# CAPTIVE INSURANCE PREMIUM TAX EXEMPTIONS

EVALUATION SUMMARY

SEPTEMBER 2019
2019-TE27

THESE EVALUATIONS ARE INCLUDED IN COMPILATION REPORT SEPTEMBER 2019

| | CAPTIVE RETURN PREMIUM EXEMPTION | CAPTIVE RECEIPT OF ASSETS EXEMPTION |
|---|---|---|
| YEAR ENACTED | 1972 | 1992 |
| REPEAL/ EXPIRATION DATE | None | None |
| REVENUE IMPACT | Could not determine | Could not determine |
| NUMBER OF TAXPAYERS | Could not determine | Could not determine |
| AVERAGE TAXPAYER BENEFIT | Could not determine | Could not determine |
| IS IT MEETING ITS PURPOSE? | Yes | Yes |

## WHAT DO THESE TAX EXPENDITURES DO?

Both provisions are limited to captive insurance companies (captives), which are specialized insurance companies owned by a parent company(ies), to which they provide insurance coverage.

CAPTIVE RETURN PREMIUM EXEMPTION [Section 10-6-128(1), C.R.S.]–allows captives to exempt from their taxable premiums "return premiums," which include any premium amounts returned or credited to policyholders due to dividends issued, early cancellation of policies, overpayments, errors, audits, or reductions in coverage.

CAPTIVE RECEIPT OF ASSETS EXEMPTION [Section 10-6-128(2)(e), C.R.S.]–allows captives to not include any assets that they receive "in exchange for the assumption of existing loss reserves and other liabilities" in their taxable premiums.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute does not explicitly state a purpose for the Captive Return Premium Exemption or the Captive Receipt of Assets Exemption. Based on our review of statute, insurance regulations, legislative history, and similar provisions in other states, we inferred that their purpose is to prevent captives from being taxed on premiums and transfers of assets that they cannot retain. These are common structural provisions in the states that tax captives using a similar structure as Colorado.

## WHAT DID THE EVALUATION FIND?

These expenditures are meeting their purpose and align the State's definition of insurance premiums with common industry practice.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to either expenditure.

# CAPTIVE INSURANCE PREMIUM TAX EXEMPTIONS

## EVALUATION RESULTS

### WHAT ARE THESE TAX EXPENDITURES?

This evaluation includes two structural tax expenditure provisions available to captive insurance companies (captives). Captives are insurance entities created and fully owned by one or more parent companies to insure the property or risks of the parent company(ies) (they typically do not sell insurance to other companies). Under this arrangement, the captive is generally structured as a separate business entity from the parent company and charges the parent company premiums for insurance contracts to cover risks to the parent company. They are a vehicle some companies use to self-insure, limit the potential liability to the parent company, and reduce the cost of insurance.

Captives that do business in Colorado are liable for a premium tax on the property or risks that they insure in state (or outside of Colorado, if no other state has levied tax on them), which, according to Section 10-6-128(2), C.R.S., is calculated as the greater of:

A $5,000; or

B The following calculations:

  1 Direct insurance premiums

    a. 0.5 percent of their first $25 million

    b. plus 0.25 percent of their next $50 million

    c. plus 0.1 percent of the rest

2 Plus reinsurance premiums

   a. 0.25 percent of their first $20 million

   b. plus 0.1 percent of the rest

As shown, statute establishes separate rates for direct premiums and reinsurance premiums collected by captives. Direct premiums are premiums insurers collect from the businesses or individuals' whose risk they are covering. Reinsurance premiums are premiums insurers collect from other insurance companies in exchange for assuming the liability for the risk of losses under policies written by the other insurer.

Section 10-6-128, C.R.S., provides the following two exemptions from the premium tax owed by captives:

Captive Return Premium Exemption [Section 10-6-128(1), C.R.S.]. This provision, enacted in 1972, allows captives to not include in their taxable premiums "return premiums," which include any amounts returned or credited to policyholders due to dividends issued, early cancellation of their policies, overpayments, errors, audits, or reductions in coverage. One common example of such returns is worker's compensation policies. Specifically, a company may project needing coverage for 30 employees and pay premiums based on this number, but at the end of the year have only employed 20. Depending on the terms of the policy, an insurer may return a portion of the premium paid to the insured.

Captive Receipt of Assets Exemption [Section 10-6-128(2)(e), C.R.S.]. This provision, enacted in 1992, allows captives to not include any assets that they receive "in exchange for the assumption of existing loss reserves and other liabilities" in their taxable premiums. According to Division of Insurance staff, this relates to a specific type of contract between insurers, called assumption reinsurance, in which one insurance company, serving as a reinsurer, takes on liability for another insurer's liability for losses in exchange for a premium. As part of this type of reinsurance contract, the first insurance company may also transfer assets (typically cash or cash equivalents) to the reinsurer that serve as collateral to cover balance sheet requirements under Colorado insurance regulations. The transferred assets are typically held by the reinsurer for the duration of the reinsurance contract and returned at the end of the coverage period. This tax expenditure exempts the assets transferred to captives under this type of arrangement from being treated as premiums, which are taxable under this type of contract.

Captives do not formally claim the Captive Return Premium Exemption or the Captive Receipt of Assets Exemption. They are able to apply them by not including the value of the transactions covered by the exemptions in the premium revenue they report to the Division of Insurance for the purposes of determining their tax liability.

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

The intended direct beneficiaries of these exemptions are captive insurers doing business in Colorado and captives' parent companies are indirect beneficiaries since they may receive lower premiums as a result of the exemptions. According to the Center for Insurance Policy Research, captives are often able to underwrite the same range of risks as other insurance companies, such as life, health, and, most commonly, property/casualty insurance. Although they have been used since the 1950's, they were less common until the mid-1980s, when commercial insurance underwent a period of rising costs. Captives can allow a parent company to obtain coverage that would be unobtainable or unaffordable in commercial insurance markets. Captives also grant their parent companies direct access to reinsurance markets, which can further reduce the cost of distributing risk.

According to the Insurance Information Institute, there are more than 3,000 captives operating in the U.S.; of these, there were seven domiciled in Colorado, all of which issue property and casualty policies according to the Division of Insurance. In addition, because out-of-state captives may also provide insurance in the state, there are likely additional captives operating in Colorado, although the Division did not have data to quantify how many. The seven Colorado-domiciled captives collected about $81 million in premiums and paid about $375,000 in premium taxes during Calendar Year 2018.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute does not explicitly state a purpose for the Captive Return Premium Exemption or the Captive Receipt of Assets Exemption. Based on our review of statute, insurance regulations, legislative history, and similar provisions in other states, we inferred that their purpose is to prevent captives from being taxed on premiums and transfers of assets that they cannot retain. These are common structural provisions in the states that tax captives using a similar structure as Colorado.

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

We determined that the exemptions are meeting their purpose because they allow captives to avoid paying taxes on payments and transfers of assets they later return. Although only three of the seven captive insurers domiciled in the state reported using either exemption, some captive insurers likely do not make transactions to which the exemptions apply. According to Division of Insurance staff, the exemptions also align the State's definition of "insurance premiums" with the common industry understanding of the term because insurers do not typically consider returned premiums and assets they receive as part of assumption reinsurance contracts as part of their premium collections.

Statute does not provide quantifiable performance measures for these exemptions. Therefore, we created and applied the following performance measure to determine the extent to which the exemptions are meeting their purpose:

**PERFORMANCE MEASURE:** *To what extent do captives use the Captive Return Premium Exemption and Captive Receipt of Assets Exemption to avoid being taxed on premium payments and transfers of assets that they return to policyholders?*

**RESULT: CAPTIVE RETURN PREMIUM EXEMPTION.** We found that at least some captives domiciled in Colorado are using this exemption to prevent the taxation of premiums that they return to policyholders. Because captives are not required to report to the Division of Insurance the amount they exempted under this provision, we lacked data to determine the full extent to which captives are applying it. However, we contacted all seven of the captives domiciled in Colorado, and three reported using the exemption, three reported not using it, and one did not respond to our request for information.

**RESULT: CAPTIVE RECEIPT OF ASSETS EXEMPTION.** We were unable to confirm whether this exemption is used by captives in the state. Of the seven captives domiciled in the state, only two reported being aware of the exemption and neither applied it to their premium tax returns because they did not have any eligible transactions to apply it to. Four other captives reported not being aware of the exemption and one did not respond to our request for information. Because captives are not required to report to the Division of Insurance the amount they exempted under this provision, we lacked data to determine the extent to which captives may have used the exemption in prior years or whether captives domiciled outside the state, but operating within the state, are currently using it. According to Division of Insurance staff, the type of transactions covered by the exemption still occur within the insurance industry and are not considered premiums, so the exemption appears to clarify the treatment of a common industry practice, as opposed to offering special treatment. Thus, if captives in the state have eligible transactions in the future, this provision would help clarify that the transfer of assets is not subject to tax.

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

We were not able to estimate the revenue impact of the Captive Return Premium Exemption or Captive Receipt of Assets Exemption due to a lack of data. Specifically, captives are not required to report the amount of either exemption in their premium tax filings with the Division of Insurance and report their premiums after already subtracting the amount covered under the exemptions. However, captives only paid about $375,000 in total premium taxes during Calendar Year 2018 and only three of the seven captives we contacted reported using either exemption; therefore, it appears likely that the revenue impact is relatively small.

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

Eliminating these insurance premium tax expenditures would result in higher taxes for captive insurers doing business in Colorado. Specifically, without these exemptions, captives would have to calculate their premium tax liability, including return premiums and assets transferred temporarily under reinsurance contracts, which would result in a higher tax base and increase their tax liability. As a result, insurance costs could rise for companies that use captives to distribute risk. Along with the higher tax burden, eliminating the exemptions might also reduce Colorado's attractiveness as a potential domicile for captive insurers.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We identified 23 states (excluding Colorado) and the District of Columbia that tax captives differently from other types of insurers. Of these, 20 states and the District of Columbia have an expenditure similar to the Captive Return Premiums Exemption. In addition, all of the 15 states and the District of Columbia that apply a tax to the reinsurance premiums of captive insurers have an expenditure similar to the Captive Receipt of Assets Exemption that exempts assets received as collateral in an assumption reinsurance transaction from taxation.

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

The Return Premium Deduction [Section 10-3-209(1), C.R.S.] allows non-captive insurers to claim an exemption for returned premiums, similar to the Captive Return Premium Exemption. Together, the provisions allow all types of insurers to avoid paying taxes on return premiums.

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

The Division of Insurance does not collect information on either exemption from captives in their premium tax filings. Specifically, captives do not include the value of the transactions covered by the exemptions when entering their premium amount on Division of Insurance tax reporting forms. Therefore, we lacked data on how much captives doing business in Colorado are claiming for either exemption. Although the Division of Insurance could add reporting lines to its return form and require captives to report the exemption amounts, this would likely require additional resources and staff time for the Division of Insurance and could increase taxpayers' reporting costs.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to the Captive Return Premium Exemption or the Captive Receipt of Assets Exemption.