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KANSAS HOUSE BILL 2082: LEVELING THE FIELD FOR FOREIGN INSURANCE COMPANIES

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The Kansas Legislature recently passed House Bill No. 2082¹ to remedy its discriminatory method of taxing foreign insurance companies at a higher rate than domestic carriers. Previously, under Kan. Stat. Ann. 40-252 and 40-253 (1994) domestic insurance companies were taxed on premiums received at a rate of 1%, while foreign carriers were taxed at a rate of 2%. A foreign insurance company could receive a credit under Kan. Stat. Ann. 40-252c (1994) up to 25% of the tax if 30% of company assets were invested in Kansas securities. At the behest of foreign insurance companies and the Kansas Department of Insurance, the Kansas Legislature enacted House Bill No. 2082 to avoid potential litigation over the discriminatory premium tax.

The United States Supreme Court's Effect on State Insurance Law

In *Metropolitan Life Insurance Company v. Ward*,² the United States Supreme Court struck down Alabama's discriminatory insurance premium tax which levied at the rate of 4% on premiums received by foreign insurance companies and 1% on premiums received by domestic carriers. Foreign carriers were allowed to reduce the differential by investing large amounts of their assets in Alabama bonds and securities. However, regardless of the amount a foreign carrier would invest, its rate would never be as low as the rate paid by domestic insurers.³ While the Court decided *Ward* on equal protection grounds, it rejected a Commerce Clause challenge because the *McCarran-Ferguson Act* authorizes states to regulate the business of insurance without regard to Commerce Clause restrictions which might otherwise limit state authority.⁴

In a 5-4 decision the Court held that the Alabama insurance premium tax scheme violated the Equal Protection Clause by giving domestic carriers preferential tax treatment over foreign carriers. En route to its decision in *Ward*, the Court rejected Alabama's contention that differential treatment was justified by the State's interest in promoting the financial well-being of domestic insurance carriers and encouraging foreign insurance companies to invest in local securities. Although a foreign company could reduce its premium tax liability by investing in Alabama securities, it would always receive less favorable tax treatment than any domestic insurance company. Reasoning that the Equal Protection Clause is designed to prohibit such facial discrimination in the absence of any legitimate basis for differential treatment, the majority in *Ward* invalidated the Alabama insurance premium tax scheme.⁵

Writing for the dissent in *Ward*, Justice O'Connor argued that the majority ignored the ordinarily heavy burden that is placed on taxpayers when challenging the validity of a tax. The dissent pointed out that legislatures have wide latitude in framing tax classifications and that such determinations should receive deference from the courts. After application of this deferential approach, the dissent ultimately concluded that the protection of domestic insurance carriers and the promotion of foreign investment were legitimate state interests which furnished a rational basis for upholding Alabama's tax scheme against an equal protection challenge.⁶ Despite the split decision in *Ward*, the Court's equal protection holding is the law of the land and has had a tremendous impact on state taxation of domestic and foreign insurance companies.

Following the *Ward* decision, many states were compelled to reevaluate their own methods for taxing premiums received by insurance carriers. In 1981, 26 states discriminated facially against foreign insurance companies. By 1996, 19 states enacted remedial legislation to eliminate premium tax discrimination against foreign insurance companies. Until this year, Kansas was one of only five states that imposed a different tax rate based on the insurance company's domicile. Facing a potential

was one of only five states that imposed a different tax rate based on the insurance company's domicile. Facing a potential challenge to the statute, Commissioner of Insurance Kathleen Sebelius and Deputy Commissioner Bob Kennedy worked with the Legislature to draft House Bill No. 2082 to alleviate the effects of the discriminatory tax system.

Changing the System

Ward led many foreign carriers in Kansas to question the constitutionality of the statute. If challenged, it would have likely been held unconstitutional requiring the state to refund many years of tax refunds to foreign insurers. The Commissioner's estimate was that the state could be subject to a half billion dollars in liability. Proposals were debated from late 1996 into May of 1997. Two solutions arose from the debate. The first was to lower the tax on all premiums to 1%. This would cause a substantial loss in total revenue to the state from the immediate drop in tax revenue. Alternatively, a proposal was introduced to raise the tax on all carriers to 2%, effectively doubling the current rate domestic insurers would have to pay. A compromise was needed that would insure minimum loss of revenue while eliminating the discriminatory effect of the statute.

Many of the state's largest foreign insurers formed the "Foreign Company Group" to protest the discriminatory nature of the statute. This group included such large insurers as MassMutual, MONY, New York Life, Prudential, Travelers, John Hancock, MetLife, Aetna, and Transamerica. Since the State of Kansas faced exposure to potential refund liability up to \$500 million, the Foreign Company Group possessed substantial bargaining power in seeking to eliminate premium tax discrimination against foreign insurance carriers doing business in Kansas. Commissioner Sebelius negotiated a compromise resulting in an agreement by the companies to waive any entitlement to refund for taxes paid prior to January 1, 1998, in exchange for changes in the statute that would eliminate its discriminatory effect. The insurers also wanted the asset requirement at Kan. Stat. Ann. 40-252c (1994) eliminated from the statute.

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The agreed upon proposal involves bringing all taxes on premiums up to 2%, but with a credit provision that would allow a reduction of the tax to 1%. The bill phases out the requirement of foreign companies to invest a percentage of assets in Kansas securities by 1998. Instead, a credit will be given to all carriers based on salaries paid to insurance employees in the state. It allows an enlarged credit of 30% of the salaries paid to Kansas employees by insurers to reduce the tax burden down to the 1% level. The tax burden of domestic insurers remains the same, while many foreign companies will attain the immediate benefit of the salary reduction because of branch offices located within the state. However, the bill is not without its problems. The estimated reduction in the General Fund is estimated at around \$6 million in the first year, but the Commissioner believes the additional jobs placed in Kansas by foreign companies will offset and far outweigh the initial losses to the state purse. On May 15, 1997, House Bill No. 2082 was approved by the Kansas Legislature, effectively leveling the field of taxes on premiums received by foreign insurance companies doing business in the State of Kansas.

Conclusion

Kansas House Bill No. 2082 endeavors to insulate the Kansas insurance premium tax from challenge under the Equal Protection Clause of the Fourteenth Amendment by equalizing the tax treatment of foreign and domestic insurance companies. While this legislation may eliminate unconstitutional tax discrimination against foreign insurance companies, small carriers which cannot take advantage of its incentive provisions to lower their tax liability may have cause to complain about differential premium taxation in Kansas.

Endnotes

1. 1997 Kan. Sess. Laws ch. 175 (H.B. 2082).
2. *Metropolitan Life Insurance Company v. Ward*, 470 U.S. 869 (1984).
3. *Id.* at 871-72.
4. *Id.* at 880. See generally *Western and Southern Life Insurance Company v. State Board of Equalization of California*, 470 U.S. 648 (1981) (The McCarran-Ferguson Act permits states to regulate the business of insurance and removes all

U.S. 648 (1981) (The McCarran-Ferguson Act permits states to regulate the business of insurance and removes all Commerce Clause limitations upon this authority).

5. *Ward*, 470 U.S. at 882-84.

6. *Id.* at 886-87.