Taxation of Accident and Health Insurance Companies

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PART ONE

A. INTRODUCTION.

One of the important items to be considered in the operation of the insurance business is the matter of taxes, both federal and state. Chief Justice Marshall in his famous dictum, in the case of McCulloch v. Maryland, suggested that "the power to tax involves the power to destroy." And the United States Supreme Court in more recent times "has recognized that a statute purporting to tax may be so arbitrary and capricious as to amount to confiscation." Confiscation of property or business by means of arbitrary taxation may be as definite and real a menace as any that can be suggested.

What, then, is this thing called "tax" that can be made burdensome and even destructive and yet which obviously is essential to the maintenance of our American form of political society? Where does the government, federal, state, or local, derive its authority to wield so potent a power? What, if any, are the limitations upon the power to tax? What are the requirements of the statutes, state and federal, and of the local ordinances with reference to the taxation of accident and health insurance companies? What is the future of these companies in so far as taxes are concerned? And what, if anything, can be done about this perennial problem of taxes? These are some of the questions that must be considered in order to understand rightly the problem of taxation as it affects the insurance business, and particularly accident and health insurance companies.

B. THE NATURE OF TAXES.

Cooley, in his much quoted work on Taxation, defines taxes as "the enforced proportional contributions from persons and property, levied by the state by virtue of its sovereignty for the support of government and for all public needs."

The United States Supreme Court has defined taxes as "an enforced contribution to provide for the support of government." Another court has stated that taxes are "an enforced contribution of money or other property, assessed in accordance with some reasonable rule of apportionment by authority of a sovereign state on persons or property..."
within its jurisdiction, for the purpose of defraying the public ex-
penses."5

It should be noted that, as indicated in the foregoing definitions, one
of the fundamental characteristics of a tax is that it is not a voluntary
donation or payment, but an enforced contribution exacted in accord-
ance with legislative authority, the contribution being of a proportionate
character, and usually payable in money and imposed and collected for
the purpose of raising funds to be used solely for public purposes.

C. THE THEORY OF TAXATION.

The prevailing theory of taxation is that taxes are levied upon per-
sons, businesses or property for the support of government in return
for the benefits and protection which the government affords the tax-
payer and his property or business.

The Wisconsin Supreme Court has pointed out:6

"The basic idea of exercise of the taxing power and justifica-
tion for it, is that, it involves an exchange of equivalents. The
taxing district obtains the contribution to the public treasury and
the contributor, in return, receives a legal consideration of a
pecuniary or protective nature to his person or his property or
both. It is often difficult to appreciate just where the considera-
tion comes in, but without it, in fact, the taking of one's prop-
erty, though under the form of taxation, and, so, in form, by due
process of law, would be confiscation,—an appropriation of pri-
vate property for a non-public use, even though, in the particu-
lar case, the public might be interested in the enterprise pro-
moted, and be largely, incidentally, benefited."

In Youngblood v. Sexton,7 Mr. Justice Cooley said:

"It may be supposed that some idea of special protection is
involved when a business is taxed; taxation and protection being
reciprocal. If the tax upon any particular thing was the consid-
eration for the protection given to the owner in respect to it, this
might be so; but the maxim of reciprocity in taxation has
no such meaning. No government ever undertakes to tax all it
protects. If a government were to levy only poll taxes, it would
not be on the idea that it was to protect only the persons of its
citizens, leaving their property open to rape and plunder. In
this State our taxes are derived mainly from real estate; but it
has never been suggested that real estate was entitled to special
considerations in consequence. ** Whether a person in respect
to his property or his occupation falls within the category of
taxables or not is immaterial as affecting his claim to protection
from the government. It is enough for him that the government
has selected for itself its own subjects for taxation, and pre-
scribed its own rules. It is his liability to taxation at the will of

5 French Republic v. Board of Supervisors, 200 Ky. 18, 21, 252 S.W. 124 (1923).
6 State ex rel. Owen v. Donald, 160 Wis. 21, 151 N.W. 331, 366 (1916).
the government that entitles him to protection, and not the cir-
cumstances of his being actually taxed. * * *

The justification for taxes rests in the reciprocal duties of protection and support between the state and those who are subject to its authority. The person upon whom the demand for taxes is made owes to the state a duty to contribute his just proportion toward support of the government and the state in turn gives protection to his life, property, and business.

**PART TWO**

A. **POWER OF THE FEDERAL GOVERNMENT TO TAX INSURANCE COMPANIES.**

(1) **In general.**

Under the federal law the principal tax to which an insurance company may be subject is the income tax.8 The federal old age pension tax and the federal unemployment tax also apply to insurance companies.9 The power which Congress possesses to levy taxes is obtained from the Federal Constitution,10 which provides:

"The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States."

Under the broad provisions of the above quoted Article of the Constitution, Congress is given authority to levy and collect sundry and various types of taxes. As the Court suggested in the leading case of Pollock v. Farmers Loan & Trust Co.,11 the above classification, despite intimations to the contrary, is probably broad enough to include every kind of tax known to exist.

Art. 1, Sec. 9, Clause 4 of the Constitution provides that "no Capititation, or other direct, tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."

This provision was adopted for the purpose of equalizing the tax burden among the several states. At the time of the adoption of the Constitution a tax on real estate without apportionment would have been confiscatory owing to the fact that in the South there existed large areas of land and only very few people. In the North, however, there was a large population and but very little land and, hence, such a tax would not have been unduly burdensome to that section of the country.

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8 See U.S.C.A. Title 26, sections 201, 204, 207, et seq. and pocket supplement.
9 See U.S.C.A. Title 26, sections 1400 et seq. and 1600 et seq. and pocket supplement and U.S.C.A. Title 42, section 1001 et seq. and pocket supplement.
10 United States Constitution, Article I, Section 8, Clause 1.
11 157 U.S. 429, 158 U.S. 601, 39 L. Ed. 759, 1108 (1895). In Brushaber v. Union Pac. R.R. Co., 240 U.S. 1, 12, 60 L. Ed. 493, 36 S. Ct. 236 (1915), the Court said: "That the authority conferred upon Congress by Sec. 8 of Article 1 'to lay and collect taxes, duties and imposts and excises' is inexhaustive and embraces every conceivable power of taxes has never been questioned* * *".
The framers of the Constitution sought to secure equality by the adoption of a rule of apportionment making the heavily populated sections of the nation bear the greatest burden while lightening the burden of taxation on the fewer people residing in the sparsely settled communities. The rule of apportionment means simply that after the total amount of taxes to be raised by direct taxation has been decided upon, that sum will be divided among the several states according to their population and assessed at a rate to be determined by dividing the total value of the property within the state subject to the tax into the amount apportioned to that state.\textsuperscript{12}

Prior to the adoption of the Sixteenth Amendment a tax upon income was within the power of Congress to levy but an income tax was then held to be a direct tax upon property and was unconstitutional unless apportioned among the states.\textsuperscript{13} This led to the adoption of the Sixteenth Amendment which removed the necessity which otherwise existed for apportionment among the states of taxes laid on income. However, that Amendment did not extend the taxing power of Congress to new subjects, but merely took away the necessity of apportioning the taxes laid on income.

(2) Taxation of income under the Sixteenth Amendment.

The Sixteenth Amendment to the United States Constitution provides:

"The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration."

This Amendment was submitted to the legislatures of the various states on July 31, 1909 (36 Stat. 84). The Secretary of State in a proclamation dated February 25, 1913, declared the Amendment to have been ratified by the necessary number of states.\textsuperscript{14} However, for convenience it was made effective by Congress on March 1, 1913.

In considering the Sixteenth Amendment, the United States Supreme Court in the leading case of \textit{Eisner v. Macomber},\textsuperscript{15} said:

"A proper regard for its genesis, as well as its very clear language, requires also that this Amendment shall not be extended by loose construction, so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an apportionment according to population for direct taxes upon property, real and personal. This limitation still has an ap-

\textsuperscript{12} \textit{Veazie Bank v. Fenno}, 8 Wall. 533, 19 L. Ed. 482 (1869).
\textsuperscript{14} 37 Stats. 1785 (1913).
\textsuperscript{15} 252 U.S. 189, 206, 64 L. Ed. 521, 40 S. Ct. 189 (1920).
propriate and important function, and is not to be overridden by Congress or disregarded by the courts.

"In order, therefore, that the clauses cited from Article 1 of the Constitution may have proper force and effect, save only as modified by the Amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not 'income,' as the term is there used; and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised."

(3) What is income?

In the case of *Eisner v. Macomber* the United States Supreme Court considered the meaning of income under the Sixteenth Amendment, and said:

"The fundamental relation of 'capital' to 'income' has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time. For the present purpose we require only a clear definition of the term 'income,' as used in common speech, in order to determine its meaning in the Amendment; and, having formed also a correct judgment as to the nature of a stock dividend, we shall find it easy to decide the matter at issue.

"After examining dictionaries in common use (Bouvier's Law Dict.; Standard Dict.; Webster's Int. Dict.; Century Dict.), we find little to add to the succinct definition adopted in two cases arising under the Corporation Tax Act of August 5, 1909 (36 Stat. at L. 11, chap. 6), (Stratton's Independence v. Howbert, 231 U.S. 399, 415, 58 L. ed. 285, 292, 34 Sup. Ct. Rep. 136; Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185, 62 L. ed. 1054, 1059, 38 Sup. Ct. Rep. 467) : 'Income may be defined as the gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the Doyle Case (pp. 183, 185).

"Brief as it is, it indicates the characteristic and distinguishing attribute of income, essential for a correct solution of the present controversy. The Government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word 'gain,' which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived; 'Derived—from—capital'; 'the gain—derived—from—capital'; etc. Here we have the essential matter: not a gain accruing to capital, not a growth or

16 252 U.S. 189, 64 L. Ed. 521, 40 S. Ct. 189 (1920).
increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested or employed, and coming in, being 'derived,' that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit, and disposal;—that is income derived from property. Nothing else answers the description.

"The same fundamental conception is clearly set forth in the Sixteenth Amendment—'incomes, from whatever source derived' —the essential thought being expressed with a conciseness and lucidity entirely in harmony with the form and style of the Constitution."

In *United States v. Safety Car Heating & Lighting Company,*17 in discussing the meaning of income, the Court said:

"In February, 1913, if our analysis of the facts is accurate, there was a contested and contingent claim for profits, not fairly to be characterized as income for that year or earlier. In 1925 this inchoate and disputed claim became consummate and established. It was now something more than a claim. It was income fully accrued, and taxable as such. Till then the patentee had its capital, the patent, and an expectancy of income, or income, more accurately, in the process of becoming. Thereafter it had something different. No doubt the income thus accrued derived sustenance and value from the soil of past events. We do not identify the seed with the fruit that it will yield.

"Income within the meaning of the Sixteenth Amendment is the fruit that is born of capital, not the potency of fruition. With few exceptions, if any, it is income as the word is known in the common speech of men. When it is that, it may be taxed, though it was in the making long before (citations omitted)."

And, in *Helvering v. Independent L. Ins. Co.*,18 the Court said:

"Unquestionably Congress has power to condition, limit or deny deductions from gross income in order to arrive at the net that it chooses to tax."

In view of the foregoing it is clear that the term "income" as used in the Sixteenth Amendment does not refer to gross receipts, but rather to gross receipts less such deductions as Congress chooses to allow. Of course, capital cannot be taxed and before there can be any income there must be gain.19

Another interesting case on this subject is *MacLaughlin v. Alliance Insurance Company.*20 In this case a Pennsylvania stock fire and marine insurance company received a profit from the sale in 1928 of prop-

20 286 U.S. 244, 76 L. Ed. 1083, 52 S. Ct. 538 (1932).
erty acquired before that time. The Commissioner of Internal Revenue assessed a tax against the company, which was arrived at by including in the taxable income all of the gains attributable to the increase in value of the property after March 1, 1913, and realized by the sale in 1928. The company contended that only so much of the gain as accrued after the effective date of the Revenue Act of 1928 could constitutionally be taxed, and it was upheld in this contention by the lower court. The Supreme Court, in denying the claim of the taxpayer and upholding the position of the Government, said:

"The tax under this and earlier revenue acts was imposed upon net income for stated accounting periods, here the calendar year, 1928, * * * and it is only gain realized from the sale or other disposition of property, which is included in the taxable income. Realization of the gain is the event which calls into operation the taxing act, although part of the profit realized in one accounting period may have been due to increase of value in an earlier one. While increase in value of property, not realized as gain by its sale or other disposition, may, in an economic or bookkeeping sense, be deemed an addition to capital in a later period, it is nevertheless a gain from capital investment which, when realized, by conversion into money or other property, constitutes profit which has consistently been regarded as income within the meaning of the Sixteenth Amendment and taxable as such in the period when realized.

"Here there is no question of a tax on enhancement of value occurring before March 1, 1913, the effective date of the income tax act of that year, for the Collector asserts no right to tax such increase in value. The fact that a part of the taxed gain, represented increase in value after that date, but before the present taxing act, is without significance. Congress, having constitutional power to tax the gain, and having established a policy of taxing it, may choose the moment of its realization and the amount realized, for the incidence and the measurement of the tax. Its failure to impose a tax upon the increase in value in the earlier years, assuming without deciding that it had the power, cannot preclude it from taxing the gain in the year when realized, any more than in any other case, where the tax imposed is upon realized, as distinguished from accrued, gain. If the gain became capital by virtue of the increase in value in the years before 1928, and so could not be taxed as income, the same would be true of the enhancement of value in any one year after the adoption of the taxing act, which was realized and taxed in another. But the constitutionality of a tax so applied, has been repeatedly affirmed and never questioned. The tax being upon realized gain, it may constitutionally be imposed upon the entire amount of the gain realized within the taxable period, even though some of it represents enhanced value in an earlier period before the adoption of the taxing act."

In determining what income is we must bear in mind that although income is often defined as "the gain derived from capital, from labor,
or from both combined," yet Congress has broad powers, both to grant deductions from gross income and to take away deductions. In other words, as a practical matter taxable income is gross income (not including capital investment) less deductions authorized by Congress.

B. LIMITATIONS UPON THE POWER OF THE FEDERAL GOVERNMENT TO LEVY TAXES.

(1) In general.

Contrary to opinions expressed by many uninformed people there are certain constitutional limitations upon the power of the Federal Government to levy the taxes authorized under the Constitution. Although the power of Congress to levy taxes is very great, it is not unlimited. We shall now consider briefly the limitations upon the power of the Federal Government to levy taxes.

(2) Jurisdiction.

It is manifest that the power of the Federal Government to tax cannot extend beyond its sovereignty. That is to say, the power to tax must depend on jurisdiction. Jurisdiction may be based either on (1) citizenship of the person or corporation against whom the tax is levied, (2) domicile, or (3) source of income.

Thus, the Supreme Court held that the income of an American citizen residing in Mexico was subject to the federal income tax, although such income was derived wholly from property located outside of the United States. And, in the case of non-resident aliens the power of the Government to levy income taxes depends on whether there is any income from sources within the United States. Thus, in DeGanay v. Lederer the Court held that the Federal Government had power to tax a non-resident alien upon income received from a trust comprised of intangible property administered by resident trustees within the United States. And in Ingram v. Bowers it was held that royalties received by Enrico Caruso, an Italian subject, from the sale of Victrola records, recorded in America but sold in foreign countries, were subject to the federal income tax upon income from sources within the United States. The theory of the statute and of the Court's decisions is that since non-resident aliens enjoy the protection of the laws

26 57 Fed. (2d) 65 (1932).
of the United States with respect to their income, they may be taxed for the benefits received.

(3) Rule of uniformity.

The Constitution provides that duties, imposts and excises must be uniform throughout the United States. That is, a tax cannot be levied at one rate in one locality and at another rate in another locality upon the same object or business, nor may Congress exempt from taxation taxpayers of a certain class located in one part of the country and not taxpayers of the same class living in another part of the country. The effect of the Sixteenth Amendment was to treat the income tax on incomes from real and personal property as an indirect tax rather than as a direct tax. However, the Court never has treated the tax on incomes from business, trades, professions or employments as a direct tax, but only the tax on incomes from real or personal property prior to the Sixteenth Amendment. Therefore, since income taxes are not direct taxes, the rule of uniformity applies to income taxes, which rule under the Constitution is limited to excises, duties and imposts.

(4) Double taxation.

There is no constitutional objection to so-called "double-taxation," at least as far as the United States Constitution is concerned. Unfair though it may be, and the courts at times have characterized it as such, nevertheless double taxation has been sustained against all attacks as to its constitutionality.

(5) Retroactive taxation.

For more than half a century it has been settled that a law of Congress imposing a tax may be retrospective in its operation. Each of the income tax acts adopted from time to time has been retroactive, in that it applied to income earned prior to the passage of the act, during the calendar year. The Act of October 3, 1913, ch. 16, 38

29 United States Constitution, Article I, Section 8.
Stats. 114, 166, which taxed all incomes received after March 1, 1913, was specifically upheld in *Brushaber v. Union Pacific R.R. Co.*, and in *Lynch v. Hornby.* Some of the acts have taxed income earned in an earlier year. The Joint Resolution of July 4, 1864, No. 77, 13 Stat. 417, imposed an additional tax on incomes earned during the calendar year 1863; this additional tax being imposed after the taxes for the year had been paid. In *Stockdale v. Atlantic Insurance Co.*, Mr. Justice Miller said:

"* * * no one doubted the validity of the tax or attempted to resist it."

Except for the peculiar tax involved in *Nichols v. Coolidge* no federal revenue measure has been held invalid on the score of retroactivity. The need of government for revenue has always been deemed a sufficient justification for making a tax measure retroactive whenever the imposition seemed consonant with justice and the conditions were not such as would ordinarily involve hardship.

(6) *Arbitrary and capricious taxes.*

While the power of Congress to levy and collect excise taxes is very broad, it is not unlimited and the courts have ruled that arbitrary and capricious taxes will not be sustained. This limitation on the power of Congress is found in the Fifth rather than in the Sixteenth Amendment to the Constitution. Thus, the Supreme Court in holding void a portion of Sec. 402(c) of the Revenue Act of 1919 on the ground that it was arbitrary and capricious, said:

"This court has recognized that a statute purporting to tax may be so arbitrary and capricious as to amount to confiscation and offend the Fifth Amendment (citing cases). And we must conclude that Sec. 402(c) of the statute here under consideration, in so far as it requires that there shall be included in the gross estate the value of property transferred by a decedent prior to its passage merely because the conveyance was intended to take effect in possession or enjoyment at or after his death, is arbitrary, capricious and amounts to confiscation. Whether or how far the challenged provision is valid in respect of transfers made subsequent to the enactment, we need not now consider."

C. THE FEDERAL INCOME TAX LAW AS APPLIED TO ACCIDENT AND HEALTH INSURANCE COMPANIES.

Under the federal law an insurance company other than life or mutual is subject to the imposition of an income tax under the provi-
sions of Section 204, Title 26 U.S.C.A. Those life insurance companies that are engaged in the business of issuing life policies including contracts of combined life, health and accident insurance are subject to taxation under the provisions of Sections 201, 202 and 203 of Title 26 U.S.C.A. Mutual companies other than life come under Sec. 207, Title 26 U.S.C.A.

Section 201(a) of the Internal Revenue Code relating to taxation of life insurance companies, provides in part that

"(a) Imposition of tax.
   (1) In general. There shall be levied, collected, and paid for each taxable year upon the adjusted normal-tax net income (as defined in section 202) and upon the adjusted corporation sur-tax net income (as defined in section 203) of every life insurance company taxes at the rates provided in section 13 or section 14 (b) and in section 15 (b)."

Section 201(b) of the Internal Revenue Code defines a life insurance company as one "which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance) or noncancellable contracts of health and accident insurance, and the life insurance reserves (as defined in subsection (c) (2)) plus unearned premiums and unpaid losses on noncancellable life, health, or accident policies not included in life insurance reserves, of which comprise more than 50 per centum of its total reserves."

Section 204(a) of the Internal Revenue Code relating to insurance companies other than life or mutual provides in part as follows:

"There shall be levied, collected, and paid for each taxable year upon the normal-tax net income and upon the corporation surtax net income of every insurance company (other than a life or mutual insurance company) and every mutual marine insurance company and every mutual fire insurance company exclusively issuing either perpetual policies, or policies for which the sole premium charged is a single deposit which (except for such deduction of underwriting costs as may be provided) is refundable upon cancellation or expiration of the policy taxes at the rates specified in section 13 or section 14(b) and in section 15(b)."

Section 207 of the Internal Revenue Code, relating to mutual insurance companies other than life or marine, provides in part as follows:

"(a) Imposition of tax. There shall be levied, collected, and paid for each taxable year upon the income of every mutual insurance company (other than a life or a marine insurance company or a fire insurance company subject to the tax imposed by section 204 and other than an interinsurer or reciprocal underwriter) a tax computed under paragraph (1) or paragraph (2)
whichever is the greater and upon the income of every mutual insurance company (other than a life or a marine insurance company or a fire insurance company subject to the tax imposed by section 204) which is an interinsurer or reciprocal underwriter, a tax computed under paragraph (3):

"(1) If the corporation surtax net income is over $3,000 a tax computed as follows:

"(A) Normal tax. A normal tax on the normal-tax net income, computed at the rates provided in section 13 or section 14(b), or 30 per centum of the amount by which the normal-tax net income exceeds $3,000, whichever is the lesser; plus

"(B) Surtax. A surtax on the corporation surtax net income, computed at the rates provided in section 15(b), except that if the corporation surtax net income is not more than $6,000 the surtax shall be 12 per centum of the amount by which the corporation surtax net income exceeds $3,000.

"(3) ***

"(B) Surtax. A surtax on the corporation surtax net income, computed at the rates provided in section 15(b), or 28 per centum of the amount by which the corporation surtax net income exceeds $50,000, whichever is the lesser. As amended Nov. 8, 1945, 5:17 p.m., E.S.T., c. 453, Title I, Sec. 121(b), 59 Stat. 568."

Section 13 of the Internal Revenue Code provides in part as follows:

"(b) Imposition of tax. There shall be levied, collected, and paid for each taxable year upon the normal-tax net income of every corporation the normal-tax net income of which is more than $25,000 (except a corporation subject to the tax imposed by section 14, section 231(a), Supplement G, or Supplement Q) whichever of the following taxes is the lesser:

"(1) General rule. A tax of 24 per centum of the normal-tax net income; or

"(2) Alternative tax (corporations with normal-tax net income over $25,000, but not over $50,000). A tax of $4,250, plus 31 per centum of the amount of the normal-tax net income in excess of $25,000."

Section 14 of the Internal Revenue Code provides in part as follows:

"(b) Corporations with normal-tax net incomes of not more than $25,000. If the normal-tax net income of the corporation is not more than $25,000, and if the corporation does not come within one of the classes specified in subsection (c), (d), or (e) of this section, the tax shall be as follows:

"Upon normal-tax net incomes not in excess of $5,000, 15 per centum.

"$750 upon normal-tax net incomes of $5,000, and upon normal-tax net incomes in excess of $5,000, and not in excess of $20,000, 17 per centum in addition of such excess."
"$3,300 upon normal-tax net incomes of $20,000, and upon normal-tax net incomes in excess of $20,000, 19 per centum in addition of such excess."

Section 15 of the Internal Revenue Code provides in part as follows:

"(a) Corporation surtax net income. For the purposes of this chapter, the term ‘corporation surtax net income’ means the net income minus the credit for dividends received provided in section 26(b) and minus, in the case of a public utility, the credit for dividends paid on its preferred stock provided in section 26(h). For the purposes of this subsection dividends received on the preferred stock of a public utility shall be disregarded in computing the credit for dividends received provided in section 26(b).

"(b) Imposition of tax. There shall be levied, collected, and paid for each taxable year upon the corporation surtax net income of every corporation (except a Western Hemisphere trade corporation as defined in section 109, and except a corporation subject to the tax imposed by section 231(a), Supplement G or Supplement Q), a surtax as follows:

"(1) Surtax net incomes not over $25,000. Upon corporation surtax net incomes not over $25,000, 6 per centum of the amount thereof.

"(2) Surtax net incomes over $25,000 but not over $50,000. Upon corporation surtax net incomes over $25,000, but not over $50,000, $1,500 plus 22 per centum of the amount of the corporation surtax net income over $25,000.

"(3) Surtax net incomes over $50,000. Upon corporation surtax net incomes over $50,000, 14 per centum of the corporation surtax net income."

A number of questions have arisen from time to time concerning the proper construction and interpretation of the above taxing sections of the internal revenue law. Thus, under Section 203, Title 26, U.S.C.A. in the case of Ocean Accident and Guaranty Corporation v. Commissioner, it was held that an insurance company in computing income is entitled to deduct policy losses paid or accrued within the taxable year, and in Massachusetts Mutual Life Insurance Company v. U. S. it was held that the provision allowing life insurance companies to deduct from income for tax purposes interest paid or "accrued" did not permit deduction of interest on policy dividends credited but not paid during the taxable year. In Rockford Life Insurance Company v. Commissioner, it was held that under the provision allowing life insurance companies "a reasonable deduction" for depreciation of property, the deduction was limited to depreciation on only such furniture and fixtures as were used in connection with the company's investment

37 47 Fed. (2d) 582 (1931).
business. In *National Life Insurance Company v. U. S.* it was held that rents paid by a life insurance company to a separate corporation, the stock of which was owned by the former, for space occupied by its officers, were not deductible from the gross income. In *MacLaughlin v. Alliance Insurance Company,* it was held that Section 204 was valid even though construed as taxing the entire gains by a stock fire insurance company in 1928 from the sale of property acquired previously. In *Maryland Casualty Company v. U. S.* it was held that insurance premiums collected by local agents, but which in conformance with agency contracts were not transmitted to the company’s treasury within the calendar year were nevertheless a part of the gross income of the company received by it during such year.

D. **TAXATION UNDER THE SOCIAL SECURITY ACT.**

The Social Security Act went into effect on approval by the President on August 14, 1935. On May 24, 1937, the Federal Social Security Act was held constitutional in all respects by the United States Supreme Court. This Act was designed primarily to do two things: First, to provide security during their working years for all (with some exceptions) who are dependent for their livelihood upon obtaining work from others rather than upon obtaining a livelihood in their own business; Second, to provide security from want in old age for workers through a retirement pension program.

In construing the Social Security Act the courts have ruled that since these sections are remedial, they require a construction which will give effect to the intention of Congress considered in the light of the mischief to be corrected and the end to be obtained. It is clear that the taxing phase of the Act is incidental and secondary to the main purpose of providing security for workers.

The Federal Social Security Act levies a tax in two respects. It first imposes an excise tax on all employers of eight or more employees, which tax is based on remuneration paid for employment. With the exception of certain specifically excluded employments, all services performed in the United States are included in the term “employment.”

The Federal Act does not attempt to set up a federal unemployment compensation system but rather, by the use of a credit provision, or tax offset, seeks to induce each state to enact its own unemployment insurance law. To accomplish this purpose the taxpayer is allowed to credit against the federal tax all contributions paid by him under any

41 286 U.S. 244, 76 L. Ed. 1083, 52 S. Ct. 538 (1932).
42 251 U.S. 342, 64 L. Ed. 297, 40 S. Ct. 155 (1920).
approved state unemployment compensation law. The excise tax levied under this statute upon employers of eight or more is three per cent of the total wages paid by the employer, less credits for contributions to state unemployment funds under approved state unemployment acts.\footnote{Section 1600 et seq., Internal Revenue Code, Title 26, U.S.C.A.}

Secondly, an excise tax on employers and an income tax on employees under the Federal Old Age Benefit provisions of the Social Security Act began to accrue on January 1, 1937. All employers, regardless of the number of their employees, are subject to the excise (payroll) tax under this Title of the Act, unless specifically exempt thereunder. Also every employee under the age of sixty-five is subject to the income tax under this Act, unless engaged in an exempted employment. Independent contractors are, of course, not employees.

The tax on both employer and employee is based on "wages" payable for employment during the calendar year. The term "wages" is defined in the Act as the remuneration up to the first $3,000 only, payable each year to each employee. The basis upon which remuneration is paid and the time of payment are immaterial in determining whether such remuneration constitutes wages.

Under the terms of the old law it was provided that during 1937 each employer must pay a tax of one per cent on the first $3,000 of each employee's wage and each employee must also pay one per cent on his yearly wages, up to the first $3,000. This tax rate was to have been increased one-half per cent every three years until, for the year 1949 and thereafter, it was to have been fixed at three per cent on the first $3,000 of each employee's annual wage. However, subsequent amendments to this law have kept the tax rate at one per cent yearly for both employers and employees, up to the first $3,000.00 of the employee's yearly wages.\footnote{Section 1400 et seq., Internal Revenue Code, Title 26, U.S.C.A.}

The employer is made responsible under the Act for the payment of both his own and his employees' taxes. He is required to deduct the amount of each employee's tax from wage payments, as and when paid. At the time each wage payment is made, the employer must furnish a written statement to the employee showing the amount of employees' tax deducted. It is immaterial that the wages are paid in some medium other than money. Until collected from him the employee also is liable for the employees' tax with respect to all wages received by him.

The employees' tax attaches at the time that the wages are either actually or constructively received by the employee. Wages are constructively received when they are credited to the account of or set apart for an employee so that they may be drawn upon by him at any
time, although not then actually reduced to possession. Similarly, the employers' tax attaches at the time that the wages are either actually or constructively paid by the employer.

PART THREE

POWER OF THE STATE TO TAX ACCIDENT AND HEALTH INSURANCE COMPANIES

(1) Nature and source of power.

The power of the state to tax is not derived from a grant in a constitution as is that of the Federal Government, but rather from its inherent right of sovereignty. It is well settled that the power of taxation rests upon necessity and is an essential attribute of sovereignty belonging to every free state or government. Thus, the power of the state to levy and collect taxes for public purposes is plenary and absolute, except in so far as it is restrained by provisions of the Federal or State Constitution or by inherent limitations, and extends to all persons and property and business within its jurisdiction. The only security against an abuse of the power of taxation by the state is found in the safeguards provided in the Federal and State Constitutions, by certain inherent limitations, and in the structure of government itself in that in imposing a tax the legislature acts upon its constituents. When a tax becomes unduly oppressive or burdensome the taxpayers affected will usually adopt measures adequate to protect their interests. As one may well recall, an abuse of the power of taxation was one of the causes of the American Revolution and the ultimate establishment of the United States of America.

(2) Limitation upon the power of the state to levy taxes.

(a) Jurisdiction.

Since the jurisdiction of the state does not extend beyond its territorial limits, it cannot lawfully impose taxes upon persons, natural or artificial, or property, residing or situated beyond such limits. In a case where neither owner nor property is within the state, no protection is afforded by that government and there is nothing for which taxation can be equivalent. A tax on property or interests beyond the territorial limits of the state constitutes a taking of property without due process of law. As was well said in *Western Union Tel. Co. v. Kansas*:

"It is firmly established that, consistently with the due process clause of the Constitution of the United States, a State can-

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49 216 U.S. 1, 54 L. Ed. 355, 30 S. Ct. 190 (1910).
not tax property located or existing permanently beyond its limits."

The rule above quoted applies likewise to persons, artificial or natural, over whom the state has no jurisdiction, and a tax levied against them or against their property constitutes a taking of property without due process of law.50

(b) Taxation for private purposes.

One of the limitations on the power of the state which inheres in its very nature, whether declared or not in the state constitution, is the want of power to tax for a private purpose. In Jones v. Portland,51 the Supreme Court said:

"It is well settled that moneys for other than public purposes cannot be raised by taxation, and that exertion of the taxing power for merely private purposes is beyond the authority of the State."

Although the legislature has, in the first instance, a large discretion in determining the objects for which a tax shall be levied, its decision is not final, and the question, what is a public purpose, is one of law for the courts to decide.52

(c) Taxation of federal agencies.

While there is no express provision in the Federal or State Constitution forbidding the state to tax properties of the Federal Government or of agencies or instrumentalities thereof it is the universal rule that such property is not taxable by the state.53 This prohibition applies equally well to a privilege tax imposed on a federal instrumentality for the privilege of performing its functions.54

(d) Impairment of obligations of contract.

Article I, Sec. 10, Clause 1 of the United States Constitution, provides that no state shall impair the obligations of a contract. This section applies as well to state contracts as to private contracts.55

The rule that a state cannot impair the obligations of a private contract, however, does not mean that a state may not impose a lawful tax on a new subject or an increased tax on an old subject without impairing the obligations of contract. Thus the Court held that a tax on in-
surance premiums would not impair the obligations in an insurance contract within the purview of the Federal Constitution.66

(e) State income tax.

The law is now well settled that a state if authorized to impose an income tax has the power to levy a tax upon the income of all residents, regardless of whether such income is derived from sources within or without the state,67 and in the case of a non-resident the state may levy such a tax if the income is derived from property situated within the state or from a business carried on therein.58

The same rules apparently apply in the case of corporations as apply in the case of individuals. Thus, a domestic corporation, being a creature of the state, appears to be taxable on income arising from sources outside the state.69

In so far as foreign corporations are concerned, it appears to be settled that they are taxable only with respect to income from sources within the state. However, a state may, in determining the taxable income of a foreign corporation, apply a formula for determining the proportionate income subject to state tax of a foreign corporation doing both intrastate and interstate business.60

A state cannot, however, constitutionally impose an income tax on income derived from the sale of securities by a foreign corporation licensed to do business in the state and carrying on its principal business in the state, under a statute providing that a foreign corporation whose business is carried on or transacted in the state shall be deemed a resident for income tax purposes.61

(f) Interstate or foreign commerce.

The state has no power to interfere in any way by taxation with interstate or foreign commerce. It is the law today that insurance is commerce and, if the business of insurance is conducted across state lines it constitutes interstate commerce.62 Therefore, this limitation is of utmost importance in connection with the taxation of insurance companies by the several states. In Prudential Life Ins. Co. v. Benjamin63

63 328 U.S. 408, 90 L. Ed. 1342, 66 S. Ct. 1142 (1946).
the Supreme Court upheld a South Carolina premium tax statute that levied a three per cent premium tax on foreign insurance companies and levied no premium tax on domestic insurance companies.

(g) **Bonds or securities of the United States.**

A state may not tax bonds or securities of the United States nor may it tax the interest derived from tax exempt securities, for to do so would be an interference with the power conferred upon Congress in the United States Constitution to borrow money. Such a tax would be unconstitutional under the rule first announced in *McCulloch v. Maryland* that without Congressional action there is immunity from state and local taxation implied from the Constitution itself of all properties, functions and instrumentalities of the Federal Government. However, a state has power to levy on a franchise a tax measured by net assets or net income, including tax exempt federal instrumentalities or their income.

(h) **Equal protection of the laws.**

Under the Fourteenth Amendment to the Federal Constitution, no state may deny to any person within its jurisdiction the equal protection of laws. A corporation has been held to be a person within the meaning of this provision. Thus, while a state may not make arbitrary classifications for the purpose of taxation, yet it has the power to classify property or occupations on some basis having a fair and reasonable relation to the object of the legislation so that all persons similarly situated will be treated alike. Hence, if a state treats all persons in a similar class alike, it may classify, for purposes of taxation, properties, occupations, businesses, trades or callings. A state under this provision may constitutionally impose upon foreign corporations licensed to do business in the state for the privilege of doing business within the state more onerous conditions than it imposes upon domestic corporations, and may exact from foreign corporations a tax or rate of tax other than that imposed upon domestic corporations of like character.

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65 4 Wheat. 316, 4 L. Ed. 579 (1819).
(i) **Due process of law.**

Under the express provisions of the Fourteenth Amendment, no state has power to deprive a person of property without due process of law. A corporation is also treated as a person within the meaning of the due process clause and, therefore, a state, while it may impose conditions upon the right of a foreign corporation to enter the state to do business therein, may not impose such conditions as would require the relinquishment of the foreign corporation's constitutional rights,\(^\text{70}\) nor may a state take from a foreign corporation its property without due process of law.\(^\text{71}\)

(j) **Discrimination against citizens.**

Article IV, Sec. 2, Clause 1, of The Federal Constitution provides that citizens of each state shall be entitled to all the privileges and immunities of citizens of the several states. This section insofar as taxation is concerned applies only to discrimination against citizens of other states, who operate a business or own property in the taxing state, at a higher rate than its own citizens are taxed under the same circumstances.\(^\text{72}\) It has been held, however, that corporations are not citizens within the meaning of this constitutional provision.\(^\text{73}\) This section has been before the Court many times under varying circumstances.\(^\text{74}\)

The Fourteenth Amendment goes further than the Fourth Amendment and forbids a state from abridging the privileges and immunities of citizens of the United States, whether its own citizens or others. The courts have had this particular section of the Fourteenth Amendment before them but very little and, hence, no specific or comprehensive enumeration has been made of the privileges and immunities which are protected thereunder.\(^\text{75}\)

(3) **State taxation of insurance companies.**

(a) **Validity of state tax on premiums.**

The validity of a tax on insurance companies often depends upon whether the tax is in fact an excise or privilege tax or is merely a property tax designated as an excise. As was well stated by the United States Supreme Court in the case of *Educational Films Corporation v. Ward*:\(^\text{76}\)

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\text{"* * *the nature of a tax must be determined by its operation rather than by particular descriptive language which may}
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\(^{\text{70}}\) *Fidelity & Deposit Co. v. Tafoya,* 270 U.S. 426, 70 L. Ed. 664, 46 S. Ct. 331 (1926).


\(^{\text{72}}\) *Ward v. Maryland,* 12 Wall. 418, 20 L. Ed. 449 (1871).

\(^{\text{73}}\) *Paul v. Virginia,* 8 Wall. 168, 19 L. Ed. 357 (1869).

\(^{\text{74}}\) *Shaffer v. Carter,* 252 U.S. 37, 64 L. Ed. 445, 40 S. Ct. 221 (1920).

\(^{\text{75}}\) *Colgate v. Harvey,* 296 U.S. 404, 80 L. Ed. 299, 56 S. Ct. 252 (1935).

\(^{\text{76}}\) 282 U.S. 379, 75 L. Ed. 400, 51 S. Ct. 170 (1931).
have been applied to it. "* * * neither state courts nor legislatures, by giving the tax a particular name, or by using some form of words, can take away our duty to consider its nature and effect * * * this Court must determine for itself by independent inquiry whether the tax here is what, in form and by the decision of the state court, it is declared to be."

And in *Equitable Life Assurance Society v. Pennsylvania,* the Court said:

"* * * it is argued that this is a property tax. But, as we have said, the Supreme Court of Pennsylvania speaks of it as a tax for the privilege of doing business within the Commonwealth, and whether the statement is a construction of the act or not we agree with it so far at least as to assume that if that characterization is necessary to sustain the tax, the Legislature meant to avail itself of any power appropriate to that end."

It appears to be the weight of authority that an excise tax upon insurance companies measured by gross premiums is constitutional where it is in the nature of a license tax for the privilege of doing business within the state. Thus, it has been held that a state acts conformably with the Federal Constitution when it imposes upon foreign insurance companies a privilege tax based upon the amount of premiums received by the company although the tax exceeds that exacted of domestic companies. Also a privilege tax upon foreign insurance companies was held valid even though domestic insurance companies were exempted from the tax altogether. Conversely a privilege tax on domestic insurance companies measured by premiums received was held not to be unconstitutional even though foreign insurance companies were exempted from the operation of the statute.

However, in *Hanover Fire Ins. Co. v. Harding,* a state statute imposing a tax measured by net receipts of foreign insurance companies at the same rate of taxation as that imposed upon other personal property and providing that such tax shall be in lieu of all town and municipal taxes, was held void as a denial of the equal protection of the laws. Here domestic insurance companies were required to pay no tax upon net receipts, for the tax as levied was not in fact a license

77 238 U.S. 143, 59 L. Ed. 1239, 35 S. Ct. 829 (1915).
82 272 U.S. 494, 71 L. Ed. 372, 47 S. Ct. 179 (1926).
tax, but a property tax with respect to which there was no constitution-
al ground for discrimination between foreign and domestic companies.

In *Equitable Life Assurance Society v. Pennsylvania,* a privilege
tax imposed upon foreign life insurance companies measured by gross
premiums received from business done within the state was held not
to be unconstitutional as taking property without due process of law
although premiums paid to the company outside the state by residents
of the state were included in the gross premiums upon which the tax
was computed.

In *Northwestern Mutual Life Ins. Co. v. Wisconsin,* the Court
held void a state statute providing that domestic insurance companies
shall pay a certain per cent of their gross income from all sources for
the privilege of transacting business within the state where such income
was construed to include income derived from United States bonds.
The Court held that the tax amounted to one upon property rather than
upon privileges or franchise of the company and pointed out the dis-
tinction between a tax measured by gross receipts and one measured
by gross returns.

However, in two leading cases the Supreme Court has sustained
corporation excise taxes which in effect taxed the income from federal
securities by measuring the tax by the net income of the corporation
from all sources.

So also a state statute that imposed upon insurance corporations a
license tax based on a percentage of the gross premiums after deduct-
ing certain items was held valid and not violative of the state constitu-
tion which required that the property of corporations shall be subject to
taxation the same as that of individuals since the tax in question was
an excise tax and not one on property.

(b) Requirements of statutes imposing a license tax on premiums.

There appears to be no uniformity in the requirements of the stat-
utes enacted by the several states levying premium taxes upon insur-
ance companies. Thus in some states a flat tax based on a percentage
of the gross receipts from premiums after deducting specified items
is imposed on both foreign and domestic insurance companies. In other
states the statutes tax foreign corporations, but exempt domestic in-

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85 *Pacific Company v. Johnson,* 285 U.S. 480, 76 L. Ed. 893, 52 S. Ct. 424 (1932); *Educational Films Corporation v. Ward,* 282 U.S. 379, 75 L. Ed. 400, 51 S. Ct. 170 (1931); See also *Smith v. Davis,* 323 U.S. 111, 89 L. Ed. 107, 65 S. Ct. 137 (1944) where it was held that without Congressional action there is im-
munity from state and local taxation implied from the Constitution itself of all
properties, functions and instrumentalities of the Federal Government.
(1906).
urance corporations from the payment of a premium tax. It has been held that such statutes are constitutional.87

In some states, as for example Alabama, the statutes require that foreign insurance corporations pay a higher tax on premiums than domestic corporations of the same kind. In Connecticut domestic companies are taxed at the rate of two per cent of the gross premiums, while foreign corporations are taxed only under the reciprocal provisions of the insurance law which is at the rate that Connecticut companies are taxed in the home state of the foreign companies whose taxes are under consideration. In some states the rate of premium taxes varies with the type of insurance dealt in, that is the rate for a life company may be greater or smaller than the rate imposed upon a casualty or fire company. And the rate itself varies all the way from one and three-fourths per cent of the gross premiums as in Delaware to three per cent of the gross premiums as in Idaho and a few other states. In Oklahoma the premium tax is four per cent and in Texas this tax is three and one-half per cent. In some states the rate fixed by the legislature for premium taxes varies in so far as accident and health companies are concerned depending on whether it is a life company authorized to do an accident and health insurance business or whether it is a casualty company doing that type of business.

This lack of uniformity in the taxing statutes of the several states and the difficulty in determining at times the exact tax to be paid on premiums because of the reciprocal provisions, would indicate that steps should be taken to solve this problem by the enactment of uniform premium tax laws in all the states. Such uniform legislation would remove many serious objections to the present laws of many of the states, would make the administration of such laws much easier for the state officers, and would certainly lighten the task in so far as the accident and health company officials are concerned.

In determining the amount of taxes to be paid under the several premium tax statutes notice must be taken of the items of deduction allowed. In some states the statutes provide for the deduction of return premiums, reinsurance paid to admitted companies, premiums on farm property, cancellations, losses, dividends or return from savings. The statutes of the several states vary greatly in the deduction allowances. In some states only return premiums and reinsurance paid admitted companies are allowable deductions. In other states one or more of the items previously mentioned are authorized by statute to be deducted from the gross premiums in computing the premium tax.

In construing the Kentucky statute the Attorney General of Kentucky advised the Director of the Division of Insurance that the two per cent premium tax on insurance business done in Kentucky applies to group insurance and other types where premiums are sent directly by the insured to the home office in another state. The Attorney General ruled that whether the business had been written by a Kentucky agent or not made no difference so far as the applicability of the tax was concerned and that the insurance carried on residents of Kentucky and paid for by Kentucky business houses was Kentucky business within the meaning of the premium tax statute. In Kentucky, as in many other states, all taxes are subject to the retaliatory law.

(c) Retaliatory or reciprocal taxing statutes.

In many states of the Union the so-called retaliatory or reciprocal taxing statutes have been enacted. For example, under Section 444 of the Illinois Insurance Code it is provided:

"Whenever the existing or future laws of any other state or country shall require of companies incorporated or organized under the laws of this State as a condition precedent to their doing business in such other state or country, compliance with laws, rules, regulations and prohibitions more onerous or burdensome than the rules and regulations imposed by this State on foreign or alien companies, or shall require any deposit of securities or other obligations in such state or country, for the protection of policyholders or otherwise or require of such companies or agents thereof or brokers the payment of penalties, fees, charges or taxes greater than the penalties, fees, charges or taxes required in the aggregate for like purposes by this Code or any other law of this State, of foreign or alien companies, agents thereof or brokers, then such laws, rules, regulations and prohibitions of said other state or country shall apply to companies incorporated or organized under the laws of such state or country doing business in this State, and all such companies, agents thereof, or brokers doing business in this State, shall be required to make deposits, pay penalties, fees, charges and taxes, in amounts equal to those required in the aggregate for like purposes of Illinois companies doing business in such state or country, agents thereof or brokers. Whenever any other state or country shall refuse to permit any insurance company incorporated or organized under the laws of this State to transact business according to its usual plan in such other state or country, the director may, if satisfied that such company of this State is solvent, properly managed, and can operate legally under the laws of such other state or country, forthwith suspend or cancel the license of every insurance company doing business in this State which is incorporated or organized under the laws of such other state or country to the extent that it insures in this State against any of the risks or hazards which are sought to be in-

88 Illinois Revised Statutes, 1947, Chapter 73, section 1056.
sured against by the company of this State in such other state or country. As amended by act approved July 21, 1941, L. 1941, vol. 1, p. 837."

It is manifest that retaliatory statutes will affect an insurance corporation with its home office in one state quite differently than an insurance corporation with its home office in a different state.

For example assume that State A has a retaliatory statute on its books, and that State B then enacts a statute affecting all foreign companies doing business within the state by imposing upon them obligations, conditions, fees or taxes in excess of those levied upon foreign companies by State A. When State B enacts its statute, the retaliatory one in State A becomes immediately operative, even though there are no companies from State A doing business in State B at the time. Also State A will treat the excessive provisions found in the statute of State B as if found in so many words in its own statute when it enforces its own statute against companies from State B which are doing business in State A. A retaliatory statute being highly penal in nature will be strictly construed and a foreign corporation will not be excluded from the state under its provisions unless it is manifest that the effect of the foreign law in its practical administration would be to exclude similar companies organized under the laws of the state. In *Metropolitan Life Ins. Co. v. Commonwealth,* the court held that the retaliatory statute was intended only to create reciprocal relations between the taxation of Massachusetts companies operating in another state and the taxation of similar companies of that state operating in Massachusetts.

Retaliatory statutes have been uniformly upheld against many constitutional objections and particularly the claim that they violate constitutional provisions against unequal taxation. In Alabama, however, in the face of the United States Supreme Court decision and the decisions of other state courts upholding the validity of retaliatory laws, the retaliatory provision against foreign corporations has been held unconstitutional.

(d) **Other taxes and fees.**

Most of the states require accident and health insurance companies to pay an annual fee with the filing of their annual statement. This fee for the filing of the annual statement varies from five to fifty dollars.

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89 198 Mass. 466, 84 N.E. 863 (1908).

91 *State v. Firemen's Fund Ins. Co.,* 223 Ala. 134, 134 So. 858 (1931); *Clark & Murrell v. The Port of Mobile,* 67 Ala. 217 (1880); See also note on Retaliatory tax laws in 91 A.L.R. 795.
In some states no fee is exacted with the filing of the annual statement unless a fee is required in other states of local companies.

Another fee which is exacted by most of the states is an annual charge for a certificate of authority. This fee also varies greatly, the amount being five dollars in some states and up to three hundred fifty dollars in the State of North Carolina, where a company writing both accident and health insurance must pay this sum for a certificate of authority. The State of Virginia requires an annual registration fee varying from five dollars for capital of fifteen thousand dollars employed in the state to twenty-five dollars for stock companies whose capital is more than three hundred thousand dollars. Some states (North Carolina, etc.) require all companies to maintain a general agent in the state and all companies must secure a general agent's license for which the state collects a fee. The states also require local, district and special agents' licenses and the payment of a fee to the state for such licenses. In some states insurance company adjusters, if other than local, must pay a fee. In Florida such fee is ten dollars regardless of the number of companies represented.

Some states exact in addition a small tax often based on gross premiums for maintaining the Bureau or Department of Insurance. In Montana for example, a corporation license tax is required. This tax is based on the net income of the corporation from Montana sources. Alabama likewise exacts a tax known as a corporation permit fee based on the capital employed in the state, the minimum being a fee of five dollars.

Many states require corporations doing business in the state to pay an income tax, but insurance companies doing business in the state and paying a premium tax on premiums received in the state are generally exempt from the income tax requirements.

**PART FOUR**

**TAXATION OF INSURANCE COMPANIES BY LOCAL GOVERNMENTS**

(1) *Nature and source of power of local subdivisions to tax and limitation thereon.*

As we have noted hereinbefore, the power to tax is an essential and inherent attribute of every independent government or state. And, except in so far as this power is restricted by the provisions of the Federal or State Constitution, the state's power of taxation, if exercised for a public purpose, is absolute and unlimited.

There has been a claim advanced that local governments, that is, counties, towns, cities, villages and other political subdivisions of the state, have inherent powers of taxation. This claim is apparently based on the theory that the Magna Charta recognized such rights before the establishment of the American colonies and that these rights formed a
part of the existing power in the colonial governments at the time of the adoption of the Federal Constitution. Though this claim may have been recognized in a few instances, yet the almost universal rule in America is that the right of a municipality to control its own affairs is dependent upon constitutional or legislative authority. This is on the theory that since a municipal corporation is solely a creature of the state, it has no inherent power. To the extent that the power to tax is exercised by a municipality it is merely a delegated power, subject to repeal or modification and subject to such restrictions and limitations as may be placed upon it by constitution or statute. Hence, a municipality may levy a tax upon the insurance business only when permitted by constitution or statute so to do.

It should be noted that in some cases the state constitutions provide directly for assessment and collection of taxes by counties, cities, towns or other local subdivisions. Occasionally a limitation is placed upon the purpose and extent of this delegated power to tax. In some cases the state constitution authorizes the legislature to confer the right to tax upon local political subdivisions. Ordinarily, such a provision is not self-executing but requires legislative action to confer the power to tax. Because of the large number of taxes imposed by counties, cities, towns, villages and other local subdivisions, an enumeration thereof is difficult. It should be noted, however, that the amount of taxes collected by local municipalities is very large and that the most important item of local taxation is the general property tax.

(2) Taxation of the insurance business by local subdivisions.

The following questions frequently are asked: (1) How many states empower local governments to tax the insurance business? and, (2) How many municipalities which are authorized by law to tax insurance companies are presently exercising the power?

Almost one-half of the states in America today—chiefly in the middle west and in the south—authorize taxation of the insurance business by local governments, that is, by counties, towns, cities, villages or other political subdivisions. Taxes of this type may in general take the form of a tax imposed upon either (1) the insurance agent for the privilege of engaging in the business of selling insurance, or (2) the insurance agency for the privilege of selling insurance as a business, or (3) the insurance company for the privilege of operating within the territorial limits of the municipality imposing the tax.

The privilege tax imposed by local governments upon the insurance agent for the privilege of engaging in the occupation of selling insur-

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TAXATION OF INSURANCE COMPANIES

Insurance may take one or more of three forms: first, a flat tax for a stated period of time and without regard to the amount or types of insurance sold; second, a flat tax as stated above plus an additional fee based upon the number of companies represented by the agent; and third, fees the amount of which vary with respect to the types of companies represented.

In the levying of taxes upon insurance agencies by local governments the practice as to method and rate of taxation has varied quite widely. In some cases the municipality has adopted a flat tax for all agencies regardless of type or size. The tax has varied in some cases in accordance with the number of companies represented by the agency or in accordance with the number of agents employed. In other cases the tax has been based solely upon the type of agency obtaining the license.

The taxes imposed upon insurance companies are usually levied either at flat rates or as a percentage of the gross premiums. For example, the City of Shreveport, Louisiana, in its license ordinance adopted December 28, 1920, provided for a license tax of life and accident insurance companies, and provided further that the tax shall be based on the gross annual premiums on "all risks located within the city and all risks located elsewhere contracted for in" the city. The ordinance created thirty-nine classes based on gross premiums received by the companies with the taxes varying from a tax of one hundred forty dollars when the premiums are less than thirty thousand dollars, to a tax of two thousand eight hundred eighty dollars when the premiums are four hundred thousand dollars or more.

The validity of local ordinances taxing insurance companies often depends upon the power of the local government to enact such an ordinance. Grants of power to municipalities to impose a tax on occupations are usually strictly construed especially where the sole purpose of the ordinance is to raise revenue.94 And, a municipality cannot, by assuming to act under the police power, impose a tax for revenue purposes where it has no authority to impose a revenue tax.95

If, however, the constitution and statutes authorize the imposition of a license fee upon insurance companies, ordinances which levy such a fee will be upheld.

Thus, in Kentucky96 the statutes provide that the general council of cities of the first class "shall, by ordinance, provide for the following licenses, to be paid into the sinking fund, * * *:

"Insurance company. Every life, fire or accident, casualty and indemnity insurance company, title company, title insurance

96 Baldwins, Kentucky Statutes, 1936 Revision, Section 3011.
company, or abstract company, doing business in said city, shall, on or before the first day of February of each year, pay to the sinking fund not less than $2.00 nor more than $3.00 on every hundred dollars of premiums received on business done in the city during the previous year."

The Kentucky court in considering the validity of the above section held that under sections 174 and 181 of the constitution, this section of the Kentucky statutes was a valid exercise of power and that an ordinance enacted pursuant to such section of the statutes is valid.97

A few years ago many insurance companies refused to pay the municipal taxes levied on insurance premiums in Caddo Parish, Louisiana, on the ground that these taxes were an unlawful burden on interstate commerce. Similar action was at that time contemplated with respect to municipal premium taxes elsewhere.98 The view that these taxes were invalid was based upon the ruling of the United States Supreme Court in the case of Nippert v. Richmond99 holding invalid a local licensing ordinance as applied to a foreign corporation doing business in the municipality levying the tax. The Nippert case involved a salesman representing an out-of-state manufacturer who was charged by Richmond, Virginia, authorities with failure to pay the city tax of a fifty dollar flat license fee for the first year, and one-half of one per cent on gross earnings each year thereafter. The Court held that this tax could not be defended on the ground that it was a "local incident" (here solicitation by the salesman) since in practically every state some local incident could be found on which to hang a tax. The Nippert case merely reiterated and applied the rule in effect since 1887 that a flat fee license by municipalities is an unlawful interference with interstate commerce.100 However, this doctrine has been narrowly limited by the Court to apply only to flat fee licenses and only to the solicitation of orders for the purchase of goods which are later shipped into the state to the buyer pursuant to such order. However, insurance companies, just as other companies, are subject to state and local taxation if there is no undue burden on interstate commerce or if the transaction does not involve interstate commerce.101

After the decision of the United States Supreme Court in the state premium tax cases, the Louisiana local tax cases were all settled. Taxation of insurance companies in the form of municipal premium taxes is highly objectionable to the companies. Therefore, it is not surprising to see resistance develop to such taxes. One of the reasons

97 Fidelity and Cas. Co. v. Louisville, 106 Ky. 207, 50 S.W. 35 (1899).
100 Robbins v. Taxing District, 120 U.S. 489, 30 L. Ed. 694, 7 S. Ct. 592 (1887).
for resisting payment of such local taxes is the multiplicity of such
taxes. The most obnoxious of these taxes is the flat license fee since
the companies must pay such tax even though only a small amount of
business is done in the municipality levying the tax.

**PART FIVE**

**CAN THE TAXATION OF THE INSURANCE BUSINESS BE CONTROLLED?**

It is manifest that the insurance companies cannot directly control
the taxation of the insurance business. Taxes are levied by Congress,
the several state legislatures and by local taxing authorities, and any
control of taxation must come indirectly through control of the body
which levies the tax. The amount of revenue to be used annually is
determined by the needs of government. As the cost of government in-
creases the need for additional revenue likewise increases. During the
past two decades increasing pressure from all sides for more revenue
due, in part, to the added complexity of our society and, in part, to the
late depression and World War II has led to the tapping of new sources
for taxes, and to the increasing of the tax rate and the broadening of
the tax base to unprecedented levels.

Few people or corporations object to paying their fair share of the
cost of government, such payment being based upon either ability to
pay or upon benefits or protection bestowed by the government or both.
However, a tax imposed merely because it is easy to collect or because
it is thought the taxpayer has huge so-called "free assets" available
out of which the tax may be collected, where the tax is not based either
on ability to pay or on benefits received or on any other recognized
theory of taxation, is very objectionable even where legal. It seems
clear that many of the taxes imposed upon the insurance business are
levied, in part, because of the fallacious theory—which is altogether
too prevalent—that insurance companies have large amounts of "free
assets" which may be tapped for revenue purposes with impunity
and without any particular damage to the companies or the policy-
holders. This notion is entirely erroneous and an effort should be made
to correct it in order that the harm which threatens the insurance busi-
ness because of discriminatory taxes may be escaped.

Taxes levied by the states upon insurance companies were orig-
inally based upon the amount of premiums received by the com-
pany in the state in exchange for protection accorded by the state and
in payment of the cost of supervising such companies in the interests of
the insurance buying public. The purpose in levying this type of tax
was primarily to pay for the cost of state supervision. At that time the
premium tax unquestionably was a justifiable tax. Today, however, an
analysis of taxes paid by the insurance business discloses that less than
five cents out of every dollar collected is spent for government super-
vision of insurance and that the balance, or about ninety-five cents out
of every dollar of tax collected, is used for general revenue purposes.
It would seem that the taxes collected from the insurance business to-
day are somewhat out of line insofar as the benefits received by the
insurance companies are concerned. And, even though the tax rates
remain the same, it is obvious that the amount of taxes paid yearly by
the insurance business has been and will continue to mount steadily
due to the consistently increasing yearly gain in premium volume in
nearly all lines of insurance. It is estimated that health and accident
insurance companies pay annually a total of more than twenty million
dollars in taxes.

The states of the Union in the early history of taxation imposed
taxes mainly upon property of persons, partnerships and corporations.
Excise taxes were not favored at that time and it was not until the
need for additional funds owing to the growing complexity of our so-
ciety began to be acute that the several states undertook to exercise
their authority to levy excise taxes. This usually took the form of a
tax for the privilege of doing business in the state. These taxes which
in the beginning were small in amount have increased both in rate and
amount until today they yield a large source of revenue to the state.
There will be no decrease in the tax rate in the very near future, but
on the contrary if the Federal Government's or state's need for revenue
becomes pressing an increase might be expected.

How, then, can the tax burden imposed upon the insurance business
be controlled? Of course, it is impossible to do away with all taxes and
no one expects nor wants all government activities eliminated entirely
nor even curtailed to an extent that government ceases to function
properly. All that is asked is that useless government activities be
curbed and that the tax imposed upon the insurance business be fair
and not confiscatory.

It would seem clear from the ever mounting burden of taxes placed
upon the insurance business that these companies must be vigilant to
protect their interests when measures affecting them are considered, to
the end that the insurance business be not taxed out of existence. In-
surance, and particularly accident and health insurance, is too vital, too
important to the community and to the public welfare to be made the
subject of confiscatory taxation. A continuous study of the problem of
taxation should be undertaken by the insurance industry in order that
Congress and the several state legislatures may be accurately informed
of the true relationship between taxation and the cost of insurance to
the individual. If the cost of accident and health insurance rises be-
yond the means of the average individual its usefulness to the com-
community and the state will be seriously impaired.
An analysis of the statutes relating to taxation of insurance companies discloses the following: (1) that there is no uniformity among the several states in the taxation of the insurance business, (2) that due in part to this lack of uniformity and in part to retaliatory statutes much confusion on the subject exists, (3) that the imposition of taxes by local governments, towns, villages and cities, and the like, while not burdensome in most cases, is extremely annoying and inconvenient and requires a great deal of additional work on the part of the companies, and (4) that during the last decade or two the trend definitely has been and now is toward increased taxation of the insurance business.

Probably the ultimate solution of the problem of taxation of the insurance business lies in the enactment by all the states of a uniform tax law so drawn as to protect the several states against tax evasion and against undue advantages which the companies might claim, and which at the same time would protect the insurance business so that it would not pay more than its just share of the expense of government. Such uniform legislation would also remove any serious objection to the imposition of multiple taxes on the insurance companies in the several states. Such uniform state tax statutes relating to the taxation of insurance companies will be adopted only if the need therefor is effectively demonstrated by the insurance industry. Moreover, if the taxation of insurance companies and their agents by local governments were eliminated, it would further simplify the tax problem. There probably would be some objection on the part of those local communities which now impose a tax on the insurance business to this loss of existing revenue but such communities could be reimbursed by the state for their loss of such revenue by a division of state premium taxes with local communities.

The solution to the menace of ever mounting taxes on insurance, while neither an easy nor simple one, is nevertheless within the grasp of the insurance industry. Certainly it is worth striving for. The lower the cost of insurance the more the benefits of insurance will be extended to the masses and particularly among the lower income group that has the greatest need for complete insurance coverage.