

Tax Burden Imposed on Property/Casualty Insurers in Texas

Prepared for

**American Insurance Association
Property Casualty Insurers Association of America
Texas Coalition for Affordable Insurance Solutions**

May 14, 2004

 **ERNST & YOUNG**

Table of Contents

EXECUTIVE SUMMARY	1
Significant Taxes and Other Assessments Paid by Property/Casualty Insurers in Texas.....	1
Comparison to General Corporate Taxation in Texas	1
I. TAXES AND OTHER ASSESSMENTS ON PROPERTY/CASUALTY INSURERS IN TEXAS.....	3
Taxes.....	3
Premium Tax and the "In Lieu Of" Clause	3
Maintenance Taxes.....	3
Retaliatory Taxes Collected by Texas.....	5
Non-Insurance Taxes.....	5
Administrative Services Tax	6
Other Assessments.....	6
Guaranty Association Assessments.....	6
Automobile Theft Prevention Authority Assessment	6
Texas Rural Volunteer Fire Department Assistance Fund Assessment	7
Examination Fees / Overhead Assessments	7
Texas Department of Insurance and Office Public Insurance Counsel Fees.....	7
II. RETALIATORY TAXES PAID BY TEXAS INSURERS TO OTHER STATES	7
III. TEXAS FRANCHISE TAX ON GENERAL CORPORATIONS.....	7
APPENDIX: ESTIMATION METHODOLOGY FOR TEXAS TAX LIABILITIES.....	9
Corporation Franchise Tax	9
Retaliatory Taxes Paid by Texas Property/Casualty Insurers to Other States	9
Sales Tax	9
Property Taxes.....	10
Unemployment Taxes.....	10

List of Exhibits

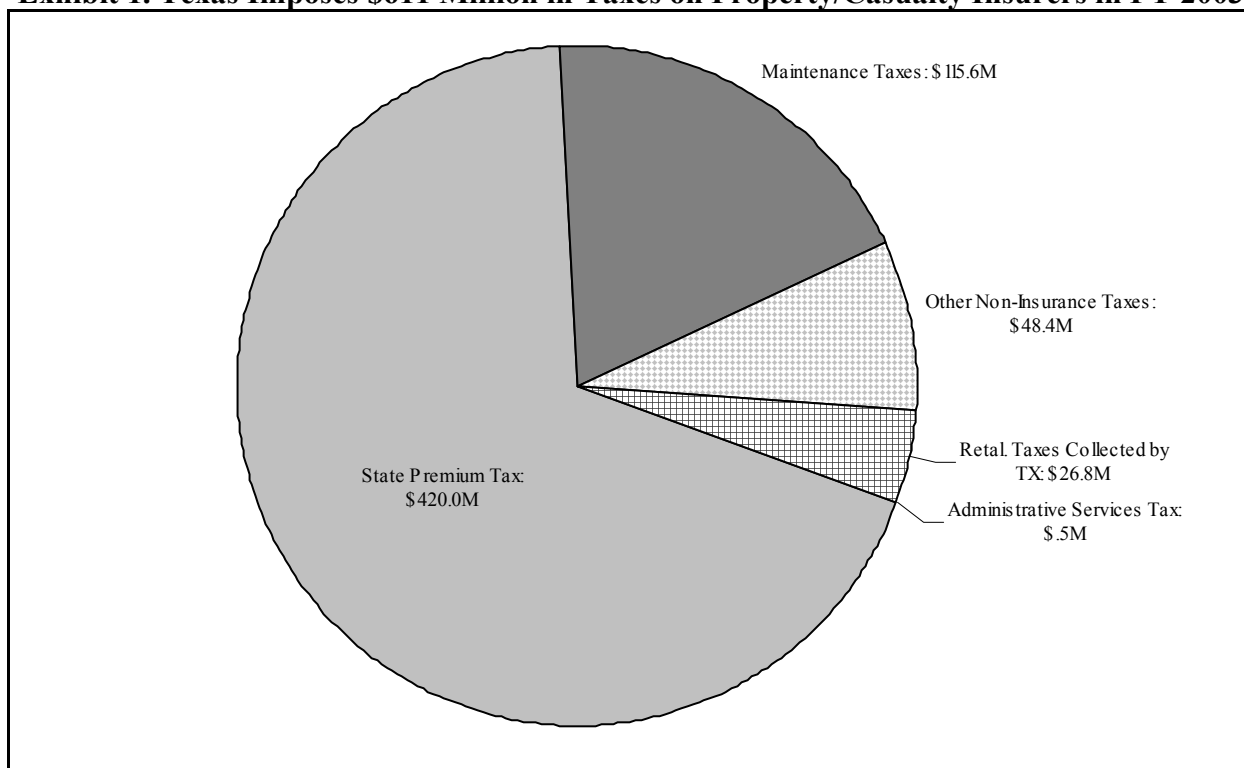
Exhibit 1. Texas Imposes \$611 Million in Taxes on Property/Casualty Insurers in FY 2003.....	1
Exhibit 2. Texas Imposes Higher Taxes on P/C Insurers than on General Corporations	2
Exhibit 3. Franchise Tax Equivalent of the Insurance Taxes.....	2

Executive Summary

Significant Taxes and Other Assessments Paid by Property/Casualty Insurers in Texas

Texas imposes a high level of state and local taxes, assessments and fees on property/casualty insurers. *The industry's tax payments* to state and local governments in Texas are estimated at **\$611 million in fiscal year 2003**. The majority of this amount results from the state's premium tax on insurance companies. In addition, property/casualty insurers pay significant amounts of other state and local taxes, including maintenance taxes, retaliatory taxes and certain non-insurance-specific taxes. These taxes are summarized in Exhibit 1.

Exhibit 1. Texas Imposes \$611 Million in Taxes on Property/Casualty Insurers in FY 2003



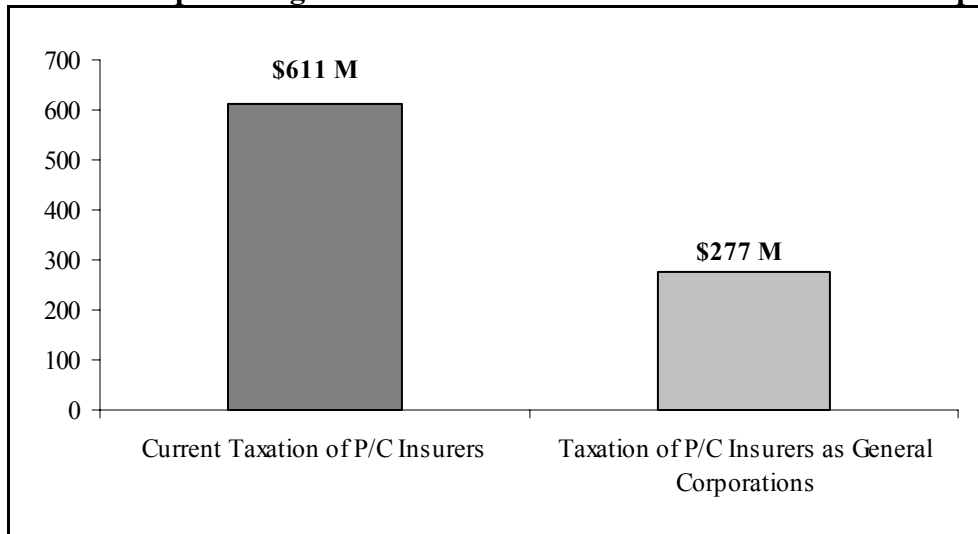
Source: FY 2003 tax collections reported by state and local government agencies, and FY 2003 tax liability estimates by Ernst & Young. Property/Casualty insurers are also assessed Guaranty Association Assessments and certain special purpose assessments, which totaled \$98M in FY2003, and are described in Section I of this report. Premium tax shown before credits.

Comparison to General Corporate Taxation in Texas

As shown above, the largest component of the taxes on property/casualty insurers in Texas is the premium tax. The premium tax is imposed on insurance companies based on gross premiums received on risks resident in the state, minus dividends. By contrast, other financial institutions and general corporations are subject to a corporate franchise tax on net taxable capital or net taxable earned surplus (net income) apportioned to Texas. The premium tax and other state and local taxes impose a significantly higher tax on property/casualty insurers than the tax they would pay if taxed as general corporations.

This study estimates the property/casualty insurers **paid \$334 million more taxes in FY 2003** than they would have if they were taxed as general corporations (see Exhibit 2).

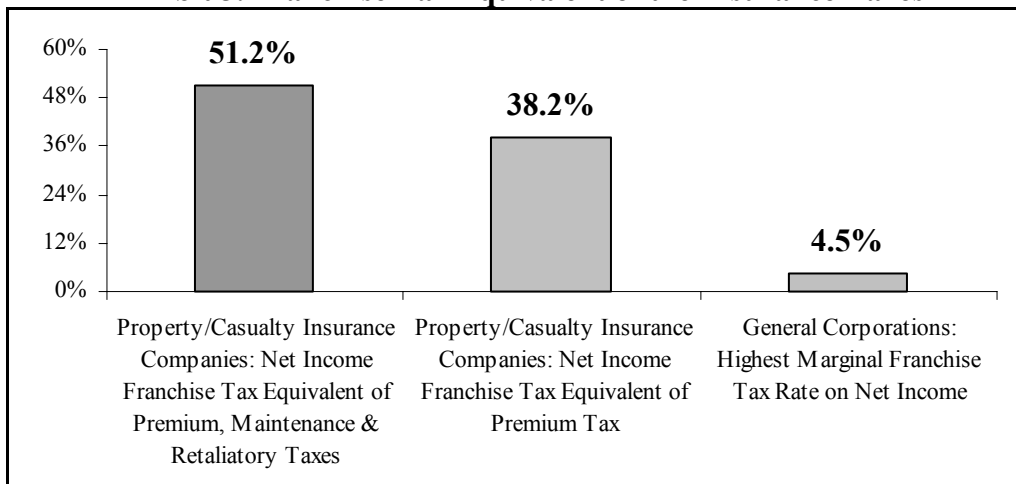
Exhibit 2. Texas Imposes Higher Taxes on P/C Insurers than on General Corporations



Source: FY 2003 tax collections reported by state and local government agencies, and 2003 tax liability estimates by E&Y. \$277M taxation of P/C insurers as general corporations includes: Franchise Tax: \$86.1M; Maintenance Taxes: \$115.6M; Other Non-Insurance Taxes: \$48.4M; Retaliatory Taxes Collected by Texas: \$26.8M; and Administrative Services Tax: \$0.5M.

As shown in Exhibit 3, while general corporations are subject to a maximum statutory rate of 4.5 percent of net taxable earned surplus (net income), the **premium taxes paid by property/casualty insurers are equivalent to an effective 38.2 percent of net taxable earned surplus.** The sum of premium, maintenance and retaliatory taxes are equivalent to an effective 51.2 percent of net taxable earned surplus.

Exhibit 3. Franchise Tax Equivalent of the Insurance Taxes



Source: FY 2003 tax collections reported by Texas, and 2003 tax liability estimates by Ernst & Young. 51.2% franchise tax equivalent estimated as the sum of premium, maintenance and Texas retaliatory tax collections divided by "net taxable earned surplus" (net income)tax base. 38.2% franchise tax equivalent estimated as premium tax collections divided by net income tax base. The franchise tax subjects corporations to the greater of a tax on "net taxable earned surplus" or a tax on "net taxable capital".

I. Taxes and Other Assessments on Property/Casualty Insurers in Texas

This section discusses the state and local taxes and assessments paid by property/casualty insurers as a result of taxes imposed by Texas. As described below, the *total FY 2003 tax payments by property/casualty insurers were \$611 million, and total other assessments were \$98 million*¹.

Wherever possible, the tax payments are based on actual tax collection data obtained from state and local governments and regulatory agencies in Texas. Where tax collection data are not available, tax liabilities were estimated by Ernst & Young. The methodology for these estimates is described in the appendix.

Taxes

Premium Tax and the "In Lieu Of" Clause

Premium taxation of property/casualty insurance companies in Texas consists of a general premium tax of 1.6 percent and a 1.75 percent tax on accident & health premiums written by P/C companies. Companies are taxed on gross premiums less non-taxable premiums. This tax is payable to the Texas Comptroller of Accounts. In FY 2003, Texas collected \$420 million in premium tax from property/casualty insurers (gross of Guaranty Association credits of \$18.8 million).² The premium tax accounts for 69 percent of the taxes paid by property/casualty insurers. The Texas premium tax is imposed "in lieu of" the franchise tax.

Maintenance Taxes

Texas imposes several maintenance taxes on property/casualty insurers, which are described below. The maintenance taxes paid by property/casualty insurers in FY 2003 totaled \$115.6 million.

Workers' Compensation Commission Maintenance Tax

The rate for the Workers' Compensation Commission Maintenance Tax is determined by the Texas Labor Commission. The purpose of the tax is to "pay the costs of administering this subtitle and to support the prosecution of workers' compensation insurance fraud in this state."³ In 2003, a rate of 1.125% was assessed; the statutory maximum is 2.0%. In 2003, property/casualty insurers paid \$74.2 million in the Texas Workers' Compensation Commission Maintenance Tax.⁴

¹ Because of the premium tax credit for guaranty fund assessments, \$18.8 million of the \$98 million is included in the \$611 million premium tax amount for 2003.

² Texas Comptroller of Accounts

³ Texas Labor Code 403.002

⁴ Texas Comptroller of Accounts

Fire and Allied Lines Maintenance Tax

The maintenance tax on fire and allied lines premiums is collected at the judgment of the Commissioner of the Texas Department of Insurance, so that the Commissioner can “produce the amount of funds that it estimates will be necessary to pay all the expenses of regulating all classes of insurance specified... during the succeeding year.”⁵ The maintenance tax is levied on gross premiums net of non-taxable premiums for designated fire and allied lines. Payments are made to the Texas Comptroller of Public Accounts. The maximum statutory rate for the tax is 1.25%; the assessment in 2003 was at 0.188%. In FY 2003, property/casualty insurers paid \$24.3 million in the Texas Fire and Allied Lines Maintenance Tax.⁶

Casualty and Fidelity Maintenance Tax

The Casualty and Fidelity Maintenance Tax is levied by the discretion of the Commissioner, with the statutory maximum of 0.4%, and an assessment at 0.091% in 2003. The tax is applied to the gross premiums written in certain designated property/casualty lines. In FY 2003, property/casualty insurers paid \$7.4 million in the Texas Casualty and Fidelity Maintenance Tax.⁷

Motor Vehicle Maintenance Tax

The Motor Vehicle Maintenance Tax is levied on “gross motor vehicle insurance premiums of all authorized insurers writing motor vehicle insurance.”⁸ The rate is determined by the Comptroller of Accounts, who is advised by the Commissioner. In 2003 the rate was 0.035%; the statutory maximum is 0.2%. In FY 2003, property/casualty insurers paid \$6.9 million in the Texas Casualty and Fidelity Maintenance Tax.⁹

Workers' Compensation Maintenance Tax

In addition to the Workers' Compensation Commission Maintenance Tax, workers' compensation premiums in Texas are subject to the Workers' Compensation Maintenance Tax. The Workers' Compensation Maintenance Tax rate is determined by the Commissioner and cannot exceed 0.6%. In 2003 the rate was 0.03%. In 2003, property/casualty insurers paid \$2.5 million in the Texas Workers' Compensation Maintenance Tax.¹⁰

Accident and Health Maintenance Tax

Maintenance taxes on accident and health premiums are collected at the judgment of the Commissioner of the Texas Department of Insurance, so that the Commissioner can “produce the

⁵ Art. 5.49

⁶ Texas Department of Insurance, *2003 Annual Report*.

⁷ Texas Department of Insurance, *2003 Annual Report*.

⁸ Art. 5.12

⁹ Texas Department of Insurance, *2003 Annual Report*.

¹⁰ Texas Department of Insurance, *2003 Annual Report*.

amount of funds that it estimates will be necessary to pay all the expenses of regulating life, health, and accident insurers during the succeeding year.”¹¹ The maximum statutory rate for these taxes is 0.04%; the 2003 rate was 0.026%. In FY 2003, property/casualty insurers paid \$0.3 million in Texas Accident & Health Maintenance Taxes.¹²

Retaliatory Taxes Collected by Texas

In addition to the premium tax, state insurance taxes contain a unique feature called the "retaliatory tax" which is imposed on premiums written outside an insurer's state of domicile ("home state"). The retaliatory tax is the difference between the tax liability in the market state and the tax liability in the insurer's home state. In effect, the retaliatory tax makes insurers pay the higher of the tax liability in the market state or the tax liability in their home state on the premiums in the market state.

In FY 2003, Texas collected \$26.8 million in retaliatory taxes from property/casualty insurers domiciled in states that impose a higher tax burden than Texas.¹³

Non-Insurance Taxes

Texas property/casualty insurers are generally subject to the sales tax on their purchases of operating inputs and capital equipment. Based on the total input and investment purchases, the sales tax liability of Texas property/casualty insurers is estimated to be approximately \$22.7 million in FY 2003.

Property taxes in Texas are imposed on real property and on business tangible personal property. Insurance company taxable property is taxed at the same rate as property owned by other businesses. Real and personal property owned by Texas property/casualty companies includes real property occupied by insurance industry employees and operations, tangible personal property used in insurance industry operations, and income-generating real property held by insurers as investments or for sale. Intangible property taxes are generally not levied and have not been included in the estimated property tax liability. Texas property/casualty insurers paid an estimated \$19.0 million in local property taxes in 2001, the most recent year for which data are available.

Texas employers are required to make contributions for unemployment insurance based on the number of covered employees, the unemployment wage base, and the employer's contribution rate.¹⁴ Covered employees are defined as those who are paid wages of \$1,500 or more during a calendar quarter in the current or preceding calendar year; or who employed at least one individual for a portion of at least one day during 20 or more different calendar weeks of the current or preceding calendar year. Texas property/casualty insurance industry employer contributions for unemployment insurance totaled approximately \$6.7 million in FY 2003.¹⁵

¹¹ Art. 4.17

¹² Texas Department of Insurance, *2003 Annual Report*, apportioned to property/casualty based on premium share.

¹³ Texas Comptroller of Accounts

¹⁴ Title 4, Subtitle A of the Texas Labor Code

¹⁵ E&Y estimates based on data from the Texas Department of Labor and the U.S. Bureau of Labor Statistics

Administrative Services Tax

Also known as the Third Party Administrators Maintenance tax, this tax is levied on insurance carriers providing services under an administrative services contract. According to Art. 4.11A, an administrative services contract is “a management contract, agency contract, or other written or oral contract or agreement under which the management, administration, or servicing of a plan or any portion of a plan, is provided by an insurance carrier or other person.” A 2.5% rate is applied to gross services receipts. In FY 2003, property/casualty companies paid approximately \$0.5 million in administrative services tax.¹⁶

Other Assessments

Guaranty Association Assessments

Similar to guaranty assessments in other states, the Texas Property and Casualty Insurance Guaranty Association Assessment is designed to protect affected parties should an insurer become insolvent. All property/casualty companies doing business in Texas must be members of the Association, and as the need arises, the Association may impose assessments to maintain the proper level of funds.

Assessments are made when the Association’s Board of Directors decide that additional funds are needed to perform the duties of the Association, specifically when an insurer becomes impaired. Assessments are levied based upon the lines of business in which the impaired insurer wrote premiums. A member company writing in the same lines of business will be charged the portion of the amount needed to be raised based upon the proportion of the line’s total premiums the insurer wrote. Property/casualty companies paid \$59.2 million to the Association in FY 2003.¹⁷

The assessments are entirely recouped over 10 years pro-rata, through credits against the premium tax. P/C insurers received guaranty association credits for prior year assessments totaling \$18.8 million in FY 2003.

Automobile Theft Prevention Authority Assessment

In order to fund programs aimed at fighting car theft, all insurance companies that write auto insurance policies are charged an assessment of one dollar per motor vehicle years insured. Motor vehicle years is defined “as the total number of motor vehicles covered under an insurer’s policies for the year or portion of the year at the time the policies are issued.”¹⁸ The assessment is paid to the Comptroller of Accounts twice a year. In 2003, property/casualty companies paid \$15 million for this assessment.

¹⁶ Texas Department of Insurance, *2003 Annual Report*, apportioned to property/casualty based on premium share.

¹⁷ Texas Department of Insurance, *2003 Annual Report* and Art. 21.28-C

¹⁸ Texas Automobile Theft Prevention Authority Assessment Report

Texas Rural Volunteer Fire Department Assistance Fund Assessment

The Rural Volunteer Fire Department Assistance Fund Assessment was passed in 2001 to help fund volunteer fire departments across the state. The property/casualty industry will pay \$15.0 million annually through 2011, based upon insurers' share of total fire-related Texas premiums.

Examination Fees / Overhead Assessments

The Texas Department of Insurance examines insurers every three years. Companies that are examined are charged assessments to cover a portion of examiners' salaries. In addition, an overhead assessment to cover administrative charges is levied on examined companies based on their admitted assets and gross premium receipts. Texas collected approximately \$5.5 million from property/casualty insurers from these assessments in FY 2003.¹⁹

Texas Department of Insurance and Office Public Insurance Counsel Fees

The Texas Department of Insurance (TDI) charges insurance companies fees for various functions performed by the department. TDI fees on property/casualty insurers amounted to about \$2.2 million in FY 2003.²⁰

The Office Public Insurance Counsel (OPIC) is charged with representing the interests of insurance consumers in Texas, and the OPIC fees assessment is used to fund the services the office provides. The assessment is based upon the number of policies an insurer has in force at the end of the calendar year, with each policy in force requiring a \$0.057 fee. Both property/casualty and life, accident and health insurers are subject to this assessment. In FY 2003, this assessment totaled \$1.0 million for the property/casualty industry.

II. Retaliatory Taxes Paid by Texas Insurers to Other States

In addition to the retaliatory taxes collected by Texas from foreign companies, Texas domiciled property/casualty insurers paid an estimated \$8.3 million in retaliatory taxes to other state governments in FY 2003, because these states have lower taxes on property/casualty insurers. While these taxes are not collected by Texas authorities, they are a result of the excess of the insurance tax burden imposed by Texas over the burden imposed on Texas insurers by the retaliating state, and are paid by Texas domiciled companies over and above the other states' non-retaliatory insurance taxes.

III. Texas Franchise Tax on General Corporations

The Texas franchise tax is levied on corporations doing business in Texas. Insurance companies are exempt under the "in lieu of" clause discussed in the previous section. Under the franchise tax, corporations are required to pay the greater of a tax on "net taxable earned surplus" (net

¹⁹ Texas Department of Insurance, *2003 Annual Report*, apportioned to property/casualty based on premium share.

²⁰ Texas Department of Insurance, *2003 Annual Report*. Includes domestic and foreign filing fees, state fire marshal fees, and annual statement filing fees.

income) or a tax on "net taxable capital". Net income is taxed at 4.5 percent and apportioned based on gross receipts. Net taxable capital (total assets minus total debts) is taxed at 0.25 percent, also apportioned based on gross receipts.

Ernst & Young estimates that property/casualty insurers would have paid \$86.1 million in franchise tax in FY 2003 if they had been subject to the tax. While general corporations are subject to a maximum statutory rate of 4.5 percent of net taxable earned surplus (net income), the premium taxes paid by property/casualty insurers are equivalent to 38.2 percent of net taxable earned surplus (\$420 million in FY 2003 premium tax based on 2002 premiums / \$1.1 billion in 2002 net income apportioned to Texas). Premium, maintenance and retaliatory taxes are collectively equivalent to 51.2 percent of net taxable earned surplus.

Appendix: Estimation Methodology for Texas Tax Liabilities

The data provided in this report are tax collection numbers from Government sources, except for the following taxes, which were estimated as described below:

Corporation Franchise Tax

The franchise tax liabilities of property/casualty companies were calculated for each insurer writing business in Texas as the greater of 4.5 percent of net income or 0.25% of net taxable capital. Net income and net taxable capital were calculated based on publicly available information from NAIC Annual Statement filings, as described below:

Net Income: The net income of property/casualty insurance companies was estimated based on federal and foreign income taxes incurred (NAIC Annual Report, Underwriting and Investment Exhibit, Statement of Income, line 19 - federal and foreign income taxes incurred) grossed up by 35 percent, plus investment income from bonds exempt from US tax (line 1.1 of the Exhibit of Net Investment Income).

Net Taxable Capital: Net taxable capital was estimated as Total Assets (line 28 of the Assets exhibit) less Total Liabilities (line 26 of the Liabilities, Surplus and Other Funds exhibit). This calculation differs from the tax base of the net taxable capital tax in that it uses assets minus liabilities instead of assets minus debt.

Both net income and net taxable capital were apportioned to Texas based on each company's ratio of Texas premiums to total U.S. premiums.

Retaliatory Taxes Paid by Texas Property/Casualty Insurers to Other States

The retaliatory taxes paid to other states by property/casualty insurers doing business in Texas were estimated on a company-by-company basis using the Ernst & Young State Insurance Tax Model. This model has been used to estimate the premium and retaliatory tax liability impact of various public policy, tax planning and redomestication scenarios. The model contains 2002 NAIC annual statement data for over 4,500 life/health and property/casualty insurers, and line-by-line FY 2003 tax and fee information for the 50 states and the District of Columbia.

Sales Tax

The Texas property/casualty insurance industry's sales tax liability was estimated using the E&Y state-by-state sales tax model. The model estimates sales tax liabilities based on national input-output, employment, and operating data for 1) industry operating inputs and 2) investments in capital equipment and structures. Both categories of sales tax liability are estimated assuming a 7.75% statewide average effective combined state and local sales tax rate.²¹

²¹ E&Y estimate based on reports from the Texas Comptroller's Office.

The model estimates sales tax liabilities related to property/casualty insurer purchases of operating inputs based on the taxability of industry purchases from 125 other industries and researched tax law parameters. Special insurance industry services to other Texas insurers, including claims adjusting and actuarial services, are included in the business input liability estimated by the model. Insurance industry sales taxes related to investments in real and personal property were estimated using researched tax law parameters and estimated Texas insurer investments in real and personal property subject to Texas sales and use taxes.

Property Taxes

Property taxes in Texas are imposed on all privately held real property and on business tangible personal property imposed on insurance company property at the same rate as property owned by other businesses. Real and personal property owned by Texas property/casualty-insurance companies includes real property occupied by insurance industry employees and operations, personal property used in insurance industry operations, and income-generating real property held by insurers as investments or for sale. Texas statutes also authorize intangible property taxes on insurance companies to the extent the value of such property has not already been taxed.²²

Texas property/casualty company property tax liabilities were estimated by allocating national property/casualty insurance industry property to Texas and applying statewide average effective property tax rates. The estimated property tax was calculated as the sum of liabilities related to three categories of property: 1) real and personal property used in operations, 2) real properties generating investment income, and 3) real property held for sale.

Property taxes are levied locally by counties, school districts, incorporated cities, and other special taxing districts. Based on total levies and the assessed value of property in each taxing district, an average effective property tax rate was calculated for incorporated areas, 2.28%.²³ This rate assumes that property is located in incorporated municipal jurisdictions.

Unemployment Taxes

State unemployment insurance taxes were estimated based assuming that employers pay at the 1.56% experienced firm rate on a \$9,000 qualified state wage base for 33,002 covered property/casualty employees. Covered employees are defined as those who are paid wages of \$1,500 or more during a calendar quarter in the current or preceding calendar year or who are employed at least one individual in employment for a portion of at least one day during 20 or more different calendar weeks of the current or preceding calendar year.

²² Although a Property Tax Code provision authorizes taxation of insurance company intangibles (Sec. 11.02(b), Tax Code), an Insurance Code statute permits the deduction of intangibles from the measure of tax (Art. 4.01, Insurance Code). The result is that intangibles are taxed only to the extent that they may represent value determined under the computation to derive "other personal property" discussed above. Other Property Tax Code statutes provide that the situs (Sec. 21.08, Tax Code) and appraisal techniques (Sec. 23.15, Tax Code) for intangibles are both determined under Art. 4.01 of the Insurance Code; that statute provides that amounts taxable as "other personal property" are taxed at the site of the principal business office and that property is valued as other such property for assessment. Personal property other than that derived from the balance sheet computation is taxed where located.

²³ Calculations based on Texas Comptroller of Accounts property tax reports.