Structural Insurance Premium Tax Expenditures

OFFICE OF THE STATE AUDITOR
COLORADO

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Colorado levies a 2 percent insurance premium tax on the premiums insurers collect from policyholders in the state. The Structural Insurance Premium Tax Expenditures help define the State's system for taxing insurers and establish the amount of premiums that are subject to the insurance premium tax. The tax expenditures include:

- The Insurance Premium Income Tax Exemption, which exempts insurers from the State's corporate income tax.
- The Return Premium and Early Termination Deductions, which allows insurers to deduct premiums that they later refunded to policyholders when calculating the premium amount that is subject to the premium tax.
- The Reinsurance Deduction, which exempts reinsurance (i.e., insurance premiums assumed by another insurer) from the premium tax.

Together these expenditures prevent the double taxation of insurers and define the premiums that are taxable in Colorado.

The Structural Insurance Tax Expenditures are meeting their purpose because insurers are generally aware of and using them.

Insurers and the Division of Insurance reported that these tax expenditures are commonly used in Colorado and we found that they are also common in other states. Insurers account for refunded and returned premiums, as well as reinsurance as part of their financial reporting processes. Therefore, the state deductions are already subtracted from total premiums prior to reporting their taxable premiums to the Division of Insurance.

Policy Considerations

We did not identify any policy considerations in this evaluation.

	Insurance Premium Income Tax Exemption	Return Premium Deduction	Early Termination Deduction	Reinsurance Deduction
Tax Type:	**Income**	**Insurance Premiums**	**Insurance Premiums**	**Insurance Premiums**
Expenditure Type:	**Exemption**	**Deduction**	**Deduction**	**Deduction**
Statutory Citation:	**Section 39-22-112(1), C.R.S.**	**Section 10-3-209(1)(a), C.R.S.**	**Section 10-3-209(1)(a), C.R.S.**	**Section 10-3-209(1)(a), C.R.S.**
Year Enacted:	**1937**	**1913**	**1973**	**1913**
Repeal/Expiration Date:	**None**	**None**	**None**	**None**
Revenue Impact:	**We could not determine**	**We could not determine**	**We could not determine**	**We could not determine**

Purpose given in statute or enacting legislation? **No**

Structural Insurance Premium Tax Expenditures

Background

Colorado levies an insurance premium tax (generally set at 2 percent) on the premiums insurers collect from policyholders in the state. Most types of insurance sold in the state, including property and casualty (e.g., auto and homeowners' insurance), life, health, and title insurance are subject to the insurance premium tax. This evaluation covers four tax expenditures—referred to collectively as the Structural Insurance Premium Tax Expenditures—that help define the State's system for taxing insurers and establish the amount of premiums that are subject to the insurance premium tax.

The Insurance Premium Income Tax Exemption exempts insurance companies from the state corporate income tax because they are instead subject to the insurance premium tax. Colorado created the insurance premium tax in 1913, before it established a corporate income tax. In 1937, when Colorado adopted an income tax, the law included the Insurance Premium Income Tax Exemption to exempt insurers from paying income tax. Due to operational and accounting differences in the insurance industry, taxing insurers using a premium tax can be less complicated to compute, collect, and administer, and provides a more stable source of revenue for the State compared to a state income tax. Specifically, insurers need to maintain funds in reserve to pay off future claims and benefits of policyholders; however, the unpredictable timing and amount of future claims and benefits payments can make it difficult to determine how much of the premiums collected by insurers and held in reserve will ultimately result in net income to the company after it makes payments to policy holders. Consequently, it is difficult to compute the taxable income of insurers while allowing for needed reserves.

Technical Notes

Captive insurers (i.e. subsidiary insurers that provide insurance to their non-insurance parent company) with a majority of their income not from insurance premiums do not qualify for the Insurance Premium Income Tax Exemption and instead pay corporate income taxes.

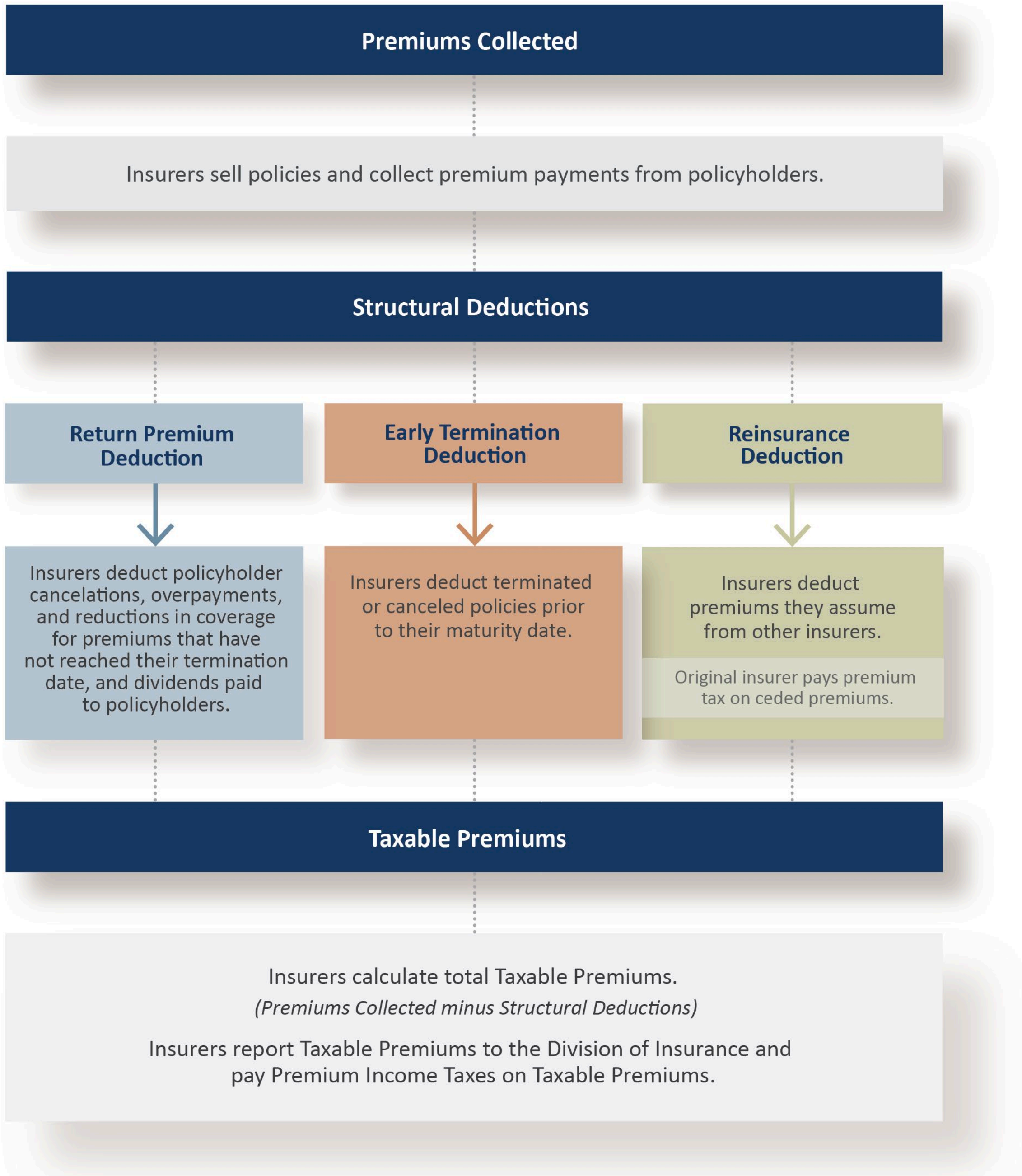
The Return Premium Deduction allows insurers a deduction for premiums they returned or credited to policyholders. The Return Premium Deduction includes dividends or unabsorbed premiums or premium deposits that were returned or credited to policyholders.

The Early Termination Deduction allows insurers to subtract premiums that were terminated or cancelled prior to their maturity date. The Early Termination Deduction applies to credit life, credit accident, and health insurance policies. Credit insurance policies are occasionally taken out by debtors in conjunction with their credit cards, auto loans, and mortgages to ensure that their debt is paid off in case they die (in the case of credit life) or become ill or injured and, consequently, unable to work (in the case of credit accident).

The Reinsurance Deduction allows reinsurers to deduct reinsurance premiums they receive from other insurers because the initial insurer is responsible for the premium tax. Reinsurance serves as insurance for insurance companies. Insurance companies that issue polices and wish to transfer the policies' risk can purchase reinsurance, which requires them to pay a premium to the reinsurer, effectively transferring some or all of the premiums they receive on the original policy. Insurance companies purchase reinsurance, which is commonly used within the industry, to expand their capacity to write additional policies, stabilize underwriting results, access additional financing, provide catastrophe protection, withdraw from a class of business, spread risk, or acquire expertise.

Exhibit 1 shows how insurers write premiums and account for the Structural Insurance Premium Tax Expenditures on their financial statements to determine their premium tax liability which is reported and remitted to the Division of Insurance (Division).

Exhibit 1
Determining Insurers Premium Tax Liability



Source: Section 10-3-209(1)(a), C.R.S., and Office of the State Auditor analysis of the operation of the Structural Insurance Premium Deductions.

We considered the intended beneficiaries of the Structural Insurance Premium Tax Expenditures to be insurance companies that are subject to the State's insurance premium tax. In Calendar Year 2021, there were 1,517 insurance companies required to file premium taxes in Colorado, and a total of $51 billion in premiums paid by Colorado consumers. According to Office of the State Controller, the State collected $336.3 million in insurance premium taxes in Fiscal Year 2021.

While statute does not state a purpose for the Structural Insurance Premium Tax Expenditures, based on our review of their operation and legislative history, we considered them to have the following purposes:

- **The Insurance Premium Income Tax Exemption avoids double taxing insurers.** Insurers' premiums are subject to the State's insurance premium tax which is levied on insurers in lieu of the State's corporate income tax.

- **The Return Premium and Early Termination Deductions prevents taxation of the portion of premiums that insurers return or refund to policyholders.** The deductions allow insurers to avoid tax on these revenues since insurers cannot retain them as profit or use them to pay claims on policies.

- **The Reinsurance Deduction prevents double taxation of insurance premiums collected on policies that are later reinsured.** Because the premiums an insurer collects on an original policy that is the basis of a reinsurance policy it purchases are likely already taxed, taxing the reinsurance premiums would effectively result in a double tax.

We developed the following performance measures to evaluate the tax expenditures:

1. Are insurers aware of and paying the premium tax instead of the state corporate income tax?

2. Are insurers aware of and using the return premium and early termination deductions?

3. Are insurers aware of and using the reinsurance deduction?

Evaluation Results

The Structural Insurance Premium Tax Expenditures are meeting their purpose because insurers are generally aware of and applying them.

We found that insurers are aware of and using the Structural Insurance Premium Tax Expenditures. Based on our discussions with Division staff and stakeholders—and review of Division forms—both during the current evaluation and our 2019 evaluation of these tax expenditures, we found that these provisions are commonly known and used across the insurance industry. However, we lacked the data necessary to quantify their use because insurers are not required to report this information to the Division. In addition, these tax expenditures are also common across other states. Specifically,

- Similar to Colorado, 46 of the 48 other states (including the District of Columbia) with a corporate income tax (or similar type of business tax) exempt insurance companies from their income tax and instead levy a tax on premiums.

- We were able to identify at least 45 other states that had a tax provision similar to the Return Premium Deduction and/or the Early Termination Deduction.

- Stakeholders reported that most states exclude reinsurance premiums from the premium tax base, and we identified at least 25 other states that have explicit deductions for reinsurance.

Therefore, insurers, many of which operate in other states in addition to Colorado, are likely familiar with these types of tax expenditures.

We were not able to determine how much insurers claimed for the Structural Insurance Premium Tax Expenditures or their revenue impact to the State because insurers do not report the amounts claimed to the Division when filing their insurance premium tax. However, we identified research indicating that the Insurance Premium Income Tax Exemption may not decrease state revenue. Specifically, although insurers are exempt from the State's corporate income tax, levying a tax on insurers' premiums as a substitute may instead result in the State collecting a greater amount of total taxes from insurers. Research from the Fiscal Research Center at Georgia State University indicated that, nationally, insurance companies pay roughly double the amount in premium taxes than they would otherwise pay if they were instead subject to the corporate income tax, although we lacked data to quantify the difference in Colorado.

Policy Considerations

We did not identify any policy considerations for the Structural Insurance Premium Tax Expenditures. In our previous evaluation of the Structural Insurance Premium Tax Expenditures, released January 2019, we included a policy consideration that the General Assembly may want to consider allowing insurers to deduct from their premium tax base the amount of any licenses, fees, or taxes they pay to local governments. The General Assembly did not take any legislative action on this policy consideration.

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