

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 427

February 1, 1987

TAXATION OF INSURANCE COMPANIES ENGAGED IN NONINSURANCE BUSINESS ACTIVITIES

Syllabus:

Issue Presented: Does Section 28 of Article 13 of the California Constitution prevent the imposition of tax under the Bank and Corporation Tax Law on income of an insurance company engaged in an active trade or business distinct from its business as an insurer?

Decision: No. The exemption provided by Section 28 of Article 13 of the California Constitution is limited to insurance and insurance-related business activity.

Discussion: Section 28(f) of Article 13 of the California Constitution provides that the gross premiums tax imposed by Article 13, Section 28, is "in lieu of all other taxes and licenses, state, county, and municipal, upon such insurers and their property"

The question as to whether the "in lieu" language described above extended to a noninsurance trade or business activity conducted by an insurance company was addressed in a personal property ad valorem tax context in Massachusetts Mutual Life Insurance Co. v. City and County of San Francisco, (1982) 129 Cal.App.3d 876, 181 Cal.Rptr. 370 (Sup.Ct. hg. den. June 9, 1982). The Court of Appeal there held that a mutual insurance company which actively participated in management of a hotel and shared in its profits was not engaged in a mere passive investment traditional in and incidental to the conduct of the insurance enterprise. The court noted that the "in lieu" exemption was provided to offset the effects of the imposition of the more burdensome gross premiums tax. The court then stated:

Since the "in lieu" exemption is granted in return for imposition of a tax on gross, rather than net, receipts, and is functionally related to the tax which insurers must pay on gross premiums paid to the company for insurance benefits (Allstate Ins. Co. v. State Board of Equal., (1959) 169 Cal.App.2d 165, 168 [336 P.2d 961]), in our view it would be inappropriate to allow a tax exemption for property owned by an insurer but not used to produce taxable gross premiums. If it were otherwise, an insurer could entirely escape taxation of all revenue-producing property not used to generate "gross premiums." Under such circumstances, as in the present case, the quid pro quo for the "in lieu" exemption no longer exists; the insurer retains the privilege of doing business,

and derives profits, but pays the state nothing for property owned and used in deriving a conceivably substantial source of its income. We do not think the electors intended such a result.

Plainly, if an insurance company were allowed to own an income-producing business and its fixtures and equipment while escaping taxation under the "in lieu" provision, it would be placed in an unwarranted competitive advantage over other taxed enterprises engaged in the same business. This also we think was not contemplated by the constitutional amendment.

The above analysis applies equally well to the California Bank and Corporation Tax Law. If the exemption from corporate tax under the "in lieu" provision of the Constitution was granted in return for the tax on gross premiums, then to the extent that an insurance company derives income from an unrelated trade or business which is not subject to the gross premiums tax, the quid pro quo for the "in lieu" provision no longer exists.

As applied to the Bank and Corporation Tax Law, however, the above analysis is in conflict with the earlier decision of First American Title Insurance and Trust Co. v. Franchise Tax Board, (1971) 15 Cal.App.3d 343, 93 Cal.Rptr. 177. That case held that income of a noninsurance company, which was otherwise reportable by the insurance company under former Section 23253, Rev. and Tax. Code, in connection with the noninsurance company's liquidation into its insurance company parent, was exempt under the "in lieu" provision discussed above. The court found that the language of the constitutional exemption was "clear and unequivocal and, as such, needs no outside aid to test its meaning, which is that the tax there presented is 'in lieu of all other taxes.'"

The appellant insurance company in Massachusetts Mutual raised the same argument, viz., that the constitutional "in lieu" provision should be interpreted in accordance with its "plain meaning." The court rejected that argument and looked instead to the use to which the insurance company's hotel property was put. It held that the exemption does not extend to "property owned and used by it in the operation of an active business which generates gross operating revenues as opposed to gross insurance premiums" (emphasis in original). Massachusetts Mutual v. San Francisco, supra, 129 Cal.App.3d 876, 886.

Given that the purpose for the "in lieu" constitutional provision is a quid pro quo for the gross premiums tax imposed on insurance-related activities, the Massachusetts Mutual opinion is the better reasoned decision. Accordingly, income from an active trade or business not reasonably related or incidental to the activities traditionally associated with the insurance industry is subject to taxation under the Bank and Corporation Tax Law.

Not all forms of nonpremium income received by an insurance company will subject it to the Bank and Corporation Tax Law. Income generated from the

investment of premiums in debt securities, common and preferred stocks, mortgages and similar instruments which do not require the active conduct of or participation in a trade or business, other than for purposes of protecting an investment interest as in foreclosure or bankruptcy proceedings, as well as gain derived from the disposition of property giving rise to such income, will not subject an insurance company to the Bank and Corporation Tax Law. This distinction is consistent with the holding of Massachusetts Mutual which is grounded upon the conduct of an active trade or business not reasonably related to or incidental to the activities traditionally associated with the insurance industry.

Legal Ruling 20, December 5, 1958, CCH P200-974, P-H P13,522; Legal Ruling 159, December 5, 1958, CCH P201-113, P-H P13,569; and Legal Ruling 307, August 25, 1966, CCH P203-406, P-H P13,521, are modified in accordance with this opinion.