NO. 05-0541

IN THE SUPREME COURT OF TEXAS

FIRST AMERICAN TITLE INSURANCE COMPANY and OLD REPUBLIC NATIONAL TITLE INSURANCE COMPANY,

Petitioners,

v.

SUSAN COMBS, Comptroller of Public Accounts of the State of Texas, and GREGG ABBOTT, Attorney General of the State of Texas,

Respondents.

From the Court of Appeals for the Third Appellate District at Austin

BRIEF OF AMICUS CURIAE IN SUPPORT OF PETITIONERS' MOTION FOR REHEARING

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ISSUES PRESENTED

I. Whether the Comptroller's revised interpretation of the retaliatory tax statute, which accounts for the full tax burden imposed by other states but only part of the tax burden imposed by Texas, causes actual discriminatory effects by not equalizing tax burdens and thus violates the Equal Protection Clause.

II. Whether allowing the Comptroller's revised interpretation would undermine the retaliatory tax system and its effectiveness in eliminating discriminatory taxes.

III. Whether the Comptroller's revised interpretation is supported by substantial evidence and therefore entitled to deference.

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Attorney General of the State of Texas,
Respondents.

On Petition for Review from the
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AMICUS CURIAE BRIEF

To the Honorable Texas Supreme Court:

NOW COMES the Tax Foundation—a non-partisan, non-profit research institution based in Washington, D.C.—appearing in the capacity as Amicus Curiae to the Court in support of the Petitioners, and urging the Court to grant the Petitioners' Motion for Rehearing herein.

STATEMENT OF INTEREST

The Tax Foundation is a non-partisan, non-profit research organization, exempt from tax under Section 501(c)(3) of the Internal Revenue Code, founded in 1937 to

educate taxpayers about sound tax policy. Based in Washington, D.C., our aim is to make information about public finance understandable, and our economic and policy analysis at all levels of government is guided by the principles of neutrality, simplicity, transparency, and stability. All costs and fees associated with this *amicus curiae* brief have been paid by Tax Foundation, with the exception of local counsel, whose fees are being offered *pro bono*.

We further our mission by educating the legal community and the general public about economics and taxpayer protections, and by advocating that judicial and policy decisions on tax law promote principled tax policy. Recent federal and state cases involving allegations of discriminatory taxation where the Tax Foundation has participated as *amicus curiae* include *Department of Revenue of Kentucky v. Davis*, 128 S. Ct. 1801 (2008), *CSX Transportation, Inc. v. Georgia State Board of Equalization*, 128 S. Ct. 467 (2007); and *DaimlerChrysler Corp. v. Cuno*, 547 U.S. 332 (2005).

This case involves important tax policy issues on a national scale. Because the decision of this Court may be relied upon for authority by the courts of other states, changes in the interpretation and application of the Texas retaliatory tax statute that radically stray from the legitimate purposes of retaliatory taxes will affect other states. Furthermore, the Tax Foundation has conducted extensive research into the field of retaliatory insurance taxation, which may prove helpful to the Court. Accordingly, the Tax Foundation has an institutional interest in this case.

SUMMARY OF ARGUMENT

The Court should grant the petition for rehearing because, notwithstanding the appearance of neutrality, the challenged interpretation issued by the Comptroller will produce unprecedented interstate tax discrimination on a national scale. Under the Comptroller's interpretation, the Texas retaliatory tax on title insurance will not equalize tax burdens between Texas and the states of domicile of out-of-state (foreign) title insurers as it is designed and meant to do. Rather, it will encourage other states to retaliate against the new tax burden created by the Texas Comptroller. Because Texas has one of the largest and most robust economies in the nation, other economically troubled states are likely to respond in kind and set off an interstate tax war, harming consumers.

When assessing the discriminatory effects of any disparate tax regime, courts should look to the real economic incidence of the tax, which in this case falls upon the policyholders who purchase policies from foreign title insurers, as well as employees and shareholders of title insurance companies. Excluding tax burden impacts on these individuals undermines the only legitimate purpose of retaliatory taxes, which is to deter other states from imposing excessive and discriminatory taxes on insurance premiums.

ARGUMENT

I. The Comptroller's Interpretation Will Produce Actual Discriminatory Effects, Notwithstanding Formal Neutrality.

The purpose of insurance retaliatory taxes is to equalize the total insurance tax burden on foreign companies and on domestic companies of the retaliating state. Thus, if State A taxes foreign insurers at 2.0% of premiums while State B taxes them at 2.5%,

State A will impose a retaliatory tax of 0.5% on insurers domiciled in State B in order to equalize the tax burden imposed on State A's companies doing business in State B, thus deterring State B's discriminatory tax.

The Comptroller asserts, and the Court's opinion concludes, that her revised interpretation will accomplish this purpose. But the Comptroller's interpretation ignores the Texas premium tax attributable to 85% of premiums (the portion paid to the title agents) while including 100% of premiums in calculating the tax for a foreign insurer's state of domicile. This cannot be correct because 15% of premiums in Texas does not equal 100% of premiums in another state. Despite formally appearing to equalize tax burdens, the tax will in reality impose a burden on policies issued by foreign companies beyond that imposed on policies issued by domestic companies.

When assessing a tax law's potential equal protection violation, courts should look to the economic incidence of the tax in question. The Comptroller's application of the Texas retaliatory tax to the Texas premiums of foreign title insurance companies does not do so. By focusing instead on who has the legal obligation for the tax, a foreign title insurer will always pay more in total insurance taxes in Texas than an in-state (domestic) title insurer. The price of such additional tax is borne by and ultimately paid by the insured, regardless of the fact that insurers may remit the tax. These discriminatory effects went unexamined by the Court in its earlier opinion, which focused on the formal impact of the Comptroller's interpretation on foreign title companies, without considering the actual burden imposed on policyholders, who are the consumers of title insurance.

A. The Revised Interpretation Results in an Invalid Retaliatory Tax.

States generally cannot constitutionally impose a higher tax rate on out-of-state companies than that imposed on in-state companies. In the landmark *Western & Southern Life Insurance Co. v. State Board of Equalization* case, 451 U.S. 648 (1981), the U.S. Supreme Court applied this rule to insurance retaliatory taxes and outlined a narrow exception that does not apply to the Comptroller's interpretation:

> We 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.

Id. at 667-68. The Court found the purpose of California's retaliatory tax to be "to promote the interstate business of domestic insurers by deterring other states from enacting discriminatory or excessive taxes." *Id.* at 668. The Court found this purpose legitimate, and that California's retaliatory tax rationally related to it. *See id.* at 671-72.

The purpose of the Texas retaliatory tax is the same. By imposing an additional burden upon insurers from higher tax states, Texas legitimately urges such other states to reduce their taxes and thereby deter excessive taxation. *See, e.g., id.* at 669 ("There can be no doubt that promotion of domestic industry by deterring barriers to interstate business is a legitimate state purpose."). The ability of retaliatory taxes to deter discriminatory taxes is real though not readily apparent, as discussed *infra* in Part II.

Because only a retaliatory tax that has this legitimate purpose of equalizing tax burdens can survive equal protection review, a retaliatory tax that does not have the

purpose and effect of equalizing tax burdens is not constitutional. In *Western & Southern*, the Court considered evidence of this purpose and effect, by noting that retaliatory taxes have succeeded in deterring excessive taxes (suggesting that the enacting state's motivation was rational) and that states imposing retaliatory taxes have not received substantial additional tax revenues (suggesting that the motivation was not additional revenue raising). *See id.* at 673-74.

States generally calculate retaliatory taxes so as "to achieve equality of taxation between foreign and domestic companies of the various jurisdictions, and [such taxes are] to be construed in a manner that would accomplish that purpose." Lee R. Russ, *Construction, Application, and Operation of State "Retaliatory" Statutes Imposing Taxes or Fees on Foreign Insurers Doing Business Within the State*, 30 A.L.R.4th 873 (1984). Several courts have recognized that, "to the extent practicable, application of the retaliatory statute was to be determined by comparing the aggregate burden of taxes, obligations, and prohibitions imposed by a foreign jurisdiction on insurers from the retaliating state, with the like aggregate burden of taxes, obligations, and prohibitions ordinarily imposed by the retaliating state on insurers from the foreign state." *Id. See also First Am. Title Ins. Co. v. Strayhorn*, 169 S.W.3d 298, 310 (Tex. App. - Austin 2005, pet. denied) ("The retaliatory tax statute is designed to equalize burdens imposed on Texas-based insurers by foreign states and the burdens imposed by Texas on foreign-based insurers."); *Employers Cas. Co. v. Hobbs*, 89 P.2d 923, 926 (Kan. 1939) (holding that the aggregate burden imposed by the taxes is the basis of comparison); *Indem. Ins. Co. v. Stowell*, 174 N.E.2d 536 (Ohio 1961) (same).

Prior to the Comptroller's interpretation of the retaliatory tax on title insurers, Texas was in line with other states that simply compared tax burdens on Texas premiums under the laws of Texas and the laws of the foreign insurer's state of domicile. This is illustrated in the following example which assumes a total premium of $1,000:

Retaliatory Tax Calculation: Ordinary Method	Texas	Foreign Insurer's State of Domicile	
Premiums	1,000.00	1,000.00	
Tax Rate	x 1.35%	x 2.00%	
Tax	$13.50	$20.00	
Retaliatory Tax	$6.50		($20.00 - $13.50)
Total Tax on Premiums	$20.00		($13.50 + $6.50)
Effective Tax Rate on Premiums	2.00%		

The Comptroller's interpretation in practice does not equalize tax burdens, as demonstrated by the following example using the same $1,000 in premiums:

Retaliatory Tax Calculation: Comptroller's Interpretation Method	Texas	Foreign Insurer's State of Domicile	
Premiums	1,000.00	1,000.00	
Portion Attributed to Insurer	x 15%	x 100%	
	150.00	1,000.00	
Tax Rate	x 1.35%	x 2.00%	
Tax Attributed to Insurer	$2.03	$20.00	
Retaliatory Tax	$17.97		($20.00 - $2.03)
Total Tax Attributed to Insurer	$20.00		($2.03 + $17.97)
Premiums	1,000.00		
Portion Attributed to Agent	x 85%		
	850.00		
Tax Rate	x 1.35%		
Tax Attributed to Agent	$11.48		
Total Tax on Premiums	$31.48		($20.00 + $11.48)
Effective Tax Rate on Premiums	3.148%		

Under the ordinary method for computing retaliatory taxes, both Texas's and the

foreign state's effective tax burden is brought into balance. Under the Comptroller's interpretation, however, the portion of the tax attributed to the agent does not count, so the effective tax rate on premiums is 3.148%, greatly exceeding the 2.00% rate imposed by the foreign state on Texas title insurers.

The Court of Appeals held that the Comptroller's interpretation is valid because it equalizes the tax burdens for "the portion of premium taxes that [the insurers] actually pay." *Strayhorn*, 169 S.W.3d at 310. This Court notes in its opinion that the Comptroller may validly consider only those taxes "directly imposed" on title insurers in Texas. *First Am. Title Ins. Co. v. Combs*, No. 05-0541, 2008 WL 2069840, at *3 (Tex. May 16, 2008) (citing former Tex. Ins. Code Ann. art. 21.46 (Vernon 2002)).

This result is inequitable. The premiums of foreign title insurance policies are taxed at substantially higher rates in Texas than the premiums of Texas title insurance policies would be taxed in the domiciliary states of foreign title insurers. Instead of recognizing that the company/agent split of the premium is the equivalent of a commission routinely paid to insurance agents and embedded in gross premiums in other insurance products, the Comptroller applies the statute in a way that guarantees that insurance policies sold by foreign companies will be taxed at a higher rate than insurance policies sold by in-state companies. Stripped of its rationale of equalizing tax burdens, Texas's tax in excess of a legitimate retaliatory tax (by $11.48 in the example), and becomes impermissibly discriminatory.

Because the Comptroller's interpretation results in a large disparity, it does not qualify for the narrow exception to the equal protection rule prohibiting discriminatory

taxes. If Texas retaliatory statute excludes the share of tax attributable to the agents' portion of the premium, the retaliatory tax violates the Equal Protection Clause.

B. When Evaluating Discriminatory Effects of a Tax, Courts Should Look to the Economic Incidence of the Tax, Not the Legal Incidence.

The Court's opinion focuses on whether the statute as interpreted by the Comptroller is formally discriminatory on the basis of residence, without considering *de facto* discriminatory effects. Both must be considered. *See Hillsdale Dairy, Inc. v. Lyons*, 539 U.S. 59, 67 (2003) ("The tax did not on its face draw any distinction based on citizenship or residence. It did, however, impose a higher rate on persons who had their principal offices out of State.... [W]e concluded that the practical effect of the provision was discriminatory." (citing *Chalker v. Birmingham & Nw. Ry.*, 249 U.S. 522 (1919))); *Bethlehem Motors Corp. v. Flynt*, 256 U.S. 421, 423-24 (1921) (holding that an ostensibly neutral tax, from which in-state companies but no foreign company can effectively receive rebates, violates the Equal Protection Clause); *Yick Wo v. Hopkins*, 118 U.S. 356, 373-74 (1886) ("Though the law itself be fair on its face, and impartial in appearance, yet, if it is applied and administered . . . so as practically to make unjust and illegal discriminations between persons in similar circumstances, material to their rights, the denial of equal justice is still within the prohibition of the constitution.").

This Court considers whether the portion of the premium tax attributed to the agent's 85% share of the premium and remitted to the Comptroller by the insurer is "directly imposed" on the insurer, and concludes that it is not. This, however, presumes that remitting or paying a tax is the same as bearing the burden of a tax's imposition.

Ultimately, it comes to the question of who pays or bears the burden of taxes.

Companies and other entities can remit taxes, but they do not "pay" them in that they do not bear the burden of their imposition in the end. Joel Slemrod, *Does It Matter Who Writes the Check to the Government? The Economics of Tax Remittance*, 61 Nat'l Tax J. 251, 254 (2008) ("In common parlance, we say that the personal income tax is a tax *on* the individual, even though much of it must be remitted by the individual's employer . . . . Writers on taxation, including economists, use the phrase to "pay" taxes sometimes to refer to the remittance of money to the tax authority, and sometimes to refer to bearing the burden of a tax."). Companies are intangible entities existing in contemplation of law. All taxes imposed on corporations are ultimately borne by individuals (customers paying higher prices, employees receiving reduced wages, or shareholders receiving lower dividends). In the case of title insurance, the policyholder ultimately bears much of the cost of insurance taxes attributable to title policy taxes since taxes are included in the premiums charged.

By limiting the retaliatory tax calculation to taxes "directly imposed" on insurers, the statute clarifies that only insurance taxes are included in the calculation, as distinguished from other taxes generally imposed on companies and individuals (such as real property taxes or sales and use taxes). This makes sense in the context of the retaliatory tax, which should only be calculated to consider taxes imposed on insurance companies *qua* insurance companies, not taxes that make up the general tax burden in a state. Since retaliatory taxes are not meant to equalize general tax burdens, construing the term "directly imposed" as referring to insurance taxes fits. If the Comptroller contends

that the "directly imposed" language serves another purpose, she has no statutory basis for not including all incidental taxes imposed on insurers (sales taxes, real property taxes, the margins tax, etc.) in the retaliatory tax calculation.

No matter how the Legislature divides up responsibility for remitting and paying taxes on insurance premiums, those taxes are ultimately paid by shareholders, employees, and most of all, consumers (policyholders). For the Comptroller to count only some of these amounts paid in calculating retaliatory taxes is to ignore the actual economic effects of taxes on insurance. Considering the actual economic effects of the Comptroller's interpretation demonstrates that insurance taxes, while remitted by companies, are imposed on and paid by policyholders, shareholders, and employees. Accordingly, the Comptroller's interpretation leads to the imposition on these individuals of a greater retaliatory tax by Texas than any other state would impose.

Such effects discriminate against foreign title insurers by converting the retaliatory tax into an impermissible revenue-raising penalty on doing business in Texas. If this Court seeks to look behind the insurer to determine who actually pays the tax, it should hold that it is "directly imposed" on shareholders, workers, and consumers. Any comparison or evaluation of other insurance taxes should consider the amounts borne by these individuals, without reductions based on amounts arbitrarily allocated to agents in the form of commissions.

II. The Court's Opinion Undermines the Retaliatory Tax System It Purports to Uphold.

The retaliatory tax system has functioned remarkably well both in deterring

enactments of excessively high premium tax rates across the country and in eliminating discriminatory taxes in the United States.

The Supreme Court's decision in *Western & Southern*, 451 U.S. 648 (1981), holding that a properly designed retaliatory tax did not violate the Equal Protection Clause, led to a broader decision four years later in *Metropolitan Life Insurance Co. v. Ward*, 470 U.S. 869 (1985), which held that discriminatory premium taxes based on residence violate the Equal Protection Clause. At the time, twenty-six states (including Texas) had facially discriminatory taxes on foreign insurers, and an additional eight states had statutes that appeared equal but in operation and effect discriminated against foreign insurers. In the wake of the *Western & Southern* and *Ward* decisions, twenty-five of the thirty-four states with domestic company tax preferences in 1981 (again including Texas) have abandoned their discriminatory taxes in favor of equal taxes on domestic and foreign companies, in most cases at a rate that is lower than the former rate on foreign companies. As a result, insurance companies in much of the country now compete on market factors unaided by artificial tax inducements.

Permitting the Comptroller's interpretation to stand will undermine this remarkable trend toward lower, non-discriminatory premium taxation. Although the Comptroller may call a 3.148% effective tax rate a 2.0% tax, other states cannot be rationally expected to do so. The boost given to Texas's domestic insurers will be only temporary. Other states will certainly boost their retaliatory tax on Texas title insurers to equalize the burden of the new taxes that their own title insurers must remit in Texas. And then Texas can certainly be expected to re-retaliate against the title insurers in such

other states, and this process will continue until foreign title insurers are driven from the interstate marketplace and confined to their states of domicile, with disastrous results for insurance consumers everywhere. The obvious result is certainly *not* "to promote the interstate business of domestic insurers." *Western & Southern*, 451 U.S. at 668.

There is no rational basis for believing that the Comptroller's interpretation furthers the legitimate interest of reducing other states' premium taxes. The boost given to Texas insurers will be temporary, and as Texas dares other states to retaliate, it will set off a chain reaction of increases, and lead to foreign title insurers leaving the interstate marketplace and doing business only in their state of domicile, harming consumers. This result cannot be the purpose or meaning of the statute in question. Whatever purpose underlies the Comptroller's interpretation, it is not embraced by the one legitimate purpose of retaliatory taxes. It must be reconsidered and soundly rejected.

III. The Revised Interpretation is Capricious and is Not Entitled to Deference.

The Comptroller's sudden and dramatic reversal of longstanding policy should not be accorded deference by this Court, absent a searching inquiry as to whether such reinterpretation is capricious or otherwise not in accord with the law. The Comptroller asserts the ability to change policy without first promulgating a rule, arguing that "[t]here is no estoppel against the state" when a prior agency "policy or practice reduced past taxes." (Appellees' Reply Br. 32-34.) But sufficient explanation is needed to indicate that a shift in position is not capricious.

In *Flores v. Employees Retirement System*, 74 S.W.3d 532, 545 (Tex. App.—Austin 2002, *pet. denied*), the court noted that an agency must explain its reasoning when

it appears to have departed from the consistency of its earlier policies or determinations. In *Public Utility Commission v. Gulf States Utilities Co.*, 809 S.W.2d 201 211-12 (Tex. 1991), this Court concluded that the absence of such an explanation warranted the setting-aside of agency action as arbitrary and capricious. *See also Combs*, No. 05-0541, 2008 WL 2069840, at *12 (Hecht, J., dissenting) ("[A]n agency's decision to depart from a longstanding interpretation is entitled to 'considerably less deference' unless the agency provides some reasonable explanation for the change." (quoting *Watt v. Alaska*, 451 U.S. 259, 273 (1981))).

Requiring agencies to explain departures from long-standing settled practices serves important policy purposes. Such safeguards against capricious actions ensure that agency decisions are based on applicable legal rules and permissible discretion, apprise parties of the grounds of an unexpected agency decision, and enable reviewing courts to apply proper standards of judicial review. *See Charter Med.-Dallas, Inc. v. Tex. Health Facilities Comm'n*, 656 S.W.2d 928, 936-37 (Tex. App.—Austin 1983) *rev'd on other grounds*, 665 S.W.2d 446 (Tex.1984) (describing the functions of considering whether agency determinations are due deference (citing *Citizens to Preserve Overton Park v. Volpe*, 401 U.S. 402, 416 (1971))).

Against this backdrop, the Comptroller's unexpected reinterpretation should not be accorded deference, as the change was unaccompanied by sufficient justification. The Comptroller refers to the movement of the premium tax provision, from former Texas Insurance Code Article 4.10 to Article 9.59, as support for her policy revision. (Appellees' Reply Br. 33-34.) However, this cosmetic change, unaccompanied by any

substantive modification of the statute, is insufficient reason to accord the Comptroller's reinterpretation deference. Indeed, previous Comptrollers believed they had no power to adopt the current interpretation, and the Legislature's acquiescence in the prior interpretation reinforces this view. *See Combs*, No. 05-0541, 2008 WL 2069840, at *13 (Hecht, J., dissenting). The Comptroller also argues that the policy revision is supported by changes to retaliatory tax instructions, asserting that these revised instructions conform to changes in "an *unrelated* retaliatory provision." (Appellees' Reply Br. 34, emphasis added.) But a revision of instructions to account for an unrelated change should not eliminate the need to justify a reversal of longstanding policy. *See Am. Cyanamid Co. v. Geye*, 79 S.W.3d 21, 26-27 (Tex. 2002) (stating that agency views and pronouncements are not entitled to the same level of legal deference as promulgated regulations (citing *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944))). Absent legislative change to the language of the premium or retaliatory taxing provisions, or other convincing justifications, the validity of the Comptroller's new interpretation should be subject to searching inquiry, and not be accorded the deference given to other administrative rules and decisions.

CONCLUSION AND PRAYER

For the foregoing reasons, Amicus respectfully requests that the Court grant rehearing, reverse the judgment, and remand with instructions to render judgment for Petitioners.

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the Amicus Curiae Brief of the Tax Foundation in support of the Petitioner's Motion for Rehearing has been forwarded via certified mail, return receipt requested to the following attorneys on record on this ____th day of August, 2008:

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