

ANNUITIES EXEMPTION



EVALUATION SUMMARY

JULY 2020
2020-TE23

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2020

YEAR ENACTED	1977
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	\$141.5 million (TAX YEAR 2018)
NUMBER OF TAXPAYERS	217
AVERAGE TAXPAYER BENEFIT	\$652,000
IS IT MEETING ITS PURPOSE?	Yes

WHAT DOES THIS TAX EXPENDITURE DO?

The Annuities Exemption [Section 10-3-209(1)(d)(IV), C.R.S.] exempts premiums that policyholders pay insurers for annuities from the State's 2 percent premium tax. An annuity is a contract, typically between a life insurance company and contract holder, that allows the contract holder to make a lump sum payment or series of payments to the insurer in return for regular disbursements, beginning either immediately or at some point in the future.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Annuities Exemption. Based on statute and legislative testimony, we inferred that the exemption was created to equalize the tax treatment of purchases of annuities with that of contributions to pension plans and other forms of retirement savings, which are also not taxed.

WHAT DID THE EVALUATION FIND?

We found that the Annuities Exemption is meeting its purpose because insurance companies use it, resulting in similar tax treatment of annuities with defined benefit pension plans and other forms of retirement savings, thereby lowering their cost.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider whether deposit-type funds should continue to be covered under the Annuities Exemption.

ANNUITIES EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

Colorado levies a 2 percent premium tax on insurance companies' in-state premiums, which is the revenue insurers collect for writing insurance policies covering property or risk in the state [Section 10-3-209(1)(b)(I)(A), C.R.S.]. In 1977, the General Assembly created the Annuities Exemption [Section 10-3-209(1)(d)(IV), C.R.S.], which exempts premiums (also called considerations) policyholders pay insurers for annuities from the premium tax. An annuity is a contract, typically between a life insurance company and contract holder, that allows the contract holder to make a lump sum payment, or series of payments, to the insurer in return for regular disbursements, beginning either immediately or at some point in the future. Annuities are typically used to fund individuals' retirements and are often structured to provide payments for the life of the individual or other named beneficiaries. Although the Annuities Exemption exempts purchases of annuities from the insurance premium tax, the income individuals or organizations receive from their annuities once insurers begin to make payments may be subject to income tax.

The Annuities Exemption, created by House Bill 77-1016, exempted premiums on endowment policies in addition to annuities. Endowment policies, which have not been widely used since the 1980s, are life insurance policies that double as savings by paying a lump sum after a period of premium payment. The Tax Equity Act of 1987, House Bill 87-1331, removed the exemption for endowment policies from the provision, but left the Annuities Exemption intact. There have been no substantive changes made to the Annuities Exemption since it was created.

To claim the exemption, life insurers enter the amount of payments they receive for annuities from Colorado contract holders on "Worksheet #1" of their insurance premium tax returns, which they file with the Division of Insurance within the Department of Regulatory Agencies, the state agency responsible for regulating insurers and administering the insurance premium

tax. They then subtract the amount they received for annuities from their taxable premiums before calculating their premium tax.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

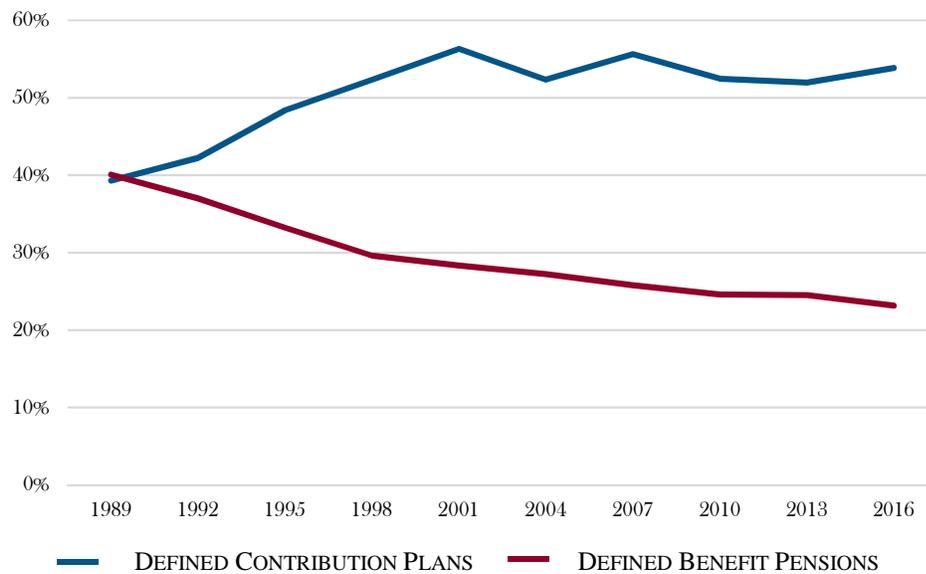
Statute does not explicitly identify the intended beneficiaries of the Annuities Exemption. Based on statute and the exemption's legislative history, we inferred that the intended direct beneficiaries of this exemption are life insurers that write annuity contracts in Colorado. In addition, since the cost of the insurance premium tax may be passed on to consumers, the exemption may result in reduced prices for annuities. As a result, we inferred that individuals and organizations who purchase annuities appear to be indirect beneficiaries of the exemption.

Of the 359 life insurers licensed to write annuities in Colorado, 217 received \$7.1 billion in payments for annuities from contract holders in the state in 2018. Over half of this amount was attributable to individual annuities, with the remainder spread between group annuities (annuities purchased by employers or retirement plan trustees to provide retirement benefits for employees) and deposit-type funds, which are accounts sometimes used to fund annuities that are not tied to the death of a contract holder or other individual (see the *What Policy Considerations Did the Evaluation Identify* section below for additional discussion of deposit-type funds). Annuities accounted for 14.5 percent of all insurance premiums collected by insurers in Colorado in 2018.

Annuities are a common source of retirement income, becoming more popular since 1977, when the Annuities Exemption was established, due to changes in retirement plans available to employees. Until the early 1980s, employer-sponsored defined benefit pension plans, which pay a defined lifelong income to retired employees, were widely used by both private and public sector employees to ensure income throughout retirement. Since then, a number of factors, including shifts in governmental regulations, consumer preferences, and the U.S. labor market at large, led to the rise of defined contribution retirement plans, such as 401(k)s, as the predominant retirement savings vehicle offered to workers. EXHIBIT 1.1 shows the increase in

households with defined contribution plans and corresponding decrease in those with defined benefit plans since the 1980s.

**EXHIBIT 1.1. SHARE OF NON-RETIRED U.S. HOUSEHOLDS WITH
DEFINED CONTRIBUTION PLANS AND
DEFINED BENEFIT PENSIONS
1989 THROUGH 2016**

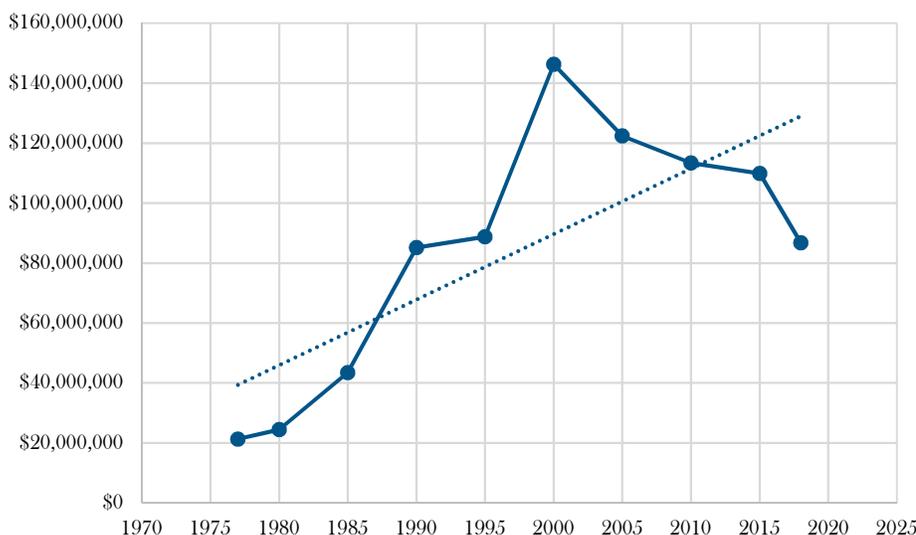


SOURCE: Christian Weller's calculations based on data from the Federal Reserve's Survey of Consumer Finances: *How the Decline of Pensions Furthered the Racial Wealth Gap*, Forbes (2019).

This increase in the use of defined contribution plans appears to have led to an increase in the use of annuities. Rather than providing a lifelong income, as defined benefit pensions do, defined contribution plans are typically funded by voluntary employee contributions, which are often matched by employers. Employees' accounts grow over time based on the amount contributed to their accounts and the performance of the investments in the accounts. Upon retirement, the individual must determine how to allocate the funds in their defined contribution account to meet their income needs. According to a representative from a major life insurance industry group, it is fairly common for individuals to use the disbursement from their 401(k) to buy an annuity, which can then be structured to yield monthly distributions for the rest of the contract holder's life, essentially providing a similar benefit to what would be offered through a defined benefit pension. Accordingly, there has been significant growth in the annuity market corresponding with the rise of defined contribution plans and the fall of defined benefit plans.

Specifically, from 1977 to 2018, there was a 307 percent increase in annuity premiums per capita (adjusted for inflation) in the U.S., although there has been a decline in annuity premiums in the past two decades. EXHIBIT 1.2 provides inflation-adjusted annuity premiums paid by contract holders for each year per 100,000 members of the U.S. population.

**EXHIBIT 1.2. ANNUITY PREMIUMS/100,000 POPULATION
(INFLATION ADJUSTED¹)
U.S. 1977-2018**



SOURCE: Office of State Auditor analysis of American Council of Life Insurers tabulations of National Association of Insurance Commissioners data.

¹Adjusted to 2015 dollars.

According to a 2015 survey by TIAA-CREF, about 14 percent of American adults own annuities, and according to a 2019 Deloitte survey, about 12 percent of retirement plan sponsors offer annuities.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Annuities Exemption. Based on statute and legislative testimony, we inferred that the exemption was created to equalize the tax treatment of purchases of annuities with that of contributions to pension plans and other forms of retirement savings, which typically are also not taxed. Specifically, during the testimony surrounding the passage of House Bill 77-1016, the bill's sponsor discussed the

importance of making annuity products available as an alternative for individuals who may not have adequate pensions through their employer.

IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We found that the Annuities Exemption is meeting its purpose because insurance companies use it, resulting in similar tax treatment of annuities with defined benefit pension plans and other forms of retirement savings, thereby lowering their cost.

Statute does not provide quantifiable performance measures for this tax expenditure. Therefore, we created and applied the following performance measures to determine the extent to which the exemption is meeting its inferred purpose:

PERFORMANCE MEASURE #1: *To what extent do insurance companies use the Annuities Exemption to harmonize the tax treatment of annuities with defined benefit pension plans?*

RESULT: We found that the Annuities Exemption is broadly claimed by eligible insurance companies, thereby avoiding a tax on annuity purchases and making their tax treatment similar to contributions to defined benefit pension plans. As discussed, we found that insurers applied the exemption to approximately \$7.1 billion in annuity purchases in Calendar Year 2018, with 217 insurers claiming the exemption based on Division of Insurance data. Stakeholders, including a prominent industry trade group and two major annuity-writing firms, confirmed that it is standard practice in the industry to apply the exemption.

PERFORMANCE MEASURE #2: *To what extent does the exemption reduce the cost to consumers of annuity contracts?*

We lacked information necessary to quantify the extent to which the Annuities Exemption reduces the cost of purchasing annuities. However, we found evidence that at least some of the tax savings are passed on to consumers, either by making annuities less expensive or providing additional

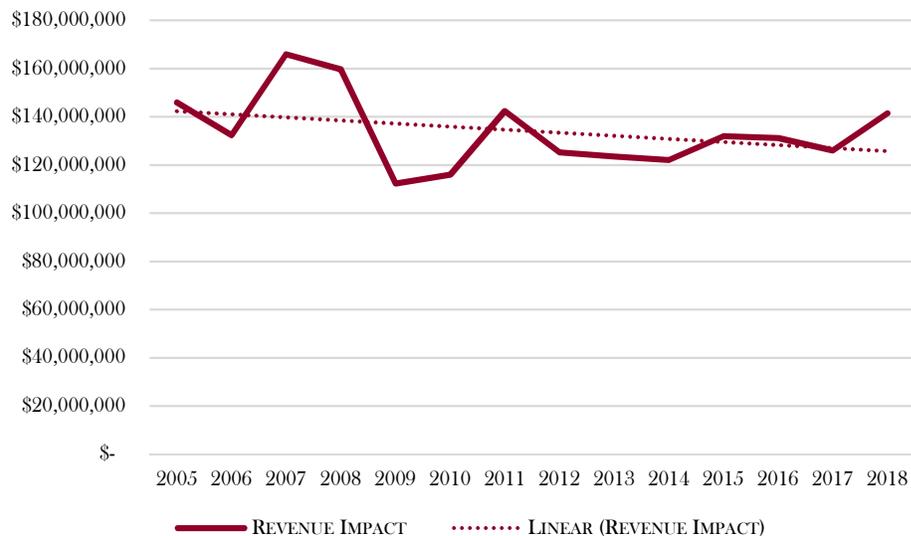
income to the consumers during the annuities' payment period. Specifically, the insurers we contacted generally indicated that they pass the tax savings onto the annuity contract holders through lower premiums or higher annuity disbursements. Also, because 217 insurers were offering annuities in Colorado as of Calendar Year 2018, it appears that there is a competitive market for annuities' sales, such that insurers likely face market pressure to pass the tax savings on to consumers. However, because Colorado's insurance premium tax rate is 2 percent, the reduction in costs or increased disbursements offered by insurers likely provide a relatively moderate benefit to consumers. For example, assuming an individual purchased an annuity for \$100,000 and all of the premium tax savings from the Annuity Exemption were passed on to the individual, this would provide a \$2,000 tax savings spread out throughout the life of the annuity. For a 65-year-old individual who purchases a lifetime annuity, this savings would equate to about a \$12 increase in monthly payments, assuming a life expectancy of 20 years and a 3.5 percent annuity rate.

WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURE?

In Tax Year 2018, based on Division of Insurance data, the Annuities Exemption reduced the insurance premium taxes collected by the State by \$141.5 million, which is equivalent to how much the 217 life insurers who claimed the exemption saved—an average of \$652,000 per insurer.

EXHIBIT 1.3 shows the annual revenue impact of the exemption from Tax Years 2005 to 2018. As shown, the Annuities Exemption's annual revenue impact has remained relatively stable during the past 14 years.

**EXHIBIT 1.3.
ANNUITIES EXEMPTION REVENUE IMPACT
TAX YEARS 2005 THROUGH 2018**



SOURCE: Office of the State Auditor analysis of Division of Insurance data.

**WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE
HAVE ON BENEFICIARIES?**

Eliminating the Annuities Exemption would result in a higher tax burden for the 217 life insurers who are claiming the exemption. Overall, these life insurers would have owed \$141.5 million in additional premium taxes if the Annuities Exemption was not in place during Tax Year 2018. Comparatively, these insurers paid a total of \$77.4 million in premium taxes to the Division during Tax Year 2018. This means that if the exemption was eliminated, these insurers' premium taxes owed would have increased by about 183 percent. If the exemption was eliminated, most of the additional tax burden would fall on 23 life insurance companies that, combined, write about 75 percent of all annuities in Colorado. This could also cause Colorado to be a relatively less attractive place to write and purchase annuities than other states, since, as discussed below, most other states provide a similar exemption.

To the extent that these life insurers would pass the additional 2 percent premium tax on to purchasers, eliminating the exemption could also cause a corresponding increase in costs or decrease in annuity payments for

individuals and organizations who purchase annuities, which in turn might reduce the amount or value of annuities they purchase. The insurers we contacted indicated that taxes on annuities are typically passed on to consumers in the form of higher prices. However, to the extent that life insurers maintain their rates, they would have to instead absorb some of the additional tax burden. Furthermore, because annuities are long-term contracts, removing the Annuities Exemption could cause financial stress for life insurers. They may be forced to pay tax on premiums for contracts that they are obligated to honor with certain payouts, but that they wrote under the expectation of being exempt from premium tax. This could impact the costs and disbursements of future annuities.

Eliminating the exemption might also result in a higher tax burden for Colorado-domiciled insurers doing business in other states. This is because 49 states (including Colorado) and the District of Columbia have retaliatory insurance provisions in their statutes that allow them to impose taxes or other requirements on out-of-state insurers at the same level that other states impose taxes and requirements on their home-state insurers. Since eliminating the exemption would increase the effective tax rate of these out-of-state life insurers doing business in Colorado, it is possible that other jurisdictions in which they are domiciled would respond by raising taxes on the 10 Colorado-domiciled insurers that write annuities. By similar logic, eliminating the exemption might additionally result in Colorado receiving less retaliatory tax from out-of-state life insurers, since the effect of removing it would be to reduce the difference between Colorado's effective tax rate for out-of-state life insurers and other states' effective tax rates for Colorado life insurers.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 48 other states (excluding Colorado) and the District of Columbia that levy an insurance premium tax, we identified 40 states, as well as the District of Columbia, generally exempt annuity premiums. Seven states fully or partially levy premium tax on annuity premiums – California, Florida, Maine, Nevada, South Dakota, t, West Virginia, and Wyoming – at premium tax rates ranging from 0.5 percent to 2.35 percent. Four of the seven states without a full exemption do not have a personal income tax, and some stakeholders

indicated that these states tax annuities because their state budgets are more constrained due to the lack of income tax revenues. Moreover, in five of these states, annuities that are purchased as part of tax qualified retirement plans, such as 401(k)s and IRAs, are exempt or taxed at lower rates compared to other annuities. Beginning in 2021, West Virginia will no longer tax annuities.

ARE THERE OTHER TAX EXPENDITURES OR PROGRAMS WITH A SIMILAR PURPOSE AVAILABLE IN THE STATE?

PENSION AND ANNUITY INCOME TAX DEDUCTION [SECTION 39-22-104(4)(f), C.R.S.]. Colorado taxpayers who are at least 55 years old or are the beneficiary of a death benefit at any age, can deduct the value of any pension or annuity income they receive. The deduction is limited to up to \$20,000 a year, increasing to \$24,000 for taxpayers at least 65 years old. It is not allowed for pension and annuity distributions that are subject to a federal tax penalty, which is generally applied to distributions received before a taxpayer reaches 59.5 years old.

WHAT DATA CONSTRAINTS IMPACTED OUR ABILITY TO EVALUATE THE TAX EXPENDITURE?

We did not identify any data constraints related to the Annuities Exemption.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER WHETHER DEPOSIT-TYPE FUNDS SHOULD CONTINUE TO BE COVERED UNDER THE ANNUITY EXEMPTION. These accounts, which are financial products sold by insurance companies, can be used by individuals or organizations who pay a lump sum into the account, which automatically funds a retirement annuity and/or a tax-free death benefit, but they also have the option to borrow from the accounts. Amounts that remain in such deposit-type funds after the underlying policies' premiums are paid are generally used to increase the policies' payouts. Deposit-type funds are also not contingent upon continued survival, as is the case for traditional annuity contracts. Some examples of deposit-type funds are:

- **Premium deposit accounts**, which are interest-earning accounts used to pay life insurance premiums each year;
- **Structured settlements**, which are agreements between claimants and defendants in civil lawsuits in which the defendant agrees to pay the claimant a sum of money periodically rather than in a lump sum; and
- **Guaranteed investment contracts**, which are savings contracts offered by insurance companies that allow investors to pay a sum of money up front for a low interest, guaranteed return in the future.

Although statute does not specify whether deposit-type funds should be considered “annuities” for the purposes of the Annuities Exemption, the Division of Insurance allows insurance companies to apply the exemption to premiums they receive for these accounts because they can be used similarly to annuities and as a way to fund annuities. Overall, this practice aligns with the majority of states, which also exempt deposit-type funds from insurance premium taxes under their annuities exemptions. However, the American Council of Life Insurers defines deposit-type contracts as contracts that do not incorporate mortality or morbidity risks, while life insurance and most annuities generally do incorporate such mortality and morbidity risks. This lack of “insurance” risk allows some deposit-type funds, such as guaranteed investment contracts, to function more like non-insurance investments than other more commonly used annuity products. Therefore, the General Assembly may want to consider whether all deposit-type fund contracts should be included in the Annuities Exemption. In June 2020, the General Assembly passed the Tax Fairness Act, House Bill 20-1420. This bill originally included language that would have specified that deposit-type funds are to be excluded from the Annuities Exemption; however this language was removed prior to its passage. In 2018, Colorado insurers received \$1.2 billion in deposit-type fund premiums, and the exemption of those premiums had a revenue impact of about \$24.3 million (\$1.2 billion multiplied by the 2 percent premium tax rate) to the State.