

INSURANCE PREMIUM TAXES*

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INTRODUCTION

WHILE NOT THE MOST VISIBLE OF TAXES, THE state insurance premium tax is levied on insurance companies by every state, generally as a substitute for the state corporate income tax being imposed on insurance companies. In 2004, \$14 billion in taxes on insurance premiums were collected on \$960 billion worth of insurance premiums and annuity considerations, accounting for 2.4 percent of state tax revenue. Between 2000 and 2004, insurance premium tax revenue grew by 43 percent. The marginal premium tax rate is in the 2.5 percent range, but because the tax is on gross premiums rather than profits, its effects may be quite substantial. For example, Neubig, Jaggi, and Messina (2002) estimate that the premium tax rate is almost double the tax rate that an insurance firm would pay if it were subject to the state corporate income tax.

Recently, policy makers in several states have discussed reducing or eliminating their state's premium tax as an effort to induce insurance companies to locate offices and headquarters in the state.¹ This is seen as a desirable job creation strategy since jobs in this industry are relatively high wage and environmentally clean.

The remainder of the paper proceeds as follows. In the next section the insurance premium tax is described and the relevant literature discussed. The third section presents a simple theoretical framework, while the fourth section discusses the variation in the insurance tax rates across states and over time. In the fifth section we explore the relationship between insurance premium taxes and the size of the property-causality insurance industry in a state.

TAXES ON INSURANCE PREMIUMS

The regulation and taxation of the insurance industry has been left almost entirely to the states.

A post-Civil War Supreme Court decision asserted the fact that insurance was subject solely to state regulation and that the congressional commerce power did not apply to the regulation and taxation of the industry.² That changed in 1944, when the Supreme Court, in *United States v. South-Eastern Underwriters*, held that the insurance industry was subject to the Constitutional commerce clause provisions, and specifically, the antitrust laws. Congress reacted almost immediately to overturn *United States v. Southeastern Underwriters*, 1944 by passing the McCarran Ferguson Act of 1945, which returned to the states the sole power over regulation and taxation of insurance.

Because states had free reign to tax the insurance industry, a number of anomalies developed. First, as states were not subject to commerce clause restrictions on taxation, they could, and did, discriminate against out-of-state commerce by imposing a higher tax rate on out-of-state carriers.³ Second and almost uniformly, states adopted defenses to these discriminatory taxes in the form of a so-called retaliatory tax.⁴ That is, if state A taxes state B's companies at a higher rate than its own companies, State B would tax State A's companies at the higher of the two states' tax rates.

The retaliatory tax was challenged in *Western & Southern Life Insurance Co. v. State Board of Equalization*, 1981. It is commonly believed the retaliatory tax is necessary to keep states from engaging in extreme domestic preferences that result in taxing other states' companies at high rates. In *Western & Southern Life Insurance Co. v. State Board of Equalization*, 1981, the Court upheld the constitutionality of the retaliatory tax based on the congressional delegation of authority to the states in the McCarran-Ferguson Act. Because Congress specifically exempted insurance from the commerce clause's restrictions, the Court allowed the states to tax in any way they deemed necessary.⁵

In general, insurance companies are not subject to the state corporate income tax, but are taxed on the value of premiums written in a state. All companies writing policies in a state are subject to the

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premium tax, which is levied as a fixed percentage of the value of the premiums written in the state less a deduction for any premiums returned or dividends paid to the policyholder.⁶ Many states apply different rates to the various lines of insurance, such as property and casualty, life, health, reinsurance, self-insurance, and other nontraditional lines.

Neubig and Vlasisavljevich (1992) provide a thorough review of the nonfederal taxes facing insurance companies. These include premium taxes and income or franchise taxes, but also may include state and local property taxes. In all states, the premium tax paid is credited against the corporate income tax so that the firm only pays the greater of the two liabilities, which is always the premium tax. Many states offer special domestic company tax credits or preferences, such as tax credits for investments and employment and retaliatory taxes paid to other states. In addition, some states lower the rates under certain conditions. For example, in Georgia if the insurer invests a quarter of its assets in certain qualified investments, the state tax rate is lowered from 2.25 to 1.25 percent. If the invested amount is equal to 75 percent of total assets, then the tax rate is further lowered to 0.005 percent.

Finally, states may require companies to pay into a guaranty fund designed to cover the claims of insolvent insurance companies. While some states offer a credit against the premium tax for amounts paid into the fund, not all do, nor do all the others provide a 100 percent credit (National Association of Insurance Commissioners (NAIC), 2006).

There has been little written on the effects of taxes as they relate specifically to the insurance industry, and none of the papers consider the effect on employment. Wheaton (1986) considers the impact of state taxes on life insurance company asset growth rates. Using company level data on the 77 largest life insurance companies in the country, the author constructs an effective tax rate consisting of the combined effect of domestic

and foreign premium taxes, corporate income premium tax credits, and the method of corporate apportionment to determine the effective state tax rate for a typical firm for several states. Company growth in assets over the 1966-1981 period is regressed against this effective tax rate as well as other factors believed to be determinants of company growth. The econometric analysis reveals a consistently negative and significant coefficient associated with the effective state tax rate. While the results indicate a fairly small effect, a \$10 million increase in tax liability decreases company growth by 0.9 percent, the effect is statistically significant. Wheaton does not consider the effect of taxes on the location of headquarters or employment.

There are some other documented effects of the premium tax. Petroni and Shackelford (1995), for example, consider the effect of both state taxes and regulation on the choice of organizational form of property and casualty insurers. The results indicate that states with higher insurance premium tax rates and regulatory burdens have significantly lower numbers of domesticated insurance companies or a lower percentage of insurance premiums sold by domestic insurers. In addition, Ke et al. (2000) find that increases in premiums of non-automobile lines of insurance increases self-insurance in a state.

RELATIONSHIP BETWEEN STATE PREMIUM TAX AND INSURANCE INDUSTRY EMPLOYMENT

We start with a simple example to illustrate the incentive that the insurance premium tax has on insurance companies. The premium tax is a form of gross receipts tax paid on a destination basis. If this was the end of the story, the premium taxes would not affect where the firm located. But, the presence of retaliatory taxes changes the incentive. For example consider the hypothetical situation presented in Table 1. Assume that a firm is considering locating in one of three states, denoted Low, Medium, and High to reflect the relative magnitude

Table 1
Illustration of Premium Tax

	Premium Tax Rate	Premium Tax Paid
State Low	1%	$(t_L^*P_L) + (t_M^*P_M) + (t_H^*P_H) = T_L$
State Medium	3%	$(t_M^*P_L) + (t_M^*P_M) + (t_H^*P_H) = T_M$
State High	5%	$(t_H^*P_L) + (t_H^*P_M) + (t_H^*P_H) = T_H$

of their premium tax rate. Let t represent the state premium tax rate and P represent the value of total premiums written in a state.

Regardless of where the firm writes policies, the firm's total premium taxes are lowest if it locates in the state with the lowest tax rate, a result due to the retaliatory tax. Therefore, this firm has an incentive to locate in the low tax state so as to lower its tax liability nationwide.

If the firm does not write policies in the low tax state, then the firm is indifferent between locating in the low-tax and the medium-tax state, but would still prefer either to locating in the high-tax state. On the other hand, once located in the low-tax state, the firm has an advantage over foreign insurers writing policies in the low-tax state. That is because the domestic firm would be subject to the low domestic rate and the foreign insurers would be subject to the higher retaliatory rates. The advantage depends on the difference between the domestic rate and the rate paid by foreign firms.

To formalize the effect of insurance premium taxes on location, consider the following simple model. Assume there are two states, denoted 1 and 2. Let the premium tax be denoted t_1 and t_2 , and assume that $t_1 > t_2$. Given the retaliatory nature of insurance taxation, a firm pays the higher of the domestic tax rate and the tax rate in the state in which the premium is written. Thus, a firm domiciled in state 1 pays a tax of t_1 on all premiums regardless of which state they are written, while a firm domiciled in state 2 pays a tax of t_2 on premiums written in state 2 and t_1 on premiums written in state 1. Let N represent the size of the insurance industry (for example the number of employees), where $N = N_1 + N_2$. Let P_i equal the total value of premiums in state i divided by N . Let the cost per dollar of premium, denoted c , be the same for all firms in a state and constant.

We assume that a firm has a competitive advantage in the state in which it is domiciled, and thus insurance firms domiciled in a state write more premiums in that state than do foreign firms. Let f_i measure the increase in the volume of premiums that a domiciled firm will write in its home state. We assume that f_i is a decreasing function of N_i/N , and that if $N_i/N = 1$, then $f_i = 1$.

Equations 1 and 2 are the profits for an insurance firm domiciled in state 1 and state 2, respectively.

$$(1) \quad \pi_1 = P_1 f_1 (1 - t_1) - c_1 P_1 f_1 + \left[\frac{(P_2 - P_2 f_2 N_2)}{N_1} \right] (1 - t_1) - c_2 \left[\frac{(P_2 - P_2 f_2 N_2)}{N_1} \right]$$

$$(2) \quad \pi_2 = P_2 f_2 (1 - t_2) - c_2 P_2 f_2 + \left[\frac{(P_1 - P_1 f_1 N_1)}{N_2} \right] (1 - t_1) - c_1 \left[\frac{(P_1 - P_1 f_1 N_1)}{N_2} \right]$$

We assume that firms will sort themselves across the two states until profits are equal. If P_i and the function f are the same across states, then one can easily show that in equilibrium $N_2 > N_1$. Assuming that $f_i N_i$ decreases as N_i increases, we can also show that N_2 is an increasing function of c_1 , t_1 and P_2 , and a decreasing function of t_2 , c_2 , and P_1 .

INSURANCE PREMIUM TAX RATES

Our focus is on the property-casualty (PC) industry, in part because it is possible to obtain information about the taxes paid by each insurer writing insurance in a state for this industry.⁷ We constructed state-specific effective tax rates as follows: total direct taxes paid to state j by insurance companies domiciled in state j by premiums written in state j by insurance companies domiciled in state j . Total taxes include the premium tax less any credits. Thus, our tax variable reflects state-specific institutional provision of the premium tax.

The data for constructing the effective tax rates come from the *NAIC Annual Report*, State Page (various years). This dataset contains a state-by-state enumeration of premiums, losses, expenses, commissions, and taxes for each company-writing business in a state in a given year. Specifically, the data contain the amount paid in a given year for premium taxes, licenses, and fees. The effective rates for the domestic industry are calculated as the sum of domestic taxes, licenses and fees, as a percent of total premiums by domestic companies. The foreign effective rate is similarly defined for companies chartered in states other than the state

Table 2

State Nominal and Effective Premium Tax Rates for Property/Casualty Lines of Coverage, 2004

State	General Tax Rate	Effective Tax Rate	
		Foreign	Domestic
Alabama	3.6%*	3.58%	2.13%
Alaska	2.70%	2.71%	3.05%
Arizona	2.00%	2.32%	2.40%
Arkansas	2.50%	3.01%	2.77%
California	2.35%	2.35%	2.54%
Colorado	2.00%	1.80%	1.04%
Connecticut	1.75%	2.33%	2.27%
Delaware	1.75%	2.98%	1.98%
District of Columbia	1.70%	4.02%	1.61%
Florida	1.75%*****	2.59%	2.43%
Georgia	4.75%****	4.99%	3.21%
Hawaii	4.265%	3.81%	2.11%
Idaho	2.50%	2.90%	1.42%
Illinois	privilege tax of 0.5%/0.4%**	2.17%	1.54%
Indiana	1.30%	1.83%	0.41%
Iowa	1.50%	1.84%	1.82%
Kansas	2.00%	1.95%	1.44%
Kentucky	3.00%****	3.14%	0.21%
Louisiana	2%***	3.39%	2.42%
Maine	2.00%	2.86%	2.73%
Maryland	2.00%	2.26%	2.23%
Massachusetts	2.28%	2.70%	2.88%
Michigan	taxed under Single Business Tax	1.70%	0.98%
Minnesota	2.00%	2.27%	1.96%
Mississippi	3.00%	3.87%	3.72%
Missouri	2.00%	2.08%	1.76%
Montana	2.75%	2.96%	3.64%
Nebraska	1.00%	1.84%	1.83%
Nevada	3.50%	3.26%	1.82%
New Hampshire	2.00%	2.93%	3.70%
New Jersey	2.10%	2.54%	1.26%
New Mexico	3.03%	3.11%	5.48%
New York	2.00%	2.71%	3.04%
North Carolina	1.90%	2.45%	2.58%
North Dakota	1.75%	1.44%	1.60%
Ohio	1.40%	1.75%	1.62%
Oklahoma	2.25%	2.30%	2.24%
Oregon	s.t. corporate excise tax on net income	1.62%	2.40%
Pennsylvania	2.00%	2.37%	2.66%
Rhode Island	2.00%	2.48%	3.73%
South Carolina	3.25%****	4.17%	4.72%
South Dakota	2.50%	2.44%	1.72%
Tennessee	2.50%	2.79%	0.92%
Texas	1.60%	2.02%	1.76%
Utah	2.25%	2.65%	7.28%
Vermont	2.00%	2.59%	2.83%
Virginia	2.25%	2.68%	2.76%
Washington	2.00%	2.12%	2.06%
West Virginia	3.00%	4.03%	0.81%
Wisconsin	2% or income tax*****	1.93%	1.49%
Wyoming	0.75%	1.88%	1.98%

Source: NAICS, 2005.

Note: The effective rates include all taxes, licenses, and fees and thus will differ from the nominal tax rate shown in the second column. Many states also subject premiums to an additional tax on a portion of premiums for the provision of fire services. There may be additional taxes on marine insurance, workers compensation, and for insurance sold by non-licensed carriers. These additional taxes, along with the retaliatory tax, will often raise the effective tax rate. States also have provisions which provide domestics (and in some cases foreign companies) with job credits or credits for investments made within the states. This will tend to reduce the effective rate from the nominal rate.

*The 2.3% rate applies to Life Insurance companies. Accident and Health lines face a tax rate of 1.6%.

**The 0.5% rate applies to all lines except Health. Health lines are subject to a tax rate of 0.4%.

***Tax is \$140 for premiums less than \$7,000 or less. Add \$225 for each additional \$10,000 or fraction thereof.

****Includes local premium tax.

*****Applies to certain life insurance companies.

*****Florida makes an additional assessment to pay for past hurricane losses covered by state catastrophe fund.

in question. That is, the foreign tax rate is the sum of taxes paid to state *j* by foreign firms divided by the premium written in state *j* by foreign firms. Table 2 shows the average premium tax rate by state for the property-casualty industry for 2005.

The states have different tax policies for foreign and domestic companies that lead to differences in tax rates between domestic and foreign companies. This is seen in the data in Table 2. The overall U.S. average insurance premium tax rates are different between foreign and domestic companies. These differences in tax policy toward domestic and foreign companies can be as simple as a rate difference or as subtle as differences in credits. For example, Georgia nominally has the same tax rate for foreign and domestic companies, but it provides a lower rate for those companies that invest 75 percent of their assets in the state. Domestic companies are more likely to be able to invest 75 percent of their assets within the state to obtain a significant reduction in the tax rate than would foreign companies. This is, in part, because in Georgia local companies are relatively small and while there are some small foreign companies, most of the

large ones would not be permitted (for prudential reasons) to invest 75 percent of their assets in any one state. Table 2 also illustrates the possible rationale for using the insurance tax system to attract companies to the state. Companies chartered in relatively high premium tax rate states will face higher premium taxes in relatively low tax environments.⁸

There is a substantial range of effective domestic tax rates. For 2004, the rates ranged from 0.21 percent to 7.28 percent, with a mean of 2.33 percent and median of 2.13 percent. Nearly one-half of the states have tax rates within 0.5 percentage points of the median. There is little correlation between the nominal and effective domestic tax rates; the correlation coefficient is 0.14. The range of the effective foreign tax rates is 1.44 percent to 4.99 percent, with a mean of 2.64 percent and a median of 2.54 percent. The correlation coefficient between the foreign and domestic effective rates is 0.296.

Figure 1 shows the pattern of the U.S. average foreign and domestic effective tax rates over the period 1992-2004. As can be seen, the effective foreign tax rate declined over the period, from 3.2

Figure 1: Average Effective Tax Rate, 1992-2004

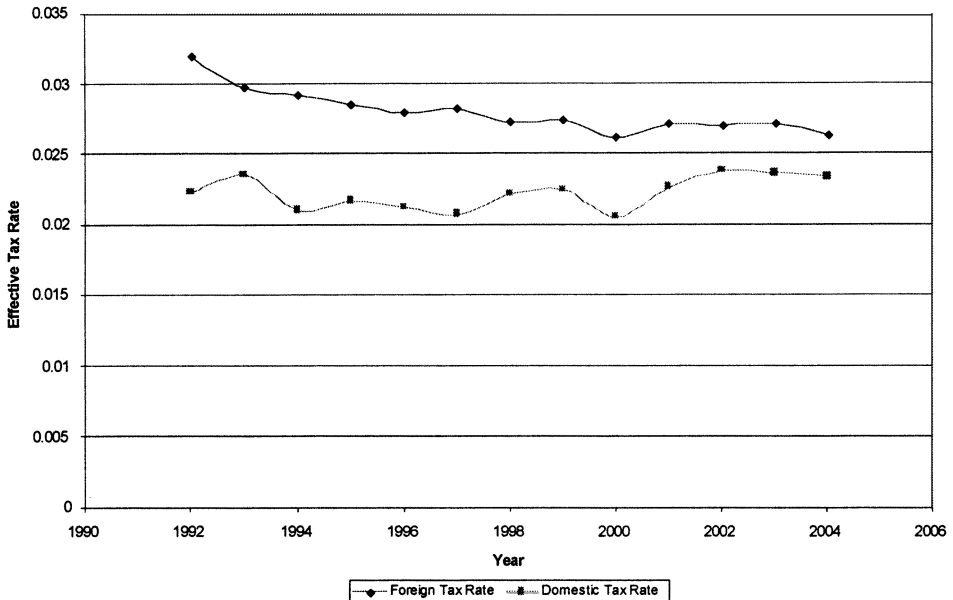


Table 3
Transition from Quintile in 1992 to Quintile in 2004, Effective Domestic Tax Rate

		2004				
		0	1	2	3	4
1992	0	5	1	2	0	1
	1	0	6	2	2	0
	2	4	2	2	2	0
	3	0	1	2	4	3
	4	0	0	2	2	8

Table 4
Transition from Quintile in 1992 to Quintile in 2004, Effective Foreign Tax Rate

		2004				
		0	1	2	3	4
1992	0	3	0	4	0	2
	1	1	3	0	2	4
	2	2	1	3	2	2
	3	0	1	1	4	4
	4	3	5	2	2	0

percent to 2.6 percent. The U.S. average domestic effective tax rate has fluctuated over the period, but there is no discernable trend. The effective foreign tax rate is larger than the effective domestic tax rate, but the difference has declined over the period.

Tables 3 and 4 compare the distribution by quintile for the 1992 and 2004 domestic and foreign effective tax rates tax, respectively. For the domestic tax rate, nearly 50 percent of the states were in the same quintile in both periods, while nearly an equal percentage were in higher and lower quintiles. For the effective foreign tax rate, only 25 percent of the states were in the same quintile in both years, and a slightly greater percent of states had a higher tax rate in 2004 than in 1992.

TAX RATES AND THE SIZE OF THE STATE INSURANCE INDUSTRY

Table 5 contains a list of the number of insurance companies by product line domiciled in each state in 2006. There is a wide variation among the states. Larger states in terms of population tend

to have more domestic companies, but there are exceptions. For example, Vermont has almost 500 “other” companies, which are so-called captive companies owned by non-insurer parents. Arizona has a large number of life and health companies. Texas has 151 property-liability companies, many of which write insurance in a relatively small area and are the result of historical regulatory policy.

The average state in 2004 had about 40 domestic companies and an additional 597 foreign companies operating in the state. The average state also had about 2 percent of the national property casualty employment and about 2.4 million dollars in premiums per 1,000 people. The average domestic property-casualty market share was just under 20 percent.

We compare tax rates to the employment in the property-casualty industry (excluding agents) in a state in a given year. These data come from the U.S. Census Bureau; we have a consistently defined series from 1992-2004. The series for PC employment is from the NAICS series 524126. The average state has 1,499 employees per 1000 population.

Figure 2 shows how insurance employment per capita varies with the effective domestic tax rate. It is hard to see much of a pattern, and a simple regression produces a negative but statistically insignificant coefficient on the tax rate. Of course, this regression does not control for any of the other factors that might explain the variation in employment in the insurance industry across states. There are several states that have a low tax rate but low insurance employment per capita (for example, Wyoming, West Virginia, Idaho, and North Dakota), while a few have a high tax rate and high insurance employment (for example, New Hampshire, Rhode Island, and Massachusetts). We also ran a regression on the number of property-casualty firms in a state against the effective domestic tax rate. Again the coefficient is negative but statistically insignificant.

We ran the same two regressions but used the effective foreign tax rate. For these two regressions, the coefficients on the tax variable are both negative and statistically significant. However, the coefficients are very small, and imply an elasticity of employment per capita with respect to the tax rate that is very close to zero.

Table 5
Distribution of Insurance Companies by State, 2005

<i>State</i>	<i>Life/ Health</i>	<i>Property/ Casualty</i>	<i>Health Only*</i>	<i>Other**</i>	<i>Total</i>	<i>% of US Total</i>
Alabama	13	22	5	4	44	0.57
Alaska	0	7	2	2	11	0.14
Arizona	220	46	19	66	351	4.58
Arkansas	35	11	8	16	70	0.91
California	27	125	NA	34	186	2.43
Colorado	10	18	21	16	65	0.85
Connecticut	32	69	6	2	109	1.42
Delaware	37	79	10	7	133	1.73
District of Columbia	3	7	7	65	82	1.07
Florida	40	124	72	317	553	7.21
Georgia	15	39	14	60	128	1.67
Hawaii	3	17	5	158	183	2.39
Idaho	3	9	6	1	19	0.25
Illinois	70	197	25	98	390	5.09
Indiana	44	69	18	54	185	2.41
Iowa	23	54	9	115	201	2.62
Kansas	14	26	7	3	50	0.65
Kentucky	9	7	12	24	52	0.68
Louisiana	51	33	11	37	132	1.72
Maine	2	21	4	0	27	0.35
Maryland	8	46	24	1	79	1.03
Massachusetts	19	54	14	5	92	1.20
Michigan	25	67	46	9	147	1.92
Minnesota	12	50	16	99	177	2.31
Mississippi	23	17	3	7	50	0.65
Missouri	34	53	27	115	229	2.99
Montana	2	4	4	26	36	0.47
Nebraska	28	35	4	34	101	1.32
Nevada	2	14	14	66	96	1.25
New Hampshire	3	29	8	1	41	0.53
New Jersey	6	86	4	17	113	1.47
New Mexico	3	9	9	0	21	0.27
New York	85	194	57	223	559	7.29
North Carolina	5	66	14	2	87	1.13
North Dakota	3	17	5	15	40	0.52
Ohio	37	135	28	63	263	3.43
Oklahoma	28	50	11	7	96	1.25
Oregon	3	15	22	108	148	1.93
Pennsylvania	37	193	41	30	301	3.93
Rhode Island	4	24	4	0	32	0.42
South Carolina	14	34	9	123	180	2.35
South Dakota	1	18	6	19	44	0.57
Tennessee	14	20	11	22	67	0.87
Texas	157	237	52	31	477	6.22
Utah	15	10	12	16	53	0.69
Vermont	2	15	4	546	567	7.40
Virginia	14	18	19	25	76	0.99
Washington	10	21	21	4	56	0.73
West Virginia	2	5	5	11	23	0.30
Wisconsin	35	182	37	126	380	4.96
Wyoming	0	2	2	1	5	0.07
United States***	1299	2725	811	2831	7666	

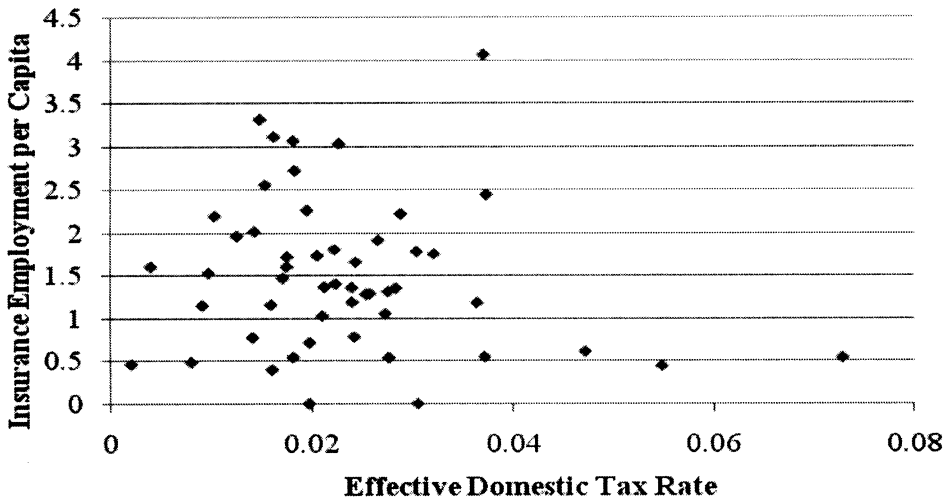
*Blue Cross/Blue Shield, HMOs and hospital, medical and dental indemnity (HMIDI) plans that provide stipulated payments to an insured person during hospital confinement for virtually all costs related to hospital stays; other medical expenses; and for dental services and supplies.

**Includes Fraternal, Title, Risk Retention Group, and Other lines.

***Includes territories and possessions.

Source: The Insurance Information Institute, 2006.

Figure 2: Insurance Employment and Effective Tax Rate



Notes

- ¹ For example, there have been conversations in Georgia about reducing the insurance premium tax.
- ² *Paul v. Virginia*, 1869.
- ³ The commerce power generally restricts states from taxing out-of-state companies at differentially higher rates. See *Bacchus Imports, Ltd. v. Dias*, 1984.
- ⁴ The Supreme Court upheld the use of retaliatory taxation by the states in *Western & Southern Life Insurance Co. v. State Board of Equalization*, 1981 based on the notion that Congress gave power to the states to tax and remove commerce power restrictions.
- ⁵ The Court did have trouble with the Equal Protection Clause argument, and this was the genesis for the Court's decision in *Metropolitan Life Ins. Co. v. Ward*, 1985 invalidating the broad protection a state had in setting domestic preferential tax rates.
- ⁶ While almost every state has the premium tax, some have both a premium tax and an income tax. However, because the premium tax is always greater than then income tax (and the income tax is creditable against the premium tax), in this paper we refer to the premium tax as the method of taxing the insurance industry.
- ⁷ This level of detail for state taxes is not available for the life insurance industry.
- ⁸ One other item to note is that the data underlying the effective tax rate includes premium taxes, retaliatory taxes, as well as other fees and assessments. The fees tend to be relatively small as they are charges for regulatory reviews and licenses. Assessments can be relatively large and occur when a bankrupt insurer has

liabilities greater than its assets. In almost every state, the remaining insurers are assessed an amount based on market share to cover any shortfall caused by an insurer's bankruptcy. Some portion of this assessment each year is often deductible (or creditable) against the premium tax as a carryforward. In addition, there are some other differences in state taxation that may lead to effective rates being greater or less than the nominal rates.

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