A REVIEW OF PAST ECONOMIC ARRANGEMENTS WITH VIRGINIA-HEADQUARTERED INSURANCE COMPANIES

PREPARED BY THE VIRGINIA ECONOMIC DEVELOPMENT PARTNERSHIP

DECEMBER 1, 2007

PREFACE

Budget Item number 119-S in the 2007 Appropriations Act directed the Virginia Economic Development Partnership to conduct a review of past economic arrangements with Virginia-headquartered insurance companies to determine if those arrangements have achieved their intended purposes and offer findings which, if acted upon, could further the economic development goals underlying those arrangements.

ACKNOWLEDGEMENTS

The Virginia Economic Development Partnership would like to acknowledge the work of the staff of the Bureau of Insurance at the State Corporation Commission in providing research and guidance for this study.

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BACKGROUND

In lieu of a corporate income tax, Virginia levies a gross premium tax on its insurance companies that is based on all premiums collected from Virginia written policies by insurance companies. Virginia lowered its premium tax rate from 2.75% to 2.25% in 1987. At that time, the reduction placed Virginia's rates in the mid-range of state rates. When a state has a premium tax rate that is higher than another state, its domestic companies will generally be subject to retaliatory taxes on the premiums for policies written in the lower tax rate state.

A retaliatory tax is levied on the difference between the premium tax rate charged in the taxing state and the tax rate of the company's state of domicile. For example, if a Virginia insurer writes a policy in Maryland where the premium tax rate is 2.0%, the Virginia insurer must pay Maryland the 2.0% premium tax on its Maryland premiums plus a retaliatory tax of 0.25% on its Maryland premiums to match the rate a Maryland insurer would have to pay in Virginia. Conversely, if Virginia has a lower premium rate than an insurer's state of domicile, then Virginia collects retaliatory taxes on the premiums that insurer collects in the Commonwealth. Due to the high Virginia premium tax rate, Virginia collects a very small percentage of retaliatory tax compared to the total premium tax receipts. Since 1999, nineteen states have enacted legislation to reduce their premium tax rates.

In 1996, a major insurance conglomerate announced it was considering consolidating and locating its corporate headquarters in the Commonwealth. Prior to the announcement, the company informed the Virginia Economic Development Partnership (VEDP) that Virginia's 2.25% premium tax rate was too high and increasingly out-of-line with other states. The company recognized that it would incur a retaliatory tax burden on its insurance companies domiciled in Virginia. At the time, the national average for the premium tax rate was 2.09%. Reports by a select committee of Virginia legislators, VEDP, the Secretary of Commerce and Trade, and industry analysts demonstrate the impact of the retaliatory taxes on Virginia's domestics. (See Appendix 1: Comparative Premium Tax Table for Life Insurance Lines.) Not only does the increasing premium tax rate spread between Virginia and lower rate states result in additional retaliatory taxes for Virginia domestic insurers, but premium and retaliatory taxes also create a higher overall tax burden than that of other business sectors. Studies using methodologies to equate premium tax to corporate income tax by the American Council of Life Insurance (ACLI) and Ernst and Young estimate that Virginia's 2.25% premium tax rate is the equivalent of an income tax rate of 11.1% to 15.1%, depending on the study (House Document 49, Commonwealth of Virginia, 2000, p.4).

VIRGINIA'S INSURANCE INDUSTRY

Virginia's insurance industry can be characterized as a comparatively stable sector in the overall economy. The insurance sector is made up of a variety of subsectors that fall into two main categories: insurance carriers (such as life, health, or property/casualty insurance) and insurance agencies, brokerages and related services.

As of 2006, Virginia had 777 domestic and foreign insurance carrier establishments, a modest 3.5% increase over 2000. Table 1 documents the number of domestic Virginia insurance companies by type of license. Employment in these important subsectors of the insurance industry has remained relatively stable at 24,000. The average 2006 salary for these Virginia employees was $62,156.

Table 1: 2006 Insurance Carriers Licensed in Virginia

TYPE OF LICENSE	TOTAL #	VIRGINIA DOMESTICS
Property and Casualty Insurers	837	16
Life, Accident & Health Insurers	479	8
Health Insurers	47	21
Title Insurance	26	1
Mutual Assessment PC Ins.	--	18
TOTAL	**1,389**	**64**

Source: State Corporation Commission, Bureau of Insurance

The State Corporation Commission (SCC) Bureau of Insurance reports Virginia was home to 64 insurance carrier companies (domiciled in the state) in 2006. Another 1,400 insurance carrier companies were licensed to do business in the state. Many of these "foreign" companies, selling in the Virginia market, also have significant operation centers and even corporate offices located in Virginia.

In 2005 (the latest year available), the insurance industry contributed nearly $4.4 billion to Virginia's gross state product. Total compensation of the industry's employees was over $3 billion. Virginia's estimated premium and retaliatory tax receipts from the insurance industry totaled $424,763,656 in 2006 before tax-related credits or other premium adjustments. Virginia's retaliatory tax revenue is approximately less than one-half of one percent of the total premium and retaliatory tax receipts.

THE IMPACT ON THE INSURANCE COMPANY HEADQUARTERS

Since the major insurance conglomerate located its corporate headquarters in Virginia in 1997, the company has increased its Virginia workforce by more than 1,400 jobs at several Virginia locations (as of the first quarter of FY 2007). This job growth is more than four times the initial commitment the company made at the time of the announced relocation. Over this same period, the company's average annual salary in Virginia has also more than doubled, reflecting the increased number of executive and professional employees attendant with insurance company headquarters operations.

VEDP estimates that the on-going employment of this major insurance conglomerate since 2000 has directly contributed $76 million in personal income tax and sales tax on household spending

to the Commonwealth. Indirect employment in Virginia that occurred as a result of the company, is estimated to have contributed another $48 million in revenue over the 2000-2006 period. On average, this amounts to tax revenue of $20 million per year over this six-year period.

EVALUATION OF ECONOMIC ARRANGEMENTS WITH VIRGINIA-HEADQUARTERED INSURANCE COMPANIES

Because Virginia has voiced a strong commitment to recapture and build the financial service sector of its economy, the following points are significant items of economic consequence in arrangements between the Commonwealth and headquartered insurance companies, all of which were specifically offered to induce the insurance company's relocation to Virginia:

1) RETALIATORY TAX CREDIT

The select committee's report (*Virginia's Gross Receipts Tax imposed on Insurance Companies*; House Document 78, 1997) proposed that the General Assembly consider a retaliatory tax credit to offset Virginia's above average premium tax rate. In 1998, as part of the agreement between Virginia and the relocating company, the General Assembly enacted a retaliatory tax credit for Virginia insurers. It was envisioned that this credit would fully offset the impact of Virginia's above average 2.25% premium tax. The Commonwealth delivered on its commitment to enact the legislation, but the economic benefits for the relocating company and all Virginia insurers have not been fully realized.

The retaliatory tax credit was originally only available for qualifying domestic companies making investments in Virginia that resulted in the creation of at least 325 net new insurance industry jobs, plus maintained existing levels of employment in Virginia for license years beginning on or after July 1, 1998. The credit for such qualifying companies was available against 100% of Virginia premium tax in a given year, allowed an excess refund of up to $800,000 per year, and a five-year carry-forward of net unused retaliatory tax credits.

Legislation enacted in 2003 amended the retaliatory tax credit statute. The legislation broadened the tax credit to all Virginia domestic insurance companies with more than 100 full-time Virginia employees during a given tax year, beginning with tax year January 1, 2001. These qualifying domestic companies receive tax credits capped at 60% of their annual premium tax liability, plus the features of an $800,000 annual refund and a five-year carry-forward.

The major insurance conglomerate headquartered in the Commonwealth owns the largest insurance carrier domiciled in the Commonwealth and experiences the largest exposure to retaliatory taxes of any Virginia domestic insurance company. As of tax year 2006, the company accounted for 88% of the total retaliatory tax credits available. In a November 2007 meeting with VEDP, the company indicated that the amount of retaliatory taxes it pays is growing and it is unable to fully offset the cost of these taxes with Virginia's current retaliatory tax credit as envisioned in the original agreement with the state.

The increasing retaliatory tax cost has come about in large part due to the Company's growth in greater nationwide product sales, separation from a parent company in 2004 which reduced the availability of affiliates' premium tax base eligible for the retaliatory tax credit, and a reduction in other states' premium tax rates. As a result, the company is not able to take full advantage of the tax credits for a full offset of the retaliatory taxes paid to other states. The company does not anticipate utilization of the excess that is generated each year or the credits that have been carried forward. Additionally, certain aged credits will begin to expire in 2007. While it was envisioned that this credit would fully offset the impact of Virginia's above average 2.25% premium tax, that has not actually happened.

Nonetheless, the retaliatory tax credit has been a valuable tool to Virginia-based insurers who face retaliatory tax exposure. Since the recruited insurance company has significant retaliatory tax exposure and thereby generates significant retaliatory tax credits, the company typically does not pay premium taxes to Virginia. In 2006, all Virginia insurers took $10,282,061.35 in retaliatory tax credits, but the insurance company recruited to Virginia carried forward more than $4.7 million of the credit because its retaliatory tax exposure was greater than the domestic premium tax exposure plus the $800,000 refundable tax credit. While the carry-forward mechanism is helpful and can offer some protection to a company in the future, it does not do an adequate job sheltering companies from the retaliatory tax exposure due to Virginia's above average premium tax rate.

2) MAJOR BUSINESS FACILITY TAX CREDIT

The General Assembly passed legislation during the 1998 session to amend the Major Business Facility Tax Credit (MBFTC) so that qualifying insurance companies may aggregate new jobs created by the company and its financial services affiliated companies are eligible to earn the tax credit. This amendment also allows the company or any affiliate to utilize the tax credit against aggregate premium tax owed to Virginia. The MBFTC can be carried forward for ten years. This is an important benefit to financial services headquarters and holding companies with multiple subsidiaries. This legislative change is also among the commitments Virginia made to the insurance company. While the MBFTC is also helpful and can offer some protection to a company in the future, if an insurance company's premium tax liability is fully offset by the retaliatory tax credit, there is no financial advantage to additional tax credits.

3) REDUCTION IN VIRGINIA'S PREMIUM TAX RATE

In recognition of the economic growth potential of the insurance industry and the benefits of attracting insurance corporate headquarters, the Commonwealth also committed to re-examine a reduction of the premium tax rate. Table 2 documents historical life insurance premium tax rates nationally and indicates which states have lowered their rates since 1985.

Table 2: Life Insurance Premium Tax Rates

State	1985 Rate	1999 Rate	2006 Rate	Action
Alabama	3	2.5	2.3	Lowered
Alaska	3	2.7	2.7	Lowered
Arizona	2	2	2	
Arkansas	2.5	2.5	2.5	
California	2.35	2.35	2.35	
Colorado	2.25	2.05	2	Lowered
Connecticut	2	1.75	1.75	
Delaware	2	2	2	
D.C.	n.a	2.25	1.7	Lowered
Florida	2	1.75	1.75	
Georgia	2.25	2.25	2.25	
Hawaii	3.197	2.75	2.75	
Idaho	3	2.75	2.3[1]	Lowered
Illinois	2	Income & Privilege Tax	0.5[2]	Lowered
Indiana	2	2	1.3	Lowered
Iowa	2	2	1	Lowered
Kansas	2	2	2	
Kentucky	2	2	1.5	Lowered
Louisiana	2.25	2.25	2.25	
Maine	2	2	2	
Maryland	2	2	2	
Massachusetts	2	2	2	
Michigan	2	Est. 1.3	Est. 1.3[3]	
Minnesota	2	2	1.875[4]	
Mississippi	3	3	3	
Missouri	2	2	2	
Montana	2.75	2.75	2.75	
Nebraska	2	1	1	Lowered
Nevada	3	3.5	3.5	
New Hampshire	2	2	2.0[5]	
New Jersey	2	2.1	2.1	
New Mexico	3	3	3.003	
New York	0.08	0.7	0.7	Lowered
North Carolina	2.5	1.9	1.9	Lowered
North Dakota	2	2	2	
Ohio	2.5	2.3	1.4	Lowered

Oklahoma	4	2.25	2.25	Lowered
Oregon	2.25		Corp. Excise Tax[6]	
Pennsylvania	2	2	2	
Rhode Island	2	2	2	
South Carolina	3	0.75	0.75	Lowered
South Dakota	2.5	2.5	2.5	
Tennessee	2	1.8	1.75	Lowered
Texas	2.5	1.75	1.75	Lowered
Utah	2.25	2.25	2.25	
Vermont	2	2	2	
Virginia	2.75	2.25	2.25	
Washington	2.16	2	2	Lowered
West Virginia	3	3	3	
Wisconsin	2	2	2	
Wyoming	2.5	0.75	0.75	Lowered

Source: NAIC's Compendium of State Laws on Insurance Topics; American Council of Life Insurers, 2006; Metropolitan Life Insurance Corporation, 1999; State Tax Handbook, 1999.

[1] Idaho's rate will decrease from 2.75% in 2005 to 1.5% in 2010.
[2] Illinois modified it premium tax rate and corporate income tax rate structure. The insurance industry estimates that the interplay is equivalent to a 1.75% premium tax rate.
[3] In 1987, Michigan replaced its premium tax with a single business tax. In 1999, the Michigan legislature enacted a 23 year phase-out of the single business tax. The insurance industry estimated that the single business tax is equivalent to 1.3% premium tax.
[4] Minnesota's rate will decrease from 2.0% in 2005 to 1.5% in 2009.
[5] New Hampshire's rate decrease from 2% in 2006 to 1% in 2011.
[6] In 1997, Oregon replaced its 2.25% premium tax on out-of-state insurance companies with its corporate excise tax. For the period of 1998 through 2001, there is a transition tax, which is intended to ease the revenue impact of the change from the premium tax to the lower corporate excise tax.

In 2000, the General Assembly directed the Secretary of Commerce and Trade to conduct a study (*Report on the Effects of Gross Premium Tax Rates on the Attraction of Insurance Business to the Commonwealth*; House Document 49, 2000) to further examine the impact of Virginia's 2.25% premium tax rate and to determine the cost of lowering the premium tax rate to 2.0%. The study, based on Bureau of Insurance estimates, concluded that to reduce the premium tax rate from 2.25% to 2.0% by 0.05% per year over five years would cost the state an average of $20 million per year. Table 3 shows the historical change in the number of states with premium tax rates lower than Virginia. At the time of the study, if Virginia reduced its premium tax rate to 2.0%, Virginia-domesticated insurance companies would face retaliatory taxes in 12 states since these had rates lower than 2.0%. Therefore Virginia companies' retaliatory tax burdens (and in turn their retaliatory tax credit eligibility) would decrease. Further, the study concluded that the decreased retaliatory tax credits, however, would not come close to offsetting the $20 million revenue reduction that reducing the premium tax rate would cause.

Table 3: States with Lower Premium Tax Rates than Virginia

Year	Number
1985	26
1999	30
2006	32

The 2000 report made an important observation about insurance industry movement in the United States:

> It cannot be determined whether a reduction in the gross premium tax rate will necessarily have a significant effect on the Commonwealth's ability to attract new domestic insurance companies in the immediate future. It may be, however, that the expansion of operations by out-of-state insurers would accelerate. Nevertheless, if large insurance companies were to approach the Commonwealth with a clear interest in locating in Virginia, the anticipated return on that new investment could change the calculations, making a premium tax reduction more feasible (House Document 49, Commonwealth of Virginia, 2000, p.7).

It is important to note, however, that this early analysis of revenues did not take into consideration the annual state revenue stream that results from the high paying jobs that a major insurance headquarters brings. Therefore, a premium tax rate reduction may be more feasible than the report indicated.

4) Promote Workforce Development

The Commonwealth, through the State Council of Higher Education and together with insurance companies headquartered in Virginia, began to explore establishing university chairs and other programs to promote the study of actuarial science, life insurance and financial services and management. Out of this early effort to develop a pipeline of highly-qualified people for the insurance industry, Virginia Commonwealth University established the Center for Risk Analysis within its School of Business and is beginning to sponsor annual conferences to attract nationally recognized experts to Richmond to explore issues of importance to the insurance industry. Much more work remains to be done in this area to produce the expertise necessary to support Virginia's insurers.

5) Improving the Business Climate for Financial Services Industry in Virginia

In recognition of the complex structure of the insurance industry and rapidly changing environment in which all financial services companies must compete, the SCC Bureau of Insurance has continued to fine tune the Commonwealth's regulatory structure to meet industry needs for financial and operational flexibility. One example is an option recommended by the General Assembly's select committee's 1997 report. The select committee proposed changing rules on the distribution of dividends by members of insurance holding companies to make Virginia more attractive to insurers. Specifically, the change allows increased flexibility in

insurance company dividend payouts. The General Assembly made this change when it enacted Senate Bill 546 in 2006. With the amendment, Virginia domestic insurers can pay dividends during a twelve-month period without prior regulatory approval in an amount equal to the greater of (i) 10% of their surplus, or (ii) net gains. Prior to the change, insurers could pay dividends based on a "lesser of" basis and thus could not transfer capital as freely.

As Virginia's insurers continue to compete globally and with other financial services providers (banks & securities firms), however, ongoing flexibility and responsiveness by the SCC will be important to balance the needs of industry and consumers. Ongoing assessment and change to Virginia's insurance laws in the areas of finance, capital and investments will be required.

CONCLUSIONS AND FINDINGS

Virginia has certainly benefitted from a Fortune 500 insurance company relocating its corporate headquarters to the Commonwealth. Also, the company has enjoyed operating in a business friendly environment. Since the relocation, the company has contributed no less than $124 million of indirect and direct tax revenues to the Commonwealth. While Virginia has indeed taken at least cursory action to satisfy the economic arrangement in which it engaged with the major insurance conglomerate, the economic development goals of that arrangement have not been fully attained. From here, there are many things Virginia could do to improve the business climate for financial services and insurance companies.

FINDINGS:

1) While Virginia has re-examined a reduction in the premium tax rate, an actual reduction has not materialized. A 2.25% premium tax rate causes increased retaliatory tax credit exposure, reduced retaliatory tax revenues for the Commonwealth, and increased retaliatory tax exposure for Virginia-domiciled insurers.

2) Virginia's relative status in premium tax rates is deteriorating as other states reduce their rates. Virginia currently has the 13th highest rate in the nation which is almost 24% higher than the national average.

3) Virginia-based insurance companies suffer from an added tax burden in other states since Virginia has failed to act on reducing its premium tax rate.

4) Virginia's retaliatory tax credit does not afford full protection to Virginia-insurers from other states' retaliatory taxes.

5) Insurance regulation must continue to keep pace and evolve with the completive landscape.

6) A great opportunity exists to invest in Virginia's workforce. The financial services and insurance sectors require a well-educated workforce, knowledgeable in actuarial sciences and professional positions. As the insurance industry becomes more complex, its workforce demands will grow. Building a pipeline of well-trained workers will improve these companies' abilities to remain and/or expand in Virginia.

Appendix 1: 2006 Virginia Premium License Tax Structure

COMPANY TYPE	Taxable Premiums, $	Premium Tax Rate %	Estimated Revenue, $
Mutual Assessment Life	0	0.01	0
Burial Society	855,510	0.01	8,555
Cooperative Nonprofit Life	0	0.01	0
Dental/Optom. Plan – individual	111,733,371	0.0225	2,514,001
& open enrollment	16,119,922	0.0075	120,899
Dental Plan Organization	3,801,344	0.0225	85,530
Fraternal Benefit Society	57,900,428	0	0
HMO	2,590,973,715	0	0
Home Protection Companies	27,558,283	0.0225	620,061
Health Services Plan -- Indiv	285,116,805	0.0225	6,415,128
& open enrollment	59,010,862	0.0075	442,581
Joint Underwriting Association	0	0.0225	0
L&H -- Indiv	8,449,302,665	0.0225	190,109,310
& open enrollment (Trigon)	821,820,431	0.0075	6,163,653
Legal Services Plans	14,928,673	0.0225	335,895
Mutual Assessment P&C	82,086,197	0.01	820,862
Exempt Mutual Assess P&C	5,060,059	0	0
P&C	9,129,821,190	0.0225	205,420,977
P&C (Workers Comp)	976,964,724	0	0
Risk Retention Group	68,571,497	0.0225	1,542,859
Title	451,704,180	0.0225	10,163,344
Workers Compensation GSIA	166,784,535	0	0
Total	**$23,320,114,391**		**$424,763,656**

Appendix 2: Virginia Insurance Industry Tax and Fee and Assessment Structure Based on Gross Premiums

Classes of Insurance	Gross Premium Tax	Insurance Bureau Maintenance Assessment	Workers' Comp.	Fire Programs[1]	Auto Theft (HEAT)[2]	Flood Prevention & Protection[3]	Fraud	Corporate Tax Income
Life	2.25%	0.03%						
Accident & Sickness	2.25%	0.03%						
Property & Casualty*	2.25%	0.03%		1.0%	0.25%	1.0%	0.05%	
Annuities	--	0.03%						
Cooperative Nonprofit Life Benefit	1.0%	0.03%						
Title Insurance	2.25%	0.03%						
Mutual Assessment Fire Companies	Exempt, 1.0% or 2.25% **	0.03%		1.0%		1.0%	0.05%	
Home Protection & Prepaid Legal Plans	2.25%	0.03%					0.05%	
Prepaid Hospital, Medical, Surgical, Dental, Optometric	2.25% or 0.75% ***	0.03%						
HMOs	---	0.03%						6.0%
Workers' Compensation	---	---	1.79%					

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*Property and casualty tax assessment excludes workers' compensation premiums.
** Rate depends on location, population and other factors
*** Individual 2.25%; open enrollment 0.75%

1. Based on fire, allied lines, multiple peril, and marine insurance, with a minimum tax of $100.
2. Based on auto physical damage insurance, other than collision coverage.
3. Based on any flood insurance written, excluding policies written under the National Insurance Act of 1968, with a minimum tax of $100.