

# EMPLOYEE RETIREMENT PLAN INSURANCE PREMIUM TAX DEDUCTION EVALUATION SUMMARY



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THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2019

YEAR ENACTED	1969
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	\$186,000 (TAX YEAR 2018)
NUMBER OF TAXPAYERS	45
AVERAGE TAXPAYER BENEFIT	\$4,100
IS IT MEETING ITS PURPOSE?	Yes, but only to a small extent

## WHAT DOES THIS TAX EXPENDITURE DO?

The Employee Retirement Plan Insurance Premium Tax Deduction (Employee Retirement Plan Deduction) allows insurers to deduct from their taxable premiums any premiums collected after 1968 for policies issued on pensions, profit-sharing, or annuity plans taken out by employers for their employees, if contributions to such plans are deductible from those employers' net income.

## WHAT DID THE EVALUATION FIND?

The Employee Retirement Plan Deduction is meeting its purpose, but to a small extent because only a small percentage of employers offer the types of employee retirement plans that are covered by the deduction and other tax expenditures provide overlapping benefits.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Employee Retirement Plan Deduction. Based on statutory language, legislative history, and similar provisions in other states, we inferred that its purpose is to increase employers' provision of pension, profit-sharing, and annuity plans by reducing the cost of life insurance products, such as life insurance and annuities, which are typically connected to these plans.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to clarify whether the deduction covers insurance policies connected with retirement plans established by employers that are not organized as C-corporations, for example, limited liability companies, S-corporations, and partnerships. In addition, the General Assembly may want to consider including insurance policies issued in connection with additional types of employee retirement plans, such as 401(k) plans, within the deduction.

# EMPLOYEE RETIREMENT PLAN INSURANCE PREMIUM TAX DEDUCTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

Colorado levies a 2 percent premium tax on insurance companies' in-state premiums, which is the revenue they collect for writing insurance policies covering property or risks in the state. In 1969, the General Assembly created the Employee Retirement Plan Insurance Premium Tax Deduction (Employee Retirement Plan Deduction) [Section 10-3-209(1)(d)(IV), C.R.S.], which allows insurers to deduct from their taxable premiums any premiums they collect after December 31, 1968, on policies or contracts connected to pensions, profit-sharing, or annuity plans that employers provide to their employees, if the employer contributions to those plans are deductible for state or federal income tax purposes. Under Section 10-1-102(12), C.R.S., which defines "insurance" for the purpose of determining the income subject to the insurance premium tax, several types of contracts or policies employers may purchase from insurers when establishing eligible employee retirement plans are considered insurance, including life insurance and annuities, which are contracts issued by insurance companies that make a defined payment or series of payments in the future.

To claim the deduction, insurers enter the amount of premiums associated with retirement plans that qualify for the Employee Retirement Plan Deduction on their premium tax return, which they submit to the Division of Insurance within the Department of Regulatory Agencies. This amount is deducted from insurers' taxable premium amount before calculating the premium tax.

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

Statute does not explicitly identify the intended beneficiaries of the Employee Retirement Plan Deduction. Based on the statute, legislative history, and similar provisions in other states, we inferred that the direct beneficiaries of this deduction are life insurance companies doing business in Colorado. Life insurers offer multiple insurance products that may qualify for the deduction, such as life insurance and annuities, which can be used to fund or are otherwise connected to employer-sponsored pension, profit-sharing, or annuity plans. However, since the cost of insurance premium tax may be passed on to policyholders, the employers sponsoring qualifying retirement plans and the employees who receive benefits from these plans appear to also be the intended beneficiaries. These policies or contracts typically provide benefits to the employee and often also cover the employee's dependents, such as spouses and children.

Annuities and other life insurance contracts are used by employers who offer employees "defined benefit" type retirement plans, such as pensions, which provide a guaranteed payment amount in the future. Purchasing such contracts from third-party insurers allows employers to provide the employee with a guaranteed benefit at retirement without having to manage the investment of the funds, which reduces the risk of having unfunded pension liabilities in the future. For "defined contribution" type retirement plans, which provide a specific up-front contribution with an unknown future value, employers do not have the same need for life insurance products like annuities because they do not bear the risk associated with paying a guaranteed amount in the future. Profit-sharing plans, which are typically structured as defined contribution plans, allow employers to contribute a discretionary amount to employees' retirement plans on a periodic basis, when profits are known, as opposed to plans where the benefit is defined at the outset of the period of employment. They may also utilize life insurance products such as annuities.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Employee Retirement Plan Deduction. Based on statute, legislative history, and similar provisions in other states, we inferred that the purpose of the deduction is to increase employers' provision of pension, profit-sharing and annuity plans connected to qualifying life insurance products by lowering their cost. Although the deduction is claimed directly by insurers, it was likely intended to reduce the cost of the insurance products employers purchase in order to provide retirement plans, based on the expectation that insurance companies would pass the savings from the deduction on to employers who purchase eligible insurance products.

This purpose aligns with other legislation the General Assembly passed at the same time, which also appears to have been intended to expand access to pensions. Specifically, in 1969, the same year the General Assembly created this deduction, it passed 17 bills related to expanding pension benefits or employees' access to them.

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

We found that the Employee Retirement Plan Deduction is meeting its purpose, but only to a small extent because of significant changes to the types of retirement plans offered by employers and the creation of other similar tax expenditures since the deduction went into effect.

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

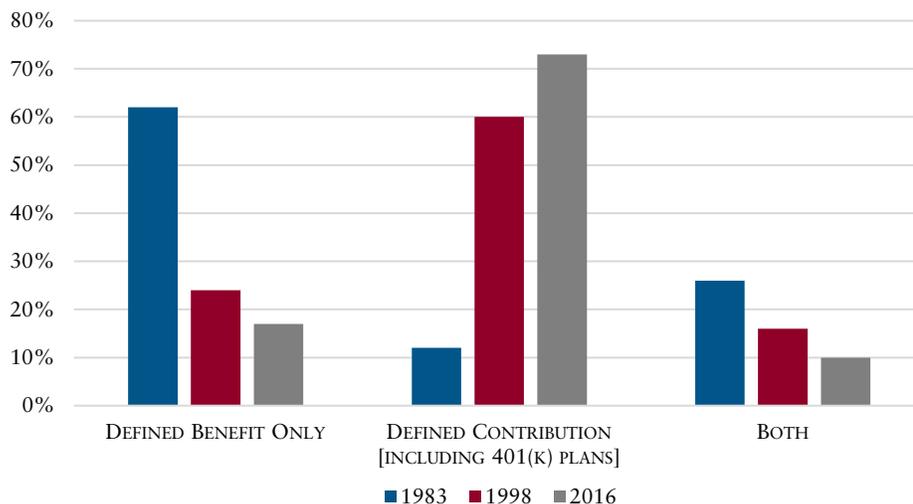
**PERFORMANCE MEASURE:** *To what extent does the Employee Retirement Plan Deduction increase employers' provision of pension, profit-sharing, and annuity plans to employees?*

**RESULT:** The deduction appears to have only a small impact on employers' provision of pension, profit sharing, and annuity plans based on its limited use and there being relatively few potential qualifying retirement plans. We lacked data to quantify the actual extent to which the deduction increased employers' provision of qualifying plans. However, in Tax Year 2018, life insurers reported earning \$9.3 million in premiums that qualified for the deduction, which, based on the 2 percent insurance premium tax and applicable rate reductions claimed by insurers who took the deduction, would have resulted in a potential savings of only \$186,000 across all employers in the state who provided qualifying retirement plans. Further, there are relatively few employers offering "defined benefit" retirement plans, such as pensions, that would qualify for the deduction. Specifically, according to the federal Pension Benefits Guarantee Corporation, which insures almost all private sector defined benefit plans, there were 310 private sector employers in Colorado with employee defined benefit pension funds as of March 2018. However, we were not able to determine how many of these employers purchased insurance products that would qualify for the deduction.

It is possible that the deduction may have had a more significant impact in prior years; however, major changes to employer-provided retirement benefits since the deduction was created have significantly reduced the number of retirement plans with insurance-related components that would qualify. According to a 2010 Georgetown University Law Center report, *A Timeline of the Evolution of Retirement in the United States*, which compiled data from the Employee Benefits Research Institute, in 1970, 45 percent of all private-sector workers in the U.S. were covered by a pension plan, a percentage that stayed relatively constant until 1990. Employers often purchased annuities or life insurance policies, which would qualify for the deduction, from insurers in connection with defined benefit plans and pensions. Moreover, employer-provided

profit-sharing plans were sometimes connected with life insurance or annuities, which would also qualify. However, since the deduction was created, employers' use of pensions and other defined benefit retirement plans eligible for the deduction has declined significantly as defined contribution plans have become more common. Specifically, in 1974 the federal Employee Retirement Security Act (ERISA) increased federal regulation of pensions and other defined benefit plans and introduced individual retirement accounts (IRAs), which are defined contribution plans. In addition, the federal government created 401(k) plans in 1978, which are also defined contribution plans and soon became the most popular type of employee retirement plan. As a result, during the 1980s through 2000s, most employers who offered their employees retirement benefits gradually switched from defined benefit plans to defined contribution plans. Defined contribution plans are not typically structured as pensions, annuities, or profit-sharing plans and according to Division of Insurance staff, they are generally not eligible for the deduction. While employees are still allowed to purchase life insurance as part of certain defined contribution retirement plans, including 401(k)s, many employers/plans do not offer this option. EXHIBIT 1.1 illustrates the decline of defined benefit plans and the increase of defined contribution plans among workers in the U.S. during the past four decades.

### EXHIBIT 1.1. U.S. WORKERS WITH RETIREMENT PLAN COVERAGE BY TYPE OF PLAN, 1983-2016



SOURCE: Center for Retirement Research at Boston College.

In addition to changes in the insurance market, in 1977, the General Assembly created the Annuity Exemption under Section 10-3-209(1)(d)(IV), C.R.S., which exempts all purchases of annuities from insurance premium taxes regardless of whether the annuities are connected with an employer-provided retirement plan. Therefore, annuities, which would otherwise be a common type of insurance product covered under the Employee Retirement Plan Deduction, are now exempted under the broader Annuity Exemption and would not be subject to tax regardless of the deduction.

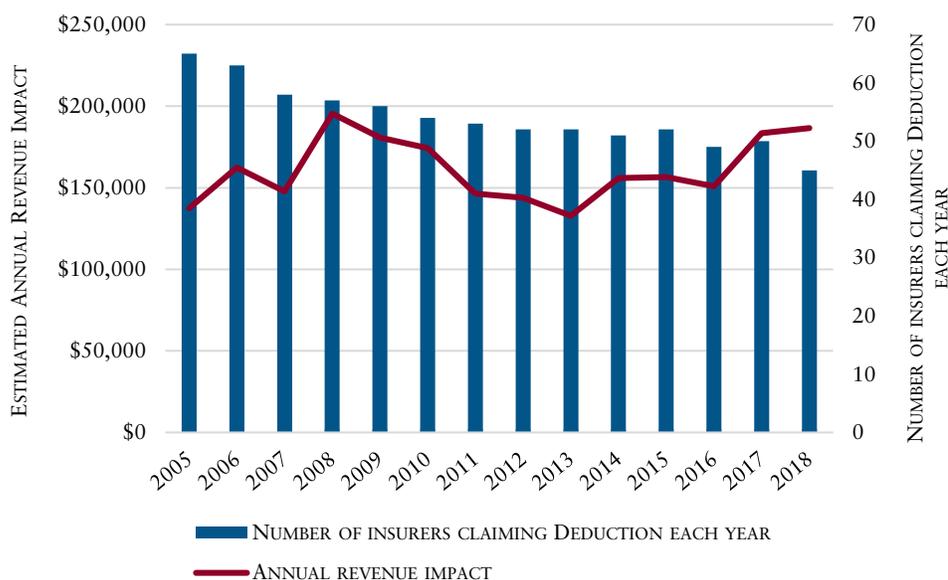
### WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURE?

In Tax Year 2018, we estimate that the Employee Retirement Plan Deduction reduced the insurance premium taxes collected by the State by \$186,000, which is equivalent to the amount the 45 insurers who took the deduction claimed, with three insurers accounting for 67 percent of the eligible premiums. We calculated this estimate using premiums data provided by the Division of Insurance and based on the 2 percent premium tax and applicable rate reductions that the insurers

who took the deduction also claimed. Of the insurance premiums that were used to claim the deduction, 99.8 percent were based on life insurance policies purchased by employers in connection with retirement plans. Although employers also purchase annuities in connection with eligible plans, we did not include annuities in our revenue impact estimate because all annuities, regardless of whether they are purchased in connection with employee-sponsored retirement plans, are now exempt from premium tax under the broader Annuity Exemption [Section 10-3-209(1)(d)(IV), C.R.S.].

EXHIBIT 1.2 shows the number of insurers claiming the Employee Retirement Plan Deduction and its estimated revenue impact since 2005, the first year for which the Division has data.

### EXHIBIT 1.2. ESTIMATED REVENUE IMPACT OF EMPLOYEE RETIREMENT PLAN DEDUCTION, 2005-2017



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

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

Eliminating the Employee Retirement Plan Deduction would result in a slightly higher tax burden for the 45 insurers who are claiming the deduction. Overall, the additional tax would apply to 0.6 percent, or \$9.3 million, of the \$1.5 billion in life insurance premiums these insurers received in Tax Year 2018, for a total tax increase of about \$186,000. To the extent that these insurers would pass the additional 2 percent premium tax on to purchasers, eliminating the deduction could also cause a corresponding increase in costs to employers and employees who purchase insurance policies that qualify.

Eliminating the deduction 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 deduction would increase the effective tax rate of these 45 insurers, it is possible that other jurisdictions would respond by slightly raising taxes on Colorado-domiciled insurers. However, as noted below, only 15 states and the District of Columbia have a similar provision.

#### ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 48 states (excluding Colorado) and the District of Columbia that levy an insurance premium tax, the following 16 jurisdictions have an insurance premium tax deduction similar to the Employee Retirement Plan Deduction: Delaware (rate reduction for a subset of eligible life insurance), the District of Columbia, Idaho, Illinois, Iowa, Kansas, Maine, Mississippi, Missouri, Nebraska, New Jersey, North Carolina, Oklahoma (rate reduction), Tennessee, Washington, and Wyoming. Among those states, Illinois', Mississippi's, and Washington's expenditures apply to some or all defined contribution plans, but not to defined benefit plans. Additionally, Illinois limits deductions to only life insurance premiums related to retirement plans of certain public sector employees.

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

Since 1977, annuity premiums have been exempt from premium tax in Colorado under the Annuity Exemption [Section 10-3-209(1)(d)(IV), C.R.S.]. Although the annuity premiums that qualify for the Employee Retirement Plan Deduction would also qualify, this exemption is broader and exempts all annuity premiums from tax regardless of whether they are connected to an employer-provided retirement plan. Despite this overlap, taxpayers do not receive a duplicate tax benefit since both provisions function to eliminate the full tax liability for the annuity premiums covered.

In addition, the same 1969 bill that created the Employee Retirement Plan Deduction also created a Tax-Exempt Organization Insurance

Deduction (Section 10-3-209(1)(d)(IV), C.R.S.) for the life insurance, health insurance, and other insurance premiums purchased by tax-exempt employers for their employees.

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

We did not identify any data constraints related to the evaluation of the Employee Retirement Plan Deduction.

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

THE GENERAL ASSEMBLY MAY WANT TO CLARIFY WHETHER PREMIUMS FROM RETIREMENT-RELATED INSURANCE POLICIES PURCHASED BY PARTNERSHIPS, LIMITED LIABILITY COMPANIES (LLCs), S-CORPORATIONS, AND OTHER PASS-THROUGH ENTITIES SHOULD BE INCLUDED IN THE EMPLOYEE RETIREMENT PLAN DEDUCTION. According to statute [Section 10-3-209(1)(d)(IV), C.R.S.], to be eligible for the deduction, the premiums must be connected to a retirement plan “established by an employer for employees” and the employer’s contributions to the plan must be “deductible by such employer in determining such employer’s net income as defined in [S]ection 39-22-304, C.R.S.” However, Section 39-22-304, C.R.S., only defines what expenses are deductible from the income of C-corporations and therefore, according to Division of Insurance staff, only premiums for policies and contracts purchased by C-Corporations are eligible for the deduction. The Division of Insurance has not established any guidance for insurance companies regarding this requirement and we were unable to determine how insurance companies have interpreted and applied the requirement in practice.

Based on our review of legislative history, it is unclear if the General Assembly intended to limit the deduction to premiums received from C-corporations and exclude the premiums received from partnerships, limited liability companies, or S-corporations. These types of

businesses, which are known as “pass-through entities,” allow owners to pass income and losses from the business through to their individual tax returns. According to our review of U.S. Census Bureau data, in Calendar Year 2016, 51 percent of Colorado’s private sector workforce was employed by a pass-through business. None of the 15 states and the District of Columbia with tax expenditures similar to the deduction appear to limit theirs to C- corporations.

If pass-through business entities are included in the deduction, it could increase the revenue impact to the State, although we lacked data to estimate this impact.

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER IF INSURANCE PREMIUMS ISSUED IN CONNECTION WITH OTHER TYPES OF EMPLOYEE RETIREMENT PLANS SHOULD ALSO BE ELIGIBLE FOR THE EMPLOYEE RETIREMENT PLAN DEDUCTION. When the deduction was created in 1969, most defined contribution retirement plans that are in use today were not yet allowed by the federal tax code. Today, employees often have access to a range of defined contribution retirement plans, such as 401(k) plans, 457 plans for employees of states and local governments, and IRAs. According to the Center for Retirement Research at Boston College, these plans were initially viewed mainly as supplements to employer-funded pension and profit-sharing plans, but are now the primary retirement plan for most employees. Life insurance premiums connected to these plans are typically not eligible for the deduction, which limits eligibility to “pension, profit sharing, or annuity plan[s].” Based on the changes to the retirement plans employers typically offer, the General Assembly may want to consider whether this limitation is consistent with the deduction’s purpose. Of the 15 other states and the District of Columbia with tax expenditures similar to the deduction, 14 explicitly allow life insurance products connected to one or more defined contribution plans to also qualify, and one—Nebraska—explicitly allows insurance-related to IRAs to qualify.

Making premiums connected to other types of retirement plans eligible for the deduction would likely increase the revenue impact to the State.

Although we lacked data to estimate this cost, the impact would be limited to premium taxes collected on insurance policies issued in connection with these plans. For example, if an employer offered life insurance in connection with a 401(k) plan, the premiums for the life insurance could be covered by the deduction and reduce the revenue the State would collect. The amounts the employer contributed to the 401(k) are not insurance and therefore, would not be eligible for the deduction or subject to the insurance premium tax.