

Investment Income and the Insurance Gross Premiums Tax

LEGISLATIVE ANALYST'S OFFICE



INTRODUCTION

Chapter 868, Statutes of 2004 (AB 263, Oropeza), requires the Legislative Analyst's Office (LAO) to conduct a study on the state revenue impact from tax provisions regarding the treatment of investment income earned by insurance companies. Specifically, state law seeks to avoid situations in which insurance companies have excessively large amounts of total income relative to the volume of premiums they collect. This is a concern because, under certain circumstances, corporations may try to avoid taxes on their noninsurance income by locating the income within an insurance subsidiary.

The purpose of this report is to assess the extent of this problem and whether current protections in law address it. Among other things, the report's purpose is to:

- Assess the ability of taxpayers subject to the corporate income and franchise taxes (CT) to avoid the payment of taxes through the ownership of one or more insurance companies, which are not themselves subject to these taxes.
- Determine whether current statutory provisions that are designed to prevent companies from avoiding taxation of noninsurance income should be relaxed.
- Evaluate the amount of gross premiums taxes paid by the insurance industry and compare the method of their collection and the amount of such tax payments to that which would occur under the CT.

Principal Findings

We find that:

- No companies have triggered the statutory provisions that have been in place to protect against avoiding taxation of noninsurance income. It also appears unlikely that any insurance company will trigger the higher limit that went into effect on January 1, 2008. As a result, we see no need to amend this provision.
- The Legislature should require the Franchise Tax Board (FTB) to collect additional data that would improve its ability to enforce tax laws involving the taxation of insurance dividends.

The remainder of this report first provides background information on how insurers are taxed in California, how this differs from the tax treatment of other businesses, and the rationale for this different tax treatment. It next identifies the issues that this different tax treatment raises, Chapter 868's approach to dealing with these issues, and our findings regarding the fiscal effects of Chapter 868. Lastly, it provides our recommendations regarding whether the provisions of Chapter 868 should be modified, and our general assessment of California's special treatment of insurers versus other types of businesses.

BACKGROUND—TAXATION OF INSURERS IN CALIFORNIA

The California Gross Premiums Tax

Insurance companies in California are subject to a gross premiums tax equal to 2.35 percent of all California premiums written. The gross premiums tax is established in Article XIII, Section 28, of the California Constitution. For most types of insurers, this tax is in lieu of all other taxes except property taxes and vehicle license fees. Thus, insurers do not pay tax on other forms of income, such as investment income, or income earned from other trades or businesses. In fiscal year 2006-07, the gross premiums tax raised approximately \$2.2 billion in state General Fund revenues. Most other states also have a state-level gross premiums tax.

How Most Corporations Are Taxed

The taxation of insurers in California differs from both federal taxation of insurers and California's taxation of other types of businesses. At the federal level, there is no gross premiums tax. Rather, insurance companies are subject to the standard federal corporate income tax. As a result, the issues described below regarding insurance companies do not arise in the context of federal taxation.

California also levies a CT on companies other than insurers. Technically, for many taxpayers this tax is a franchise tax based on the amount of the taxpayer's net income. For other taxpayers, it is an income tax. In this report, the term "income tax" will include both the franchise and income taxes. The tax rate is 8.84 percent for regular corporations (referred to as C-corporations) and 1.5 percent for Subchapter S corporations (referred to as S-corporations). These S-corporations are corporations with a limited number of shareholders that pass all of their income through to their shareholders for tax purposes every year.

There are two aspects of how noninsurers are taxed that are especially important to understand for the context of this report. These are:

- ***Combined Reporting.*** In California, corporations that are commonly owned and/or operated (such as a parent company and its subsidiaries) file a "combined report." This means they generally file a single tax return based on their combined income. Under this system, most payments *between* such related corporations do not affect taxes. For example, if Corporation A makes a \$1 million payment to related Corporation B, Corporation A's profits will decrease by \$1 million, and Corporation B's profits will increase by \$1 million, but for the combined group these two accounting entries will cancel and the combined group's profits will be unchanged.
- ***Deductions for Dividends Received.*** Revenue and Taxation Code (RTC) Section 24402 allows a parent corporation to deduct the amount of dividends received from subsidiary corporations when calculating its income. Otherwise, the CT would tax this income twice—once at the subsidiary and once at the parent cor-

poration. This deduction leaves the combined income of the two corporations unaffected by the payment of the dividend from one to the other.

How Insurance Companies Are Taxed

In California, insurance companies are subject to the gross premiums tax. Since their activities have already been taxed in this manner, to also include their income on their parents' combined CT returns would result in double taxation. Insurance subsidiaries are, therefore, an exception to the general rules for corporations regarding combined reporting. Their income and expenses are not considered in the calculation of their parents' taxes.

The economics of the insurance industry is a key reason for the special treatment of insurance companies. Most CT taxpayers calculate their income by subtracting costs incurred in the production of a good or service from the revenues received from their sale. Insurance companies, by contrast, collect their revenues up front, then make payments to policyholders based on contingent events that occur many months or years later. Thus, it can be difficult to "match up" revenues to related expenses. In an income tax framework, insurers ideally would be allowed to deduct the current value of all future obligations (claims) covered by the insurance policies they have written when calculating their taxable income for a given year. Because the actual amount of these obligations is uncertain, as are the amount of investment earnings on accumulated premiums received during the intervening period, an accurate determination of the theoretically appropriate amount of taxable income proves very difficult to achieve in practice. For this reason, a premiums tax was adopted.

Advantages and Disadvantages of the Gross Premiums Tax

There are plusses and minuses associated with relying on a gross premiums tax instead of an income tax to tax insurers. The primary advantage of the gross premiums tax is its administrative simplicity. In addition, revenues from the premiums tax are much less volatile over time than those from an income tax, thus making budgetary management easier. This is because premium income does not bounce around much from year to year. (On the other hand, insurance claims, and, hence, the net income of insurers, vary substantially from year to year due to the sporadic nature of events such as natural disasters.)

There are, however, disadvantages to a gross premiums tax:

- One major disadvantage of the gross premiums tax is that it imposes the same tax rate on premiums regardless of the actual profits ultimately associated with a given amount of premiums written. This may be viewed as being inequitable since it implicitly levies a tax that is larger as a percent of profits for less profitable firms than for more profitable firms.
- A second disadvantage is that the overall burden of the gross premiums tax is unlikely to be equivalent to the burden that would exist under the CT. Based on

available information about insurance premiums and insurers' incomes, the gross premiums tax appears, in most years, to raise more revenue than would be raised by applying the CT to insurers' net income. However, because the effects of the two taxes on consumers, employees, and investors tend to be different, the relative burdens of the two taxes on the insurance industry are difficult to assess.

The overall desirability of the gross premiums tax depends on one's assessment of the advantages and disadvantages identified above. In practice, the tax's administrative simplicity and relative stability appear to have been valued highly enough to have made the gross premiums tax the preferred approach.

Tax Liabilities Under the Premiums Tax Versus the CT

The 2008 May Revision projects that gross premiums tax revenues will total approximately \$2 billion in 2008-09. Comparing this to what insurers would pay if, instead, they were subject to the CT is complicated because they do not currently report what their taxable corporate income, if taxed, would generate. One approach, however, to identifying the relative amounts of the two taxes would be to look at federal income tax data on insurers. Economists who have examined state insurance taxes have found that a simple comparison of premiums to net income suggests that insurance premiums tax revenues are several times higher than a profits tax would produce.

This also is true in California. For corporations in the Insurance Carriers and Related Activities industry with net income in 2005, federal income subject to tax was approximately \$100 billion. If California taxable income for these insurers comprised about 10 percent of federal taxable income, applying the state's 8.84 percent CT rate would have generated a little less than \$1 billion in revenues. This is much less than the amount of tax paid under the gross premiums tax.

Whether any particular insurer would owe less tax under the CT than under the gross premiums tax, however, depends on the insurer's actual amounts of investment income relative to premium income. Determining the tax burden on insurers under the two approaches is further complicated by the unknown manner in which the two taxes affect the level of insurance premiums, and thus the way that their tax burden is shared among consumers of insurance, the providers of insurance, and investors in insurance companies. For example, economists generally have concluded that premium taxes are likely to be borne largely through higher premiums paid by households and businesses. In contrast, the CT is more likely to be borne by shareholders, although in the long run, the burden may be partially shifted to workers and consumers (depending on market conditions).

ISSUES ASSOCIATED WITH TAXING INSURANCE SUBSIDIARIES

Two types of concerns arise from the exclusion of insurance subsidiaries from their parents' combined report under California tax law. The first involves *double taxation*. As with subsidiaries that are included in combined reports, insurance subsidiaries can pay dividends to their parents. If the gross premiums tax has collected an amount of money

from the business activities of the insurance company that the state believes is appropriate, then it would be inappropriate to collect additional taxes on this activity from the parent at the time of dividend payment. Because insurance companies are not subject to California Corporation Tax law, however, their dividends are not eligible for deduction under RTC Section 24402. In response to this concern, California created RTC Section 24410 that allows a parent corporation to deduct most dividends paid to it from an insurance company.

The second concern involves a parent corporation transferring income to the insurance company to avoid taxation. Specifically, because insurance companies' profits are not taxable, their parents may try to effectively "shield" their own profits inside their insurance subsidiaries. To the extent that they can do this by reporting their profits as having been earned by their insurance subsidiary, corporations do not pay taxes on those profits. There are a number of ways that this can be accomplished. For example:

- **Stuffing.** A parent corporation could contribute (or "stuff") all or much of its working capital (cash and other liquid investments) to its insurance subsidiary, even if the amount of capital contributed is far greater than would have been contributed based on any reasonable business need on the part of the insurance company. Whenever the parent corporation needs to tap these funds, the insurance subsidiary issues a dividend from the funds' investment earnings. The earnings are not taxable to the insurance company, and most of the dividend is deductible to the parent.
- **"Round Trip Sales."** A parent corporation could contribute to an insurance subsidiary a substantially appreciated asset (such as a large office building) that it wished to sell to some third party. The insurance company could then itself sell the asset to the third party. The gain on this sale would not be taxed since capital gains are not in the gross premiums tax base. When the proceeds of the sale are returned to the parent, via a dividend, they would qualify for the "dividends-received" deduction and thereby avoid taxation.
- **Excess Accumulations.** A profitable insurance subsidiary whose amount of capital had, at some earlier point in time, been determined exclusively by the subsidiary's actual business needs can, over time, accumulate more assets than it needs to sustain its operations. Because the insurance company is not subject to the CT, there is an incentive to allow profits that would otherwise be remitted to the parent, to accumulate in the subsidiary so that the earnings on the reinvestment of these profits will also qualify for the dividend deduction when finally remitted to the parent.

Below, we describe ways in which Chapter 868 attempts to restrict these activities.

Protections Against Inappropriate Reporting of Income

The California Dividends-Received Deduction

As noted above, in response to concerns about the double taxation of insurance company dividends, Chapter 1379, Statutes of 1968 (SB 606, Dolwig), created RTC Section 24410. This section generally provided a deduction for dividends received by California-domiciled corporations from insurers that were subject to the California gross premiums tax and that were 80 percent or more owned by the corporation claiming the deduction.

Section 24410 was subsequently invalidated in *Ceridian Corp. v. Franchise Tax Board* (2000) 85 Cal.App.4th 875. In this decision, the court of appeal held that Section 24410 discriminated against both non-California corporations receiving dividends from insurance companies and against insurance companies not doing insurance business in California. The FTB responded to this decision by denying all dividends-received deductions claimed under Section 24410 for taxable years ending on or after December 1, 1997. (For corporations with earlier tax years still subject to audit, the discrimination was instead remedied by allowing deductions to all corporations and from all insurance companies.)

Chapter 868 repealed and replaced the invalidated Section 24410. The new Section 24410 allows the deduction of 80 percent of qualified dividends for tax years beginning on or after January 1, 2004, and before January 1, 2008, as well as for tax years ending after December 31, 1997 and starting before January 1, 2004 that were still subject to audit. For tax years beginning after January 1, 2008, the deductible portion of qualified dividends rises to 85 percent. The deduction is available to all corporations, whether domiciled in California or not.

Transferring Income to Avoid Taxation

In response to concerns that corporations may try to transfer profits to their insurance subsidiaries in order to avoid taxation, Chapter 868 established several limits on transactions between corporations and their affiliated insurers, including the phase out of the deduction on dividends and a limitation on the amount of nontaxable, noninsurance income an insurance subsidiary may earn. These two provisions are discussed in more detail below.

The Phase Out of the Dividends-Received Deduction. The new Section 24410 provides for a phase out of the dividends-received deduction based on the relative amounts of premiums received and other income generated by insurance subsidiaries. Specifically, the phase out is based on the insurer's ratio of "net written premiums" divided by the sum of net written premiums and investment income. Thus, if a corporation transfers profit-generating activities to an insurance subsidiary, this ratio will go down. All things being equal, a reduction in the ratio will increase a corporation's tax liabilities.

Chapter 868 made the following changes to the dividends-received deduction:

- For tax years prior to January 1, 2008, if the ratio exceeds 60 percent (that is, net premiums written is greater than 60 percent of the sum of net premiums plus investment income), the corporation is presumed not to be placing the parent's profits into its subsidiary and the entire dividend paid that year is qualified (that is, not taxed). If the ratio is less than 60 percent, but more than 10 percent, the portion of the dividend that is qualified is phased out. If the ratio is less than 10 percent, none of the dividend is qualified.
- For tax years beginning on or after January 1, 2008, the ratio below which the phase out begins is increased to 70 percent. In other words, compared to previous tax years, less investment income is allowed relative to premiums before the dividends-received deduction starts phasing out.

To account for the fact that different types of insurance require different amounts of assets in order to be sound financially, premiums of companies specializing in life insurance are multiplied by an adjustment factor of 1.3 and premiums for financial guaranty insurance contracts are multiplied by 2.3. In addition, the ratio is calculated using five-year averages and is applied collectively to all insurers in the corporate group.

Deemed Dividends. The dividends-received deduction determines when corporations pay taxes on investment income that is transferred to a parent corporation. A second provision identifies circumstances when investment income that is retained by an insurance company is excessive and should be considered as profits (or dividends) for the parent corporation. Specifically, RTC Section 29000 gives FTB latitude to “deem” income generated by insurance companies as taxable dividends to the parent corporation under certain circumstances. The FTB, however, does not require corporations to report deemed dividends. Instead, FTB relies on audits to identify situations where the deemed income provision applies. In addition, FTB may waive the deemed income provisions if it establishes there is a business reason for the level of income retained by the company.

For tax years beginning on or before December 31, 2007, the statute defines the “deemability” criterion as follows—FTB may assess a deemed dividend if its audit determines that the insurance company's ratio of premiums to premiums plus investment income is less than 10 percent. For tax years beginning on or after January 1, 2008, however, this threshold increases to 15 percent. In other words, a taxpayer can be assessed a deemed dividend with somewhat less investment income relative to premiums than previously.

Evaluating the Increase in the Deemed-Dividend Threshold

Chapter 868 specifically requests the LAO to assess whether the increase in the deemed-dividend ratio to 15 percent should stay in effect. The law asks our office to recommend whether the ratio should revert to the 10 percent level that was in effect prior to 2008.

Data available to assess the new ratio are limited. As noted earlier, taxpayers are not required to report deemed dividends. Rather, FTB must examine taxpayers with insurance subsidiaries and propose any appropriate deemed dividends as audit adjustments. Because of the timing of the typical audit cycle, data on these types of audits is just starting to become available. Section 24900 was first operative for tax years beginning in 2004. Most corporations filing on a calendar-year basis filed their 2004 returns in the fall of 2005, with most fiscal-year filers doing so several months later. In order to avoid duplication of effort with federal tax auditors (who share the results of their audits with the state), state tax auditors often wait one or two years after receiving a return before beginning to audit it.

Thus, under normal conditions, FTB would only now be starting to audit returns that may be subject to deemed income adjustments under Section 24900. In anticipation of the requirements of this report, however, FTB did audit a number of corporations with insurance subsidiaries earlier than it otherwise might have.

Audit staff indicate that, as of this writing, no deemed dividends have been proposed by FTB under Section 24900. Audit staff also have told us that they have not identified any taxpayers with a premiums/investment income ratio that is between 10 percent and 15 percent. (There has been one taxpayer that voluntarily adjusted its income based on the phase out provisions of Section 24410.)

We Recommend Not Changing the Deemed Dividend Threshold Ratio. The absence of any corporations with proposed deemed dividends to date indicates to us that the statute is not unduly burdensome on taxpayers with the premiums/investment income ratio threshold set at 10 percent. Audit data suggest, furthermore, that the threshold ratio of 15 percent now in effect is unlikely to result in the assessment of any additional deemed dividends. We do not, therefore, see any reason for the Legislature to restore the threshold ratio to 10 percent at this time.

Given the very limited data available for our analysis, however, we are unable to advise the Legislature in determining whether the current limits on insurance companies' investment income are appropriate. The FTB does not require taxpayers to identify the amount of deemed dividends on their tax returns. As a result, FTB can only advise that the few insurance companies that have been audited to date do not reach the thresholds required to generate deemed dividends.

Better Data Are Needed. The tax policies discussed in this report are complex, and are designed to reflect the nature of insurance companies that serve the various insurance markets. Because FTB does not require these companies to provide data on their noninsurance income, the Legislature cannot adequately evaluate these policies. The phase out of the dividends-received deduction, for instance, applies to a very broad range of situations. As we discussed earlier, the phase out begins for companies that have a premiums to premiums plus investment income ratio of less than 70 percent (where investment income is roughly one-half the size of premiums). The deduction is eliminated at a ratio of 10 percent (where investment income is nine times the size of premiums). In addition, current law adjusts this ratio for life insurance and financial in-

insurance companies. This is a very broad range of investment income that is designed to cover a wide variety of circumstances. Without better data on the amount of investment income earned by insurance companies, however, we are unable to evaluate the reasonableness of these provisions.

Therefore, we recommend enactment of legislation requiring FTB to collect data on insurance company investment income. Audit staff at FTB have indicated that it is not easy to look at an insurance tax return and identify whether or not the taxpayer has a deemed dividend issue. By changing existing tax forms or requiring the filing of a new form by taxpayers having insurance subsidiaries, FTB would be able to calculate the premiums-to-investment-income ratio in a way that auditors can quickly determine if a deemed dividend should be investigated. In addition, this data would provide the information for the Legislature to better evaluate these tax provisions. We think the reporting burden on business would be modest.



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