UNAUTHORIZED INSURANCE PREMIUM TAX EXPENDITURES

JANUARY 2020
2020-TE1

EVALUATION SUMMARY

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2020

	FEDERAL PREMIUM, EXCISE, AND STAMP TAX DEDUCTION	INDEPENDENTLY-PROCURED INSURANCE EXEMPTION	EDUCATIONAL AND SCIENTIFIC INSTITUTION LIFE INSURANCE EXEMPTION
YEAR ENACTED	1967	1967	1967
REPEAL/EXPIRATION DATE	None	None	None
REVENUE IMPACT	Could not determine	Could not determine	$0
NUMBER OF TAXPAYERS	Could not determine	Could not determine	0
AVERAGE TAXPAYER BENEFIT	Could not determine	Could not determine	None
IS IT MEETING ITS PURPOSE?	Could not determine	Could not determine	No, because it is not being used

WHAT DO THESE TAX EXPENDITURES DO?

These tax expenditures relate to unauthorized insurance, which is insurance sold by insurers not legally authorized to sell insurance in the state, but for which a limited number of policies are lawfully sold.

FEDERAL PREMIUM, EXCISE, AND STAMP TAX DEDUCTION [Section 10-3-909(1), C.R.S.] allows a deduction for the amount of premiums on which certain other federal or non-federal taxes were paid if such taxes were 2.25 percent or more.

INDEPENDENTLY-PROCURED INSURANCE EXEMPTION [Section 10-3-909(1), C.R.S.] exempts premiums from unauthorized insurance premium tax *if the taxpayer already* paid regular or surplus lines premium tax on the unauthorized insurance premiums.

EDUCATIONAL AND SCIENTIFIC INSTITUTION LIFE INSURANCE EXEMPTION [Section 10-3-910(3), C.R.S.] exempts premiums paid to non-profit life insurers organized and operated exclusively to assist non-profit educational or scientific institutions (or their employees) from unauthorized insurance premium tax.

WHAT DID THE EVALUATION FIND?

We did not find evidence that any of these tax expenditures are currently meeting their purposes, since they either can only be used under limited circumstances or not at all.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

FEDERAL PREMIUM, EXCISE, AND STAMP TAX DEDUCTION. [Section 10-3-909(1), C.R.S.]—We inferred that the purpose of this deduction is to exempt industrial insureds from the unauthorized insurance premium tax if they had already paid at least 2.25 percent in taxes on the premiums to at least one government entity (i.e., state, local, federal governments), thereby demonstrating that they did not purchase unauthorized insurance as a way to avoid paying taxes.

INDEPENDENTLY-PROCURED INSURANCE EXEMPTION. [Section 10-3-909(1), C.R.S.]—We inferred that the purpose of this exemption is to avoid double taxing unauthorized insurance premiums.

EDUCATIONAL AND SCIENTIFIC INSTITUTION LIFE INSURANCE EXEMPTION. [Section 10-3-910(3), C.R.S.]—We inferred that the purpose of this exemption is to prevent insurance purchased by nonprofit, educational and scientific institutions and sold by specialized nonprofit insurers from being treated as unauthorized insurance.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider the following:

- Repealing or modifying the Federal Premium, Excise, and Stamp Tax Deduction because it does not appear to align with other insurance provisions in its treatment of unauthorized insurance.
- Repealing the Educational and Scientific Life Insurance Deduction because it is not being used and there are currently no eligible insurers.
- Evaluating whether the unauthorized insurance premium tax rate is accomplishing its purpose, since unauthorized insurance is taxed at a lower rate than other similar forms of insurance.

UNAUTHORIZED INSURANCE PREMIUM TAX EXPENDITURES

EVALUATION RESULTS

WHAT ARE THESE TAX EXPENDITURES?

This evaluation covers three tax expenditures related to unauthorized insurance. Unauthorized insurance is insurance sold by insurance companies or brokers that are not licensed or otherwise authorized to sell insurance under the State's insurance laws and regulations. Section 10-3-104, C.R.S., generally prohibits the purchase or sale of unauthorized insurance, stating that "it is unlawful for any person, company, or corporation in this state to procure, receive, or forward applications for insurance in, or to issue or deliver policies for, any company not legally authorized to do business in this state." However, certain types of specialized insurance, typically purchased by businesses, are exempted from this prohibition under the provisions of Title 10, Articles 5 and 15, and part 9 of Article 3, C.R.S.

In 1955, the General Assembly passed House Bill 55-302, the Regulation of Unauthorized Insurance Act (codified at Section 10-30-901 et seq., C.R.S.). This legislation created a regulatory framework intended to allow the State, and residents who may have unknowingly purchased unauthorized insurance, to more effectively litigate against insurers issuing fraudulent insurance policies and insurers not operating within the State's insurance regulations. In 1967, House Bill 67-1491 updated the Regulation of Unauthorized Insurance Act and established the unauthorized insurance premium tax, which was intended to "[protect] the premium tax revenues of this state" [Section 10-3-902, C.R.S.], by levying a 2.25 percent tax on unauthorized insurance premiums [Section 10-3-909(1), C.R.S.]. This tax is to be paid by the policyholder or the broker they use. In addition to unauthorized insurance purchased or sold unlawfully, under Section 10-3-910(1), C.R.S., "industrial insureds," which are larger companies that (1) employ a full time insurance manager, (2) have aggregate annual premiums of at least $100,000, and (3) employ at least 100 full-time employees, may purchase unauthorized insurance but must also pay the unauthorized insurance premium tax. However, the insurance they purchase is not otherwise subject to regulation under the Regulation of Unauthorized Insurance Act.

Statute provides the following three tax expenditures that reduce taxpayers' unauthorized insurance premium tax liability:

1. **FEDERAL PREMIUM, EXCISE, AND STAMP TAX DEDUCTION [SECTION 10-3-909(1), C.R.S.].** Policyholders (or their insurance brokers) can deduct from their taxable unauthorized insurance premiums, the amount of any premiums on which federal premium tax, federal or non-federal excise tax, or federal or non-federal stamp tax was already paid, if such tax was 2.25 percent or more. Stamp taxes are also known as "examination fees" and may be charged by some government entities to cover the cost of administering insurance regulations.

2. **INDEPENDENTLY-PROCURED INSURANCE EXEMPTION [SECTION 10-3-909(1), C.R.S.].** Policyholders who procure unauthorized insurance directly from an insurer (rather than through a broker) are exempt from unauthorized insurance premium tax *if they already paid* regular or surplus lines premium tax on the unauthorized insurance premiums.

3. **EDUCATIONAL AND SCIENTIFIC INSTITUTION LIFE INSURANCE EXEMPTION [SECTION 10-3-910(3), C.R.S.].** Policyholders (or their insurance brokers) are exempt from unauthorized insurance premium tax on premiums or annuity payments paid to non-profit life insurers organized and operated exclusively to assist non-profit educational or scientific institutions (or their employees).

The 2.25 percent unauthorized insurance premium tax and its related tax expenditures only apply to premiums paid to unauthorized insurers.

Unauthorized insurers are those that have not been licensed by the Division of Insurance, and that have not met the requirements to be on a list of "non-admitted" insurers who are approved by the commissioner of insurance or be included on the National Association of Insurance Commissioners (NAIC) list of eligible foreign insurers (these are also known as "surplus lines" insurers, which typically offer specialized, high-risk policies). Insurance sold by licensed insurers is generally subject to the 2 percent insurance premium tax and surplus lines insurance is subject to a 3 percent surplus lines insurance premium tax.

In order to claim any of the unauthorized insurance premium tax expenditures, policyholders or brokers are required to do the following:

FEDERAL PREMIUM, EXCISE, AND STAMP TAX DEDUCTION. The taxpayer decreases their unauthorized insurance premium amount by the amount of any premiums that were subject to a federal premium tax, or federal or state excise or stamp tax prior to reporting their premiums to the Division of Insurance on its Unauthorized Insurance Premium Tax Reporting Form.

INDEPENDENTLY-PROCURED INSURANCE EXEMPTION. To qualify for this exemption, the taxpayer must have already paid either the State's insurance premium tax for licensed insurers or the surplus lines insurance premium tax. If the taxpayer has filed and paid one of these taxes, then they are not required to pay the unauthorized insurance premium tax or file the Unauthorized Insurance Premium Tax Reporting Form.

EDUCATIONAL AND SCIENTIFIC INSTITUTION LIFE INSURANCE EXEMPTION. Non-profit life insurers that wish to qualify for this exemption must pay an annual registration fee of $5,000 and file a copy of their policies and financial statements with the Division of Insurance. Once they have met these requirements, non-profit life insurers are no longer considered unauthorized insurers and do not have to pay the unauthorized insurance premium tax or file the Unauthorized Insurance Premium Tax Reporting Form.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not explicitly identify the intended beneficiaries of the unauthorized insurance premium tax expenditures. Based on statute, legislative history, and stakeholder input, we inferred that the beneficiaries of the Federal Premium, Excise, and Stamp Tax Deduction and Independently-Procured Insurance Exemption are businesses that can legally purchase unauthorized insurance, such as those that qualify as industrial insureds, who have procured insurance through an unauthorized insurer and who, according to Section 10-3-910(1), C.R.S., are liable for paying the unauthorized insurance premium tax. Although the expenditures would also apply to unlawfully purchased insurance, Division of Insurance staff indicated that the unauthorized insurance premiums that are reported, and for which taxes are paid, are likely not for illegal insurance, but are instead, for specialized insurance purchased by large companies, such as those that qualify as industrial insureds and can legally purchase such policies.

For the Educational and Scientific Institution Life Insurance Exemption [Section 10-3-910(3), C.R.S.], we inferred that the intended beneficiaries include non-profit life insurers organized to assist non-profit, educational or scientific institutions, the institutions themselves, and their employees, who would benefit from the insurance policies.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Statute does not explicitly state a purpose for any of the unauthorized insurance premium tax expenditures. Based on our review of statute, legislative history, and stakeholder input, we inferred the following purposes for each expenditure:

FEDERAL PREMIUM, EXCISE, AND STAMP TAX DEDUCTION [Section 10-3-909(1), C.R.S.]. Based on the operation of the statute and discussions with Division of Insurance staff, we inferred that the purpose was to exempt industrial insureds from the unauthorized insurance premium tax if they had already paid at least 2.25 percent in taxes on the premiums to at least one government entity (i.e., state, local, federal governments). This appears intended to ensure that unauthorized insurance is subject to a tax like other forms of insurance in the state, but to avoid applying the State's unauthorized insurance premium tax to taxpayers who demonstrate that they are not purchasing unauthorized insurance as a way to avoid taxes altogether or to obtain a tax rate lower than the State's.

INDEPENDENTLY-PROCURED INSURANCE EXEMPTION [Section 10-3-909(1), C.R.S.]. We inferred that the purpose of this exemption is to avoid double taxing unauthorized insurance premiums, since to qualify for the exemption, taxpayers must have paid either the State's insurance premium tax for licensed insurers or surplus lines insurance premium tax. This appears to be a structural provision that helps clarify the application of insurance taxes.

EDUCATIONAL AND SCIENTIFIC INSTITUTION LIFE INSURANCE EXEMPTION [Section 10-3-910(3), C.R.S.]. We inferred that the purpose of this exemption is to prevent insurance purchased by nonprofit, educational and scientific institutions and sold by specialized nonprofit insurers from being treated as unauthorized insurance. Specifically, the provision exempts this type of insurance from the entire Regulation of Unauthorized Insurance Act [Section 10-3-901 et seq., C.R.S.], which includes provisions related to the State asserting jurisdiction over unauthorized insurance, in addition to the unauthorized insurance premium tax.

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

We did not find evidence that any of these tax expenditures are meeting their purposes. Statute does not provide quantifiable performance measures for these tax expenditures. Therefore, we created and applied the following performance measure to determine the extent to which the expenditures are meeting their purposes.

PERFORMANCE MEASURE: *To what extent are the **UNAUTHORIZED INSURANCE PREMIUM TAX EXPENDITURES** being used by taxpayers?*

RESULTS: FEDERAL PREMIUM, EXCISE, AND STAMP TAX DEDUCTION [Section 10-3-909(1), C.R.S.]. This deduction is likely only being used under limited circumstances. We found that the only tax other than the State's unauthorized insurance premium tax that could potentially apply to unauthorized insurance premiums, thereby qualifying the premiums for the deduction, is the federal foreign insurer excise tax under 26 USC 4731. This provision levies a 4 percent tax on casualty insurance premiums of foreign insurers that are not already exempted from the federal excise tax, either through treaties between the U.S. and the insurer's country of domicile or through an agreement between the U.S. Internal Revenue Service and the individual foreign insurer. It is possible that the federal excise tax could apply to unauthorized insurance premiums sold in Colorado since unauthorized insurance is typically procured through a foreign insurer. However, we could not determine if any unauthorized insurance policyholders are claiming the deduction because the Division of Insurance does not collect the data from taxpayers on its use.

INDEPENDENTLY-PROCURED INSURANCE EXEMPTION [Section 10-3-909(1), C.R.S.]. We could not determine whether this tax expenditure is meeting its purpose because the Division of Insurance does not collect data on its use and we lacked information necessary to determine whether it is being used by taxpayers. This exemption is difficult to evaluate because taxpayers who would qualify for it, that is, those taxpayers who procured unauthorized insurance without the use of a broker and filed and paid the insurance premium taxes that are intended to apply to licensed insurers or surplus lines insurers, may have been unaware that they were purchasing unauthorized insurance. According to the Division of Insurance, taxpayers are responsible for determining whether the insurance they are purchasing is from a licensed insurer or surplus lines insurer authorized to sell insurance in the state. Though it appears that the circumstances to which it would apply would occur infrequently, this structural expenditure may serve its purpose by clarifying the tax treatment of unauthorized premiums for which regular or surplus lines insurance premium taxes have been paid.

EDUCATIONAL AND SCIENTIFIC INSTITUTION LIFE INSURANCE EXEMPTION [Section 10-3-910(3), C.R.S.]. We found that this tax expenditure is not currently meeting its purpose because it is not being used. The Division of Insurance reported that since at least 2008, no insurers have complied with the statutory regulations required to provide this specific type of life insurance coverage in the state. In addition, we spoke with the Colorado Nonprofit Association and confirmed that they do not currently have an insurance subsidiary that could provide this type of coverage for its constituents and currently has no plans to create one.

Despite the exemption's current lack of applicability, it was likely intended to serve a function beyond providing a tax exemption since it clarifies the types of insurance that are subject to regulation as unauthorized insurance. Therefore, it may serve this purpose in the future, but only if qualifying non-profit insurers are established in the state.

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

We were not able to estimate the revenue impact of the Federal Premium, Excise, and Stamp Tax Deduction or the Independently-Procured Insurance Exemption because the Division of Insurance does not receive information from taxpayers on their usage. However, if the tax expenditures are resulting in a revenue impact, it is likely minimal because unauthorized insurance is used infrequently. Specifically, Division of Insurance data show that, from July 2015 to March 2019, taxpayers reported procuring 58 policies through unauthorized insurers worth about $3.3 million in written premiums. For these policies, the Division of Insurance collected just over $79,000 in unauthorized insurance premium tax payments.

In addition, we were able to confirm that there has been no revenue impact due to the Educational and Scientific Institution Life Insurance

Exemption since there are no insurers operating in the state that can provide life insurance policies complying with the requirements of the exemption.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

Eliminating these tax expenditures would have a limited impact on beneficiaries because they are all either not used or likely only used minimally, and under limited circumstances.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

FEDERAL PREMIUM, EXCISE, AND STAMP TAX DEDUCTION. Of the 49 states (excluding Colorado) and the District of Columbia that levy an insurance premium tax, we identified no other states that provide an expenditure similar to the Federal Premium, Excise, and Stamp Tax Deduction for unauthorized insurance.

INDEPENDENTLY-PROCURED INSURANCE EXEMPTION. Our review found that six other states include an exemption similar to the Independently-Procured Insurance Exemption that limits taxpayers' liability for unauthorized insurance tax if they have paid other insurance taxes.

EDUCATIONAL AND SCIENTIFIC INSTITUTION LIFE INSURANCE EXEMPTION. We identified 11 states that exempt nonprofit life insurers organized and operated exclusively to assist nonprofit educational or scientific institutions from unauthorized insurance regulations in the state, but do not exempt premiums or annuity payments from taxation and require these insurers to pay a separate tax. Only one state (Alabama) has a provision exempting insurance purchased by non-profit educational and scientific institutions from premium tax altogether.

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

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

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

The Division of Insurance does not collect information on the Federal Premium, Excise, and Stamp Tax Deduction or the Independently-Procured Insurance Exemption from taxpayers in their premium tax filings. Specifically, taxpayers subtract the value of both tax expenditures prior to filing their premium taxes with the Division of Insurance. In cases where these provisions completely offset any premiums subject to the unauthorized insurance tax, the taxpayer would not file an unauthorized insurance premium tax reporting form with the Division of Insurance. To collect this information, the Division of Insurance would need to add fields to its unauthorized insurance premium tax reporting form to collect this data from policyholders. However, this may result in a higher administrative burden for taxpayers and the Division of Insurance would incur additional costs to make this administrative change. Furthermore, for the Independently-Procured Insurance Exemption, taxpayers who qualify may not be aware that they purchased unauthorized insurance and that the provision limits their tax liability; therefore, additional reporting requirements may not provide adequate data to evaluate its use.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER REPEALING OR MODIFYING THE FEDERAL PREMIUM, EXCISE, AND STAMP TAX DEDUCTION. As discussed, we could not determine whether this deduction is meeting its purpose, though it likely only applies to limited circumstances where unauthorized insurance is purchased from a foreign insurer who is subject to a federal excise tax over 2.25 percent. In addition, this deduction appears to be inconsistent with the tax treatment of other forms of insurance. Specifically, taxpayers who purchase surplus lines insurance, which is a more commonly used form of specialized insurance typically purchased by businesses, cannot deduct the value of premiums that were subject to taxes by other government entities. Instead, taxpayers who purchase surplus lines insurance that is subject to taxes other than the State's premium tax can only deduct the amount of the other taxes (not the entire premiums subject to the other taxes) as provided in Section 10-5-111, C.R.S.

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER REPEALING THE EDUCATIONAL AND SCIENTIFIC INSTITUTION LIFE INSURANCE EXEMPTION. As discussed, this exemption is not currently accomplishing its purpose as a tax expenditure because it hasn't been used since at least 2008, and there are currently no non-profit insurers that meet the requirements to claim it. However, despite the exemption's current lack of applicability, it was likely intended to serve a function beyond providing a tax exemption since it clarifies the types of insurance that are subject to regulation as unauthorized insurance. Therefore, the General Assembly may wish to leave it in place to define the types of insurance that are treated as unauthorized insurance in the event that there are eligible insurers in the state in the future.

THE GENERAL ASSEMBLY MAY WANT TO EVALUATE WHETHER THE UNAUTHORIZED INSURANCE PREMIUM TAX RATE IS ACCOMPLISHING ITS PURPOSE. In 1967, the year that the 2.25 percent unauthorized insurance premium tax was established, the surplus lines premium tax rate was 2 percent, which could indicate that the General Assembly originally wanted to tax unauthorized insurance at a higher rate than other forms of insurance. However, in 1992, the General Assembly increased the surplus lines premium tax rate to 3 percent, but made no changes to the unauthorized insurance premium tax rate.

Division of Insurance staff indicated that in recent years the taxpayers who have paid unauthorized insurance premium taxes typically have purchased insurance from unauthorized insurance companies domiciled outside the U. S. that operate similarly to surplus lines insurers, but that have not met the requirements to legally sell surplus lines insurance in Colorado. Therefore, it is unclear whether the lower rate for unauthorized insurance is consistent with the General Assembly's intent. To address this uneven treatment, the General Assembly could consider increasing the unauthorized insurance tax rate. The District of

Columbia and 44 other states tax unauthorized and surplus lines insurance at the same rate.