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Brief Supports Challenge to Punitive Tax on Out-of-State Insurance Companies

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The Tax Foundation, in a friend-of-the-court brief filed with the Texas Supreme Court, urges the reversal of a Comptroller's ruling imposing additional taxes on insurance companies from other states. The brief explains that allowing the Comptroller's ruling to stand will result in other states raising their tax rates on Texas insurance companies, setting off an interstate tax war and ultimately harming consumers.

Insurance Retaliatory Taxes Legitimately Deter Discriminatory Taxes

If a state imposes a higher tax on products sold by out-of-state firms than on products sold by domestic firms, such a tax would typically violate the U.S. Constitution's Commerce Clause or the Equal Protection Clause. Insurance retaliatory taxes are an exception to this general rule, as recognized by the U.S. Supreme Court in the landmark 1981 *Western & Southern* case. States may impose these taxes on an out-of-state insurer if the insurer's home state has a punitive tax on out-of-state companies. The result is that a state is deterred from discriminating against other states' insurance companies, lest its companies suffer retaliatory taxes in other states.

For example, assume State A taxes out-of-state insurers at 2.0% of premiums while State B taxes them at 2.5%. In order to equalize the tax burden imposed on State A's companies doing business in State B, State A will impose a 0.5% retaliatory tax on insurers from State B. This serves as a deterrent to State B's discriminatory tax.

To be constitutional, the goal of retaliatory taxes must be to equalize tax burdens and discourage discriminatory taxes. The retaliatory tax system has functioned remarkably well in both respects. In 1981, 34 states had discriminatory insurance taxes; since then,

25 have eliminated the preference for in-state companies, in most cases by lowering rates. As a result, insurance companies in much of the country now compete on market factors, not artificial tax distortions.

The Texas Comptroller's Ruling is Designed to Impose Discriminatory Taxes

Until recently, Texas was among these states. The Comptroller would calculate the tax burden other states imposed on Texas companies, and if it was lower than Texas's, a retaliatory tax would be imposed on out-of-state companies to equalize the burden. Now, however, the Comptroller has decided to count only 15 percent of Texas's tax in figuring the calculation, arguing that insurance companies only keep 15 percent of premiums (the remainder goes to agents). Because no other state does this, Texas effectively pretends that its insurance taxes are much lower than they actually are, enabling it to impose huge retaliatory taxes.

This result is inequitable. The premiums of foreign title insurance policies are taxed at substantially higher rates in Texas than the premiums of Texas title insurance policies would be taxed in the home states of out-of-state insurers. Instead of recognizing that the company/agent split of the premium is the equivalent of a commission routinely paid to insurance agents and embedded in gross premiums in other insurance products, the Comptroller applies the statute in a way that guarantees that insurance policies sold by foreign companies will be taxed at a higher rate than insurance policies sold by in-state companies. Stripped of its rationale of equalizing tax burdens, Texas's tax exceeds a legitimate retaliatory tax and becomes impermissibly discriminatory.

For example, if another state imposes a 2.0% premium tax on Texas insurers, Texas would impose a 3.148% premium tax on that state's insurers. That state would retaliate with an even-higher retaliatory tax to equalize the tax burden, setting off a chain reaction of increases until no insurance companies do interstate business at all. This, ultimately, would greatly harm consumers.

Insurance Companies Do Not Pay Taxes; Insurance Consumers and Shareholders Do

The Tax Foundation's brief emphasizes that the Court should look to the economic incidence of the tax, not the legal incidence. The Supreme Court's earlier opinion had placed emphasis on the fact that the statute allowed the Comptroller only to calculate taxes "directly imposed" on insurers, but this refers to insurance-specific taxes, not taxes "paid" by insurance companies. Companies do not "pay" taxes because they do not bear the burden of their imposition in the end. While it is true that insurance companies remit premium taxes, they are ultimately imposed on consumers (paying higher prices), shareholders (receiving lower dividends), and employees (received reduced compensation).

The brief also notes that because the Comptroller's ruling was a policy reversal unaccompanied by legislative action, it should not be given deference by the Court. This

rule helps ensure stability and knowledge of the law and the proper limited role of administrative agencies.

The case, *First American Title Insurance Company, et al. v. Combs, et al.*, is No. 05-0541. On May 16, 2008, the Texas Supreme Court issued a 5-4 opinion upholding the Comptroller's ruling. The petitioners are now seeking a rehearing.

The brief can be found on the Tax Foundation's website at <http://www.taxfoundation.org/publications/show/23539.html>.

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