Approved: March 30, 2010
Date

MINUTES OF THE HOUSE TAXATION COMMITTEE

The meeting was called to order by Chairman Richard Carlson at 9:09 a.m. on March 1, 2010, in Room 783 of the Docking State Office Building.

3/1/10

All members were present except:
Representative Tom Hawk- excused
Representative Mario Goico- excused

Committee staff present:
Gordon Self, Office of the Revisor of Statutes
Scott Wells, Office of the Revisor of Statutes
Chris Courtwright, Kansas Legislative Research Department
Brandon Riffel, Kansas Legislative Research Department
Marla Morris, Committee Assistant

Conferees appearing before the Committee:
Bob Tomlinson, Assistant Insurance Commissioner, Kansas Insurance Department
Marlee Carpenter, Kansas Association of Health Plans (KAHP)
William Sneed, Polsinelli Shughart, American Health Insurance Plans
David Hanson, Kansas Insurance Association, PCI, and AFLAC
Bill Smoot, Legislative Counsel for Blue Cross Blue Shield of Kansas and the American Insurance Association

Others attending:
See attached list.

Bob Tomlinson, Assistant Insurance Commissioner, Kansas Insurance Department, defined the history of the insurance tax credits, explaining the credit has produced 10,000 jobs in Kansas. His testimony provided insight to the value of the tax credits, and possible repercussions should the credits be repealed (Attachment 1). Tax credits that don't go through the Department of Revenue are listed in the post audit report, he agreed those that are recommended in the post audit for repeal related to insurance should be eliminated. He stood for questions.

Marlee Carpenter, Kansas Association of Health Plans (KAHP). The KAHP would oppose elimination of the insurance tax credits because it would increase the cost of doing business in the state. Elimination would penalize the companies that Kansas wants to continue to do business in the state–those that create jobs. If these tax credits are eliminated, companies may choose to move their employees to a state in which the tax treatment is more favorable, taking with it jobs, income tax, property tax and sales tax (Attachment 2). She stood for questions.

William Sneed, Polsinelli, Shughart, provided background on the inception of insurance tax credits, resulting from the successful passage of **HB 2082 - Insurance tax reform,** by the 1997 Legislature. The legislation required tax credits to be equal between domestic and foreign insurance companies (Attachment 3). For information purposes Mr. Sneed provided the 2001 Performance Audit Report on Employee Credits Against Premium Taxes: Reviewing Issues Related to Those Credits. He stood for questions.

David Hanson, represents domestic insurance companies and the Kansas Insurance Association, PCI and AFLAC. He stressed the current difficulties of doing business in Kansas with the disastrous storms and struggling economy. The loss of the insurance salary credit will result in loss of companies in Kansas (Attachment 4).

Brad Smoot, Legislative Counsel for Blue Cross Blue Shield of Kansas and the American Insurance Association, offered information on the history and inception of the insurance tax credit (Attachment 5). He stood for questions.

Chairman Carlson welcomed Representative Melany Barnes to the Taxation Committee. She was appointed to serve in the absence of Representative Hawk.

The next meeting is scheduled for March 2, 2010.

The meeting was adjourned at 10:25 a.m.

HOUSE TAXATION COMMITTEE

DATE: March 1, 2010

NAME	REPRESENTING
Bill Sneed	Polsinelli
Bob Eckhardt	Self
Dave Holthaus	KEC
Trudy Racine	KCSL
Phil Wages	KEPCo
[illegible]	KARA
Kent Eckles	KS Chamber of Commerce
John C. Bottenberg	Delta Dental
Gayle Shaw	KACCT
Lee Wright	Farmers INS
Kerry Spulman	KAIM
Michelle Butler	Cap. Strategies
Bill Brady	" "
Kendra Hanson	Hein Law Firm
Kristi Cole	
Whitney Damron	KS Gas Service
Judith Gadd	Capitol Advantage
Larry Berg	Midwest Energy
Brad Smoot	BCBS / AIA
David Hanson	Ks Insurance Assns

HOUSE TAXATION COMMITTEE

DATE: March 1, 2010

NAME	REPRESENTING
Natalie Haag	Security Benefit

Kansas Insurance Department
Sandy Praeger, Commissioner of Insurance

TESTIMONY ON
Insurance Department Tax Credits

HOUSE TAXATION COMMITTEE
March 1, 2010

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to appear today regarding the insurance company credits that may be used against premium tax liability. Due to its size and usage relative to other tax credits we understand that the employee salary tax credit has come under particular scrutiny. Today I have two goals, to explain the history of how this tax credit came about and to explain how it is being utilized by insurance companies doing business in our state.

In 1997 the Kansas Insurance Department taxed domestic insurance companies (those domiciled within our borders) at 1% of their gross premium volume while taxing foreign insurance companies (those domiciled outside our borders) at 2% of their gross premium volume. With the precedence of a 1985 Supreme Court ruling that states must equal their premium taxes for insurance companies foreign and domestic; the foreign companies threatened a lawsuit in the vicinity of $500 million dollars. To avoid this liability the Kansas Legislature explored two options. The first was to lower the foreign premium tax to 1%. The second was to raise the premium tax for domestic insurers to 2% and extend these tax credits to insurers both foreign and domestic based upon the wages they pay to Kansas employees. The later path was chosen which brings us to today.

The law allows for a credit of 15% of the wages a company pays to Kansas employees. This credit is not unlimited however. For affiliated insurance companies and their subsidiaries 15% of Kansas wages may only be used up to 1% of the company's gross domestic premiums. For un-affiliated insurance companies the cap is higher at 1.25% of the company's gross domestic premiums.

In 2008, the tax credit was utilized by insurance companies for $52,013,855.66. From 2004 to 2008 the utilization of this tax credit increased by an average of $1.62 million per year. Our records show that 138 licensed insurance companies employ 9,906 Kansans with total wages of $648,657,078.87. That works out to a mean salary of $65,481.23 per year, with a median of what we believe to be between $45,000 and $50,000.

It also must be stated that in the event this tax credit is repealed, it is a possibility that other states may enact retaliatory taxes against domestic Kansas insurers. The consequences of repealing the Insurance Department employee salary tax credit are not fully clear, but what is certain is that repeal would mean insurers within and without the state would have less incentive to employ people within our borders.

Thank you for the opportunity to appear and I will stand for questions at the appropriate time.

Bob Tomlinson
Assistant Insurance Commissioner

House Taxation
Date: 3-1-10
Attachment: 1

Kansas Insurance Clipboard

Confidentiality of KDOL Salary Information
KDOL salary information shall be used only in support of KID's responsibility to administer the proper collection of insurance premium taxes. KID employees shall protect it from any other use and from unauthorized access or disclosure.

2008 KDOL Insurance Company Salaries

Number of Companies: 138
NAIC #'s: 388

Total KDOL Wages: $648,657,078.87

Total KDOL Employees: 9,906

Note: includes in-progress and unsubmitted companies, and ones that may have been entered in error.

☐ View table

1-2

Kansas Association of Health Plans

815 SW Topeka Boulevard, Suite 2C
Topeka, Kansas 66612

(785) 213-0185
marlee@brightcarpenter.com

March 1, 2010

Insurance Department Tax Credits
Testimony Before the House Taxation Committee
Marlee Carpenter, Executive Director

Chairman Carlson and members of the Committee;

I am Marlee Carpenter, Executive Director of the Kansas Association of Health Plans (KAHP). The KAHP is a nonprofit association dedicated to providing the public information on managed care health plans. Members of the KAHP are Kansas licensed health maintenance organizations, preferred provider organizations and other entities that are associated with managed care. KAHP members serve the majority of Kansans enrolled in private health insurance. KAHP members also serve the Kansans enrolled in HealthWave and Medicaid managed care. We appreciate the opportunity to provide comments about the insurance tax credits to this committee.

Health insurance companies are businesses, like any other business that operates in the state of Kansas. Health insurance companies create jobs and employee thousands of individuals. Insurance companies have seen a dramatic increase in the cost of unemployment insurance as well as an increase in other business costs and have been effected by the weakening economy in the state. Because of these increased costs, companies are struggling to keep employees and to continue to operate in the state. I have attached information to my testimony that shows the direct and indirect impact of health insurance related jobs in Kansas. This only represents health insurance companies, not life insurance or property and casualty insurance companies.

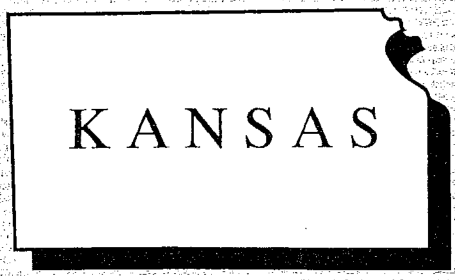
Insurance companies do not pay income tax, but pay a premium tax on the amount of premiums that are paid in the state. In the late 1990's, the premium's tax for domestic insurance companies was increased from 1% to 2% to equalize the rate between foreign and domestic companies. Foreign insurance companies continued to pay at the 2% rate. To offset the increase to domestic companies, a tax credit was put into place so that companies could take a tax credit for the number of employees in the state. This tax credit has been used to grow the insurance industry in Kansas.

KAHP would oppose elimination of this tax credit because it would dramatically increase the cost of doing business in the state. Elimination would penalize the companies that Kansas wants to continue to do business in the state—those that create jobs. If these tax credits are eliminated, companies may choose to move their employees to a state in which the tax treatment is more favorable, taking with it jobs, income tax, property tax and sales tax.

We encourage you to not repeal the insurance the credit for employees in the state. In these tough economic times, job creation is critical to economic recovery.

Thank you for your time and I will be happy to answer any questions.

House Taxation
Date: 3-1-10
Attachment: 2

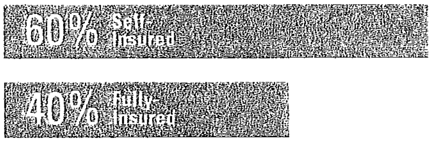


STATE HEALTH FACTS

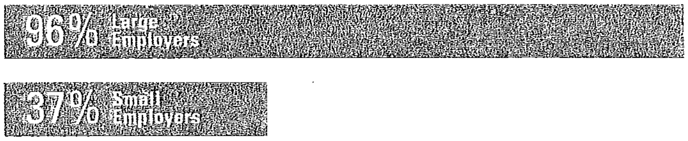
STATE RANKINGS

People with Private Health Insurance Coverage

- People Covered by Private Insurance 2,033,000



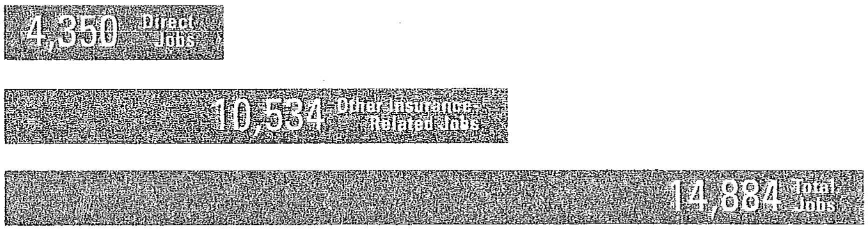
Percent of Employers Offering Health Insurance



Average Annual Health Insurance Premiums

- Individual Market Single $2,363
- Individual Market Family $5,011
- Small Group Market Single $3,588
- Small Group Market Family $9,420
- Total State Premium Taxes Collected from Insurance Companies[1] $122,027,000

Jobs in Health Insurance Industry[2]



- Payroll Direct Jobs ....$197,516,000[h]
- Payroll Other Insurance-Related Jobs ....$379,156,000[i]
- Average Wage Direct Jobs $49,690
- Average Wage Other Insurance-Related Jobs $38,753

Polsinelli Shughart pc

Memorandum

TO:	The Honorable Richard Carlson, Chairman House Taxation Committee
FROM:	William W. Sneed Polsinelli, Shughart pc
SUBJECT:	Insurance Tax Credits
DATE:	March 1, 2010

Mr. Chairman, Members of the Committee: My name is Bill Sneed and I am a partner with the law firm of Polsinelli, Shughart pc. As many of you know, a majority of my practice is comprised of lobbying, and within that practice I have represented the insurance industry for a number of years. During 1995 and 1996, I was involved with a group of insurance industry representatives, along with the Kansas Commissioner of Insurance, regarding a problem Kansas had relative to its premium tax situation, and I appreciate the opportunity to present this background for your review.

Prior to July 1, 1997, Kansas domestic insurance companies were taxed annually at 1% of their premium income, and foreign, or out-of-state, insurers were taxed at a 2% premium tax rate. In 1985, the United States Supreme Court, in *Metropolitan Life Insurance Co, v. Ward*, held that a similar tax differential imposed by the State of Alabama was unconstitutional. A number of state supreme courts also invalidated their premium tax statutes because they taxed in-state and out-of-state companies at a different rate.

After the *Metropolitan Life Insurance Co.* decision in 1985, over 50 foreign insurers continued to pay their premium taxes to Kansas but did so under protest. The Insurance Department estimated that in 1997, if the Kansas tax were challenged and overturned, and if the Court ordered the state to pay back all foreign premium taxes above the 1% domestic rate, the State of Kansas would have to refund five hundred million dollars. Because of this huge potential tax refund, during 1996 the Kansas Insurance Department met with members of the insurance industry to formulate a resolution to the tax differential, and at the same time address the potential effect such tax increase could have on the Kansas domestic industry, and to find a way to "hold harmless" those carriers.

All of this was completed with the successful passage of H.B. 2082 by the 1997 Legislature. Although there were several components to the bill, the major piece increased domestic insurance premium taxes to 2%, while at the same time enacting a tax credit against premium taxes for salaries paid to Kansas employees. By doing this, the Kansas Legislature corrected the constitutional problem, and by allowing for the tax credits, lessened the adverse effect of the increase in premium taxes, predominantly for domestic insurers, and as an additional benefit, created an economic tool to encourage employment in the State of Kansas. That is not to say foreign companies could not take advantage of the tax credit for their

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House Taxation
Date: 3-1-10
Attachment: 3

employees inasmuch as whatever tax proposal was passed, it had to be the same for domestics and foreign insurers. Thereafter, as a result, the state benefited by not having to pay out over five hundred million dollars in tax refunds, as the industry agreed to waive those claims as a part of getting this legislation passed.

Another point that should be made is that these credits against premium tax, although they may fluctuate some, will remain fairly stable over time. The benefit to the state, in addition to the relief given of the five hundred million dollar potential liability, is that premium taxes continue to increase inasmuch as they are based on a percentage of premiums paid. As I am sure most of you recognize, insurance premiums continue to increase, and it was demonstrated to the Legislature in 1997 that those increases in premiums multiplied by the additional premium tax would exceed the credits against the premium tax over time.

As you can see, there is a massive amount of detail in this particular area, and by way of summary, I hope I have not unintentionally left out any specific information the Committee would deem relevant. I will be happy to provide additional information to the Committee at its convenience.

Respectfully submitted,

William W. Sneed

William W. Sneed

WWS:kjb
cc:
/

PERFORMANCE AUDIT REPORT

Employee Credits Against Premium Taxes: Reviewing Issues Related to Those Credits

A Report to the Legislative Post Audit Committee
By the Legislative Division of Post Audit
State of Kansas
February 2001

01-04

3-3

Legislative Post Audit Committee

Legislative Division of Post Audit

THE LEGISLATIVE POST Audit Committee and its audit agency, the Legislative Division of Post Audit, are the audit arm of Kansas government. The programs and activities of State government now cost about $8 billion a year. As legislators and administrators try increasingly to allocate tax dollars effectively and make government work more efficiently, they need information to evaluate the work of governmental agencies. The audit work performed by Legislative Post Audit helps provide that information.

We conduct our audit work in accordance with applicable government auditing standards set forth by the U.S. General Accounting Office. These standards pertain to the auditor's professional qualifications, the quality of the audit work, and the characteristics of professional and meaningful reports. The standards also have been endorsed by the American Institute of Certified Public Accountants and adopted by the Legislative Post Audit Committee.

The Legislative Post Audit Committee is a bipartisan committee comprising five senators and five representatives. Of the Senate members, three are appointed by the President of the Senate and two are appointed by the Senate Minority Leader. Of the Representatives, three are appointed by the Speaker of the House and two are appointed by the Minority Leader.

Audits are performed at the direction of the Legislative Post Audit Committee. Legislators or committees should make their requests for performance audits through the Chairman or any other member of the Committee. Copies of all completed performance audits are available from the Division's office.

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Representative Richard Alldritt
Representative John Ballou
Representative Dean Newton
Representative Dan Thimesch

Senator Lynn Jenkins, Vice-Chair
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Senator Dave Kerr
Senator Derek Schmidt
Senator Chris Steineger

LEGISLATIVE DIVISION OF POST AUDIT

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Barbara J. Hinton, Legislative Post Auditor

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LEGISLATURE OF KANSAS
LEGISLATIVE DIVISION OF POST AUDIT

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February 22, 2001

To: Members, Legislative Post Audit Committee

Representative Lisa Benlon, Chair	Senator Lynn Jenkins, Vice-Chair
Representative Richard Alldritt	Senator Anthony Hensley
Representative John Ballou	Senator Dave Kerr
Representative Dean Newton	Senator Derek Schmidt
Representative Dan Thimesch	Senator Chris Steineger

This report contains the findings, conclusions, and recommendations from our completed performance audit, *Employee Credits Against Premium Taxes: Reviewing Issues Related to Those Credits*.

The report includes a recommendation for appropriate legislative committees to explore options to bring premium tax receipts closer to earlier estimates, if such legislative interest exists. The report also includes several recommendations for the Kansas Insurance Department to help ensure that insurance companies don't claim salary credits they are not entitled to, and to ensure that salary credits that are claimed meet the requirements of the law.

We would be happy to discuss these recommendations or any other items in the report with any legislative committees, individual legislators, or other State officials.

Barbara J. Hinton

Barbara J. Hinton
Legislative Post Auditor

Background

Despite the fact that the U.S. Supreme Court ruled in 1985 that states couldn't charge out-of-state companies higher premium tax rates than in-state companies, Kansas continued to tax in-State and out-of-State insurance companies at different rates. As a result, companies began paying premium taxes under protest and threatened to sue to recover taxes levied contrary to the Supreme Court ruling. By 1997, the Insurance Commissioner estimated the potential liability from such lawsuits could be as much as $500 million.

To address the problem, the 1997 Legislature equalized tax rates at 2% for both in-State and out-of-State companies. It also approved a tax credit for salaries paid to insurance company employees located in Kansas. The allowable credit in the first year was 25% of qualified salaries up to 1% of taxable premiums. For all subsequent years, the credit was increased to 30% of salaries up to a maximum of 1.25% of taxable premiums. Other provisions of the law allowed "affiliated" companies to share unused salary credits with each other.

Question 1: Why Did Insurance Premium Taxes Decline So Much More Than Expected After the Legislature Changed the Premium Tax Law in 1997?

Compared with fiscal year 1998, premium tax collections dropped by about $20 million the first year after the law was changed, and by nearly $27 million the second year. *Most changes to the premium tax law became effective for tax year 1998, so most of the monetary impact showed up for the first time in fiscal year 1999. The Insurance Department initially estimated that premium taxes attributable to salary credits would drop $3.7 million that first year, and $7.1 million in fiscal year 2000. Instead, the drop was about $12 million in 1999, and almost $25 million in fiscal year 2000.* .... page 7

The drop in premium tax receipts was so much greater than expected because far more out-of-State companies were able to take the salary credit than the Department had projected. *Some had operations in Kansas the Department was unaware of. They accounted for about $6 million of the unexpected drop that first year, and about $11 million the next year. In addition, more than 90 out-of-State companies claimed a salary credit they otherwise wouldn't have been entitled to because of the affiliate provision in the law–they could use their affiliate companies' unused salary credits, even though they didn't have employees in* .... page 8

Kansas. The Department's estimates didn't include any impact from this provision. We estimate it reduced tax collections by as much as $4 million in fiscal year 1999, and potentially by as much as $7 million the next year.

Insurance companies that claimed the salary credit in 1999 paid an average tax equal to 0.63% of taxable premiums. *That's compared with an average tax rate of about 1.8% for a sample of companies that didn't qualify for the salary credit.* . . . page 11

If the Legislature granted more in premium tax breaks than it intended, salary credits could be adjusted to bring tax receipts back in line with original projections. *The Insurance Commissioner provided the 2000 Legislature with several options, and we explored some of those same options. For example, based on 1999 tax returns:* . . . page 12

- *reducing the maximum credit from the current 1.25% of taxable premiums to 0.75% would have increased premium tax receipts by about $12.8 million*
- *reducing the percent of salaries used in computing the salary credit from 30% to 10% would have increased collections by an estimated $8.5 million*

Question 1 Conclusion: . . . page 13

Question 1 Recommendation: . . . page 14

Question 2: Are the Insurance Department's Procedures Adequate To Ensure That Insurance Companies Claim Only the Salary Credits They're Entitled To?

Insurance companies could claim more in salary credits than they're entitled to in several ways. *By law, eligible salaries are those paid only to employees located in Kansas and only for insurance-related operations. They can't include commissions or amounts paid to independent contractors. If companies share salary credits, they must meet the statutory definition of "affiliation."* . . . page 15

Despite some strengths, the Insurance Department's procedures for ensuring that companies aren't claiming too much in salaries have several weaknesses. *The Department has good procedures for ensuring that taxable premiums are accurately reported and that mathematical errors are caught. Department staff also request verification of salaries used in computing the salary credit when they think they need it. However,* . . . page 16

only 11 of the 20 company files we reviewed had acceptable documentation in the files supporting the amount of salaries the companies used in computing the salary credit. Also, the Department doesn't check whether companies are meeting the statutory requirements of affiliation, so it has no way of knowing whether companies that share salary credits are in fact eligible to do so. Finally, the Department doesn't check to ensure that reported salaries were only for insurance-related operations.

We found 19 discrepancies in the salaries reported by 197 companies we reviewed, but those discrepancies didn't affect the credits they could claim. *One group of 6 affiliated companies reported only $544,000 in salaries to the Department of Human Resources for unemployment tax purposes, but reported nearly $2 million in salaries to the Insurance Department on their 1999 premium tax returns. If the numbers reported to the Department of Human Resources were correct, it would mean the group claimed about $41,000 in salary credits it wasn't entitled to. An official representing this group told Insurance Department officials the group had mistakenly under-reported salaries to the Department of Human Resources and would file amended reports. In addition, 8 other groups and 10 single companies in our sample reported more salaries to the Insurance Department than to the Department of Human Resources. In these cases, however, the salaries reported to Human Resources still were enough to allow the salary credits they got.* . . . page 17

Finally, in some cases, it was difficult to determine which companies were affiliated and sharing credits as one group. The risk is that companies could inappropriately claim affiliation and get more salary credits than they were entitled to.

Question 2 Conclusion: . . . page 19

Question 2 Recommendations: . . . page 20

APPENDIX A: *Scope Statement* . . . page 21

APPENDIX B: *Agency Response* . . . page 24

This audit was conducted by Katrin Osterhaus, Jill Shelley, and Kate Watson. Leo Hafner was the audit manager. If you need any additional information about the audit's findings, please contact Ms. Osterhaus at the Division's offices. Our address is: Legislative Division of Post Audit, 800 SW Jackson Street, Suite 1200, Topeka, Kansas 66612. You also may call us at (785) 296-3792, or contact us via the Internet at LPA@lpa.state.ks.us.

Employee Credits Against Premium Taxes: Reviewing Issues Related to Those Credits

Life, property, and casualty insurance companies doing business in Kansas pay an annual tax based on the amount of premiums they collect for policies on people or property located in the State. In the past, out-of-State companies paid a higher rate than in-State companies. The 1997 Legislature amended the premium tax law to equalize the tax rates, but allowed companies to take a credit against that tax based on a percentage of the salaries they paid to Kansas employees. Under State law, the Insurance Commissioner must verify the premium tax returns companies file and assess the appropriate taxes.

Premium tax receipts dropped much more than expected after the changes in the law, raising legislative concerns about why the drop was so great. Legislators were particularly concerned with whether insurance companies were claiming higher salary credits than allowed by law. To address these concerns, the Committee directed the Legislative Division of Post Audit to conduct a performance audit answering the following questions:

- **How does the Insurance Department plan to ensure that companies receive only the tax credits to which they are entitled?**

- **Are insurers complying with State law in the way they calculate and apply employee salary credits?**

To answer these questions, we interviewed Insurance Department officials to determine how they estimated the fiscal impact of equalizing tax rates and granting the salary credit. We reviewed the 1999 premium tax returns for all companies that took the credit. We also evaluated the Department's procedures for checking the accuracy of information reported on 20 premium tax returns, and we determined whether Department staff appeared to be following good procedures on those returns. Finally, we reviewed quarterly wage statements filed with the Department of Human Resources for a sample of 197 companies that took salary credits in 1999 to determine whether the amount of Kansas salaries the companies reported for unemployment tax purposes was at least as much as the amount of salaries the companies claimed credit for on their premium tax returns. Where discrepancies were found, we provided that information to Insurance Department officials for follow-up.

A copy of the scope statement for this audit approved by the Legislative Post Audit Committee is included in Appendix A. Because the majority of the drop in premium tax receipts was attributable to the salary credit, we focused the majority of our work on it. Accordingly, we modified the questions slightly for reporting purposes.

In conducting this audit, we followed all applicable government auditing standards set forth by the U.S. General Accounting Office.

3-10

Companies that sell insurance policies in Kansas pay premium taxes in lieu of the corporate income taxes that other businesses pay. Premium taxes are imposed on the "taxable" premiums insurance companies collect (because of certain statutory exemptions, not all premiums are subject to the premium tax). The Insurance Department currently doesn't compile information about companies' taxable premiums, but those companies reported their gross premiums were more than $8.5 billion for tax year 1999.

Until recently, Kansas' 40 domestic or in-State insurance companies (companies incorporated in Kansas) paid a tax of 1% on their taxable premiums. The more than 1,400 foreign or out-of-State companies paid 2%. These companies aren't incorporated in Kansas, but they do sell policies insuring the lives or property of people in Kansas.

In 1996, the Insurance Commissioner Proposed Raising the Premium Tax Rate on In-State Companies, but Offsetting That Increase With a Salary Tax Credit

In 1985, the U.S. Supreme Court ruled that states couldn't charge out-of-state insurance companies higher premium taxes than in-state companies without violating the equal protection clause of the U.S. Constitution. After that ruling, out-of-State insurance companies started paying their Kansas taxes under protest, threatening to sue the State. According to the Insurance Commissioner, companies had won such lawsuits in every state where this issue had gone to court.

The Commissioner's proposal was intended to avoid possible lawsuits and a potential liability of up to $500 million. It called for the Legislature:

- to equalize premium tax rates at 2% for both in-State and out-of-State companies
- to allow companies with Kansas employees to take a tax credit in an amount equal to 25% of these employees' annual salaries, up to a maximum of 1% of a company's taxable premiums in Kansas

This second provision was intended to help offset the higher taxes that were being imposed on in-State companies. But to meet the Supreme Court's mandate, it had to apply to all companies that paid salaries to Kansas employees. Under this proposal, companies that could claim the maximum salary tax credit would reduce their effective tax rates back to the 1% level. The Insurance Department assumed in-State companies would be eligible for the full salary tax credit, but most out-of-State companies generally wouldn't be able to take advantage of it.

Legislators, the Commissioner, and members of the business community also hoped the new tax credit would serve as an economic development incentive for insurance companies to move more jobs to the State to take advantage of the credit.

The legislation that passed in 1997 contained a number of new and amended premium tax credits. As the premium tax bill was introduced, it included a provision allowing insurance companies that "affiliate" with each other to share their salaries among the group. (To be considered affiliates, the parent company had to own 100% of the voting stock of the "affiliated" companies.) This provision wasn't part of the Insurance Commissioner's proposal. It was included in a draft proposal for legislation prepared by insurance industry representatives.

Statutory Changes Made in 1997 That Could Have Affected The Amount of Premium Taxes Paid

Changes that lowered the premium taxes companies had to pay:

- Creating a salary tax credit for insurance companies with Kansas employee salaries
- Repealing the privilege tax. This was the tax every domestic life, fire and casualty, hail, and county mutual fire insurance company paid for the privilege of doing business in Kansas. The tax was equal to 5% of a company's net income.
- Extending the Firefighters Relief Fund credit and Fire Marshal credit to out-of-State companies. The fire fighter relief credit is for taxes paid for fire and lightning premiums written in Kansas. The Fire Marshal credit is for tax paid to fund the Office of the Kansas State Fire Marshal.
- Creating an education tax credit for companies spending more than 2% of the company's total payroll costs on education and training costs.
- Creating a machinery and property tax credit for insurance companies paying taxes on specific types of equipment, such as commercial and industrial equipment.
- Creating a small insurance company tax credit for companies with premiums of less than $15 million.
- Repealing taxes on annuity sales effective January 1, 1997.

Changes that increased the premium taxes companies had to pay:

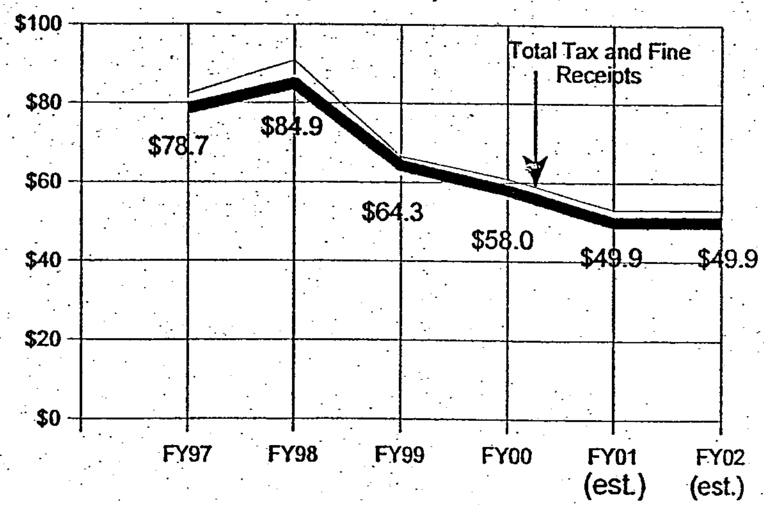
- Raising premium tax rates for in-State insurance companies from 1% to 2%.
- Repealing the investment tax credit for in-State companies that had 30% of their assets invested in Kansas securities.
- Reducing the Health Insurance Association Assessment credit. Certain insurance companies must belong to the Association and pay assessments proportional to their health insurance premiums in Kansas. The tax credit of 80% of the assessment was phased down to 60% for tax year 2000 (fiscal year 2001).

Under this affiliate provision, if 3 companies with Kansas premiums were affiliated and only one of them had employees located in Kansas, that company could share its unused salary credits with the other 2 companies, up to the maximum cap. This provision allowed the other companies to take a salary credit even though they didn't have employees in Kansas. (See the example on page 11.)

The final bill increased the salary credit to 30% of eligible salaries after tax year 1998, and raised the maximum allowable credit to 1.25% of taxable premiums. Additional credits and changes to the tax law that were part of this legislation are summarized in the box on the previous page.

After the 1997 changes went into effect, premium tax collections dropped off fairly significantly. For fiscal year 1999–the first year the changes would have been felt–premium taxes collected were almost $21 million lower than they'd been in fiscal year 1998. The following graph shows those tax receipts from fiscal years 1997 through 2002.

Premium Tax Collections FY 1997-2000
(In millions)



These totals don't include receipts from the privilege tax, the fire marshal tax, the retaliatory tax, or fines and penalties.

The Kansas Insurance Department
AT A GLANCE

Authority: Created by K.S.A. 40-101. The Department determines which companies are authorized to transact insurance business in Kansas, then authorizes, supervises, and regulates their operations. It also regulates fraternal benefit societies and health maintenance organizations in the State, and is responsible for collecting various taxes and fees.

Staffing: The Department has 164.5 full-time-equivalent positions and 2 other unclassified positions.

Budget: In fiscal year 2000, the Department collected more than $84 million in taxes and fees paid by insurance companies. Almost $61 million of that amount went to the State General Fund to finance other State operations. Since 1993, the Insurance Department has been funded entirely by fees paid by the insurance industry. The money generated by those fees, and how the Department spent that money, is summarized below.

FY 2000 Funding Sources

Type	Amount	% of Total
Firefighters Relief Fund	$5,202,437	24%
Insurance Co. Regulation	6,940,167	32%
Insurance Co. Examination	986,636	5%
Workers Compensation	7,868,115	36%
Group-Funded Workers Compensation	45,068	0.2%
Municipal Group-Funded Pools	35,002	0.2%
Dept Service & Capital Improvement	511,109	2%
Total Funding:	**$21,588,534**	**100%**

FY 2000 Expenditures

Type	Amount	% of Total
Salaries/Wages	$6,510,295	30%
Contractual Services	2,694,686	13%
Commodities	225,695	1%
Capital Outlay	62,635	0.3%
Debt Service	73,286	0.3%
Aid to Local Govts.	5,207,157	24%
Other Assistance	6,376,957	30%
Capital Improvements	437,823	2%
Total Expenses:	**$21,588,534**	**100%**

Percentages don't add to 100% because of rounding.

Question 1: Why Did Insurance Premium Taxes Decline So Much More Than Expected After the Legislature Changed the Premium Tax Law in 1997?

Compared with fiscal year 1998, premium tax collections dropped by more than $20 million the first year after the law was changed, and by nearly $27 million the second year. Several factors appear to have contributed, but the new salary tax credit caused the bulk of the decline–about $12 million in fiscal year 1999 and almost $25 million in fiscal year 2000. When the Legislature enacted the salary tax credit, the available estimates indicated it would reduce premium tax receipts by only about $3.7 million the first year and $7.1 million the second.

The drop was so much greater than anticipated because more out-of-State companies were able to take the salary credit than the Department projected, either because they had operations in Kansas the Department was unaware of, or because of the affiliate provision. Because of the 1997 changes to the law, the effective tax rate for the 238 companies that took the salary credit in 1999 averaged 0.63%. If the Legislature granted more in premium tax breaks than it intended, several options exist for bringing those rates back to earlier levels. These and related findings are discussed in more detail in the sections that follow.

Premium Tax Collections Dropped by About $20 Million the First Year After the Premium Tax Law Was Changed, and by Even More the Second Year

Most changes to the premium tax law became effective for tax year 1998, so most of the monetary impact would have shown up for the first time in fiscal year 1999. The table on the following page shows what happened to premium tax receipts in fiscal years 1999 and 2000. (It doesn't include privilege, Fire Marshal, or retaliatory tax receipts, or fees and penalties.)

As the table shows, a significant portion of the drop in premium tax receipts was caused by the salary tax credit. For this reason, and because salary credits were a major concern when this audit was requested, we focused our review on salary credits and on why they had so much more of an impact than anticipated.

Premium Tax Receipts and Salary Credits
Fiscal Years 1998-2000

	Fiscal Year 1999 (tax year 1998)	Fiscal Year 2000 (tax year 1999)
Premium Tax Receipts: FY 1998 base year = $84.9 million	**$64.3 million**	**$58.0 million**
Decline from fiscal year 1998 base year (before the law was changed)...	**- $20.6 million**	**- $26.9 million**
Amount of decline attributable to equalizing tax rates plus authorizing the salary credit (a)...	**-$12.0 million** In-State + $ .3 million Out-of-State - $12.3 million	**-$24.9 million** In-State - $ 2.8 million Out-of-State - $22.1 million
Number (%) of companies claiming the salary credit...	**150** In-State = 27 (71%) Out-of State = 123 (9%)	**238** In-State = 28 (78%) Out-of-State = 210 (15%)

(a) In fiscal year 1999, almost all the reduction is attributed to out-of-State companies taking the salary tax credit. Most in-State companies took the salary tax credit that year–up to the maximum of 1% of taxable premiums. But because their premium taxes also had been increased from 1% to 2%, the credit and tax increases almost offset each other.

The Salary Credit Caused A Much Larger Drop in Premium Tax Receipts Than Anticipated

Insurance Department estimates projected that the salary credit would reduce premium tax receipts by $3.7 million in 1999 and $7.1 million in 2000. As the following table shows, that impact ended up being much greater.

Insurance Department Estimates of the Impact
of the Salary Tax Credit on Premium Tax Receipts

	Fiscal Year 1999 (Tax Year 1998)	Fiscal Year 2000 (Tax Year 1999)
Amount of decline attributable to equalizing tax rates plus the salary credit...	**- $12.0 million**	**- $24.9 million**
Insurance Department estimate of the impact...	**- $3.7 million**	**- $7.1 million**
Unanticipated drop in premium tax receipts...	**- $8.3 million**	**- $17.8 million**

To determine why premium tax receipts had dropped so much more than anticipated, we looked for such things as:

- whether the Department's estimates appeared to be based on reasonable assumptions
- whether more insurance companies took the tax credit than expected (either separately or as "affiliates" of other companies)
- whether companies were claiming more credits than they should

The testwork we did for the last point is discussed more fully under question 2. As part of that testwork, we reviewed files for a large sample of companies that took the salary credit, and compared what they reported on their premium tax returns with other salary information they'd reported to the Department of Human Resources for unemployment tax purposes. In brief, we identified 19 instances in which companies reported higher salaries to the Insurance Department than to the Department of Human Resources, but none of these appeared to result in companies getting too large of a salary credit.

Far more out-of-State companies took the salary credit than the Department had assumed. Nailing down the reasons why actual salary credits claimed were so much larger than anticipated was difficult. Staff who prepared those estimates are no longer with the Department, few records exist, and existing records are incomplete.

Based on the information we could review, it appeared Department staff correctly assumed that most <u>in-State</u> companies would take the maximum credit, and that this credit would offset the 1% increase in premium tax rates. However, the estimated impact from <u>out-of-State</u> companies taking the credit was too low. We identified two primary reasons:

❑ **The Department was unaware of some out-of-State companies that had locations and employees in Kansas.** The Department initially estimated 26 out-of-State companies would be eligible to claim the salary credit because they had Kansas employees. The first year, a total of 47 out-of-State companies actually had salaries in Kansas and claimed the credit–or almost twice as many as the Department thought. Department officials told us their list of out-of-State companies was put together based on what staff members thought was a complete list, rather than on a survey of all out-of State companies.

Altogether, this reason accounted for about $6 million of the unanticipated drop in premium tax receipts in fiscal year 1999. The profile on page 10 shows that just 5 large companies accounted for nearly $5 million of this amount.

For fiscal year 2000, the impact of undercounting the number of out-of-State companies that could take the salary credit could have accounted for as much as $10.8 million of the unanticipated drop in premium tax receipts. (Records aren't available to allow us to be more precise.)

- **The Department didn't include the impact of companies being able to share unused salary credits with their affiliates in its estimates.** Department officials told us they didn't think many companies could take advantage of this provision. However, it appears from Department records that 93 companies were able to use it for 1999 to claim salary credits they otherwise wouldn't have been able to claim, 92 of which were out-of-State companies.

  The Department's initial proposal didn't include the affiliate provision, but as explained in the overview the bill that was introduced did include the affiliate provision. In preparing a fiscal note for the bill, Department staff used estimates they'd prepared earlier that didn't include any impact of the affiliate provision. The impact of the affiliate provision in the law reduced the premium taxes for out-of-State companies by about up to $4 million the first year, and by up to $7 million the second year.

Examples of Insurance Companies That Apparently Weren't Included in the Department's Estimates of the Fiscal Impact of the Salary Credit

When the Legislature amended the premium tax law in 1997, it was acting on fiscal estimates provided by the Insurance Department. However, the actual impact of these credits was $8.3 million greater than the Department estimated for fiscal year 1999, and $17.8 million greater for fiscal year 2000. One reason for the difference: many more out-of-State insurance companies took the credit than the Department had anticipated.

Given the information available to us, it appeared the following 5 companies weren't included in the Department's estimates. These companies–which we selected for further review because of the large salary credits they took–claimed a total of almost $5 million in salary credits for the 1998 tax year.

- State Farm Mutual Automobile Insurance Company reported paying $16 million in Kansas salaries. The company took a salary credit of $2.4 million, based on the 1% cap of taxable premiums.
- State Farm Fire & Casualty Insurance Company reported paying $5.7 million in Kansas salaries. The company took a salary credit of $1.3 million, based on the 1% cap of taxable premiums.
- New York Life Insurance Company reported paying more than $1.9 million in Kansas salaries. The company took a salary credit of almost 500,000, based on the 25% of salaries.
- Metropolitan Life Insurance Company reported paying $4.4 million in Kansas salaries. The company took a salary credit of almost $418,000, based on the 1% cap of taxable premiums.
- Great West Life and Annuity Insurance Company of Colorado reported paying $6.2 million in Kansas salaries. Insurance Department officials learned from the company that it had a location in Fort Scott, Kansas. The company took a salary credit of over $260,000, based on the 1% cap of taxable premiums.

Example of How the Affiliation Provision Can Increase Salary Credits

Affiliated Insurance Companies	KS Employee Salaries	Potential salary credit (based on 30% of Kansas salaries)	Taxable Premiums	Salary credit each company could take (max of 1.25% of taxable premiums)	Salary credit taken
Company A	$9,000,000	$2,700,000	$2,500,000	$ 31,250	$ 31,250
Company B	$0	$0	$3,500,000	$ 43,750	$ 43,750
Company C	$0	$0	$7,400,000	$ 92,500	$ 92,500
Total	**$9,000,000**	**$2,700,000**	**$13,400,000**	**$167,500**	**$167,500**

Because companies B and C had no salaries in Kansas, they wouldn't have been eligible to take any salary credits without the affiliate provision. However, as affiliates of company A, which had more than $2.6 million in unused salary credits, the two companies were able to claim salary credits totaling $136,250.

For tax year 1999, the 238 insurance companies that took the salary credit paid an average premium tax rate of .63%. Under the 1997 changes to the law, the premium tax rate was set at 2%. However, companies that were able to claim the salary credit that year (up to a maximum of 1.25% of taxable premiums) generally could expect to pay an effective tax rate of only .75%.

The table below shows the average premium tax rates paid by the 238 companies that took the salary credit and the average rate paid by a sample of 23 companies that didn't take the credit.

Effective Average Tax Rates For All Companies That Took the Salary Credit and For a Sample of Companies That Didn't Take the Salary Credit In Tax year 1999

238 Companies that took the Salary Credit	
Number of in and out-of State companies	**Effective average tax rate [a] for 1999 tax year**
28 in-State companies	.38%
210 out-of-State companies	.66%
Sample of 23 Companies that didn't take the Salary Credit	
2 in-State companies	1.81%
21 out-of-State companies	1.84%

[a] The effective tax rate includes other credits companies are allowed to claim on their premiun tax returns.

As the table shows, companies that took the salary credit as well as those that didn't paid an average tax rate lower than what would be expected. That's due to the effect of other credits companies are allowed to claim on their premium tax returns.

Kansas' Premium Tax Rate
Is In Line with Rates in Neighboring States

Most of the neighboring states have set their premium taxes at about 2%. The exception is Nebraska which has a tax rate of 1% as shown below.

Kansas	2.0%	Iowa	2.0%
Colorado	2.25%	Nebraska	1.0%
Missouri	2.0%	Oklahoma	2.25%

Source: March 11, 1997, information provided by the Department to the Senate Committee on Assessment and Taxation.

If the Legislature Granted More in Premium Tax Breaks Than It Intended, Salary Credits Could Be Adjusted To Bring Tax Receipts Back In Line With Original Projections

A number of remedies exist for returning premium tax receipts to their earlier anticipated levels. In February 2000, the Insurance Department provided information to the Legislature and the Budget Division identifying several options for adjusting the salary credits. Those estimates were based on the first year's experience with the salary credits.

We explored some of those same options using the second year's experience, and assuming everything else stayed the same. Both estimates are summarized in the table at right.

Obviously these options could be considered in various combinations. We didn't try to estimate their impact, but such estimates could be computed.

Possible Actions To Return Premium Tax Receipts to Previous Levels

	Insurance Department estimates (based on tax year 1998 data)	Legislative Post Audit estimates (based on tax year 1999 data)
Reducing the **% of taxable premiums** used to compute the maximum allowable salary credit	impact for every <u>1/4% reduced</u>: **= a $6.25 million increase in premium tax receipts**	reducing from 1.25% to .75%: **= a $12.8 million increase in premium tax receipts**
Reducing the **% of salaries** that can be claimed for the salary credit	impact for <u>every 1%</u> reduction: **= a $1.0 million increase in premium tax receipts** (These estimates didn't take into account the impact of the maximum cap allowed for the salary credit. Most companies are subject to the cap.)	reducing <u>from 30% to 20%</u>: **= a $1.2 million increase in premium tax receipts** reducing from <u>30% to 10%:</u> **= a $8.5 million increase in premium tax receipts**
Eliminating the affiliate provision, which allows companies to share unused salary credits with their affiliates	estimated impact not computed	eliminating affiliate provision: **= up to a $7 million increase in premium tax receipts** (this figure would represent the maximum)

CONCLUSION

By equalizing premium tax rates for in-State and out-of-State companies, the 1997 Legislature avoided what might have been as much as $500 million in lawsuits from out-of-State companies that had been assessed higher tax rates for years. And by allowing any company with Kansas employees to claim a salary credit, the Legislature helped offset the impact of the 1% premium tax rate increase on in-State companies. However, these changes have cost the State much more than the Legislature expected. The State will be experiencing a significant drop in premium tax receipts when the effects of the salary credit have leveled off. This annual cut in taxes is about 4-5 times greater than Insurance Department estimates projected.

Those estimates undercounted the number of out-of-State companies eligible for the salary credit, and didn't consider the impact of allowing companies to share their unused salary credits with other affiliates. It's impossible to say what the Legislature would have done if it had known these changes were going to reduce premium taxes as much as they have. But armed with better cost data, the Legislature may want to revisit the premium tax law and the level of tax cuts it granted.

RECOMMENDATION If there's legislative interest in bringing premium tax receipts closer to earlier estimates, the appropriate legislative committees should explore the options presented in this report–or from any other source–for adjusting the factors that make up the salary tax credit. Those options, most of which also were previously suggested by Department officials, could include:

- reducing the percentage of taxable premiums used to compute the maximum allowable salary credit,
- reducing the percentage of salaries that can be claimed for the salary credit,
- eliminating the provision that allows companies to share unused salary credits with their affiliates, or
- any combination of the above.

Question 2: Are the Insurance Department's Procedures Adequate To Ensure That Insurance Companies Claim Only the Salary Credits They're Entitled To?

The Department has good procedures for ensuring that taxable premiums being reported are accurate and that forms are being filled out correctly, but it doesn't do enough to verify the information companies report about salaries and affiliates to ensure that what's being reported is both accurate and allowable under law. Our testwork on 197 insurance companies (covering 34 affiliated groups) showed that companies generally paid enough salaries in Kansas to support the amount of credits they and their affiliates had claimed. We identified a number of cases where insurance companies had reported higher salaries to the Insurance Department than they'd reported to the Department of Human Resources for unemployment tax purposes. However, none of these appeared to result in companies getting too large a salary credit. We also identified several problems related to how affiliate groups report their salaries and claim the salary credits. These and other findings are discussed in the sections that follow.

Insurance Companies Could Claim More in Salary Credits Than They're Entitled To In Several Ways

Each year, insurance companies file premium tax returns that include such information as their taxable premiums, the salaries they pay their Kansas employees, the salary credit they're claiming, and their affiliated companies. Given the way the salary credit works, insurance companies could intentionally or unintentionally circumvent the law in any of the following ways:

- **insurance companies could report more in salaries than allowed by law.** The law allows companies to claim a credit for 30% of their "eligible" salaries (up to the 1.25% cap). To be eligible, those salaries must be paid only to employees in Kansas, must be for insurance-related operations only, and can't include commissions or amounts paid to independent contractors. For the 28 insurance companies that took a salary credit based on 30% of their salaries, the risk would be that:

  ✓ they claimed higher insurance-related Kansas salaries than they really had
  ✓ they claimed non-Kansas salaries
  ✓ they claimed commissions or amounts paid to contractors

- **insurance companies could share unused salary credits with companies that don't meet the legal definition of "affiliate," or could double-count the salaries within affiliated groups.** By law, to be affiliated one insurance company must own 100% of the voting stock of the other company(ies). Affiliated companies are treated like one big company–if any company in the group can't use the full 30% of salaries for the credit (because it's subject to the 1.25% cap)–the others get to share those salaries. Thus, an affiliated group of companies could claim more salary credits collectively than they could as individual companies.

- **insurance companies could make mathematical errors or incorrectly transfer information from one place to another on their premium tax returns.**

Despite Some Strengths, The Department's Procedures For Ensuring That Companies Aren't Claiming Too Much in Salaries Have Several Weaknesses

The Department has good procedures for ensuring that taxable premiums are accurately reported and that mathematical errors are caught. It also has some good procedures for ensuring that salary credits are accurate and allowable. For example:

- The instructions on the premium tax return ask companies to provide verification that the salaries reported are for compensation (not commissions) for Kansas employees performing insurance company operations in Kansas. They also ask companies to provide the location(s) of their operations.

- If companies don't submit anything to support the salary credits taken, Department staff are supposed to send a letter requesting such information again. That letter indicates the companies could provide copies of the quarterly wage reports they submit to the Department of Human Resources. Department officials also occasionally request copies of these quarterly wage reports on their own. These reports provide an independent check on the salaries reported. While companies may have an incentive to overstate the salaries they report on their premium tax returns, they have an incentive to understate the salaries they report for unemployment tax purposes. In our review of 20 random companies, 40% submitted these unemployment wage reports for supporting documentation.

- If any of the salary information reported appears to be questionable, Department staff are supposed to do additional follow-up work, and may deny certain amounts claimed. During this audit, we learned of one instance in which all of the salaries a company claimed on its premium tax return were from out-of-State, and the Department denied the salary credit.

However, we identified several weaknesses in the Department's procedures or in the way they were carried out:

- **Only 11 of the 20 company files we reviewed had what we'd consider acceptable documentation to support the amount of salaries they were claiming.** Of the remaining 9:

  → 5 had no supporting documentation. Department staff hadn't sent a follow-up letter requesting it, as required

  → 4 had letters from the company "attesting" that the information reported was accurate. Department staff told us they accept such letters in lieu of other supporting documentation, but we don't consider this to be sufficient documentation.

- **The Department doesn't check whether companies are meeting the statutory requirements of "affiliation."** In addition, while Department officials told us they compare tax returns of a company's affiliates to make sure each has provided identical information, we found at least one instance in which such reconciliation didn't happen.

- **The Department doesn't ensure that the salaries being reported are all related to insurance operations.** The law defines insurance operations broadly to include medical, legal, and investment services related to insurance policies, as well as public relations, advertising, training of sales staff, and services to policyholders. But if a company has both insurance and non-insurance operations in Kansas, the Department currently has no way of knowing whether the company was only reporting salaries related to its insurance operations.

We Found 19 Discrepancies in the Salaries Reported by 197 Companies We Reviewed, But Those Discrepancies Ultimately Didn't Affect The Credits They Could Claim

To determine whether insurance companies may be claiming salary credits they weren't entitled to, we reviewed salaries for 197 companies that claimed the salary credit on their 1999 tax returns. This sample included 182 companies that were affiliated in 34 groups, and 15 individual companies.

For each of the individual companies or groups, we checked the salaries they'd reported on their premium tax returns against the salaries they'd reported for unemployment tax purposes to the Department of Human Resources. We wanted to see if the companies had reported at least enough Kansas salaries to justify the amount of salary credits they claimed on their premium tax returns.

3-25

Most Companies Claiming Salary Credits Are Claiming the Maximum Allowed by Law

As mentioned elsewhere in this report, the maximum salary credit an insurance company can claim on its premium tax return is limited to 30% of salaries or 1.25% of taxable premiums, whichever is less. The following information about the 238 companies that took the salary credit on their 1999 returns shows that most companies have more salaries than they can claim credits for.

Companies claiming credits based on 1.25% of premiums

Number of companies - 210

Reported Kansas Salaries - $448,044,562

Reported Taxable Premiums - $2,713,590,716

Companies claiming credits based on 30% of salaries

Number of companies - 28

Reported Kansas Salaries - $9,366,777

Reported Taxable Premiums - $439,555,472

The 19 discrepancies we found are summarized below:

- **1 group of 6 affiliated companies had reported only $544,000 in Kansas salaries to the Department of Human Resources, but they claimed a total of nearly $2 million in Kansas salaries on their 1999 premium tax returns.** These 6 companies collectively claimed salary credits of $204,400 (remember, credits are given on only 30% of reported salaries up to a maximum of 1.25% of the companies' taxable premiums). If the salaries reported to the Department of Human Resources were right, the salary credits claimed should have been only $163,000, or about $41,400 less.

  At the time this report was written, a group representative told Insurance Department officials the group would provide additional information to the Insurance Department supporting the salaries it claimed for the salary tax credit. Group representatives also indicated they apparently had under-reported salaries to the Department of Human Resources, and would file amended wage reports. We'll be passing this information on to the Department.

- **8 groups of affiliated companies and 10 single companies claimed more Kansas salaries on their 1999 premium tax returns than they reported to the Department of Human Resources, but those differences had no impact on the amount of salary credits they could claim.** That's because the salaries these companies reported on their premium tax returns already were higher than the maximum amount they could use in computing the salary credit (in other words, they were subject to the 1.25% cap). Thus, even though the amount they reported to the Department of Human Resources was less than what they claimed on their premium tax return, that amount was still more than enough to allow them to take the maximum credit.

It's possible that some of these 19 companies or groups of companies may have reported additional salaries to the Department of Human Resources under another company name. However, we searched records under both the company names and the FEIN numbers they listed on their premium tax returns, and had to make our determinations based on that search because we had no other information to go on.

During our file reviews, we also noted some cases where it was difficult to determine which companies were affiliated as one group. Companies are supposed to list all their affiliates on the salary credit form they fill out, but we found at least one situation where a company claimed to be affiliated with another, but the other company didn't claim to be affiliated with the first one. In this instance, it was difficult to verify the salary credits each company claimed. The risk here is that one company could claim to be affiliated with another company without that actually being the case, and potentially could claim salary credits it wasn't entitled to.

CONCLUSION

Although we didn't find a significant problem with companies claiming salary credits they weren't entitled to, it would be difficult for Insurance Department officials to know if they were. That's because two provisions of the law are nearly impossible to enforce without detailed audits–using a spot-check or risk-based approach–of insurance company records. One of those provisions allows only salaries related to insurance operations to be claimed for the credit, and the other allows companies to be considered affiliates only if one company holds 100% of the voting stock of another. Insurance Department auditors don't specifically check for these things when they audit insurance companies. While there are some things the Department can and does do to help ensure that salaries claimed are correct, the procedures currently in place don't ensure that all the provisions of law are met.

RECOMMENDATIONS

1. To help ensure that insurance companies don't claim salary credits for any salaries already claimed by another company, and that they have sufficient salaries to justify the credits being claimed, the Insurance Department should do the following:

a. establish a memorandum of understanding with the Department of Human Resources that will allow the Insurance Department to obtain copies of quarterly wage reports filed for unemployment tax purposes for companies that claim a salary credit.

b. change the premium tax form to make clear that all companies sharing salaries must provide the following information:

- how much of the salaries are attributable to the company filing the premium tax return
- how much is being claimed from affiliated companies, and the amount coming from each such company
- how much is being shared with other affiliated companies, and the amount going to each such company.

The information reported by each company in an affiliated group should be reconciled to ensure that no salaries are double counted.

c. for companies filing separately or as part of an affiliated group, verify the total amount claimed with the amounts reported on the quarterly wage reports and on other supporting documentation the companies may submit.

2. To ensure that insurance companies claiming the salary credit are meeting the requirements of law, the Insurance Department should periodically audit a sample of companies taking those credits. Using a spot-check or risk-based approach will keep these audits cost-effective.

APPENDIX A

Scope Statement

This appendix contains the scope statement approved by the Legislative Post Audit Committee for this audit on August 11, 2000. The audit was requested by Representative Tomlinson.

SCOPE STATEMENT

Reviewing Issues Related to Employee Credits Against Premium Taxes Paid by Insurance Companies

Life, property, and casualty insurance companies doing business in Kansas pay an annual tax based on the amount of premiums they collect in the State. In the past, the tax rate was 1% for companies based in Kansas and 2% for companies based in other states. The 1997 Legislature equalized the rates at 2% for all insurers, but allowed them to take a credit against that tax based on a percentage of salaries paid to Kansas employees. The credit may not reduce the tax by more than 1.25% of the insurer's taxable premiums, but State law allows insurers to share the credits with other companies with which they are affiliated.

Insurance companies file an annual return with the Insurance Commissioner stating the amount of all premiums received in Kansas, and provide information on how they calculated the salary credit. Under State law, the Insurance Commissioner must verify the returns and assess the appropriate tax. Insurance Department officials said they didn't audit the credit information reported for tax year 1998, but plan to do so for the1999 returns.

In fiscal year 1998 insurers paid nearly $85 million in premium taxes, but in fiscal year 1999 they paid only $64 million. This drop in revenue is far greater than the $7 million decline anticipated in the fiscal note provided to the 1997 Legislature when it voted to equalize the rates. Legislative concerns have been raised about why the decline in premium tax revenues has been so much greater than anticipated, and specifically whether insurance companies are claiming credits only to the extent allowed by the law. The Insurance Commissioner provided the Legislative Post Audit Committee with information showing the amounts being collected, but that information doesn't show whether those are the appropriate amounts.

A performance audit in this area would address the following questions:

1. **How does the Insurance Department plan to ensure that companies receive only the tax credits to which they are entitled?** To answer this question, we'd review whether the original estimate of fiscal impact was reasonable. We'd interview Department officials to see how they plan to verify premium and credit amounts reported by companies, and assess whether those procedures are likely to provide reasonable assurance that the amounts reported are correct.

2. **Are insurers complying with State law in the way they calculate and apply employee salary credits?** We'd review the law to determine what it allows (for example, some employees' salaries can't be counted toward the credit). We'd do an in-depth review of a sample of companies (some based in Kansas, some not) to determine whether the employees for whom they were claiming the credit were eligible. We'd also review information available from State agencies such as the Department of Human

Resources and the Department of Revenue to see if the reported salary information appeared to be correct. In addition, we'd determine the extent to which companies are sharing credits with their affiliates, and the effect that has had on the total premium tax collected. We'd perform other testwork as needed.

Estimated time to complete: 6 - 10 weeks, depending on availability of data

APPENDIX B

Agency Response

On February 22, 2001 we provided copies of the draft audit report to the Department. Its response is included as this Appendix.

As a result of discussions with Department officials during their review of the draft report, we made some minor clarifications to the draft audit that didn't affect any of our findings or conclusions.

LEGISLATIVE POST AUDIT

FEB 22 2001

Kathleen Sebelius
Commissioner of Insurance
Kansas Insurance Department

February 22, 2001

Members of the Legislative Post Audit Committee

and

Barbara J. Hinton
Legislative Post Auditor

I am most proud that the Department, the Legislature, and the insurance industry were able to work together four years ago to craft the Premium Tax Reform Act. This law resolved a potential unconstitutional Kansas Law that, if unchanged, would have cost the state a minimum of $500.0 million.

This relatively new law has resulted in a significant loss of premium tax receipts to the State General Fund. As soon as the Department noticed the drop in receipts we began to investigate. We then presented, to two legislative committees and the Division of the Budget, suggestions for mitigating this loss. Your recommendations are in agreement with many of the points I raised at that time.

I appreciate the Division of Legislative Post Audit's observation that the Insurance Department has "good procedures for ensuring that taxable premiums being reported are accurate and that forms are filled out correctly." Further, the report stated that my Department "has some good procedures for ensuring that salary credits are accurate and allowable."

Basically, this report summarizes possible changes that can be made to the law to mitigate loss of revenue. Further, it provides evidence that the Insurance Department is accurately applying current statutes and properly collecting premium taxes.

Page two of this letter outlines the primary recommendations by the Division of Legislative Post Audit for Department procedures to enhance accurate application of the salary credit law. Next to those recommendations I've indicated the Department's current practices and/or its plans to implement the Division's recommendations.

420 SW 9th Street
Topeka, Kansas 66612-1678
ksebelius@ins.wpo.state.ks.us

785 296-3071
Fax 785 296-7805

Consumer Assistance Hotline
1 800 432-2484 (Toll Free)

Recommendation Legislative Post Audit	Department Response
1. The Insurance Department should establish a memorandum of understanding with the Department of Human Resources that will allow the Insurance Department to obtain copies of quarterly wage reports filed for unemployment tax purposes for companies that claim a salary credit.	1. A letter will be immediately sent to companies that in previous years claimed a salary credit. Companies will be required to provide copies of the quarterly wage reports that they file with the Department of Human Resources. Companies will also be asked to verify affiliate status, where applicable. (See Attachment A.)
2. Change the premium tax form to require all companies sharing salaries to provide the following - amount attributed to the companies filing the tax return; how much is being claimed from affiliated companies; how much is being shared with other affiliated companies.	2. The salary credit tax form already includes this information. (Attachment B) The form will be modified for clarification purposes. Documentation to verify numbers is largely done and information rigorously reviewed.
3. To ensure that insurance companies claiming the salary credit are meeting the requirements of law, the Insurance Department should periodically audit a sample of companies taking those credits.	3. Currently ALL tax files are audited. A sampling of files will be **re-audited** by accounting staff to ensure compliance with audit procedures.

The Department continues to perfect its premium tax procedures and appreciates the Division of Legislative Post Audit's review and thoughtful recommendations. We recognize that premium taxes are a significant revenue source for the State General Fund and we look forward to working with the Legislature in any way possible to adequately address this situation.

Sincerely,

Kathleen Sebelius

Kathleen Sebelius

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ATTACHMENT A

IMPORTANT TAX INFORMATION

March 2, 2001 Due Date

February 22, 2001

ATTENTION: TAX DEPARTMENT
Person Responsible for the Preparation of Premium Taxes for Kansas

RE: **COMPANIES CLAIMING THE KANSAS SALARY CREDIT**

A review of our records indicates your company in the past has claimed a credit for employee salaries. This credit was taken against the premium tax payable in Kansas.

The instructions for taking this credit require that you provide verification of particular aspects of the employee salary credit portion of the amount shown on Line A1 of Schedule A, Credit Summary, of the Annual Premium Tax Statement. This information is still required.

It will also be necessary for all companies claiming the salary credit to submit the following:

1. **Copies of the Employers Quarterly Wage Report and Contribution Returns (Form K-CNS100) that have been filed with the Kansas Department of Human Resources. This request is for the year ending December 31, 2000.**

2. **If your company is claiming salary credits allocated among affiliates, you must also submit documentation verifying affiliate status as defined under Kansas Statutes Annotated 40-252d(b)(1).**

If your company has already submitted the above-required documentation, it is not necessary to submit the documentation again.

Any questions on this request should be addressed to Roger Swarts (Life Companies) or Mel Scott (Property and Casualty Companies).

Thank you for your cooperation,

Roger L. Swarts

Phone: 785-296-7857
Fax: 785-291-3673
Email: rswarts@ksinsurance.org

Mel Scott

Phone: 785-296-7838
Fax: 785-291-3673
Email: mscott@ksinsurance.org

ATTACHMENT B

YEAR 2000
INSURANCE DEPARTMENT
STATE OF KANSAS

FIRE AND CASUALTY INSURANCE COMPANY
ANNUAL PREMIUM TAX STATEMENT
SCHEDULE B

EMPLOYEE SALARY/SMALL COMPANY CREDIT

NAME OF COMPANY ______________________

Employee Salary Credit Calculation

(a) Affiliated Insurance Companies*	(b) Kansas Employees' Salaries	(c) 30% of Amount in Column (b)	(d) Line 7 Annual Premium Tax Statement	(e) 1.25% of Amount in Column (d)
________	$________	$________	$________	$________
________	$________	$________	$________	$________
________	$________	$________	$________	$________
________	$________	$________	$________	$________
________	$________	$________	$________	$________
________	$________	$________	$________	$________
B1. Total Columns (c) and (e)		$________		$________
B2. Salary Credit to be allocated (Smaller of the two totals on Line B1)				$________

Affiliated Insurance Companies*	Allocated Amount from Line B2 per Company
B3. ________	$________
B3. ________	$________
B3. ________	$________
B3. ________	$________
B3. ________	$________
B3. ________	$________

* Attach additional sheets, if necessary, for other affiliated companies.

Small Company Credit Calculation
(Allowed only for those companies that have paid Kansas employees' salaries)

B4.	Maximum premiums written	$ 15,000,000
B5.	All premiums written in all states	$________
B6.	Line B4 less Line B5, but not less than $0	$________
B7.	Divide Line B6 by 15,000,000	$________
B8.	Multiply Line B7 by 90,000	$________
B9.	Credit Limit	$ 30,000
B10.	Small company credit (Smaller of Line B8 or Line B9)	$________

B11.	Employee salary credit allocated to this company on Line B3	$________
B12.	Small company credit (From Line B10)	$________
B13.	Total credit prior to limitation (Line B11 plus Line B12)	$________
B14.	Taxable premium limit (Enter 1.25% of Line 7, Annual Premium Tax Statement)	$________
B15.	Employee Salary/Small Company Credit (Smaller of Line B13 or Line B14)	$________

GLENN, CORNISH, HANSON & KARNS, CHARTERED
800 SW Jackson - Suite 900
Topeka, Kansas 66612
785-232-0545

March 1, 2010

TO: **House Taxation Committee**

RE: Insurance Premium Tax Credit for Kansas employee salaries

Mr. Chairman and Members of the Committee:

Thank you for this opportunity to appear before the Committee. I am David Hanson and am appearing on behalf of the Kansas Association of Property and Casualty Insurance Companies, whose members are domestic insurance companies in Kansas, and also on behalf of PCI, the Property Casualty Insurers Association of America, with over 1,000 member companies across the country writing about 38% of the property-casualty market last year.

In the latter part of 1997, representatives of several of our member companies were invited to join with legislative leaders, former Insurance Commissioner Sebelius and business development leaders in a task force to explore ways to improve the business climate for insurance in Kansas. The task force recognized the positive impact that insurers have on the economy and sent a clear message to insurers that Kansas wants insurers to bring the jobs and other benefits that only an increased competitive environment in insurance, like any industry, can bring. One of the reports received by the task force indicated that state regulation on underwriting restrictions and cancellation/nonrenewal restrictions ranked second most significant of regulatory burdens of concern to insurers. One of the conclusions reached by the task force was that a regulatory climate in Kansas that was unnecessarily burdensome would prevent insurers from wanting to come to Kansas to compete. As a result of its study, the task force recommended that Kansas should pursue "...accelerated general deregulation and the movement to open competition..." if Kansas is to remain competitive with other states. (See Final Report of the Task Force on the Kansas Insurance Industry, December 1997; Recommendation No. 4)

Consequently, we try to alert you to positive enhancements, as well as to unduly burdensome or unnecessary restrictions. We realize that this often entails a tough policy decision on your part. Insurers are also faced with difficult decisions in managing their businesses. The salary credit for Kansas employees goes to the very heart of the staffing decisions insurers need to be able to make in order to be competitive. And, to be competitive in insurance means to be able to offer the best coverages at the best rates to consumers.

We are also concerned that this proposal may have an unintended effect of impeding growth and competition, since companies would generally be reluctant to enter new market areas where there are significantly increased tax burdens which will be compounded by retaliatory taxes and the likely reduction in staffing in Kansas.

We appreciate your consideration of our concerns and would ask that the salary credit not be reduced or repealed in light of these concerns.

Respectfully,

DAVID A. HANSON

House Taxation
Date: 3-1-10
Attachment: 4

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BRAD SMOOT

ATTORNEY AT LAW

800 SW JACKSON, SUITE 808
TOPEKA, KANSAS 66612
(785) 233-0016
(785) 234-3687 (fax)
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SUITE 230
LEAWOOD, KANSAS 66206

STATEMENT OF BRAD SMOOT
LEGISLATIVE COUNSEL
AMERICAN INSURANCE ASSOCIATION
And
BLUE CROSS BLUE SHIELD OF KANSAS
HOUSE TAXATION COMMITTEE
INFORMATIONAL HEARING ON PREMIUM TAX SALARY CREDITS
March 1, 2010

Mr. Chairman and members:

I am pleased to appear today on behalf of two very different insurance interests. The American Insurance Association is composed of more than 300 property and casualty insurers providing auto, home, workers compensation, business and general liability coverage for hundreds of thousands of your fellow Kansans. Our membership includes many household names such as Farmers, The Hartford, The Travelers and many more. AIA member companies employ tens of thousands of Kansans in clean well-paying jobs with benefits throughout the entire state. AIA member companies are among the largest employers in Johnson and Sedgwick Counties.

Blue Cross Blue Shield of Kansas is the state's largest health insurer with nearly 900,000 Kansans carrying a BCBS card. As a Topeka-based mutual insurance company, we are owned by our policyholders. BCBS, and our 1500 employees most of whom work in Shawnee County, contribute significantly to the federal, state and local taxes. The state's premium tax is the third largest source of the SGF yet it represents just one of the many taxes that insurers pay.

We appreciate the opportunity to comment on Kansas' premium tax salary credit, K.S.A. 40-252d. We think it entirely appropriate that the Legislature regularly review various tax credits, particularly those created solely for the reason of economic development. As you may know, however, the premium tax salary credit has a much more complex and significant history. For decades, Kansas illegally taxed out of state insurers at twice the rate of domestic insurers. After many years, these unfairly burdened carriers began paying their taxes under protest, creating an enormous liability for the state of Kansas, potentially in the $100 million range. When the US Supreme Court declared unequivocally that such disparate tax rates were unconstitutional, Kansas reluctantly became the last state in the nation to correct the inequity. To remedy this problem, the Legislature had to change the tax code. But how to do so without damaging the domestic insurance industry or increasing retaliatory taxes levied by other states on our companies while getting rid of the $100 million civil liability was no small challenge. The Senate proposed raising all premium taxes to 2% making Kansas a high insurance tax state and the House wanted to lower the rate for all carriers to 1%, bringing Kansas in line with lower taxing states, thus protecting the domestic insurance industry. The compromise took months of negotiations and give and take on all sides. In the end, the best solution was to equalize the tax on all insurers at 2% but give any insurer, whether domiciled in

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Kansas or elsewhere, an employee salary credit against the 2% premium tax for jobs located in Kansas. This way, domestic insurers were not hit so hard by the doubling of the tax rate. A cap was placed on the salary credit so that no insurer could pay less than the original domestic premium tax rate of 1% as a result of the salary credit. As a part of the arrangement, carriers which had filed their taxes under protest agreed to abandon their claims and the state treasury retained approximately $100 million dollars. About 4 years later, the state recognized that it had underestimated the number of insurance jobs in the state and made an adjustment to the salary credit rate which generated more income to the state but still met the general parameters of the original '97 agreement.

While the goals of the premium tax salary credit go far beyond the ordinary economic development objectives of other legislation, the benefits of the salary credit in job retention and creation is clearly demonstrable. Universal Underwriters domesticated to Kansas after the salary credit was enacted. I believe they employ well over 1000 in Johnson County alone. Farmers Insurance moved a large customer service center to Olathe after the salary credit was enacted, creating more than 500 new jobs.

BCBS, like any insurance company, can do much of its work from almost anywhere. For example, BCBSKS had been the administrator of Medicare for the US government for decades. When the government decided to consolidate several states for administration, BCBSKS bid on the new federal contract in order to keep the nearly 500 Topeka jobs associated with this business. In the end, however, another carrier was able to win the contract, taking those jobs elsewhere. The point is that, unlike a fireman, a barber, a restaurant, a gas station or a home builder, financial institutions, including insurance companies, can do much of their claims processing and computer work from almost anywhere. So whether it's bringing new jobs or trying to retain existing ones, tax rates and other operational costs determine where the jobs go. Where the jobs go, so go the state and local taxes associated with them. By my quick count, at least 17 other states have salary, wage or investment tax credits available to insurers against their premium tax obligations. Clearly, the competition to retain and attract insurance jobs is keen.

Finally, taxes imposed on insurers are a direct pass through to premium rate payers. Such fixed costs are understandably approved as part of any rate filing. So while we might not immediately think of repealing the salary credit as a tax increase, it is. We want Kansans to buy health insurance. Lenders require businesses and homeowners to buy insurance as a condition of lending. And the state of Kansas makes it illegal to drive without auto coverage or run a business without workers compensation. Our state public policy clearly supports optimizing insurance coverage of all types. Our task is to keep that coverage affordable. Raising taxes on insurers is not the way to keep insurance affordable. For these reasons, we urge the 2010 Kansas Legislature to respect the agreements that were forged more than a decade ago; to stand behind the sound public policy associated with the premium tax salary credits and allow Kansas to continue to benefit from a growing insurance workforce and the tax benefits it brings. Thank you for consideration of your views. I would be pleased to respond to your questions.