Texas Comptroller of Public Accounts

State Taxation of Insurance Organizations,

Insurance Premium Tax, Miscellaneous Fees, Assessments and Retaliatory Tax

State Tax Planning and Court Case Review

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July 28, 2008

History and Overview of Insurance Taxes

Licensed Insurers

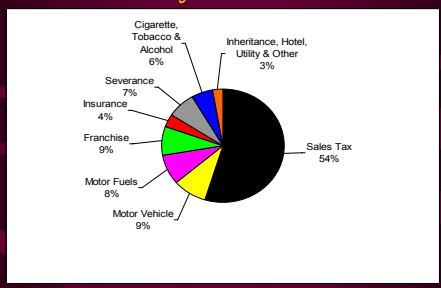
- The first tax on insurance companies in Texas was an annual fee of $50 in 1862.
- Current concept for taxation as a percentage of gross premiums was adopted in 1893.
- The Robertson Law, enacted in 1907, required all companies to have 75% of their legal reserves on Texas business in Texas investments. Companies that achieved this requirement qualified for a lower tax rate.

History and Overview of Insurance Taxes

Licensed Insurers

- Changes in later years allowed companies to qualify for a lower tax rate in Texas if the companies met certain investment requirements in Texas securities.
- Life, Accident and Health companies went to a flat tax rate in 1995.
- Property and Casualty and Title insurers went to a flat tax rate in 2000.

Fiscal 2007 Total State Tax Revenue by Source



McCarran Ferguson Act

In 1944, the Supreme Court ruled in *United States vs. South-Eastern Underwriters Association* (322 U.S. 533) that insurance was not commerce.

As a result, in 1945, Congress passed the McCarran-Ferguson Act.

It allows:

- state law to regulate the business of insurance without federal government interference
- states to establish mandatory licensing requirements
- the preservation of certain state laws of insurance.

Texas Franchise Tax

Franchise Tax

- The Texas franchise tax is a privilege tax imposed on each taxable entity chartered/organized in Texas or doing business in Texas.
- The revised franchise tax applies to partnerships (general, limited and limited liability) corporations, limited liability companies (even if directly owned by one person), business trusts, professional associations, business associations and other legal entities.
- The tax does not apply to sole proprietorships; general partnerships directly and entirely owned by natural persons, unless they have limited liability (i.e., LLPs) and passive entities.
- In addition, the tax does not apply to insurance organizations and title agents that are subject to premium receipts taxes under Chapters 221, 222, 223 or 224, Insurance Code.

Taxation of Insurance Business

Insurance Taxes & Assessments

- Insurance premium taxes and assessments are paid by 2,300 licensed insurance companies and health maintenance organizations, including title insurance agents.
- Taxes are also paid in the non-licensed insurance market by surplus lines agents, unauthorized insurers, and policyholders that "independently procure" coverage on Texas risks.
- In addition to premium taxes, the Comptroller collects various maintenance taxes from licensed insurance companies, health maintenance organizations (HMOs), and licensed third party administrators to cover the costs of regulation incurred by the Texas Department of Insurance (TDI).
- In fiscal 2007, insurance premium taxes accounted for 92 percent of total insurance tax revenue; and total insurance tax revenue accounted for 4.0 percent of general revenue-related tax revenue.

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Major Areas of Taxation

Licensed Insurers and HMOs

and

Non-Licensed Market

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Licensed Insurers and HMOs

- Premium tax is an occupation tax in lieu of the Franchise tax.
- Taxed by broad categories:

Property and Casualty Insurers	1.6%
Life, Accident and Health Insurers	1.75%
HMOs	1.75%
Title Insurers and Agents	1.35%

- Retaliatory tax (an equalizer tax on foreign insurers where their state of domicile taxes Texas domiciled insurers a higher amount than Texas taxes foreign insurers)

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Licensed Insurers and HMOs

Licensed insurers and HMOs are subject to a variety of other fees and assessments

- Guaranty Association Assessments
- Examination Expenses
- Windstorm Association Assessments
- Regulatory Fees (Maintenance taxes)
- Office of Public Insurance Counsel Assessment
- Automobile Burglary and Theft Prevention Authority Assessment
- Volunteer Fire Department Assistance Fund Assessment

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Non-Licensed Market

- Transaction Tax instead of an occupation tax
- Generally through the surplus lines market using licensed agents placing policies with approved or "eligible" insurers
- Other types of non-licensed market premium tax include

  Independently Procured

  Unauthorized

Tax rate for all of these categories is 4.85%

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Major Areas of Taxation

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Retaliatory Tax

NOT intended as a source of State Revenue

Western & Southern Life Insurance Co v. State Board of Equalization of California, No. 79-1423, U.S. Supreme Court (1981)

Decision: State statute imposing retaliatory tax on foreign insurers doing business in state, set in response to insurance tax laws of insurer's home state, held not violative of Commerce or Equal Protection Clause of the Fourteenth Amendment.

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Texas Retaliatory Tax Statute

Chapter 281, Insurance Code

Retaliatory tax involves two issues:

1) A comparison of Texas and other states' aggregate tax and other charges

   Involves aggregate taxes, assessments and routine fees – administered by the Texas Comptroller's Office

2) A comparison of Texas and other states' penalties and other obligations

   Regulatory in nature – administered by the Texas Department of Insurance

Both are intended to level the playing field so that a Texas domestic insurer does not have a higher tax burden or regulatory burden than an insurer from another state that is licensed and operates in Texas.

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Texas Retaliatory Tax

- The tax statute is based on what another state would require of a Texas domiciled insurer that is, or may be authorized to engage in business in that other state.
- It requires a comparison of similar insurers (Life to Life, P&C to P&C, Title to Title)
- Similar insurers have authority to write the same lines of insurance.
- The statute does not consider size, financial condition or whether insurers are mutual or stock companies.
- The Texas statute compares only the burdens on INSURERS, not the overall burden that may be placed on other entities.
- The comparison does not include special purpose assessments such as guaranty association assessments, or assessments where insurers may directly recoup the amount from their policyholders (as opposed to building the cost into premium rates).

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Retaliatory Tax Case Study
Texas Title Premium Tax Statute

Chapter 223, Insurance Code

Section 223.003(a)

An annual tax is imposed on ***all premiums*** from the business of title insurance.

Section 223.005(a)

Premiums received from the business of title insurance are subject to the tax under this chapter regardless of whether paid to a title insurance company or retained by the title agent, with the tax being in lieu of the tax on premium retained by a title insurance agent.

Section 223.005(b)

The state facilitates the collection of the premium tax on the premium retained by a title insurance agent by establishing the division or premiums between the title insurance company and the title insurance agent so that the company receives the premium tax due on the agent's portion of the premiums and remits it to the state.

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Lawsuit Case History

One title insurer domiciled in Texas also operates in 48 states and paid retaliatory tax in 20 states.

For tax planning purposes, Taxability response requested:

If a title agent failed to pay the premium due the insurer, would the insurer owe the tax on this premium?

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Taxability Response

- The agent's portion of the tax is included in the premium paid to the insurer.
- If the insurer does not receive the premium, ***the agent*** would be responsible for paying the premium and maintenance tax due on the premium received by the agent.
- The insurer would not be responsible for paying tax on policies where no premium was received from the agent.
- Enforcement action would be taken to collect the premium tax due the state.

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Results of the Response

- Comptroller auditors modified audit procedures.
- Tax form and instructions modified to reflect the retaliatory tax impact:
  Only the insurer's portion of the aggregate taxes were to be used in calculating the Texas retaliatory tax due.
- The two title insurers in the lawsuit were assessed substantial Texas retaliatory taxes.
- The Texas domiciled title insurer's retaliatory tax burden in other states was significantly reduced.

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First American Title Insurance Company and Old Republic National Title Ins Co v. Susan Combs, Comptroller of Public Accounts

Points to consider:

1) Aggregate tax burden Texas and plaintiff's states of domicile place on licensed title *INSURERS*
2) Do the tax statutes in question apply only to insurers or also to the title agent that retains 85% of the collected premium?
3) Does the Texas retaliatory tax statute look at all tax burdens on the premium or only the burden as it applies to insurers?

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Key Findings

- When interpreting a statute, first look to the plain meaning of the words. As long as the statute is clear and unambiguous, we must rely on the common meaning in a way that gives effect to every word, clause, and sentence.
- Retaliatory taxes are not penal in nature since the principal purpose is to promote the interstate business of domestic insurers – not to punish foreign corporations doing business in the state.
- The Comptroller has clear authority to implement the statute in a fair and reasonable method as may be appropriate.

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Key Findings

- Since title agents and insurers are both subject to the tax, the decision to enforce the statute against both is valid.
- The retaliatory statute limits the Comptroller to a comparison of the tax burdens of ***insurers only***.
- The retaliatory statutes does not impose a tax on comparative tax rates. It imposes a tax based on comparative tax burdens.
- The Texas tax scheme allows an "apples to apples" comparison since only the premium received by the insurers is used in the retaliatory calculation.
- Equal Protection Rights: The Comptroller's interpretation exerts some downward pressure on foreign tax rates, regardless of how other states may respond.

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Taxation of Insurance Organizations and State Retaliatory Taxes

Considerations:

Currently 49 states have Retaliatory Tax Statutes.

Statutes are similar but NOT identical.

Example:

Texas measures the overall tax burden on an insurer only while Minnesota measures the overall tax burden of the insurers and their agents.

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Taxation of Insurance Organizations and State Retaliatory Taxes

Result:

Different measuring stick used in determining:

1. What is being measured or included in the tax base (taxes, fees, assessments) and
2. What entity or entities are included in this comparison.

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Taxation of Insurance Organizations and State Retaliatory Taxes

Some retaliatory statutes **exclude** from their comparison of tax burdens, **"special purpose assessments,"** such as state guaranty association assessments, assessments for the state fire marshal and workers' compensation second injury fund assessments. The key is each state's definition of "special purpose assessment."

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Measuring Tax Burdens

How should overall tax burdens be measured for states with "tiered rates" that allow insurers a lower premium tax rate if they make certain qualifying investments in that state?

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Retaliatory Tax Case Law

Aetna Fire Insurance Co v. State Board of Insurance

By Texas' use of the lower tiered rate that applied to the foreign insurer, the application of the retaliatory statute negated the insurers' investment in Texas because they merely paid higher retaliatory taxes.

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Retaliatory Tax Case Law

American Fire & Casualty Co v. New Jersey Division of Taxation

Involved a New Jersey "tax cap."

New Jersey Supreme Court ruled that both the premium tax statute and the retaliatory tax statute must be taken into consideration in order to reach a reasonable application of both statutes.

As a result, the tax statutes taken together must allow foreign insurers that qualify for the premium tax cap to have this qualification preserved in the calculation of the retaliatory tax.

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Disagreements between States

What happens if states do not agree how to apply another states' statutes in the calculation of their retaliatory tax?

This could result in the possible retaliation by each state against the other states' domiciled insurers!

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Disagreements between States

Some states have statutory authority to set aside their retaliatory statute using "reciprocity agreements."

Two or more states can agree not to retaliate against each others' domestic insurers

(§281.008, Texas Insurance Code)
The comptroller by rule may enter into a reciprocity agreement with another state under which the parties agree to mutually set aside retaliatory provisions in situations in which this state and the other state determine that retaliation is not the preferred approach to protect their domestic insurers from excessive taxation or other financial obligations.

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State Tax Planning

Massachusetts Study - Commission on Corporate Taxation

Concerns with current Massachusetts law:

1) Insurance Companies are subject to tax based on Massachusetts policy premiums only. Other streams of income (real estate investments, insurance-related services, financial services and investment income) are not taxed.
2) If the subsidiary businesses (partnerships or limited liability companies) are owned by the insurance companies, the income from these entities is currently sheltered from taxation.

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State Tax Planning

Massachusetts Proposal:

Massachusetts could pass legislation to tax the business income of these entities, ***either on the parent insurer*** or ***directly on each of the limited liability companies and partnerships*** that conduct non-insurance business of the parent insurer.

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State Tax Planning

Concern with new proposal:

Would other states retaliate against Massachusetts domiciled insurers under either scenario?

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State Tax Planning

Insurance Industry Response:

Trigger large retaliatory tax increases outside Massachusetts for Massachusetts-domiciled insurers.

If there is an apportionment of the income from the non-insurance business, states would levy a retaliatory tax on the basis of the apportionment and tax the Massachusetts domiciled insurer.

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State Tax Planning

Suggestions/Results

Option 1

If a Massachusetts tax statute change is directed at insurers, other states may retaliate against Massachusetts-domiciled insurers that are licensed and doing business in those states.

The underlying question is whether or not other states would regard this taxation as an additional burden borne by their domestic insurers that do business in Massachusetts.

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State Tax Planning

Option 2:

If the Massachusetts statute change is directed at the non-insurance entities, some states might consider retaliation and some might not.

States **may** argue that an additional financial burden **directly** on an insurer or **indirectly** on an affiliate effectively limits competition in the insurance marketplace by making it more difficult for small foreign insurers to compete in Massachusetts.

Note: Any retaliation on this basis would probably be limited only to "sourced revenues" that the LLCs and partnerships have in the other states, if any.

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State Tax Planning

Option 3:

Possible industry responses to retaliation

If Massachusetts-domiciled insurers are subjected to retaliation as a result of a tax statute change, they could:

1) Redomesticate to another state with an overall lower insurance tax scheme or
2) Shift insurance business to other insurers in their group that are domiciled in lower tax rate states.

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New York State Example

CT-33 return for life insurers considers certain important factors:

- Federal taxable income and subsidiary income
- The floor for tax purposes is 1.5% on the premiums

(this results in retaliatory taxes being paid to Texas)

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State Tax Planning

- In insurance tax retaliation, states do not care about how a given state taxes domestic insurers of that state, they care about equal tax treatment, equal access to the insurance market, and how a state taxes insurers domiciled in other states.
- In retaliation, the retaliating state has an advantage in enforcing their retaliatory tax statutes in that one state cannot instruct the retaliatory state on how to interpret its retaliatory tax statue.
- States generally cooperate in sharing tax information for retaliatory purposes.
- States do not always agree on how to apply retaliatory statutes.

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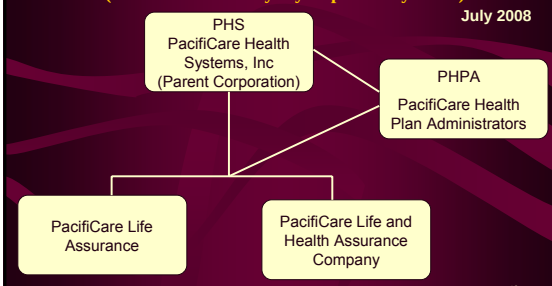
PacifiCare Health Systems, et al v. Oregon Department of Revenue

(Disallowance of Royalty Expense Payments)

July 2008



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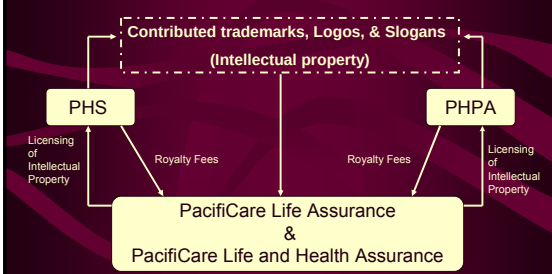
Sham Transaction – No Valid Business Purpose Tax Avoidance Only



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Questions for Discussion

- Should "eligible", non-licensed, surplus lines insurers be subject to state income taxes?
- How is nexus established?
- How might the Financial Service Modernization Act of 1999 (GLB Act) impact the taxation of insurers and other financial institutions?

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