SURPLUS LINES INSURANCE TAX AND EXAMINATION FEE DEDUCTION

EVALUATION SUMMARY

SEPTEMBER 2019
2019-TE29

THIS EVALUATION IS INCLUDED IN COMPILATION REPORT SEPTEMBER 2019

YEAR ENACTED	1949
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	Could not determine
NUMBER OF TAXPAYERS	Could not determine
AVERAGE TAXPAYER BENEFIT	Could not determine
IS IT MEETING ITS PURPOSE?	Yes, though its applicability is limited.

WHAT DOES THIS TAX EXPENDITURE DO?

Surplus lines insurance is specialized, high-risk insurance and is subject to a 3 percent tax on the premiums collected for risks insured in the state. The Surplus Lines Deduction allows taxpayers to deduct from their gross premiums "sums collected to cover federal and other state taxes and examination fees" when calculating the premium amount subject to the surplus lines premium tax.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not directly state a purpose for the Surplus Lines Deduction. Based on our review of legislative history, other states' statutory language regarding surplus lines premiums, and stakeholder outreach, we inferred that the purpose is to define the tax base for surplus lines premiums. Specifically, this deduction defines what amounts collected from surplus lines policyholders should be considered "premiums" subject to the State's surplus lines premium tax.

WHAT DID THE EVALUATION FIND?

We determined that the Surplus Lines Deduction is likely meeting its purpose, although it only applies to a limited amount of insurance premiums.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

SURPLUS LINES INSURANCE TAX AND EXAMINATION FEE DEDUCTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

This evaluation covers the Surplus Lines Insurance Tax and Examination Fee Deduction (Surplus Lines Deduction) [Section 10-5-111, C.R.S.]. Surplus lines insurance is a specialized form of insurance that often covers risks that are unique to the policyholder, including high-risk policies for which traditional insurance markets do not offer coverage. For example, according to a representative from a surplus lines insurance industry organization, in Colorado, a significant amount of surplus lines premiums relate to policies written to cover liabilities arising for contractors involved in large-scale residential projects. Traditional licensed insurers often do not offer policies covering the risks typically covered using surplus lines insurance because these policies can be too specialized or innovative to have a significant loss history from which to establish the risk and potential size of claims, which makes this type of coverage difficult to price. In other cases, surplus lines policies, or the policyholders themselves, may carry known risks that are too high for licensed insurers to insure based on insurance regulations.

Section 10-5-101.2, C.R.S., limits surplus lines coverage to disability, property, or casualty insurance. In addition, surplus lines insurers are not required to be licensed in Colorado, but they must maintain eligibility to sell surplus lines insurance in the state either by filing with the Division of Insurance, within the Department of Regulatory Agencies, on an annual basis or by meeting the eligibility requirements of the National Association of Insurance Commissioners.

Colorado levies a 3 percent tax on in-state surplus lines insurance premiums, which are the amounts insurers collect from surplus lines policyholders for risks insured within the state. Although insurers collect surplus lines premiums, either brokers selling the insurance policy or individuals who procure the insurance directly are responsible for paying the tax and are referred to collectively as "taxpayers" throughout this evaluation. The Surplus Lines Deduction allows taxpayers to deduct from their premiums "sums collected to cover federal and other state taxes and examination fees" when calculating the premium amount subject to the tax. This provision refers to taxes and fees that may be levied on the premiums, in addition to the State's surplus lines premium tax. Examination fees, which are also known as a "stamp tax," may be charged to cover costs related to the administration of surplus lines premium taxation. EXHIBIT 1.1 shows how the Surplus Lines Deduction is applied when taxpayers file for premium taxes in the state.

EXHIBIT 1.1. CALCULATION OF SURPLUS LINES PREMIUM TAX, APPLYING THE SURPLUS LINES DEDUCTION

Surplus lines premiums

+

Federal taxes, other state taxes, and examination fees

=

Total due from policyholder prior to application of the state surplus lines tax

-

Surplus Lines Deduction (equivalent to federal taxes, other state taxes, and examination fees)

=

Taxable surplus lines premiums

X

State surplus lines premium tax rate (3 percent)

=

State surplus lines premium tax

SOURCE: Office of the State Auditor analysis of Colorado Revised Statutes.

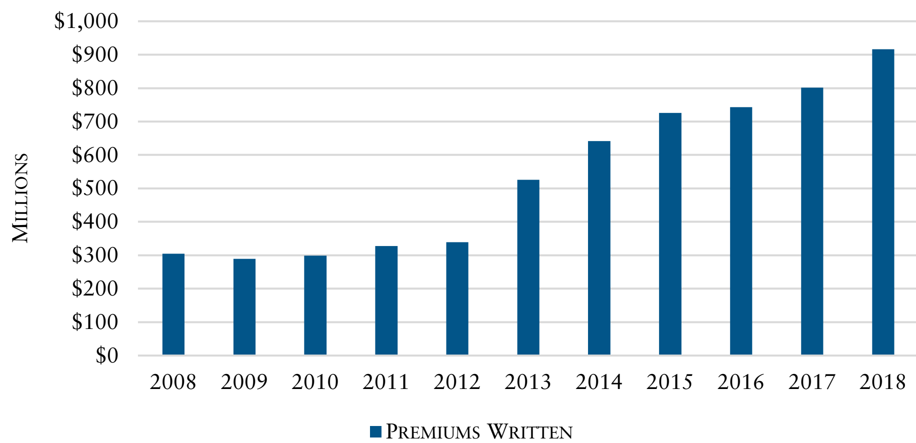
Taxpayers are not required to report the Surplus Lines Deduction when filing their returns with the Division of Insurance. Instead, taxpayers calculate the amount that they collected to cover the cost of any other taxes and examination fees related to surplus lines policies. Taxpayers then subtract this amount from their surplus lines premiums, which are subject to the surplus lines premium tax, prior to reporting that amount to the Division of Insurance. Surplus lines insurance is typically procured through a licensed insurance broker, although the policyholder may also purchase it directly from the insurer. Therefore, in most cases, insurance brokers are responsible for paying the insurance premium tax on behalf of the policyholder. If an individual independently enters into a surplus lines insurance contract with an insurer, then the individual is responsible for remitting the premium tax. Either the broker or the individual procuring the insurance would apply the Surplus Lines Deduction.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the Surplus Lines Deduction. Based on the statutory language and stakeholder input, we inferred that the direct beneficiaries are brokers who procure surplus lines insurance for their customers and individuals who purchase surplus lines insurance directly from an insurer. Because brokers typically pass the insurance premium tax on to policyholders through higher premiums, the indirect beneficiaries are the individuals, businesses, and other organizations who benefit from lower insurance premiums from application of the surplus lines deduction.

According to the Insurance Information Institute, in 2017, the total United States surplus lines market consisted of almost $45 billion in premiums for policies written. EXHIBIT 1.2 shows the amount of surplus lines premiums for policies sold by brokers in Colorado over the last decade.

EXHIBIT 1.2. COLORADO SURPLUS LINES PREMIUMS [1]
CALENDAR YEARS 2008 THROUGH 2018



SOURCE: Division of Insurance data on surplus lines premiums for policies written during Calendar Years 2008 through 2018.
[1] Includes only surplus lines premiums sold by brokers. Individually procured premiums are not included and represent less than 1 percent of surplus lines premiums.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not directly state a purpose for the Surplus Lines Deduction. Based on our review of legislative history, other states' statutory language regarding surplus lines premiums, and stakeholder outreach, we inferred that the purpose of the Surplus Lines Deduction is to define the tax base for surplus lines premiums. Specifically, this deduction defines what amounts collected from surplus lines policyholders should be considered "premiums" subject to the State's surplus lines premium tax and excludes from taxable premiums the amounts collected from policyholders to pay taxes and fees that are levied in addition to the surplus lines premium tax.

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

We determined that the Surplus Lines Deduction is likely meeting its purpose, although it only applies to a limited number of premiums. Statute does not provide quantifiable performance measures for this deduction. Therefore, we created and applied the following performance measure to determine the extent to which the deduction is meeting its purpose:

PERFORMANCE MEASURE: *To what extent is the Surplus Lines Deduction used by taxpayers to avoid paying the state surplus lines premium tax on the amount collected to pay federal taxes, other state taxes, and examination fees?*

RESULT: The Surplus Lines Deduction is likely meeting its purpose under limited circumstances, although we were unable to quantify the extent to which it is being used. As discussed, the deduction applies to amounts collected to pay (1) federal taxes, (2) state taxes (in addition to the surplus lines premium tax), and (3) examination fees. Based on our review of state and federal law, federal excise taxes are the only type of tax or fee that applies to surplus lines insurance, other than the state surplus lines premium tax itself, and this would be the only type of tax collected that taxpayers could deduct from their taxable premiums using the Surplus Lines Deduction. Specifically, a federal excise tax may be levied on surplus lines premiums when policies are purchased from foreign insurers. The excise tax is 1 percent of the premium amount for reinsurance policies and 4 percent for casualty policies. However, most foreign insurers are exempt from this tax based on federal treaties. As a result, the deduction would not apply to insurance purchased from these exempt insurers and would only provide a benefit in limited circumstances where taxpayers purchase surplus lines insurance from a foreign insurer that is not exempt from federal excise tax under an applicable treaty.

Besides the federal excise tax, there are no other federal or state taxes (other than the surplus lines premium tax) or examination fees that apply to surplus lines premiums at this time. From 1982 through 2006, the Surplus Lines Association of Colorado, Inc. (Association) was responsible for the assessment and collection of premium taxes due on surplus lines insurance policies, as well as record keeping and financial management. During this time, the Association assessed an examination fee on gross premiums, which varied from 0.1 percent to 0.2 percent, to cover its administrative costs. During this period, the deduction allowed taxpayers to subtract the examination fee amount from their taxable premiums. However, in 2007, the Division of Insurance assumed premium tax assessment and collection responsibilities from the Association and discontinued the examination fee.

Because the Division of Insurance does not require taxpayers to report the amount they claimed for the Surplus Lines Deduction, we lacked data to measure the extent to which it has been used. According to a representative for a Colorado surplus lines industry stakeholder organization, the deduction helps establish a definition of the term "premiums" that aligns with the common understanding of the term in the industry because insurance brokers typically would not consider the amounts collected to pay the types of taxes and fees that are included in the deduction to be part of their premium collections. Thus, it appears that the deduction would likely be used by taxpayers when applicable. However, stakeholders indicated that it is uncommon for the federal excise tax to apply to surplus lines premiums for policies sold in Colorado by foreign insurers, since many are exempt from the excise tax under treaties and agreements with the federal government. Most likely, the deduction does not currently apply to any premiums, although it could be used in rare circumstances.

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

We were not able to estimate the revenue impact of the Surplus Lines Deduction due to a lack of data. However, the revenue impact appears to be minimal since the deduction only applies under limited circumstances and a representative of a Colorado surplus lines industry organization indicated that it is likely not used, or used only rarely. To estimate the potential maximum amount of the deduction, we calculated the revenue impact if all $916.7 million in premiums for surplus lines policies written in Colorado during Calendar Year 2018 were subject to the 4 percent federal excise tax. Under this scenario, the maximum revenue impact to the State if the Surplus Lines Deduction were applied to all of these premiums would be about $1.1 million. However, the actual amount claimed under the deduction is likely substantially less than this amount.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Surplus Lines Deduction would have a minimal immediate impact on beneficiaries and the insurance industry because the deduction has limited applicability and a representative of a Colorado surplus lines industry organization reported that it is likely not being used. Furthermore, even for insurance premiums that it may currently apply to, the deduction provides a relatively small tax benefit. For example, for a surplus lines policy with $1 million in annual premiums that is subject to the 4 percent federal excise tax, eliminating the deduction would increase the premium taxes due from the broker or policyholder from $30,000 to $31,200, an increase of $1,200.

Despite its limited current applicability, according to an industry representative, the deduction is helpful because it establishes a definition of "premiums" that aligns with industry practice. Further, the provision would help clarify the tax treatment of the amounts collected from policyholders if additional applicable taxes or fees were established in the future. As discussed, as recently as 2006, Colorado insurers were responsible for paying an examination fee and a similar fee is currently in place in 17 states. To demonstrate the potential impact on taxpayers if the deduction were no longer in place, in EXHIBIT 1.3 we provide a hypothetical calculation of the additional tax benefit of the deduction if the Division of Insurance had assessed a 0.1 percent examination fee, (the same rate assessed in 2006) on surplus lines premiums in Calendar Year 2018.

EXHIBIT 1.3. HYPOTHETICAL ADDITIONAL TAX BENEFIT OF THE SURPLUS LINES DEDUCTION IF AN EXAMINATION FEE HAD BEEN IN PLACE DURING CALENDAR YEAR 2018

SURPLUS LINES PREMIUMS WRITTEN	SURPLUS LINES PREMIUM TAX [1]	EXAMINATION FEE [2]	TAX BENEFIT OF THE SURPLUS LINES DEDUCTION [3]
$916.7 million	$27.5 million	$916,700	$27,501

SOURCE: Office of the State Auditor calculations based on Division of Insurance data.
[1] Surplus Lines Premium tax is 3 percent of the total premium amount written.
[2] The examination fee is calculated at 0.1 percent of the total premiums written.
[3] The tax benefit of the Surplus Lines Deduction is calculated as 3 percent (the surplus lines premium tax rate) of the hypothetical examination fee.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

All 50 states and the District of Columbia impose a tax on surplus lines premiums. These tax rates range from 1 percent in Iowa, to 6 percent in Alabama, Kansas, Oklahoma, and South Carolina. Thirteen states (excluding Colorado) have a provision similar to the Surplus Lines Deduction, with three states (Delaware, Idaho, and Washington) having identical deduction language to Colorado.

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.

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

The Division of Insurance was not able to provide information on the total number of taxpayers claiming the deduction or the amount claimed because taxpayers do not report this information when filing their insurance premium taxes. To have data on the number of taxpayers claiming the deduction and the amount claimed, the Division of Insurance would have to create a separate reporting line on its premium tax reporting form and require brokers and those who independently procure surplus lines coverage to report this information. However, since it is likely that only a limited number of taxpayers may claim the deduction, it may not be worthwhile for the Division of Insurance to collect this data.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to the Surplus Lines Deduction.