

**CONFIDENTIAL: ATTORNEY-CLIENT PRIVILEGE**

**Memorandum**

To : Mr. William P. Kimsey  
 (MIC:56)

Date: April 12, 1995

From : Robert W. Lambert  
 Senior Staff Counsel

TO  
 STOD

Subject:

This is in response to your request for an opinion and recommendation with respect to the retaliatory tax refund proposal regarding the Insurance Company received from the Department of Insurance (Department). Please accept my apologies for the delay in responding to your request.

1. **Summary of Recommendation.** For the reasons set forth below, it is my opinion that, unless the Department is found to have made errors in its calculations, the Department's refund recommendation should be followed. In this case, it appears that the taxpayer paid taxes to New York in excess of those actually "imposed" by New York. And, in applying the retaliatory tax, it is my opinion that we should use the "imposed" tax, and not a greater tax that might simply have been mistakenly applied by the taxpayer. Presumably, a hypothetical California insurer in New York would only have paid the minimum "imposed" tax.

2. **Summary of the Facts and Law.** The Insurance Company is a New York domiciled insurer.

During the years in question, an insurance company doing business in New York state was required to pay state taxes equal to the lesser of the following:

- a. A "gross direct premiums" tax of 2.6 percent<sup>1</sup> (NY CLS Tax @ §1505) [the "limitation rate"]; or

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<sup>1</sup>The limitation rate appears to be 2.6 percent, and not the 2.65 percent rate that is recited in some of the documents.

- b. A tax on (i) net income allocated to New York; or (ii) capital allocated to New York; or (c) the alternative base (i.e., net income and officers' salaries), whichever is greater (NY CLS Tax @ §§ 1501 and 1502), plus a tax at the rate of 1.2 percent on "gross direct premiums" (NY CLS Tax @ §1510) [the "combined method"].

In this case, for the 1987 and 1988 tax years, filed its New York tax returns using the "limitation rate" of 2.6 percent. Apparently, practice was to automatically and arbitrarily use the limitation rate--as opposed to calculating the various alternatives that required the completion of detailed schedules.

After filed its New York state tax forms with the Department, the Department, under the "mirror image" principle, computed a California retaliatory tax using the 2.6 percent premiums tax rate.

These retaliatory tax assessments were processed as deficiency assessments since New York companies cannot normally complete their CT-33 forms until September of each year. In this case, after paid the deficiency assessments, it timely filed a claim for refund.

3. **Legal Analysis.** Ordinarily, it is appropriate to utilize whatever tax method or tax rate that was applied to an out-of-state insurer in its state of domicile as the basis for calculating the retaliatory tax in California. For instance, if the premiums tax rate in another state depends upon the amount of investments in that state, the Department will use whatever particular tax rate applies to an insurer from that state in a given year to determine the respective retaliatory tax which that insurer must pay in California for that year. This is the "mirror image" principle.

Thus, if a New York insurer paid its New York taxes using a flat 2.6 percent gross premiums method, the Department would ordinarily simply apply that same flat 2.6 percent rate in

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<sup>2</sup>Perhaps it was this apparent tolerance of the New York state taxation agency in allowing to forego the filing of the other schedules, and the calculation of the other tax alternatives, that led Treasurer to state that had a special or "singular" arrangement for payment of its taxes.

computing California's retaliatory tax to that insurer and we find nothing objectionable in this practice.

However, in this case, there is another factor. Here, in 1990, a newly-appointed Treasurer for [redacted] represented to the Department that, upon assuming his duties, he discovered that the arbitrary use of the 2.6 percent "limitation rate" had led [redacted] to consistently overpay its New York state taxes for a considerable period of time. In other words, that, even though the New York tax law states that the insurer is to pay the lesser of the combined method or the limitation rate method (2.6 percent), [redacted] had consistently paid the greater<sup>3</sup> of these alternatives in using the limitation rate method.

It is this contention that is the basis for the claim for refund in this matter; that, for the years 1987 and 1988, [redacted] overpaid its taxes in New York. [redacted] contends that it has now prepared amended returns for New York showing the correct calculations, but admits that it was not able to obtain a refund since the limitations periods had expired. Nevertheless, after filing these tax returns and supporting documents with the Department, [redacted] apparently convinced the Department that its claims were accurate. In other words, that they had, in fact, overpaid [redacted] New York taxes in 1987 and 1988; and that, thus, the \$20,472 retaliatory tax refund should be paid to [redacted] for these two years.

Therefore, this is the basis for the Department's recommendation to the Board:

- a. Our retaliatory tax law speaks to those "taxes, licenses, and other fees, in the aggregate" that are "imposed" on an insurer; not those that the insurer might simply mistakenly pay (Cal.Const. art. XIII, §28, subsection (f)(3));
- b. Even though this insurer paid a 2.6 percent tax rate on its premiums in New York, it should have paid taxes using the combined method; and
- c. Therefore, it is only those taxes that should have been imposed on this taxpayer in New York under the combined method that should be utilized in computing

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<sup>3</sup>As referenced above, under New York law, the limitation rate method per Section 1505 should only be used if it results in a tax that is less than the tax computed under the standard combined method pursuant to Sections 1501, 1502, and 1510.

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the California retaliatory tax for the 1987 and 1988 tax years. In other words, the hypothetical California taxpayer in New York would only have had the "combined method" imposed on it; not the higher 2.6 percent rate mistakenly used by this taxpayer.

I believe that this argument has merit. If you examine the material submitted by the Department, you will find form 1987 and 1988 New York returns submitted by the taxpayer showing the calculation of the various tax alternatives. While I have not confirmed the accuracy of these returns (or of the data set forth therein), they do purport to demonstrate that the 2.6 percent method resulted in greater New York taxes than should have been paid. And, also in the back-up documents are the Department's Retaliatory Tax Calculations for 1987 and 1988 -- these show that the correct amount of New York taxes that should have been imposed on are less than the "California Tax on Foreign Insurer" calculation; resulting in no retaliatory taxes due.

4. Conclusion. For the above reasons, it is my opinion that the Department's recommendation has merit. Our law refers to "imposed" taxes, not taxes actually paid. Therefore, unless your staff has any problems with or objections to my reasoning--or has found errors in materials or the Department's worksheets--it is my opinion that this refund should be granted as recommended.

*Robert Lambert*

RWL:plh

cc: Mr. Monte Williams (MIC:56)  
Mr. Scott Miller (MIC:56)  
Mr. Gary Jugum

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"Unless you believe that we can successfully argue that, once the limitations period has expired, that, in such circumstance, the "tax imposed" must, by necessity, be the same as the "tax actually paid" since, at that late date, no other tax (whether larger or smaller) is possible. I question whether we can succeed with such an argument.