



STATE BOARD OF EQUALIZATION

LEGAL DIVISION (M/C: 82)
450 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0082)
Telephone: (916) 445-4380
FAX: (916) 323-3367

JOHAN KLEHS
First District, Hayward

DEAN F. ANDAL
Second District, Stockton

ERNEST J. DRONENBURG, JR.
Third District, San Diego

KATHLEEN CONNELL
Controller, Sacramento

JOHN CHIANG
Acting Member
Fourth District, Los Angeles

E. L. SORENSEN, JR.
Executive Director

February 5, 1998

Mr. Brian Toman
Chief Counsel
Franchise Tax Board
P.O. Box 3070
Rancho Cordova, CA 95741-3070

Handwritten signature: Brian Toman

Re: Taxation of Captive Insurance Companies

Dear Mr. Toman:

This is in response to your memorandum of November 21, 1997, in which you ask whether admitted captive insurance companies are subject to the gross premiums tax provided by Article XIII, section 28 of the California Constitution. You define a "captive" insurance company as a subsidiary of a parent corporation which provides substantially all of its insurance to its parent and affiliates.

You state that the taxation of admitted captive insurance companies is important to the Franchise Tax Board (FTB) in two contexts, the administration of the nonadmitted insurance tax and the combination of captive insurance companies in combined reports for purposes of reporting franchise and income tax. With respect to the administration of the nonadmitted insurance tax, it is our understanding that FTB has been applying the nonadmitted insurance tax to all nonadmitted insurers without distinguishing between captive and noncaptive insurers.

With respect to the combination of captive insurers in combined reports, you state that FTB currently combines captives with other companies in its unitary group on the basis that such companies are not true insurance companies. Insurance companies are not combinable with other companies under FTB Legal Ruling 385. You further state that the combining of captive insurance companies has been tested before the Board of Equalization (BOE). In the summary decision dated [redacted], BOE held that FTB properly combined [redacted] and its captive insurance subsidiary. BOE determined that the "in lieu" provision of section 28 of Article XIII of the California Constitution was not applicable because [redacted] failed to provide any persuasive evidence that [redacted] ever regularly engaged in insurance business. With regard to the agreement between [redacted] and [redacted], BOE relied on *Clougherty Packing Company v. Commissioner*, 811 F.2d 1297 (9th Cir. 1987), to conclude that it was not an agreement for insurance because it did not shift the parent's risk of loss. [redacted] subsequently filed suit in [redacted]

Mr. Brian Toman
February 5, 1998
Page 2

superior court. The court's Statement of Decision, filed on January 17, 1997, stated that did not meet the prerequisites for exclusion from combined reporting provided by FTB Legal Ruling 385. filed a Notice of Appeal of that decision on

DISCUSSION

Insurance companies doing business in this state are liable for an annual gross premiums tax imposed by California Constitution Article XIII, section 28, in lieu of all other taxes and licenses, with certain limited exceptions. (See also Rev. & Tax Code § 12102.) Insurance Code section 22 defines the term "insurance" as a contract whereby one undertakes to indemnify another against loss, damage, or liability arising from a contingent or unknown event. An "insurer" is the person who undertakes to indemnify another by insurance. (Cal. Ins. Code § 23.) Accordingly, if a company enters a contract to indemnify another legal entity from loss, damage, or liability from a contingent or unknown act, that company is an insurer who would be subject to the gross premiums tax. (See Rev. & Tax. Code § 12003.)

By way of a letter dated July 22, 1997, Mr. Hon Chan, Senior Staff Counsel of the Department of Insurance (DOI), advised FTB that: (1) captive insurance companies are subject to the gross premiums tax; DOI has always applied the gross premiums tax equally to all admitted insurers without distinguishing between captive and noncaptive insurers because the gross premiums tax statutes do not make that distinction; (2) an insurance policy issued by a captive insurer is no less valid per se than an insurance policy issued by a noncaptive insurer; any true shifting of risk determination would need to be made on a case-by-case basis irrespective of whether the insurer is a captive or noncaptive insurance company; and (3) the form of an insurer is not controlling for purposes of determining whether it is a true insurer.

While the Board has previously addressed the issue of whether captive insurance companies should be combined with other companies in its unitary group in th:

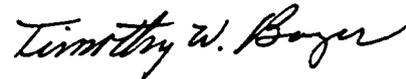
we would recommend to the Board that it reconsider its position in light of DOI's position that the gross premiums tax applies to captive insurance companies. As you know, the California Legislature has granted DOI with the authority to regulate, audit, and investigate companies transacting insurance business in this state. Thus, DOI has the sole jurisdiction to determine whether a contract entered by a company with another legal entity is an insurance contract such that the company would be subject to the requirements set forth in the Insurance Code and in the rules and regulations promulgated by DOI. Specifically, with regard to admitted captive insurance companies, once DOI determines that the captive company is a separate legal entity from its parent corporation and its affiliates, and that the contract executed by the captive company with its parent corporation or other affiliated entities is an insurance contract, the captive company is subject to the gross premiums tax. Accordingly, if an admitted captive insurance

Mr. Brian Toman
February 5, 1998
Page 3

company enters into a contract with its parent corporation or other affiliated entities to indemnify them from loss, damage, or liability from a contingent or unknown act, the admitted captive insurance company would be considered to be an insurer subject to the California gross premiums tax.

If you need any further information, please feel free to contact me.

Sincerely,



Timothy W. Boyer
Chief Counsel

TWB:rz