the federal government taxes insurance companies by means of the corporate income tax; now, therefore, be it

RESOLVED by the House of Delegates, the Senate concurring, That the Secretary of Finance is hereby requested to study the taxation of insurance companies in Virginia. The study shall include, but not be limited to, an examination of the philosophy of the gross receipts tax structure in lieu of the corporate income tax, the varying tax rates on the different types of insurance provided, the impact and equity of taxing direct gross premium income in contrast to all income, the tax exempt status placed on various insurers, and the numerious changes occurring in the insurance and financial services industries.

The State Corporation Commission and the Bureau of Insurance shall cooperate with the Secretary of Finance and provide any information and data that are necessary for the study.

The Secretary of Finance is requested to submit his report by December 15, 1985, to the Governor and the General Assembly of Virginia.

APPENDIX B

SUMMARY OF TAXES IMPOSED ON INSURANCE COMPANIES BY STATE

	TAX ON PREMIUMS[1] OR SUBSCRIBER FEES				OTHER TAXES				
State	Life & Health	Property & Casualty	Health Maintenance Organization	Prepaid Health[2]	Franchise[3]	Income[4]	Fire Programs[5]	Ocean Marine[6]	Other Major Taxes[7]
Alabama[8]	1% D[9] 3% F	1% D 4% F	—	1%	$10 per $1,000 capital D $3 per $1,000 capital F	—	—	3/4%	—
Alaska	1 1/2% D[10] 3% F	1 1/2% D[10] 3% F	—	6% of gross subscriptions minus claims paid	—	—	—	3/4%	—
Arizona[8]	1% D 2% F	1% D 2% F .4312% Additional Premium Tax on certain vehicle policies	1% D 2% F	1%	—	—	—	—	3% Surplus line premium tax
Arkansas	2 1/2%	2 1/2%	—	1% F	$100 on capital stock $500,000, $200 if $500,000	Domestic companies only 1% of first $3,000 2% of next $3,000 3% of next $5,000 5% of next $14,000 6% of $25,000+	—	3/4%	—
California	2.35%	2.35%	—	—	—	—	—	5% taxable underwriting profit	—
Colorado[8]	1% D 2 1/4% F	1% D 2 1/4% F	—	—	—	—	—	—	—

APPENDIX B (Cont.)

State	TAX ON PREMIUMS[1] OR SUBSCRIBER FEES				OTHER TAXES				
	Life & Health	Property & Casualty	Health Maintenance Organization	Prepaid Health[2]	Franchise[3]	Income[4]	Fire Programs[5]	Ocean Marine[6]	Other Major Taxes[7]
Connecticut	2%	2%	Nonprofit, nonstock corporations exempt	2%	—	10% D adjusted federal income	—	—	—
Delaware	1 3/4%	1 3/4%	—	—	Domestic companies only, sliding scale on authorized capital	—	3.75%	5% taxable underwriting profit	—
District of Columbia	2%	2%	—	—	—	—	—	—	—
Florida[8]	2%	2%	—	2%	—	5% adjusted federal income 2% Emergency Excise Tax- deduction allowed in computing adjusted federal income exclusive of §168(b)(3) of Internal Revenue code (Premium tax credited)	.625%	3/4%	2% Municipa Fireman' Pension Fund (propert policies 1% Municipa Police Officers Fund (casualt policies
Georgia[8]	2.25%	2.25%	2.25%	2.25%	—	—	1%	—	2.5% County & Municipa Premium Tax
Hawaii	2.9647% D 3.197% F Accident & Sickness: 2.9647% D 4.2824% F	2.9647% D 4.2824% F	—	—	—	—	—	.8755%	—

A IX B (Cont.)

	TAX ON PREMIUMS[1] OR SUBSCRIBER FEES				OTHER TAXES				
State	Life & Health	Property & Casualty	Health Maintenance Organization	Prepaid Health[2]	Franchise[3]	Income[4]	Fire Programs[5]	Ocean Marine[6]	Other Major Taxes
Idaho[8]	3%	3%	—	—	—	—	—	—	—
Illinois[8]	2%	2%	—	2%	—	4% 2.5% Personal Property Replacement Income Tax (Premium tax credited)	.5% Fire Marshall Tax 2% Fire Department Tax–F	—	—
Indiana	2% Domestic companies choose between premium tax and income tax	2%	—	2%	—	Domestic companies only 1.25% Gross Income Tax (phasing out) 3% Adjusted Gross Income Tax 4% Supplemental Net Income Tax	.5%	—	—
Iowa	2%	2%	2% Exempt from premium tax for first 5 years of operation	2%	—	—	—	6 1/2% net underwriting profit	—
Kansas	1% D 2% F	1% D 2% F	.5% years 4 & 5 1% after year 5	1%	—	5% Privilege Tax – D	1.25% Fire Marshall Tax 2% Firefighters' Relief Fund Tax	—	—
Kentucky	2%	2%	—	—	—	—	3/4% 1.5% Property & Casualty Surcharge	—	—

APPENDIX B (Cont.)

State	TAX ON PREMIUMS[1] OR SUBSCRIBER FEES				OTHER TAXES				
	Life & Health	Property & Casualty	Health Maintenance Organization	Prepaid Health[2]	Franchise[3]	Income[4]	Fire Programs[5]	Ocean Marine[6]	Other Major Taxes
Louisiana[8]	$140 for gross premiums to $7,000, $225 for each additional $10,000 or fraction	$180 for gross premiums to $6,000, $185 for each additional $10,000 or fraction	2.25%	2.25%	—	4% of first $25,000 5% of next $25,000 6% of next $50,000 7% of next $100,000 8% of excess over $200,00 (Premium tax credited)	1.25% Fire Marshall Tax .25% Fire Training Program Tax 2% Fire Department Tax - F	—	—
Maine	1% D 2% F	1% D 2% F	—	—	—	—	.95%	—	—
Maryland	2%	2%	—	—	—	—	—	—	—
Massachusetts	2%	2%	2% (for profit only)	—	—	1% Gross Investment Income Tax - D	—	5.7 net underwriting profit	—
Michigan	2% F	Foreign companies only 2% casualty, surety, fidelity 3% fire, marine, auto	—	—	—	Domestic companies & foreign companies with gross receipts $40,000 2.35% Single Business Tax federal taxable income	—	—	—
Minnesota	2%	2%	—	—	—	12% Corporation Excise Tax	1/2% Fire Marshall Tax 2% Fireman's Relief Fund Surcharge (3 cities)	5% net underwriting profit	—

APPENDIX B (Cont.)

	TAX ON PREMIUMS[1] OR SUBSCRIBER FEES				OTHER TAXES				
State	Life & Health	Property & Casualty	Health Maintenance Organization	Prepaid Health[2]	Franchise[3]	Income[4]	Fire Programs[5]	Ocean Marine[6]	Other Major Taxes
Mississippi[8]	1 1/2% D 3% F	1 1/2% D 3% F	No law	3%	—	3% of first $5,000 4% of excess (Premium tax credited)	1/2% Fire Marshall Tax 1/2% Municipal Firemen & Policemen Disability & Relief Fund	—	—
Missouri	2%	2%	—	—	—	—	—	—	—
Montana[8]	2 3/4%	2 3/4%	No law	—	—	—	3/4% State Fire Marshall Tax 1 1/2% Firemen's Pension Tax	3/4%	—
Nebraska	6/10% D 2% F	6/10% D 2% F	6/10%	6/10%	—	25% of individual tax rate on first $50,000 federal taxable income, 35% of tax rate on excess (Premium tax credited)	3/8% D 3/4% F	—	—
Nevada[8]	3%	3%	3%	3%	—	—	—	—	—
New Hampshire	2%	2%	2% unless nonprofit	—	—	8% Business Profits Tax companies with gross income $12,000. Taxable income before deductions. 1985 13.5% surtax (Premium tax credited)	—	5% net underwriting profit	—

APPENDIX B (Cont.)

	TAX ON PREMIUMS[1] OR SUBSCRIBER FEES				OTHER TAXES				
State	Life & Health	Property & Casualty	Health Maintenance Organization	Prepaid Health[2]	Franchise[3]	Income[4]	Fire Programs[5]	Ocean Marine[6]	Oth Maj Tax
New Jersey	2% 1% Accident & Sickness	2% 1% Accident & Sickness	—	—	—	—	2% F	5% net underwriting profit	—
New Mexico[8]	3%	3%	3%	3%	—	—	—	—	—
New York	1%	1.2%	—	—	—	Largest of the following: (1) 9% of net income, or (2) 9% of officers compensation alternative, or (3) .0016 times allocated business and investment capital, or (4) minimum tax $125. Plus: .0008 times allocated subsidiary capital.	2% F	—	—
North Carolina	1 1/2% D 2 1/2% F	1% D 2 1/2% F 1% Additional Annual Gross Premium Tax fire and lightning policies. Domestic companies pay premium tax or income tax whichever is greater.	—	—	—	6%	1/2%	—	—

APPENDIX B (Cont.)

State	TAX ON PREMIUMS[1] OR SUBSCRIBER FEES				OTHER TAXES				
	Life & Health	Property & Casualty	Health Maintenance Organization	Prepaid Health[2]	Franchise[3]	Income[4]	Fire Programs[5]	Ocean Marine[6]	Other Major Taxes
North Dakota	2% .5% Accident & Sickness	1% .5% Accident & Sickness	--	.5%	--	Domestic companies that do not pay premium tax 3% of first $3,000 4% of next $5,000 5% of next $7,000, 6% of excess	.5% D	--	--
Ohio[11]	2 1/2% F	2 1/2% F	--	--	Domestic companies only .6% of value of capital & surplus or 2 1/2% of gross premiums	--	3/4%	--	--
Oklahoma[8]	4% F	4% F	--	--	--	4% D	5/16% F	--	--
Oregon[11]	2 1/4% F	2 1/4% F	2.25% (foreign, for profit only)	--	--	7 1/2% D	1%	5% net underwriting profit - F	--
Pennsylvania	2%	2%	--	--	--	--	--	5% net underwriting profit	--
Rhode Island	2%	2%	--	--	--	--	--	5% net underwriting profit	--
South Carolina[8] [12]	2% Graded 1% Graduated F	2% Graded 1% Graduated F	--	2%	--	--	1/10% 1% F	--	--
South Dakota[8]	2 1/2%	2 1/2%	2 1/2%	2.50%	--	--	1/2%	--	--

State	TAX ON PREMIUMS[1] OR SUBSCRIBER FEES				OTHER TAXES				
	Life & Health	Property & Casualty	Health Maintenance Organization	Prepaid Health[2]	Franchise[3]	Income[4]	Fire Programs[5]	Ocean Marine[6]	Other Major Taxes
Tennessee[8]	1 3/4% D 2% F	2 1/2%	—	1.75%	15¢ per $100 of outstanding stock, surplus, undivided profits and reserves	6% (Premium tax credited) 6% D stock and bond interest	.75%	—	—
Texas[8]	2.5%	3.5% 2.5% Accident & Sickness	2.5%	2.5%	—	—	—	—	—
Utah	2 1/4%	2 1/4%	—	2 1/4%	—	—	—	5% net underwriting profit	—
Vermont	2%	2%	—	—	—	—	—	—	—
Virginia	2 1/4% 2 3/4% disability, double indemnity, accident and sickness	2 3/4%	—	—	—	—	.8%	—	—
Washington	1.16% D 2.16% F 4% surtax	1.16% D 2.16% F 4% surtax	—	3¢ per subscriber per month	—	—		.91%	—
West Virginia[8]	2% 1% Additional Premium Tax	2% 1% Additional Premium Tax 1% Additional Fire & Casualty Premium Tax	—	—	—	—	1/2%	—	1.15% Busin and O patio Tax (rent inco
Wisconsin[13]	2% F	Fire: 3/8% F 2 3/8% A Casualty: 2% A	No law	—	—	7.9% D[14] adjusted federal taxable income	2%	3/8% F 1/2% A	—
Wyoming[8]	1 1/2% D 2 1/2% F	1 1/2% D 2 1/2% F	—	1.5%	—	—	—	3/4%	—

APPENDIX B (Cont.)

1 Tax rates are applied to gross premiums minus specific deductions unless otherwise noted. Deductions vary from state to state and may include retur premiums, reinsurance ceded, policyholder dividends and annuities.

2 Rates apply to Blue Cross/Blue Shield subscriptions unless otherwise indicated.

3 For purposes of this table, a franchise tax is considered to be a tax on capital however measured. Taxes imposed on income have been included under the income tax column even though states consider them to be franchise taxes.

4 Rates are applied to net income unless otherwise noted.

5 These taxes are in addition to the premium taxes applied to property and casualty policies. The taxes generally apply to gross premiums minus vario deductions on fire, auto fire or lightning policies and specific percentages which define the fire portion of other premiums on property risks.

6 Rates are applied to gross underwriting profit on ocean or wet marine and transportation insurance unless otherwise noted. Gross underwriting profi is determined by subtracting from gross premiums all return premiums, reinsurance ceded and net losses paid during the calendar year under ocean mar contracts. Net or taxable underwriting profit is that proportion of the total average annual net underwriting profit on ocean marine insurance writ within the United States during the last preceding 3 calendar years which the gross premiums of the company from such insurance written within the state bears to the gross premiums of the company from such insurance written within the United States during the same period. A company which has no written such business for three full calendar years in the state taxed upon its net underwriting profit for the current taxable year, subject to an adjustment at the end of the third full calendar year of business.

7 Any tax above 1% excluding Workers' Compensation.

8 Reductions in premium tax rate allowed when certain percentage of assets (Alabama, Georgia, Idaho, Louisiana, Mississippi, New Mexico, Oklahoma, Tennessee, Texas and Wyoming) or assets or capital stock (Montana) or reserves (South Carolina) invested in state. In West Virginia the additional t not imposed if 25% of assets invested in state. South Dakota and Nevada have a rate reduction for companies with regional or home offices. Foreign tax rate applied to domestic companies that do not have a home/regional office in state (Arizona, Colorado, Florida and Illinois).

9 D equals the rate applied to domestic companies (those that are chartered in the state).
F equals the rate applied to foreign companies (those that are chartered out of state).
If not specified, the tax rate applies to both domestic and foreign companies.

10 Domestic companies are exempt from taxation for five years. After the fifth year, domestic tax rates are equal to one half the foreign tax rate.

11 Foreign tax rates also apply to domestic companies that are insurance holding company affiliates controlled by a nonresident affiliate and have risks in the state formerly written by its foreign affiliates in a total amount exceeding the risks outstanding that arise from business initially written it in the state (Ohio) or domestic insurers organized after January 1, 1971 owned or controlled directly or indirectly by a foreign insurer or foreig corporation owning or controlling directly or indirectly a foreign insurer (Oregon).

12 Domestic companies have a ceiling on premium tax liability of 5% of net income.

13 A equals the rate applied to alien companies (those that are chartered out of the country).

14 Domestic insurance companies other than life insurance companies engaged exclusively in life insurance, companies writing mortgage guaranty, town mutual insurance companies and mutual insurance companies exempt from federal income taxation are subject to an insurance franchise tax beginning wit the calendar year 1972.

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APPENDIX C

PREMIUM TAXES ON BLUE CROSS/BLUE SHIELD PLANS
AND HEALTH MAINTENANCE ORGANIZATIONS NATIONWIDE

	Prepaids			HMOs		
State	Taxed	Tax Rate°	Rationale	Taxed	Tax Rate°	Rationale
Alabama	Yes	1% D° (Domestic) 3% F (Foreign)	volunteered for tax	No	-	encourage development
Alaska	Yes	6% gross premiums minus claims and state employee premiums	insurance company	No	-	not insurance
Arizona	Yes	1% D, 2% F gross premiums minus premiums from government agencies	volunteered for tax	Yes	1% D 2% F	insurance company
Arkansas	Yes	1% F	incentive for domestics	No	-	encourage development
California	No	-	nonprofit	No	-	nonprofit
Colorado	No	*	nonprofit	No	-	encourage development
Connecticut	Yes	2%	insurance company	No	-	encourage development
Delaware	No	-	no tax on health care coverage	No	-	not insurance
District of Columbia	No	-	nonprofit	No	-	nonprofit
Florida	Yes	2% gross premiums minus home office exclusions equals zero net tax°	insurance company	No	-	not insurance
Georgia	Yes	2.25%°	insurance company	Yes	2.25%°	insurance company
Hawaii	No	-	no BC/BS plans	No	-	no state law
Idaho	No	*	nonprofit	No	*	nonprofit
Illinois	Yes	2% gross premiums minus exclusions equals zero net tax°	insurance company	No	-	encourage development
Indiana#	Yes	2%	insurance company	Yes	2% (for-profit only)	insurance company

State	Prepaids			HMOs		
	Taxed	Tax Rate°	Rationale	Taxed	Tax Rate°	Rationale
Iowa	Yes	2%	insurance company	Yes	2% gross premiums after five years	insurance company
Kansas	Yes	1% D° 2% F	insurance company	Yes	.5% years 4+5 1% years 6+	insurance company
Kentucky	No	*	nonprofit	No	-	encourage development
Louisiana	Yes	2.25%°	insurance company	Yes	2.25%°	insurance company
Maine	No	-	nonprofit	No	-	no state law
Maryland	No	-	nonprofit	No	-	nonprofit
Massachusetts	No	-	nonprofit	Yes	2% (for-profit only)	tax for-profits
Michigan	No	-	nonprofit	No	-	nonprofit
Minnesota	No	-	nonprofit	No	-	nonprofit
Mississippi	Yes	3%	insurance company	No	-	no state law
Missouri	No	-	no tax on health care	No	-	no tax on health care
Montana	No	*	nonprofit	No	-	no state law
Nebraska	Yes	.6% D 2% F	insurance company	Yes	.6% D 2% F	insurance company
Nevada	Yes	3%°	insurance company	Yes	3%°	insurance company
New Hampshire	No	-	nonprofit	Yes	2% (for-profit only)	tax for-profits

State	Prepaids			HMOs		
	Taxed	Tax Rate	Rationale	Taxed	Tax Rate	Rationale
New Jersey	No	*	nonprofit	No	-	nonprofit
New Mexico	Yes	3%°	insurance company	Yes	3%°	insurance company
New York	No	*	nonprofit	No	-	nonprofit
North Carolina	No	*	nonprofit	No	-	encourage development
North Dakota	Yes	.5%	insurance company	Yes	.5%	insurance company
Ohio	Yes	2.5% mutuals * nonprofits	insurance company	No	-	nonprofit
Oklahoma	No	-	nonprofit	No	-	not insurance
Oregon	No	-	incentive for domestics	Yes	2.25% (foreign, for-profit only)	nonprofit and domestic companies exempt
Pennsylvania	No	-	nonprofit	No	-	nonprofit
Rhode Island	No	-	nonprofit	No	-	nonprofit
South Carolina	Yes	2%°	insurance company	No	-	nonprofit
South Dakota	Yes	2.5%	insurance company	Yes	2.5%	insurance company
Tennessee	Yes	1.75% gross premiums minus self insurance premiums	insurance company	No	-	encourage development
Texas	Yes	2.5% gross premiums minus welfare premiums°	insurance company	Yes	2.5% gross premiums minus welfare premiums°	insurance company

State	Prepaids			HMOs		
	Taxed	Tax Rate°	Rationale	Taxed	Tax Rate°	Rationale
Utah	Yes	2.25%	insurance company	No	-	no tax on health care
Vermont	No	-	nonprofit	No	-	encourage development
Virginia	No	-	nonprofit	No	-	encourage development
Washington	Yes	.044% gross premiums minus claims	profit-making	Yes	.044% gross premiums minus claims	profit-making
West Virginia	No	-	nonprofit	No	-	encourage development
Wisconsin	No	-	no tax on health care	No	-	no tax on health care
Wyoming	Yes	1.5%°	insurance company	No	-	encourage development

° Tax rates are applied to gross premiums unless otherwise noted.

° State allows credits for in-state assests.

* State imposes fee/assessment in lieu of tax.

Mutual companies have choice of premium tax or franchise tax.

SOURCE: Department of Planning and Budget

BP/2488w/pht

APPENDIX D

Representatives of the Insurance Industry

Stephanie J. Baynon, American Council of Life Insurance
Larry Berman, George Washington University Health Plan
James W. Brittain, PruCare, Inc.
S. W. Clark, Jr., Virginia Mutual Insurance Company
Grover E. Czech, American Insurance Association
Wayne C. Defferding, Aid Association for Lutherans
Leo W. Doyle, National Association for Independent Insurers
Ammon G. Dunton, Jr., Northern Neck Mutual Fire Association of Virginia
Charles Foster, Lawyer's Title Insurance Corproation
Joan M. Gardner, HealthKeepers
Hugh Garnett, Home Beneficial Life Insurance
Allen C. Goolsby, Medical Society of Virginia
J. Mark Gregory, Blue Cross and Blue Shield of Virginia
W. N. Gregory, Jr., Virginia Mutual Insurance Company
William G. Haneke, Aetna Choice Healthcare Plan
David M. Harris, State Farm Insurance Companies
B. Michael Herman, Blue Cross and Blue Shield of Southwestern Virginia
Louanna Heuhsen, Medical Society of Virginia
Kelly Houp, Humana Care Plus
Richard D. Jackler, PruCare
Lawrence A. Kinzler, Southern Health Services
Shelley B. Kleinman, Group Hospitalization, Inc. & Medical Services of D.C.
D. Patrick Lacy, Jr., Group Hospitalization, Inc. & Medical Services of D.C.
J. Christopher LaGow, Nationwide Mutual Insurance Company
Michael Landymore, CapitalCare
Phillip S. Marstiller, Blue Cross and Blue Shield of Virginia
Kathleen Mehfoud, Group Hospitalization, Inc. & Medical Services of D.C.
J. Maurice Miller, Jr., Aetna Insurance Company
Phillip B. Morris, State Farm Insurance Companies
David W. Mulligan, HealthAmerica
Margaret M. Parker, Life Insurance Company of Virginia
James C. Preas, Jr., Commonwealth Life Insurance Company
Mary Ann Raesener, HealthAmerica
Judy N. Riddle, Lawyer's Title Insurance Corporation
Thomas Sandford, Virginia Farm Bureau Mutual Insurance
Laurens Sartoris, Virginia Hospital Association
William Shands, Life Insurance Company of Virginia
Cyndy Simonson, Southern Health Services
Langhorne Smith, Blue Cross and Blue Shield of Virginia
Gary R. Summers, Kaiser Permanente
Frank A. Sutherland, Jr., Life Insurance Company of Virginia
Roger S. Taylor, M.D., United Medical Plan of Virginia
Stephen Zachary, Kaiser Permanente