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Senate Bill 447 (Substitute S-2 as passed by the Senate)

Senate Bill 448 (Substitute S-2 as passed by the Senate)

Sponsor: Senator Dick Posthumus

Committee: Finance

Date Completed: 10-12-87

## RATIONALE

Under State law, domestic (Michigan-based) insurers are taxed under the Single Business Tax Act, while foreign (out-of-state) insurers are subject to a tax under the Insurance Code upon a percentage of their gross premiums collected. A recent decision of the Michigan Court of Appeals, however, invalidated the premiums tax on foreign insurers (Penn Mutual v Department of Licensing and Regulation). As a result, because the State will no longer be able to assess that tax, foreign insurers will be subject to a so-called "retaliatory tax", which requires an out-of-state insurer to pay the same rate a Michigan-based insurer would have to pay in the foreign insurer's state. Under the retaliatory tax, the State may recoup much, but not all, of the lost premiums tax revenue. It has been proposed that foreign insurers also be subject to the single business tax (SBT), and that other revisions be made in the way Michigan taxes insurers. (For a discussion of the Penn Mutual case, see BACKGROUND below.)

## CONTENT

The bills would revise the ways in which in-state and out-of-state insurance companies are taxed by doing the following:

- Eliminating the premiums tax on out-of-state insurers, and consequently making them liable to pay a retaliatory tax.
- Make all insurance companies doing business in Michigan liable for the SBT.
- Revise the ways in which insurance companies calculate their tax base in determining SBT liability.

The bills are tie-barred. Following is a detailed description of the bills.

### Senate Bill 447

The bill would amend the Insurance Code to eliminate the current method of taxing "foreign insurers" (formed under the laws of another state or country) by repealing provisions that require such companies to pay taxes based upon a percentage of gross premiums collected from insurance purchasers. As a result, foreign insurers would be taxed under provisions in the Code that provide for a retaliatory tax; that is, the tax on foreign insurers would be equal to the tax imposed on domestic insurers (Michigan-based companies) in other states, where the tax burden on Michigan companies exceeds the burden imposed by this State on companies of the other states doing business in Michigan. The bill provides that a domestic insurer owned or controlled by a foreign insurer, that had not obtained a certificate of authority before the effective date of the bill, would be considered domiciled in the same state or country as the foreign insurer.

The bill states that the purpose of the provision requiring payment of the retaliatory tax would be to "promote the interstate business of domestic insurers by deterring other states from enacting discriminatory or excessive taxes".

The Code requires the Insurance Commissioner annually to place a value on the reserve liabilities for all outstanding life insurance policies, and annuity and pure endowment contracts of every life insurer doing business in the State. An insurer is required to pay the Commissioner a valuation fee of one cent for each \$1,000 insured. The bill provides that the evaluation fee would not apply to contracts of reinsurance.

MCL 500.443 et al.

### Senate Bill 448

The bill would amend the Single Business Tax Act to provide that domestic and foreign insurance companies would be subject to the SBT. The bill provides that, under the Act, 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. An insurer's tax base could be reduced by the amount of accident and health premiums paid in Michigan, minus credit and disability income premiums.

The bill would eliminate a provision that allows domestic insurers to exempt from taxation that part of payroll represented by insurance sales commissions paid to employees and salaries of employees primarily involved in claims adjustment.

MCL 208.22 et al.

## BACKGROUND

On August 3, 1987, the Michigan Court of Appeals invalidated Michigan's premiums 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

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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).

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 premiums tax be invalidated prospectively only, and asking the Court to enjoin the collection of premiums 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 premiums 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 premiums 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 premiums tax and retaliatory tax 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 IMPACT**

Senate Bill 447 and Senate Bill 448 would raise approximately the same revenue from insurance companies as prior to the recent court decision that invalidated the premiums tax on foreign insurers. In the aggregate, the 1986 State tax liability of Michigan-based companies would have risen from \$1-\$2 million currently to approximately \$21.2 million. Out-of-state companies would be subject to an SBT rate equal to the rate for Michigan-based companies and the retaliatory tax. Without the premiums tax, the tax liability of out-of-state companies would have fallen from approximately \$149 million to \$124 million in 1986.

## **ARGUMENTS**

### **Supporting Argument**

Because of recent and pending court cases affecting the application of taxes on insurance companies, both nationwide and in-state, the State finds itself in the position of having to alter its tax statutes. Since the Michigan Court

of Appeals ruled last August that the State's method of imposing different and higher taxes on foreign insurance companies, compared to domestic companies, is unconstitutional, a solution must be found that prevents undue revenue loss but at the same time treats insurers fairly.

Currently, the situation for both the State and insurers is complex and uncertain. Though the Court of Appeals ruled that the State's method of imposing the premiums tax on foreign insurers is invalid, the Insurance Commissioner has informed foreign insurers that they still must pay the premiums tax until all motions on the decision have been resolved, and premium taxes collected for the third quarter of this year are to be placed in escrow. Although foreign companies will still be liable for the existing retaliatory tax if the premiums tax is finally invalidated, the State meanwhile faces a cash flow problem, as well as a revenue loss.

In light of this, and the added pressure of recent predictions of State budget shortfalls, a prompt solution is needed. The bills would make all insurance companies liable for the SBT and would require foreign insurers to pay the retaliatory tax. This would keep insurance tax revenues relatively stable, while not placing a burden on either foreign or domestic insurers. By relying on the retaliatory tax the bills would discourage other states from enacting unfair taxes on out-of-state insurers, and thus would promote interstate business for Michigan insurers.

### **Opposing Argument**

Due to the recent Court of Appeals decision, the State must take action regarding insurance taxes or face a critical revenue decline at a time when budget problems are foreseen. The method proposed by the bills, however — making foreign insurers liable for the SBT and depending heavily on the retaliatory tax — is not the answer. Under this proposal, the biggest chunk of total insurance taxes would come from the retaliatory tax, a shaky concept at best because it would depend upon the tax rates of 49 other states. Why should Michigan's tax structure, and thus its ability to predict revenues, be based upon and subjected to the changes made by other states in their treatment of insurance taxes? In addition, insurers nationwide are challenging the retaliatory tax, and asking that payments for the tax be placed in escrow. If the retaliatory tax ultimately is found to be unconstitutional, not only would the State find itself again searching for another way to tax foreign insurers, it would likely not be able to claim any escrowed retaliatory taxes, which in turn would compound revenue problems. Placing too much emphasis on the retaliatory tax at this fiscally sensitive time could eventually lead to far greater problems.

**Response:** The constitutionality of at least one state's retaliatory tax already has been upheld by the U.S. Supreme Court in the California case (discussed under BACKGROUND, above). As for the argument that Michigan should not base its tax on the tax system of other states, it is unlikely that, in any one year, a number of states would alter their insurance taxes so dramatically that revenues from Michigan's retaliatory tax would be significantly affected. In the unlikely event the retaliatory tax is someday successfully challenged, the Legislature can review the situation and find another method of properly taxing foreign insurers.

### **Opposing Argument**

Toward maintaining a balanced budget and restoring equity in taxes on insurers the State should, as several other states do, simply apply a single premiums tax rate on both foreign and domestic insurers. Not only would this solution level the playing field between foreign and domestic insurers, it should bring an end, in Michigan, to

the threat of insurers' legal challenges to taxes based on unequal tax treatment. Applying a premiums tax to all insurers also would close what many people have considered a tax loophole that has given domestic insurers a high tax break.

The Department of Treasury has said that domestic insurance companies paid under \$1.2 million in SBT in 1984, and around \$900,000 in 1985, which amounts to less than 3% of what their tax bill would have been if they were treated in the same way as foreign insurers. According to committee testimony by the State Treasurer, 60 of 80 domestic insurers didn't pay any SBT last year, a situation that could be called protectionist for domestics.

The domestic insurers have pointed out that they should receive some preferential treatment since they pay greater property taxes than foreign companies, they create jobs, their employees pay income taxes to the State, and the insurers help increase the availability of insurance in the State. There is little evidence to date, however, that the tax advantages that domestic insurers have enjoyed have resulted in lower insurance premiums for Michigan residents. There also is little evidence, according to the Court of Appeals, that domestic insurers' tax advantages have increased the availability of insurance in areas of greatest public need, which was the State's purported reason for allowing those tax breaks.

Though the bills would increase taxes on domestic insurers, foreign insurers — because they would have to pay the retaliatory tax — would still end up paying a much greater percentage of tax. To solve the problems of tax equity and to avoid further legal challenges, these bills should re-apply, rather than repeal, the premiums tax.

**Response:** Application of the premiums tax to domestic insurers would result in a sudden, enormous tax increase that could not by any stretch of the imagination be called "equitable". If the premiums tax were adopted, many domestic insurers would probably be run out of business, hardly a wise use of tax policy in a State that claims to want to create jobs. Insurance companies in Michigan are relatively small firms by industry standards, and they claim that the Federal Tax Reform Act of 1986 will already cause them to pay substantially more in State taxes. They further point out the extent to which they, unlike other businesses, support State guaranty funds and high risk pools.

If the Legislature and the courts are concerned about unequal tax treatment of foreign and domestic insurers, the issue can be addressed in many ways that don't involve a mammoth tax increase for domestics and that recognize, as the bills do, the need for retaliatory tax policies to protect domestic companies. It must be remembered that while it currently appears that foreign insurers pay almost all of the insurance taxes in Michigan, this apparent tax disparity does not translate into a business advantage for domestics because many foreign insurers receive huge tax credits in their home states for taxes paid elsewhere.

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