BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Petitions for Redetermination Under the Tax on Insurers Law of

California Automobile Insurance Company

Appearing for

Petitioner:	Derick Brannan PriceWaterhouseCoopers Theodore Stalick, Witness
Department of Insurance:	Geoffrey Margolis Senior Staff Counsel David Okumura Senior Insurance Examiner
Property and Special Taxes Department:	Trecia Nienow Supervising Tax Counsel III
Appeals Division:	Lucian Khan Tax Counsel IV

MEMORANDUM OPINION

This opinion considers the merits of two petitions for redetermination for the years 1998, 1999 and 2000. At issue is whether the gross premiums tax under Article XIII, section 28, subdivision (c), of the California Constitution and Revenue and Taxation Code section 12221 (hereinafter section 12221) should be reported and paid on a cash basis or accrual basis.

The disputed language in the Constitution and section 12221 states that, in the case of an insurer not transacting title insurance business in this state, the gross premiums tax is based on "the amount of gross premiums, less return premiums, received in such year by such insurer upon its business done in this State." Through 1997, petitioner reported gross premiums tax using the accrual

basis method (i.e., premiums-written method) regardless of when the premiums were actually received. Starting in 1998, however, petitioner commenced reporting its gross premiums using the cash basis method (i.e., premiums-received method). Petitioner's audit liability is for the difference between the gross premiums tax computed on an accrual and cash basis.

Petitioner contends that it correctly reported taxable premiums using the gross amount of premiums received, less return premiums, upon its business done in this state. Petitioner claims that it is unaware of any legal basis or restrictions that prevent it from reporting premiums on a "received" basis under the California Tax on Insurers Law. According to petitioner, it is only following the "plain meaning of the language" in the statute and Constitution.

The Department of Insurance (DOI) disagrees contending that it has historically interpreted the statute to impose tax on premiums written, thus requiring that tax be reported on an accrual basis. DOI's reasoning is as follows:

> "In order for the plain meaning of 'premiums received' to only mean cash basis, one would have to imply that 'premiums received' means premiums received and collected and not premiums received and to be received. At the moment un-present words are added to the statute, it becomes very difficult to declare that the existing language has only one plain meaning. Even if one could argue that it is more reasonable to imply the word 'collected,' rather than the words 'to be received,' into the statute, the fact that either could be implied suggests two possible interpretations."

In other words, DOI interprets the statute to mean that tax must be reported on premiums received and premiums to be received (i.e., the premiums-written or accrual method).[1] As further support, DOI points out that Insurance Code section 900 requires every insurer to file an annual (financial) statement in the form and methods prescribed by the commissioner. Insurance Code section 923 specifically requires that the annual statement "shall be completed in conformity with the Accounting Practices and Procedures Manual adopted by the National Association of Insurance Commissioners" (NAIC) and that "the Commissioner may make any changes from time to time in the form of the statements and the number and method of filing reports…."

[1] Note, however, that while not conceding the case, DOI's General Counsel has admitted to an Appeals Division staff attorney that his interpretation of the Constitution and section 12221 was consistent with petitioner's. In other words, the DOI General Counsel has admitted that he interprets state insurance tax law as supporting the imposition of the gross premiums tax on a premiums-received or cash (not premiums-written or accrual) basis. The apparent split of opinion between DOI and its principal attorney is unexplained.

DOI also points out that Insurance Code section 900.2, subdivision (a), provides that the annual statement that insurers are required to file must be audited by a certified public accountant in accordance with the instructions adopted by NAIC and that Insurance Code section 995.5 specifically states that tax shall be reported and paid by an insurer "on the basis that it has received the full premium charge…less returned premiums as permitted by law." DOI further notes that Schedule T (which is included in the annual statement insurers must file) specifically refers to premiums "written" or "direct premiums written," as the basis for reporting gross premiums tax.

We conclude that both the Constitution and section 12221 provide that, for insurers not transacting title insurance in this state, the tax applies to the net amount of premiums *received* each year (i.e., gross premiums received less premiums returned). That is, the tax is imposed on a cash basis. DOI's reliance on Insurance Code section 995.5 is misplaced. The language in that statute is specifically referring to "any contingent or retrospective compensation arrangement including policy fees" as includable in gross premiums tax. In other words, unlike section 12221 which specifies that the tax is due on premiums when received, Insurance Code section 995.5 addresses amounts that are *includable* in gross premiums tax.

We also note from a review of DOI's own historical records (e.g., memos, returns, etc.) that, contrary to its representations to the Board, it appears that for some period of time it previously imposed the tax on the insurers' premiums-received. In other words, DOI previously taxed insurers' gross premiums using the cash (not accrual) basis method. Thus, DOI had formerly taken the same interpretation and cash-basis approach as petitioner.

Although we conclude that premiums actually received in any tax year is the appropriate method for reporting gross premiums tax for that year, we are concerned that for over 30 years DOI has incorrectly interpreted and applied the statute by requiring insurers to report gross premiums tax on an accrual basis. At present, only 38 out of approximately 1300 insurers have attempted to utilize the cash-basis method. We recognize that some accrual-basis insurers may prefer to stay on an accrual basis to avoid the necessity of filing amended returns and also to avoid the cost of converting to a cash basis.

Presumably, the accrual-basis insurers have set up their compliance systems to operate on the premiums-written basis. Such compliance systems also may tie into accrual-basis reporting responsibilities to other states and agencies. Given that DOI has been misinterpreting the statute for many years and those insurers who might now be required to convert to cash reporting have relied on DOI's misinterpretation to their detriment, we also consider whether equitable estoppel should apply to avoid any detriment insurers may face if they are immediately required to convert to cash reporting, both retroactively and prospectively.

The Board of Equalization has been recognized as a constitutional agency for resolving tax disputes (Cal. Const., Art. XIII, § 17; *Citicorp North America, Inc., et al. v. Franchise Tax Board* (2000) 83 Cal.App.4th 1403, 1418). As such, the Board has exercised equitable powers in resolving tax disputes, where appropriate (*Appeal of Wilfred and Gertrude Winkenbach, et al.,* 75-SBE-081). Although Article VI, section 1 of the California Constitution provides that the judicial power of this state is vested in the Courts, it has long been recognized that judicial powers may be exercised by administrative agencies in administrative proceedings. This includes the application of equitable estoppel (*Lentz v. McMahon* (1989) 49 Cal.3d 393, 404-406).

Subject to some recognized exceptions, the estoppel doctrine may be applied against a government agency under appropriate facts. (13 Witkin, Summary of Cal. Law (10th ed. 2006) Equity, § 199.) As it applies here, the four elements of the doctrine of estoppel are: (1) the party to be estopped (DOI) must be apprised of the acts; (2) DOI must intend that its conduct shall be acted upon, or must so act that the party asserting the estoppel (insurers reporting on an accrual basis) has a right to believe it was so intended; (3) the insurer must be ignorant of the true state of facts; and (4) the insurer must rely upon the conduct to its injury. (*Strong v. County of Santa Cruz* (1975) 15 Cal.3d 720, 725.) Furthermore, the California courts have held that, in limited and narrow circumstances, a state government agency may be subject to such estoppel, even in a matter related to taxation. (*Fischbach & Moore, Inc. v. State Board of Equalization* (1981) 117 Cal.App.3d 627.)

In this case, we find that DOI both was aware and intended that insurers report tax on an accrual basis because it was DOI that required them to do so. The insurers who reported on an accrual basis did so based on the advice and directives of DOI. Furthermore, we find that it is likely that any

insurer who now might be required to convert to a cash-reporting basis will incur additional administrative and accounting expenses in so doing.

We therefore believe that if, based upon this decision, DOI were to attempt to require any accrual-reporting insurer to retroactively convert to the cash basis for any open past years, then such insurer may be able to present a compelling case, at least factually, for application of an estoppel against DOI. (*Fischbach & Moore, Inc. v. State Board of Equalization*, *supra*, 117 Cal.App.3d 627.) Accordingly, we urge DOI not to so compel any unwilling insurer to file an amended return based upon this opinion. In the interests of fairness, equity, and sound tax administration, we further urge DOI not to require any unwilling insurer to convert to the cash-reporting basis in the future until such time as it has promulgated administrative regulations which address the proper procedure for transitioning from accrual to cash reporting, as well as all related issues, including whether or not it is possible for an insurer to elect or change a prior election of an accounting method. Of course, those insurers who wish to immediately convert to cash reporting or file amended returns for open past years may rely upon this opinion as authority for such actions.

Accordingly, we find that California law requires the imposition of the gross premiums tax on the premiums-received or cash basis. We, therefore, grant the petitions and allow petitioner to report its gross premiums tax using the premiums-received method.

Adopted at Sacramento, California, on December 12, 2006.

John Chiang, Chair

Bill Leonard, Member

Betty T. Yee, Acting Member