OPINION NO. 2007-017

Syllabus:

The Superintendent of Insurance has the authority to use the amount of ''direct premiums written'' on risks covered in Ohio, as reported on Schedule T of the Annual Statement by insurance companies filing a ''National Association of Insurance Commissioners Property and Casualty Companies—Association Edition annual statement,'' as the basis upon which to calculate the franchise tax imposed on these types of insurance companies under R.C. 5725.18 or R.C. 5729.03.

To: Mary Jo Hudson, Director, Ohio Department of Insurance, Columbus, Ohio
By: Marc Dann, Attorney General, June 19, 2007

Your predecessor has asked about the proper basis for calculating the annual franchise or ''premium'' tax imposed on domestic insurance companies, specifically insurance companies that file a ''National Association of Insurance Commissioners Property and Casualty Companies—Association Edition annual statement,'' hereinafter referred to, for ease of reference, as ''property and casualty insurance companies.''

We begin with a brief description of the premium tax and the ''annual statement'' that insurance companies are required to file showing the condition of their finances, which provides the information upon which the premium tax is based. We then will discuss the form that an annual statement must take.

Premium Tax

Each domestic insurance company is subject to an annual franchise tax ''on the privilege of being an insurance company.'' R.C. 5725.18(A).[1] The amount of the tax is computed as a percentage of the ''gross amount of premiums received

[1] R.C. 5725.18(A) reads in pertinent part:

> An annual franchise tax on the privilege of being an insurance company is hereby levied on each domestic insurance company. In the month of May, annually, the treasurer of state shall charge for collection from each domestic insurance company a franchise tax in the amount computed in accordance with the following, as applicable.... (2) ... one and four-tenths per cent of the gross amount of premiums received from policies covering risks within this state ... as reflected in its annual statement for the preceding calendar year.

from policies covering risks within this state ... as reflected in [the insurance company's] annual statement for the preceding calendar year.'' R.C. 5725.18(A)(2). Domestic insurance companies are entitled to the deductions afforded foreign insurance companies, which are also subject to a premium tax based on the gross amount of premiums received.[2] R.C. 5725.18(B). These deductions are for ''return premiums and considerations received for reinsurance,'' as described below. R.C. 5729.03(A). Taxes levied against domestic insurance companies under R.C. 5725.18 are paid into the state treasury to the credit of the general revenue fund. R.C. 5725.24(B).

Annual Statements

As set forth above, the premium tax is based on the ''gross amount of premiums received,'' as reported on the company's ''annual statement.'' R.C. 5725.18(A)(2). Each domestic insurance company and foreign insurance company doing business in the state is required to prepare and file with the Superintendent of Insurance,[3] within the first sixty days of each year, a statement of the company's

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R.C. 5725.18 makes special provision for insurance companies that are health insuring corporations and insurance companies that are not a health insuring corporation but operate a health insuring corporation as a line of business. *See* R.C. 1751.40. These provisions are not at issue in this opinion.

[2] R.C. 5729.02 reads in pertinent part:

> Every foreign insurance company shall set forth in its annual statement to the superintendent of insurance the gross amount of premiums received by it from policies covering risks within this state during the preceding calendar year, less return premiums paid for cancellations and considerations received for reinsurance of risks within this state, provided that dividends paid or otherwise allowed to policyholders shall not be deducted except as provided in section 5729.04 of the Revised Code.

R.C. 5729.03 reads in pertinent part:

> If the superintendent of insurance finds the annual statement required by [R.C. 5729.02] to be correct, the superintendent shall compute the following amount ... of the balance of such gross amount, after deducting such return premiums and considerations received for reinsurance, and charge such amount to such company as a tax upon the business done by it in this state for the period covered by such annual statement.... (2) ... one and four-tenths percent of the balance of premiums received ... as reflected in its annual statement.

[3] The Superintendent of Insurance is also known as the Director of the Department of Insurance. R.C. 3901.011. We will use the title, ''Superintendent,'' throughout the opinion, since it is the term used in Title 39 of the Revised Code.

condition as of December 31st of the preceding year. R.C. 3929.30.[4] This statement must show the amount of the company's capital stock, and the company's assets, liabilities, income, and expenditures during the preceding year. *Id.* A company that fails to make the statement required by R.C. 3929.30 is subject to a monetary forfeiture. R.C. 3929.32.

Forms for Filing Annual Statements

R.C. 3929.30 explicitly requires that the annual statement of an insurance company's condition be ''submitted on the forms adopted by the superintendent pursuant to section 3901.77 of the Revised Code.'' Under R.C. 3901.77, the Superintendent has the responsibility to prescribe the forms on which the annual statement required by R.C. 3929.30 and other statutorily required reports are to be made, but ''shall adopt the forms, instructions, and manuals prescribed by the national association of insurance commissioners, for the preparation and filing of statutory financial statements and other financial information.'' R.C. 3901.77(A). The Superintendent may, however, adopt by rule ''modifications to the prescribed forms, instructions, and manuals as the superintendent considers necessary.'' *Id.* Also, the Superintendent may ''determine accounting practices and methods for purposes of preparing statutory financial statements and other financial information,'' ''[f]or circumstances not addressed by the forms, instructions, and manuals prescribed by the national association of insurance commissioners.'' R.C. 3901.77(B).

Issue Presented

R.C. 5725.18 requires that the premium tax be measured by the gross amount of premiums received, as reflected in a company's annual statement, and as discussed above, the Superintendent is required to adopt the forms for the annual statement that are prescribed by the National Association of Insurance Commissioners (NAIC). The forms that have been adopted by the NAIC for filing annual statements, however, do not include a place for insurance companies to report the ''gross amount of premiums received,'' either as a total, or on a state-by-state basis. Your predecessor indicated that the dollar amount reported on the NAIC's form that most closely approximates ''premiums received'' is ''premiums written,'' and the

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[4] *See also* R.C. 3927.08 (a foreign insurance company other than a life insurance company ''annually, at the time and in the form and manner required of similar companies organized under the laws of this state, shall file a statement of its condition and affairs in the office of the superintendent of insurance''); R.C. 3929.301 (each property and casualty insurer that has ''annual total direct premiums written in this state of five million dollars or more'' must report specified financial information, including ''direct premiums written'' and ''direct premiums earned,'' ''for each line of insurance written in this state for the previous calendar year'').

Superintendent calculates the tax based on ''premiums written,'' as reported in the annual financial statement on Schedule ''T.''[5]

A property and casualty insurance company has challenged this basis of calculating the premium tax. The company argues that a distinction exists between ''premiums written'' and ''premiums received,'' and that R.C. 5725.18 requires that the tax be calculated based on ''premiums received.'' The company contends that the amount of ''premiums written'' represents the total amount of premiums due from the insured over a complete billing cycle, and that, because accounting practices mandate that premiums be recorded on the effective date of the policy, the amount reported on the annual financial statement as ''premiums written'' overstates the company's premium receipts because not all of the premiums written are actually received. For example, some policyholders let their policies lapse for non-payment once they have presented proof of insurance to the Ohio Bureau of Motor Vehicles.

A resolution of this question thus requires us to examine more closely the relationship between the meaning of the statutory language, ''gross amount of premiums received'' and the manner in which property and casualty insurance companies are required to prepare and file their annual statements.

''Gross amount of premiums received''

Although the language, ''gross amount of premiums received,'' has been a part of Ohio's tax code since the late 1800's for foreign insurance companies, and 1933 for domestic insurance companies,[6] it has never been statutorily defined, and has been the subject of interpretation in only one Ohio judicial decision of which we are aware, *State ex rel. Northwestern Mutual Life Insurance Co. v. Tomlinson*, 99 Ohio St. 233, 124 N.E. 220 (1919).

In *Tomlinson*, the Ohio Supreme Court was faced with the issue whether a foreign mutual insurance company could deduct from gross premiums received the amount of dividends it paid to policyholders. The court observed that, ''[t]he question as to the meaning of the term 'gross amount of premiums received' is not a new one in the courts of the United States, nor in the courts of many of the states,[7] but has never been settled in Ohio;'' furthermore, ''[t]he weight of authority, both in the federal courts and the state courts other than Ohio, is in accord with the ... the-

[5] Again, we are discussing only insurance companies that file a ''National Association of Insurance Commissioners Property and Casualty Companies—Association Edition annual statement.''

[6] *See* 1888 Ohio Laws 183 (H.B. 458, eff. Dec. 31, 1888) (foreign insurance companies); 1933 Ohio Laws 548, 576-77 (Am. S.B. 30, filed July 20, 1933) (domestic insurance companies).

[7] In 1935, the Tennessee Supreme Court noted that the ''assessment of gross premiums received is quite a common method of taxation of insurance companies,'' and went on to quote Cooley on Taxation: '''The most common form of taxation at the present time, both of domestic and foreign insurance companies, is a tax on

ory,'' that ''the term 'gross amount of premiums received' from policies covering risks within this state contemplated *only the premiums actually paid by the policy holders to the insurance company.*'' [8] (Emphasis and footnotes added.) 99 Ohio St. at 235-36. Based on the legislative history of the Ohio statutes, however, the court felt constrained to conclude that G.C. 5432 and G.C. 5433 (now R.C. 5729.02 and R.C. 5792.03) meant ''the gross premiums stipulated on the face of the policies,''[9] and that the insurance commissioner was authorized to base the excise tax imposed on foreign insurance companies doing business in Ohio ''upon the gross premiums stipulated to be paid on the face of the policies in force in Ohio during the preceding year.'' 99 Ohio St. at 239. *See State ex rel. National Life Insurance Co. v. Jay*, 37 Wyo. 189, 199, 260 P. 180 (1927) (commenting that the *Tomlinson* decision ''turned upon the peculiar and special course of legislation,'' and the ''Ohio court frankly admits that except for such legislation, it would have held otherwise'').

The General Assembly has never amended the statute in response to *Tomlinson*, nor has the issue been addressed by an Ohio court, either as to foreign or domestic insurance companies, since *Tomlinson* was decided. Therefore, the phrase in R.C. 5725.18(A)(2), ''gross amount of premiums received,'' would mean, if standing alone, ''*the gross premiums stipulated on the face of the policies.*'' This interpretation would include within ''gross amount of premiums received'' premiums never ultimately received under a written policy.

Gross Amount of Premiums Received, as Reflected in the Annual Statement

R.C. 5725.18(A)(2) goes on, however, to qualify the phrase, ''gross amount of premiums received'' as that amount ''*reflected in [the insurance company's] annual statement for the preceding calendar year,*'' which is filed under R.C. 3929.30. As noted above, R.C. 3929.30 specifically requires that the annual statement of an insurance company's condition be ''submitted on the forms adopted by the superintendent pursuant to section 3901.77 of the Revised Code,'' and under R.C.

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gross premiums received.''' *New England Mutual Life Insurance Co. v. Reece,* 169 Tenn. 84, 90, 92, 83 S.W.2d 238 (1935).

[8] *See, e.g., Commissioner of Corporations and Taxation v. Metropolitan Life Insurance Co.*, 327 Mass. 582, 99 N.E.2d 866 (1951); *State ex rel. National Life Insurance Co. v. Jay*, 37 Wyo. 189, 260 P. 180 (1927); *New England Mutual Life Insurance Co. v. Reece*; *In re Continental Casualty Co.*, 189 Iowa 933, 179 N.W. 185 (1920); *State of Indiana ex rel. O'Brien v. Continental Insurance Co. of New York*, 67 Ind. App. 536, 116 N.E. 929 (Ind. App. 1917); *State of New York ex rel. Continental Insurance Co. v. Miller*, 177 N.Y. 515, 70 N.E. 10 (1904); *German Alliance Insurance Co. v. Vancleave*, 191 Ill. 410, 61 N.E. 94 (1901).

[9] The legislative history leading the court to this conclusion is fully explained in the decision. Other cases that have been decided consistently with *Tomlinson* include: *United Pacific Insurance Co. v. Bakes,* 57 Idaho 537, 67 P.2d 1024 (1937); *Cochrane v. National Life Insurance Co.,* 77 Colo. 243, 235 P. 569 (1925); *Massachusetts Bonding & Insurance Co. v. Chorn,* 274 Mo. 15, 201 S.W. 1122 (1918); *Fire Association of Philadelphia v. Love,* 101 Tex. 376, 108 S.W. 158 (1908).

3901.77(A), the Superintendent has the responsibility to prescribe the forms on which the annual reports are to be made, but "shall adopt the forms, instructions, and manuals prescribed by the national association of insurance commissioners."

By way of background, the NAIC was organized in 1871 by the various state insurance commissioners "to address the need to coordinate regulation of multistate insurers." NAIC Website, http://www.naic.org/index_about.htm. *See also Interstate Fire Insurance Co. v. United States,* 215 F. Supp. 586, 592 (E.D. Tenn. 1963) (state insurance commissioners organized the NAIC "[a]s a matter of mutual assistance and to achieve greater uniformity in the regulation of insurance companies"). "The first major step" in coordinating the regulation of insurers "was the development of uniform financial reporting by insurance companies." NAIC Website, http://www.naic.org/index_about.htm. The NAIC "publishes standard detailed forms for each type of insurance company to report its annual financial condition upon, the form being commonly referred to as the 'Convention Form' or 'Annual Statement.'" *Interstate Fire Insurance Co. v. United States,* 215 F. Supp. at 592. State regulators use the Annual Statement to monitor the solvency of insurance companies and thereby protect policyholders. *See Continental Insurance Co. v. United States,* 474 F.2d 661, 666-67 (Ct. Cl. 1973) (explaining the function and purpose of the Annual Statement, and its role in the states' regulation of insurance companies and protection of policyholders).[10]

Inseparable from the Annual Statement form are the Statements of Statutory Accounting Principles ("SSAP's"), an accounting method promulgated by the NAIC that is used by insurers to prepare Annual Statements, and by state regulators to interpret them.[11] *See Home Group, Inc. v. Commissioner of Internal Revenue,* 875 F.2d 377, 378 (2nd Cir. 1989) (the annual statements of financial condition filed

[10] The NAIC explains:

> The primary responsibility of each state insurance department is to regulate insurance companies in accordance with state laws with an emphasis on solvency for the protection of policyholders. The ultimate objective of solvency regulation is to ensure that policyholder, contract holder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide an adequate margin of safety. The cornerstone of solvency measurement is financial reporting. Therefore, the regulator's ability to effectively determine relative financial condition using financial statements is of paramount importance to the protection of policyholders.

NAIC Accounting Practices and Procedures Manual, vol. I, p. P-5 to P-6, ¶ 27 (March, 2006).

[11] As explained in the NAIC Policy Statement on Coordination of the Accounting Practices and Procedures Manual and the Annual Statement Blank:

> The purpose of the codification of statutory accounting principles (SAP) project was to produce a comprehensive guide to SAP for use by

on NAIC approved forms ''are prepared using the earned and incurred basis of accounting (known in the insurance industry and hereinafter referred to as the Statutory Method). [The insurance company] also uses the Statutory Method in computing its taxable income''). The NAIC describes the SSAP's as ''[a]n accounting model based on the concepts of conservatism, consistency, and recognition,'' which are ''essential to useful statutory financial reporting.'' NAIC Accounting Practices and Procedures Manual, vol. I, p. P-5 to P-6, ¶ 27 (March, 2006). Every state, the District of Columbia, and U.S. territories require insurance companies authorized to do business within its jurisdiction to file NAIC's Annual Statement, using the SSAP's.[12]

The figures reported in the Annual Statement reflect, for the most part, total business done by an insurance company nation-wide (and beyond). In *Continental Insurance Co. v. United States,* 474 F.2d at 667, the court explained why the NAIC's Annual Statement form reports total business conducted, rather than simply the figures relating to the business done by the company within the state to which it is reporting:

> There is a very sound reason for the total approach of the Annual Statement. State insurance departments are concerned with assuring that a company's financial position is sound enough to protect policyholders in their respective states. In determining the financial strength of a large, multi-state insurer ... it would be illogical for the insurance department of a particular state to scrutinize only that part of [an insurance company's] business carried on within that state. [The insurance company's] business in that one state might be prospering, while elsewhere it might be hopelessly insolvent. Thus a state insurance department must examine all of [the company's] assets and liabilities, and all of its income and expenses

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> insurance departments, insurers, and auditors. Statutory accounting principles, as they existed prior to codification did not always provide a consistent and comprehensive basis of accounting and reporting. Insurance companies were sometimes uncertain about what rules to follow and regulators were sometimes unfamiliar with the accounting rules followed by insurers in other states. This was due in part to the fact that prior to codification, accounting guidance could be found in the NAIC Accounting Manual, annual Statement Instructions, Examiners Handbook, and various states' laws and regulations. As a result, insurers' financial statements were not prepared on a comparable basis. Now that accounting requirements have been more rigidly stipulated by the NAIC, it is imperative that the accounting requirements and the reporting and disclosure requirements remain synchronized.

NAIC Accounting Practices and Procedures Manual, vol. III, p. F-12 (March, 2006).

[12] *See* NAIC Accounting Practices and Procedures Manual, vol. I, p. P-12, ¶ 58 (March 2006) (''[e]ach state requires all insurance companies doing business in that state to file an annual financial statement. All states use the annual statement blank promulgated by the NAIC...'').

> and apply its rules to [the company's] total business if policyholders within that state are to be adequately protected.

Under the current system, therefore, each insurance company need prepare only one Annual Statement that can be filed with every state in which it does business. And, because every annual statement is filed on the same form, using the same accounting system and showing the total picture of a company's business condition, each state regulator can more accurately and consistently interpret the statement to evaluate a company's financial health.

While the use of a ''total approach'' in reporting financial information is desirable for purposes of evaluating a company's solvency, it is perhaps less useful as a basis for computing a company's state tax liability. Ohio may base its tax of domestic and foreign insurance companies only on premiums received from policies covering risks *within this state*[13]—however, the Annual Statement shows only limited information on a state-by-state basis.[14] *See Continental Insurance Co. v. United States*, 474 F.2d at 666-67 (''an insurance company sets forth in its Annual Statement, filed with each state, financial data regarding all of its business, wherever conducted,'' and ''[n]one of the assets or liabilities, or items of income or deduction, are allocated on a state-by-state basis. These fundamental facts were understood to be the case and taken for granted in numerous judicial decisions considering to what extent the Annual Statement should be followed for federal income tax purposes'').[15] More specifically, the Annual Statement has no place for reporting ''gross premiums received''—either on a state-by-state basis, or as a total

[13] R.C. 5725.18; R.C. 5729.02; R.C. 5729.03. Constitutional principles also so dictate. *See, e.g., Connecticut General Life Insurance Co. v. Johnson,* 303 U.S. 77, 80-81 (1938) (''a state which controls the property and activities within its boundaries of a foreign corporation admitted to do business there may tax them. But the due process clause denies to the state power to tax or regulate the corporation's property and activities elsewhere'').

[14] The information that is allocated by state on Annual Statements filed by property and casualty insurance companies is: Direct Premiums Written, Direct Premiums Earned, Dividends Paid or Credited to Policyholders on Direct Business, Direct Losses Paid (Deducting Salvage), Direct Losses Incurred, Direct Losses Unpaid, Finance and Service Charges Not Included In Premiums, Direct Premiums Written for Federal Purchasing Groups, Direct Unearned Premium Reserves, Direct Defense and Cost Containment Expense Paid, Direct Defense and Cost Containment Expense Incurred, Direct Defense and Cost Containment Expense Unpaid, Commissions and Brokerage Expenses, Taxes, Licenses and Fees, and information on Interstate Compact Products. (These figures are reported on Schedule T, Schedule T-Part 2, and Exhibit of Premiums and Losses-Statutory Page 14).

[15] The federal tax code refers to the NAIC's Annual Statement form and the SSAP's at several points in the determination of an insurance company's income tax liability. *See, e.g.,* 26 U.S.C. § 811(a) (accounting methods); 26 U.S.C. § 832(b)(1)(A) (computing gross income); 26 U.S.C. § 832(b)(6) (expenses incurred).

amount. As a result, the Department uses the dollar amount reported by property and casualty insurance companies that most closely approximates "gross premiums received," (and that is allocated by state), which is "Direct Premiums Written"—as reported on Schedule "T," column 2 and the state page Exhibit of Premiums and Losses (Statutory Page 14), column 1.

Direct Premiums Written

We turn now to the meaning of "Direct Premiums Written." As used in the insurance industry, and on the NAIC's Annual Statement Form for property and casualty insurance companies, a "written premium" is "the contractually determined amount charged by the reporting entity to the policyholder for the effective period of the contract based on the expectation of risk, policy benefits, and expenses associated with the coverage provided by the terms of the insurance contract." SSAP No. 53, ¶ 3. NAIC Accounting Practices and Procedures Manual, vol. I, p. 53-3 (March, 2006). Written premiums are "recorded as of the effective date of the contract." SSAP No. 53, ¶ 5. *Id.* "Direct premiums" include premiums received by a company on policies later ceded to a reinsurer, but do not include premiums received by a company as a reinsurer. As explained by the NAIC, "[t]he major por-

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In *Commissioner of Internal Revenue v. Standard Life & Accident Insurance Co.*, 433 U.S. 148, 162, n.26 (1977), the U.S. Supreme Court rejected the argument that, "Congress would not have intended 'to relegate the substantive matter of [whether deferred and uncollected life insurance premiums are includable in a company's reserves, assets, and gross premium income], with its concomitant impact on the resulting tax, to the NAIC.'" *See also Sears, Roebuck and Co. v. Commissioner of Internal Revenue,* 972 F.2d 858, 866 (7th Cir. 1992) ("[s]tate insurance commissioners' preferences about reserves thus are not some intrusion on federal tax policy; using their annual statement is federal tax law"). *But cf. Colonial American Life Insurance Co. v. Commissioner of Internal Revenue,* 491 U.S. 244, 255 (1989) (under the taxpayer insurance company's interpretation, "the fundamental question whether an expense is properly characterized as a capital outlay which has to be amortized or instead as an ordinary business expense subject to immediate deduction would be answered by simple reference to accounting procedures in the industry. It is inconceivable that Congress intended to delegate such a core policy determination to the NAIC"); *Harco Holdings, Inc. v. United States,* 977 F.2d 1027, 1033 (7th Cir. 1992) (attempting to reconcile *Standard Life & Accident Insurance Co.* and *Colonial American Life Insurance Co.*).

For examples of the varying degrees to which the federal courts have deferred to the Annual Statement and SAP's in determining tax liability, *see Home Group, Inc. v. Commissioner of Internal Revenue,* 875 F.2d 377 (2nd Cir. 1989); *Hanover Insurance Co. v. Commissioner of Internal Revenue,* 598 F.2d 1211 (1st Cir. 1979); *Western Casualty and Surety Co. v. Commissioner of Internal Revenue,* 571 F.2d 514 (10th Cir. 1978); *Western and Southern Life Insurance Co. v. Commissioner of Internal Revenue,* 460 F.2d 8 (6th Cir. 1972); *American International Group, Inc. v. United States,* 38 Fed. Cl. 274 (1997).

tion of most companies' premiums written is direct premiums. Direct premiums include all premiums arising from policies issued by the company acting as the primary insurance carrier. These premiums should be adjusted for any return or additional premiums arising from endorsements, cancellations, audits, and retrospective rating plans. Direct written premiums are generally recorded for the full policy term.'' IP (Statutory Issue Paper) No. 53, ¶ 17. NAIC Accounting Practices and Procedures Manual, vol. II, p. IP 53-4 (March, 2006). Schedule ''T'' of the Annual Statement calls for a company to report under ''Direct Premiums Written'' the amount remaining after Return Premiums and Premiums on Policies Not Taken are subtracted from ''Gross Premiums'' (including Policy and Membership Fees).

The use of ''Direct Premiums Written'' (reported on Schedule ''T'') as the basis for computing the franchise tax for property and casualty insurance companies is in no way inconsistent with state law. The concept of a ''written premium'' as the amount charged by an insurance company to the policyholder for the period of the policy is analogous to the standard adopted in *Tomlinson*, that gross premiums received are ''the premiums stipulated on the face of the policies.'' ''Direct premiums'' include premiums on policies later ceded by the company to a reinsurer, but do not include premiums received by the company as a reinsurer, and R.C. 5725.18 and R.C. 5729.03 permit insurance companies to deduct consideration received for reinsurance and do not exclude premiums later paid by the company to a reinsurer. The amounts reported on Schedule ''T'' do not include return premiums, and R.C. 5725.18 and R.C. 5729.03 permit companies to subtract return premiums from the amount of gross premiums received. R.C. 5725.18(B); R.C. 5729.03.

In sum, the Superintendent's use of the amount of ''Direct Premiums Written,'' as reported on Schedule T of the Annual Statement, to compute the franchise tax for property and casualty insurance companies is consistent with *Tomlinson* and state statutes.

Accounting for Premiums Never Received

We return to the position of the insurance company that, ''the gross amount of premiums received,'' does not include premiums never actually received by the company, and that the Superintendent should not use ''direct premiums written'' since that does include premiums never received. The duty of an insurance company to provide coverage for a period of time after it intends to cancel a policy for nonpayment of premiums, coupled with the ''conservative'' accounting of that transaction required by the SSAP's, may, indeed, lead to an instance where the basis upon which a company is taxed includes a portion of the premium never received.

For example, if an insurance company wishes to cancel an automobile insurance policy, it must provide written notice to the policyholder, and the effective date of cancellation may be no sooner than 30 days following the date of notice, except that, if cancellation is due to nonpayment of premiums, cancellation may be no sooner than 10 days following the date of mailing the notice of cancellation.

R.C. 3937.31-.33.[16] Under SSAP No. 53, that portion of the premium related to the period of coverage that the insurance company is required by statute to provide prior to cancellation is included in the amount of premiums written, even though the policyholder never pays the insurance company for that coverage.

The NAIC explains that, SSAP No. 53, paragraph 3, ''supports the inclusion of earned but uncollected premium as direct and assumed written premium since the reporting entity is 'at risk' and subject to 'actual exposure' for the extended period of time when the policy is still in force and effective.... the reporting entity is required by SSAP No. 53, paragraph 3, to include this extended coverage as part of the direct and assumed written premiums to include the effective period of the contract *whether or not the reporting entity collects a premium for this time period.*'' (Emphasis added.) INT (Interpretation) 05-06, ¶ 5. NAIC Accounting Practices and Procedures Manual, vol. I, p. B-291, (March, 2006). This practice of including within ''premiums written'' the portion of a premium corresponding to the period of coverage, even though unpaid, is consistent with the policy of conservatism because the SSAP's require a company to establish a reserve upon recording a written premium. SSAP No. 53, ¶ 5. The requirement that reserves be established during the time that coverage is in effect thus helps to preserve the financial health of a company since it is ''at risk'' and ''subject to actual exposure,'' during the ten-day period [or other time period prescribed in a policy] before cancellation of the policy for nonpayment. Thus, when an insurance company provides coverage, the portion of the premium that corresponds to the period of coverage must be included in the basis for calculating the franchise tax, even though the company never received the premium for this period of time.[17]

[16] According to the NAIC, ''[r]eporting entities may utilize a voluntary procedure whereby policies are not cancelled for nonpayment of the premium until after an extended cancellation period (example 30 days), as opposed to the shorter statutory cancellation period. There are other instances when a reporting entity provides coverage for periods when the payment has not been received.'' INT (Interpretation) 05-06, ¶ 1. NAIC Accounting Practices and Procedures Manual, vol. I, p. B-291 (March, 2006).

[17] Federal courts, when deciding income tax matters, have not been averse to accepting a ''fiction'' necessitated by state regulatory requirements and corresponding accounting methods. *See, e.g., Commissioner of Internal Revenue v. Standard Life & Accident Insurance Co.*, 433 U.S. at 158 (''[h]aving decided that unpaid premiums must be treated to some extent as though they had actually been paid, the more difficult question is how far to apply this fictional assumption... this is essentially an accounting problem''); *Western and Southern Life Insurance Co. v. Commissioner of Internal Revenue,* 460 F.2d 8, 12 (6th Cir. 1972) ('''[t]he assumption that the annual premium has been received in full [in computing reserves] is, of course, a fiction''') (citation omitted). *See also Commissioner of Internal Revenue v. New Hampshire Fire Insurance Co.,* 146 F.2d 697, 700 (1st Cir. 1945) (''as a fundamental principle tax returns must truly reflect income, and ... returns based exclusively on the Convention Form do not;'' there are, however, counterbalancing

Nature of Franchise Tax

We bear in mind that the premium tax is an excise tax. The premium tax is levied on a domestic insurance company as a ''franchise tax on the privilege of being an insurance company,'' R.C. 5725.18(A), or on a foreign insurance company ''as a tax upon the business done by it in this state,'' R.C. 5729.03(A). It is neither an income tax nor a property tax. *See generally Angell v. City of Toledo,* 153 Ohio St. 179, 183, 91 N.E.2d 250 (1950) ('''[a]n excise upon those engaged in a particular occupation, although graded in accordance with income, is an occupation tax and not an income tax''') (quoting Cooley on Taxation)).[18] ''[T]he plain language of [R.C. 5725.18] indicates that the tax is assessed not against gross premium receipts, but is instead a more general tax on the privilege of doing business within the state;'' the reference to gross premium receipts merely constitutes the method for measuring the amount of liability. *Union Central Life Insurance Co. v. Commissioner,* 720 F.2d 420, 422 (6th Cir. 1983). *Accord Massachusetts Bonding & Insurance Co. v. Chorn,* 274 Mo. 15, 26-27, 201 S.W. 1122 (1918) (although the amount of the franchise tax is imposed on premiums received, the ''thing taxed in this case is the right to transact the business of various kinds of so-called insurance.... The business of which the State necessarily assumes the oversight and protection, is measured by the financial magnitude of its licensed and protected activities''); *Fire Association of Philadelphia v. Love,* 101 Tex. 376, 379, 108 S.W. 158 (1908) (concluding that the state franchise tax on ''gross amount of premiums received'' included premiums returned to policy holders upon cancellation of policies: while it was ''plausible to say that absolute property right did not attach to the premium thus received,'' it could ''not be said that the insurance company did not enjoy the privilege of doing the business.... The whole purpose and object of ascertaining the amount of premiums received is to fix the value of the privilege granted''); *State v. Continental Assurance Co.,* 176 Tenn. 1, 5-6, 137 S.W.2d 277 (1940) (''[t]hough measured by two and a half per cent of premiums received on policies issued by the company while exercising its license from the State, the tax was levied upon the privilege of entering the State and engaging in the insurance business, and not upon the annual premiums. *The distinction between the tax and the measure of the tax should not be confused*, and when the distinction is kept in mind the purpose of the Legislature seems clear'' (emphasis added)).

Similarly, a premium not actually received for coverage that is provided by an insurance company, under the circumstances described above, may not constitute income to the company; however, by soliciting business, issuing the policy, providing coverage, and paying claims where necessary, the company acts as an insurance company and conducts business within the state, subject to oversight and

considerations, and ''the Tax Court correctly decided that the Convention Form ... 'should be followed precisely according to its terms and as employed, accepted, and complied with throughout the United States''').

[18] *Cf.* Ohio Const. art. XII, § 3(C) (laws may be passed providing for excise and franchise taxes) *with* Ohio Const. art. XII, § 3(B) (laws may be passed providing for the taxation of incomes) *and* Ohio Const. art. XII, §§ 2, 2a (property taxes).

regulation by the State—it ''enjoys the privilege of doing the business.'' To include an unpaid portion of a written premium in the computation of the premium tax is not inconsistent with its nature of the premium tax as an excise tax.

In sum, the Superintendent has the authority to use the amount of ''direct premiums written,'' on risks covered within Ohio, as reported on Schedule ''T'' of the Annual Statement filed by property and casualty insurance companies, as the basis upon which to calculate the franchise tax imposed on property and casualty companies. This basis for taxation is supported by *State ex rel. Northwestern Mutual Life Insurance Co. v. Tomlinson,* the taxing statutes, R.C. 5725.18, R.C. 5729.02 and R.C. 5729.03, and the duty imposed on the Superintendent in R.C. 3901.77 to adopt the NAIC's Annual Statement form, with its attendant accounting principles.

Based on the foregoing, it is my opinion, and you are hereby advised that, the Superintendent of Insurance has the authority to use the amount of ''direct premiums written'' on risks covered in Ohio, as reported on Schedule T of the Annual Statement by insurance companies filing a ''National Association of Insurance Commissioners Property and Casualty Companies—Association Edition annual statement,'' as the basis upon which to calculate the franchise tax imposed on these types of insurance companies under R.C. 5725.18 or R.C. 5729.03.