

**STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
45 Fremont Street, 24th Floor
San Francisco, California 94105**

INITIAL STATEMENT OF REASONS

REPORTING AND FILNG OF PREMIUM TAXES

Date: July 5, 2011

REG-2007-00002

INTRODUCTION

On December 12, 2006, the State Board of Equalization's opinion issued on December 12, 2006, in *Matter of the Petitions for Redetermination Under the Tax on Insurers Law of California Automobile Insurance Company* held that pursuant to the California Constitution, insurers doing business in California are required to report and pay premium taxes based on premium received and not on premium written. Historically, the California Department of Insurance ("CDI") has required the reporting and payment of premium taxes based on premium written and not on premium received as required by the California Constitution. The State Board of Equalization ("SBE") also determined that since the CDI had historically required the reporting and payment of taxes based on premium written, it would allow admitted insurers to elect whether to continue paying premium taxes on written premium or on premium received.

SBE further found that is likely that if an insurer is required to convert to a cash-reporting basis it will incur additional administrative and accounting expenses in doing so. Consequently, the SBE concluded that in the interests of fairness, equity, and sound tax administration the CDI is "urged 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."

The Commissioner believes that the proposed regulations are necessary to carry out the intent and purpose of the State Board of Equalization's opinion and create a framework for an insurer who opts to transition from reporting and paying premium taxes based on premium written to premium received, while requiring newly admitted insurers to report and pay premium taxes on premium received as provided by the California Constitution.

The purpose of these regulations is to provide a regulatory scheme to permit an insurer to transition from reporting and paying premium taxes based on premium written to premium received as required by the California Constitution as interpreted by the SBE in *Matter of the Petitions for Redetermination Under the Tax on Insurers Law of California Automobile Insurance Company*.

Historically the CDI interpreted the California Constitution to require insurers to report and pay premium taxes owed based on premium written and not when the premium is received, although

the Constitution specifically provides that the “‘basis of the annual tax’ is, in respect to each year, the amount of gross premiums, less returned premiums, *received in such year* by such insurer upon its business done in this state, . . .” (emphasis added).

SPECIFIC PURPOSE AND REASONABLE NECESSITY OF REGULATIONS

The specific purpose of each adoption and the rationale for the Commissioner’s determination that each adoption is reasonably necessary to carry out the purpose for which it is proposed are set forth below.

SECTION 2327: Definitions.

This section defines each of the terms used to determine the applicable basis upon which premium taxes are assessed, defines standard accounting terms which will be used by the insurer for its financial statements, defines terms used in determining whether premium has been collected by the insurer for purposes of assessing and payment of taxes based on premium received, defines terms used for purposes of preparing financial statements based on statutory accounting principals, defines which lines of insurers are subject to the regulations and taxation of premium, and defines what is an open taxable year for purposes of filing amended tax returns.

Section 2327, Paragraphs (a) and (b)

These definitions are added as they relate to the basis for accounting for premiums written or received. Accrual basis and cash basis is specifically defined so that an insurer is able to delineate the difference between the methodology previously used by the Department of Insurance, accrual basis, versus cash basis as determined in the State Board of Equalization’s decision in *California Automobile Insurance Company* (December 12, 2006).

Section 2327, Paragraph (c)

This definition has been added for purposes of defining the portion of premium written during the tax year that is to be included as premium collected on a cash basis for calculating amount of premium taxes due as determined in the State Board of Equalization’s decision in *California Automobile Insurance Company* (December 12, 2006).

Section 2327, Paragraph (d)

The definition of Direct Premiums is included to exclude reinsurance premiums for purposes of calculating an insurer’s premium tax obligations since it specifically excluded by California Revenue and Taxation Code Section 12221 and federal law.

Section 2327, Paragraph (e)

This definition is added to define what is excluded from gross premium for purposes of determining the initial basis for calculating premium taxes.

Section 2327, Paragraph (f)

This definition is added to reflect what form of legal entity is obligated to pay premium taxes and to specifically exclude ocean marine insurance and title insurance since ocean marine insurance is taxed pursuant to Revenue and Taxation Code section 12101 et al; and Cal Constitution, Art. XIII § 28 specifically excludes title insurance from calculating and paying taxes based on premium received.

Section 2327, Paragraph (g)

This definition is added since the National Association of Insurance Commissioners promulgates schedules and forms adopted for purposes of filing statutory financial statements used in determining payment of premium taxes.

Section 2328, Paragraph (h)

This definition is included for purposes of defining what the Annual Statement Schedule T is as defined by the NAIC and adopted by most states for purposes of determining the amount of premium that is subject to taxation.

Section 2327, Paragraph (i)

This definition is included for purposes of limiting the prior tax years that an insurer can file an amended return for if it elects to pay premium taxes on a cash basis for prior years so that the regulations comport with the limitation found in California Revenue and Taxation Code section 12978.

Section 2327, Paragraph (j)

This definition is included so that all premium tax activity is captured and accounted for purposes of determining the appropriate basis for calculating premium taxes due and payable.

Section 2327, Paragraph (k)

This definition is included for purposes of defining what portion of premium would be necessarily excluded from the insurer's calculation of premiums received for purposes of determining its tax basis if it selects calculating taxes on a cash basis in order to comport with the State Board of Equalization's decision in *California Automobile Insurance Company* (December 12, 2006).

SECTION 2327.1: Selection of Cash or Accrual Basis

This section is added to comport with the requirements of the California Constitution that an insurer is required to pay taxes based on premium received during the tax year and not based on premium written.

However, the State Board of Equalization in issuing its decision in *California Automobile Insurance Company* (December 12, 2006) determined that since the insurers have been reporting their taxes based on premium written and not premium received, it would be inequitable to require an insurer to incur significant costs to revise its accounting, compliance and reporting systems to permit it to report and pay its California taxes based on premium received and not on premium written. Consequently, this section provides the insurer with an election whether or not to continue reporting and paying taxes on premium written instead of premium received. However, once an admitted insurer elects to report and pay taxes on a premium received, the insurer is required thereafter to always report and pay its taxes based on premium received.

Section 2327.1, Paragraph (a)

This section is added to make it clear that an insurer is required to pay taxes on all premiums received during the tax year whether filing and paying on cash basis or a premium written accrual basis.

Section 2327.1, Paragraph (b)

This section is added so that an insurer knows that whether it files and pays premium taxes based on either a cash basis or accrual basis, the insurer is required at a minimum to pay taxes on all premium received by the insurer during the applicable tax year.

Section 2327.1, Paragraph (c)

This section is added to provide that an insurer who elects to file on an accrual basis rather than on a premium received cash basis is required to pay taxes on all direct premium reported and that the return be filed at the same time as if it filed on a cash basis and the taxes paid are equivalent to or greater than if filed and reported on premium received cash basis.

Section 2327.1, Paragraph (d)

This section is added to provide an insurer with an election to switch from reporting and paying premium taxes from an accrual basis to a cash basis, but once the election is made the insurer is required thereafter to always file and report its premium taxes on a premium received cash basis.

Section 2372.1, Paragraph (e)

This section is added to prohibit an insurer from filing and paying in any tax year its premium taxes partly on an accrual basis and partly on cash basis except in the lone circumstance when a merger is completed during the tax year and then the surviving insurer may elect to file its return and pay premium taxes partly on accrual and party on a cash basis. Additionally, this section grants the commissioner the authority to exercise his discretion whether to allow the surviving insurer to file in subsequent tax years in part on an accrual basis and a cash basis.

SECTION 2327.2: Insurers Filing on a Cash Basis

This section is added for the purpose of defining the methodology to be used by an insurer electing to file taxes on a cash basis and in compliance with the requirements of the California Revenue and Taxation Code.

Section 2327.2, Paragraph (a)

This section is added so that an insurer transitioning to reporting and paying taxes on premium received is still required to calculate the taxes due pursuant to Revenue and Taxation Code section 12221.

Section 2327.2, Paragraph (b)

This section is added to provide a methodology to permit an insurer to amend its tax returns for prior open tax years using a ratio of the insurer's direct premium written in California to the insurer's total premium as reported in the insurer's NAIC annual Statement Scheduled T to calculate the basis for its taxes when applying Revenue and Taxation Code section 12221 in the event that the insurer cannot readily provide without undue hardship the data necessary to calculate its taxes in accordance with section 2327.2(a).

IDENTIFICATION OF STUDIES

There is no studies relied upon in the adoption of this article. In adopting the proposed regulations the Department is relying on the State Board of Equalization's opinion issued on December 12, 2006, in *Matter of the Petitions for Redetermination Under the Tax on Insurers Law of California Automobile Insurance Company*, the California Constitution, Article 13, Section 28, the United States Supreme Court decisions regarding the limits of taxing premiums, etc.

SPECIFIC TECHNOLOGIES OR EQUIPMENT

Adoption of these regulations would not mandate the use of specific technologies or equipment.

ALTERNATIVES

The Commissioner has determined that no reasonable alternative exists to carry out the purposes for which the regulations are proposed.