CALIFORNIA STATE BOARD OF EQUALIZATION

SUMMARY DECISION UNDER REVENUE AND TAXATION CODE SECTION 40

In the Matter of the Claim for Refund Under the Tax on Insurers Law of:	Case ID:	240627
	Oral hearing date:	June 25, 2015
	Decision rendered:	August 20, 2015
	Publication due by:	December 18, 2015
TRUCK INSURANCE EXCHANGE		
Claimant		

Representatives:

For Claimant:	Richard G. De La Mora, Attorney
For Department of Insurance:	David Okumura, Sr. Insurance Examiner Laszlo Komjathy, Jr., Staff Counsel IV
For Special Taxes and Fee Department:	Andrew Kwee, Tax Counsel III
For Appeals Division:	David H. Levine, Tax Counsel IV

LEGAL ISSUE

Whether claimant is entitled to a refund of the insurance tax it paid because it did not claim a deduction on its insurance tax return for a payment made to resolve a dispute with policyholders.

FINDINGS OF FACT AND RELATED CONTENTIONS

Claimant is an interinsurance exchange subject to the tax on insurers imposed by the California Constitution (art. XIII, § 28) and by the Tax on Insurers Law (Rev. & Tax. Code, § 12001 et seq.). Claimant issued an insurance policy to the California Hospital Association (CHA) to provide insurance to its members (hereafter subscribers) for the period, as relevant here, January 1, 1973, through policy termination on December 31, 1984. Claimant and CHA also entered into an agreement related to that policy, entitled "Hospital Professional Liability Premium Determination and Disposition Agreement" (PDA), under which claimant agreed to apply certain surplus amounts to reduce premiums payable by subscribers during the policy period, and to thereafter pay certain surplus amounts to subscribers. Based on the policy termination date, these surplus payments were to be made annually beginning on June 1, 1990, and to continue through June 1, 2000.

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In May 1994, after four of the eleven required annual payments presumably had been made, a lawsuit was filed on behalf of subscribers alleging that claimant had not paid all amounts it was required to have paid pursuant to the PDA. After the filing of the suit, claimant agreed to make a $5,623,231 payment to subscribers, which subscribers agreed to return if they did not prevail in the lawsuit. The only additional payment claimant made in connection with the PDA was its payment in 2000 of $45,000,000 to settle the lawsuit. The court awarded the attorneys $15,810,771 payable from this settlement as attorneys' fees and costs, and the remaining $29,189,229 of the settlement was remitted to subscribers.

Claimant had claimed deductions on its applicable insurance tax returns for the payments it made to subscribers pursuant to the PDA after the term of the insurance policy ended and before the filing of the lawsuit, and for the $5,623,231 payment it made to subscribers after the filing of the lawsuit. These deductions were apparently never challenged by the Department of Insurance (DOI), and the statute of limitations for challenging such deductions has long since passed. Claimant did not take a deduction on its return for 2000 for the $45,000,000 payment it made to settle the litigation, but it thereafter filed a timely claim for refund of the additional insurance tax it paid because it failed to claim a deduction for that payment, asserting that the $45,000,000 payment was return premiums under Revenue and Taxation Code section 12221. Later during the appeals process claimant raised the alternate contention that, even if the payment did not qualify as a return of premiums, it had the right to deduct the payment to compute its reportable gross premiums because that payment constituted an amount "returned to subscribers . . . as savings" for purposes of Insurance Code section 1530.

DOI concluded that premiums paid by subscribers for insurance during the coverage period had been used to pay claims and, to the extent any premiums might have remained after payment of those claims, such amounts had been returned to subscribers as part of the four annual payments that were paid as required under the PDA prior to the filing of the lawsuit. DOI further concluded that the funds used to make the payment to settle the litigation were not derived from premiums on which claimant had paid the tax on insurers but rather were derived entirely from investment income (i.e., earnings on premiums prior to their use and earnings on prior earnings). Nor did DOI regard the settlement-related payment as coming within the savings provision of Insurance Code 1530 since payment of the amount

was not based on a discretionary decision by claimant after concluding that such payment would not impair claimant's assets or required reserves. (Cf. Ins. Code, § 1420.)

APPLICABLE LAW

As an insurer, claimant is subject to the tax imposed on insurers by article XIII, section 28 of the California Constitution and by the Tax on Insurers Law (Rev. & Tax. Code, § 12001 et seq.). The measure of the insurance tax is "the amount of gross premiums, less return premiums, received in such year by such insurer upon its business done in this state . . . ." (Cal. Const., art. XIII, § 28, subd. (c); Rev. & Tax. Code, § 12221.) The insurance tax is imposed on insurers in lieu of virtually all other state and local taxes, with limited exceptions, including taxes on real estate and motor vehicle registration license fees. (Cal. Const., art. XIII, § 28, subd. (f); Rev. & Tax. Code, § 12204.) Thus, as relevant here, an insurer, such as claimant, who is subject to the tax on insurers pays no income or franchise tax.

Claimant was required to report and pay the insurance tax on its premiums from insurance issued to subscribers measured by 2.35 percent (Rev. & Tax. Code, § 12202), and did so. Similar to virtually all other insurance companies, claimant invested any such premiums not used to pay claims or other expenses in order to earn additional income.[1] However, without regard to just how much investment income claimant earned (whether directly on the tax-paid premiums or on reinvested income), under the constitutional "in lieu" provision claimant owed no insurance tax, no income tax, and no franchise tax on such investment income.

While Revenue and Taxation Code section 12221 restates the constitutional provision that the insurance tax is measured by gross premiums less return premiums, it goes on to state that, for an interinsurance exchange company (such as claimant), gross premiums is determined by section 1530 of the Insurance Code, which as relevant here provides:

> For the purposes of Section 12221 of the Revenue and Taxation Code, the term gross premiums, as applied to reciprocal or interinsurance exchanges, includes all sums paid by

[1] When DOI considers whether the amount of premium charged by an insurer for insurance is excessive, inadequate, or unfairly discriminatory, DOI is required to consider whether the rate mathematically reflects the insurance company's investment income. (Ins. Code, § 1861.05, subd. (a).) That is, an insurer must take into account the investment income it expects to earn when it sets its premium. However, such investment income is not taken into account in determining the insurance tax owed by the insurer; the tax is measured solely by the premiums actually received.

> subscribers in this state by reason of the insurance exchange, whether termed premium deposit, membership fee, or otherwise, after deducting therefrom premium deposit returns or cancellations, and all amounts returned to subscribers or credited to their accounts as savings . . . .

ANALYSIS AND DISPOSITION

Under the PDA, claimant was required to make certain payments to subscribers if, after payment of claims and costs, "surplus" remained from policy funds (premiums, investment income on premiums, and investment income on prior income). We regard such payments to subscribers as payment of savings from policy funds. While the lawsuit filed against claimant included several different claims, there is no real dispute that the payment at issue here was made to settle the parties' lawsuit regarding the payments required by the PDA. That is, the payment was essentially made pursuant to the PDA. Accordingly, under the facts here, we conclude that the payment constituted a return of savings to subscribers within the meaning of Insurance Code section 1530, to the extent that subscribers actually received such payment.

Claimant made a payment of $45,000,000 to settle the lawsuit, $15,810,771 of which was retained by the attorneys representing subscribers in the litigation for fees and costs, and only the remainder, $29,189,229, was remitted to subscribers. We therefore conclude that claimant returned savings of $29,189,229 to its subscribers and could have properly deducted this amount to compute its reportable gross premiums for the year 2000, but that the $15,810,771 retained by the attorneys for fees and costs did not constitute savings returned to subscribers for purposes of Insurance Code section 1530. We conclude that such amount also cannot qualify as a return of premiums to subscribers for the same reason, and we therefore do not address the issue of return premiums further.

We conclude that claimant overpaid tax measured by $29,189,229 because it was entitled to deduct such amount as savings returned to subscribers when it computed the gross premiums it was required to report on its insurance tax returns for the year 2000.

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ORDER

Pursuant to the analysis of law and facts above, the Board ordered that a refund be issued to claimant measured by $29,189,229. Adopted at Sacramento, California, on this 27th day of October, 2015.

George Runner, Member

Fiona Ma, Member

Diane L. Harkey, Member