

# POLICY BRIEF



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## The Insurance Premium Tax

The Arizona Chamber Foundation (501(c)3) is a non-partisan, objective educational and research foundation. The Foundation produces research studies on Arizona public policy issues such as health care, budget, education, regulation, energy, and others in an effort to inform policy makers, business leaders, and the general public.

### Introduction

As Arizona's elected leaders continue their efforts to resolve Arizona's unprecedented budget deficit, the Governor and legislative leadership have signaled their interest in implementing long-term tax reforms that will stimulate economic development and job creation. A reduction in the corporate income tax was a core component of the tax reform package that came out of the legislature earlier this year. This measure would strengthen Arizona's ability to attract and retain corporate headquarters and other major business operations. A complementary element that was not included in the tax reform package was an adjustment to the insurance premium tax. The insurance premium tax, which is paid only by insurance companies, is structured in a completely different way from other forms of corporate taxation and is considerably higher than other types of business taxes.

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### Insurance Premium Tax

Corporations pay an income tax that is calculated as a percentage of the firm's earnings. These rates vary by state, and in Arizona the rate is 6.9%. Alternatively, insurance companies pay the premium tax, which is a gross receipts tax on premiums written. Like the corporate rate, the premium tax varies by state and in Arizona the rate is 2%. While the premium tax initially appears to be a lower rate, it actually generates a much larger tax burden because it is based on revenue, not income. Some insurance companies operating in Arizona estimate that they actually face an equivalent income tax rate of 11%-14%, compared to the corporate rate of 6.9%. An Ernst and Young study found that in 2000, the equivalent income tax rate paid by life insurance companies averaged 13.5% across the 50 states<sup>1</sup>. Clearly this system places an unequal tax burden on insurers relative to other types of corporations. The current structure of the premium tax system in Arizona increases the overall cost of insurance, reduces the competitiveness of insurance companies, places a disproportionate share of business tax liability on insurers, and fails to incentivize job creation and economic growth.

### Important Industry

Arizona should address this issue because a strong insurance industry benefits the state through the generation of nonpolluting, high wage jobs (34%

higher than the national hourly median<sup>2</sup>) and by offering health care benefits to 88% of employees<sup>3</sup>. Insurers employed over 36,200 Arizona residents in 2008, but insurance employment in the state is on the wrong path<sup>4</sup>. While the national insurance industry saw employment expand by 1.7% from 2005-2008, Arizona insurance employment shrank by 5%<sup>5</sup>. The current system for taxing the insurance industry in Arizona imposes an inequitable tax burden on insurers compared to other types of business and also inhibits job creation. Any reform of the corporate income tax without addressing the premium tax will further exacerbate this problem. Placing insurers on a more even playing field with other business by offering tax credits or reducing the premium tax rate will improve Arizona's ability to attract insurance companies to the state and stimulate job growth.

**Inconsistent, Inequitable**

While the corporate income tax and the insurance premium tax are both forms of business taxation, there is no structural consistency between the two. The corporate tax is based on net income while the premium tax is based on revenue. Additionally, multistate corporations apportion income using a combination of sales, property, and payroll factors, while the premium tax only considers sales. This structural inconsistency leads to inequitable results.

First, the tax liability of insurance companies will always be 2% of premiums, regardless of profitability, while an unprofitable corporation is liable for just \$50<sup>6</sup>. This discrepancy is significant because insurers face competition from both other insurance companies, who pay the premium tax, as well as non-insurers who pay the income tax. All insurance companies compete with these non-insurers in the markets for capital and labor, and life insurance companies also compete with banks and financial services companies for investment business. In these markets, the current tax structure creates a competitive disadvantage by arbitrarily choosing to impose a greater tax burden on firms in the insurance industry.

**Disproportionate share of liability**

An important component of tax policy that is fair, consistent, and equitable is to tax over the broadest possible base. On average, from FY 2004-2008, the corporate income tax generated \$768 million annually for the Arizona general fund, while the premium tax generated around \$369 million<sup>7</sup>. The corporate tax generates roughly two times the amount of revenue as the premium tax, but the tax base of corporations is more than 25 times larger than the tax base of insurance companies<sup>8</sup>. Consequently, the tax liability per insurer is significantly higher than the liability per corporation. This result is inequitable because the structure of the tax system, rather than the performance of the firms, causes a relatively small group to generate a disproportionate share of the tax burden. A reduction in the corporate tax rate without any consideration for the insurance premium tax will further increase this disparity.

**Retaliatory tax system**

In addition to the premium tax, insurers also face a unique system of retaliatory taxes when operating across state lines. This system complicates the effort to improve the business environment for insurers operating in Arizona. To illustrate the mechanism of the retaliatory tax, consider two insurance companies, one incorporated in California and one incorporated in Arizona. Both companies operate in both states. The premium tax rate is 2.35% in California and 2% in Arizona. Table 1 shows the tax rate paid by each firm depending on where the premium is written.

	Doing Business In:	
	California	Arizona
Arizona Based	2.35%	2%
California Based	2.35%	2% + .35% retaliatory

As table 1 indicates, the California firm will always pay 2.35%, even when it operates in Arizona. Arizona retaliates against California firms because California charges Arizona firms a higher tax rate.

This system of retaliation occurs in every state with the exception of Hawaii.

### Why does the retaliatory system exist?

The retaliatory system is an outdated tax policy designed to discourage states from engaging in discriminatory taxation against out of state insurance companies. The need for such a system stems from the McCarran-Ferguson Act of 1945 that exempted the insurance business from the U.S. Constitution's Commerce Clause. Among other things, the Commerce Clause prevents states from imposing higher taxes on out of state firms<sup>9</sup>. As a result, states must charge all corporations the same income tax rate, regardless of their state of domicile. However, the McCarran-Ferguson exemption allowed states to charge out of state insurers a different tax rate than in state insurers. For example, Arizona could choose to impose a 2% premium tax on Arizona based insurers and a 4% premium tax on any out of state insurer operating in Arizona. While the exemption allowed this type of discriminatory taxation, retaliatory taxes created a disincentive for a state to implement such a policy by subjecting the in state insurers to higher taxes on all out of state business. In fact, the Supreme Court determined in 1981 that retaliatory taxes were constitutional based on the assertion that "detering other States from imposing discriminatory or excessive taxes" was a "legitimate" purpose<sup>10</sup>.

In 1985, another Supreme Court ruling determined that discriminatory taxes violate the Equal Protection Clause of the U.S. Constitution<sup>11</sup>. The McCarran-Ferguson Act does not exempt insurers from that clause, and as a result, retaliatory taxes are no longer necessary to deter states from imposing discriminatory taxes. Despite that ruling, the system still exists today, imposing unnecessary tax burdens on insurers and complicating the efforts of states to improve the business climate for the insurance industry.

### Tools to improve insurance business environment

While the retaliatory system complicates efforts to reduce the tax burden on insurers, some states in the region have already taken steps to improve the business environment for insurers who meet minimum requirements related to number of in state employees, in-state salaries, office space occupied, or other factors. Colorado offers a 50% tax rate reduction to qualifying firms, while Nevada offers tax credits for up to 80% of tax liability<sup>12</sup>. Both options offer strong economic incentives to attract insurers. The main difference between the two approaches is how they address the issue of retaliatory taxes.

#### *Rate reduction*

Under current law, a reduction in the Arizona premium tax rate would apply to in-state insurers and out of state insurers based in states with lower rates than Arizona. However, retaliatory taxes would neutralize any tax benefit for an insurer based in one of the 15 states with a higher tax rate than Arizona. In order for the reduced rate to apply to these firms, Arizona would need to take Colorado's lead and specifically exempt qualifying firms from the retaliatory tax.

#### *Tax Credit*

Tax credits would also succeed in lowering the tax burden for both in state and out of state firms while reducing the effects of the retaliatory tax. Using the example of the Arizona and California based insurers, the Arizona based firm would pay an amount equal to the 2% premium tax, less the value of the credit. The California firm would pay an amount equal to the 2% premium tax, plus the .35% retaliatory tax, less the value of the credit. Again, both the credit and the rate reduction would only be offered to firms that meet the qualifications established by the legislature.

### Conclusion

As Arizona leaders continue to develop a long term tax reform strategy that will improve Arizona's business environment and spur job creation, the inclusion of premium tax reform in the overall package will reduce existing inequities in the business taxation system. Lowering the tax liability for insurers through either credits or rate reductions could encourage these companies to invest in Arizona-based operations, create and retain jobs, and maintain competitive insurance rates.

<sup>1</sup>Quantitative Economics and Statistics Group of Ernst and Young LLP. "Excessive Taxation of Life Insurance Companies in the 50 States." State Tax Notes, August 12, 2002.

<sup>2</sup>Bureau of Labor Statistics, Occupational Employment Statistics, May 2008. Data available at <http://www.bls.gov/oes/current/oesosci.htm>

<sup>3</sup>Bureau of Labor Statistics, Employee Benefits Survey, March 2009. Data available at <http://www.bls.gov/ncs/ebs/benefits/2009/ownership/private/table05a.pdf>

<sup>4</sup>Arizona Department of Commerce, Workforce Informer. Data available at <http://www.workforce.az.gov/?PAGEID=67&SUBID=160>

<sup>5</sup>Bureau of Labor Statistics, Occupational Employment Statistics. Data available at <http://www.bls.gov/oes/current/oesosci.htm> and [http://www.bls.gov/oes/oes\\_arch.htm](http://www.bls.gov/oes/oes_arch.htm)

<sup>6</sup>Joint Legislative Budget Committee, 2009 Tax Handbook

<sup>7</sup>Joint Legislative Budget Committee, 2008 Tax Handbook.

<sup>8</sup>Arizona Department of Revenue 2004-2008 Annual Reports: approximately 50,000 annual corporate tax filings. Arizona Department of Insurance 2004-2008 Annual Reports: approximately 1860 insurers operating in Arizona.

<sup>9</sup>Boston Stock Exchange v. State Tax Comm'n, 429 U.S. 318 (1977)

<sup>10</sup>Western & Southern Life Ins. Co. v. Board of Equalization, 451 U.S. 648 (1981)

<sup>11</sup>Metropolitan Life Ins. Co v. Ward, 470 U.S. 869 (1985)

<sup>12</sup>Colorado Revised Statutes § 10-3-209 (1)(b). Nevada Revised Statutes 680B.050.