

OHIO'S TAX REFORM OF THE NON-ADMITTED INSURANCE MARKET.

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As part of a significant and major overhaul of its business taxes, Ohio after a contentious legislative process reformed the taxes imposed on business conducted in the state.¹ Tucked away in HB 66 were amendments to Ohio's taxing scheme on the insurance business conducted in the unauthorized market and/or the surplus lines market. The significant changes were (1) the elimination of the "employer insured" exemption, and (2) the adoption of new exemptions. The new exemptions were intended to benefit certain narrow interests in the medical malpractice market. This article will review the background for the amendments and the unintended consequences that have occurred since their enactment.

When discussing the topic of unauthorized insurance activity two distinct segments are often lumped together. These are the unauthorized insurance marketplace and the surplus lines marketplace.

The unauthorized insurance market includes insurance companies that do not have a certificate of authority to do business in any state. These companies are both US based insurers, alien (non-US) insurers, as well as the variety of offshore and onshore captive insurance companies. For this market insurance buyers will make direct placements with such insurers. Another common characteristic is that these insurers do not intend to seek admission in any US state and may not have financial statements that have been prepared pursuant to statutory accounting procedures that comply with NAIC instructions for statement preparation. In contrast the surplus lines market has US based insurers that are admitted in at least the state of domicile of the insurer. These companies have financial records prepared according to statutory accounting procedures and NAIC statement instructions. There are also certain alien insurers recognized in this market whereby these insurers have filed financial information with the NAIC to qualify for the NAIC Quarterly Listing of Alien Insurers, (the Quarterly List) which demonstrates a minimum level of financial reporting. Access to the surplus lines market is through licensed surplus lines brokers that have met certain regulatory requirements² and have assumed extra duties in regard to a placement in the surplus lines market. A significant duty is the collection and remittance of the surplus premium tax³.

For the purpose of this article these two segments of the market will be referred to as the non-admitted market. An immediate significance of using the non-admitted market is the higher tax rate (5% - unauthorized or surplus lines tax) compared to the admitted market tax rate (1.4% generally). This higher rate is intended to generate revenue as well as act to discourage the use of the non-admitted market by making coverage uncompetitive compared the admitted market. Regulators believe that the admitted market is the better choice for the insurance buyer.

From the tax perspective, the gross amount of revenue produced by the non-admitted market was approximately \$12 million dollars for year 2004. This compares with admitted premium tax collections for 2004 of \$396.6 million dollars⁴. One objective of the reform brought about by HB 66, this was an attempt to find and close loopholes in Ohio tax structure and increase revenues.

Taxing non-admitted business is a common practice in most states. Ohio's version has a number of exemptions that are also common for most states⁵. The "employer insured" exemption was of particular importance in Ohio because of its low threshold. A purchase of insurance coverage in the non-admitted market would be tax exempt if the insured purchasing the coverage qualified as an "employer insured" defined as an insured that:

- 1) Uses the services of a full time employee acting as an insurance manager or buyer, or uses the services of a regularly and continuously qualified insurance consultant. Insurance consultant does not include a person licensed under Chapter 3905, of the Ohio Insurance code.
- 2) The aggregate annual premiums on all risks total at least twenty five thousand dollars.
- 3) (the insured) has at least twenty-five employees⁶.

For the last several decades the practical outcome of this exemption is that most of the placements in the non-admitted market are exempt from this tax. In the commercial insurance community, meeting the exemption is almost reason enough to use the non-admitted market. Likewise, a regulator would have good reason to question the suitability of using the non-admitted market if the insured did not otherwise qualify for the exemption.

Since the presumptive reason for repealing the exemption was to reform the business tax system and also raise revenues, it was hoped that the taxes generated by the 5% premium tax would increase revenues to approximately 28M from the 2004 level of approximately 12M. That target has not been reached for a few reasons. First, the effective date of the repeal was June 30, 2005. Since many policies were renewed in the first half of the year the exemption still applied. It will not be until the 2006 results are available and that a full years impact will be known. Even when fully implemented the non-admitted tax is relatively small in relation other revenue streams to the State.

At the time HB 66 was under consideration by the legislature, the Ohio Department of Insurance was conducting a series of meetings of the Ohio Medical Malpractice Commission⁷ to address the issue of the effects that the availability of medical malpractice coverage has on health care in the state. With the potential that medical malpractice rates could increase in the non-admitted market, two new exemptions were proposed by the health care community. This article will not review the issues and context of the medical malpractice debate other than to note that medical providers who were looking to the insurance regulator to effect reform in this area did not favor changes

that would make the options for coverage to medical providers and hospitals more expensive. The following two exemptions were inserted in place of the “employer insured” exemption.

The first was an exemption for professional or medical liability insurance procured by a hospital⁸. Ohio statutes define hospitals⁹ to include public health centers and general, mental, chronic disease, and other types of hospitals, and related facilities, such as laboratories, outpatient departments, nursing home facilities, extended care facilities, self-care units, and central service facilities operated in connection with hospitals, and also includes education and training facilities for health professions personnel operated as an integral part of a hospital, but does not include any hospital furnishing primarily domiciliary care. Accordingly these entities can buy coverage in the non-admitted market and not pay the premium tax, even though had they bought coverage from an admitted insurer they would be paying the tax as part of the premiums.

Although the second new exemption does not specifically name the health care industry, it was the health care industry that suggested the new language. The exemption allows captives to escape the premium tax. This language provides that in the non-admitted market the following defined captives are exempt from the tax¹⁰.

For transactions involving policies issued by a captive insurer, and for the purposes of the tax a "captive insurer" means any of the following:

- (a) An insurer owned by one or more individuals or organizations, whose exclusive purpose is to insure risks of one or more of the parent organizations or individual owners and risks of one or more affiliates of the parent organizations or individual owners;
- (b) In the case of groups and associations, insurers owned by the group or association whose exclusive purpose is to insure risks of members of the group or association and affiliates of the members;
- (c) Other types of insurers, licensed and operated in accordance with the captive insurance laws of their jurisdictions of domicile and operated in a manner so as to self-insure risks of their owners and insureds.

The intent was to not stifle the formation of single parent or trade association captives that are providing alternate risk mechanisms for the healthcare market, namely hospital organized captives as well as hospital association captives. However a close reading of the subdivision (c), could apply to almost any captive organization, since an argument can be made that the use of a captive is in itself an indication that the insured is engaged in a program of alternative risk management using some form of self insurance.

In effect the exemption from the premium tax encourages the use of captives to the exclusion of the non-captive, non-admitted market. It is questionable whether this is good policy. There is a recognized non-admitted market with insurers of substantial resources due primarily to the qualification of these non-admitted insurers in at least one state, or

by filing financials with the NAIC. The unintended result of this amendment is to steer business to the lesser capitalized and potentially more unstable captive market place.

Interestingly the growth of the captive market and enactment of favorable tax policies creates a conflict within the regulatory community especially as captives provide liability coverages. First, there is the regulators' interest in providing a regulatory climate that fosters markets that make affordable coverage available to the insurance buyer. The second responsibility of the regulator is to third parties who will be claimants where company stability and solvency are primary, not just low insurance cost to the buyers.

Another unintended consequence of these tax amendments relates to the variety of insurance buyers that may have an argument to claim a tax exemption as a matter of public policy. A previous Ohio Attorney General's opinion¹¹ held that certain health districts created by statute were exempt from the non-admitted premium tax because the district was a special form of organization that escaped the imposition of the tax. The non-admitted tax statute uses the words association, corporation and company to describe the target of the tax. The Attorney General opined that a health district was something other than an association, corporation or company and therefore it was not taxable. Since that opinion was first issued in 1978, a variety of classes of insurance buyers, including municipal corporations, charitable organizations, regional governmental entities and others have tried to argue their case that it should not be the public policy to impose a tax on an entity that relies on tax dollars or charitable contributions for their budget. This issue has been before the Ohio regulator for several decades, however other than the Attorney General's opinion, it has not been addressed. The availability of the "employer insured" exemption has deferred decisions in this area as the insurance buyers who would be asking for an exemption often qualify for the "employer insured" exemption as well. As noted in prior discussions, when one of these public or charitable entities buys insurance from the admitted market they are paying premium tax.

In sum, the good intentions to close what appear to be loopholes in a business tax program has not yet provided the claimed increase in revenues and has opened up additional questions for the tax administrators and insurance regulators to solve.

¹ 2005 H 66, Effective June 30, 2005

² Sections 3905.30 - .35 Ohio Revised Code ("ORC")

³ ORC 3905.34

⁴ Ohio Department of Taxation – 2004 Summary of Taxes at http://www.tax.ohio.gov/divisions/communications/publications/brief_summaries

⁵ ORC 3901.36

⁶ This language deleted from ORC 3905.36 by H 66

⁷ The Ohio Medical Malpractice Commission – Created by 2003 S 281, Effective April 11, 2003, Reports available on Ohio Department of Insurance website www.ins.state.oh.us

⁸ ORC 3905.36(B) (4)

⁹ ORC Chapter 3701

¹⁰ ORC 3905.36 (B)(3) a-c

¹¹ OAG 78-009, issued 1978

