To: American Council of Life Insurers
American Insurance Association
Property Casualty Insurers Association of America

From: Professor Richard D. Pomp

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You have asked me to address a number of issues that are being discussed by the Multistate Tax Commission (MTC) regarding the taxation of the insurance industry. I have a number of technical observations on various proposals that will be the subject of future correspondence; for now, I am much more concerned about issues of process.

The insurance industry is unlike any other, and that fact requires a different process from what typically accompanies MTC proposals. Most states use a premiums tax, although a few use an income as well. All states combine either the more common premiums tax or the less common income tax, with a retaliatory tax, and with in lieu provisions.

The workings of the retaliatory tax are not always fully appreciated outside the cognoscenti.[1] The retaliatory tax is unique because it applies only to foreign companies, i.e., those that are not domiciled in the taxing state. All states except Hawaii (which has no domestic insurance companies) have a retaliatory tax.

Any other tax that applied only to foreign companies would be unconstitutional under the Commerce Clause. However, the tax is immune from Commerce Clause attack under the McCarran-Ferguson

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[1] Indeed, although my casebook has the leading cases on the retaliatory tax that I teach as part of my advanced courses, it was not until I argued American Fire and Cas. Co. v. New Jersey Div. of Taxation, 912 A.2d 126 (2006) that I fully appreciated the degree of complexity and sophistication that accompanies that tax.

Act, 15 U.S.C. Secs. 1011 et seq. and was upheld by the U.S. Supreme Court in Western and Southern, 451 U.S. 648 (1981).

Unless you specialize in insurance taxation, the retaliatory tax is an unfamiliar feature of state taxation. Yet understanding it is critical to evaluating any proposal to change the status quo. Many policy bromides need to be re-thought because of this unique aspect of insurance taxation. Without appreciating the interaction between the retaliatory tax and changes in the existing rules, the best of intentions may well backfire.

A large majority of states also have so-called in lieu provisions found in either statutes or in state constitutions. These provide that insurance companies are subject to a gross premiums tax in lieu of a corporate income tax or franchise tax.

The insurance industry has legitimate reliance interests that need to be addressed by any change in the way they are taxed. For over 100 years, insurance companies have been subject to the premium tax, the retaliatory tax, and in-lieu provisions. In addition, unique and uniform accounting and financial reporting rules developed by the National Association of Insurance Commissioners apply. The result has been a non-volatile and predictable revenue source, certainly more stable than an income tax. As numerous studies suggest, the current regime for taxing insurance companies probably raises more revenue than would be raised by substituting a corporate income tax for the premium tax.

The industry has structured itself and made its investment decisions around the premiums tax, the retaliatory tax, and the in lieu provisions. The industry, of course, has no constitutional right to be immunized from change. Nonetheless, it certainly has the right to expect that any change be preceded by thoughtful, careful, and sophisticated analysis, which takes into account the benefits of the current regime, the costs of change, and the law of unintended consequences.

Like any industry, tax minimization strategies may exist. As I have written elsewhere regarding Delaware holding companies, there are the good, the bad, and the ugly. Every state should be on guard against illegitimate tax minimization schemes and be given adequate tools to combat those. But a rifle is always more appropriate than a shotgun, especially given the retaliatory tax.

For example, one of the issues that the MTC is concerned about is the treatment of pass-through entities. Any proposal, however, that singles out the income taxation of pass-through entities based on whether they are owned by insurance companies raises an issue of how the retaliatory tax will be applied. To be sure, the whole issue of how to tax pass-through entities raises a serious issue of tax policy, but one that is independent of the insurance industry. I would certainly encourage the MTC in its efforts to take on that larger issue.

Another proposal discussed by the MTC is the forced combination of insurers with non-insurers. I have, in general, been a strong and longtime supporter of forced combination. Insurance companies, however, unlike the rest of corporate America, have the benefit of the in lieu provisions. Forced combination might well violate these provisions.

In short, the insurance industry raises sui generis issues of tax policy that are different from other industries. The unique features of insurance taxation, especially the retaliatory tax and the in lieu provisions, require a re-thinking of traditional approaches. As a matter of process, any changes in the law need to be fully vetted by the industry, state insurance regulators, academics, and other experts with unique insights and understanding. The sheer size of the industry, the extent of its investments and legitimate reliance interests, and the role it plays in the American economy place a premium on a robust and thorough debate, based on rigorous analysis. The law of unintended consequences should caution against any rush to judgment.