FRATERNAL SOCIETY EXEMPTION

EVALUATION SUMMARY

JANUARY 2019
2019-TE2

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2019

YEAR ENACTED	1883
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	$3.8 million (CALENDAR YEAR 2017)
NUMBER OF TAXPAYERS	35
AVERAGE TAXPAYER BENEFIT	$108,000
IS IT MEETING ITS PURPOSE?	Yes, but the insurance market has changed significantly since its enactment.

WHAT DOES THIS TAX EXPENDITURE DO?

The Fraternal Society Exemption exempts fraternal benefit societies (fraternals), which are social groups organized around a common bond that offer insurance products to their members, from insurance premium tax.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for this expenditure. We inferred that the purpose is to exempt fraternals from taxation because, historically, governments, including the State of Colorado, have considered fraternals to be beneficial to the public.

WHAT DID THE EVALUATION FIND?

We determined that the Fraternal Society Exemption is likely meeting its purpose since fraternals are claiming it and continue to provide insurance and conduct charitable activities. However, fraternals provide a much smaller share of the insurance market and have a significantly smaller economic and social impact today than they had during the time the exemption was created.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider reviewing the Fraternal Society Exemption due to its age and the large changes in the role of fraternals in society and the insurance industry since it was created to assess whether the exemption continues to serve a valid purpose.

FRATERNAL SOCIETY EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

In 1883, Colorado began levying a premium tax on insurance companies' in-state premiums, which are the revenues they collect for writing insurance policies covering property or risks in the State. Since 2000, this tax has been set at 2 percent of the premiums collected. The bill that created the premium tax, also created the original version of the Fraternal Society Exemption currently codified in Section 10-3-209(1)(d)(I), C.R.S., which exempts "fraternal benefit societies" (fraternals) from the tax.

Under Sections 10-14-101 and 102, C.R.S., for insurers to qualify as fraternals they must:

- Be "conducted solely for the benefit of [their] members and their beneficiaries."
- Operate as nonprofits.
- Operate through various parent and subordinate "lodges" or branches with a "ritualistic form of work."
- Have a representative form of government.
- Not issue stock.

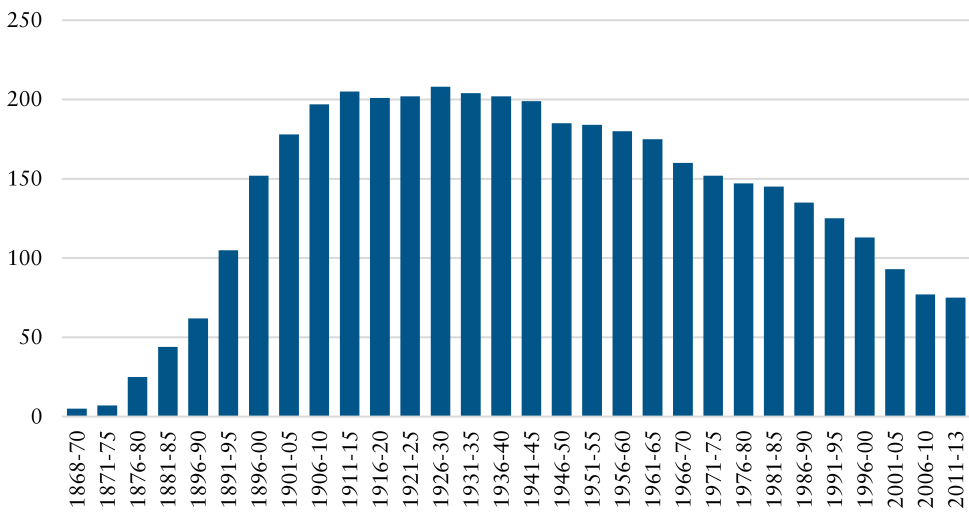
Fraternals must be licensed with the Division of Insurance, within the Department of Regulatory Agencies to claim the exemption, and are required to pay annual fees and abide by specific regulatory requirements, such as those outlining how they are governed and the amount of reserves they must hold.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

The intended beneficiaries of this expenditure are fraternals operating in Colorado, which are organized around a common bond shared by members, such as ethnic or religious ties. According to various studies of fraternals and historical publications, early fraternals typically restricted membership to males; however, all but one operating in Colorado now accept both male and female members. Fraternals are often modeled on older lodge-based organizations that typically did not offer insurance, like the Freemasons or Odd Fellows, and became common across the United States in the late-19th century, particularly during the period of industrialization. During this time, working-class families faced significant income-related risks due to potential layoffs, illnesses, retirement, infirmity, and death of the primary income earner. Fraternals helped reduce these income risks by providing early forms of unemployment, worker's compensation, health, accident, and life insurance, both by underwriting insurance policies and through informal, discretionary benefits, at a time when commercial insurance was either expensive or not available for workers and their families. They were also known for their social and charitable activities, with members often receiving other benefits as well, such as scholarship funds, free educational trainings, job exchanges, and access to events.

By 1895, fraternal societies wrote half of all life insurance policies in the United States, according to historical publications, and until the early 20th Century, many fraternals also offered their members early forms of health insurance through contracting with local physicians. By 1900, research compiled at the time estimated that 40 percent of adult male Americans were members of one or more fraternals. As shown in EXHIBIT 1.1, the number of fraternals in the United States began to decline in the 1930s. Based on academic publications we reviewed, this occurred because the Great Depression increased claims and reduced members' ability to pay dues; access to government welfare programs, affordable commercial insurance (including life insurance and healthcare), and affordable entertainment activities increased; and states also started increasing fraternals' reserve and deposit requirements. This period coincided with a reduction in the number of members in fraternals, as well. In addition, many fraternals de-emphasized their social and ceremonial aspects over time and other fraternals shed their rituals and lodge structures altogether and became commercial mutual insurers, which are not eligible for the exemption.

EXHIBIT 1.1.
NUMBER OF US FRATERNALS IN OPERATION
1868-2013



SOURCE: "Close Cousins of Cooperatives: an Overview of Fraternal Benefit Societies" by James M. White and Michael A. Boland, *Journal of Cooperatives*, volume 31, 2016.

As of August 2018, of the 72 fraternals in the United States, 35 operate in Colorado. These 35 fraternals—30 of which began operating in Colorado before 1917—have 319 lodges that serve about 116,000 members across the state and received $189 million in premiums from their Colorado members in Calendar Year 2017. According to the Division, in Calendar Year 2017:

- 34 fraternals wrote life insurance policies.

- 30 fraternals wrote annuity contracts, which provide a future income stream to investors in exchange for an advance payment or payments.

- 14 fraternals wrote accident and health insurance policies.

In addition, some fraternals also offer different products, such as disability insurance, Medicare supplement insurance, and pre-need funeral coverage. Life insurance and annuities constituted 87 percent of the total premiums fraternals received during this time period.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for this tax expenditure. Based on the enactment date, historical context, and other states' tax expenditure evaluations, we inferred that the purpose is to exempt fraternals from taxation due to the societal benefits they provide. Because the expenditure was created concurrently with the establishment of the State's insurance premium tax, it appears that the exemption was not intended to provide a new tax benefit for charitable organizations, but instead to define which entities and individuals would be subject to the tax. In the United States, there is a well-established history of providing preferential tax treatment to fraternals—similar to the tax treatment that charitable and non-profit organizations receive—because governments have considered them to be beneficial to the public due to their insurance, social, and charitable activities. Therefore, tax exemptions for fraternal organizations are a common structural element within many states' tax codes.

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

We determined that the Fraternal Society Exemption is meeting its purpose because Colorado fraternals are using it to avoid paying insurance premium tax. In addition, many fraternals continue to provide societal benefits, though the extent of their insurance benefits are unclear as the insurance industry has changed significantly since the exemption was created.

Statute does not provide any performance measures for the expenditure.

Therefore, we created and applied the following performance measures to determine the extent to which the expenditure is meeting its purpose.

PERFORMANCE MEASURE #1: *To what extent has the Fraternal Society Exemption been used by fraternals?*

RESULT: We found that the exemption is likely being used by all 35 of the fraternals that have lodges and policyholders in Colorado. We spoke to staff from the two fraternals headquartered in Colorado, as well as a number of insurance stakeholders representing all fraternals, and they were all aware of the exemption. Our interviews with Division of Insurance staff also indicated that Colorado fraternals that receive insurance premiums are taking the exemption.

PERFORMANCE MEASURE #2: *To what extent are fraternals providing societal benefits through their insurance, social, and charitable activities?*

RESULT: We found that, collectively, fraternals continue to provide benefits to society through their insurance, and social and charitable activities, but to a significantly lesser extent relative to their impact at the height of their popularity in the late 1800's and early 1900's. Specifically, based on information from the American Fraternal Alliance, there are 116,000 members of fraternals in Colorado, or 2.7 percent of the State's adult population of about 4.3 million. Although we lacked historical data on fraternal membership in Colorado, our review of publications on the history of fraternals indicated that at their peak, between 33 to 40 percent of adult males in the United States, or about 16.5 to 20 percent of the total population, were members of fraternals. Similarly, the proportion of insurance policies provided by fraternals has declined substantially. Historical publications indicate that as much as 50 percent of the life insurance policies in the United States were once provided by fraternals. In Colorado, as of Calendar Year 2017, about 2.4 percent of all life insurance policies were purchased through fraternals.

Despite their decline in membership and insurance market share, we found that many fraternals continue to provide social and charitable benefits to the State. Specifically, according to the American Fraternal Alliance, fraternal organizations and their members provided about $8.1 million in charitable contributions and 1.3 million volunteer hours statewide in Calendar Year 2017. Moreover, fraternals often provide benefits that are not part of the insurance contract and for which a premium payment is not charged, such as infant death payments, orphaned children payments, and scholarships for current members and/or their spouses and children. However, as discussed below, there is some evidence suggesting that fraternal insurance policies may no longer be less expensive than commercial alternatives.

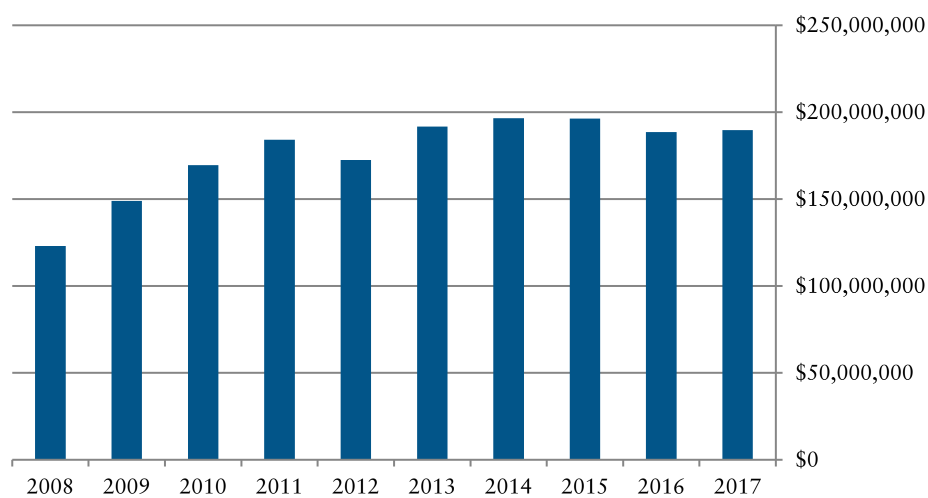
WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURE?

THE FRATERNAL SOCIETY EXEMPTION HAD A REVENUE IMPACT TO THE STATE OF $3.8 MILLION IN CALENDAR YEAR 2017. We used data from the Division of Insurance to estimate this revenue impact. Specifically, we calculated the premium tax that would be due if fraternals were not exempt based on the $189 million in premiums that the 35 fraternals wrote on Colorado policies multiplied by the 2 percent insurance premium tax rate. The revenue impact to the State is also equivalent to how much money the policyholders of these fraternals may save, since premium tax is typically passed on to those who purchase insurance policies. This impact varies greatly depending on the insurer—particularly since just three fraternals accounted for 90 percent of fraternal premiums in Colorado in 2017—and ranged from zero dollars for a fraternal that wrote no Colorado premiums to $2.6 million for a fraternal that wrote $128.8 million in premiums. EXHIBIT 1.2 provides the direct state revenue impact and the average savings realized by the eligible beneficiaries.

EXHIBIT 1.2. STATE REVENUE IMPACT OF FRATERNAL SOCIETY EXEMPTION CALENDAR YEAR 2017		
NUMBER OF FRATERNALS CLAIMING EXEMPTION	STATE REVENUE IMPACT	STATE REVENUE IMPACT PER FRATERNAL
35	$3.8 million	$108,000
SOURCE: Office of the State Auditor analysis of data from the Division of Insurance.		

Despite the historical decline in the number of insurance policies provided by fraternals, the total premiums collected by fraternals, which correlates with the revenue impact of the Fraternal Society Exemption, has been relatively stable in recent years. As shown in EXHIBIT 1.3, fraternal premiums grew slightly from Calendar Year 2009 to 2011, and have remained at a similar amount through 2017.

EXHIBIT 1.3.
PREMIUMS FROM FRATERNALS IN COLORADO



SOURCE: Data from the National Association of Insurance Commissioners.

Overall, the Fraternal Society Exemption likely has little impact on the insurance industry or Colorado citizens' ability to afford insurance. Specifically, the $3.8 million in tax savings fraternals received represents less than 0.1 percent of the $35.8 billion in insurance premiums collected in the State. Furthermore, because fraternals only write a small portion of insurance in Colorado, the exemption likely has little impact on the availability or cost of insurance in the state.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Fraternal Society Exemption would result in a higher tax burden for fraternals doing business in Colorado. However, who would experience the specific impact of eliminating the exemption would depend on how fraternals compensate for this additional expense. For example, since many fraternals (and their chapters) have charitable arms, they could compensate for the additional cost by reducing the amount of money and volunteer time they contribute to their communities. They may also reduce other non-insurance benefits available to members, such as aid for lower-income members and members experiencing a significant crisis. In addition, the fraternals could compensate for the additional cost by increasing insurance premiums paid by members. All of the stakeholders we contacted said that this exemption is beneficial for Colorado's insurance sector.

Eliminating the exemption could also result in a higher tax burden for the two Colorado-domiciled fraternals 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, 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. Colorado's retaliatory provision is located at Section 10-3-209(2), C.R.S. Since eliminating the exemption would increase the effective tax rate of all fraternals licensed in Colorado, it is possible that other jurisdictions would respond by raising taxes on Colorado-domiciled fraternals doing business in their states. Eliminating the exemption might also slightly increase the accounting burden on fraternals, given that many other states also offer a similar exemption.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Provisions similar to the Fraternal Society Exemption exist in all states and the District of Columbia, although other states sometimes tax insurers in different ways. For example, 10 states impose both premium taxes and income taxes on insurers, and many subject insurers to different rates depending on their line of business. One state, North Carolina, limits its exemption to fraternals who only issue policies to members (and not, for instance, family members or other dependents of members).

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

Fraternals are also exempt from state and federal income taxes, per Section 39-22-112(1), C.R.S., and Internal Revenue Code (IRC) 501(c)(8). The eligibility requirements of the federal exemption largely mirror that of the state exemption. However, unlike charitable organizations that are governed by section 501(c)(3) of the IRC, since a 1996 Colorado Supreme Court ruling, fraternals have not been eligible for the Sales to Charitable Organizations sales tax exemption provided by Section 39-26-718(1)(a), C.R.S., which means that they must pay sales tax on all goods and services they purchase in Colorado. In addition, taxpayers are also unable to deduct donations to a fraternal from their state and federal income tax liability, unless that fraternal created a 501(c)(3) charity.

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

We did not identify any data constraints while conducting this evaluation.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER REVIEWING THE FRATERNAL SOCIETY EXEMPTION DUE TO ITS AGE AND THE LARGE CHANGES IN THE ROLE OF FRATERNALS IN SOCIETY AND THE INSURANCE INDUSTRY SINCE IT WAS CREATED TO ASSESS WHETHER THE EXEMPTION CONTINUES TO SERVE A VALID PURPOSE. As discussed, membership in fraternals has declined significantly and fraternals now provide a much smaller share of the insurance market than they once did during the late 1800's and early 1900's. In addition, there now exist private and public sector safety nets for workers, such as more affordable commercial insurance, employer-provided group insurance, worker's compensation insurance, Social Security, Medicaid, Medicare, and the Supplemental Nutrition Assistance Program that significantly reduce the demand for fraternal insurance. Furthermore, while some studies from the late 19th and early 20th centuries suggest that fraternals offered less expensive insurance at that time, a 1993 Treasury Department study, as well as information provided by industry stakeholders suggests that fraternal insurance policies may currently be priced on par with or be even more expensive than commercial policies. However, because fraternals continue to conduct social and charitable activities, and operate as non-profits, the original purpose of the exemption may still apply to the extent that it was intended to benefit fraternals due to these aspects of their operations.