

**FORC QUARTERLY JOURNAL
OF
INSURANCE LAW AND REGULATION**

Spring 1998 March 14, 1998 Vol. X, Edition I

THE CONTINUING DEMISE OF THE DOMESTIC PREFERENCE TAXES,

William S. Hanley, Esq.
(217) 544-1144

Late last year one more State's domestic preference tax ended a checkered life. After several attempts the Illinois 2% domestic preference ("premium") tax, 215 ILCS 5/409(1) (West 1994), is no more. On December 1, 1997, the Illinois Supreme Court declined a petition for rehearing and its 4-3 decision finding the tax invalid on state constitutional grounds was final. *Milwaukee Safeguard Insurance Co. v. Selcke*, 179 Ill. 2d. 94, 227 Ill. Dec. 731, 688 N.E. 2d, 68 (October 23, 1997). The majority agreed with the Circuit Court of Cook County and 65 insurers that the tax violates the "Uniformity Clause" of the Revenue Article in the comparatively new 1970 constitution (Ill. Const. 1970, art. IX 2). Illinois, like many states, has for more than half a century imposed a tax in some form on foreign (out-of-state) company premiums, but not on premiums of its domestic companies. Noting that the Uniformity Clause imposed "standards of reasonableness which are more rigorous" than those developed under the federal Equal Protection Clause, the majority concluded:

. . . imposing the privilege tax on all foreign insurance companies does not bear a reasonable relationship to the object of the legislation or public policy.

227 Ill. Dec. at 735.

Among the elements which the State advocated but the Court found unreasonable was the use of the tax to induce foreign companies to incorporate in Illinois. Additionally, the Court found no merit in the argument that the tax protects the interests of Illinois policyholders "because the tax is imposed on all foreign companies regardless of their financial strength or their level of compliance with the [record keeping and business] requirements of section 409(4)". 227 Ill. Dec. at 736.

Unlike the Circuit Court which also invalidated the tax on equal protection grounds, the Illinois Supreme Court found it "unnecessary" to rule further given its affirmation of the decision under the "uniformity clause". 227 Ill. Dec. at 736. Without addressing any of the federal constitutional issues, the demise of the tax was a certainty with the denial of a petition for hearing.

This was the third in a series of recent attempts to invalidate the tax in Illinois. Earlier litigation was settled without legislative change. See *Metropolitan Life Insurance Company v. Washburn*, 112 Ill. 2d. 486, 98 Ill. Dec. 50, 493 N.E. 2d. 1071 (1986) (Dismissal order entered January 3, 1989). The tax was declared unconstitutional in *Melahn v. Dep't. of Ins.*, No. 88-L-134 (Sangamon Cty. Cir. Ct., 7th Jud. Cir., Mar. 1, 1993), but the case was settled on appeal in 1994 for \$75,000 with no subsequent legislative change.

What occurred in Illinois, however, is but one more step in the judicial and legislative erosion of state domestic preference taxes. The seminal case was the 1985 decision of the United States Supreme Court in *Metropolitan Life Insurance Co. v. Ward*, 470 U.S. 869 (1985), invalidating the Alabama tax. Putting this in context, it is helpful to note that in 1981 thirty-four (34) states had some form of domestic preference taxes. However, by the time of the decision in Illinois, only 13 states still had some vestige of the tax. A summary of the status of the tax among the 34 states follows:

Alabama*² - The U.S. Supreme Court held the primary purposes of the statute invalid in *Metropolitan Life Ins. Co. v. Ward*, 470 U.S. 869 (1985). Litigation settled in 1993 in exchange for equalizing legislation effective in 1995 providing a five-year

470 U.S. 869 (1985). Litigation settled in 1993 in exchange for equalizing legislation effective in 1995 providing a five-year phase-in of equal life and health rates, equalized property/casualty rates subject to limited economic development credits, special equalized rates for certain lines, and repeal of the tax on annuity considerations. The property/casualty tax was held unconstitutional at the trial court level on state grounds in *Alabama Municipal Ins. Corp. v. Alabama*, No. CV-95-518-PR (Montgomery Cty. Cir. Ct., June 11, 1997); appeal pending.

Alaska* - Equalizing legislation was enacted in 1986. Litigation was settled on a confidential basis in 1986. Other litigation commenced by non-parties to settlement held old tax invalid, but denied refunds to claimants. *Principal Mutual Life Ins. Co. v. State*, No. IJU-87-585 Cl (Super. Ct. 1st Jud. Dist., Oct. 26, 1987), aff'd 780 P.2d 1023 (Alaska 1989).

Arizona* - Equalizing legislation enacted in 1985.

Arkansas* - A salary credit was enacted in 1987 to equalize life company taxes (tax rate on property/casualty premiums having been equal). The tax under both old and new laws held to be invalid in *Principal Mutual Life Ins. Co. v. Taylor*, No. 87-3353 (Pulaski Cty. Ch. Ct., 1st Div., Apr. 1, 1991), and refunds were ordered from date suit was filed. The decision was modified in *Principal Mutual* at request of foreign and domestic interveners (July 11, 1991) to delete ruling as to new law (salary credit).

Colorado - No legislative change.

Florida* - Equalizing legislation involving a salary credit was enacted in 1987 and amended in 1988, effective July 1, 1988; however, there was a 20% of the salary credit from foreign companies in 1989 legislation which also mandated a premium tax study during 1990. A premium tax study recommended repeal of the take back and establishment of a minimum effective tax rate of .62%. The pre-July 1, 1988, domestic preference tax was upheld in *Gallagher v. Motors Ins. Corp.*, 605 So.2d 62 (Fla. 1992), and *State v. Melahn*, 605 So.2d 73 (Fla. 1992) (based on opinion in *Motors*). Petitions for writ of certiorari filed in the U.S. Supreme Court were dismissed by stipulation and settlement (*Motors* and *Melahn* at 506 U.S. 1074 (1993)).

Georgia - No legislative change.

Hawaii - The pre-July 1, 1992, law was invalidated in *Keystone Provident Life Ins. Co. v. Ramil*, No. 2380 (Haw. Tax. App. Ct., July 10, 1986). Litigation was then put on hold pending legislative efforts. Equalizing legislation was agreed to with domestics and passed the Legislature in 1990, but was vetoed by the Governor. 1991 legislative efforts failed and the trial court severed domestic company rates in *Keystone* (June 28, 1991). Domestics commenced paying at foreign company rates on premiums received after June 30, 1991. Despite revenue neutral tax equalization legislation agreed to between foreigners and domestics, a *de facto* domestic preference tax proposed by the State was enacted effective July 1, 1992. The final judgment in *Keystone* ordered refunds of the tax differential for taxes paid under protest entered and the State appealed. A second round of litigation was commenced challenging the post-June 30, 1992 *de facto* domestic preference tax; however, litigation through 1991, including the appeal in *Keystone* was settled in 1993 for \$11.5 million. The second round of litigation for 1992 to 1997 was settled in August 1997 for \$3,498,581 without remedial legislation.

Idaho - Legislative changes in 1983, 1985, 1987 and 1988 went full circle first to remove and then restore the domestic preference tax.

Indiana - No legislative change.

Kansas* - Refund claims and protests were withdrawn in exchange for tax equalization legislation enacted in 1997 but effective in 1998 with a two-year phase-in.

Kentucky - Litigation is now pending, but there has been no legislative change.

Louisiana - No legislative change.

Maine* - Equalizing legislation enacted in 1986.

Michigan* - The premium tax invalidated in *Penn Mutual Life Ins. Co. v. Dep't. of Licensing and Regulation*, 412 N.W.2d 668 (Mich. App. 1987). Litigation was settled in 1987 for enactment of equalizing legislation.

Mississippi - Litigation is pending. Legislation was enacted in 1985 to change from *de jure* to *de facto* domestic preference.

Montana* - Equalizing legislation was enacted in 1987.

Nebraska* - Equalizing legislation was enacted in 1986 retroactive to 1985.

Nevada - No legislative change.

New Jersey - Legislation was enacted in 1985 effectively grandfathering companies then enjoying the tax preference. A 1989 amendment retroactively extended grandfather date by six months to permit several additional companies to qualify.

New Mexico* - Tax equalization legislation with a two-year phase-up of the preferential (domestic company) rate enacted in 1991. Pending litigation was voluntarily dismissed.

North Carolina* - Equalizing legislation enacted in 1986.

North Dakota* - Domestic preference tax was held invalid by North Dakota Supreme Court in *Metropolitan Life Ins. Co. v. Comm'r. of Dep't. of Ins.*, 373 N.W.2d 399 (N.D. 1985). Equalizing legislation was enacted in 1983 retroactive to 1982.

Ohio* - Litigation was settled in exchange for tax equalization legislation enacted in 1997 but effective in 1998 with a five-year phase-in.

Oklahoma* - Litigation was settled in 1987 with refunds of \$35 million; equalizing legislation with a two-year phase-in was enacted in 1988.

Oregon* - Litigation was settled in exchange for tax equalization legislation enacted in 1995 but effective in 1997 with a five-year phase-in.

South Carolina* - Equalizing legislation was enacted in 1986. Litigation over item-by-item retaliatory tax enacted in 1987 was settled in 1989 for \$9.5 million. An aggregate retaliatory tax was reenacted in 1990 pursuant to settlement.

South Dakota - Pending litigation is on hold. Legislation enacted in 1982 to change from *de jure* to *de facto* domestic preference. A discriminatory tax on unlicensed insurers was struck down in *State v. American Bankers Ins. Co.*, 374 N.W.2d 609 (S.D. 1985), citing *Ward*.

Tennessee* - Equalizing legislation with a five-year phase-down of the foreign life company rate to the domestic life company rate was enacted in 1994 (tax rate on property/casualty premiums having been nondiscriminatory). Pending litigation was voluntarily dismissed.

Texas* - Legislation was enacted in 1984 to change from *de jure* to *de facto* domestic preference on life companies in 1985. Litigation through 1984 settled for \$54.2 million in refunds. A 1986 interim study rejected investment approach of the 1984 *de facto* statute on life companies. Litigation was settled in 1989 for tax legislation with a six-year phase-in to equal rates for life companies by 1995.

Washington* - Equalizing legislation enacted in 1986.

West Virginia - No legislative change.

Wyoming* - The domestic preference tax was held to be invalid in *Mutual Life Ins. Co. v. Wyoming Ins. Dep't.*, Nos. 96-360 et al. (Dist. Ct. 1st Jud. Dist., June 21, 1985). Litigation was settled through 1984 with refunds of \$1.75 million. Legislation was enacted in 1986 retroactive to 1985 changing from *de jure* to *de facto* domestic preference. Claims for 1985 were settled in 1988 for \$900,000. Tax equalization legislation containing a three-year phase-in was enacted in 1991 under a settlement agreement. Post-1985 refund claims were withdrawn pursuant to settlement agreement.

Whatever may be said of the changing scene of domestic preference taxation, it is apparent that much has yet to be done. In Illinois, at press time, the matter of replacing lost premium tax revenues remains unresolved. However, it is anticipated these will be some form of a flat rate premium tax, with a lower rate for the health indemnity companies, HMO's and other providers (Blue Cross), together with a formula for integration with payments under the Illinois income tax, which had been an offset to the invalidated premium tax.

The Illinois story does not end with a rewritten premium tax. The State's retaliatory tax remains, 215 ILCS 5/444. Basically, it is designed to equalize the tax burden between Illinois and the home state of the foreign company. See *Mutual Life Insurance Company of New York v. Washburn*, 137 Ill. 2d. 312, 148 Ill. Dec. 723, 561 N.E. 2d. 29 (1990).

However, as may be seen from the above summary, applying the retaliatory tax can invoke a tangled tax web state to state. The retaliatory tax itself has been a frequent subject of judicial attention (if not confusion). See *Mutual Life op. cit.* Recent case law held that the Illinois 4.8% income tax and the 2.5% add on "personal property replacement tax" did not count in the retaliatory calculation because they were not taxes on the privilege of doing insurance business in Illinois. *Mutual Life, op. cit.*; see also *Trinity Universal Insurance Company v. O'Connor*, 113 Ill. App. 3d. 580, 69 Ill. Dec. 502, 447 N.E. 2d. 937 (1983). This result stood notwithstanding the fact that both components of the income tax were allowed as offsets to the old premium tax, which itself was a tax on the privilege of doing insurance business in Illinois.

However, this too may change. *Milwaukee Safeguard* prompted a spate of companies to pay their fourth quarter estimates of Illinois retaliatory tax under protest with follow-up court challenges to the constitutionality of the retaliatory tax itself. Various grounds have been asserted in a cluster of cases, including a challenge to disallowing the income tax in the retaliatory calculation now that the premium tax has met its demise. It is anticipated that just as the Illinois premium tax may be rewritten to be truly "uniform" in taxing both domestic and foreign companies, so too the retaliatory tax may be amended by legislation and applied in pending protest cases to allow the income tax to be used in the retaliatory calculation, thereby undoing *Mutual Life*.

If the two certainties of life are death and taxes, it is evident that the demise of domestic preference taxation is not the end of taxation. It is, however, a significant step toward more consistent and fair treatment of foreign and domestic companies among the states.

Endnotes

1. Special appreciation for article content is extended to Robert R. Baldwin, Esq, Associate Tax Counsel, Metropolitan Life Insurance Company.
2. *States which have enacted equalizing legislation.

