

# INSURANCE PREMIUM TAX EXPENDITURES

## EVALUATION SUMMARY



We Set the Standard for Good Government  
JANUARY 2019  
2019-TE3

THESE EVALUATIONS WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2019

	INSURANCE PREMIUM INCOME TAX EXEMPTION	REINSURANCE DEDUCTION	RETURN PREMIUM DEDUCTION	EARLY TERMINATION DEDUCTION
YEAR ENACTED	1883	1913	1913	1973
REPEAL/EXPIRATION DATE	None	None	None	None
REVENUE IMPACT	\$83.6 million	Could not determine	Could not determine	Could not determine
NUMBER OF TAXPAYERS	1,459	Could not determine	Could not determine	Could not determine
AVERAGE TAXPAYER BENEFIT	\$57,000	Could not determine	Could not determine	Could not determine
IS IT MEETING ITS PURPOSE?	Yes	Yes	Yes	Yes

### WHAT DO THESE TAX EXPENDITURES DO?

The Insurance Premium Tax Expenditures essentially define insurers' state tax base. The Insurance Premium Income Tax Exemption requires insurance companies to pay a premium tax on the gross amount of revenue they receive from policies or contracts on risks or obligations located in Colorado, rather than paying an income tax. The Reinsurance Deduction allows insurers to deduct from their premium tax base any reinsurance premiums they receive for assuming another insurer's in-state risks. The Early Termination and Return Premium Deductions allow certain insurers to deduct from their premium tax base any dividends and refunds that they make to policyholders.

### WHAT ARE THE PURPOSES OF THESE TAX EXPENDITURES?

Statute does not directly state a purpose for these expenditures. We inferred that the purpose of the Insurance Premium Income Tax Exemption and Reinsurance Deduction is to avoid double taxation, while the purpose of the Return Premium and Early Termination Deductions is to prevent insurers from being taxed on payments they return to policyholders.

### WHAT DID THE EVALUATION FIND?

We determined that the Insurance Premium tax expenditures are meeting their purpose

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider allowing insurers to deduct any licenses, fees, or taxes they pay to local governments for the purpose of determining their premium tax liability.

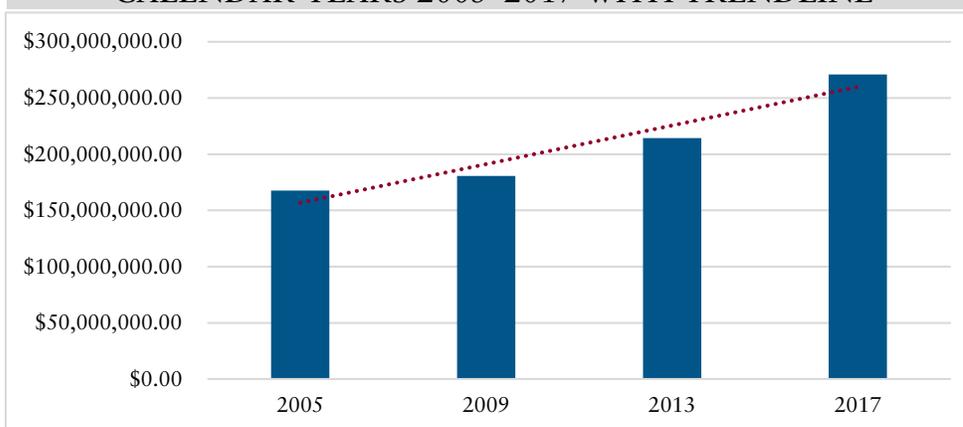
# INSURANCE PREMIUM TAX EXPENDITURES

## EVALUATION RESULTS

### WHAT ARE THE TAX EXPENDITURES?

In 1883, Colorado began levying a tax on premiums collected in-state by insurance companies for policies that they issued covering property or risks in the state [Section 10-3-209, C.R.S.]. The same bill that created the premium tax also included the Insurance Premium Income Tax Exemption, which exempts insurance companies from paying state income tax [Section 39-22-112(1), C.R.S.]. Without this exemption, insurance companies would have been subject to both an income tax and a premium tax on the premiums they collect. Statutes around the premium tax requirement and the exemption have changed periodically throughout the years, but remain substantially the same since first enacted. The premium tax rate is generally 2.0 percent of gross premiums. The amount of premium tax revenue collected in Colorado has grown over the years, and was about \$270.9 million for Calendar Year 2017, as shown in EXHIBIT 1.1.

EXHIBIT 1.1.  
INSURANCE PREMIUM TAX REVENUE  
CALENDAR YEARS 2005–2017 WITH TRENDLINE



SOURCE: Division of Insurance.

Subsequent to the initial bill implementing the premium tax and the Insurance Premium Income Tax Exemption, statute was amended to establish the following three tax expenditures that can be deducted from an insurance company's premium tax base (amount that the premium tax is calculated on), and thus, reduce the amount of premium tax owed:

- **REINSURANCE DEDUCTION**—This provision was originally added in 1913 and then amended in 1953, to allow insurers to deduct from their premium tax base the amount that they receive as reinsurance premiums for business in the state. Reinsurance is when one insurance company takes on part or all of the risk for a policy that has been issued by another insurance company in consideration for a premium payment. That is, the insurance company that originally issued a policy itself purchases insurance to help cover any losses incurred from the first policy.
- **RETURN PREMIUM DEDUCTION**—This provision was also originally added in 1913 and then amended in 1955, to allow insurance companies, other than those providing life insurance, to deduct from their premium tax base any “return premiums,” which includes any amounts returned or credited to policyholders due to dividends issued, early cancellation of their policies, overpayments, errors, audits, or reductions in coverage.
- **EARLY TERMINATION DEDUCTION**—This provision was added in 1973 to allow insurers to deduct from their premium tax base any credit life, credit accident, or health insurance premiums they refund due to policyholders terminating their policies prior to their maturity dates. Credit insurance policies are occasionally taken out by debtors in conjunction with their credit cards, auto loans, and mortgages to ensure that their debt is paid off in case they die (in the case of credit life) or become ill or injured and, consequently unable to work (in the case of credit accident).

Insurance companies pay premium taxes quarterly or annually to the Division of Insurance within the Department of Regulatory Agencies.

Insurance companies do not formally claim the Insurance Premium Income Tax Exemption, or the three deductions. Instead, they are required to report how much reinsurance they assumed or transferred to other insurers on a national, but not state-specific, basis on their Underwriting and Investment Exhibit, which is a standardized form developed by the National Association of Insurance Commissioners (NAIC) and submitted to state insurance regulators. In addition, insurers are required to report the amount of dividends paid to policyholders, and for non-life/health insurers, the amount they refunded to policyholders due to return premiums and early terminations. The insurers net these amounts from their gross premium revenue and the resulting amount is the tax base on which most states, including Colorado, levy insurance premium tax.

#### WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

The intended beneficiaries of these tax expenditures are insurance and reinsurance companies doing business in Colorado. These include property and casualty insurers (that provide auto insurance, homeowner's insurance, bail bonds, and other types of insurance), life and health insurers, title insurers, reinsurance-only firms, and other types of insurers.

There are several types of organizations that are not impacted by the premium tax or these expenditures. Specifically, organizations that operate as third-party administrators to most private-sector employee benefit plans, which fall under the federal Employee Retirement Income Security Act of 1974 (ERISA), are not typically subject to state regulation or insurance premium taxes. In addition, federal law exempts Medicare, Medicaid, and the health insurance premiums of federal employees, including military service members, from state taxation, as well as other federal insurance programs. Finally, other organizations commonly thought of as "insurers" are also not subject to state premium taxes and thus are not beneficiaries of these expenditures, such as managed care organizations (including "HMOs" and prepaid dental

care plans); public entity self-insurance pools; pre-need funeral sellers; and Pinnacol Assurance, a political subdivision of the State and the workers' compensation insurer of last resort.

As of June 2018, there were 1,481 insurers in Colorado that provided insurance or insurance-like products that were subject to the premium tax requirements. Colorado insurers collected about \$27.1 billion in premiums and paid about \$270.9 million in premium taxes during Calendar Year 2017.

### WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Statute does not directly state a purpose for any of these tax expenditures. Based on our review of legislative history, other states' tax expenditure evaluations, and general tax policy research, we inferred the following purposes:

**THE INSURANCE PREMIUM INCOME TAX EXEMPTION WAS CREATED TO AVOID DOUBLE TAXING INSURERS.** The unique nature of the insurance industry makes taxing insurers on their income difficult to do in a fair manner. Insurers need to keep reserves in order to pay off future claims and benefits, but the timing and amount of these future payments is often unknown, which means the size of their reserves must vary over time. Consequently, it is difficult to compute the taxable income of insurers while allowing for needed reserves. A tax on insurers' premiums instead is relatively uncomplicated to compute, collect, and administer, and has the added benefit of providing a stable source of revenue for the State compared to the income tax. Most insurers are incorporated as C corporations, and thus, the biggest effect of this exemption is to substitute insurers' state corporate income tax liability with their premium tax liability. Insurers are still required to pay federal income tax.

**THE REINSURANCE DEDUCTION WAS ALSO CREATED TO PREVENT DOUBLE TAXING PREMIUMS.** Insurance companies reinsure each other's policies or turn to specialized reinsurers to spread out risks, reduce concentrated

exposures, and limit the total losses that might be incurred by the original insurer, particularly for riskier policies. This allows insurers to offer more competitive rates to policyholders. Because the premiums on the original policy that is the basis for the reinsurance premiums, was likely already taxed, either by Colorado or another taxing jurisdiction (since most of these reinsurance transactions occur between insurers located in different states or countries), taxing the reinsurance premium would effectively result in a double tax.

**THE RETURN PREMIUM AND EARLY TERMINATION DEDUCTIONS WERE CREATED TO PREVENT INSURERS FROM BEING TAXED ON PAYMENTS THAT ARE RETURNED TO POLICYHOLDERS.** These two deductions typically deal with money that insurers initially receive from policyholders, but later return to them in the form of refunds, credits on future payments, or dividends. The insurance companies net out these amounts from their gross premiums since they did not keep them before calculating the tax owed.

**ARE THE TAX EXPENDITURES MEETING THEIR PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?**

We determined that the tax expenditures are meeting their purposes because they prevent insurance and reinsurance premiums from being double-taxed, and they prevent insurers from paying taxes on payments that are returned to policyholders. Statute does not provide quantifiable performance measures for these expenditures. Therefore, we created and applied the following performance measures to determine the extent to which the expenditures are meeting their purposes:

**PERFORMANCE MEASURE #1:** *To what extent do the Insurance Premium Income Tax Exemption and Reinsurance Deduction prevent insurers from being double-taxed on premiums?*

**RESULT:** We found evidence to suggest that insurance companies are paying premium taxes, but are applying the Insurance Premium Income

Tax Exemption to not pay state income tax, and are using the Reinsurance Deduction to avoid double taxation on premiums. As of January 2019, according to the Division of Insurance, 1,459 of the 1,481 insurance companies in Colorado required to file for premium taxes in Calendar Year 2017, had submitted the required forms and paid the premium tax amount owed. However, we lacked data to determine if any of these insurers also paid Colorado income tax on their insurance income or did not deduct reinsurance premiums from their taxable premium amount. Stakeholders that we spoke with indicated that insurers are very much aware of and apply the exemption and deduction when calculating their tax liabilities. This would indicate that insurers are not paying state income tax on the premiums collected or paying a premium tax on reinsurance premiums.

**PERFORMANCE MEASURE #2:** *To what extent do the Early Termination and Return Premium Deductions prevent insurance companies from being taxed on payments that they return to policyholders?*

**RESULT:** We found that the Early Termination and Return Premium Deductions are likely helping to prevent insurers from being taxed on the premiums that they returned to policyholders. The refunds, credits, or dividends covered by these deductions encompass most of the payments that insurers receive, but sometimes later return to policyholders. For example, non-life insurers generally record an “unearned premium liability” when they receive a premium payment from a policyholder, which corresponds to the amount of the premium that they have not yet had the time to “earn,” and that decreases with time. Insurers will refund this unearned portion to the policyholder if the policy is canceled prior to its end date, at which point the amount returned becomes deductible to the premium tax base under the Early Termination or Return Premium Deduction. We lacked data to determine the extent to which insurance companies are applying these deductions. However, based on our review of Division of Insurance tax forms and interviews with stakeholders, it appears that insurers are aware of and apply the deductions.

## WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURES?

We estimate that about \$83.6 million in state revenue was forgone in Calendar Year 2017 as a result of the state income taxes that insurers did not pay due to the Insurance Premium Income Tax Exemption. Because Division of Insurance data was not available to measure the state revenue impact of this expenditure, we used NAIC data on the national net income of insurers subject to Colorado premium taxes to develop our estimate. We then apportioned a segment of their net income after expenses to their Colorado operations by using the overall ratio of premiums written in Colorado to total premiums written nationwide, which we subsequently multiplied by the statutory tax rate for Colorado corporations, which is 4.63 percent. It is important to note that this estimate is less reliable because we did not have data on the actual federal taxable income of the insurers, which differs from the income that they report on their annual statements to the NAIC and state insurance regulators. We also did not take into account any credits, deductions, or exemptions insurers might have claimed if they were taxed as corporations.

Because the Insurance Premium Income Tax Exemption was designed to work in conjunction with the policy decision to use an insurance premium tax, we also estimated the revenue impact of the State's policy of taxing insurers on their premiums as opposed to their income. In Tax Year 2017, the State collected about \$270.9 million in insurance premium taxes. Therefore, based on our estimate of \$83.6 million in potential corporate income taxes above, if the State instituted an income tax on insurers to replace the insurance premium tax, the State would have collected about \$187.3 million less from insurers in Calendar Year 2017.

We were not able to estimate the revenue impact of the Reinsurance, Early Termination, or Return Premium Deductions due to a lack of data. With the exception of life insurance companies, insurers are not

required to report the amount deducted in their premium tax filings with the Division of Insurance.

### WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

Eliminating these insurance premium tax expenditures would result in significantly higher taxes for insurers doing business in Colorado. Specifically, without these expenditures, insurers would have to pay state income tax on their revenue, in addition to the premium tax, and the amount of premiums that the premium tax is based on would be higher, resulting in a substantially higher amount of taxes due. For example, based on our estimated \$83.6 million state revenue impact of the Insurance Premium Income Tax Exemption, which is equivalent to the additional income tax insurers would have to pay without the exemption, eliminating this expenditure alone would increase insurers' state taxes by 31 percent (from about \$270.9 million in Tax Year 2017 to \$354.5 million). Insurers would likely respond to this additional tax by increasing premiums charged in Colorado, resulting in a higher cost of insurance in the state.

In addition, if Colorado no longer had these tax expenditures, Colorado-domiciled insurers doing business in other states might also have a higher tax burden in these 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, fees, assessments, or other monetary requirements on out-of-state insurers that would result in an effective tax rate that is equivalent to the rate that their in-state insurers pay in other states. Since eliminating these expenditures would increase the effective tax rate of most insurers licensed in Colorado, it is possible that other states would respond by raising taxes on Colorado-domiciled insurers doing business in their states. All of the stakeholders we spoke with about these tax expenditures said that they are very beneficial for Colorado's insurance sector.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We found that all of the 49 states and the District of Columbia that levy a tax on insurance premiums have at least two tax expenditures similar to those available in Colorado. Oregon is the only state that does not have a premium tax. EXHIBIT 1.2 shows that all 49 states and the District of Columbia offer both a reinsurance deduction and a return premium and/or early termination deduction and 39 states and the District of Columbia offer the Insurance Premium Income Tax Exemption.

EXHIBIT 1.2. JURISDICTIONS THAT OFFER INSURANCE PREMIUM TAX EXPENDITURES SIMILAR TO COLORADO	
EXPENDITURE	NUMBER OF JURISDICTIONS IDENTIFIED
Insurance Premium Income Tax Exemption	40 <sup>1</sup>
Reinsurance Deduction	49
Return Premium/Early Termination Deduction	49 <sup>2</sup>

SOURCE: Bloomberg BNA, 2017 NAIC State Retaliation Guide.

<sup>1</sup>Some states limit the exemption to certain types of insurers or tax certain types of investment income.

<sup>2</sup>Includes 13 states that do tax some or all dividends that insurers issue to policyholders.

There are 10 states that also levy an income tax on insurers, in addition to a premium tax. However, all of these states either cap insurers' income tax liability or allow them to credit their income tax paid against their premium tax liability, which is always higher.

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

We did not identify any other tax expenditures or programs with a similar purpose in Colorado.

## WHAT DATA CONSTRAINTS IMPACTED OUR ABILITY TO EVALUATE THE TAX EXPENDITURES?

The Division of Insurance does not collect information on these expenditures from most types of insurers in their premium tax filings.

Specifically, insurers net out the value of their return premiums and refunds due to early terminations when entering the amount of premiums collected or contracted for on Division of Insurance tax reporting forms. In addition, insurers only report the value of any reinsurance transferred and assumed on a national basis. Therefore, we lacked data on how much Colorado insurers are claiming for the Return Premium and Early Termination Deductions. Similarly, insurers do not have to report the value of their federal taxable income to the State since they are not subject to state income taxes. If the General Assembly would like a revenue impact estimate for these four expenditures, then the Division of Insurance would need to add fields to its online premium tax filing system to collect this data from insurers. However, this may result in a higher administrative burden for insurers operating in Colorado, and the Division of Insurance would incur additional costs to make this administrative change.

#### WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER ALLOWING INSURERS TO DEDUCT FROM THEIR PREMIUM TAX BASE THE AMOUNT OF ANY LICENSES, FEES, OR TAXES THEY PAY TO LOCAL GOVERNMENTS. A 1971 Colorado Supreme Court case ruled that the provisions of Section 10-3-209(1)(c), C.R.S., which prohibit Colorado municipalities and counties from levying a per-employee “occupational privilege tax” (sometimes called a “head tax”) on insurers, was unconstitutional in relation to home rule jurisdictions seeking to raise revenue. Five Colorado home rule jurisdictions (Aurora, Denver, Glendale, Greenwood Village, and Sheridan) currently levy an occupational privilege tax each month on most businesses and employees, ranging from a total monthly tax of \$4 per employee in Aurora and Greenwood Village to \$10 in Glendale. Greenwood Village also requires businesses that are liable for the tax to pay a one-time licensing fee of \$10. The General Assembly may want to consider allowing insurers to deduct these local taxes and fees when determining their premium tax liabilities, since they were not allowable at the time the expenditures

were created. Five states offer a deduction or credit against some or all of these local taxes, licenses, and fees, while six other states expressly cap the amount of these obligations that local governments can impose on insurers. Allowing for such a deduction may also have the added effect of reducing any retaliatory taxes currently levied on Colorado-domiciled insurers, since many state insurance regulators take into account taxes levied by political subdivisions of other states in their own calculations of retaliatory taxes.