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7 **BOARD OF EQUALIZATION**
 8 **STATE OF CALIFORNIA**

9
 10 In the Matter of the Appeal of:) **REHEARING SUMMARY**
 11) **CORPORATION FRANCHISE TAX APPEAL**
 12 **ARGONAUT GROUP, INC.**¹) Case No. 287738
 13)
 14)

<u>Year Ended</u>	<u>Claims For Refund</u>
December 31, 1994	\$ 52,199
December 31, 1995	690,951
December 31, 1996	16,265
December 31, 1997	884,165
December 31, 1998	414,238
December 31, 1999	1,311,083

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 20 Representing the Parties:

21 For Appellant: Marty Dakessian, Attorney
 22 Alice Ward, Director, Regulatory & Corporate Compliance
 23 For Franchise Tax Board: Karen D. Smith, Tax Counsel IV
 24

25 QUESTION: Whether appellant, a California general corporation with insurance company subsidiaries,
 26 may apply Revenue and Taxation Code (R&TC) section 25137 to reduce its California
 27

28 ¹ Appellant appears to be domiciled in Texas, but appears to have significant operations in Los Angeles County.

1 franchise tax?

2 REHEARING SUMMARY

3 Background

4 This case presents the question of whether R&TC² section 25137 (the Uniform Division
5 of Income for State Tax Purposes Act distortion remedy) should apply. Appellant sourced 100% of its
6 income to California, and argues that application of R&TC section 25137 is necessary and appropriate to
7 fairly reflect its income.

8 Appellant owns 100% of several insurance company subsidiaries operating in California,
9 Georgia, Idaho, Illinois, and Louisiana. Premiums written by these subsidiaries are exempt from the
10 franchise and income tax in California³ and Idaho,⁴ exempt from franchise and capital stock taxes in
11 Louisiana,⁵ and are deductible from business income for reporting net corporation income taxes in
12 Illinois.⁶

13 The taxpayer in this case is appellant Argonaut Group, Inc. (“AGI”), a California
14 corporation that does business only in California. For each of tax years ending on December 31 of 1994,
15 1995, 1996, 1997, 1998 and 1999, AGI (pursuant to section 25101.15), filed a combined report with
16 _____

17 ² All statutory references are to the R&TC unless otherwise noted.

18 ³ See California Constitution, Article XIII, Section 28(f).

19 ⁴ See Idaho Statutes, Title 41, Section 405.

20 ⁵ See Louisiana Revised Statutes, Title 22, Section 791 (“No insurer paying the license taxes levied under this Part shall be
21 liable for any franchise or capital stock tax”).

22 ⁶ This insurance premiums tax appears to exist in all 50 states and the District of Columbia. The website of the National
23 Association of Insurance Commissioners (NAIC), www.naic.org, contains an Online Premium Tax tool whereby insurers can
electronically file and pay premiums taxes to each of the 50 states and the District of Columbia.

24 Idaho by statute exempts insurers from all taxes other than the premium tax; see Idaho Statutes 41-405. Louisiana exempts
25 insurers paying the premiums tax from all franchise and capital stock taxes; see Louisiana Revised Statutes, Title 22, Section
791. Illinois allows insurers to deduct from their corporate income tax payments the amount of premiums tax paid in the
26 previous year that exceeds 1.5% of the net taxable premium for that prior year; see Illinois Consolidated Statutes Chapter
215, Section 409. Illinois Consolidated Statutes, Chapter 35, Section 304(b) provides that business income of an insurance
27 company shall be apportioned based on the proportion of premiums written in Illinois divided by premiums written
“everywhere.”

28 Georgia taxes all corporations on their net income, but does not appear to have any exclusion for insurance companies similar
to California Constitution Article XIII, Section 28(f). See Georgia Code sections 33-8—24 (premiums tax on insurers) and
48-7-21 (6% tax on net income of all corporations).

1 another corporation also doing business solely in California, AGI Properties, Inc. (“AGIP”⁷).⁸ Each
2 return reported dividends received from Argonaut Insurance Company (“AIC”), a California insurance
3 company owned 100% by AGI.

4 For tax years prior to December 1, 1997 (1994, 1995 and 1996), respondent ultimately
5 determined that appellant was entitled to deduct 100% of dividends received from AIC because it was
6 owned 80% or more by appellants.⁹ For tax years 1997, 1998, and 1999, respondent ultimately
7 determined that appellant had made the election required by Assembly Bill 263 (Statutes of 2004,
8 Chapter 868) (“Assembly Bill 263”), thus entitling it (pursuant to amended R&TC section 24401,
9 subdivision (b)(1)) to deduct 80% of the dividends received from AIC in these years. It appears that the
10 20% of dividends it could not deduct for these years total approximately \$29 million.

11 Appellant filed amended returns for each of the six tax years in this appeal, claiming both
12 a 100% dividends received deduction¹⁰ (totaling \$264,581,496) for all six years¹¹ and a further
13 reduction in net income for each year based upon inclusion of apparent net losses and other factors from
14 the following subsidiaries referenced in appellant’s claims for refund letter and the organizational chart
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16 _____
17 ⁷ According to appellant, AGIP “owned and leased California-based real estate and automobiles” and “had no employees”
18 because “AIC personnel handled its day-to-day operations.” Appellant states that it added AGIP as a subsidiary to AIC so
19 “the [AGIP] properties could count as surplus to satisfy the surplus requirements of the California Department of Insurance.”
20 Appellant’s Opening Brief on Rehearing, at page 10: 7 – 12.

21 ⁸ Section 25101.15 states as follows:

22 If the income of two or more taxpayers is derived solely
23 from sources within this state and their business activities are such
24 that if conducted within and without this state a combined report
25 would be required to determine their business income derived from
26 sources within this state, then such taxpayers shall be allowed to
27 determine their business income in accordance with Section 25101.

28 ⁹ Assembly Bill 263 (Statutes of 2004, Chapter 868), allowed an automatic 100% reduction for dividends received from 80%
or more owned insurance companies for tax years ending before December 1, 1997. For tax years after this date, the
legislation required taxpayers to make an election on or before March 28, 2005 in order to claim an 80% reduction. This
legislation was a response to the decision in *Ceridian Corporation v. Franchise Tax Board* (2000), 85 Cal.App.4th 875 (mod.
of opn. on denial of rehearing, 86 Cal.App.4th 383).

¹⁰ Using now-invalidated Section 24410, which authorized a dividends-received deduction only for California-domiciled
insurance companies. This statute was declared unconstitutional in *Ceridian Corporation v. Franchise Tax Board, supra*, 85
Cal.App.4th 875, 875 (mod. of opn. on denial of rehearing, 86 Cal.App.4th 383).

¹¹ As discussed above, respondent has granted a 100% deduction for 1994 to 1996 and an 80% deduction for 1997 to 1999,
based on Assembly Bill 263 (Statutes of 2004, Chapter 868).

1 attached to such letter:

- 2 • Argonaut Insurance Company (“AIC”), a “first-tier subsidiary” “established in California in
3 1948” and owned 100% by AGI;
- 4 • Argonaut Great Central Insurance Company (“AGCIC”), a “second-tier subsidiary”
5 “headquartered in Peoria, Illinois”;
- 6 • The Argonaut Midwest Insurance Company, an Illinois insurance company;
- 7 • The Argonaut Northwest Insurance Company, an Idaho insurance company;
- 8 • The Argonaut Southwest Insurance Company, a Louisiana insurance company;
- 9 • The Georgia Insurance Company, a Georgia insurance company.¹²

10 According to appellant’s claim for refund letter, inclusion of the “factors” from these insurance
11 companies is appropriate based on the distortion remedy language of Section 25137.¹³ According to
12 appellant, unless factors from these insurance companies are included, respondent is overstating
13 appellant’s California income and is unconstitutionally taxing AGI income earned in other states.

14 Respondent disallowed all claims for refund based on appellant’s addition of insurance
15 company factors and section 25137. Respondent noted that had it permitted appellant to use
16 section 25137, appellant would not have been entitled to a dividend received deduction because “the
17 dividends would have been eliminated under section 25106” as a transaction between combined

18 ¹² The domicile states of the latter four entities are taken from the organizational chart, which lists Federal Employer
19 Identification Numbers (FEIN), domicile states, and National Association of Insurance Commissioners (NAIC) numbers for
20 each.

21 ¹³ Section 25137 states as follows:

- 22 If the allocation and apportionment provisions of this act
23 do not fairly represent the extent of the taxpayer's business
24 activity in this state, the taxpayer may petition for or the
25 Franchise Tax Board may require, in respect to all or any part of the
26 taxpayer's business activity, if reasonable:
- 27 (a) Separate accounting;
 - 28 (b) The exclusion of any one or more of the factors;
 - (c) The inclusion of one or more additional factors which will
fairly represent the taxpayer's business activity in this state; or
 - (d) The employment of any other method to effectuate an equitable
allocation and apportionment of the taxpayer's income.

Respondent’s Regulation 25137 states that this provision may be used “only in limited and specific cases” where “unusual
fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results under the apportionment and
allocation provisions contained in these regulations.”

1 reporting group entities.¹⁴ In addition, respondent noted that its 1975 Legal Ruling 385 expressly
2 prohibited the inclusion of income from insurance companies and other entities that are not taxable in a
3 combined report. Respondent issued Notices of Proposed Assessment (NPAs) that were combined with
4 appellant's claims for refund. Respondent subsequently issued Notices of Action (NOAs) disallowing
5 the portions of claimed refunds where the claims were based upon appellant's Section 25137 arguments.
6 This appeal followed. On June 27, 2006, the Board voted to sustain respondent.¹⁵ On February 1, 2007,
7 the Board by a 5-0 vote granted appellant's petition for rehearing. No specific grounds were specified in
8 the letter granting the rehearing.¹⁶ According to appellant, the issues presented are as follows:

- 9 1. "Whether the distortion at issue in this appeal may be remedied by Regulation 25137."
- 10 2. "Whether application of an alternative formula is supported by the regulations
11 interpreting section 25137."
- 12 3. "Whether apportionment based on gross premiums is an appropriate remedy."
- 13 4. "Whether apportioning AGI income based on costs of performance is an appropriate
14 remedy."

15 Therefore, appellant argues that "roughly 70%"¹⁷ of its the net income reported on its California returns
16 should be "apportioned out" of California because that figure relates to the servicing of insurance
17 premiums written in other states (apparently, Illinois, Idaho, Louisiana and Georgia). Alternatively,
18 appellant suggests apportionment based on the non-California location of expenses incurred in its
19 operating costs, which would "apportion out" 51.83% of the net income reported to California during all
20 ///

21 _____
22 ¹⁴ Respondent's Opening Brief, at page 4: 1-4.

23 ¹⁵ The vote was 3-1-1, with then Board Member Parrish voting "no" and then Board Chairman Chiang abstaining.

24 ¹⁶ Appellant states that the transcript of the June 27, 2006 Board hearing quotes Board Member Steele as follows:

25 "I move to grant the petition for rehearing because Claimant showed three different remedies [to distortion]
26 but at the board hearing, we heard only one, so I think it's fair to give them one more chance to have a
27 hearing."

(See appellant's Opening Brief on Rehearing, at page 3: 22-24, quoting "Board Audio" for June 27, 2006.)

28 This is apparently a quote from the February 1, 2007 Board Hearing where the petition for rehearing was granted.

¹⁷ Appellant's Opening Brief on Rehearing, at page 13: 15-17.

1 six appeal years.¹⁸

2 Contentions

3 Appellant's Contentions

4 Appellant asserts that "from 1994 to 1999, Argonaut generated over *\$165 million in*
5 *federal taxable losses*. Despite these catastrophic losses, Argonaut still paid over *\$6 million in gross*
6 *premiums tax*. Now, because of the distortion caused by the standard three-factor formula, Argonaut
7 would have to pay an additional *\$3.6 million in California corporate income tax*. This makes no sense
8 under the unique circumstances of this appeal." (Underlining and italics included in original).¹⁹
9 According to appellant, respondent's standard California three-factor "apportionment formula" is
10 vulnerable to United States Supreme Court invalidation if appellant can prove "by clear and cogent
11 evidence" that the income of AGI attributed to California is in fact "out of all appropriate proportions to
12 the business transacted in that State" or has led to a "grossly distorted result."²⁰ Also according to
13 appellant, section 25137 allows this Board or respondent to depart from the standard California
14 apportionment formula where the formula results fail to "fairly represent the extent of the taxpayer's
15 business activities in California"²¹ even where the distortion does not violate the United States
16 Constitution Due Process or Commerce clauses.²² Appellant therefore argues that application of the
17 standard California three-factor apportionment formula "to its non-insurance business has led to the sort
18 of distortion that precludes application of the formula in this case."²³

19 _____
20 ¹⁸ Appellant's Opening Brief on Rehearing, at pages 16: 25 through 17: 19. A table showing expenses incurred and their
21 apportionment appears on page 17 at lines 1-10. At the hearing, the parties may wish to discuss whether the calculation of
22 the percentage of income that is apportioned-out takes into account (or should take into account) the receipt of dividend
23 received deductions. Staff notes that it is not clear whether appellant would report this apportioned-out income to the
24 corporation franchise tax administration entities in Georgia, Idaho, Illinois and Louisiana, or to the Multistate Tax
25 Commission (MTC) (of the five states with entities involved in this appeal, only Idaho and California are full members; see
26 www.mtc.gov), or whether or not the applicable statutes of limitation have run in those states.

27 ¹⁹ Appellant's Opening Brief on Rehearing, at page 6: 8 – 12.

28 ²⁰ *Container Corporation v. Franchise Tax Board* (1983) 463 U.S. 159, 170.

²¹ *Microsoft v. Franchise Tax Board* (2006) 39 Cal.App.4th 750, 769.

²² *Ibid.*

²³ Appellant's Opening Brief on Rehearing, at page 5: 1-3.

1 According to appellant, the result of the standard California apportionment formula is
2 that “100% of the income of the California non-insurance companies is apportioned to California, even
3 though the reason that the income exists is the result of—and to support—insurance activities, the
4 overwhelming majority of which took place outside California during the subject years.”²⁴ Appellant
5 further argues that the distortion is caused by the “unique organizational structure”²⁵ of AGI during the
6 tax years, where AGI used a holding company to manage its insurance businesses rather than using
7 subsidiaries each separately owned by a holding company (according to appellant, this is a more typical
8 insurance corporate structure appellant says it began to use after a 2006 corporate reorganization).²⁶
9 Appellant acknowledges that 100% of the property, payroll and sales of AGI were in California, but
10 claims that AGI used these factors to manage insurance operations conducted by AIC (a California
11 insurance company), an Illinois insurance company known as Great Central Insurance Company, and a
12 “pooled group” of AIC and four non-California insurance companies in Illinois, Georgia, Idaho, and
13 Louisiana.²⁷ According to appellant:

14 “Insurance policies were written at field offices around the country and could be written
15 on any of the five regional operating companies under a pooling agreement, depending on
16 the state to which the premium related. . . . All premiums were surrendered to AIC. AGI
17 arranged for third party reinsurance for the pooled group. Premiums, losses and expenses
18 of the pooled group were allocated to the participants by AIC based upon the percentages
19 in the pooling agreement. The pooled group had field offices around the nation. The
20 employees at the field offices were responsible for marketing and underwriting policies,
21 handling claims, and various accounting functions. While AIC’s senior management
22 (including AGI employees involved in the insurance operations) was headquartered in
23 Menlo Park, California, they regularly traveled to the field offices to meet with brokers
24 and insureds to discuss strategy and to review operations, AIC was a highly decentralized
25 operation; this was necessary because AIC wrote large dollar policies and its insureds
26 wanted personal, ‘hands-on’ service.”²⁸

22 ²⁴ *Id.*, at page 5: 9-12.

23 ²⁵ *Id.*, at page 5: 15-16.

24 ²⁶ *Id.*, at page 6: 1 through 7: 13. Appellant also notes that after the 1994-1999 tax years in question, the AGI management
25 function for the Argonaut collection of companies “moved to San Antonio, Texas.” Appellant’s Opening Brief on Rehearing,
26 at 10: 16.

26 ²⁷ *Id.*, at pages 9: 9 through 10: 12.

27 ²⁸ *Id.*, at page 9: 12 – 26. Respondent notes that it cannot verify these claims because it has never conducted a “unitary audit”
28 of AGI, and that it had no need to do so since AGI admits all of its income was earned in California. *See* Respondent’s
Supplemental Brief on Rehearing, page 5: 16 – 23.

1 Although appellant states that it has not found any published or unpublished decisions of
2 this Board that come close to addressing these facts, it argues that its proposed alternative apportionment
3 formulae are justified by respondent's use of alternative formulae for income from intangible property,²⁹
4 the combination of general and financial corporations,³⁰ and mutual fund and asset service providers.³¹

5 Respondent's Contentions

6 Respondent contends that section 25137, which is part of the Uniform Division of
7 Income for State Tax Purposes Act (UDITPA), does not apply to appellant because appellant applied all
8 of its reported non-premium income (interest income, rental income, intercompany apportioned income,
9 and approximately 10% of dividends received)³² 100% to California.³³ Section 25121 states:

10 Any taxpayer having income from business activity which is
11 taxable both within and without this state shall allocate and
12 apportion its net income as provided in this act.

13 Section 25121, like section 25137 relied upon by appellant, was enacted by California as part of its
14 enactment of UDITPA. However, because appellant concededly does not have "income from business
15 activity which is taxable both within and without this state", respondent contends that section 25137
16 does not apply. The insurance company income from insurance premiums is expressly not taxed in
17 California. Section 23151 imposes a tax "measured by...net income" on "every corporation doing

18 ²⁹ Appellant notes that Regulation 25137 states:

19 "Where the income producing activity in respect to business income from intangible personal property can
20 be readily identified, such income is included in the denominator of the sales factor and, if the income
21 producing activity occurs in this state, in the numerator of the sales factor as well."

22 Therefore, appellant interprets Regulation 25137 as "call[ing] for the exclusion of AGI's dividends from the numerator of
23 AGI's California sales factor and inclusion of those same dividends in the denominator." Appellant's Opening Brief on
24 Rehearing, at page 11: 20 – 22.

25 ³⁰ Regulation 25137-10, which states that where income is apportioned among both general and "financial" corporations and
26 intangibles are excluded, there is a "strong presumption" of distortion. It should be noted that the term "financial
27 corporation" as used in this Regulation and cross-referenced section 23181 does not include insurance companies.

28 ³¹ Regulation 25137-14, which sources management income from managing mutual fund assets to the domicile state of the
29 mutual fund customer. According to appellant, if the underlying logic of this regulation were applied to AGI, it would result
30 in apportionment of AGI management income to the domicile states of the insurance entities whose assets AGI is managing.

³² Respondent's Supplemental Brief on Rehearing, at page 7: 27-28; *see also*, *id.*, page 9: 6-12.

³³ *Id.*, page 9: 13-15, referring to appellant's tax returns for 1994-1999.

1 business within the limits of this state and not constitutionally exempted from taxation by the provisions
2 of the Constitution of this state or by this part.”³⁴

3 Article XIII, section 28 of the California Constitution subjects all insurers other than title
4 insurers or ocean marine insurers, to an annual tax on their gross premiums. Subdivision (f) of Article
5 XIII, section 28 states that the gross premiums tax “is in lieu of all other taxes and licenses, state, county
6 and municipal” other than real property taxes and vehicle license fees.³⁵ Therefore, when respondent for
7 the 1964 tax year attempted to include within the “net income” of an insurer (First American) covered
8 by this provision the receipt by the taxpayer of liquidated assets of four escrow subsidiaries, the
9 California Court of Appeal ruled against respondent:

10 “This section of the [California] Constitution is unambiguous and clearly creates a tax
11 exemption applicable to First American as an ‘insurer’ not subject to any other tax or
license whatsoever.”

12 (*First American Title & Trust Co. v. Franchise Tax Board* (1971) 15 Cal.App.3d 343, 347.)

13 Ninety-five years ago, the California Supreme Court similarly held that an insurance company was
14 exempt from a state license tax similar to the current franchise tax in *Hartford Fire Ins. Co. v. Jordan*
15 (1914) 168 Cal. 270, 142 P. 839. More recently, the California Supreme Court held that Article XIII,
16 Section 28 exempts insurance company parking lot and office rental income from the City of Los
17 Angeles business license tax: “California’s gross premiums tax...is in lieu not merely of taxes on the
18 business of insurance, but of taxes ‘upon such insurers and their property.’” (*Mutual Life Insurance Co.*

19 _____
20 ³⁴ See also, Section 23038, subd. (a)(defining “corporation” as every corporation except those ‘expressly exempt from the tax
21 imposed by this part or the Constitution of this state.”

22 ³⁵ The history of Article XIII, Section 28 is discussed in detail in *Mutual Insurance Company of New York v. City of Los*
23 *Angeles, supra*, at 50 Cal.3d 409. The provision was created in the 1910 “separation of sources” constitutional amendment,
24 and in 1933 the voters’ adoption of the Riley-Stewart Plan (Proposition 1 on the June 1933 special election ballot) added
25 language that the premiums tax was “in lieu of all other taxes on such companies or their property”. Proposition 1 was
26 approved by a 62%-38% vote. In November 1942, Proposition 7 revised this text to substitute the current “in lieu of all other
27 taxes on such insurers and their property” now found in Article XIII, section 28(f). Proposition 7 was approved by a 69.7%
28 “yes” vote on Proposition 7 in the November 1942 general election. The voter-approved text included the exact text of the
current subdivision (f) [then designated subdivision (i)], which expressly exempts insurers from “all other taxes.” The
affirmative ballot argument did not discuss this provision, and there was no opposing ballot argument. This is equally true of
Proposition 1 in 1933. See www.sos.ca.gov/elections, “Publications and Resources”, “Historical Voter Information Guides”,
which links to the “California Ballot Proposition Database” maintained the University of California Hastings College of the
Law Law Library, at www.holmes.uchastings.edu/cgi-bin/starfinder/26232/calprop.txt

At the November 1974 general election, California voters adopted Proposition 8 revising numerous provisions of the
California Constitution and re-designating this provision to its present day Article XIII, Section 28 designation.

1 *of New York v. City of Los Angeles* (1990) 50 Cal.3d 402, 409.)

2 Respondent indicates that since 1975 it has consistently applied its Legal Ruling 385,
3 which states that any unitary affiliate is included in a combined report unless it is established that the
4 affiliate is a type of entity wholly exempt from corporate franchise taxes based on net income, either by
5 sections 23701 through 23709 (non-profit organizations) or by the California Constitution. “The Legal
6 Ruling [385] reflects the fact insurance companies and exempt entities are not properly considered in a
7 combined report with a general corporation that is a member of its commonly controlled group. In other
8 words, Legal Ruling 385 reflects the unique status of entities exempt from the franchise and income
9 taxes under California law, including insurance companies. As noted above, such entities are separated
10 from and unconnected to the corporation franchise and income tax system.”³⁶ Respondent states that in
11 one published formal decision and two nonprecedential decisions, this Board has strictly followed Legal
12 Ruling 385 and has precluded the inclusion of insurance companies in combined reports: (1) *Appeal of*
13 *Control Data Corporation*, 96-SBE-002 (Feb. 2, 1996)(insurance companies cannot be included in a
14 combined report even if they have a unitary relationship with noninsurance companies); *Appeal of Dial*
15 *Finance, Inc.* (February 10, 1993)(depublished after petition for rehearing granted and resolution
16 without further Board action; noting respondent “excludes insurance companies from combined reports
17 and formula apportionment procedures”); *Appeal of Fremont General Corporation* (December 20, 2001)
18 (nonprecedential; “Legal Ruling 385 makes clear that the income and the apportionment factors of
19 appellant’s insurance subsidiaries may not be included in the combined report of appellant’s unitary
20 group”). Recently, the Idaho Supreme Court held that because insurance companies are taxed
21 differently than general corporations, they cannot be included in the combined report:

22 “It is undisputed ...that AIA Services and Universe Life are unitary. ... Here, Universe
23 Life and AIA Services, while unitary, do not have the same tax liability, i.e., Universe
24 Life is required to pay premium taxes instead of income taxes. Therefore, we hold that
AIA Services was not required to file a combined report with Universe.”

25 (*AIA Services Corporation v. Idaho State Tax Commission* (2001) 136 Idaho 184, 30 P.3d 962, 965.)

26 The Idaho State Tax Commission in 1997 codified this requirement in its Administrative Rule 600. As
27

28 ³⁶ Respondent’s Opening Brief, at page 9: 17-22.

1 noted above, one of the insurance companies appellant wishes to combine with AGI is domiciled in
2 Idaho.

3 Respondent's combined reporting regulation, 18 California Code of Regulations
4 ("regulation") 25106.5 precludes the inclusion of insurance companies. Subdivision (b)(3) of that
5 regulation defines "combined reporting group" as "those corporations with business income...";
6 "corporations" is defined by regulation 25106.5, subdivision (b)(19) by reference to section 23038,
7 which expressly excludes "corporations expressly exempt from the tax by . . . the Constitution of this
8 state." Similarly, the combined reporting definition (regulation 25106.5, subdivision (b)(18)) of "net
9 income" references net income before allocation and apportionment: "the total net income from all
10 sources . . . as determined under the Revenue and Taxation Code, before allocation and apportionment."
11 In contrast, appellant is attempting to use allocation and apportionment to define net income, in effect
12 putting the cart before the horse.

13 When the Legislature enacted Assembly Bill 263, it expressly recognized that "insurance
14 companies are not subject to the Corporation Tax Law...and cannot be included in the combined
15 report..." (Assembly Bill 263 (Statutes of 2004, Chapter 868), section 6.)

16 Respondent further contends that appellant's two proposed remedies were not specifically
17 mentioned in the Claim for Refund, and cannot be raised in a Petition for Rehearing filed after the
18 statute of limitations has run. Therefore, respondent asserts that this Board lacks jurisdiction to consider
19 them. Respondent contends that, even if the Board did have jurisdiction, none of the distortion asserted
20 as a basis for these remedies (alleged federal tax losses, the percentage of premiums written inside of
21 and outside of California, and the locations of incurred expenses) have been substantiated.³⁷ (After
22 respondent filed its Supplemental Brief on Rehearing, appellant subsequently provided, in Exhibits "A"
23 and "B" to its Supplemental Brief on Rehearing, spreadsheets regarding premiums written and expenses
24 incurred by jurisdiction in each of the tax years).

25 Respondent notes that appellant's federal tax losses for 1994-1999 resulted from use of
26 100% net operating loss carryforwards and carrybacks and other Internal Revenue Code provisions that
27

28 ³⁷ Respondent's Supplemental Brief on Rehearing, at pages 10-13.

1 do not exist under California law for 1994-1999.³⁸ In addition, respondent notes that AGI's annual
2 reports and federal tax returns show it had a total of \$425 million in net income for the 1994-1999 years,
3 and that during this period AIC paid appellants \$265 million in dividends.³⁹

4 Contentions of the Parties Regarding Potentially Relevant Decisions

5 In a request for additional briefing, Appeals Division Staff suggested that the parties
6 might wish to discuss six potentially relevant decisions. The discussion below summarizes the
7 contentions of the parties regarding those recent decisions.

8 *MeadWestvaco v. Illinois Department of Revenue* (2008) ___U.S___, 170 L.Ed.2d 404.

9 Appellant: *MeadWestvaco* confirms that the case law has "extended the reach of the unitary business
10 principle to justify the taxation by apportionment of net income, *dividends*, capital gain, and other
11 intangibles." (citing *MeadWestvaco* at p. 1501 (emphasis supplied by appellant).) Here, the income in
12 question is plainly apportionable under Supreme Court precedent, as most recently articulated in
13 *MeadWestvaco*.

14 Respondent: This decision held that Illinois could apportion multistate income only where the income
15 arose from a unitary business. In contrast, appellant and AGIP are 100% in California.

16 *Allied-Signal, Inc. v. Director, Division of Taxation* (1992) 504 U.S. 768.

17 Appellant: Income from an asset employed in a taxpayer's business, such as working capital, could
18 give rise to apportionable income, even though the taxpayer was not engaged in a unitary business with
19 the investments in its working capital fund. Appellant indicates that the Court stated "that where income
20 from assets owned by a taxpayer serves an "operational function" as opposed to an "investment
21 function," apportionment was appropriate." (App. June 9, 2008 Br., p. 12.) The relevant assets here
22 serve an operational function in appellant's unitary business and thus generate apportionable income.

23 Respondent: In this case, a unanimous Supreme Court held that only business income related to
24 activities in the taxing state could be apportioned. Therefore, the taxpayer's income from stock in
25 another entity was non-business income (the four dissenters believed that it was apportionable business
26

27 ³⁸ Respondent's Reply to Appellant's Second Supplemental Brief, at pages 13: 20 through 14: 2.

28 ³⁹ *Id.*, at page 14: 3-6.

1 income). In contrast, appellant and AGIP report all of the income at issue as business income sourced
2 100% to California.

3 *In re Appeal of Crisa Corporation, 2002 SBE-004 (June 20, 2002).*

4 Appellant: Appellant indicates that *Appeal of Crisa Corporation* would preclude it from using section
5 25137 to seek inclusion of the *insurance companies' income* into its apportionment base (emphasis
6 supplied by appellant). However, appellant contends, this is not what it seeks to do: “[r]ather, it seeks
7 representation of the insurance companies’ factors in its apportionment formula, because the *taxpayers’*
8 *income*, which includes dividends received from the insurance companies, necessarily reflects the
9 economic activities of the insurance companies.” (App. June 9, 2008 Br., p. 14 (emphasis supplied by
10 appellant).) Appellant notes that *Appeal of Crisa Corporation* stated that the central question under
11 section 25137 “is whether there is an unusual fact situation that leads to an unfair reflection of business
12 activity under the standard apportionment formula.” (*Id.* (citing *Appeal of Crisa Corporation*).)

13 Respondent: The Board stated that:

14 “Section 25137 is part of UDITPA, which deals only with allocation and apportionment
15 of income, and not with the determination of income itself. Accordingly, this Board has
16 held that relief is not available under section 25137 to correct alleged distortion in the
17 amount of income to be apportioned. Therefore, section 25137 provides no relief in this
18 case to the extent of any alleged distortion in the determination of income.”

19 *In re Appeal of Control Data Corporation, 96-SBE 002 (Feb 22, 1996).*

20 Appellant: Appellant quotes the following language from the decision:

21 “The income-producing property in the instant appeal, the stock of the unitary insurance
22 subsidiaries, is clearly integrally related to the unitary business operations of the
23 corporate group. In analogous situations, we have held that income derived from such
24 property is business income subject to formula apportionment.”

25 Appellant explains that:

26 “Although the decision contained minimal discussion and no analysis regarding factor
27 representation, the application of unitary theory is incomplete without accounting for the
28 factors of each member of the unitary group in computing an apportionment factor.”

(App. June 9, 2008 Br., p. 13.)

Respondent: This Board held that FTB Legal Ruling 385 precluded a general corporation from
including insurance companies in its combined report, meaning that insurance company received
dividends should be treated as nonbusiness income allocated to the parent insurance company’s

1 domicile, and that even if dividends were treated as business income, there would be no allowance for
2 them in the apportionment factors.

3 *In re Appeal of Willamette Industries*, 89-SBE-008 (March 2, 1989).

4 Appellant: Appellant states that this decision held that section 25106 “provides for the elimination of
5 dividends which are paid out of the unitary business income of the corporations engaged in a unitary
6 business.” Appellant states that the taxpayer in that case had argued for elimination of nonunitary
7 dividends.

8 Respondent: This decision held that dividends paid from earnings and profits accumulated prior to the
9 payor becoming part of the unitary group were nonapportionable nonbusiness income, however, the
10 Court of Appeal reversed and found them to be apportionable business income (in *Willamette Industries*
11 *v. Franchise Tax Board* (1995) 33 Cal.App.4th 1242).

12 *In re Appeal of Dial Finance, Inc.*, 93-SBE-004 (February 10, 1993) (depublished).⁴⁰

13 Appellant: Appellant notes that *Appeal of Dial Finance* stated that:

14 “Inclusion in a combined report does not determine whether companies are unitary with
15 one another, it is the fact that companies are engaged in a unitary business that
determines whether they can be included in a combined report.”

16 Appellant contends that, since Argonaut and its insurance subsidiaries constitute one unitary
17 business, unitary business principles, including factor representation, must apply to apportion its
18 income, regardless of whether respondent chooses to include certain entities in the combined
19 report.

20 Respondent: Prior to granting rehearing and resolving the case without further hearings (thus
21 depublishing the published decision), this Board held that dividends from an insurance subsidiary were
22 dividend income of the recipient, and not of the parent.

23 Appellant’s and Respondent’s Answers to Board Questions Posed On April 25, 2008

24 On April 25, 2008, this Board’s Appeals Division submitted a set of 13 questions to both
25 parties.

26
27
28 ⁴⁰ The Appeals Division’s further briefing letter stated that, while this decision is no longer citable, the discussion contained therein may be instructive on some of the issues presented in this appeal. Thus, the letter concluded that the parties are free to comment on whether the Board’s analysis of these issues in *Dial Finance* is sound and representative of current law, notwithstanding the opinion’s depublication.

1 *Issues Where Respondent and Appellant Agree*

2 Question 1: The scope of a combined reporting group is not necessarily co-extensive with the
3 scope of a unitary business, and the number of companies engaged in a unitary business can be
4 smaller or larger than the number of companies in a combined reporting group.

5 A combined reporting group is defined by regulation 25106.5, subdivision (b), whereas a unitary
6 business is defined by United States Supreme Court decisions interpreting the Due process and
7 Commerce Clauses (appellant's position) or by respondent's Legal Ruling 385 and a taxpayer's
8 decision to make a water's edge election that excludes otherwise combinable companies
9 (respondent's position).

10 Question 4: Must an explicit election be made in order to file a combined report under section
11 25101.15?

12 No, respondent and appellant agree that the statute does not require an election, although
13 Schedule R-7 requires one.

14 Question 5: Did AGI and AGIP make any required election to file combined reports under
15 section 25101.15?

16 No, because they were not required to do so.

17 Question 8: Is UDITPA a prerequisite to performing a section 25137 distortion analysis?

18 Both appellant and respondent answer "yes."

19 Question 12-a: Under UDITPA, would the \$29 million in dividends received from the insurance
20 subsidiaries be classified as business income?

21 Both appellant and respondent answer "yes."

22 Question 13: Other than dividends received from insurance subsidiaries, what other types of
23 income did AGI and AGIP include in their combined reports?

24 Both appellant and respondent describe this income as interest income, AGIP rental income, and
25 income from managing subsidiary operations.

26 *Issues Where Respondent and Appellant Do Not Agree*

27 Question 2: Whether the allocation and apportionment provisions of sections 25120
28 through 25138 apply to income and activities of only those corporations in a pre-defined

1 combined reporting group.

2 Appellant – No, respondent first applies UDITPA, and the combined report implements
3 respondent’s application of UDITPA to a particular unitary group.

4 Respondent – Yes, sections 25120 through 25138 apply only to corporations in a pre-defined
5 combined reporting group, and UDITPA provisions apply only to entities that do business
6 within and without California and that are engaged in a unitary business.

7 Question 3: Does respondent agree that appellant AGI and AGIP engaged in a unitary
8 business with AGI’s insurance business?

9 Appellant – Cannot speak for respondent, but quotes respondent’s briefs as saying AGI and
10 AGIP “may” be in a “unitary” relationship with “unitary insurance subsidiaries.”

11 Respondent – “Neither agrees nor disagrees” and “has no knowledge” because respondent has
12 not performed a “unitary audit.”

13 Question 6: Does appellant agree that AGI and AGIP filed a combined report under section
14 25101.15 and reported 100% of their combined net income as sourced to California?

15 Appellant – No. Argonaut filed amended returns indicating that the unitary group included AGI,
16 AGIP and Argonaut’s insurance subsidiaries, some of which were in California and some of
17 which were wholly outside California.

18 Respondent – Yes.

19 Question 7: Does UDITPA apply to a section 25101.15 intra-state combined report?

20 Appellant – Yes.

21 Respondent – No.

22 Question 9: Can section 25137 be used to remedy distortion caused by the exclusion of
23 particular entities from a combined report?

24 Appellant – Yes, because combined reporting and UDITPA, while codified separately in the
25 Revenue & Taxation Code, are interrelated.

26 Respondent – No, because UDITPA is separate from combined reporting.

27 Question 10: Does non-inclusion of the insurance companies’ factors result in an “unfair
28 reflection of business activities in California” if the combined reports from AGI and AGIP

1 also include business income “properly...attributable to the entire unitary business?”

2 Appellant – Yes, because the three streams of business income (dividends, interest
3 income, and rental income) “increase the policyholders’ surplus of the insurance group...”

4 Respondent – No, because the only income in the combined report is from the California
5 activities of AGI and AGIP in managing the insurance companies; all income was either
6 received in California, relates to services performed in California, or to rents received from
7 California property.

8 Question 11: If the answer to Question 10 is in the affirmative, can the distortion be
9 remedied by section 25137?

10 Appellant – Yes.

11 Respondent – No.

12 Question 12-b: If the \$29 million in dividends received from the insurance companies is
13 classified as business income (as both appellant and respondent agree, see above), is it
14 attributable to the entire unitary business, or only AGI and AGIP (the combined report
15 entities)?

16 Appellant – Yes, the dividends are attributable to the entire unitary group.

17 Respondent – No, because “the dividends are attributable to appellant’s ownership of stock
18 in the insurance companies.”

19 Applicable Law

20 Article XIII, section 28(f) of the California Constitution exempts insurers (other
21 than ocean marine insurers), from all taxes except a 2.35% tax on gross premiums less return premiums
22 (“gross premiums tax”), real property taxes, and vehicle license fees. Thus, insurers, unlike general
23 corporations and financial corporations, do not pay the 8.84% California franchise and income tax on
24 their net income. A similar exclusion from net income, franchise, or capital stock taxes and substitution
25 of a gross premiums tax exists in many other states, including Idaho, Illinois and Louisiana, three of the
26 four other states that are the domiciliary states of the insurance companies whose premiums appellant
27 wants to use as a remedy for claimed distortion.

28 Under California law, a corporation with net income can file a combined report with

1 other corporations under two circumstances. First, under section 25101.15, effective during the 1994-
2 1999 tax years in this appeal, a corporation with 100% of its property, payroll and sales in California
3 may file a combined report with another taxpayer whose income is derived “solely from sources within
4 this state” and if the business activities of the combined entities are such that combined reporting would
5 be required if the entities did business within and without California (appellant’s combined reporting in
6 this case is based upon this statute). Second, under section 25101, a corporation with property, payroll
7 and sales that are within and without California may file a combined report with other corporations with
8 which it has a unitary business relationship and meets the other requirements of section 25121 and
9 respondent’s combined reporting regulation, regulation 25106.5. Section 25101 (with a different
10 numbering designation) was part of the original Franchise Tax Act; UDITPA was added to the Revenue
11 & Taxation Code in 1954, through section 25101.

12 Respondent’s Legal Ruling 385, issued in 1975, prohibits respondent from allowing the
13 inclusion of insurance companies and other entities not subject to net income taxes in a combined report.
14 Respondent issued this ruling four years after the California Court of Appeal held in *First American*
15 *Title & Trust Co. v. Franchise Tax Board* (1971) 15 Cal.App.3d 343, that respondent could not include
16 the income of liquidated insurers in the net income of a general corporation. In 1990, the California
17 Supreme Court held in *Mutual Life Insurance Co. of New York v. City of Los Angeles* (1990) 50 Cal. 3d
18 402, that Article XIII, section 28(f) prohibited the City of Los Angeles from applying its business
19 license tax to the parking lot and office rental income of an insurance company.

20 Section 25137 permits respondent or this Board to remedy distortion caused by
21 application of “this act”, meaning UDITPA, regardless of whether the distortion violates the United
22 States constitution. The California Supreme Court held in *Microsoft Corporation v. Franchise Tax*
23 *Board* (2006) 39 Cal.4th 750, 765, that the party invoking section 25137 has the burden of proving such
24 distortion by “clear and convincing evidence.”⁴¹

25 United States Supreme Court cases hold that the Due Process Clause of the Fourteenth
26 Amendment and the Commerce Clause [Article I, section 8, clause 3] of the United States Constitution
27

28 ⁴¹ Four years before the California Supreme Court issued its opinion in *Microsoft, supra*, this Board held that the distortion
remedy proponent bears the burden of proof. (*Appeal of Crisa Corporation*, 2002-SBE-004 (June 20, 2002).

1 prohibit the application of a state tax on net income to non-business income or to entities that are not
2 part of a unitary business with nexus to the taxing state. Article III, section 3.5 of the California
3 Constitution prohibits statewide administrative agencies, including this Board and other constitutional
4 agencies, from declaring statutes unconstitutional or unenforceable absent a court of appeal decision.

5 STAFF COMMENTS

6 It appears that the insurance premiums written by AGI's California insurance subsidiary
7 (AIC) are exempt from the California franchise and income tax,⁴² and that the insurance company
8 premiums written by AGI's Idaho subsidiary are exempt from the Idaho franchise and income tax⁴³ and
9 Louisiana franchise and capital stock taxes.⁴⁴ The insurance company premiums written by AGI's
10 Illinois insurance company subsidiaries appear to serve as a basis for deducting the income tax that
11 exceeds the premiums tax in the prior year from the premiums tax in the current year.⁴⁵ Georgia, the
12 other state with AGI insurance company subsidiaries referenced in this appeal, appears to tax all
13 corporations without any apparent exemption for insurance companies.⁴⁶

14 Under California law, respondent may not apply the franchise and income tax to an
15 insurer, even when the insurer acquires the assets of liquidated general corporations.⁴⁷ Similarly, this
16 same provision prevents the City of Los Angeles from taxing the parking lot and office rental income of
17 an insurance company.⁴⁸ In light of this background, the parties should discuss whether it is appropriate
18 and permissible to use activity that is exempt from the California franchise and income tax to reduce
19 appellant's franchise and income tax in six years where it reported that 100% of its property, payroll and
20 ///

21 _____
22 ⁴² California Constitution, Article XIII, section 28(f).

23 ⁴³ Idaho Statutes, Title 41, section 405.

24 ⁴⁴ See Louisiana Revised Statutes Title 22, section 791.

25 ⁴⁵ Illinois Consolidated Statutes, Chapter 215, section 5/409.

26 ⁴⁶ See Official Code of Georgia, section 48-7-21, subdivision (a) (6% income tax on net income of every domestic and
27 foreign corporation).

28 ⁴⁷ *First American Title Insurance & Trust Company v. Franchise Tax Board* (1971) 15 Cal.App.3d 343.

⁴⁸ *Mutual Life Insurance Co. of New York v. City of Los Angeles* (1990) 50 Cal.3d 402.

1 sales were in California.⁴⁹

2 Section 25137 is part of UDITPA, and appellant agrees with respondent that UDITPA is
3 a prerequisite to performing a section 25137 distortion analysis.⁵⁰ However, UDITPA applies only
4 where a taxpayer's business operations occur both within and without California such that income must
5 be apportioned between more than one state. Section 25101 permits use of UDITPA or other
6 apportionment formulae where income is derived "from sources both within and without this state."
7 This Board noted in *Crisa* that "UDITPA deals only with the allocation and apportionment of income,
8 and not with the determination of income itself." In addition, this Board in *Control Data* adhered to
9 respondent's Legal Ruling 385 and held that insurance companies could not be included in a general
10 corporation's combined report, even if there was a unitary business relationship between them. At the
11 hearing, appellant should be prepared to discuss how these authorities impact its legal theory on appeal.

12 Staff notes that all of appellant AGI's insurance company servicing operations are in
13 California. Presumably, if AGI used property, payroll or sales in other states to conduct these servicing
14 operations, then AGI would have no trouble using the UDITPA apportionment formula to remove the
15 factors represented by such insurance servicing operations in other states. However, appellant is not
16 seeking to include insurance servicing operations that are taxable under other states' franchise and
17 income taxes. Rather, appellant is apparently seeking to effectively give some representation to the
18 operation of insurance companies, which are exempt from the franchise and income tax or franchise and
19 capital stock tax in at least four of the states mentioned by appellant, in its combined report.⁵¹ If
20 appellant prevails, either 51.83% (based on location of expenses) or "roughly 70%" (based on location
21 of premiums written) of its income reported as 100% sourced to California will be apportioned out of
22 California.

23 _____
24 ⁴⁹ The alternative apportionment formulae for mutual fund providers, combined general and financial corporations, and
25 intangible property all involve income streams that are taxable under a net income tax in California, unlike appellant's insurer
26 subsidiaries' premiums.

27 ⁵⁰ See answers to Appeals Division Question Number 8 in Appellant's Supplemental Brief on Rehearing, at page 6: 16-25;
28 Respondent's Supplemental Brief on Rehearing, at pages 8-9.

⁵¹ See the previous discussion in this hearing summary regarding California, Idaho, Illinois, and Louisiana. The information
on insurance taxation in these states comes completely from this summary writer's research, and is not mentioned anywhere
in the multiple briefs filed by appellant and respondent in this matter.

1 Staff notes that the Multistate Tax Commission (MTC) staff in 2005 proposed a draft
2 statute that, if adopted in individual states,⁵² would permit taxpayers to directly include insurance
3 companies in combined reports filed by non-insurance corporations. The full MTC, which includes a
4 rotating representative each year from this Board or respondent casting a vote,⁵³ has not acted on this
5 proposal, and as of November 24, 2008, the proposal does not appear on the “Uniformity” portion of the
6 MTC website, www.mtc.gov. The MTC staff draft proposal has drawn strong opposition in comments
7 filed by the Council on State Taxation (COST), the American Council of Life Insurers (ACLI), the
8 American Insurance Association (AIA), and the Property and Casualty Insurers Association of America
9 (PCI).⁵⁴

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12 ///

13 Argonautrev1_sk

26 ⁵² In California, this proposal could be adopted only via an amendment to the California Constitution, since Article XIII,
27 Section 28(f) exempts insurers from all taxation other than the gross premiums tax, real estate taxes, and vehicle license fees.

28 ⁵³ See Multistate Tax Compact in section 38006.

⁵⁴ Respondent’s Opening Brief, page 24: 9-23.