

PREMIUM TAX CREDIT TRENDS AND DEVELOPMENTS IN COLORADO

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Regulators in the state of Colorado are taking steps to revise the process by which insurance companies can qualify for abatements against premium taxes. First, the Colorado Division of Insurance has proposed revisions to its Regional Home Office (“RHO”) regulation.¹ Second, industry representatives have presented testimony before the state’s Commission on Taxation² which promotes implementation of a salary (or employment) credit for compensation paid to insurance company employees working in Colorado.

Changes to the RHO Regulation

Colorado taxes insurers using a premium tax system under which the tax is imposed on a gross receipts basis.³ The rate of tax on the gross premiums covering property or risks in Colorado is 2%. Under current Colorado law an insurer can apply for a reduction in its premium tax rate from 2% to 1% if it maintains a qualified RHO or home office in Colorado.⁴

The purpose of the RHO regulation, in conjunction with state statute, is to provide a tax incentive for insurance companies to bring employment to the State of Colorado through the establishment of home or regional home offices in the state. In July 2001, the Colorado Division of Insurance formed a Task Force to explore potential statutory changes and/or revisions to the existing regulation. The impetus for the revisions, as stated by the Division, is that “insurance company structures and operations have dramatically changed in the last decade” and that the “RHO qualification process has not adjusted to accommodate these changes.” The Task Force’s goals were to amend Colorado’s RHO law to: (1) simplify and update the qualification criteria and process to accommodate the way companies function in the current environment; (2) create flexibility to accommodate how companies may function in the future; and (3) to maintain an incentive using premium tax relief to encourage companies to have a significant economic presence in Colorado without realizing a fiscal impact to the Division or the General Fund.

The existing RHO statute and regulation require a burdensome application process and, due to the subjective, discretionary nature of the RHO requirements, insurers have an uncertain chance of success in qualifying for the credit. To qualify for the RHO credit, under current law, an insurance company must establish each year that its Colorado office “substantially” performs nine categories of functions⁵ for each line of business in at least three states, or maintains “significant direct insurance operations” in Colorado, supported by operational functions that are similar to the nine listed functions. Furthermore, an insurer cannot qualify unless it proves that it meets two of the following three additional requirements: (1) the insurer maintains 200 full-time employees; (2) the insurer owns or leases 60,000 square feet of office space, and (3) the insurer spends at least \$5 million on the listed functional operations.⁶

The Division of Insurance, working with the RHO Task Force, has crafted proposed amendments to the regulation that will serve to make the application process less burdensome and more attuned to the operations of today’s insurance companies.⁷ The proposed amended regulation will make several changes to the qualifying process. First, rather than filing a long form application annually, an insurer will only need to file a “long form” application to qualify and then every fifth year thereafter, with a short form application filing every year for the interim four years. Second, the new regulation will allow for qualification on an affiliated group basis under the significant direct operations test. This is a welcome change from the current regulation that requires each affiliate company to apply for RHO qualification separately and individually meet the requirements. Barring any unexpected snags, the amended regulation is scheduled to become effective on January 1, 2002.

Insurance Tax Reform

Unfortunately, amendments to the RHO regulation, while welcome, still compel the Division to make essentially

subjective determinations during the RHO qualifying procedure. Therefore, proposals have been made to Colorado's Commission on Taxation that call for a statutory change to create a salary (or employment) credit. This proposed salary tax credit would provide an objective method of evaluating insurers' eligibility for a tax credit while continuing to offer incentives for insurers to maintain a business presence in the state of Colorado. Under the RHO system, if a company fails to qualify, it gets no benefit. With a salary credit, the benefit provided to the insurance company/taxpayer is proportional to the benefit received by the state, preserving incentives for all taxpayers to bring jobs and investment to a state.

RHO-type credits have been replaced in most states by other types of economic incentive credits, including salary tax credits. There are several reasons for the movement away from RHO-type credits. Notably, many states' schemes for taxing insurance companies contained a domestic company tax preference that arguably violates the equal protection clause.⁸ Furthermore, recent competition-driven changes in the insurance industry, such as the increased use of centralized operations and technology, have made RHO-type credits obsolete. Technological advances now allow insurers to increasingly make use of efficient, centralized, internet-based technologies for underwriting functions. The statutory RHO functions in Colorado law, adopted over thirty years ago in 1969, do not work well with the changes in the insurance business fostered by emerging technologies and their attendant business practices.

Many states have promulgated new economic incentive credits in recent years.⁹ Additionally, 19 states already have various forms of salary credits against premium tax, including Florida,¹⁰ where the salary credit replaced a RHO credit, and Kansas,¹¹ where the salary credit was adopted in 1997. The salary credits in Florida and Kansas are broadly aimed at promoting insurance industry jobs and investment statewide.

The salary credit adopted by Kansas allows a credit for at least 15% of salaries paid to Kansas insurance employees by an insurance company or its affiliate. The credit is only available for insurance company operations performed in Kansas and only applies to salaries paid to employees based in Kansas. An insurer may allocate the credit among its affiliates and the credit may reduce the premium tax rate from the 2% rate to as low as 1%.

Colorado's adoption of a properly designed salary credit would benefit the state and taxpayers alike. Implementation of a salary credit would update what has become a burdensome and dated insurance tax credit system; promote secondary employment in industries that support the insurance industry; promote increased state and local tax revenues, including property tax, sales tax and personal income tax; simplify tax administration and compliance; and directly help promote jobs growth in Colorado.¹²

Conclusion

The proposed amendments to the RHO credit regulation are an improvement to the qualification system, and will appreciably simplify and update the qualification criteria in the short term. However, premium tax credits for salaries paid to Colorado-based insurance employees would do much to improve the certainty, simplicity, equity and revenue stability of Colorado's tax system and enhance Colorado's competitiveness. Colorado should adopt a meaningful tax incentive for locating insurance industry jobs to the state.

Implementation of such premium tax reform will allow insurance companies greater certainty in financial planning as it will provide an objective standard rather than the current subjective one which adds unnecessary complexity and uncertainty for the state and taxpayers alike.

Endnotes

1. Colorado Insurance Regulation 2-1-2. Accessible at: <http://www.dora.state.co.us/Insurance/regs/2-1-2.HTM>.
2. The Colorado state legislature established the Commission in 2000 to review the current system of taxation by the state and local governments and to develop and propose for consideration any modifications to the current system of state and local taxation. The Colorado Commission on Taxation's website is located at:

<http://www.dola.state.co.us/taxcommission/index.htm>

3. Colo. Rev. Stat. § 10-3-209 (2001).
4. *Id.*
5. The nine specified functions are: actuarial, medical, legal, approval or rejection of applications, policy issuance, information and service, advertising and publications, public relations, and hiring, testing and training of sales and service forces. C.R.S. § 10-3-209(1)(b)(II)(A).
6. Insurance Regulation 2-1-2 (VI)(B)(2).
7. The proposed amended regulation is accessible at: <http://www.dora.state.co.us/Insurance/regs/NOH.html>.
8. *See Metropolitan Life Ins. Co. v. Ward*, 470 U.S. 869 (1985).
9. *E.g.*, California, Florida, Illinois, Iowa, Maryland, Massachusetts, Missouri and New York.
10. Fla. Stats. Title 37, § 624.599 (2001).
11. Kan. Stat. Ann. § 40-252d (2001). The Kansas credit is the model for salary credits that are under active consideration by the legislatures in Arizona and Georgia.
12. *Cf.* David A. Hughes and Benjamin W. Wong, "Illinois Job Tax Credit Gives State the "EDGE" in Relocations and Expansions," Journal of Multistate Taxation, Electronic Version August 2001. (Warren Gorham Lamont) (a nonrefundable credit against state corporate income tax based on the personal income tax payments of newly hired employees resulted in increases in the creation and retention of new jobs, in total return on investment and in the number of companies attracted to the state.)