

**COMPARATIVE ANALYSIS OF THE TAXATION
OF THE INSURANCE INDUSTRY IN OHIO, 1987-1992**

Prepared for the

**Ohio Insurance Institute
and the
Association of Ohio Life Insurance Companies**

by

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EXECUTIVE SUMMARY

The purpose of this study is to compare the Ohio tax burden on the insurance industry with the Ohio tax burden on a representative set of industries during the six-year period from 1987 to 1992¹. The study was commissioned by the Ohio Insurance Institute and the Association of Ohio Life Insurance Companies. The Institute and the Association are state trade associations representing mostly domestic companies that provide all lines of life, health, and property and casualty insurance to policyholders in Ohio and other states.

Key Findings

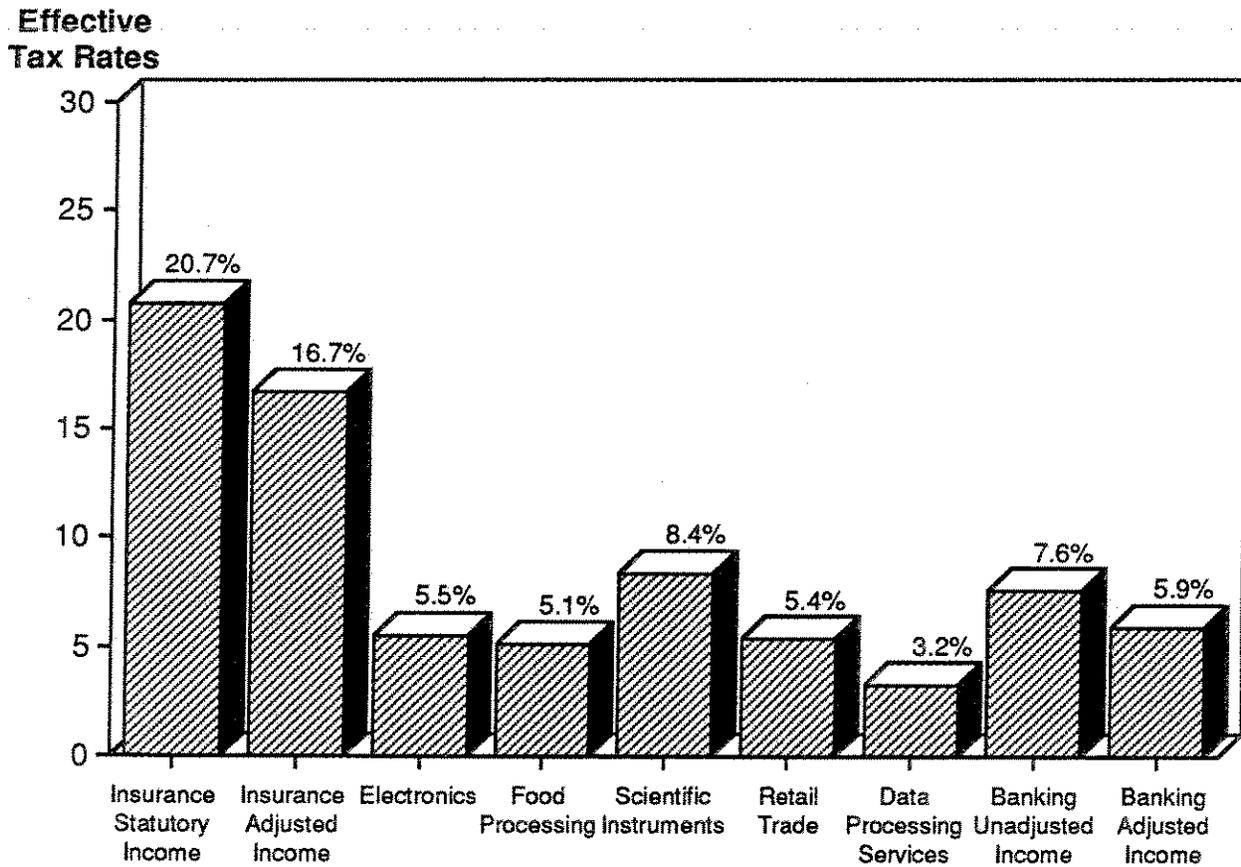
- The insurance industry was subject to an Ohio effective tax rate of 20.7 percent over the six-year period from 1987 to 1992, (based on the statutory net income measure used for insurance regulation). The effective tax rates for the six comparison industries in the manufacturing, retail trade, service and banking sectors ranged from 3.2 to 8.4 percent over the same period. Chart 1 displays six-year average Ohio effective tax rates for the insurance industry and each of the comparison industries.
- Even using a broad measure of pre-tax income, the insurance industry was subject to an effective tax rate of 16.7 percent over the six-year period from 1987 to 1992.
- Retaliatory taxes are a major additional burden on Ohio-domiciled insurance companies. Ohio companies paid an estimated \$50 million in retaliatory taxes to other states in 1990, due to the above average Ohio premium tax rate. Any

¹ This study updates the December 14, 1992 report by Price Waterhouse and Levin & Driscoll to include information from 1991 and 1992.

increase in the Ohio premium tax rate or fees would not only increase retaliatory taxes paid by Ohio companies to other states, but would also be a further disincentive for domestic insurers to expand investment and business in Ohio.

- The effective tax rates for the insurance industry were computed without fire marshal tax, retaliatory taxes or other fees and assessments. If they were included, the effective tax rates for the industry would be higher.
- Total taxes and fees paid by insurance companies to the state of Ohio doubled between 1980 and 1991, growing 110 percent from \$144.1 million in 1980 to \$302.6 million in 1991. Chart 2 shows the growth of insurance taxes and fees during this twelve-year period.
- The insurance industry plays an important role in the Ohio economy. The industry as a whole provides 90,300 jobs in Ohio, roughly the same number as the steel and automobile manufacturing industries. In addition, 248 insurance companies are domiciled (licensed and incorporated and headquartered) in Ohio.

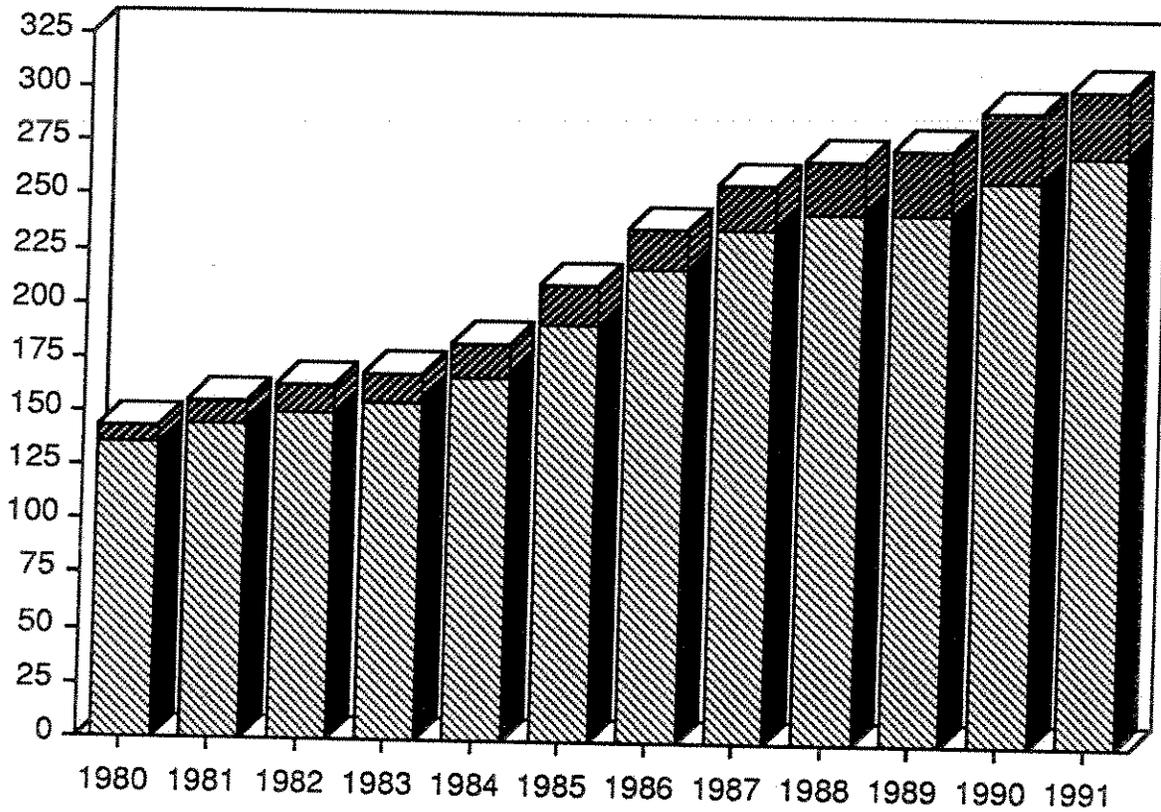
Chart 1 Comparison of Effective Ohio Tax Rates (6-Year Average for 1987-1992)



Source: Price Waterhouse

Chart 2 Ohio Insurance Taxes and Fees, 1980-1991

\$ Millions



■ Other Taxes and Fees
▨ Franchise and Premium Tax

Source: Ohio Department of Insurance Annual Reports for 1990 and 1991

I. OVERVIEW OF STUDY

Corporate Taxation In Ohio

Ohio tax policy is similar to other states in that insurance corporations are taxed in a different manner than other corporations. Corporations doing business in Ohio, with the exception of insurance companies, dealers in intangibles and most public utility companies, are subject to the corporate franchise tax. Although an alternative net worth computation is provided, most franchise tax liability is based upon net income. The maximum statutory tax rate applied to net income was 9.12 percent (including litter tax) during 1987 to 1992. Banks are subject to a franchise tax at the rate of 1.5 percent of net worth.

Ohio collects most of its insurance tax revenue from a 2.5 percent premium tax. The premium tax base is gross premium revenue excluding annuities, refunds, returned premiums and assumed reinsurance. The premium tax base does not allow subtractions for operating expenses or payments to cover losses of insured parties. Thus, unlike the franchise tax, the premium tax does not vary with changes in the profitability of the taxpayer. Rather, premium tax revenue increases or decreases to the extent that premium volume increases or decreases from year to year.

Ohio-domiciled insurance companies pay the lesser of the 2.5 percent tax on Ohio premiums or a tax on their total capital and surplus. The capital/surplus tax is 0.6 percent of total annual statement capital and surplus plus certain conditional reserves and non-admitted assets. Although the premium tax rates are low relative to the corporate franchise (net income) tax rate, the insurance tax base is gross receipts rather than net income. Capital and surplus tax base is unallocated capital and surplus rather than Ohio net income.

Premium and capital/surplus taxes are the primary taxes imposed by Ohio on insurance companies. Insurers are also subject to a number of special assessments, taxes and fees. State fire marshal taxes equal to 0.75 percent of fire insurance-related premiums are earmarked to finance the operation of the fire marshal program. Insurance companies also pay various licenses and fees.

Finally, retaliatory taxes substantially affect the tax burden of Ohio-domiciled companies and foreign insurers (that is, companies that are incorporated in other states). The intent of state retaliatory taxation has been to protect companies that are domiciled within the state from excess taxation or regulations imposed by other states. In most cases retaliatory statutes are not limited to the general premium taxes, but cover fire marshal taxes, fees, licenses, fines, restrictions, deposits, special assessments and other burdens.

Retaliatory taxes are discussed in more detail in Chapter V of this report. However, basically these retaliatory statutes allow each state to impose an additional tax on a foreign insurer if the foreign insurer's home state imposes higher taxes and burdens. For example, Indiana's premium tax rate on foreign insurers is 2.0 percent; Ohio's premium tax rate is 2.5 percent. Thus, an Ohio domiciled insurer doing business in Indiana would pay a 2.0 percent premium tax plus a 0.5 percent retaliatory tax to Indiana.

Thirty-six states impose retaliatory taxes on Ohio-domiciled insurance companies because the premium tax rate on Ohio insurance companies doing business in those states is below Ohio's 2.5 percent rate. Only 12 states impose premium tax rates higher than Ohio's rates, so companies domiciled in those states have to pay retaliatory taxes to Ohio. The amount of retaliatory taxes paid by Ohio domiciled companies to other states far exceeds the amount of retaliatory taxes collected by Ohio from foreign insurers.

Methodology For Tax Comparisons

In order to compare Ohio tax burdens on the insurance industry with other industries that are subject to the franchise tax based on net income or net worth, it is necessary to convert these burdens into comparable effective tax rates.

Comparison Industries - Six industries were selected as comparison industries reflecting a range of profitability during the initial study period of 1987 to 1990. The five nonfinancial industries are food processing, electronics, scientific instruments, retail trade, and electronic data processing services. The use of return on equity as the selection criterion avoids bias in choosing comparison industries. For example, the four-year return on equity in food processing was above the average for all manufacturing industries while returns were below average for electronics. The average return on equity for these five industries as a composite approximates the average return on equity for all manufacturing, retail trade, and service firms during the 1987 to 1990 period. The sixth comparison industry is commercial banking, which is subject to a financial institutions tax based upon net worth.

Concept of Effective Tax Rates - Comparable effective tax rates have been calculated for the insurance industry and the comparison industries. For the insurance industry, the effective tax rate is a fraction the numerator of which is premium and capital/surplus taxes and the denominator of which is "pre-tax income". For the comparison industries, the numerator is corporate franchise or bank taxes and the denominator is "pre-tax income".

Definition of Pre-tax Income - Effective tax rate studies often use a different concept of income than taxable income for two reasons. First, the definition of taxable income includes numerous exclusions and deductions which have nonuniform impacts across industries. Second, statutorily-defined taxable income changes over time so that its use as a measure of income may be inconsistent from year to year.

In order to achieve comparability, consistent measures of pre-tax income have been constructed for the insurance industry and comparison industries. For insurance companies, the measure of pre-tax income starts with pre-tax statutory net income, as reported on the annual statement filed with state regulatory commissions.

Two alternative income measures for the insurance industry are presented. One measure is statutory net income without adjustment. A second, broader measure is statutory net income with adjustments. These adjustments include differences between federal tax and annual statement reserves and deferred acquisition costs, as defined for federal income tax purposes, as well as an adjustment for the lower yield on tax-exempt bonds.

Comparable pre-tax income measures were developed for the comparison industries. The measure for the manufacturing, retail trade and service industries is book income as defined by financial statements. The measure for the banking industry is book income as reported to regulatory authorities, with and without certain adjustments. These income measures are more consistent than taxable income across the seven industries and over the six-year period.

Data Sources and Effective Tax Rate Calculation Methods - The financial data used to calculate effective tax rates for the insurance industry were obtained from annual statements filed by the insurers with state regulatory commissions and compiled by A.M. Best Company, Inc. Price Waterhouse developed a model to estimate the premium and capital/surplus tax liability of both property and casualty insurance and life and health insurance companies doing business in Ohio. Tax liability was divided by pre-tax income apportioned to Ohio based upon Ohio premiums as a percent of total U.S. premiums for each company in the sample.

Price Waterhouse also developed a model to estimate effective tax rates for the comparison industries. A modeling approach was used because aggregate information on corporate income and liability, by industry, was not available. The data used to estimate pre-tax

financial income and tax liability were obtained from the Quarterly Financial Reports published by the U.S. Bureau of the Census and the Standard and Poor's Compustat data base (in the case of manufacturing, retail trade and services) and The Federal Deposit Insurance Corporation reports (in the case of banking). The model methodology is described in detail in Appendix II of this report.

The tax burden measure for the insurance industry was also calculated in Chapter V to reflect the effects of retaliatory taxes. While not part of the effective Ohio tax rate comparison, these additional tax liabilities directly result from Ohio insurance taxes and impose an additional tax burden on the Ohio-domiciled insurance companies.

Economic Impacts of Insurance Taxation

The insurance industry plays an important role in the Ohio economy. In 1993, the insurance industry directly provided 90,300 jobs in Ohio. Ohio is also headquarters for many insurance companies. In 1991, 152 insurance companies were domiciled in Ohio.

Higher insurance company taxes would have an adverse impact on economic activity in Ohio. In addition to potential negative effects on employment and investment, higher insurance company taxes can encourage inappropriate use of self-insurance. Some self-insured businesses may not have the financial resources to meet all claims. Furthermore, as lower-risk individuals and businesses self-insure, higher "marginal" risks will remain in the regular insurance pool with resulting higher prices. Higher insurance company taxes would also increase retaliatory taxes paid by Ohio-domiciled companies to other states.

II. THE STATE TAXATION OF INSURANCE COMPANIES IN OHIO

Starting with an excise tax in 1830, insurance companies were one of the first businesses to be subject to a special excise tax in Ohio. In 1888, the State began a supplemental tax on the premiums of foreign insurers designed to produce 2.5 percent of premiums when added to the property tax. In 1902, this system was replaced with a direct 2.5 percent tax on the premiums of foreign insurers levied as a state tax. This method for taxing foreign insurers has remained unchanged since that date.

Meanwhile, domestic insurers continued to pay a tax on property until 1933 when the tax method was changed to a franchise tax equal to the smaller of 0.2 percent of total capital and surplus or 1.67 percent of gross Ohio premiums. In 1971, those rates were changed to 0.3 percent on capital and surplus and 2.5 percent of Ohio premiums with the insurer paying the lesser of the two computations. In 1981, the General Assembly increased the rate on capital and surplus to 0.6 percent. Thus, the general method for taxing domestic insurers has remained unchanged since 1933, although two rate increases have occurred since that time.

Method for Taxing Insurance Companies Today

Ohio tax law continues the distinction between "foreign" and "domestic" insurance companies. A "foreign" insurer is a company or association incorporated or organized outside of Ohio which is licensed to sell insurance in the state of Ohio. A "domestic" insurer is a company or association incorporated or organized within Ohio to sell insurance. As noted, foreign insurers pay a 2.5 percent premium tax while domestic insurers pay the lower of the 2.5 percent premium tax or a 0.6 percent tax of their capital and surplus. Other significant taxes include:

1. *Fire Marshal's Tax*

Property and casualty insurers also pay a special tax to support the State Fire Marshal. The fire marshal tax equals 0.75 percent of the gross premiums paid for fire insurance. For policies that mix both fire and other coverages, a portion of the policy premium is allocated to fire protection based on standard percentages designated by the Ohio Department of Insurance.

2. *Retaliatory Taxes*

The most distinctive feature of insurance taxation in the United States is the use of retaliatory taxes. Ohio, like all other states except Hawaii, levies a special tax on foreign insurance companies called a "retaliatory tax." The tax applies to foreign insurers if the foreign insurer's home state imposes higher taxes, fees and other burdens. Most retaliatory statutes cover not only taxes, but all fees, licenses, and other burdens as well. The rate of the tax equals the difference between a state's taxes, fees and burdens, and the taxes, fees and burdens imposed by the foreign insurer's home state.

For example, Illinois has a two percent premium tax rate on foreign insurers. Ohio has a 2.5 percent premium tax rate on foreign insurers. When an Ohio insurance company sells a policy in Illinois, it pays a two percent premium tax and a 0.5 percent retaliatory tax. When an Illinois company sells a policy in Ohio it pays the 2.5 percent premium tax but no retaliatory tax is due to Ohio since the Illinois rate is lower.

Ohio's retaliatory tax produces little revenue because Ohio's tax rate exceeds that of most other states. States with rates higher than Ohio include only Alabama, Alaska, Hawaii, Idaho, Mississippi, Montana, Nevada, New Mexico, Texas, and West Virginia. (Texas though only has a higher rate for property and casualty premiums and provides credits which

can reduce the rate to 1.6 percent by investing in certain Texas securities.) Obviously, these states with rates higher than Ohio are not the home base for many insurers.

While retaliatory taxes are not important as a source of revenue for Ohio, they have extraordinary significance for Ohio based insurance companies. The impact of retaliatory taxes on Ohio insurance companies is discussed in more detail in Chapter V of this report. However, the subject requires a cautionary note. Retaliatory taxes sometimes get confused with the practice of taxing domestic insurance companies with different rates from foreign insurance companies. The two are entirely separate. Retaliatory taxes compare the taxes, fees and burdens imposed on foreign companies, not domestic companies. Thus, in the example above, Illinois retaliatory tax would apply to an Ohio company's premiums sold in Illinois regardless of whether the Ohio company paid the Ohio premium or capital/surplus tax.

3. Other Taxes, Assessments and Fees

In addition to the taxes noted above, all insurance companies doing business in Ohio must pay guaranty fund assessments which are used to pay unpaid claims owed by insolvent insurance companies. Credits for guaranty fund assessments spread over a five year period are available for life and health insurers. While these assessment vary by year, they have increased in significance.

Insurers also pay over \$20 million in license and audit fees. Over \$12 million is used to pay for the Ohio Insurance Department's budget.

Finally, insurance companies pay the premium or capital/surplus tax in lieu of the corporate franchise tax and taxes on their tangible personal property. Insurance companies, however, do pay real property taxes and personal property taxes on leased property.

III. THE INSURANCE INDUSTRY IN OHIO'S ECONOMY AND REVENUE SYSTEM

It would be difficult to overstate the importance of insurance in our daily lives. In fact, Americans have come to take its existence so much for granted that we often forget how central it is to helping us accomplish some of our most basic life goals. As author Robert Mehr observes in an insurance textbook, "Few people could own homes, drive cars, attain adequate medical attention, and provide financial security for their families without it."²

This chapter examines the critical role of insurance in the Ohio economy and the contribution the industry makes to Ohio's government revenues.

A few simple facts can quickly illustrate how much our country has come to depend on insurance and the insurance industry:

1. Ninety-six percent of the nation's homeowners carry household insurance to protect themselves against potential financial loss.
2. Over four-fifths of U.S. households own life insurance, averaging more than \$121,000 per insured household.
3. Americans hold insurance on nearly 134 million personal automobiles.
4. Over two million people nationwide are employed in the insurance industry, more than the combined populations of Cleveland, Columbus, and Cincinnati.
5. In 1990, insurance premium payments (excluding annuities) totaled \$354.7 billion for the nation and \$12.9 billion for Ohio.

²Robert Mehr, Fundamentals of Insurance, Richard D. Irwin, Inc., 1983.

Employment in the Ohio Insurance Industry

While premium volume is an important measure of the economic significance of Ohio's insurance industry, there are several other ways to measure its impact on the State's economy. According to the most recent (1992) Annual Report of the Ohio Department of Insurance, 1,649 insurance companies are authorized to do business in the state, including 646 life insurance companies and 767 property and casualty companies. (The remaining 236 companies are distributed among 11 different categories, including title insurance companies, fraternal benefit societies, and health maintenance organizations). Of these 1,649 companies, 49 life insurance and 103 property and casualty insurance companies have their legal domicile in Ohio.

Insurance companies operating in Ohio provide employment for a significant number of Ohioans, more, in fact, than is generally understood. Information from the Ohio Bureau of Employment Services (OBES) is most useful. To illustrate this point, Table 1, prepared from November, 1993 statistics published by OBES, shows total insurance industry employment in Ohio to be 90,300 people.

Table 1 provides some perspective by comparing insurance industry employment with a few selected other industries in the state. Ohioans are well-aware that automobile manufacturing and steel-making are major industries in their state. They might be surprised to learn, however, that nearly as many people are employed in the insurance industry as in making motor vehicles or in making steel and other primary metals. Table 1 also shows that the Ohio insurance industry provides employment for more people than banks and savings and loans combined, about twice as many workers as the real estate industry, and over six times as many as the mining industry.

Table 1
EXAMPLES OF OHIO EMPLOYMENT IN SELECTED INDUSTRIES
 (as of November 1993)

<u>Selected Ohio Industries</u>	<u>Number Employed</u>
Banks and savings and loans	87,200
Chemical manufacturing	67,400
INSURANCE	90,300
Mining	13,700
Motor vehicle manufacturing	95,500
Paper products manufacturing	35,400
Primary metals manufacturing	91,200
Real estate	46,300

Source: Ohio Bureau of Employment Services

Ohio Insurance Taxes: Growth compared to other Business Taxes

Insurance companies not only make major contributions to the state's economy through protection against losses by businesses and individuals and by providing jobs to thousands of Ohioans, they also provide significant revenues to the state through taxes they pay.

The amount of taxes and fees paid to Ohio by insurance companies has been growing substantially over the last decade. In fact, according to the Ohio Department of Insurance, these taxes and fees more than doubled in the period from 1980 to 1991, growing 110 percent from \$144.1 million in 1980 to \$302.6 million in 1991, according to the Ohio Department of Insurance. While this was slightly less than the growth rate of total state taxes in that period (mainly because of the large growth in personal income tax revenues), it was significantly greater than the growth in other business taxes.

Two other comparisons can provide relevant benchmarks for the growth of insurance industry taxes during this period. Tables 2 through 4 compare insurance taxes to those paid by general corporations and financial institutions. (Because tax data for general corporations and financial institutions are compiled by the Department of Taxation rather than the Department of Insurance, the taxation department's published figures for insurance taxes were used here to assure consistency. Consequently, insurance tax figures shown in these two tables will not match figures shown elsewhere in this report.)

In Table 2, insurance taxes are compared to corporation franchise taxes paid by "regular" or "general" corporations ("general" corporations connotes all corporations other than insurance companies and financial institutions). The last column in the table illustrates that Ohio insurance taxes have increased substantially more in the 1980's than taxes paid by general corporations under Ohio's corporation franchise tax. In 1980, insurance companies paid 23 percent as much as all general corporations, but by 1991 insurance companies were paying 40 percent as much.

Table 2

INSURANCE COMPANY TAXES COMPARED TO CORPORATION FRANCHISE TAXES PAID BY GENERAL CORPORATIONS, OHIO, 1980 TO 1991

Fiscal Year	Insurance Company Taxes * (In Millions)	Corporation Franchise Taxes ** (In Millions)	Insurance Taxes As Percent Of Corporation Taxes
1980	\$134	\$582	23%
1981	\$137	\$555	25%
1982	\$160	\$600	27%
1983	\$154	\$444	35%
1984	\$159	\$557	29%
1985	\$166	\$634	26%
1986	\$191	\$708	27%
1987	\$217	\$692	31%
1988	\$235	\$740	32%
1989	\$246	\$815	30%
1990	\$249	\$722	34%
1991	\$270	\$675	40%

* Only premium and capital and surplus tax.

** Not including taxes paid by financial institutions.

Note: Calculations by Levin & Driscoll from Ohio Department of Taxation data.

While this percentage fluctuates from year to year, its overall trend is clearly increasing. The cause for this trend lies mainly in the difference between how insurance companies are taxed relative to other businesses. Because insurance premium taxes are unrelated to income, insurance company taxes tend to increase every year, in good years and bad. In fact, insurance taxes failed to rise only once in the eleven-year period. In contrast, corporation franchise taxes declined in five of the eleven years because they are related, at least in part, to income which fluctuates with the business cycle.

This difference is seen most dramatically in the comparison for the most recent year. In 1991, corporation franchise taxes declined \$47 million while insurance taxes increased by \$21 million. The result, as noted earlier, was that in 1991 insurance taxes were 40 percent as much as the corporation franchise taxes paid by all non-financial corporations.

In Table 3, insurance company taxes paid to the State of Ohio are compared to financial institution taxes (banks and savings and loans) since they are perhaps most similar to the insurance industry. In 1980, insurance companies paid \$134 million, roughly the same amount paid by financial institutions, \$135 million. However, by 1991, insurance taxes had grown to \$270 million, in part due to the increase in the capital/surplus tax rate in 1981. In contrast, financial institution taxes, which were modified and reduced by the General Assembly in the early and mid-1980's, had grown to only \$147 million in 1991.

As the last column in Table 3 indicates, while insurance company taxes were 99 percent of financial institution taxes in 1980, they had increased to 184 percent by 1991.

Table 3

**INSURANCE COMPANY TAXES COMPARED TO TAXES PAID BY
FINANCIAL INSTITUTIONS, OHIO, 1980 TO 1991**

Fiscal Year	Insurance Company Taxes (In Millions)	Financial Institution Taxes (In Millions)	Insurance Taxes As Percent Of Financial Institution Taxes
1980	\$134	\$135	99%
1981	\$137	\$143	96%
1982	\$160	\$132	121%
1983	\$154	\$138	112%
1984	\$159	\$ 99	161%
1985	\$166	\$ 99	168%
1986	\$191	\$ 94	203%
1987	\$217	\$105	207%
1988	\$235	\$110	214%
1989	\$246	\$130	189%
1990	\$249	\$143	174%
1991	\$270	\$147	184%

Note: Calculations by Levin & Driscoll from Ohio Department of Taxation data. For financial institutions, figures represent liability from the corresponding calendar year, since collections are not available separately from what other taxpayers pay.

Table 4 combines the figures for corporation franchise taxes shown in Table 2 with those shown for financial institution taxes in Table 3. That is, insurance company taxes are compared with the total of corporation franchise taxes and financial institutions taxes. This not only provides a more global comparison, but also allows the two most recent years of data to be included, fiscal years 1992 and 1993, since total collections are available for those years even though the financial institutions portion is not available as a separate figure.

The percentages shown in the final column of Table 4 are, of course, lower than in Tables 2 or 3 alone, because insurance company taxes are compared to a combined total. However, the trend of increasing insurance taxes relative to other industries is just as apparent.

Table 4 shows that insurance company taxes were 19% of the combined taxes paid by general corporations and financial institutions in 1980, but had grown to 33% in 1993. This figure is somewhat volatile since it depends in part on the annual level of general corporation profits, but the trend is obvious: the state tax burden on insurance companies relative to other Ohio industries has increased significantly since the early 1980's. Given the different method of taxing insurance companies, it is likely to remain at this higher level in the foreseeable future.

Table 4

**INSURANCE COMPANY TAXES COMPARED TO COMBINED CORPORATION
FRANCHISE AND FINANCIAL INSTITUTION TAXES, OHIO, 1980 TO 1993**

Fiscal Year	Insurance Company Taxes (In Millions)	Corporate Franchise and Financial Institution Taxes (In Millions)	Insurance Taxes As Percent of Corporate franchise and Financial Institution Taxes
1980	\$134	\$717	19%
1981	\$137	\$698	20%
1982	\$160	\$732	22%
1983	\$154	\$582	26%
1984	\$159	\$656	24%
1985	\$166	\$733	23%
1986	\$191	\$802	24%
1987	\$217	\$797	27%
1988	\$235	\$850	28%
1989	\$246	\$945	26%
1990	\$249	\$865	29%
1991	\$270	\$822	33%
1992	\$275	\$814	34%
1993	\$285	\$854	33%

Note: Calculations by Levin & Driscoll

Source: Tables 2 and 3, and Ohio Department of Taxation data.

IV. COMPARISON OF OHIO TAX BURDENS ON INSURANCE AND OTHER INDUSTRIES

Noninsurance corporations doing business in Ohio are generally subject to the Ohio corporate franchise tax based upon net income. Insurance companies are subject to a premium tax, or in the case of domestic companies, a franchise tax based upon capital and surplus, if lower.

Since insurance, banks, and general corporations are taxed differently, a common measure of effective tax rates must be developed in order to accurately compare premium and income tax burdens for different industries. This chapter describes the methodology that has been used to measure effective tax rates and presents the comparative burden analysis.

Methodology for Measuring Effective Tax Rates

The analysis covers a multi-year period from 1987 to 1992. A multi-year study timeframe is of special importance because tax liabilities and corporate profits fluctuate from year to year. The 1987-1992 period includes both high and low profit years for insurance companies. This time period also reflects variation of profits of manufacturing, retail trade, service and banking industries during years of relatively slow and rapid growth.

The common measure of tax burden is tax liability stated as a percent of pre-tax income. For insurance companies, premium and capital/surplus taxes form the numerator of the effective tax rate calculation. Pre-tax income is the denominator.

The use of a consistent pre-tax income concept is a critical feature of the burden analysis. Industry tax burden studies typically use a pre-tax financial income concept in the denominator of the tax rate calculation. The pre-tax income measure used in this study provides a consistent measure of ability-to-pay across industries and over time. Taxable income is not used because it includes tax incentive or preference features that may distort the measurement

of economic profits. The use of a uniform and consistent income concept helps to insure appropriate inter-industry comparisons.

Effective Tax Rates on the Insurance Industry

The insurance industry effective tax rates presented in this report were developed from annual statement information filed with state regulatory agencies and compiled by A.M. Best Company, Incorporated. The annual statements detail information about the insurer's state of domicile, premiums, capital and surplus, and balance sheet and income statement. The A.M. Best 1992 database includes 101 P&C insurance companies and 46 life insurance companies domiciled in Ohio and 621 foreign P&C and 688 foreign life insurance companies doing business in Ohio. In addition, annual statement information for the Ohio Blue Cross and Blue Shield plans was included.

The data cover 95.0 percent of Ohio life, health and fire and casualty insurance premiums reported by the Ohio Department of Insurance for 1987 to 1992. The Price Waterhouse Tax Model for the Ohio insurance industry, based on annual statement data, predicts 94 percent of total premium and franchise tax reported to the Ohio Department of Insurance for 1987 to 1992.

Pre-tax Income Measures for the Insurance Industry - Different measures of income of insurance companies are used for regulatory, federal tax and financial reporting purposes. For purposes of this study, two alternative pre-tax income measures were constructed. Both measures have been applied consistently throughout the six-year study period. One measure is statutory net income before income taxes as reported for regulatory purposes. A second, broader measure is statutory net income with four adjustments to reflect federal income tax law provisions.

Statutory Net Income - The first measure of pre-tax income is statutory net income after policyholder dividends and before income taxes. Statutory income includes both underwriting income and investment income, including realized capital gains. Annual statutory income for insurance companies nationwide increased from \$27.2 billion in 1987 to \$39.9 billion in 1991 before slipping to \$26.1 billion in 1992 (a year with large catastrophic property & casualty losses).

States levying insurance premium taxes collect taxes on policies written to cover risks located in the state. For purposes of calculating the effective tax rate, pre-tax income was apportioned to Ohio on the basis of the percentage of Ohio premiums to total U.S. premiums for each individual company.

Pre-tax statutory net income apportioned to Ohio increased from \$654 million in 1987 to \$1.20 billion in 1988 and \$1.36 billion in 1991, before falling to \$1.18 billion in 1992.

Adjusted Pre-Tax Income - The federal income tax law defines taxable income more broadly than statutory income used for regulatory purposes. A broader measure of income is calculated to reflect federal income tax provisions for purposes of presenting a conservative (lower bound) measure of the insurance industry's effective tax rate. Unlike the statutory net income measure, the broader measure requires estimates of the adjustments, and the adjustments are not considered by some to be appropriate for measuring the insurance industry's annual income.

Adjusted pre-tax income starts with statutory net income as reported for regulatory purposes with additions for (1) the difference between federal tax and statutory reserve deductions, (2) the difference between federal tax and statutory treatment of deferred acquisition expenses, (3) the lower yield on tax-exempt bond investments due to federal tax exemption, and (4) the federal tax imputation of income to mutual life insurance companies. A detailed description

of the adjustments is included in Appendix I. The broader measure averages 24 percent higher than statutory net income.

Insurance Industry Effective Tax Rates

Table 5 shows the calculation of effective tax rates for the insurance industry over the period 1987 to 1992. Franchise and premium taxes were divided by apportioned Ohio pre-tax income, using the two alternative measures of income.

Using statutory net income, effective tax rates on the insurance industry in Ohio range from a high of 32.9 percent in 1987 to a low of 16.6 percent in 1989. Over the six-year period, the average effective tax rate using this income measure was 20.7 percent.

Using the broader, adjusted income measure, effective tax rates range from a high of 21.2 percent in 1987 to a low of 14.3 percent in 1989. Over the six-year period, the average effective tax rate using this income measure was 16.7 percent.

As noted, fire marshal tax, retaliatory taxes, and other fees and assessments are not included. If they were included the effective tax rates for the Ohio insurance industry would be higher.

The Ohio effective tax rate varies greatly across companies, depending on their profitability relative to their taxable premiums or capital and surplus. An unprofitable company is still required to pay taxes. A company with marginal profitability would have a relatively high effective tax rate. Alternatively, a highly profitable company with relatively low taxable premiums could have a low effective tax rate.

Table 5

CALCULATION OF EFFECTIVE TAX RATES FOR OHIO INSURANCE INDUSTRY 1987-1992
(\$millions)

	1987	1988	1989	1990	1991	1992	1987-1992
STATUTORY INCOME TAX RATE CALCULATION							
Apportioned Ohio statutory income 1/	654	1204	1358	1243	1360	1183	7002
Franchise and premium tax 2/	215	240	226	244	257	267	1449
Effective tax rate 3/	32.9%	19.9%	16.6%	19.6%	18.9%	22.6%	20.7%
ADJUSTED INCOME TAX RATE CALCULATION							
Apportioned Ohio adjusted pre-tax income 1/	1015	1414	1575	1462	1646	1570	8682
Franchise and premium tax 2/	215	240	226	244	257	267	1449
Effective tax rate 3/	21.2%	16.9%	14.3%	16.6%	15.6%	17.0%	16.7%

1/ Pre-tax income for insurance companies in A.M. Best database, apportioned by Ohio premiums as percent of total U.S. premiums.

2/ Estimate of tax liability for companies doing business in Ohio in A.M. Best database. Estimated tax liability ranges from 93-98 percent of actual tax collected. Does not include fire marshal or retaliatory taxes.

3/ The effective tax rate is the franchise and premium tax rate divided by apportioned income.

Source: Price Waterhouse

Effective Tax Rates for Comparison Industries

The general business tax included in the numerator of the effective tax rate for the nonfinancial comparison industries is the combined franchise and litter tax. The franchise tax for financial institutions based solely on net worth forms the numerator of the effective tax rate for the banking industry.

Six industries that are subject to the franchise tax were selected for comparison with the insurance industry. The six industries are electronics, food processing, scientific instruments, retail trade, computer and data processing services, and banking. These industries were selected in order to reflect a range of profitability and represent a number of different sectors of the economy. The average return on equity for the five nonfinancial industries as a composite approximates the average return on equity for all manufacturing, service, and retail trade firms during the 1987 to 1990 period.

Ideally, the measurement of tax burdens for the comparison industries would be based upon actual data on franchise tax liability and corporate income, by industry, for firms doing business in Ohio during the 1987 to 1992 period. However, this approach is not feasible because, while Ohio does report some tax payment data by industry, appropriate data on corporate income is not available. Thus, estimates of effective tax rates for the comparison industries were developed through use of the Price Waterhouse Business Tax Model. This Model is an analytical tool that has been used in a number of state projects to analyze state tax burdens on new investment. The Model was specially adapted for this project.

The steps involved in calculating effective tax rates for the comparison industries are straightforward. A description of the step-by-step procedure applied to the five nonfinancial industries plus an example of this procedure are set forth in Appendix II.

Comparison of Effective Tax Rates

Table 6 presents the effective tax rates for the insurance industry and the six comparison industries. As shown, the average effective tax rate for the insurance industry is higher than the average effective tax rates for all six of the comparison industries. The insurance effective tax rates are higher using the broad, adjusted income measure as well as the statutory net income measure.

The Ohio effective tax rate of insurance companies is substantially higher than the effective tax rate of non-financial and other financial industries. The insurance industry paid an average effective tax of 20.7 percent of statutory net income in 1987-1992, or 16.7 percent of adjusted pre-tax income.

The comparison industries' effective tax rates were less than half the insurance industry's. The six-year average effective franchise tax rates for the comparison industries range from a low of 3.2 percent for data processing services to 8.4 percent for scientific instrument manufacturing.

Overall Taxes, Fees and Assessments Imposed on the Insurance Industry in Ohio

The effective tax rate comparison presented in Table 6 includes only franchise and premium taxes. It is important to note that a number of additional taxes, fees and assessments are imposed on the insurance industry in Ohio. Table 7 shows other taxes and fees paid by the insurance industry to Ohio in 1987 to 1992.

TABLE 6
Comparison of Effective Ohio State Franchise Tax Rates Across Industries

YEAR	Insurance							Banking	
	Statutory Income	Adjusted Income	Electronic	Food Processing	Instrument	Retail Trade	Data Processing	Statutory Income	Adjusted Income
1987	32.9%	21.2%	5.3%	5.4%	8.7%	5.8%	3.6%	9.2%	6.1%
1988	19.9%	16.9%	5.2%	5.3%	8.6%	5.3%	3.3%	7.3%	6.0%
1989	16.6%	14.3%	5.1%	5.2%	8.6%	5.4%	3.5%	7.5%	6.1%
1990	19.6%	16.7%	5.0%	5.2%	8.6%	5.1%	3.3%	9.4%	6.5%
1991	18.9%	15.6%	6.9%	4.8%	8.0%	4.6%	2.5%	8.1%	6.1%
1992	22.6%	17.0%	5.0%	4.7%	7.6%	6.2%	3.0%	6.0%	5.2%
6-Year Average	20.7%	16.7%	5.5%	5.1%	8.4%	5.4%	3.2%	7.6%	5.9%

Note: See text for explanation of calculation.

Table 7

**Ohio Insurance Taxes and Fees: 1987 - 1992
(\\$ thousands)**

<i>Calendar Years</i>	<i>Franchise and Premium Tax</i>	<i>Fire Marshal Tax</i>	<i>Retaliatory Tax *</i>	<i>Miscellaneous Tax</i>	<i>Fees Collected</i>	<i>Total Taxes and Fees **</i>
1987	\$235,772	\$6,232	\$3,083	\$1,614	\$10,753	\$257,454
1988	244,203	6,465	4,122	1,860	11,458	268,108
1989	244,255	6,391	4,410	2,088	16,871	274,014
1990	259,463	6,467	4,345	1,934	20,474	292,683
1991	270,980	6,336	3,630	2,277	19,383	302,606
1992	288,546	NA	NA	NA	NA	NA

* Excludes retaliatory taxes paid by Ohio companies to other states. See Chapter V.

** Excludes guaranty assessments.

Source: Ohio Department of Insurance 1992 Annual Report., and unpublished 1992 Franchise and Premium Tax from Ohio Department of Insurance.

Franchise and premium taxes account for approximately 90 percent of total taxes and fees paid by the insurance industry to Ohio. In 1991, the latest year for which detailed information was available, the industry paid \$270.9 million in franchise and premium taxes, plus an additional \$31.7 million in other taxes and fees. Fire marshal tax paid by property and casualty insurers was \$6.3 million, retaliatory taxes paid by foreign insurers was \$3.6 million, miscellaneous taxes were \$2.3 million, and total fees were \$19.4 million in 1991.

Fees collected from the insurance industry have nearly doubled over the five year period. Some insurance fees, such as annual filing fees, are similar to fees imposed on other corporations generally. Insurance guaranty fund assessments to finance unpaid claims from insurer insolvencies fluctuate depending upon need. Banks make similar payments to the Federal Deposit Insurance Corporation to deal with bank insolvencies. Thus, these fees are not included in the burden measure for the insurance industry.

Fire marshal and retaliatory taxes paid to Ohio also were not included in the effective tax rate calculations for the insurance industry. If included, they would increase the effective tax rates by several percentage points. Retaliatory taxes paid by Ohio insurance companies to other states, however, are much more important. Retaliatory taxes and their implications for Ohio-domiciled companies are discussed in the next chapter.

V. RETALIATORY TAXES AND OHIO INSURANCE TAX POLICY

It is often useful to compare the taxes of one's own state to those of other states. In the case of insurance taxes, such comparisons are essential to understand the true burden on the Ohio insurance industry.

Policymakers who regularly work with state and local tax issues frequently compare tax rates imposed in their own state or locality to similar taxes imposed in a neighboring state or district. For example, in considering a one percent increase in the corporate income tax rate, Ohio policymakers would review the taxes on business income in states like Indiana and Pennsylvania. If the difference between the tax rates of two states becomes too great, it can distort business decisions and create incentives for businesses to locate elsewhere.

However, the difference between corporate income tax rates does not affect the amount of taxes which businesses in one state pay to other states. For example, if Ohio increased its tax on corporate income, an Ohio contractor doing business in Ohio and Indiana would pay more tax to Ohio but its tax paid to Indiana would remain unchanged.

The insurance tax structure works differently: Ohio tax rates can and do affect the amount of taxes Ohio insurers pay to other states. In contrast to other more familiar taxes, insurance taxes in forty-nine of the fifty states contain a unique feature called the "retaliatory tax."

Here is how retaliatory taxes work.

Each insurance company has a home state. A company's home state is the state in which it is "domiciled." As already noted, all states levy a tax on the premiums received by a company from business in that state. The rate of tax can differ from state to state. Insurance companies often receive premiums from business in their state of domicile and from business in other states in which they sell insurance. Each insurance company pays the regular (usually premium) tax in all states in which it sells direct insurance. On premiums received

from business in other states, however, it also may be subject to an additional retaliatory tax which in effect makes it pay the higher of the tax rate charged by the other state or the tax rate charged by its home state.

Thus, the retaliatory tax is an extra tax on foreign insurers for the difference between that state's tax rate and the rate charged by the foreign insurer's home state. For example, Ohio levies a 2.5 percent tax rate on premiums. Indiana charges a 2.0 percent rate on premiums of foreign insurers. If an Ohio insurance company sells insurance in Indiana, it must pay the 2.0 percent Indiana insurance tax on premiums earned there, plus it must pay an additional 0.5 percent of those premiums to Indiana in retaliatory taxes. The retaliatory tax represents the difference between the Indiana rate and the Ohio rate.

Therefore, in the case of insurance taxes, it is not merely useful to know about the tax rates of other states; it is absolutely essential. Appendix III shows the premium tax rates for life and property and casualty insurance in 1993 for all 50 states. On the one hand, Ohio will collect additional insurance tax from companies domiciled in states with higher rates than Ohio. On the other hand, insurance companies based in Ohio pay retaliatory taxes to all states with a lower rate than Ohio. The remaining sections of this chapter present important information about Ohio's standing in the retaliatory tax system.

Retaliatory Taxes Collected by Ohio

According to the Ohio Department of Insurance, Ohio collected \$4.3 million in retaliatory taxes from foreign insurance companies in 1990. That amount represents 1.5 percent of total insurance franchise, premium, and fire marshal taxes for that year.

Premium tax rates alone do not determine retaliatory tax burdens, because certain other taxes, fees, or charges enter into the computation of the retaliatory tax. However, a comparison of premium rates gives a general indication of the states whose insurance

companies are likely to pay retaliatory taxes to Ohio. States with premium tax rates in excess of Ohio's 2.5 percent premium tax rate in 1993 are:

- Alabama (4 percent on P&C, 3 percent on life)
- Alaska (2.7 percent)
- Hawaii (4.7 percent on P&C, 2.75 percent on life)
- Idaho (3 percent)
- Kentucky (3.5 percent on P&C only)
- Louisiana (3 percent on P&C only)
- Mississippi (3 percent)
- Montana (2.75 percent)
- Nevada (3.5 percent)
- New Mexico (3.0 percent)
- Texas (3.5 percent on P&C only-but see below)
- West Virginia (3 percent)

With the exception of Texas, these states have relatively small populations, and companies domiciled in these states do not represent a large share of the insurance industry. Moreover, as noted, many property and casualty insurance companies doing business in Texas are able to reduce the effective tax rate to 1.6 percent through investments in Texas securities.

Retaliatory Taxes Paid by Ohio Insurance Companies to Other States

In contrast to the states with higher premium tax rates than Ohio, the states with lower premium tax rates include most major states, as well as most of Ohio's neighbors. Table 8 compares the premium tax rates in ten states plus Ohio. The states shown include the largest eight states plus the border states of Indiana and Kentucky and the major insurance industry state of Connecticut.

Table 8

**INSURANCE PREMIUM TAX RATES IN MAJOR STATES
1993**

Premium Tax Rate on Foreign Insurers

	<u>Life</u>	<u>P & C</u>
California	2.35 %	2.35 %
Connecticut	2.0	2.0
Florida	1.75	1.75
Illinois	2.0	2.0
Indiana	2.0	2.0
Kentucky	2.0	3.5
Michigan	1.33	1.33
New York	0.8	1.2
Pennsylvania	2.0	2.0
Texas	2.1	3.5
Ohio	2.5	2.5

The rates shown above do not tell the whole story. As discussed earlier, retaliatory taxes are more complicated than simply comparing premium tax rates, since the calculations also include fees and other burdens. Moreover, different bases and credits can be involved. For example, Michigan imposes a single business tax rather than a premium tax. New York taxes the net income of insurance companies in addition to its tax on premiums. However, the sum of the two New York taxes cannot exceed 2.6 percent of premiums written.

Even after taking these modifications into account, it is clear that Ohio's tax rate on premiums is one of, if not, the highest among the large states.

Thus, while differences do exist in the details of the methods used in the various states, the bases remain comparable enough from state to state to justify a comparison of premium tax rates. Such a comparison shows Ohio is very near, if not at, the top in premium tax rates among the largest and most comparable states and strongly suggests that Ohio insurance companies doing business outside of Ohio incur substantial retaliatory tax burdens.

Data on Ohio Companies' Retaliatory Tax Burden

Factual information and estimates developed in preparing this report confirm the expectation that Ohio companies pay substantial amounts of retaliatory taxes. Using a simple economic model of retaliatory taxes based on premium tax rates and business sold by Ohio companies in other states, Ohio companies are estimated to have paid approximately \$50 million in total retaliatory taxes to other states in 1990. Approximately \$40 million of these retaliatory taxes were paid by property and casualty insurance companies and approximately \$9 million by life and health insurance companies.

These estimates are supported by the empirical information developed in limited surveys of Ohio domiciled companies by the two trade associations. The surveys asked the companies to report their actual retaliatory tax payments to other states in 1990.

Twenty-two Ohio domiciled P&C companies that paid almost one-half of the Ohio insurance taxes paid by such companies reported retaliatory tax payments of \$23 million to other states in 1990. Fifteen Ohio domiciled life insurance companies that paid 82 percent of the Ohio taxes paid by such companies reported retaliatory tax payments of \$6.5 million to other states in 1990.

Retaliatory taxes are a significant portion of total insurance tax payments for Ohio domiciled companies.

Implications of Retaliatory Taxation for Ohio

Ohio insurance companies pay far more in retaliatory taxes to other states than Ohio collects in retaliatory taxes from foreign insurance companies. Chart 3 shows a graphic comparison between the retaliatory taxes paid by Ohio companies to other states and the retaliatory taxes collected by Ohio.

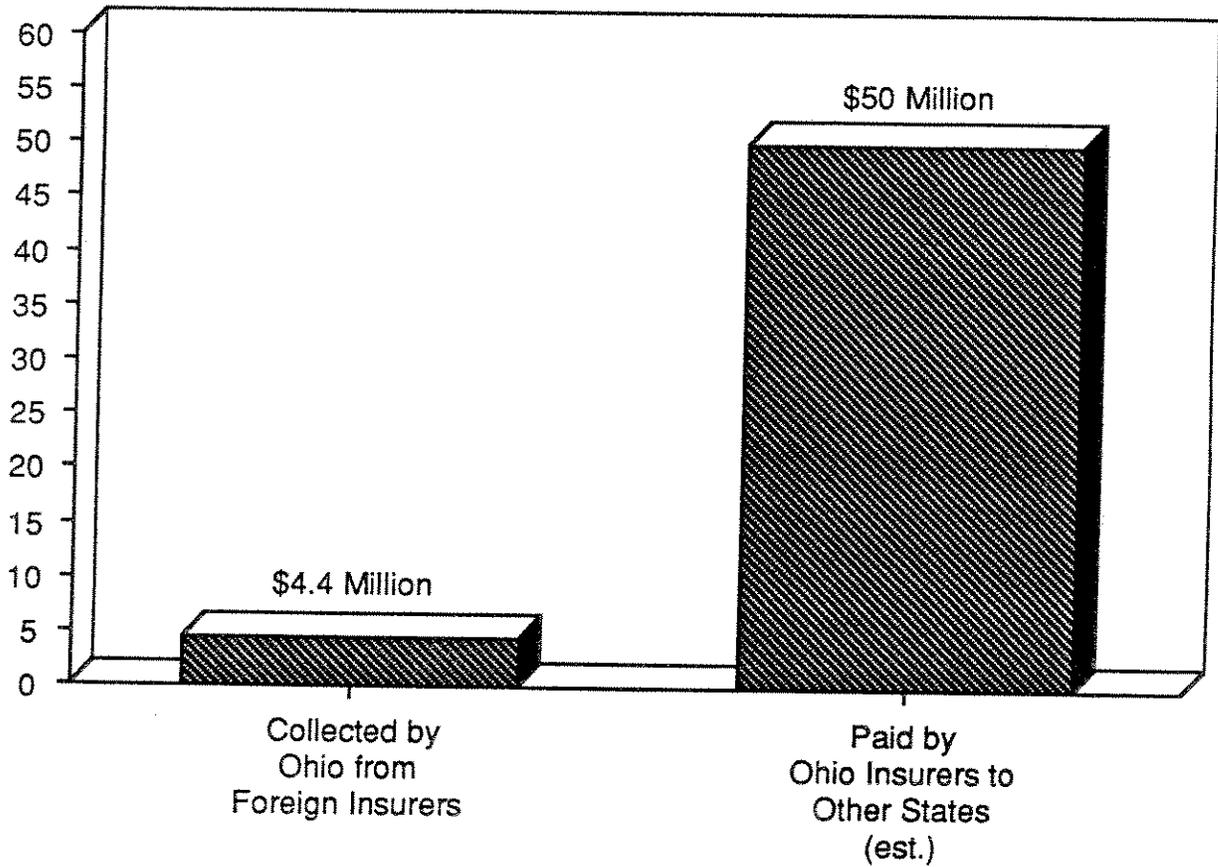
The chart shows that Ohio companies pay an estimated ten times more in retaliatory taxes to other states than Ohio gains from retaliatory tax collections.

However, the effects of the retaliatory tax system go beyond the net revenue outflow to other states shown in the chart. Adding retaliatory taxes paid by Ohio domiciled companies to other states, increases the Ohio effective tax rate on insurance companies from 19.6 percent to 23.7 percent on statutory net income in 1990. Using the broader measure of income, retaliatory taxes paid by Ohio companies to other states increase the effective tax rate from 16.6 percent to 20.1 percent in 1990.

Some analysts, accustomed to working with other kinds of taxes, might argue that taxes paid to other states should not be included in the computation of the Ohio tax burden. In most cases this makes sense. In the case of insurance taxes, the usual approach breaks down. As described earlier, through the retaliatory tax every state but Hawaii uses the tax rates of other states to determine final tax burdens on foreign insurers. A direct cause and effect relationship exists between the Ohio premium tax rate and the taxes paid by Ohio companies to other states. Because the Ohio tax rate directly affects the amount of retaliatory taxes paid by Ohio companies to other states, such taxes justifiably can be counted as part of the Ohio tax burden on these companies.

Chart 3 Comparison of Retaliatory Taxes Collected by Ohio and Estimated Retaliatory Taxes Paid to Other States 1990

\$ Millions



Source: Price Waterhouse

As a practical matter, the retaliatory taxes are a part of the burden of Ohio taxes because they impose a competitive disadvantage on Ohio companies selling policies in a national insurance market. Ohio insurers must pay an additional tax, not paid by their competitors, in four out of five neighboring states, and in most of the large states where the market is concentrated. It is likely that Ohio companies must absorb this additional burden in the form of lower profits or reduced sales. In this way, the retaliatory tax burden paid by Ohio companies to other states reduces the insurance written by Ohio companies in other states and in turn reduces investment and employment by Ohio domiciled companies.

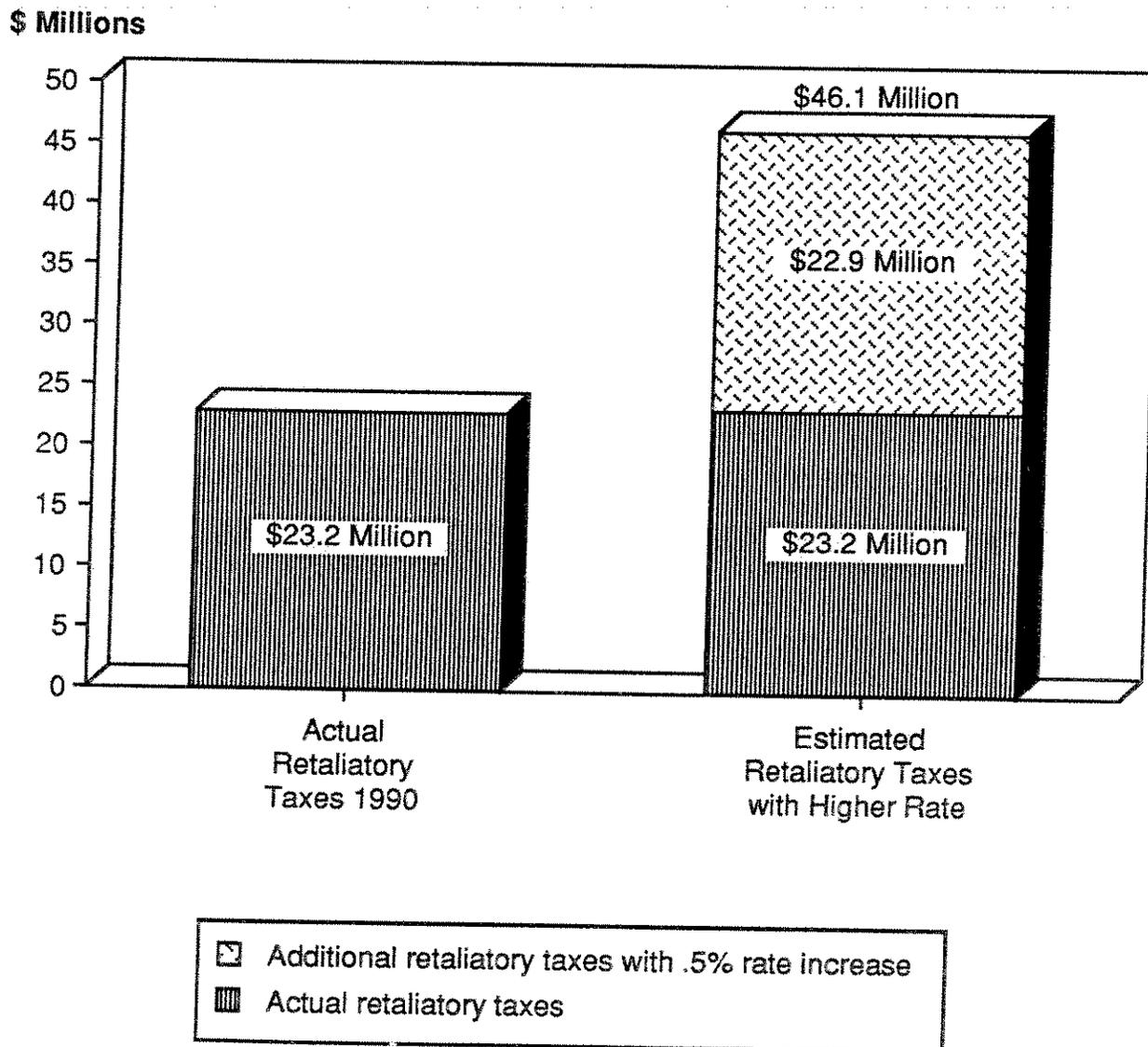
Consequences of Increasing Ohio Premium Taxes

The imbalance between retaliatory taxes collected by Ohio and retaliatory taxes paid by Ohio companies is a direct result of Ohio's high premium tax rate and fees compared to the rates of other states. Any increase in Ohio's rate or fees would place Ohio in an even more extreme position in this regard. As a result, Ohio would collect even fewer retaliatory tax dollars, and Ohio companies' tax burdens would increase.

Because Ohio already occupies a position at the high end of existing premium tax rates, any additional increase in the premium rate or fees would result in higher retaliatory tax payments to other states. Indeed Ohio's existing rate is so high that a higher tax rate would increase the current retaliatory taxes paid to other states plus would result in retaliatory taxes on premiums in additional states. For example, Chart 4 shows the estimated effect on 22 Ohio domiciled P&C companies if Ohio were to increase its premium tax rate from 2.5 percent to 3 percent, which would represent a 20 percent increase in the rate. In 1990, the 22 companies paid \$23 million in retaliatory taxes. The chart assumes that the full impact of a one-half per cent increment in Ohio's tax rate would apply to premiums received only in those states where the company already owed retaliatory taxes in 1990. Thus, the chart conservatively ignores the possibility that an additional one-half per cent tax would cause

Chart 4

Estimated Impact of a One-half Percent Increase in the Premium Tax Rate on a Sample of 22 Ohio-Domiciled P&C Companies



Source: Price Waterhouse

some Ohio companies to pay retaliatory taxes in states where no such taxes were due in 1990. Even so, the chart shows that a one-half per cent rate increase would cause these Ohio companies' retaliatory taxes paid to other states to almost double from \$23.2 million to over \$46 million.

Conclusion

It is impossible to comprehend Ohio's insurance tax system without understanding retaliatory taxes. Retaliatory taxes are a unique and fundamental aspect of the insurance tax. Given Ohio's high position among the other states in terms of its taxes, assessments and fees, retaliatory taxes constitute a significant portion of the total insurance tax burden carried by Ohio insurance companies. This burden results directly from Ohio's relatively high premium tax rate.

APPENDIX I
DESCRIPTION OF BROADER MEASURE OF
PRE-TAX INSURANCE INCOME

Four adjustments were made to statutory net income to calculate the broader measure of pre-tax income based on federal income tax law provisions.

Adjustment for statutory and tax reserve differences. The largest adjustment is for the difference between reserve deductions allowed for annual statement purposes and reserve deductions allowed for federal income tax purposes. Estimates of these differences were based on information about the effect of the federal tax law changes for life insurance reserves in 1984 and changes for property and casualty insurance reserves in 1986. Information from industry surveys and federal government estimates were used. For growing companies, the discounting of loss reserves results in a positive adjustment to net statutory income.

The adjustment for reserve deductions for the companies doing business in Ohio ranged from \$84 million to \$139 million between 1987 to 1992.

Adjustment for deferred acquisition costs. Under the Tax Reform Act of 1986, 20 percent of the increase in the unearned premium reserve for property and casualty insurance companies is deferred for federal income tax purposes. In the 1990 Omnibus Reconciliation Act, policy acquisition expenses of life insurance companies must be capitalized and amortized in future years. Life insurance policy acquisitions expenses are determined as a percentage of net premiums. In both cases, the federal tax law change was intended as a rough proxy for deferred acquisition expenses.

The adjustment for purposes of this study follows the federal tax rule. The P&C industry adjustment is based on the average industry relationship between increases in unearned premium reserves and total premiums written, while the life insurance industry adjustment is based on a discounted present value of the capitalization and amortization of a percentage of premiums. Although the federal rules for life insurance company acquisitions costs were not in effect before 1990, their fully-phased-in impact was estimated for each year. The adjustment ranges from \$29 million to \$95 million.

Adjustment for the lower yield on tax-exempt bonds. An adjustment was made for the reduced yield on state and local government bonds that are exempt from federal income tax. Tax-exempt bonds generally have yielded 13-33 percent less than comparable Treasury bonds, depending on the maturity of the bond between 1987-1992.

The adjustment adds an estimate of the amount of pre-tax interest income that insurance companies could have earned if they had invested their tax-exempt bonds in fully-taxable securities. A company typically invests in tax-exempt bonds despite the lower yield because they provide a higher after-tax return. (A similar adjustment is made for banks but not for the other comparison industries.)

The estimate of the additional income had the industry invested in taxable instead of tax-exempt bonds is based on the comparable Treasury yield applied to the industry's tax-exempt bond holdings by maturity in each of the years. The adjustment adds approximately \$70 million annually.

Adjustment for federal imputed mutual life insurance income - Federal income tax rules require mutual life insurance companies to disallow a portion of their life insurance policyholder dividend deductions. The disallowance is based on the mutual company's equity base (capital and surplus plus certain additional items) multiplied by a complicated formula that relates the average mutual life insurance rate of return on equity to that of large stock

life insurers. The imputed income adjustment is \$132 million in 1987, zero in 1989 and 1991, and \$16, \$17, and \$91 million in 1988, 1990, and 1992, respectively.

State and local income taxes paid by insurance companies would be a possible adjustment to statutory net income, but the data were not available from the annual statement information.

Total Adjustments. Table 9 presents the components of adjusted pre-tax income, apportioned to Ohio by premiums. The adjustments add \$211 million to \$387 million annually to statutory income, averaging 24 percent of statutory income between 1987 to 1992. Adjusted pre-tax Ohio income for the insurance industry ranges from \$1.0 to 1.6 billion annually.

Table 9

**STATUTORY NET INCOME AND ADJUSTED PRETAX INCOME
OF THE OHIO INSURANCE INDUSTRY, 1987-92**
(Millions)

	1987	1988	1989	1990	1991	1992
Annual statutory pre-tax income	654	1204	1358	1243	1360	1183
+ Adjustment for gross-up of tax-exempt income	55	79	70	77	75	64
+ Adjustment for deferred acquisition expenses	65	32	29	40	95	94
+ Adjustment for Federal tax reserve deductions	108	84	117	84	115	139
+ Adjustment for Federal mutual life imputed income	132	16	0	17	0	91
Adjusted pre-tax income	1015	1414	1575	1462	1646	1570
Difference between statutory and adjusted pre-tax income	361	211	217	218	286	387
Ratio of adjusted pretax to statutory income	155%	117%	116%	118%	121%	133%

Source: A.M. Best Company, Inc. databases, Price Waterhouse compilation and calculations.

APPENDIX II

DESCRIPTION OF EFFECTIVE TAX RATE CALCULATION FOR COMPARISON INDUSTRIES

The effective tax rates for the six comparison industries subject to Ohio corporate franchise tax were estimated through use of the Price Waterhouse Business Tax Model. Table 10 presents the effective tax rate calculation for representative firms with \$100 million of assets (at 1987 levels) in the comparison industries for each year.

The steps involved in using the model for the comparison industries are straight-forward. The calculation of effective tax rates for the five non-financial comparison industries is presented in a step-by-step fashion and is illustrated with a numerical example of the calculation of effective tax rates for a representative firm in 1987 and 1988. The example is followed by a description of the calculation of effective tax rates for commercial banks in Ohio.

Description of Non-Financial Industries' Effective Tax Rates

Step One: Actual data is used to develop financial profiles for representative firms in each comparison industry. The primary data source for the three manufacturing industries and the retail trade industry is the Bureau of Census, Quarterly Financial Reports (QFR). The QFR provides balance sheet and income statement data for a sample of over 7,300 manufacturing firms and approximately 700 retail trade firms from 1987 to 1992. The financial statements of the representative firms in each industry provide the average financial ratios for the firms included in the QFR sample.

TABLE 10
Effective Ohio Franchise Tax Rates for Comparison Industries: 1987-1992
(per \$100 million of 1987 U.S. Assets)

ELECTRONICS

<i>Year</i>	<i>Ohio Pretax Income (000)</i>	<i>Ohio Franchise Tax (000)</i>	<i>Effective Franchise Tax Rate</i>
1987	\$393	\$21	5.3%
1988	535	28	5.2%
1989	429	22	5.1%
1990	353	21	5.0%
1991	245	17	6.9%
1992	374	19	5.0%
6-Year Average:	388	21	5.5%

FOOD PROCESSING

<i>Year</i>	<i>Ohio Pretax Income (000)</i>	<i>Ohio Franchise Tax (000)</i>	<i>Effective Franchise Tax Rate</i>
1987	\$471	\$25	5.4%
1988	615	33	5.3%
1989	503	26	5.2%
1990	512	27	5.2%
1991	553	27	4.8%
1992	538	25	4.7%
6-Year Average:	532	27	5.1%

SCIENTIFIC INSTRUMENTS

<i>Year</i>	<i>Ohio Pretax Income (000)</i>	<i>Ohio Franchise Tax (000)</i>	<i>Effective Franchise Tax Rate</i>
1987	\$506	\$44	8.7%
1988	582	50	8.6%
1989	543	47	8.6%
1990	626	54	8.6%
1991	577	46	8.0%
1992	464	35	7.6%
6-Year Average:	550	46	8.4%

TABLE 10 (Continued)
Effective Ohio Franchise Tax Rates for Comparison Industries: 1987-1992
(per \$100 million of 1987 U.S. Assets)

RETAIL TRADE

<i>Year</i>	<i>Ohio Pretax Income (000)</i>	<i>Ohio Franchise Tax (000)</i>	<i>Effective Franchise Tax Rate</i>
1987	\$312	\$18	5.8%
1988	263	14	5.3%
1989	292	16	5.4%
1990	204	10	5.1%
1991	211	10	4.6%
1992	184	12	6.3%
6-Year Average:	244	13	5.4%

COMPUTER AND DATA PROCESSING SERVICES

<i>Year</i>	<i>Ohio Pretax Income (000)</i>	<i>Ohio Franchise Tax (000)</i>	<i>Effective Franchise Tax Rate</i>
1987	\$303	\$11	3.6%
1988	348	12	3.3%
1989	310	11	3.5%
1990	352	12	3.3%
1991	486	12	2.5%
1992	508	15	3.0%
6-Year Average:	385	12	3.2%

TABLE 10 (Continued)
Effective Ohio Franchise Tax Rates for Comparison Industries: 1987-1992
(per \$100 million of 1987 Ohio Assets)*

BANKING (Statutory Pretax Income)

<i>Year</i>	<i>Ohio Pretax Income (000)</i>	<i>Ohio Franchise Tax (000)</i>	<i>Effective Franchise Tax Rate</i>
1987	\$1,101	\$101	9.2%
1988	1,508	109	7.3%
1989	1,575	118	7.5%
1990	1,307	123	9.4%
1991	1,640	133	8.1%
1992	2,501	151	6.0%
6-Year Average:	1,605	123	7.6%

BANKING (Adjusted Pretax Income)

<i>Year</i>	<i>Ohio Pretax Income (000)</i>	<i>Ohio Franchise Tax (000)</i>	<i>Effective Franchise Tax Rate</i>
1987	\$1,658	\$101	6.1%
1988	1,811	109	6.0%
1989	1,930	118	6.1%
1990	1,900	123	6.5%
1991	2,172	133	6.1%
1992	2,927	151	5.2%
6-Year Average:	2,066	123	5.9%

* Unlike other comparison industries, Ohio assets are used for Banking sector.
 Note: Effective tax rate is franchise tax liability divided by Ohio pretax income.
 Source: Price Waterhouse.

The primary data sources for the computer and data processing services industry is the Bureau of Census, Service Annual Survey (SAS) and Standard & Poor's Compustat database. The SAS provides total business receipt data for service industries based on an extensive sample of service firms. The Compustat database contains complete income statement and balance sheet information for approximately five hundred U.S. computer and data processing service firms. A complete income statement and balance sheet for the industry was constructed by calculating, for each year, the ratio of each financial statement data item to total business receipts in the Compustat sample and applying those ratios to the estimate of total business receipts for the industry which is taken directly from the SAS.

Step Two: Pre-tax income is taken from the income statement of each representative firm. The income concept from the financial statement is generally a better approximation of pre-tax income than is taxable income and is consistent across the six-years.

Step Three: Pre-tax income for each representative firm is apportioned based upon the Ohio share of sales, property and payroll, for each industry, consistent with the three-factor Ohio apportionment formula with sales double-weighted. Since data on property by state is unavailable, payroll is used as a proxy for that factor.

Step Four: Taxable income is calculated by analyzing book-tax income ratios for a set of firms within each of the comparison industries. This analysis uses tax expense information from the QFR, and the Internal Revenue Service's Statistics of Income (SOI) Corporate Sourcebook. For example, differences between book and taxable income can arise due to different depreciation methods used for tax purposes and financial statement purposes. The sampling differences between the QFR and SOI are controlled by calculating the ratio of taxable income to assets for each industry using both the SOI and the QFR data. The SOI ratio is divided by the QFR ratio to obtain the relationship between taxable income and book income. The relationship between book and taxable income varies across industry and from year-to-year reflecting the impact of corporate tax laws.

Step Five: Apportioned taxable income is then adjusted to incorporate the adjustment of federal depreciation deductions to conform with Ohio tax law. In response to acceleration of federal depreciation deduction in 1981 under ACRS, Ohio implemented a depreciation adjustment, effectively delaying the federal depreciation acceleration for state tax purposes. Under this adjustment, a portion of the current year's depreciation deduction was "added back" to Ohio taxable income. A specified percentage of the "add back" could then be claimed as a deduction in subsequent years. The depreciation adjustment was phased out completely in 1993.

Because federal depreciation deductions vary by year across industries, and because the current year "add back" is netted against deductions of a portion of previous years' "add backs", the adjustment may either increase or decrease Ohio taxable income in relation to apportioned federal taxable income. There is, however, a tendency for the depreciation adjustment to raise Ohio taxable income in the early years it is in effect and to decrease Ohio taxable income in later years, particularly in 1991 and 1992. The Internal Revenue Service's Statistics of Income Corporate Sourcebook is the source for federal depreciation deductions for the comparison industries.

Step Six: Annual corporate franchise tax liability is calculated on the income basis for the representative firms by applying the statutory franchise income tax rates to apportioned taxable income.

Step Seven: Net value of stock (capital stock, retained earnings, deferred taxes and reserves, less certain exempted assets such as goodwill) is calculated from the balance sheet of each representative firm.

Step Eight: Taxable value is calculated by apportioning total net value of stock based upon the Ohio share of sales and property, for each industry, consistent with the three-factor Ohio

apportionment formula. Since data on property by state is unavailable, payroll is used as a proxy for that factor.

Step Nine: Annual corporate franchise tax liability is calculated on the net worth basis for the representative firms by applying the statutory franchise net worth tax rate to Ohio taxable value.

Step Ten: The amount of franchise tax due is determined by the greater of franchise tax liability calculated on net income and net worth bases.

Step Eleven: Annual corporate litter tax (tier one) liability is calculated on the income basis for the representative firms by applying the statutory litter value tax rates to apportioned taxable income.

Step Twelve: Annual corporate litter tax (tier one) liability is calculated on the net worth basis for the representative firms by applying the statutory litter net worth tax rate to Ohio taxable value.³

Step Thirteen: The amount of litter tax due is determined by the greater of litter tax liability calculated on net income and net worth bases.

Step Fourteen: Annual franchise and litter tax liabilities are added together and divided by apportioned pre-tax income to calculate effective tax rates.

³Establishments producing or selling "litter stream" products (the food processing industry and certain retail establishments) are subject to an additional tier two litter tax. This tax is again the greater of tax liability calculated by applying a statutory income tax rate to income over twenty-five thousand dollars (fifty thousand in 1988 and subsequent years) and applying a statutory net worth tax rate to Ohio taxable value.

The effective tax rates can fluctuate from year to year if there is a switch in the tax calculation from income to net worth basis, or vice versa. Firms in some industries experienced a change in tax computation from income to net worth basis as the depreciation deductions disallowed in the earlier years were "added back" in 1991 and 1992, thus lowering taxable income substantially

Example of Calculation of Effective Tax Rates for Non-Financial Industries

The following example provides an illustration of how effective tax rates have been calculated for each of the nonfinancial comparison industries. This example is the representative firm in the electronics industry. The representative firm is assumed to have \$100 million of total assets in 1987. The calculations are shown for 1987 and 1988.

	(Thousands of Dollars)	
	<u>1987</u>	<u>1988</u>
1. Total U.S. assets of the representative firm are assumed to be \$100 million in 1987. Growth in assets to 1988 is based upon actual data from the Quarterly Financial Reports (QFR).	100,000	110,170
2. In order to calculate Ohio franchise tax liability on a net income basis, the ratio of U.S. pre-tax net income to total assets is taken from the QFR income statement.	7,047	9,028
3. U.S. pre-tax income is apportioned to Ohio using the Ohio share of U.S. sales, property, and payroll, for each industry, consistent with the Ohio apportionment formula. Because property by state is unavailable, payroll is used as a proxy for that factor.	393	535
4. Ohio taxable income is calculated by applying the ratio of book-to-tax income to the pre-tax income amount from Step 3. The source of the book-tax income ratio is the Quarterly Financial Reports and the Internal Revenue Service's Statistics of Income <u>Corporate Sourcebook</u> for each comparison industry.	240	327

(Thousands of Dollars)

	<u>1987</u>	<u>1988</u>
5. Ohio taxable income is adjusted to incorporate the adjustment of federal depreciation deductions to conform with Ohio tax law. The source of federal depreciation deductions for each comparison industry is the Internal Revenue Service's Statistics of Income <u>Corporate Sourcebook</u> .	240	326
6. The statutory franchise income tax rate of 5.1 percent is applied to the first twenty-five thousand dollar (fifty thousand in 1988 and subsequent years) of apportioned taxable income from Step 4. A statutory franchise income tax rate of 8.9 percent is applied to the remainder of apportioned taxable income.	20	27
7. In order to calculate Ohio franchise and litter tax liability on a net worth basis, the ratio of net value of stock (capital stock, retained earnings, deferred taxes and reserves, less certain exempted) to total assets is taken from the QFR balance sheet.	48,119	52,003
8. Ohio taxable value is calculated by apportioning total net value of stock to Ohio using the Ohio share of U.S. sales and property, for each industry, consistent with the Ohio apportionment formula. Because property by state is unavailable, payroll is used as a proxy for that factor.	2,684	3,080
9. The statutory franchise net worth tax rate of 0.582 percent is applied to Ohio taxable value from Step 8.	16	18
10. The amount of franchise tax due is the greater of franchise tax liability calculated on income (Step 6) and net worth (Step 9) bases.	20	27
11. The statutory tier one litter income tax rate of 0.11 percent is applied to the first twenty-five thousand dollars (fifty thousand in 1988 and subsequent years) of apportioned taxable income from Step 4. A statutory tier one litter income tax rate of 0.22 percent is applied to the remainder of apportioned taxable income.	1	1

(Thousands of Dollars)

	<u>1987</u>	<u>1988</u>
12. The statutory tier one litter net worth tax rate of 0.014 percent is applied to Ohio taxable value from Step 8.	*	*
13. The amount of tier one litter tax due is the greater of tier one litter tax liability calculated under net income (Step 11) and net worth (Step 12) bases.	1	1
14. Effective rates are calculated by dividing total franchise and litter tax liability (sum of steps 10 and 13) by Ohio pre-tax income (step 3).	5.3%	5.2%

* Less than \$500

Description of Commercial Banking Industry Effective Tax Rate

The commercial banking industry's effective tax rate was calculated using data from the Federal Deposit Insurance Corporation's Call Report Aggregation Tables and Statistics on Banking for insured commercial banks domiciled in Ohio.

Financial institution franchise tax liability is calculated solely on a net worth basis. The statutory franchise tax rate of 1.5 percent is applied to Ohio taxable value (capital stock, depositors' ownership interest, retained earnings, deferred taxes and reserves, less certain exempted assets such as goodwill and abandoned property). Financial institutions are not subject to the Ohio litter tax.

The effective tax rate calculation is constructed with two measures of pre-tax income for banks. One measure is pre-tax net income as reported for regulatory purposes, without adjustments. The alternative measure reflects three adjustments: (1) the lower yield earned on tax-exempt bonds; (2) the difference between the provision for bad debts and actual net chargeoffs on bad loans; and (3) the estimated franchise tax liability.

The use of aggregate data rather than individual company call reports places some limitations on the effective tax rate calculations. Data are not available on the apportionment of interstate business activity, causing an overstatement of both the income and net worth (assets) attributable to Ohio. These factors tend to have offsetting effects and hence result in only a negligible impact on the effective tax rate calculation.

Appendix III

TABLE 11
SUMMARY OF STATE INSURANCE PREMIUM TAXATION, 1993 1/

States	Premium Tax Rates 2/	
	Life	P&C
Alabama 3/	3.0	4.0
Alaska	2.7	2.7
Arizona	2.0	2.0
Arkansas	2.5	2.5
California	2.35	2.35
Colorado 3/	2.25	2.25
Connecticut	2.0	2.0
Delaware	2.0	2.0
District of Columbia	2.25	2.25
Florida	1.75	1.75
Georgia	2.25	2.25
Hawaii 3/	2.75	4.7
Idaho	3.0	3.0
Illinois 3/	2.0	2.0
Indiana 3/	2.0	2.0
Iowa	2.0	2.0
Kansas 3/	2.0	2.0
Kentucky 3/	2.0	3.5
Louisiana	2.25	3.0
Maine	2.0	2.0
Maryland	2.0	2.0
Massachusetts	2.0	2.28
Michigan 4/	1.33	1.33
Minnesota	2.0	2.0
Mississippi	3.0	3.0
Missouri	2.0	2.0
Montana	2.75	2.75
Nebraska	1.0	1.0
Nevada	3.5	3.5
New Hampshire	2.0	2.0
New Jersey	2.1	2.1
New Mexico	3.0	3.0
New York 4/	0.8	1.3
North Carolina	1.9	1.9
North Dakota	2.0	1.75
Ohio 3/ 4/	2.5	2.5
Oklahoma	2.25	2.25
Oregon 3/	2.25	2.25
Pennsylvania	2.0	2.0
Rhode Island	2.0	2.0
South Carolina	0.75	1.25
South Dakota	2.5	2.5
Tennessee 3/	2.0	2.50
Texas 4/	2.1	3.5
Utah	2.25	2.25
Vermont	2.0	2.0
Virginia	2.25	2.25
Washington	2.0	2.0
West Virginia	3.0	3.0
Wisconsin 3/	2.0	2.0
Wyoming	1.2	1.2

Source: Commerce Clearing House, State Tax Reporter, Various Issues.

- 1/ Insurance companies may also be subject to income or franchise taxes, which may be creditable against premium taxes or vice versa. Certain credits may reduce statutory tax rates.
- 2/ Rate applicable to foreign insurers, and domestic insurers unless otherwise noted. Differential rates may apply to specific products.
- 3/ Lower premium tax rate for domestic insurers.
- 4/ Michigan's Single Business Tax taxes gross receipts, including premiums. New York limits combined premium and franchise tax to 2.6% of premiums. Ohio insurers have option of foreign premium tax rate or capital and surplus tax. Texas investment tax credits can reduce statutory rate to 1.6 percent.