



**House
Legislative
Analysis
Section**

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PREMIUM TAX ON DOMESTIC INSURERS

Senate Bill 447 (Substitute H-2)
Senate Bill 448 (Substitute H-2)
First Analysis (10-19-87)

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Sponsor: Sen. Dick Posthumus
Senate Committee: Finance
House Committee: Taxation

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THE APPARENT PROBLEM:

In August, the Michigan Court of Appeals ruled the state's taxing scheme for insurance companies unconstitutional because it denies equal protection to foreign (out-of-state) insurance companies (Penn Mutual v Department of Licensing and Regulation). The state has subjected foreign companies to a two percent or three percent tax on gross premiums (depending on the line of insurance). Domestic (in-state) insurers pay instead the single business tax. This produces a much lower tax burden for domestic companies. Their tax advantage is between ten and twenty to one, according to tax specialists. The purported justification for the discriminatory taxing scheme, as noted by the court, was to "establish a reliable source of insurance coverages within the state and to increase the availability of insurance in those areas where the public need is the greatest." While the court found this to be a legitimate purpose, it said the state's dual taxing systems were "not rationally related to promoting that purpose." The court gave its holding prospective application only, denying refunds to the foreign insurers who brought the suit. Current and future revenues, however, are threatened. Even before the court ruling, the Blanchard administration proposed subjecting domestic insurers to the premium tax as a method of making the state's insurance taxing scheme more equitable, and the House has twice passed measures to do that as part of property tax relief proposals.

THE CONTENT OF THE BILL:

Senate Bill 447 (H-2) would amend the Insurance Code to impose a two percent premium tax on all insurance companies, foreign (out-of-state) and domestic (in-state), as of September 1, 1987. There would be a small company exemption under which the first \$1 million of premiums would be exempt from the tax with the exemption reduced by \$2 for each \$1 by which an insurer's gross premiums exceeded \$1 million. Further, all insurers would have to pay personal property taxes; foreign insurers are now exempt. Senate Bill 448 (H-2) would amend the Single Business Tax Act to exempt insurance carrier services of domestic insurers beginning September 1, 1987. (Foreign and alien insurers are already exempt.) The two bills are tie-barred to one another.

Senate Bill 447 (H-2) would also establish an economic contingency fund into which the premium taxes collected from domestic insurers in the 1987-88 fiscal year would be deposited. Money from that fund would be credited to the general fund only if, and to the extent that, general fund/general purpose revenues for the 1987-88 fiscal year are less than \$6.597 billion (as reflected in the comprehensive annual financial report of the Department of Management and Budget). Remaining amounts would go to the countercyclical budget and economic stabilization fund. Beginning in the 1988-89 fiscal year, premium taxes from domestic insurers would go to the stabilization fund. The

premium taxes credited to the stabilization fund in any fiscal year, however, could be allocated as part of a school finance reform plan or a tax reform plan. Any such plan would have to indicate the amount of premium taxes to be used.

MCL 500.440 et al. (SB 447) and 208.35 et al. (SB 448)

HOUSE COMMITTEE ACTION:

The House Taxation Committee adopted substitutes for Senate Bills 447 and 448, which take domestic insurers from under the Single Business Tax Act and subject both foreign and domestic companies to the premium tax. Under the Senate-passed versions, insurance companies would pay the single business tax rather than the premium tax. A foreign insurer, however, would be faced with a retaliatory tax that would tax it at the rate Michigan companies pay in the company's home state. The Senate proposal would have adopted a method of applying the single business tax to insurance companies different from the usual SBT calculation. An insurer's tax base would have to be calculated by multiplying .25 times the insurer's gross receipts, excluding receipts from the sale of annuities and reinsurance. (The formula was arrived at by assuming that 75 percent of premiums go for claims and that the value-added of insurance companies can be understood as premiums minus claims.)

BACKGROUND:

On August 3, 1987, the Michigan Court of Appeals invalidated Michigan's premium tax on foreign insurers, holding that the state's discriminatory tax treatment violated the insurers' constitutional right to equal protection (Penn Mutual Life Insurance Co v Department of Licensing and Regulation, Court of Appeals No. 90490). In that case, the plaintiffs (foreign insurers) had based their discrimination claims on a 1981 U.S. Supreme Court case in which the court upheld California's taxing scheme that imposed a retaliatory tax on foreign insurers and a premium tax on both foreign and domestic insurers (Western & Southern Life Ins Co v State Bd of Equalization of California, 451 US 648). According to the Michigan Court of Appeals, "the U.S. Supreme Court considered it now established that the challenged discrimination between foreign and domestic corporations must bear a rational relationship to a legitimate state purpose. The test is (1) does the legislation have a legitimate purpose and (2) was it reasonable for lawmakers to believe that use of the challenged classification would promote that purpose." The court of appeals also discussed a 1985 U.S. Supreme Court case in which, "The controlling principle seemed to be that a state may not favor its own residents by taxing foreign corporations at a higher rate solely because of their residency" (Metropolitan Life Ins Co v Ward, 470 US 869).

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In its Penn Mutual decision, the court of appeals found that the purpose advanced by the state was to "establish a reliable source of insurance coverages within the state and to increase the availability of insurance in those areas where the public need is the greatest." Although the court held that the purpose was legitimate, it found that the domestic/foreign classification was not "rationally related to promoting insurers to offer insurance in the high loss ratio areas," such as medical malpractice, liquor liability, and product liability.

Neither the plaintiffs nor the state have appealed this decision to the supreme court, but on August 24, 1987, the plaintiffs filed a petition with the court of appeals asking the court to rehear its holding that the premium tax be invalidated prospectively only, and asking the court to enjoin the collection of premium tax payments or require that those payments be held in escrow. The state responded by asking the court to re-examine the constitutional issue if the court granted a rehearing. On September 22, the court of appeals denied both parties' motions. Meanwhile, certain domestic insurers filed motions for intervention and rehearing in the court of appeals, which denied the motions on September 23, 1987. The domestic insurers have filed an application for leave to appeal from that denial. On September 24, the Ingham County Circuit Court issued a temporary restraining order under which premium taxes collected are to be placed in escrow by the state treasurer.

On October 2, 1987, the Ingham County Circuit Court ordered the adoption of an escrow agreement entered into by the state and certain foreign insurers who have filed a new lawsuit in the circuit court for an injunction against the continued collection of premium and retaliatory taxes (National General Insurance Co., et al v Bowman, et al, Ingham County Circuit Court Docket No. 87-59734-CZ). The circuit court order of October 2 dissolves the temporary restraining order and requires the insurers to pay into an escrow fund all premium taxes and retaliatory taxes paid on or after September 28, 1987. The order also provides for the release, discontinuation, and/or return of all or part of the payments, depending upon the action of the courts and the legislature.

FISCAL IMPLICATIONS:

The Taxation Committee substitute would raise about \$245 million for fiscal year 1987-88, including \$75-80 million in new revenue from domestic insurance companies, according to estimates by the committee staff and the treasury department. As noted, the premium tax revenue from domestic insurers would go into a newly created fund and only to be transferred to the general fund if general fund revenues fall below the projections that underlie the 1987-88 budget. In future years revenue would go to the "rainy day fund" or could be used to finance school finance reform or other tax reform. (10-19-87) (The Senate-passed proposal aimed at being revenue neutral; in other words, it was designed to bring in \$170 million in fiscal year 1987-1988, the amount the state would have collected from insurance companies without the appeals court decision. According to the Senate Republican staff, of the \$170 million, about \$100 million would be due from applying the retaliatory tax on foreign companies, \$45-\$50 million would be collected from foreign companies under the SBT, and \$25-\$27 million would come from domestic companies under the SBT. Amendments made on the Senate floor, however, to exempt from taxation health and accident insurance premiums would affect these revenue figures.)

ARGUMENTS:

For:

The Taxation Committee's substitute for Senate Bill 447 would treat in-state and out-of-state insurance companies alike by subjecting domestic insurers to the premium tax foreign companies historically have paid. This will repair the defects that have caused Michigan's insurance taxing scheme to be declared unconstitutional and will make the state's insurance industry pay its fair share of taxes at long last. The treasury department has said that domestic insurance companies paid less than \$1.2 million in single business taxes in 1984 and about \$900,000 in 1985 (an 85-firm industry!), which amounts to less than three percent of what their tax bill would have been if they were treated like their out-of-state competitors. Many firms pay no business taxes at all. According to the state treasurer, the domestic insurance industry would have paid to the state between \$300-\$400 million over the past dozen years if its tax burden had been the same as its competition. This outrageous protectionism, however, does not appear to have benefited the state's insurance consumers. There is little evidence that lower prices have resulted or that shortages in essential product lines have been avoided. That is why the state court of appeals struck down Michigan's insurance tax system: the discrimination, it said, is "not rationally related" to its stated purpose, to assure a reliable source of coverages and increase the availability of coverages where the public need is the greatest. Even before the court decision, the tax break for domestic companies was recognized as unfair and unproductive. Twice the Michigan House of Representatives has voted to subject domestic insurers to the premium tax as part of property tax relief proposals made by Governor Blanchard.

For:

The bill provides for a prudent use of new revenues raised by imposing the premium tax on domestic insurers. The money will go in this fiscal year to a newly created fund for use in protecting the budget (not for new spending). In future years, the revenue will go to the budget stabilization fund or will go to help pay for school finance or property tax reform plans.

Against:

The bill would result in a sudden, mammoth tax increase for Michigan's insurance companies. This is bound to damage economically a domestic industry that consists of relatively small companies (by insurance industry standards). It will lead to higher prices for consumers and reduced availability in some lines as the ability of Michigan companies to write new business is impaired. Domestic insurers, without this bill, would already face higher state and federal taxes as a result of the new federal tax law. They pay large property tax bills to local communities and, unlike other businesses, support a variety of guaranty funds and high-risk pools aimed at protecting the state's insurance consumers. The companies also contribute to the economic development of the state. (A representative of the state's life insurers pointed out during one premium tax debate that one purpose of the single business tax was to encourage job-producing capital expenditures and yet companies were criticized when their tax obligations were reduced because they engaged in economically beneficial behavior.)

Rather than raising new taxes in the name of equality, the legislature should produce at least a revenue neutral

measure. Rather than apply an anachronistic, irrational kind of excise tax, the state should tax insurers under the single business tax. The Senate-passed proposal would accomplish these aims. That proposal, which representatives of Michigan companies have supported, would increase the SBT burden of domestic insurers about three-fold, which is far less than the exorbitant tax hike the House substitute contemplates. It would treat foreign and domestic insurers equally under state law and apply the retaliatory tax to foreign insurers to protect Michigan companies doing business in other states. This is a constitutional, revenue-neutral measure that would do far less damage to a vital, job-producing state industry.

The Senate proposal also exempted health insurance premiums in recognition of the fact that commercial health insurers must compete with a large, tax-exempt competitor, Blue Cross and Blue Shield of Michigan. Tax-exempt companies (the Blues and Delta Dental) have nearly three-quarters of the health insurance market in the state. Administrative-services-only (ASO) firms and third-party administrators (TPAs), who service self-insured health plans, pay only the single business tax. Commercial companies, representing a small fraction of the market, would be forced by the House proposal, however, to pay a substantial premium tax and suffer yet another blow to their ability to compete.

Response: The Senate proposal has a number of defects. For one thing, it relies heavily on the retaliatory tax for revenue. That tax's constitutionality has been under attack by insurance companies. In the case in which it was found to be constitutional (involving the state of California), the tax raised a small proportion of revenue and was seen as protection for domestic companies. There is doubt whether a retaliatory tax raising a large proportion of insurance tax revenues would withstand a similar challenge. The state needs a stable revenue source to protect its budgets. It should not rely on a tax that produces revenue based on other state's tax policies nor on a tax that has a good chance of being declared unconstitutional. The Senate proposal also employs an entirely different method of calculating single business tax liabilities for insurance companies than is used for other businesses. In fact, it appears to be a premium tax in disguise (at a rate of roughly .6 percent). If the method is understood as a variation of the SBT it grossly underestimates the tax base of insurance companies by not taking investment earnings into account.

Against:

There are ways of equalizing the tax burden of domestic and foreign insurance companies without raising new revenue. It is estimated that a premium tax of 1.3 percent on all companies would be revenue neutral.

Against:

The bill lifts the exemption from personal property taxes for foreign insurers. This is ill-advised and unjustified. There have been no estimates on what revenue this will bring in nor have there been attempts to determine what affect it could have on the acceptability of the premium tax proposal to the courts. It would also be a difficult tax to administer.

Response: Domestic companies pay personal property taxes now to local units of government. To make tax treatment equal, either foreign companies should pay the taxes or domestics should not. This could be a significant loss of revenue to local units. There do not appear to be any legal consequences from this. As for administration of the tax, it is levied now on all kinds of businesses.

POSITIONS:

The Department of Treasury supports the bills. (10-7-87)

The American Insurance Association (foreign insurers) supports the concept of the bills, but opposes lifting the personal property tax exemption. (10-16-87)

The Michigan Insurance Federation is opposed to the bills. (10-14-87)

The Life Association of Michigan is opposed to the House substitutes. (10-19-87)

American Community Mutual is opposed to the House substitutes and supports the Senate-passed bills. (10-19-87)