

Exploring New York's Mysterious System of Insurance Company Taxation

With seven taxes on insurance companies or insurance premiums, it would seem that New York had circumscribed the entire area. However, certain situations have been left completely uncovered and others, which have been addressed, remain unclear.

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New York imposes seven different taxes on insurance companies or insurance premiums. One would think that the result would be a clear and thorough system that left no insurance premium or company untaxed. However, this is not the case. One of the biggest mysteries is: why haven't the competitors of insurance companies (e.g., banks) sought Congressional legislation like the McCarran-Ferguson Act to similarly protect them. And, who designed this system, anyway?

Franchise taxes

Article 33 of the Tax Law imposes four franchise taxes on insurance corporations: the Franchise Tax imposed by New York Tax Law Section 1501; the Additional Franchise Tax imposed by New York Tax Law Section 1510; the Temporary Metropolitan Transportation Business Tax ("MTA") Surcharge imposed by New York Tax Law Section 1505-a; and the Tax Surcharge imposed by New York Tax Law Section 1520.

Article 33 was added to the New York Tax Law by Chapter 649 of the Laws of 1974. The New York Tax Law Section 1501 tax was modeled after the tax imposed by Article 9-A of the Tax Law on general business corporations. While Article 9-A has been

extensively amended in the intervening years, New York Tax Law Section 1501 remains basically unchanged. It is a tax measured by the highest of four alternative measures, plus a tax measured by a taxpayer's investments in its subsidiaries.¹ The four alternative measures are entire net income (which is federal taxable income or, in the case of life insurance companies, life insurance company taxable income, with certain modifications), business and investment capital, entire net income plus salaries paid to certain officers, and a flat \$250.²

Except for the fixed dollar minimum tax of \$250 and the tax measured by subsidiary capital, the tax is imposed only on that portion of the tax base that is attributable to business done by the taxpayer in New York. The formula for apportioning the tax bases has two factors, a nine-weighted premiums factor and a single-weighted payroll factor.³ The premiums factor is very inclusive and, as a general rule, locates premiums based on where the risk is located. The premiums factor employs a "throwback" rule. If a premium is written, procured, or received in New York on business that cannot be specifically assigned as located in another state, the premium is deemed to be a New York premium.⁴ However, in the case of reinsurance premiums, if the location of the risk cannot be ascertained, the amount of the reinsurance premiums allocated to New York is determined by multiplying such premium by the allocation percentage of the ceding company for the previous taxable year.⁵

The tax measured by the fixed dollar minimum of \$250 is not subject to allocation. The tax measured by subsidiary capital is allocated by multiplying the amount of the taxpayer's investments in its sub-

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subsidiaries by the portion of the subsidiary's own capital that is attributable to New York.⁴

It is extremely common for a corporation to pay a tax on or measured by net income or profits. This is the measure of tax used in the Internal Revenue Code⁷ and by most of the states that have taxes on the privilege of doing business.⁸ To those unfamiliar with the taxation of insurance products and insurance companies, this system does not seem out of place. However, it is very rare for a state to tax insurance companies on net income. By far, the most common state tax imposed on insurance companies is a premiums tax.⁹

The tax imposed by New York Tax Law Section 1510 is the Additional Franchise Tax on Insurance Corporations. It is a tax measured by premiums written on risks located or resident in New York. The tax is imposed on insurance companies that are authorized to transact business in New York under a certificate of authority from the Superintendent of Insurance. The tax rate varies depending on the type of company and the type of insurance. The lowest rate is .8% and the highest rate is 1.2%.¹⁰

Like Alice in Wonderland, one enters the world of insurance taxation and shakes his or her head in amazement.

Defining "premium." In general, a premium is any amount received as consideration for an insurance or reinsurance contract, other than for annuity contracts. It does not include a return of a premium where, for example, insurance is cancelled. It includes premiums written, procured, or received in New York on business that cannot specifically be allocated or apportioned and reported as taxable in another state. Premiums do not include reinsurance premiums received from a company that is authorized to transact business in New York.¹¹ This aspect of the tax computation makes the Section 1510 tax resemble, to some extent, a sales or excise tax that contains a sale for resale exclusion. The goal is that each premium dollar covering risks located in New York should be taxed once, at the "retail level," and only once. A state having only a premiums tax like Section 1510 does not tax an insurance company according to its net income or profits. It has a tax that is imposed on one type of gross receipts or sales, i.e., premiums, and that ignores all other aspects of an insurance company's activities, such as earnings and profits on investments.

At this point, the calculation of the Article 33 tax seems to be relatively straightforward. The two taxes are merely added together and one would think that is the end of the story. In truth, the tax has just started to become interesting. Like Alice in Wonderland, one enters the world of insurance taxation and shakes his or her head in amazement.

The "cap." The next step in the calculation of the Article 33 tax is to add the Sections 1501 and 1510 taxes together. However, New York Tax Law Section 1505 provides that in no event may the sum of the two taxes exceed the tax that would have been imposed under Section 1510 if the tax rate under that section had been 2.6%. The statute calls this the "limitation on tax," but those familiar with the provision call it "the cap." In the remainder of this article, the sum of the Sections 1501 and 1510 taxes, as limited by the cap, will be referred to as the basic Article 33 tax.

As a result of the cap, companies that have no premiums subject to tax under Section 1510 are not subject to tax under Article 33.¹² This category includes insurance companies whose *only* activity in New York is owning and leasing property there, managing investments from a New York office, or reinsuring risks of authorized insurance companies.—

MTA surcharge. The third tax imposed by Article 33 is the MTA Surcharge on Insurance Corporations.¹³ The tax was first enacted in 1983 and has not yet been allowed to expire. It is currently scheduled to expire with respect to taxable years ending on or after December 30, 1992. The monies collected from this tax go to a special account to fund mass transportation in the metropolitan commuter transportation district ("MCTD").¹⁴ The MCTD is basically New York City and its suburbs.¹⁵ The tax is measured by the portion of the basic Article 33 tax, after the deduction of any

¹ New York Tax Law Section 1502.

² New York Tax Law Sections 1502 and 1503.

³ New York Tax Law Section 1504.

⁴ New York Tax Law Section 1504(b)(2)(A).

⁵ New York Tax Law Section 1504(b)(2)(B).

⁶ New York Tax Law Section 1504(c)(2).

⁷ 26 USC Sections 11, 801, and 831.

⁸ Hellerstein, *State Taxation: I - Corporate Income and Franchise Taxes* 4-23 (1983).

⁹ *Metropolitan Life Insurance Co., v. Insurance Comm. of Maryland*, 473 A.2d 933, 934 (1984).

¹⁰ New York Tax Law Sections 1510(a) and (b).

¹¹ New York Tax Law Section 1510(c).

¹² There is an exception for companies more than 95% of whose premiums are from annuity contracts or from marine insurance. New York Tax Law Section 1505(b).

¹³ New York Tax Law Section 1505-a.

¹⁴ New York Tax Law Section 171-A.

¹⁵ Public Authorities Law Section 1262.

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credits, attributable to business done in the MCTD. The tax is imposed at the rate of 17%.¹⁶

The fourth tax imposed by Article 33 is the Tax Surcharge imposed by New York Tax Law Section 1520. This tax is measured by the basic Article 33 tax, after the deduction of any credits. The tax is imposed at the rate of 15% and is currently scheduled to expire with respect to taxable years ending before July 1, 1993 (by which time, the rate will have decreased to 10%).

Article 33 contains several credits against the basic Article 33 tax and the MTA surcharge.¹⁷ No credits, however, may be claimed against the New York Tax Law Section 1520 Tax Surcharge.¹⁸ The only credits that will be discussed are the two retaliatory tax credits: one allowed against the basic Article 33 tax and one allowed against the MTA surcharge.¹⁹ Before discussing retaliatory tax credits, however, it is necessary to understand retaliatory taxes.

Retaliatory taxes

Retaliatory taxes in the field of state taxation of insurance companies are extremely common. New York enacted the first retaliatory statute in 1824 and at least 48 other states, with Hawaii being the possible exception, have also enacted a retaliatory statute.²⁰ While the exact language of the state statutes is not identical, the concept of the statutes is the same: To the extent State B imposes burdens (including taxes) on insurance companies domiciled in State A greater than State A imposes on insurance companies from State B, State A's retaliatory statute provides that State A will impose increased burdens (including taxes) on insurance companies from State B.

Example. State B has a premiums tax of 3%; State A has a premiums tax of 2%. Thus, State A's retaliatory statute will impose a 1% additional tax on insurance companies from State B.

New York's retaliatory statute is found in Section 1112 of the Insurance Law.

In the field of retaliatory taxation, a foreign company (*i.e.*, not domiciled in the state) computes the tax it would pay to a nondomiciliary state using the law and rates its domiciliary state applies to foreign companies but applies that law to its business done in the nondomiciliary state. In other words, the foreign company pretends that the nondomiciliary state enacted its home state's laws that apply to foreign companies. It then claims a credit for the taxes the nondomiciliary state's law imposes on it. The amount remaining, if any, is the retaliatory tax the foreign company owes to the nondomiciliary state.

Statutes of this type have survived challenges that they violate the Commerce Clause²¹ of the U.S. Constitution. The most recent Supreme Court case, which upheld California's insurance retaliatory statute, was *Western & Southern Life Insurance Company*.²² The statute survived a Commerce Clause challenge because, "Congress removed all Commerce Clause limitations on the authority of the States to regulate and tax the business of insurance when it passed the McCarran-Ferguson Act, 59 Stat. 33, 15 U.S.C. §1011 *et seq.*..."²³

Section 1 of the McCarran-Ferguson Act provides:

The Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.²⁴

The McCarran-Ferguson Act also provides that "The business of insurance...shall be subject to the laws of the several States which relate to the regulation or taxation of such business."²⁵ It is this Federal law that permits retaliatory insurance taxation to exist.

In *Western & Southern*, the Supreme Court also found that the California retaliatory statute does not violate the Equal Protection Clause of the U.S. Constitution. The Court found that the California retaliatory statute is rationally related to the achievement of a legitimate state purpose.²⁶

The Court noted that "the principal purpose of retaliatory tax laws is to promote the interstate business of domestic insurers by deterring other States from enacting discriminatory or excessive taxes."²⁷ The Court stated that "Since the amount of revenue raised by the retaliatory tax is relatively modest, and the impetus for passage of the tax comes from the nationwide insurance industry, it is clear that the purpose is not to generate revenue at the expense of out-of-state insurers, but to apply pressure on other States to maintain low taxes on California insurers."²⁸

¹⁶ New York Tax Law Section 1501-a(a).

¹⁷ New York Tax Law Sections 1505-a(d)(2) and 1511.

¹⁸ New York Tax Law Section 1520(1).

¹⁹ New York Tax Law Sections 1511(c) and 1505-a(d).

²⁰ Note 9, *supra*.

²¹ U.S. Constitution, Art. I, Section 8, cl. 3.

²² 451 US 648 (1981).

²³ *Id.* at 653.

²⁴ 15 USCS Section 1011.

²⁵ 15 USCS Section 1012(a).

²⁶ *Id.* at 668-674.

²⁷ *Id.* at 668.

²⁸ *Id.* at 669-670 (citation omitted).

The Court also noted that insurance companies have benefited by retaliatory statutes. The Court, quoting from the "Highlights of Proposal for Quarterly Insurance Tax Payments 3" (1963), by the California State Department of Finance, Budget Division, noted,

The home-owned companies in all but a half dozen states are able to say, "Don't raise our taxes. If you do, we will have to pay more in other states." The effectiveness of this barrier is demonstrated by the fact that of the 48 states, only 9 increased their insurance tax rates in the last twelve years. . . None of these is an outstanding insurance state.²⁹

With findings like this, it seems that other industries would also benefit by having Congress enact a "McCarran-Ferguson Act" for them.

There are many issues concerning the calculation of retaliatory taxes. The statutes often consist of one or two very long sentences, sprinkled with commas and semi-colons. They make for very difficult reading and the proper treatment of many issues is difficult to discern. Which taxes, charges, fees, etc. are to be retaliated against, and which taxes, charges, fees, etc. are to be credited in the calculation of a retaliatory tax, are not always clear from the language of the statute. These topics are outside the scope of this article.³⁰ However, it is interesting to contemplate how a retaliatory tax is to be applied to a taxing scheme like New York's where the basic tax is the sum of two taxes, limited by a cap, and there are two surcharges, both imposed on the basic tax after credits, one of which is imposed on the portion of the basic tax attributable to a business done in a discrete geographic region of New York. Exactly how is a foreign state that has a straightforward 2% premiums tax to determine whether New York taxes the foreign state's domiciliary insurance companies in a more burdensome fashion than the foreign state taxes New York domiciliary companies? If it is determined that the New York taxing scheme is more burdensome, how much greater is the burden?

New York's retaliatory tax credits

After a New York domestic insurance company computes its basic tax under Article 33 of the Tax Law, it may claim a credit for 90% of the retaliatory taxes it pays to other states up to a maximum of the tax it owes under Article 33 for the year with respect to which retaliation is being imposed.³¹ This credit has an interesting effect. As the Supreme Court noted in *Western & Southern*, retaliatory statutes tend to discourage states from increasing taxes on foreign-based

companies because domestic-based companies will experience the tax increase in the foreign state by virtue of the imposition of a retaliatory tax. In New York, to the extent a domestic-based company pays a retaliatory tax to a foreign state, the state of New York "reimburses" the company for 90% of the retaliatory tax paid. This clearly diminishes any incentive a New York company might have to challenge the imposition or calculation of another state's retaliatory tax. The statute does, however, provide that the credit is to be given only for retaliatory taxes that are legally due.³²

A simple New York tax increase can actually increase revenues in other states, because New York domestic companies may owe retaliatory taxes.

As a result, in New York State, every time a tax increase for insurance companies is discussed, not only must the policy-makers consider the economic development and fiscal ramifications of a tax increase, but they must also consider the retaliatory taxes that may be imposed on domestic companies and the retaliatory tax credits that will be claimed. This is a real Mad Hatter's tea party. What starts out to be a simple New York tax increase can actually increase revenues in other states, because New York domestic companies may owe retaliatory taxes. New York then subsidizes the increase in the other states by granting a credit for these retaliatory taxes!

The plot then gets a little thicker. There is an additional retaliatory tax credit for the MTA surcharge. To the extent a state retaliates against a New York company because New York has the MTA surcharge, the law provides that the New York company can claim a credit for 90% of the retaliatory taxes it pays that are attributable to the MTA surcharge.³³

Since the MTA surcharge revenues go to a special fund for mass transportation, the effect of this provision is to prevent New York State's general fund from experiencing a revenue loss. To the extent a domestic company pays retaliatory taxes attributable to the MTA surcharge, the special account that funds mass trans-

²⁹ *Id.* at 673 (citation omitted).

³⁰ See 30 ALR 4th 873 for an in-depth discussion of retaliatory statutes and case law.

³¹ New York Tax Law Section 1511(c).

³² New York Tax Law Section 1511(c)(4).

³³ New York Tax Law Section 1505-a(d).

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ation will bear the cost of the retaliatory tax credit. As mentioned earlier, in computing, for example, New York's retaliatory tax, a foreign company computes the amount of tax it would owe New York as if the laws of its home state concerning foreign companies were enacted in New York. It then claims a credit against this amount for the amount of tax New York actually imposes on the foreign company. The amount remaining is the retaliatory tax due to New York. In New York, it is clear that the basic tax imposed by Article 33 may be claimed as a credit by the foreign company in computing its New York retaliatory tax³⁴ and that the MTA surcharge may not be claimed as a credit in the computation of the retaliatory tax.³⁵ This raises an interesting question: will the denial of MTA surcharge as a credit also trigger retaliation? When does the merry-go-round stop?

Excess line broker's tax

If a New York person cannot procure insurance from an insurance company authorized to transact an insurance business in New York by the Superintendent of Insurance, an excess line broker can be engaged to attempt to procure the insurance. The excess line broker, subject to various requirements of insurance law and regulations, may procure the insurance from a company that is not authorized to transact an insurance business in New York.³⁶

Since the insurance is placed with an unauthorized company, the company is not subject to any of the taxes imposed on insurance companies by the Tax Law. To remove any competitive advantage this could create, the Insurance Law requires the excess line broker to pay the Superintendent of Insurance an amount equal to 3.6% of the premiums charged by the unauthorized company. Where the insurance covers property or risks located or resident both in and outside New York, the amount due is to be computed based on the portion of the premium allocated to New York.³⁷

Tax on independently procured insurance

It might seem all insurance risks located in New York would be subject to tax under the Tax Law or be covered by the tax paid by the excess line brokers. Such, however, is not the case. What if an insured does not use the services of an excess line broker and instead goes directly to an unauthorized company or even forms its own unauthorized company? Until 1990, these premiums were not subject to tax.

In 1990, a new Article 33-A was added to the Tax

Law to tax insurance that an insured procured directly from an unauthorized company.³⁸ The tax is imposed on that portion of the premium that is attributable to risks located or resident in New York.³⁹

Economically, this operates as a compensating use tax. If the Tax Law Section 1510 premiums tax and the excess line broker's tax are thought of as a sales or excise tax on New York risks, which is imposed on insurers but is remitted by others, then the tax on independently procured insurance is a compensating use tax because it is imposed on and remitted by insurers who procure insurance from companies not required to remit any premiums tax.

Some premiums will be subject to two New York taxes.

There is an interesting aspect of the interaction of the excess line broker's tax, the tax on independently procured insurance, and the New York Tax Law Section 1510 premiums tax concerning reinsurance. New York Tax Law Section 1510(c)(3) provides that reinsurance premiums received from authorized insurance companies are deducted from gross premiums. However, where a company subject to New York Tax Law Section 1510 receives a reinsurance premium from an unauthorized company, this deduction does not apply. If the insured used the services of an excess line broker or paid the tax on independently procured insurance, the premium will have been taxed once at that level and then will be subject to tax at the reinsurance level. This is because New York Tax Law Section 1510 provides that reinsurance premiums can be deducted from gross premiums only if they are received from an authorized company.

As a result, some premiums will be subject to two New York taxes: The excess line broker's tax or the tax on independently procured insurance and, if the risk is reinsured with a New York authorized company, the New York Tax Law Section 1510.

In addition, there are circumstances where some

³⁴ New York Tax Law Section 1511(b).

³⁵ New York Tax Law Section 1505-a(d)(8), a very poorly worded provision. The Tax Law is somewhat unclear concerning whether the Tax Surcharge may be claimed as a credit against the retaliatory tax. See New York Tax Law Section 1520.

³⁶ New York Insurance Law Section 2118.

³⁷ New York Insurance Law Section 2118(d).

³⁸ Chapter 190 of the Laws of 1990.

³⁹ New York Tax Law Section 1552.

premium dollars may be subject to tax by more than one state. For example, an insurance company will include a premium in its New York Tax Law Section 1510 tax if the premium was written, procured, or received in New York and it was not reported by the company as taxable in another state. However, the insured may have paid a tax similar to New York's tax on independently procured insurance on some or all of the premium to another state. This is a case where each party to the transaction is paying a premiums tax: ~~one party is paying the tax to state A and the other is paying the tax to state B.~~

Since tax returns are usually treated with considerable confidentiality by both taxing authorities and taxpayers, it is unlikely that this double taxation situation will be commonly discovered. In addition, since the rules for determining how to allocate risks have not been the subject of much case law or regulations, it can be expected that each of the parties to the transaction used a different method for determining the amount of a risk that is present in a particular state.

Conclusion

With all of the taxes New York has on insurance companies and insurance premiums, it is still possible for an insurance company to do business in New York and not be subject to tax. As discussed previously, insurance companies that only reinsure risks of authorized companies are not subject to tax on their premiums or, because of the cap, on any of their investment income. Insurance companies that limit their activity in New York to owning property and/or managing their investments are not subject to tax on their premiums or, because of the cap, on any of their investment income.

Initially, it appears that all insurance premiums attributable to New York risks are subject to tax, either directly due to the tax on independently procured insurance, or indirectly, through the premiums tax imposed by New York Tax Law Section 1510 or the amount owed by excess line brokers under Section 2118 of the Insurance Law. One notable exception is where an authorized insurance company provides insurance to its own employees. In New York, neither the company's expenses attributable to the insurance coverage nor the employee's cash contributions are taxed as premiums.⁴⁰

In New York, there are circumstances where double taxation occurs. It can occur where an unauthorized company reinsures a risk with an authorized company and where New York's allocation rules differ from those of another state.

There are other interesting issues arising under the current system of taxing insurance premiums. Where the premiums tax is the liability of the insurance company, as under New York Tax Law Section 1510, or where it is the liability of the excess line broker, as under Section 1112 of the Insurance Law, what happens when the taxpayer or taxing authority learns that the taxpayer incorrectly computed the amount of risk located in New York? Since both of these taxpayers, in almost all cases, will have passed the premiums tax on to the insured, it does not seem right that the insured does not participate in any assessment for an underpayment of tax or any refund for an overpayment of tax. However, this is what happens under the law.

Forty-six years after the enactment of the McCarran-Ferguson Act, it may be appropriate to ask whether the provisions of McCarran-Ferguson permitting retaliatory taxation of insurance should be repealed. Why shouldn't state taxation of insurance be subject to the Commerce Clause, especially since the taxation of those businesses that compete with insurance companies is subject to the Commerce Clause? This is especially true in light of the current discussions concerning the deregulation of another very large sector of the financial services industry, banking.

In the event the McCarran-Ferguson Act remains unchanged, perhaps states should explore repealing the premiums taxes on insurance companies, excess line brokers, and insureds and subjecting insurance premiums to traditional sales and compensating use taxes. Such a tax would not be governed by McCarran-Ferguson because the tax is imposed on the insured. It is merely collected by the insurance company or excess line broker. As noted earlier, retaliation against a tax that is not governed by the McCarran-Ferguson Act would violate the Commerce Clause.⁴¹ Presumably, any proposal of this type would generate a discussion concerning the state taxation of insurance products, as well as the taxation of all aspects of the business of insurance companies.

In summary, retaliatory statutes have made the field of state taxation of insurance companies fertile ground for complex taxing schemes. New York's scheme most surely has achieved distinction in this regard. The only question is: what new complexities will be added? ■

⁴⁰ *Mutual Life Insurance Co. of New York v. State Tax Commission*, 32 NY 2d 348 (1973). In *Mutual Life Insurance Co. of New York v. Insurance Bureau*, 384 NW 2d 25, (1986), the Michigan Supreme Court held the employee contribution to be taxable.

⁴¹ *Western & Southern*, note 22 *supra*, at 653.