COMMONWEALTH OF VIRGINIA
Department of the Treasury

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The Honorable L. Louise Lucas
Chair, Senate Finance and Appropriations Committee

The Honorable Luke E. Torian
Chair, House Appropriations Committee

During the 2024 Special Session, the General Assembly enacted House Bill 6001, the Virginia Budget Bill. Item 261(G) of this bill directs "[t]he Department of the Treasury, in consultation with the Department of Taxation, [...] to review surplus lines insurance policies procured by state agencies and authorities and submit a report to the Chairs of the House Appropriations Committee and the Senate Finance and Appropriations Committee. The review shall estimate the benefit from exempting state agencies and authorities from being charged the insurance premium license tax by licensed surplus line brokers on insurance policies procured."

I am pleased to enclose the Department of the Treasury's report for your review. If you have any questions or comments regarding this report, please do not hesitate to contact me.

Sincerely,

David L. Richardson

David L. Richardson
Treasurer

Cc: The Honorable Stephen E. Cummings, Secretary of Finance

Table of Contents

Executive Summary

Virginia's public entities must manage distressed, unique, large capacity, and/or emerging risks as part of the services they provide to the citizens of the Commonwealth. The liability insurance coverages required to manage these types of risks are not fully available through Virginia-admitted insurers, which requires public entities to obtain some coverages via the surplus lines insurance market. While technically a tax on non-Virginia insurance companies, the companies charge agencies for the cost of those taxes. This means that the ultimate burden of paying surplus lines taxes falls to the agencies themselves. As a result, Virginia's agencies and authorities spend hundreds of thousands of dollars each year in taxes on surplus lines premiums We believe that it would be advisable to exempt agencies and authorities from the surplus lines tax. Doing so would decrease their overall expenses, and it would also put Virginia's surplus lines premium tax policy in line with several peer states.

Background

Surplus lines insurance policies provide coverage for risks that Virginia-admitted insurance carriers are unwilling or unable to insure against—i.e., "non-ideal risks." Examples of these risks are medical malpractice insurance for state hospital employees, commercial and specialized building insurance, reinsurance, and cybersecurity insurance. The surplus lines market ensures that organizations with unique risks are able to obtain insurance coverage.

Surplus lines policies are sourced through non-admitted insurers, who are not licensed by Virginia's State Corporation Commission (SCC) but are permitted to sell policies once contracted through a licensed surplus lines broker. Surplus lines insurers do not need to file their rules, rates, and forms with the SCC and are not licensed in the same manner as admitted insurers, which allows them to take on higher risks. There are over 200 surplus lines insurers recognized by the SCC's Bureau of Insurance. Because the insurers pass along the tax to their customers, any entity, including a Virginia government agency, purchasing a surplus lines policy also pays a tax on top of the premiums paid to its broker.

Per §2.2-1837 of the Virginia Code, the Virginia Department of the Treasury's Division of Risk Management (DRM) is responsible for managing risks to the Commonwealth. To accomplish part of this goal, DRM procures insurance policies for many different Virginia government agencies. Insurance coverages DRM seeks can include (for instance) property, general liability, cyber, terrorism, and aircraft and watercraft policies. Virginia government agencies pay premiums to Treasury for their insurance coverage. Virginia government agencies, independent agencies, and educational institutions may also require specialized coverages that can only be obtained through surplus lines brokers.

Consider the following example of how surplus lines premium taxes work: the Department of General Services is a member of DRM's property plan that requires insurance coverage for over 10,000 state buildings with an aggregate value in excess of $58 billion. Underwriting a policy to meet DGS's insurance needs would be difficult for a Virginia insurer to accomplish on its own. However, insurance brokers such as Lloyd's of London or Berkshire Hathaway have experience locating this type of coverage in surplus markets.

Once a surplus lines policy is sourced, Treasury pays the policy premium as well as the corresponding surplus lines premium tax to the broker. After receiving payment, the broker procures the policy and pays a 2.25% premium tax to the Virginia Department of Taxation. This year, over $300,000 in surplus lines premium tax was charged for DRM's property policy. After Tax receives payment, it then directs one third of the revenue to the Commonwealth Transportation Fund (CTF), with the remaining two-thirds earmarked for the general fund.

Our research revealed that in several peer states when state agencies pay premiums to surplus lines brokers, those agencies are not taxed on those premiums. For instance, state agencies in both North Carolina and Florida are exempt by law from paying surplus lines premium taxes.[1] Additionally, § 33-5-33 of the state code of Georgia (O.C.G.A.) provides that all "persons" must pay taxes on surplus lines premiums. Georgia takes the position that its state agencies are not "persons" as defined in the statute and thus are exempt from paying premium tax.[2] Finally, a representative of Tennessee's Risk Management Division confirmed that Tennessee's Treasury Department is also exempt from paying taxes on surplus lines premiums.

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[1] See NC Code chapter 58-21-85 (c): https://www.ncleg.gov/Laws/GeneralStatuteSections/Chapter58, and F.S. 626.932 (4): http://www.leg.state.fl.us/statutes/index.cfm?mode=View%20Statutes&SubMenu=1&App_mode=Display_Statute&Search_String=626.932&URL=0600-0699/0626/Sections/0626.932.html

[2] GA Code text: O.C.G.A. § 33-5-33 -- https://law.justia.com/codes/georgia/title-33/chapter-5/article-2/part-1/section-33-5-33/

Surplus Lines Premium Tax Estimates

TAX estimates that the total surplus lines insurance premium spend in Virginia was $1.175 billion in taxable year 2021, with nearly $26.5 million of tax assessed. The following table comes from TAX's 2023 annual report.[3]

Table 5.7

Insurance Premiums License Tax: Number of Returns, Taxable Premium Income, and Tax Liability

Based on tax returns filed for Taxable Year 2021*

	Insurance Companies (Form 800)				Surplus Lines Brokers (Form 802)			
Taxable Premium Income Reported for Virginia	Number of Returns	Taxable Premium Income	Tax Assessed	Percent of Total (Tax)	Number of Returns	Taxable Premium Income	Tax Assessed	Percent of Total (Tax)
Up to $24,999	486	$987,094	$2,142,294	0.34%	2,073	$1,252,549	$28,182	0 11%
$25,000 to $49,999	39	1,353,292	30,750	0.00%	70	2,492,399	56,079	0.21%
$50,000 to $99,999	41	3,069,754	67,929	0.01%	44	3,186,129	71,688	0.27%
$100,000 to $499,999	146	39,184,573	874,997	0 14%	156	37,953,282	853,948	3.23%
$500,000 to $999,999	92	67,453,283	1,517,702	0.24%	57	40,340,145	907,654	3.43%
$1,000,000 to $1,999,999	105	150,613,609	3,384,280	0.54%	43	58,980,316	1,327,056	5.02%
$2,000,000 to $9,999,999	282	1,471,804,836	32,952,025	5.26%	39	191,364,610	4,305,704	16.28%
$10,000,000 and Over	358	28,162,549,549	630,661,448	100.71%	24	840,965,957	18,934,759	71.59%
Total before adjustments	1,549	$29.897.015.990	$671,631,425	107.25%	2,506	$1.176.535.387	$26.485.070	100.13%
Departmental adjustments	-21	-1,963,822,065	-45,430,215	-7.25%	-10	-988,210	-35,260	-0.13%
Total After Adjustments	1.528	$27.933.193.925	$626.201.210	100.0%	2.496	$1.175.547.177	$26.449.810	100.0%

Insurance Tax Credits Claimed on Returns Processed during FY 2023

Credit	Number of Returns	Amount
Guaranty Fund Assessment Tax Credit	659	$15,767,335
Historic Rehabilitation Tax Credit	22	32,467,842
Refundable Retaliatory Costs Tax Credit	15	5,792,149

Notes:

* This table is based on the same taxable year as the previous Tax Annual Report to be consistent with the taxable year used for the Individual and Corporate Income Tax tables.

1. The administration and collection of Insurance Premiums License Tax was transferred from SCC's Bureau of Insurance to the Department of Taxation effective for taxable years beginning on or after January 1, 2013
2. For insurance companies, taxable premium income means direct premium income allocated to Virginia after taking into account any adjustments. For surplus lines brokers, taxable premium income is premium income from policies for insureds whose home state is Virginia after taking into account any additional or returned premiums.
3. Insurance companies are subject to tax on their gross premium income. Depending on the line(s) of insurance from which the premiums were derived, the tax rates for taxable year 2021 were 2.25% and 1.00%. Surplus lines brokers are required to pay the tax on each policy of insurance they produce during the preceding calendar year with an insurer that is not licensed to conduct business in Virginia. Surplus lines brokers are subject to a rate of 2.25%.
4. Tax assessed shown is before any credits claimed.
5. If a company reports negative taxable premium income, its taxable premium income is treated as zero in this table.
6. Some columns may not match totals due to rounding.
7. The amount of insurance tax credits reported is for returns processed during FY 2023, regardless of taxable year. This table lists only insurance tax credits claimed that were greater than zero.

Figure 1: This table is taken from the TAX's 2023 annual report

These totals include all insurance transactions in the state, not just transactions for state agencies and authorities. Form 802, which TAX uses to collect information about surplus lines brokers, does not ask for details about the type of insurance purchased or who purchased a policy

[3] Retrieved from https://www.tax.virginia.gov/sites/default/files/inline-files/2023-annual-report.pdf

from a broker. In addition, Virginia considers other surplus lines premium taxpayer information, like broker names, confidential.[4]

The SCC shared that just five brokers (RSG Specialty, AmWINS, AON Risk Services Northeast, CRC, and CrossCover) collectively reported about $800 million in surplus lines premiums paid in Virginia, or around 70% of reported totals in 2023.[5] Comparing this premium amount with TAX's data from 2021 suggests that surplus lines premiums, and therefore taxes collected on them, are not decreasing in Virginia.

In FY24, according to estimates of all insurance expenditures from the Department of Accounts, state agencies and authorities in the Commonwealth spent just over $88 million on aircraft, automobile liability, flood, inland marine, marine, property, boiler and machinery, general liability, money and securities, and medical malpractice insurance premiums.[6]

Not all of FY24's $88 million in premiums paid was for surplus lines policies. For example, Treasury spent an estimated $28 million on insurance in FY24, $20 million of which is surplus lines property coverage. Unfortunately, neither the Department of Accounts nor the Department of Planning and Budget collects statistics concerning what portion of insurance premiums are paid to surplus lines brokers, or what expenses are considered surplus lines premiums for tax purposes.

[4] Code reflecting privacy rights of taxpayers: https://law.lis.virginia.gov/vacode/58.1-3/ and https://law.lis.virginia.gov/vacode/title58.1/chapter18/section58.1-1845/ (9)

[5] Retrieved from SCC internal data systems.

[6] These categories correspond to DPB sub-object codes 1511, 1512, 1513, 1514, 1515, 1516, 1517, 1551, 1552, and 1553.

Potential Impact to State Agencies and Authorities from Exemption

Although Treasury pays premiums and surplus lines taxes to brokers, DRM recovers these premiums and taxes through fees charged to coverage-seeking agencies. Because of this, Treasury itself is agnostic to exempting agencies and authorities from this tax.

TAX does not take a position on exempting state agencies and authorities from surplus lines premium tax. However, TAX recommends that any proposed legislation carefully identify the types of entities eligible for exemption. Specifically, any definitions should clearly indicate whether the exemption is intended to narrowly apply only to state agencies and authorities, or more broadly to boards, commissions, councils, foundations, and/or other entities that could be considered related to the Commonwealth.

TAX suggested two ways to exempt state agencies and authorities from the surplus lines premium tax:

1. Exempt surplus lines contracts for state agencies and authorities from this tax, completely. This would decrease associated tax revenue which would be partly offset by a reduction in the appropriation necessary to account for the tax.
2. Prohibit surplus lines brokers from passing the tax on to state agencies and authorities. Currently, Virginia law allows surplus lines brokers to pass the tax onto their customers.

Treasury and TAX believe that Option 1 would only slightly impact general and non-general funds. The General Fund revenue impact would likely be offset by a corresponding reduction in the appropriation needed for state agencies to pay the tax. The CTF would see the revenue impact of this loss in relation to the size of the fund and would not be able to offset the loss. Option 2 would keep the distribution of the associated tax revenue to the General Fund and the CTF consistent with the status quo. However, if Option 2 is chosen, Treasury fears the potential for surplus lines carriers to hide this tax in higher premiums charged to agencies and authorities.

Based on Treasury's analysis of surplus lines premium spending, including discussions with various state agencies and authorities regarding the subject, we believe that exempting public entities from surplus lines taxes could result in substantial savings for Virginia agencies and authorities.

Most, if not all, Virginia state government agencies, independent agencies, and educational institutions purchase insurance through DRM. Therefore, Treasury can use several years of historical data on surplus lines insurance premium spending to estimate the potential impact to the

Commonwealth of exempting state agencies and authorities from this tax.[7] Estimated tax liability may not increase or decrease in line with surplus lines premiums due to policies being placed with *admitted* surplus lines insurers in Virginia.

Fiscal Year	**Est. Surplus Lines Premiums**	**Est. Tax Liability**
FY2021	$11,250,151.53	$183,907.56
FY2022	$16,314,358.00	$269,027.29
FY2023	$21,294,050.00	$295,814.41
FY2024 (as of 9/24)	$19,594,899.90	$384,217.07

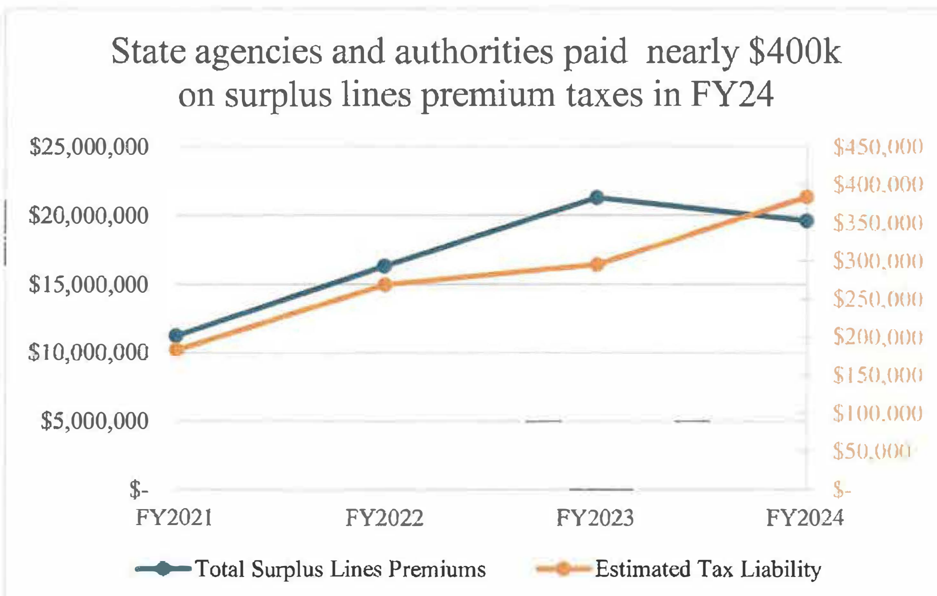

Figure 2: This chart (and the preceding table) shows Treasury's surplus lines insurance premium spend and estimated taxes for the past several fiscal years

Unfortunately, forecasting the total impact of exemption to agencies and authorities that augment or forego altogether DRM's policy procurement services is more difficult to perform because of non-standard reporting practices among those agencies, as well as varied levels of internal access granted to Treasury during our study. Despite these challenges, we were able to determine that the surplus premium tax paid by the University of Virginia, Virginia Tech, the Virginia Spaceport Authority, the Virginia Passenger Rail Authority and Virginia529 was below

7 Retrieved from DRM's internal data systems.

$10,000 annually.[8] Transportation authorities, Virginia Railway Express (VRE) and the Virginia Port Authority spend significantly more in surplus lines taxes annually. VRE spent between $90,000 – $ 96,000 and in the last fiscal year, Virginia's Port Authority said they spent over $76,000 on surplus lines premiums.

[8] Virginia Tech's estimated surplus lines premium taxes for FY24 was just over $8,000. VA529 has paid between $1,000 and $6,000 in surplus lines premium taxes in the last several fiscal years. While the University of Virginia procured some policies outside of Treasury's Division of Risk Management, in FY24 none were surplus lines policies. Virginia Spaceport Authority and the Passenger Rail Authority do not have any surplus lines policies.

Conclusion

Treasury recommends that Virginia agencies and authorities be exempt from paying the surplus lines premium tax. Doing so would result in substantial savings for many of the Commonwealth's agencies and authorities that are disproportionately burdened with having to pay the tax, while only minimally reducing the general and non-general funds currently funded in part by the tax revenue generated. Exempting state agencies and authorities from paying the tax would also align Virginia's approach with similarly situated states.