2003 Insurance Tax Year in Review: Part III - State and Local Tax Matters

by Richard J. Burness and Rick Carlson

In the third installment of a four-part report, representatives from Deloitte & Touche's Tax Practice group examine state tax developments in 2003 that have affected state revenues and insurance companies' state tax expenses.

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Overview

[1] The situation in most states over the past year can be summarized in two words: "Budget Deficits." State budget deficits have not only surfaced where surpluses once existed, but have grown to their highest levels since World War II. Unfortunately, despite spending cuts that were made over the past couple of years, budget deficits are expected to continue to increase, with projections as high as $100 billion for the 2004 fiscal year. With projections like this, states will remain focused on tax increases to address their fiscal crises.

[2] Not unexpectedly, this increased focus is leading state lawmakers to consider raising existing taxes, delaying tax rollbacks, and in some cases, enacting new tax laws. Additionally, some states, following Alabama's lead, are focusing on noninsurance company- related tax reform.

[3] With taxes in the forefront, states are also looking at the impact of "abusive" tax shelters on tax revenues. In a recent Multistate Tax Commission study, it was estimated that in 2001, corporate tax revenues would have been approximately $12 billion higher if not for the use of abusive tax shelters. With the cost to California estimated at $1.3 billion, earlier this year the "State of Arnold" became the first to enact tax shelter legislation. Given the large revenue potential, it will not be surprising to see more states join the tax shelter bandwagon to help balance their budgets.

[4] This article discusses state tax events that occurred in 2003 that will have continuing significance in determining an insurance company's state tax expense in the years to come. To facilitate our discussion, we have divided this article into five sections: (1) Legislative and Regulatory Developments, (2) Premium Tax Issues, (3) Retaliatory Tax Issues, (4) Income and Franchise Tax Issues, and (5) Other Tax Issues.

Legislative and Regulatory Developments

[5] Last year, the insurance industry was affected by tax legislation enacted to stem growing budget deficits. These changes ran the gamut from the elimination of tax exemptions to the

deferral of tax credits. Unfortunately, in the balancing act between reducing costs, raising revenue, and encouraging growth, the scales seem to have tipped in favor of raising revenue.

[6] Arizona, for instance, now subjects health care providers to the premium tax at a rate of 2 percent; Maine passed an amendment to its premium tax statutes and now imposes a tax on annuities when purchased; and South Carolina changed the basis on which it will assess taxes from premiums collected to premiums written.

[7] The need to raise revenue has also caused some states to revise their incentive programs. Connecticut passed a bill that limits the amount of premium tax that can be offset by credits to 70 percent of the insurer's premium tax liability. Alas, the days of zero tax liability are over. Georgia, on the other hand, delayed the ability to utilize a newly enacted Certified Capital Companies (CAPCO) premium tax credit until January 2007. Will other states follow or will the scale rebalance?

[8] Effective for 2003, New York changed the way property and casualty insurance companies will be taxed by removing the net income and capital tax components and taxing all premiums at a rate of 1.75 percent for accident and health insurance contracts and 2 percent for other nonlife insurance premiums. As a result, insurance companies that were not paying at the maximum 2 percent premium tax rate under the old provisions may see a significant impact on their tax liability.

[9] While some states focused on raising revenue, a few looked to providing incentives to stimulate growth. Ohio created the Ohio Venture Capital Authority (OVCA) credit for companies that invest capital with the OVCA, and Pennsylvania attempted to foster economic growth through its new Keystone Zones credit. For its part, South Carolina extended the expiration date of its South Carolina Community Economic Development Credit from June 30, 2005 to June 30, 2010.

Premium Tax Issues

Minnesota High Court: No Premium Tax on Stop-Loss Policy Payments

[10] **Citations:** *Blue Cross Blue Shield of Minnesota v. Commissioner of Revenue*, No. C8-02-1647, (June 12, 2003). For the full text, see *The Insurance Tax Review*, August 2003, p. 301; *Doc 2003-14491 (4 original pages)* [**PDF**]; or *2003 STT 116-16* .

[11] **Overview:** The Minnesota Supreme Court ruled that premiums received by an insurer on stop-loss policies are not subject to the state's premium tax.

[12] **Discussion:** The Minnesota Supreme Court's decision to affirm the trial court's ruling focused primarily on the term "direct business," which has never been defined by the courts or legislature. Interestingly, the court also chose not to define this term, but based its decision on the fact that the statutory meaning is ambiguous and stated that "ambiguous taxation provisions must be construed in favor of the taxpayer." The commissioner had argued that if a premium tax is not paid when an employer self-insures, the premium paid to the secondary insurer must be taxed to satisfy the legislature's intent to impose tax on at least one level of premium. The court thought that although the reasoning was plausible, it was not supported by legislative history. Thus, although the term "direct business" could have been interpreted to mean everything except policies sold between insurance companies, the court agreed with the

taxpayer that "direct business" existed between the employer and employees and that the insurance policy issued by the taxpayer was a reinsurance arrangement.

Texas Appellate Court: Insurance Company's Limited Partnership Holdings Not Real Property

[13] **Citations:** *United American Insurance Company v. Strayhorn*, Texas Court of Appeals, Third District, No. 03-02- 00722-CV, (May 22, 2003). For the full text, see *The Insurance Tax Review*, July 2003, p. 123; *Doc 2003-13048 (8 original pages)* [**PDF**]; or *2003 STT 104-32* .

[14] **Overview:** The Texas Court of Appeals ruled that mineral interests held by a limited partnership are not "real property, or any interest therein" for insurance premium tax benefit.

[15] **Discussion:** Prior to 1995, foreign insurance companies could qualify for a lower premium tax rate by investing a certain percentage of assets in Texas. Although real property owned in the state qualifies, owning the same real property through a partnership investment will not. The court indicated that because article 4.11 is a tax exemption statute, it must be strictly construed. As a result, Texas law characterizing this type of investment as personal property was construed literally, and, although the intent of investing in Texas assets was accomplished, the court held that real property must be directly owned by the foreign insurance company to qualify for the lower rate.

Texas Comptroller: Bad Debts Not Included in Net Insurance Premium Tax

[16] **Citations:** 200306942L (June 10, 2003). For the full text, see *Doc 2003-15326 (2 original pages)* [**PDF**] or *2003 STT 126-22* .

[17] **Overview:** The Texas comptroller of public accounts explained that bad debts are not included in the state net insurance premiums tax because it is calculated on a "premium received" basis.

[18] **Discussion:** The guidance provided by the Texas comptroller appears reasonable and straightforward. However, nothing is as simple as it appears. Insurance companies need to carefully consider the basis on which they prepare their premium tax returns. If an insurance company uses numbers from the annual statement, which generally reports premiums on a written basis, bad debts as well as uncollectible premiums will need to be reflected as an adjustment to properly calculate net taxable premiums.

New York Tax Department Explains Refund Procedure to Claim New Deduction for Reinsurance Premiums in Old Tax Years

[19] **Citations:** TSB-M-03(3)C (May 23, 2003). For the full text, see *Doc 2003-14137 (1 original page)* [**PDF**] or *2003 STT 123-21* .

[20] **Overview:** The New York Department of Taxation and Finance announced claim for refund procedures for the newly enacted deduction available for certain reinsurance premiums for open tax years beginning on or after January 1, 1990.

[21] **Discussion:** Effective for tax years beginning on or after January 1, 1990, New York now allows a deduction from gross direct premiums for certain reinsurance premiums received from

unauthorized New York insurers. To qualify for the deduction, the premiums must relate to a reinsurance transaction that is qualified under New York insurance law and be subject to the premiums tax on excess lines brokers. Because the deduction was retroactive, the New York Department of Taxation and Finance gave taxpayers a limited opportunity to request a refund of taxes paid on these premiums by allowing claims for credit or refund that would otherwise be barred by the statute of limitations. The deadline for filing refund requests was September 15, 2003. Unfortunately, the window of opportunity was only slightly ajar and no interest was paid on these credits or refunds.

Retaliatory Tax Issues

Pennsylvania Commonwealth Court Rules Insurance Company Taxable on Commercial Rent Income

[22] **Citations:** *Principal Life Insurance Co. v. City of Philadelphia Tax Review Board, et al*. No. 1391 C.D. 2003 (Dec. 22, 2003). For the full text, see *Doc 2003-27044 (17 original pages)* [**PDF**] or *2003 STT 249-13*.

[23] **Overview:** The Pennsylvania Commonwealth Court held that an insurance company is required to pay business privilege tax on rental income that it received from its commercial properties.

[24] **Discussion:** For an Iowa insurance company to exclude real estate rental income and gross receipts from the Philadelphia Business Privilege Tax (BPT), it must show that the income falls within the business of an insurance company and that the BPT is included in the calculation of the Iowa retaliatory tax. The Pennsylvania Commonwealth Court affirmed the Tax Review Board decision that operating two office buildings for five years that were acquired through foreclosure did not fall within the conduct of an insurance business. The court cited several U.S. Supreme Court decisions that defined the term "business of insurance" as meaning "the relationship between a policyholder and insurer established in an insurance contract." Because this definition does not include doing business as a commercial landlord, the rental of real estate was held to not constitute insurance business. This narrow interpretation ignores the basic principle that investments are an essential part of the life insurance business and necessary to support future insurance obligations. To exclude all or even selected investments seems contrary to this basic principle.

Income and Franchise Tax Issues

Illinois Circuit Court: Motion to Reconsider Captive Insurance Ruling Denied

[25] **Citations:** *Armstrong World Industries Inc. v. Glen Bower*, Docket No. 00 L 50705 (Feb. 11, 2003); reconsidering *Armstrong World Industries Inc. v. Glen Bower*, Docket No. 00 L 50705 (Ill. Cir. Ct. Sept. 26, 2001). For the full text of the Cook County circuit's 2001 decision in *Armstrong World Industries*, see *The Insurance Tax Review*, December 2001, p. 976; *Doc 2001-26541 (24 original pages)* [**PDF**]; or *2001 STT 204-5*.

[26] **Overview:** The Circuit Court of Cook County, Ill., denied a taxpayer's motion to reconsider its original judgment that a captive insurance company was not an insurance company for Income Tax Act purposes.

[27] **Discussion:** The Circuit Court saw no need to revisit its 2001 decision that a captive insurance company is not a "valid" insurance company for income tax apportionment purposes because it does not qualify as an insurance company under the Internal Revenue Code. Nothing has changed with regard to qualifying as an insurance company for Illinois tax purposes. It is still important that captive insurance arrangements have the business purpose necessary to pass scrutiny from both the Internal Revenue Service and the Illinois Department of Revenue.

Illinois ALJ Ruled Two-Year Carryback Period, Rather Than Three-Year Period, Applies to Insurance Companies

[28] **Citations:** *Department of Revenue v. ABC Reinsurance Co.*, IR 03-2 (Feb. 3, 2003). For the full text, see *The Insurance Tax Review*, June 2003, p. 991; *Doc 2003-9563 (9 original pages)* [**PDF**]; or *2003 STT 74-7*  .

[29] **Overview:** An Illinois Department of Revenue administrative law judge ruled that the income tax carryback period for insurance companies is two years, despite a three-year federal period.

[30] **Discussion:** It would have been difficult for the administrative law judge to allow a three-year carryback of net operating losses when section 207(a)(1) of the Illinois Income Tax Act specifically provides that "for any taxable year ending prior to December 31, 1999, such losses shall be allowed as a carryover or carryback deduction in the manner allowed under section 172 of the Internal Revenue Code." The taxpayer pointed out that Illinois defines life insurance company taxable income as the amount reported for federal income purposes, with modifications, and that the failure to follow the federal rules in their entirety (i.e., not applying Internal Revenue Code section 810, which provides for a three-year carryback) would result in unique tax consequences that could be detrimental to Illinois. The court did not dispute this result, but simply concluded that to allow a three-year carryback of losses, legislative approval would be required.

California State BOE: Interest Expenses Not Deductible

[31] **Citations:** No. 156726; In re *American General Realty Investment Corporation, Inc.*, (June 25, 2003). For the full text, see *The Insurance Tax Review*, October 2003, p. 697; *Doc 2003-18327 (19 original pages)* [**PDF**]; or *2003 STT 155-2* .

[32] **Overview:** The California State Board of Equalization (BOE) ruled that the Franchise Tax Board (FTB) properly disallowed a portion of the interest expense deductions incurred by the unitary group as there was a sufficient direct relationship between the indebtedness and the company's investment in its insurance subsidiaries.

[33] **Discussion:** As the result of the FTB's audit of the taxpayer's 1991 unitary tax return, the taxpayer was assessed and paid a deficiency relating to the treatment of dividends received from its insurance subsidiaries as apportionable business income for California tax purposes. Subsequent to the California Court of Appeal's decision in *Ceridian Corporation v. Franchise Tax Board* (2000) 85 Cal. App. 4th 875, the taxpayer filed a claim for refund. The FTB agreed with the taxpayer that it was allowed to deduct insurance company subsidiary dividends from its California business income. However, the FTB disallowed expenses, including interest expense, allocable to these nontaxable dividends. Based on the expense disallowance, the

taxpayer's refund claim was disallowed and it filed an appeal with the BOE. On appeal, the BOE sustained the FTB's disallowance and denied the taxpayer's *Ceridian*-based refund claim. In applying federal Rev. Proc. 72-18, 1972-1 C.B. 740, the BOE did not find that the interest on the indebtedness was incurred to purchase or carry its insurance subsidiaries and, as a result, the FTB properly apportioned the interest expense to the nonincludible insurance subsidiary dividends to preclude a "double deduction" or "double benefit."

Other Tax Issues

Insurance Companies Are Not Exempt From Sales and Use Tax in Texas

[34] **Citations:** *United Services Automobile Association (USAA), et al. v. Strayhorn, et al.*, No. 03-02-00747- CV (Nov. 6, 2003). For the full text, see *The Insurance Tax Review*, January 2003, p. 71; *Doc 2003-24200 (11 original pages)* [**PDF**]; or *2003 STT 219-47*.

[35] **Overview:** The Texas Court of Appeals, Third District, held that insurance company tax exemptions in the Insurance Code apply only to general occupation and franchise taxes and not to other taxes, including sales and use taxes.

[36] **Discussion:** It was no surprise that the Texas Court of Appeals affirmed the judgment of the district court that former Article 4 of the Insurance Code did not exempt USAA from paying sales and use taxes. The court concluded that the insurance provisions that date back to the early 1900s and exempt insurance companies from occupation and franchise taxes could not possibly apply to a broad- based sales and use tax enacted many years later. More specifically, the court strictly interpreted the tax exemption and found no direct or legislative intent to exempt insurance companies from the sales and use tax. Needless to say, if insurance companies were exempt from the sales and use tax, the cost to the state would be huge.

North Carolina Appeals Court Holds Insurance Company Subject to Local Use Tax

[37] **Citations:** In re *Proposed Assessments by the Sec'y of Revenue v. Jefferson-Pilot Life Insurance Co*. No. COA02- 1591 (Dec. 16, 2003). For the full text, see *Doc 2003-27002 (12 original pages)* [**PDF**] or *2003 STT 249-11*.

[38] **Overview:** The North Carolina Court of Appeals held that an insurance company is not exempt from local use tax under a statute prohibiting localities from imposing additional taxes "other than ad valorem taxes" on insurance companies.

[39] **Discussion:** As we have seen, states look very closely at issues that exempt companies from tax. Based on the plain language of G.S. section 105-228.10 that "no county, city, or town shall be allowed to impose any additional tax, license, or fee, other than ad valorem taxes, upon any insurance company or association paying the gross premiums tax on insurers," it would appear that insurance companies would not be subject to any local taxes, including a use tax. This language also seemed clear to the North Carolina Tax Review Board, who reviewed this issue twice. However, the North Carolina Court of Appeals disagreed, based on a century-old Supreme Court decision regarding appropriate statutory construction. The intended exclusion, which was later clarified in an amendment to the statute in 1998, is to only exclude privilege taxes or taxes computed on the basis of gross premiums levied by a city or county. The court strictly interpreted the statute and highlighted the fact that there are

approximately 50 exemptions from the state's sales and use taxes and nowhere in the statute is there an exemption for insurance companies. Do not be surprised if we see more in this area.

Texas Comptroller: 'We Bill All Insurance Companies'

[40] **Citations:** 200310192L (Oct. 27, 2003). For the full text, see *Doc 2003-25261 (2 original pages)* [**PDF**] or *2003 STT 232-19*.

[41] **Overview:** The Texas comptroller of public accounts explained that it bills insurance companies that are put into supervision for any tax liabilities or assessments due to the state, even if the companies no longer are able to honor any future assessment requests.

[42] **Discussion:** Texas bills insurance companies that are put into supervision, conservation, receivership, or liquidation for any tax liabilities or assessments so that in the event the company's certificate of authority is sold, existing tax liabilities will be transferred to the surviving company.

Texas Comptroller: Texas Headquartered Company Owes Insurance Tax and Performance Company Not Responsible for Insurance Tax

[43] **Citations:** 200305894L (May 15, 2003). For the full text, see *Doc 2003-13722 (2 original pages)* [**PDF**] or *2003 STT 112-26*. 200305895L (May 16, 2003). For the full text, see *Doc 2003-13682 (2 original pages)* [**PDF**] or *2003 STT 112-25*.

[44] **Overview:** The Texas comptroller issued two opinions with regard to independently procured insurance tax.

[45] **Discussion:** Taxpayers are still raising questions concerning the application of the independently procured insurance tax. *DOW Chemical Co. v. Rylander*, 38 S.W. 3d 741 (Tex. Ct. App. 2001), *review denied* (Jun 7, 2001) caused Texas to modify its procedures for collecting independently procured insurance tax. In citing *DOW Chemical*, the comptroller clarifies that independently procured insurance tax is due from entities that are domiciled or headquartered in Texas when insurance is provided by an insurance company not licensed in Texas, the policy has not been obtained through a Texas surplus lines broker, and all insurance activities have occurred outside the state.

Texas Comptroller: County Mutual Insurance Companies Exempt From Franchise Tax

[46] **Citations:** 200304826L (Apr. 8, 2003). For the full text, see *Doc 2003-10266 (2 original pages)* [**PDF**] or *2003 STT 93- 33*.

[47] **Overview:** The Texas comptroller of public accounts explained that county mutual insurance companies are exempt from franchise taxes because they are subject to a premium tax.

[48] **Discussion:** Chapter 17 of the Texas Insurance Code provides that county mutual insurance companies are exempt from all insurance laws unless otherwise specifically stated. However, an exception applies to laws provided for in Article 17.22(a)(2) which provides for a premium tax on companies writing property and casualty business in the state.

Conclusion

[49] It may not be hard to predict what taxpayers can expect if the following proposed rules are any indication of future legislation. For example, Michigan proposes to eliminate its sales and use tax exemption for insurance companies; Arkansas is attempting to raise its premium tax from 2.5 percent to 3 percent; Colorado would eliminate the CAPCO credit; and New Mexico is moving closer to passing legislation that will eliminate a tax exemption for managed care companies that serve Medicaid recipients. The next couple of years will continue to be a challenge.

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