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BILL ANALYSIS



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Senate Bill 406 (as enrolled)
 Sponsor: Senator Jon Cisky
 Committee: Finance

Date Completed: 5-9-95

RATIONALE

A 1987 amendment to the Single Business Tax (SBT) Act provides that the tax base and adjusted tax base of an insurer are equal to 25% of the insurer's gross receipts, as apportioned under the Act, excluding receipts on the sale of annuities and receipts on "the sale of reinsurance". Reinsurance is a method insurance companies use to distribute the risk an insurer takes, by purchasing insurance from other insurance companies to cover part of the risk. (For a further explanation of reinsurance, please see FISCAL IMPACT, below.)

Within a reinsurance transaction, the premium paid to the original insurer often is transferred in part to the reinsurer as payment for the assumption of part of the risk. Apparently, the reinsurer often then returns a portion of the original premium to the original insurer for that insurer's costs associated with acquiring and maintaining the original policy. In another method, the reinsurer may accept a smaller premium from the original insurer and not return any of the premium, in exchange for acquisition and maintenance costs. The premiums paid to the original insurer for a policy must be included in the insurer's tax base, while the receipts on the sale of reinsurance are excluded. The applicability of the SBT to the premiums exchanged in the process of reinsurance transactions has become an issue.

Recently, in audits of insurance companies, the Department of Treasury has stated that certain reinsurance premiums generated by reinsurance transactions (rather than the sale of reinsurance, which is excluded) are income and should be included in the tax base of insurers. Because the Department has only recently made this interpretation, many insurance companies have never included these amounts in their tax bases. Insurers contend that since the premium paid to the original insurer is included in that insurer's tax

base, and the same premium is then advanced to the reinsurer who sometimes returns part of it to the original insurer, including these reinsurance transaction amounts is, in effect, taxing the same money twice. While the Department believes that its interpretation under the Act is correct, it also has stated that it is not the Department's intent to double-count amounts paid for premiums. It has been suggested that the Act be amended to exclude from the tax base all reinsurance transactions.

CONTENT

The bill would amend Section 22a of the Single Business Tax Act to provide that the tax base and adjusted tax base of an insurance company would be equal to 25% of the insurer's gross receipts, as apportioned under the Act, excluding receipts on the sale of annuities and receipts on "all reinsurance transactions".

The bill provides that its provisions to amend Section 22a would be retroactive and effective beginning August 3, 1987; Section 22a was first applied to the tax base of insurance companies on that day.

MCL 208.22a

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

Because of recent Department of Treasury audits of insurance companies a question has arisen regarding the taxation of premiums used in reinsurance transactions. While the Act excludes the sale of reinsurance from an insurer's tax base,

it does not specifically exclude receipts on all reinsurance transactions. The Department has interpreted the Act to mean that premiums exchanged between an insurer and a reinsurer are taxable. The insurance companies contend that since they have to include in their tax bases all premiums on the original insurance they sell, the advancement of those premiums to a reinsurer or the return of those premiums by a reinsurer should not be included, because in effect it is including the same premium twice. Though the Department argues that its treatment of reinsurance premiums is correct, it has agreed that it does not wish to count the same premiums twice for purposes of determining a company's tax base. The bill would allow insurance companies to exclude from their tax bases receipts on all reinsurance transactions.

Legislative Analyst: G. Towne

FISCAL IMPACT

Department of Treasury audits reveal that insurance companies have not been including reinsurance commissions in their SBT base. If all insurance companies had been paying the SBT on reinsurance commissions, the Department estimates that the total SBT liability on these commissions would have amounted to \$4.7 million a year.

Reinsurance occurs when an insurance company buys insurance from another company to help cover the financial risk it has taken in selling policies. For example, if insurance company A sells a policy worth \$500,000, but is able to cover only a policy up to \$400,000, then company A will buy insurance from company B to cover the last \$100,000 of the original policy. The cost of buying this reinsurance is figured in the cost of the original \$500,000 policy that company A charges its customer. The premium charged the customer for the \$500,000 policy by insurance company A is included in company A's SBT tax base, while the premium for the reinsurance is not included in company B's SBT tax base, because company A already was taxed for the premium. What is at issue, however, is whether the commission payment that company B pays company A under some reinsurance transactions, should be taxed under the SBT. The commission is paid to reimburse company A for part of its expenses incurred in selling and maintaining the original policy to the customer. A major component of this cost is the commission paid to the insurance agent who originally sold the policy to the customer. The Department of Treasury has ruled that reinsurance

commissions are income and, therefore, should be included in the tax base. The bill would exempt all reinsurance transactions, including reinsurance commissions, from the SBT.

Fiscal Analyst: J. Wortley

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.