

Citizens Research Council of Michigan

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Summary Digest of Michigan Tax Study Staff Reports

As a public service the Research Council has prepared this digest of a staff report to the Michigan State Tax Study Committee. The Committee is considering basic changes in the state's tax structure and these digests have been prepared to inform the public as to what is being considered by the Committee. It should be emphasized that the material presented is a digest of the staff report to the Committee and does not represent the findings or opinions of the Michigan Tax Study Committee, its citizens advisory committee, or the Research Council.

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TAXATION OF INSURANCE PREMIUMS

A special tax on gross premium income of foreign (not domestic) insurance companies is the single most important tax paid by insurance companies. This tax is imposed in some form by all 48 states. In 1956, Michigan collected \$17.7 million from this tax – 2.3 per cent of total state taxes. Only six states derive more revenue from this source.

HISTORICAL DEVELOPMENT

Originally in most states the primary purpose of the tax was not to raise revenue, but to cover the expenses of regulation, provide funds for fire protection, encourage domestic insurance companies by imposing a discriminatory burden on foreign companies, or to retaliate against other states which were discriminatory against Michigan companies. Thirty-two states now have reciprocity provisions. The way such a provision works is that if State A imposes a tax of 3 per cent and State B a tax of 2 per cent, then State B will tax companies incorporated in State A at a rate of 3 per cent.

The Michigan insurance premium tax was first adopted in 1861 and in 1917 the tax emerged in approximately its present form. The constitutions of 1850 and 1908 provided that revenue from specific taxes be earmarked for the Primary School Interest Fund, so the revenue from the insurance premiums tax has gone into that fund. Revenue from any specific taxation of insurance premiums would appear to be dedicated to this fund, but a franchise tax on domestic companies measured by premiums collected might avoid the earmarking restriction and, therefore, be available as a general fund revenue.

CURRENT MICHIGAN TAXATION OF THE INSURANCE INDUSTRY

Foreign and Alien Companies

The tax is imposed "as a condition precedent to the privilege of doing business" in Michigan. The tax is on gross direct premiums received on Michigan business written, with certain deductions. The rate of tax paid depends on the type of company writing the policy rather than the type of policy. Thus, a single company

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writing multiple lines of insurance is placed in a class and this determines the rate all its premiums are subject to. This is a difficult task and depends on historical accident as much as anything else. Based on this classification, a 3 per cent rate is applied to fire, marine, and strictly automobile insurance companies, while all other classes of companies pay a higher rate under the reciprocal discrimination provision. Michigan collected \$266,000 in 1956 under this retaliatory provision.

Michigan collected \$17.7 million in 1956 from this tax which represents a steady average annual increase of 8 per cent in revenues since 1949. Insurance premium tax collections are \$2.35 per capita, representing .11 per cent of total state personal income and 2.3 per cent of total state tax collections.

The premium tax is in lieu of most other taxes for which foreign insurance corporations might otherwise be liable, such as the intangibles tax. They are subject to local property taxes on property owned or held for investment purposes within the state.

Domestic Companies

Domestic insurance companies pay a special franchise tax at a rate of 5 mills per dollar of paid-up capital, surplus and unassigned funds. The minimum fee is \$10 and the maximum is \$50,000. An allocation formula is used for domestic companies doing business outside the state. Revenue from this source goes into the general fund and in fiscal 1957 collections were \$416,000.

The franchise fee is in lieu of all other taxes, except property taxes. However, taxation of personal property is imposed only in reference to general assets and liabilities.

COMPARATIVE ANALYSIS OF THE PREMIUMS TAX AMONG SELECTED STATES

Any comparison of insurance premiums taxes among states is at best an approximation. Among eleven selected states, Michigan ranked seventh in total insurance tax receipts, eighth in per capita collections, tenth in ratio of insurance tax receipts to total state tax receipts; and, eighth (tied with Illinois and Wisconsin) in the ratio of insurance tax receipts to personal income. The six states realizing more revenue from insurance premium taxes than Michigan all tax at about the same rate (2 per cent) as Michigan, but three of the six states also tax domestic insurance companies.

RATIONALE

While it is sometimes argued that the insurance industry should escape all taxation, except on real estate, there is no merit to more favorable treatment being extended to insurance companies than is extended to other institutions performing comparable functions in the economy.

There have been charges of inequity arising from the nature of the tax base, particularly that the gross premiums tax makes no allowance for differences in opera-

tional procedure and economic position of the various companies. A company with large assets and investment income is taxed on the same basis and at the same rate as the competitor depending largely on premium receipts for its solvency.

Since premium rates are closely regulated in most states, it may be assumed that the premium tax is shifted to the policy purchaser in the form of higher premiums. The incidence of the tax on life insurance premiums would appear to be regressive in its distribution among income groups. In the case of insurance other than life insurance, the incidence of the tax is so broadly diffused that its distribution among individuals cannot be estimated. Favorable treatment for mutual companies is apparently an effort to impose the burden on stockholders rather than policyholders.

There are a number of practical considerations that favor the insurance premium tax. It is a reliable producer of substantial revenue in ever increasing amounts. It is established, accepted, and understood both by government and the industry. Administratively, it is relatively simple.

However, the charges of inequity against the gross premium tax are difficult to ignore, and the possibility of combining a new premium tax, taking into account loss factors, and adding investment income to the tax base, presents an interesting possibility.

ANALYSIS OF MICHIGAN TAXATION OF THE INSURANCE INDUSTRY

Gross Premium Tax

Exemptions If the premium tax is simply passed on to the policy purchaser (and this appears to be the case), then the owners of a majority of the insurance in Michigan (who hold policies of foreign companies) are being discriminated against relative to the minority holding policies issued by exempt domestic companies. The exemption of domestic companies costs the state more than \$3 million annually in potential premiums tax revenue. The economic advantage gained by the state as a consequence of exempting domestic companies is not clear – employment and the availability of investment funds are both probably little affected by the exemption.

Michigan loses about \$6 million a year in potential revenue from exemption from the premiums tax — \$3 million from exempting domestic companies, \$237,000 from fraternal benefit societies; \$3,056,000 from non-profit medical and hospital associations; and \$26,000 from domestic cooperative life and accident associations. This would be offset by the \$400,000 now collected if the franchise tax on domestic companies were dropped. Unless there are compelling reasons that justify the continuation of present discriminatory practices, equity as well as revenue considerations strongly suggest that they be carefully re-examined.

The Tax Base The inclusion of annuity considerations as taxable premiums (now exempt) rests on a judgment as to whether insurance companies and their contractual receipts should be taxed in uniform fashion, irrespective of the fact that similar

receipts of other kinds of financial institutions are not subject to the same tax. Adding annuity considerations to the premium tax base would increase revenues by about \$1.2 million. Consideration of equity would not prevent uniform treatment of certain exclusions from gross premiums (not possible under present law) and simplification of the tax structure would result.

Rates Perhaps the most difficult aspect of Michigan's tax treatment of the insurance industry to justify is that provision by which fire, marine, and strictly automobile insurance companies are taxed at a rate 50 per cent higher than other companies on their gross premiums, despite the fact that other companies may also write the same kinds of insurance written by these companies.

Elimination of this discrimination by reducing the rate on these companies would have cost the Primary School Interest Fund \$1.3 million in 1956. A uniform rate of 3 per cent would increase revenues, but might impose a disproportionate tax burden on companies operating in Michigan or on their policyholders. If the differential rate is to be continued, it would be made less discriminatory if it were based on the type of insurance written, regardless of the type of company writing it. Adoption by 32 states of some form of retaliatory rate provision may account for the relative uniformity in the premiums tax rate throughout the country.

Property Taxation

The unique treatment for tax purpose of the personal property of insurance companies might well be questioned. The net asset method used for domestic insurers creates a favorable situation enjoyed by no other comparable form of business in the state. Foreign companies pay the personal property tax only on tangible property owned or held for investment purposes.

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