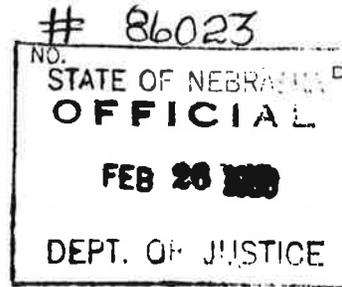


DEPARTMENT OF JUSTICE

STATE OF NEBRASKA

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DATE: February 26, 1986

SUBJECT: LB 1114 - Amendment to Insurance Premiums Tax

REQUESTED BY: Senator Vard R. Johnson  
Nebraska State Legislature

WRITTEN BY: Robert M. Spire, Attorney General  
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You have requested our opinion on certain questions regarding the constitutionality of LB 1114, as amended, a bill proposing to revise Nebraska's gross premiums tax. Under current Nebraska law, foreign insurance companies pay a tax on their gross premiums from business conducted in the state at a rate of two percent. Neb.Rev.Stat. §77-908 (Supp. 1984). Domestic insurance companies, in contrast, are taxed at a rate of six-tenths of one percent of their gross premiums. Neb.Rev.Stat. §77-909 (Supp. 1984). LB 1114, as amended, would change these statutory provisions by establishing a tax rate of two percent of gross premiums for all insurance companies licensed to do business in the state. In addition, Section 11 of the bill would provide companies with a tax credit equal to the percentage of their noncommission compensation paid in Nebraska. The proposed credit calculation would be based on the ratio of a company's total noncommission compensation paid in Nebraska to its total noncommission compensation paid everywhere, with the resulting percentage being applied to reduce the two percent tax. The credit would be subject to a minimum tax of six-tenths of one percent of the amount of a company's gross premiums.

Your initial question concerns whether the compensation credit provided under Section 11 would, in application, violate the Equal Protection Clause of the Fourteenth Amendment of the United States Constitution by discriminating against foreign insurance companies doing business in Nebraska.

The issue of the constitutionality under the Equal Protection Clause of a state tax statute providing a preference to domestic insurance companies over foreign insurance companies doing business in a state was recently addressed by the United

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States Supreme Court in Metropolitan Life Insurance Company v. Ward, 470 U.S. \_\_\_\_\_, 84 L.Ed.2d 751, 105 S.Ct. 1676, rehearing denied \_\_\_\_\_ U.S. \_\_\_\_\_, 86 L.Ed.2d 269, 105 S.Ct. 2370 (1985) (Ward). In Ward, Metropolitan Life and a group of other non-Alabama insurance companies challenged the constitutionality of Alabama's premiums tax. Under the Alabama statute, the gross premiums of domestic companies are taxed at a rate of one percent, while foreign companies are taxed at the rate of three percent for life insurance premiums and four percent for all other insurance premiums. The Alabama taxing statute permits foreign companies to reduce their tax by providing a credit for investments in certain Alabama assets and securities, but foreign companies can never reduce their gross premiums tax rate to the same level paid by domestic companies. Id. at \_\_\_\_\_, 86 L.Ed.2d at 755, 105 S.Ct. at 1678-79.

In a five-four decision, the majority opinion reiterated the Equal Protection Clause test previously articulated by the Court in Western and Southern Life Insurance Company v. State Board of Equalization of California, 451 U.S. 648, 667-68 (1981), regarding a state's authority to grant domestic corporations a tax preference by discriminating between foreign and domestic corporations:

[W]e consider it now established that, whatever the extent of a State's authority to exclude foreign corporations from doing business within its boundaries, that authority does not justify imposition of more onerous taxes or other burdens on foreign corporations than those imposed on domestic corporations, unless the discrimination between foreign and domestic corporations bears a rational relation to a legitimate state purpose. 470 U.S. at \_\_\_\_\_, 84 L.Ed.2d at 757, 105 S.Ct. at 1680.

The Court considered two purposes advanced by the State of Alabama to justify the disparate tax treatment of foreign insurance companies under the state's domestic preference statute: (1) encouraging the formation of new insurance companies in Alabama; and (2) encouraging capital investment by foreign insurance companies in Alabama assets and government securities. Id. at \_\_\_\_\_, 84 L.Ed.2d at 756, 105 S.Ct. at 1679.

The majority rejected the first purpose, holding that the goal of promoting domestic business within the state by discriminating against foreign corporations was not a legitimate state purpose. Id. at \_\_\_\_\_, 84 L.Ed.2d at 762, 105 S.Ct. at 1684. Similarly, the Court held the encouragement of capital investment in Alabama assets and government securities was not a legitimate state purpose when furthered by discrimination. Id.

at \_\_\_\_\_, 84 L.Ed.2d at 762, 105 S.Ct. at 1684. The case was remanded for further proceedings to determine whether any of some 15 additional purposes advanced by the state in support of the Alabama statute are legitimate and whether the discrimination between foreign and domestic companies bears a rational relation to a legitimate state purpose. *Id.* at \_\_\_\_\_, 84 L.Ed.2d at 758 n. 5, 762, 105 S.Ct. at 1680 n. 5, 1684.

In a dissenting opinion, Justice O'Connor, joined by Justices Brennan, Marshall, and Rehnquist, criticized the majority for "a holding that can only be characterized as astonishing." *Id.* at \_\_\_\_\_, 84 L.Ed.2d at 763, 105 S.Ct. at 1684. (O'Connor, J., dissenting). After reviewing a number of previous decisions by the Court affording states broad legislative discretion in determining when discrimination between foreign and domestic corporations is appropriate, and discussing the authority granted to the individual states in the regulation and taxation of the business of insurance within their borders under the McCarran-Ferguson Act, 15 U.S.C. §1011 *et seq.*, the dissent concluded that "[b]ecause Alabama's classification bears a rational relationship to a legitimate purpose, our precedents demand that it be sustained." 470 U.S. at \_\_\_\_\_, 84 L.Ed.2d at 772, 105 S.Ct. at 1692. (O'Connor, J., dissenting).

Because the Supreme Court did not invalidate Alabama's domestic preference tax statute, there remains some doubt as to the ultimate impact and effect of the decision in Ward. As was noted, the Court, while rejecting two purposes advanced in support of the validity of the Alabama statute, remanded the case for further proceedings to enable the Alabama courts to consider the legitimacy of the numerous other purposes asserted by the state to establish the statutes validity.

Following the issuance of the Supreme Court's decision in Ward, the Supreme Court of North Dakota, in Metropolitan Life Insurance Company v. Commissioner of the Department of Insurance, 373 N.W.2d 399 (N.D. 1985), held invalid North Dakota's domestic preference tax. Under the North Dakota statute, foreign insurance companies were subject to an annual assessment of two and one-half percent on the gross amount of premiums. Domestic insurance companies, in contrast, were subject only to the corporate income tax, privilege tax, and Vietnam bonus surtaxes imposed upon domestic corporations. *Id.* at 403-04. The evidence in the record established that the North Dakota statutory scheme for taxing insurance companies resulted in the imposition of substantially greater taxes on foreign insurance companies than on domestic insurance companies. *Id.* at 406. Rejecting 23 purposes advanced by the state in support of the legitimacy of the discriminatory scheme of taxation, the court stated:

The vast majority of the purposes presented by the State, and upon which the State relied most heavily in the district court, relate to promotion of the domestic insurance industry within the state and encouragement of capital investment in the state. Both of these purposes were determined by the Supreme Court in Ward not to be legitimate under the Equal Protection Clause when furthered by discrimination.

Id. at 407.

Nebraska's current gross premiums tax, which assesses taxes on foreign insurers at a higher rate than is applied to domestic insurers, is substantially similar to the Alabama taxing scheme at issue in Ward. Based on the rationale employed by the majority in Ward, as well as the decision in Metropolitan Life Insurance Company v. Commissioner of the Department of Insurance, supra, it appears the constitutionality of the present Nebraska gross premiums tax is subject to doubt.

LB 1114, as amended, would eliminate the disparate treatment which presently exists in the tax rates applied to foreign and domestic insurers under §§77-908 and 77-909 by imposing a tax at the rate of two percent of gross premiums for all insurance companies licensed to do business in the state. In addition to this uniform tax rate, the bill would provide a tax credit to all companies based on the percentage of their noncommission compensation paid in Nebraska, subject to a minimum tax rate of six-tenths of one percent of a company's gross premiums. Thus, LB 1114, as amended, does not expressly discriminate against foreign insurance companies with regard to the tax imposed. The taxing scheme created is facially neutral, imposing a rate of two percent on all insurers, and providing all insurance companies the opportunity to seek the benefits of the compensation credit.

The fact that the tax system created by LB 1114 is facially neutral, however, does not render the scheme of taxation proposed under the bill immune from scrutiny under the Equal Protection Clause. It is well established that a statute which is nondiscriminatory or fair on its face may constitute a denial of equal protection if it is unreasonably, unfairly, or arbitrarily discriminatory in either its operation or effect. E.g., Williams v. Illinois, 399 U.S. 235, 242 (1970). In judging the constitutionality of a tax system, its validity and purpose is determined by examining the actual operation and effect of the taxing scheme in question. See, e.g., Wisconsin v. J.C. Penney Company, 311 U.S. 435, 443-44 (1940); Lawrence v. State Tax Commission, 286 U.S. 276, 280 (1932); Hanover Fire Insurance Company v. Harding, 272 U.S. 494, 509-10 (1926); cf. Michigan National Bank v. Michigan, 365 U.S. 467, 475 (1961) (in

determining discriminatory character of state tax on shares of stock in national bank, the determinative factor is its effect, not its rate). The threshold issue, therefore, is whether LB 1114, while it imposes a tax neutral on its face, would, in effect, actually operate to discriminate against foreign insurance companies in a manner prohibited under the Equal Protection Clause.

Initially, we point out that the determination of whether LB 1114 would operate to discriminate against foreign insurance companies with respect to their tax burden would rest, in large part, on certain facts indicative of the real purpose behind the system of taxation created, as judged by its effect. In particular, the primary factual questions raised in this regard would focus on whether the compensation credit would operate to the benefit solely or primarily of domestic insurers, and, correspondingly, whether the credit would operate in such a manner as to effectively provide no tax benefits to foreign insurers.

While we do not possess sufficient information to specifically address these factual issues, we will nevertheless endeavor to make certain general observations which we believe a court might consider relevant in determining the purpose behind the compensation credit provision, and whether the compensation credit in LB 1114 would, in application, discriminate against foreign insurers in violation of the Equal Protection Clause.

An examination of the tax rate and credit provisions of LB 1114 reveals the minimum tax rate under LB 1114 is the same as the domestic tax rate under current law, and the maximum rate of two percent as identical to the current tax rate applied to foreign insurers. It is conceivable that domestic insurance companies are far more likely to maintain substantial percentages of their work forces in Nebraska, thus enabling domestic companies to enjoy the full benefit of the compensation credit. In contrast, it is conceivable that foreign insurers, whose payrolls may be concentrated in their home states or spread throughout the country, may likely be denied the benefit of any meaningful tax credit. We stress, however, that we are not in possession of the factual information necessary to allow us to definitively conclude that these observations are correct regarding the projected operation and effect of LB 1114.

In summary, with regard to the potentially discriminatory effect of LB 1114, we believe it is conceivable that the amendment proposed would, although facially neutral, operate to continue the present disparate tax treatment between foreign and domestic insurance companies.

Assuming, arguendo, that the requisite discriminatory purpose and effect is found to exist under the operation of the compensation credit in LB 1114, such discrimination may nevertheless not violate the Equal Protection Clause if it is in furtherance of a legitimate state purpose. Ward, supra; Western and Southern, supra. The purpose sought to be advanced through the compensation credit, as stated in Section 11 of LB 1114, is "to stimulate job opportunities by the development and expansion of the business of insurance from within this state by branch, regional, and home offices."

In analyzing the legitimacy of this purpose, we note that the Supreme Court, in considering other constitutional provisions, has cast doubt on the argument that promoting local employment is a legitimate purpose when achieved through discrimination. See Hicklin v. Orbeck, 437 U.S. 518, 526 (1978) (Privileges and Immunities Clause); cf. Edwards v. California, 314 U.S. 160, 173-74 (1941) (Commerce Clause). Furthermore, the bill provides the stimulation of job opportunities is a means to achieve "the development and expansion of the business of insurance from within this state." The Supreme Court's decision in Ward, supra, clearly demonstrates the promotion of domestic business is not a legitimate state purpose when achieved through the imposition of a discriminatory premiums tax. See also Metropolitan Life Insurance Company v. Commissioner of the Department of Insurance, supra, 373 N.W.2d at 407. Therefore, we believe certain questions exist with respect to the legitimacy of the purpose stated in the bill.

Finally, assuming the compensation credit were determined to serve a legitimate state purpose, the means chosen must still be rationally related to the achievement of that purpose. Ward, supra; Western and Southern, supra. In this regard, we note that the bill, as amended, provides no incentive for companies that presently have more than 70 percent of their payroll in Nebraska to increase their in-state employment, as any further increase would not result in additional tax savings. Presumably, domestic insurers alone will maintain a large percentage of their work force in Nebraska, and the bill therefore does not appear to be rationally related to the goal of motivating such companies to increase their in-state payroll.

By comparison, a large foreign insurance company with a substantial Nebraska payroll may nevertheless receive little or no benefit from the credit, if the insurer's nationwide payroll were so large as to make its ratio of Nebraska compensation to total compensation minimal. Even if such a large foreign insurer were to substantially increase its Nebraska payroll, it may not result in any significant tax savings. The incentive for such insurers to expand their work force in the state would be minimal

under these circumstances. These concerns, as well as others, lead us to question whether the calculation of the compensation credit possesses the requisite rational relationship to the goal of increasing job opportunities in Nebraska, in view of the potentially discriminatory operation and effect of its application.

We recognize that, in a case decided subsequent to Ward, the Supreme Court unanimously upheld the validity of a reciprocal regional interstate banking scheme among six New England states which discriminated against bank holding companies domiciled outside of those states. Northeast Bancorp, Inc. v. Board of Governors of the Federal Reserve System, 472 U.S. \_\_\_\_\_, 86 L.Ed.2d 112, 105 S.Ct. 2545 (1985). In a concurring opinion, Justice O'Connor stated she saw "no meaningful distinction" between the interstate banking statutes upheld in Northeast Bancorp and the Alabama premiums tax at issue in Ward. Id. at \_\_\_\_\_, 86 L.Ed.2d at 128, 105 S.Ct. at 2556 (O'Connor, J., concurring).

In spite of the decision in Northeast Bancorp, we cannot ignore the import and effect of the majority opinion in Ward. While it seems to us that the Court in Ward has made a departure from the broad discretion and latitude previously afforded states in enacting discriminatory legislation of this nature, we are not free to disregard the potentially broad implications raised by this decision. Accordingly, based on the foregoing, it is our opinion that serious questions exist as to the constitutionality of LB 1114 under the Equal Protection Clause of the Fourteenth Amendment of the United States Constitution.

Your second question concerns whether the compensation credit provided in LB 1114 would discriminate against nonresidents of the state in violation of the Privileges and Immunities Clause of Article IV, Section 2 of the United States Constitution.

The purpose of the Privileges and Immunities Clause is

to place the citizens of each State upon the same footing with citizens of other States, so far as the advantages resulting from citizenship in those States are concerned. It relieves them from the disabilities of alienage in other States; it inhibits discriminating legislation against them by other states; . . . .

Paul v. Virginia, 8 Wall. 168, 180 (1869). See also Ward v. Maryland, 12 Wall. 418 (1871); Hicklin v. Orbeck, 437 U.S. 518 (1978).

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The credit allowed by LB 1114 is based upon the ratio of the "total amount of compensation paid in this state" to the "total amount of compensation paid everywhere." LB 1114, Section 11. Section 9 of the bill defines "compensation" as "wages, salaries, and any other form of remuneration, except commissions, paid to employees for personal services." Subsections (1)(a) through (c) of Section 9 define the circumstances under which compensation is deemed to be paid in this state. The language employed in Section 9 mirrors the language providing for the payroll factor computation under the unitary business tax contained in Neb.Rev.Stat. §77-2734.13 (Supp. 1984).

In our view, the bill does not create any prohibited discrimination against nonresidents in violation of the Privileges and Immunities Clause. The factor which determines whether compensation is paid within the state is whether the service is performed in the state. No suggestion or inference is made that the salaries and wages of nonresident employees will not be included in computing the credit. As the credit is not based on the state of residence of the employees, it appears the bill does not violate the Privileges and Immunities Clause.

Finally, you have requested our advice concerning the propriety of the bill's provision of an emergency clause and a retroactive operative date to January 1, 1985. You ask whether retroactive application of the premiums tax formula in LB 1114 would be constitutional.

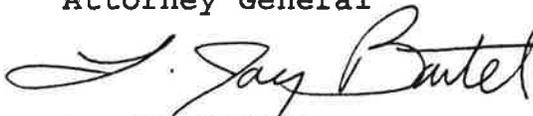
In Opinion No. 152, dated November 14, 1985, we noted the general rule of law establishing that a tax is not necessarily rendered unconstitutional merely because it has some retroactive effect. The primary constitutional objection to legislation of this nature is that it constitutes a denial of due process. In our previous opinion, we cited the leading case concerning this issue, Welch v. Henry, 305 U.S. 134, 147 (1938), in which the Court stated that, in each case, it is necessary "to consider the nature of the tax and the circumstances in which it is laid before it can be said that its retroactive application is so harsh and oppressive as to transgress the constitutional limitation." Based on the principles enunciated in Welch, supra, we do not believe it would be impermissible for the Legislature

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to provide for the retroactive application of a change in the  
premiums tax under the present circumstances.

Very truly yours,

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Attorney General

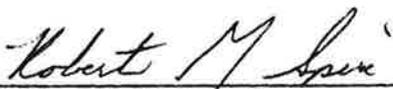


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cc: Patrick J. O'Donnell  
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APPROVED:

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