

**KENTUCKY LOCAL GOVERNMENT INSURANCE PREMIUM
TAXATION: OPPORTUNITIES FOR REFORM**

By

**David E. Wildasin^a
Martin School of Public Policy and Administration
University of Kentucky
Lexington, Kentucky 40506-0027**

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Executive Summary

1. The collection and administration of local insurance premium taxes in Kentucky present significant and costly compliance challenges for insurers, as well as administration and enforcement burdens for local governments. These drawbacks of the current administrative system, apparently unique among the states, have been widely recognized for many years.
2. The advent of new information technologies presents an opportunity to improve significantly the collection and administration of insurance premium taxes.
3. These technologies, provided or overseen by an appropriate state government agency such as the Kentucky Office of Insurance, would enable insurers to determine the proper tax liabilities for the policies that they issue with improved accuracy and reduced costs.
4. A web-based system would also allow for prompt and accurate electronic payment of taxes, whether directly to local governments or through a new administrative body charged with collecting and distributing local taxes on a centralized basis.
5. Such a modernized administrative apparatus would lower the costs of tax compliance, reduce error rates, and the frequency and costs of disputes.
6. By reducing barriers to entry, an improved administrative system would also enhance competition in the insurance industry, benefiting insurance consumers throughout the state, and especially those in municipalities and counties with small populations.
7. While streamlined tax administration does not limit local government policy prerogatives, more efficient tax administration and collection would enhance local financial management and revenue stability and predictability.
8. Increased transparency in local tax administration helps citizens to understand and monitor local policies and to hold local policymakers accountable for their policy decisions.

Introduction

This report has four parts. Section I briefly reviews the role of local insurance premium taxation in Kentucky. While these taxes are an important element of local revenue structures, they are also very diverse, with tax rates, bases, and collections that vary widely among different types of insurance and among localities. Section II describes some of the compliance challenges that this complex system presents to both taxpayers and local governments. The effective utilization of modern information technology would substantially reduce the compliance, administrative, and enforcement costs associated with local insurance premium taxation. Section III outlines the essential features of a streamlined web-based system that would allow insurers easily to determine the amounts of taxes due on the insurance premiums that they receive and to make payments electronically to the proper local authorities, either directly or through a new administrative body charged with tax collection and distribution. Section IV identifies the important policy benefits that a modernized administrative system would offer – to local governments, insurers, insurance consumers, and the general public.

I. The Role of Insurance Premium Taxation in Local Government Finance

At present, over 380 cities and more than 30 counties in Kentucky impose taxes on insurance premiums (Kentucky Office of Insurance, 2007). These taxes are imposed at widely varying rates on a wide range of insurance products, including casualty, automobile, fire, health, life, and inland marine insurance.

Insurance premium taxes play an important role in the tax structure for many local governments in the Commonwealth. Boardman (2006), utilizing Census data on government finances, shows that local governments in Kentucky derived 9.7% of their revenues in 2002 from “Other Taxes,” a category that in Kentucky’s case seems primarily to include insurance premium taxes. A report by Thompson Consulting Group (2007) finds that insurance premium taxes produced approximately \$230 million in tax revenues in 2005. Similarly, the latest available Census data, for 2004-2005, puts local revenues from “Other Taxes” at \$242.4 million, amounting to approximately 7.6% of total local revenues.¹ The importance of insurance premium taxes varies from one locality to the next, but in aggregate they account for a substantial share of local revenues.

Local governments in Kentucky, perhaps uniquely among the states, enjoy a high degree of autonomy with respect to insurance premium taxes. Some localities elect not to impose high rates of taxation, whereas tax rates in other localities are quite high. For insurance premiums subject to tax in 2007-2008, tax rates range from a low of 1% (for

¹ As discussed further in Wildasin (2007), reliable information about the finances of local governments in Kentucky is often very difficult to obtain. The US Census is frequently the best source of such data, which are however reported according to standardized Census categories. This makes it difficult to ascertain the precise correspondence between Census data and specific sources of tax revenue in the Commonwealth.

life insurance in Watterson Park) to as high as 15% (in Ravenna, on all forms of insurance other than life insurance). Tax rates frequently lie in the range of 5-10%, but values outside of this range are also common.

In addition to large variations in tax rates, the amounts of tax collected also differ widely among localities. For the state as a whole, average annual municipal insurance premium tax revenues amounted to approximately \$80 per capita during the period 2002-2005.² But average per capita revenues were much larger or smaller than this figure for many cities. For instance, 39 municipalities collected less than \$25 per capita on average during this four-year period. (Average per capita revenues in the city of Berea were only \$1.16 per capita.) By contrast, the amount of revenue exceeded \$200 per capita in 23 municipalities, most of which had small populations (less than 1,000 residents); the town of California, in Campbell County, raised an average of \$984.49 in insurance premium tax revenues for its 86 residents. It should be noted, incidentally, that Kentucky contains very many small municipalities: more than 220 municipalities have populations of less than 2000 residents, and well more than half of all municipalities have less than 3000 residents.

Local governments in Kentucky are not required to impose uniform rates of taxation on different types of insurance.. In fact, a city or county may tax the premiums paid on all, some, or none of the several types of potentially taxable insurance sold within its boundaries. A substantial number of cities elect not to tax premiums on health insurance, life insurance, or both, while taxing other types, although this practice is far from universal. For those categories of insurance that are taxed within a locality, the rates of taxation may vary substantially. For example, Glasgow taxes insurance premiums at a 5% rate except for health and life insurance, which are taxed at 2%. Ekron, by contrast, taxes all forms of insurance at a 3% rate except for life insurance, which is taxed at 10%. Different from both of these, Bowling Green imposes a tax rate of 7% on fire and inland marine insurance but only a 2% tax on casualty liability, vehicle, health, and life insurance. In addition, as noted by Yaeger and Dutton (2003), state law explicitly exempts certain forms of insurance from local taxation, including health insurance provided to state employees, insurance provided to public service companies (gas, water, electric power, freight carriers, and others), giving rise to still more variation in the tax treatment of different types of insurance.

In summary, local insurance premium taxes constitute an important but very complex component of local taxes in Kentucky, exhibiting great variation in tax rates, tax revenues, and tax bases over time and among the more than 400 localities (the majority of which are very small municipalities, with populations of less than 3000) that impose these taxes.

² The figures reported here and in the following remarks are based on data reported by the Thompson Consulting Group (2007).

II. Administration and Compliance Costs

Kentucky's complex system of local insurance premium taxation presents administrative and compliance problems for both local governments and for insurers. Before issuing an insurance policy, an insurer must determine (a) where the insured risk is located, (b) whether that location is within the boundaries of a municipality, a county, or both, that impose premium taxes, (c) whether that type of insurance is taxable, and, finally, (d) if taxable, what rate of taxation applies. After making these determinations, the insurer must then make separate quarterly tax reports and payments to each local government, with an annual reconciliation return. Errors can easily occur with respect to each of these steps, and the potential for error is compounded as jurisdictional boundaries, policyholder residences, and tax rates can and do change from year to year.

For example, households change addresses frequently, in some cases more than once annually, and may or may not inform their insurers on a timely basis of their change in location. In such cases, the household may or may not move from one taxing jurisdiction to another, and, thus, the taxes payable on premiums for life, health, vehicle and other insurance, and the jurisdiction to which they are payable, may or may not change. Businesses also frequently relocate, reorganize, and shift the locus of insured activities and property from one locality to another.

Even when a policyholder's address is accurately known, it can be difficult to determine if that address is within a taxing jurisdiction. In particular, since zip code boundaries do not coincide with local government boundaries, insurance agents usually rely on the information provided by the insured or on an agent's local knowledge. As a result, insurers may inadvertently collect too much or too little tax on individual policies and thus erroneously remit the wrong amount of taxes to local governments.

Insurance premium taxes also present local authorities with significant administrative and enforcement challenges. To determine whether an insurer is complying with local tax requirements, a local government must identify policyholders whose risks are located within its jurisdiction, the insurers who provide these policies, the type of insurance provided, and the correct rate and amount of tax on each policy. This may be an insuperable administrative burden for Kentucky's many small localities with limited staff capacity. The burden is heavy even for large cities and counties that need to incur the costs of professional staff assistance in order to administer these taxes.

Even the best efforts of insurers and local governments cannot prevent all errors and disputes in the administration of this complex system of local taxes. With many thousands of policyholders and insured risks residing in -- and moving among -- hundreds of taxing jurisdictions that apply thousands of distinct local tax rates, the potential for error is clearly very high. When these errors are discovered, insurers, policyholders, and localities alike may face unexpected and significant financial disruptions. The high costs of resolving these errors through litigation can greatly

increase the effective cost of compliance, administration, and enforcement for all concerned.

The many administrative and compliance problems associated with insurance premium taxes have been well-recognized for many years. The Kentucky League of Cities (2003, p. 12), noting significant discrepancies in state and local insurance tax records, observes that “[t]his is a strong indication of how difficult the tax is to administer and how problematic it is to collect.” Several years earlier, Department of Insurance Commissioner Nichols (Interim Joint Committee on Local Government (1999) had already identified the need for improved insurance premium tax administration, suggesting that a state-level clearinghouse could be established to streamline local tax administration.

In summary, the administration of local insurance premium taxes in Kentucky is complex, costly, and error-prone. These administrative problems have been widely recognized for many years.

III. Prospects for Improved Tax Administration

Recent advances in technology provide an opportunity for significant improvements in the administration of local insurance premium taxes. In particular, improvements in geographic information systems (GIS) technology make it possible to verify the precise location of any given address. Combined with information about county and municipal boundaries, GIS technology can thus be used to determine whether a particular address, and the insurable risks attached to it, is located within a particular taxing jurisdiction. Together with knowledge of any applicable tax rates, this information can be used to determine the amounts of any taxes that may be required on a given insured risk. The utilization of new technologies could be extended to include an electronic payment mechanism that would allow insurers to direct their tax remittances to the appropriate local authorities or, if desired, to a new centralized intermediary agency charged with revenue collection and disbursement, thus streamlining the payment process.

The Kentucky Office of Insurance and many insurers already use GIS-based technologies for locating risks for the purpose of insurance premium taxation. KOI review and certification of such technologies could provide insurers with the certainty that their mechanisms for insurance premium tax collection meet or exceed appropriate standards and that their reliance on such technologies satisfies the risk location element of their tax compliance obligations.

By assuring more reliable procedures for tax calculations, filings, and payments, these arrangements would dramatically simplify tax administration and collection. A properly-designed system based on new technologies can simultaneously provide the necessary safeguards to protect confidential information while providing the proper authorities with the information needed for tax enforcement.

The effectiveness of such a system obviously depends on the quality of the data on which it is based. The Kentucky Office of Insurance already assists in the administration of insurance premium taxes by providing web-based documentation regarding local tax rates (see Kentucky Office of Insurance, 2007). A transparent system that allows governments, insurers, and policyholders to verify address information, coupled with orderly procedures for updating and correction of errors, would improve the accuracy of the micro-level location data that, at present, is very difficult and costly to ascertain.

It should be noted that the use of modern technology in local insurance premium taxation, while potentially very helpful, by no means resolves all of the difficult administration and compliance problems created by this system of taxation. In particular, the taxation of insurance premiums for businesses operating in multiple localities requires some procedure for determining which localities may or may not impose taxes on these businesses. Although this issue goes beyond the scope of the present discussion, it warrants further consideration by policymakers.

IV. Policy Considerations

The development of an electronic system for the administration of local insurance premium taxes would serve several important public policy objectives.

First and foremost, such a system would reduce the costs of tax administration and compliance for taxpayers, insurers, and local governments. Of course, the establishment of a new system entails some start-up and some recurring costs which should be shared, in appropriate proportions, by insurers, the state government, and by local governments.

Second, by facilitating tax compliance, a new system should enhance the ability of local governments to obtain the tax revenues that are properly due. Reductions in errors will increase the predictability and stability of tax revenues.

Third, these improvements would promote competition in the insurance industry, to the benefit of households and businesses in Kentucky. At present, the costs of compliance with local insurance premium taxes, including the potential legal liabilities arising from an inability to achieve error-free compliance, create barriers to insurers who would otherwise consider doing business in Kentucky. Although these barriers may be relatively small for larger local markets in the Commonwealth, such as Louisville/Jefferson County and Lexington/Fayette County, they may be prohibitively high for the many municipalities with smaller customer bases. By discouraging insurers from competing for business in smaller cities and counties, households and firms in these localities are unable to enjoy the benefits of more competitively priced insurance products.

Fourth, a streamlined administrative system of the type described in Section III would continue to allow local governments to choose tax rates that are appropriate to local circumstances, ease their administrative burdens, and facilitate the management of their finances.

Finally, and not least, a more efficient and transparent system of administration for local insurance premium taxes would provide households and businesses with more knowledge about local tax policies and the taxes that they are paying. Informed decisions about the purchase of insurance are facilitated by transparency in pricing, including the amounts of taxes, and, indeed, some households and firms may in some cases decide to locate some of their risks in localities with more competitively-structured local taxes. Localities that impose modest insurance taxes can benefit from a system that clearly reveals their tax policies to existing and prospective residents. The present system of administration hinders the flow of information to the general public concerning local insurance premium taxes which, as noted in Section I, are at once an important but quite complex and opaque component of local revenue structures.

Conclusion

Recent advances in information technologies have created an opportunity to improve significantly the administration of local insurance premium taxes in Kentucky. The establishment of a new system that allows insurers to exploit modern technology in tracking taxable insured risks and in managing payments to local authorities would benefit local governments, insurers, insurance consumers, and the general public while preserving and enhancing local government policy autonomy.

The complexity and costliness of the current system for the administration of local insurance premium taxes has been widely recognized for many years. The reform of this system has long been needed. The availability of new technology now offers the opportunity for reforms that will benefit all concerned.

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