STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
THE UNITED STATES LIFE INSURANCE COMPANY IN THE CITY OF NEW YORK	:	DETERMINATION
	:	
for Redetermination of a Deficiency or for Refund of Franchise Tax on Insurance Corporations under Article 33 of the Tax Law for the Years 1984 and 1985.	:	
	:	

Petitioner, The United States Life Insurance Company in the City of New York, 125 Maiden Lane, New York, New York 10038-4985, filed a petition for redetermination of a deficiency or for refund of franchise tax on insurance corporations under Article 33 of the Tax Law for the years 1984 and 1985 (File No. 807011).

A hearing was held before Thomas C. Sacca, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on March 29, 1990 at 9:15 A.M., with all briefs to be submitted by July 27, 1990. Petitioner appeared by Thomas D. Hogan, Esq. The Division of Taxation appeared by William F. Collins, Esq. (Kenneth J. Schultz, Esq., of counsel).

ISSUE

Whether, in computing entire net income for purposes of the franchise tax on insurance corporations, the modifications to Federal life insurance company taxable income under Tax Law § 1503(b) should be reduced by 20% where petitioner took the 20% special life insurance company deduction provided for in Internal Revenue Code former § 806 in computing Federal life insurance company taxable income.

FINDINGS OF FACT

Petitioner, The United States Life Insurance Company in the City of New York ("USLIC"), is a life insurance company incorporated in New York State with its principal place of business in New York, New York. USLIC carried on an insurance business in New York and was classified for Federal income tax purposes as a life insurance company under Subchapter L of the United States Internal Revenue Code.

During the years in issue, life insurance companies received a special life insurance company deduction under Internal Revenue Code former § 806(a). Section 806(a) provided as follows:

> "Special life insurance company deduction. For purposes of section 804 [defining life insurance deductions], the special life insurance company deduction for any taxable year is 20 percent of the excess of the tentative LICTI [life insurance company taxable income] for such taxable year over the small life insurance company deduction (if any)."

Internal Revenue Code § 806(a) was added by P.L. 98-369, section 211(a), effective for tax years beginning after December 31, 1983. The purpose of section 806(a) was stated as follows:

> "some adjustment is necessary to avoid suddenly imposing a substantially increased tax burden on life insurance companies. Under present law, a life insurance company is able to defer or avoid taxation on a substantial portion of its current income, and thus this provision ameliorates the hardship that might otherwise result from a sudden, substantial increase in a company's tax base." (See, S Rep No. 169, 98th Cong, 2d Sess 1984; HR Rep No. 432, 98th Cong, 2d Sess 1984.)

The Tax Reform Act of 1986, P.L. 99-514, repealed section 806(a). The Senate Finance Committee Report of May 29, 1986 explained the basis for the repeal of the deduction as follows:

> "The 20 percent special life insurance company deduction was enacted in 1984 because it was believed necessary to ameliorate the sudden, substantial increase in the tax liability of life insurance companies. This increase occurred as a result of the change from the three-phase taxable income computation that was in effect previously to a single phase system consistent with generally applicable corporate tax law. The provision was not intended to tax life insurance companies at generally lower tax rates than other corporations.
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> In light of the overall reduction of corporate tax rates contained in other provisions of the bill, the committee believes that the 20 percent special life insurance company deduction is no longer necessary. Despite the elimination of this special deduction, the maximum marginal tax rate applicable to life insurance companies will decline under the bill."

During the years in issue, USLIC filed consolidated U.S. Life Insurance Company Income Tax Returns, Federal Form 1120L, with other life insurance subsidiaries of USLIFE

Corporation, its parent corporation. In calculating its LICTI for the years in issue, petitioner began with its gross income, which was the sum of premiums, investment income, net capital gains and other amounts generally includible in gross income. From this amount, petitioner took several deductions, including deductions for dividends received, interest to stockholders, New York State franchise taxes paid and depreciation under the Accelerated Cost Recovery System ("ACRS"). Finally, petitioner, in computing its LICTI, took the special life insurance company deduction by eliminating 20% of its gain from operations. Although each item of income and each deduction was not reduced by 20%, the overall effect of subtracting the special life insurance company deduction was to reduce the individual components of the gains from operations by 20%.

During the years in issue, petitioner filed Franchise Tax Returns for Insurance Corporations, New York State Form CT-33. In arriving at entire net income on Schedule B of the New York State return, USLIC reported as federal taxable income the amount of life insurance company taxable income shown on Federal Form 1120L for the corresponding years. The LICTI included the special life insurance company deduction. To federal life insurance company taxable income petitioner added back the dividend received deduction, the interest to stockholders, the New York State franchise tax deduction and the ACRS depreciation deduction. In addition, petitioner subtracted from federal life insurance company taxable income 50% of dividends from nonsubsidiary corporations. It is these five modifications to federal life insurance taxable income that are at issue in this matter.

In preparing the New York State return for 1984, petitioner, in making the modifications to federal life insurance company taxable income described in Finding of Fact "5", took the full amount as reflected on the Federal return for such year. Subsequently, on May 27, 1986, petitioner filed with the Division of Taxation an amended Form CT-33 and two claims for credit or refund of corporation tax paid, New York State Form CT-8, for the year 1984. The basis for the amended return and the claims for credit or refund was, in part, the reduction by petitioner of each of the modifications by 20%. This resulted in a net reduction of $925,851.00

in entire net income. Petitioner multiplied the net reduction by the business allocation percentage of 53.7881 to arrive at allocated entire net income of $497,998.00. The allocated entire net income was multiplied by the tax rate of 9% to arrive at a franchise tax reduction of $44,820.00. Taken together with the tax reduction of the related Metropolitan Transportation Business Tax Surcharge of $4,758.00 it resulted in a total claim for refund of $49,578.00 for the year 1984.

On or about November 6, 1987, the Division of Taxation issued to petitioner a denial of the refund claim for the year 1984. On April 29, 1988, the Division of Taxation issued to petitioner two notices of deficiency for the year 1984, showing a total amount of tax due of $10,344.00. In a letter dated April 22, 1988 and two statements of audit adjustment dated April 29, 1988, the Division of Taxation explained that the refund denial and the notices of deficiency were based on the Division's position that the modifications were to be added back at 100%.

The amount of tax claimed by petitioner as a credit or refund for the year 1984 is $49,578.00 and is computed as follows:

Modification Adjustments - Additions per Tax Report

Dividends received deduction	$1,767,935
Interest to stockholders	329,854
New York State franchise tax	2,317,584
ACRS deduction	1,623,377
Total	$6,038,750
Subtractions per Tax Report	
50% of dividends from nonsubsidiary corporations	(1,409,494)
Net Additions	$4,629,256

Reduction of modifications of Federal taxable income items by 20% to agree with the 20% modification of Federal taxable income	$925,851
Business allocation percentage	53.7881%
Reduction in allocated entire net income	497,998
Tax rate	9%
Claim for reduction in franchise tax	$ 44,820
Claim for reduction in MTA tax	4,758
Total tax reduction	$ 49,578

On the New York State Franchise Tax Return for Insurance Corporations for the year 1985, petitioner reported the modifications at 80% of the amounts shown on its U.S. Insurance Company Income Tax Return for the same year. In response, the Division, on April 7, 1989, issued two notices of deficiency to petitioner for the year 1985 assessing, in the aggregate, $49,584.00 in tax, plus penalty and interest. The amount contested by petitioner is $43,131.00 and is computed as follows:

Modification Adjustments - Additions per Tax Report

Dividends received deduction	$1,199,843
Interest to stockholders	168,668
New York State franchise tax	1,700,908
ACRS deduction	1,142,318
Total	$4,211,737
Subtractions per Tax Report	
50% of dividends from nonsubsidiary corporations	(1,008,742)
Net Additions	$3,202,995
Audit adjustment to increase modifications by 20%	4,003,744
Audit increase in entire net income	800,749
Business allocation percentage	53.9070%
Audit increase in allocated entire net income	431,660
Tax rate	9%
Audit increase in franchise tax	$ 38,849
Audit increase in MTA tax	4,282
Total tax increase	$ 43,131

SUMMARY OF THE PARTIES' POSITIONS

It is petitioner's position that the special life insurance company deduction, by reducing LICTI by 20%, effectively reduced each and every item of income and expense by 20%. Therefore, for purposes of the New York State franchise tax on insurance corporations, those same items of income and expense which individually modify federal LICTI must similarly be reduced by 20%.

In addition, petitioner maintains that the modification items must be reduced by 20% because:

(a) the reductions are necessary to maintain internal mathematical consistency;

(b) the reductions are necessary to satisfy established rules of statutory construction requiring the practical construction of a statute, the uniform interpretation of related statutes and the resolution of any doubt in favor of the taxpayer;

(c) the reductions are necessary to implement throughout the tax calculation the basic statutory presumption in Tax Law § 1503 that entire net income is presumably the same as life insurance company taxable income, citing Matter of The Prudential Insurance Company of America (State Tax Commission, May 8, 1985); and

(d) the reductions are necessary to comply with recognized accounting principles of double-entry bookkeeping using equal and offsetting debits and credits.

It is the position of the Division that the purpose of the special life insurance company deduction was to effect a rate adjustment for life insurance companies. The deduction was not intended to be a specific 20% reduction of particular items of income and expense included in LICTI.

In addition, it is the position of the Division that:

(a) the presumption referred to in Tax Law § 1503(a) that entire net income is presumably the same as LICTI refers to the starting point for the computation of entire net income, and not to the modifications of Tax Law § 1503(b);

(b) there is no specific statutory authority which would permit the modifications to be added or subtracted at any amount less than 100%;

(c) there is nothing ambiguous in section 1503(b) and therefore rules of statutory construction require that the words of the statute be given their plain meaning. According to the Division, the plain meaning of the words of section 1503(b) are that, unless expressly provided otherwise, New York modifications to federal LICTI are to be made at 100%; and

(d) tax accounting is not, and is not intended to be, the same as other accounting.

CONCLUSIONS OF LAW

A. Article 33 of the Tax Law imposes two separate taxes on insurance corporations doing business in New York. A franchise tax measured by income or capital is imposed pursuant to Tax Law § 1502, and an additional franchise tax measured by gross direct premiums is imposed under Tax Law § 1510. The franchise tax measured by income or capital is similar to the corporation franchise tax imposed on business corporations under article 9-A; it is generally based on entire net income or a combination of investment and business capital plus subsidiary capital (Tax Law § 1502).

A life insurance company's starting point for computing New York entire net income is the company's LICTI as required to be reported to the United States Treasury Department (Tax Law § 1503[a]). The entire net income is then determined by adjusting for certain modifications to federal taxable income. For the tax years at issue herein, Tax Law § 1503(b) provided:

> "Modifications. In computing entire net income, the following modifications shall be made:
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> (1) Entire net income shall not include:
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> (B) fifty percent of dividends other than from subsidiaries;
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> (2) Entire net income shall be determined without the exclusion, deduction or credit of:
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> (A) the amount of any specific exemption or credit allowed in any law of the United States imposing any tax on or measured by the income of corporations;
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> * * *
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> (D) taxes imposed under this article and article thirteen-A of this chapter;
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> * * *
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> (G) ninety percent of interest on indebtedness directly or indirectly owed to any stockholder or shareholder (including subsidiaries of a corporate stockholder or shareholder), or members of the immediate family of an individual stockholder or shareholder, owning in the aggregate in excess of five per centum of the issued capital stock of the taxpayer...;
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> * * *
>
> (M) ...the amount allowable as a deduction determined under section

one hundred sixty-eight of the internal revenue code...."

B. In calculating New York entire net income on its 1984 amended and 1985 franchise tax returns for insurance corporations, petitioner reduced the modification items at issue by 20% to coincide with the special life insurance company deduction of 20%. Those items were dividends from nonsubsidiary corporations (section 1503[b][1][B]), the dividends received deduction (section 1503[b][2][A]), New York State franchise tax (section 1503[b][2][D]), interest to stockholders (section 1503[b][2][G]) and ACRS depreciation (section 1503[b][2][M]). The Division, in recomputing the modification items to 100%, takes the position that unless the particular subsection specifically provides otherwise, the modification must be made at 100%. To fully understand and evaluate the positions of the parties, it is helpful to briefly review the tax treatment of life insurance companies under the Internal Revenue Code.

C. Generally, life insurance companies are subject to the same tax rates as corporations in general. However, because of the reserves they must carry for policyholder claims, life insurance companies are subject to special tax treatment. Specifically, they present a special problem of determining the income allocable, and therefore taxable, to them as an organization, as distinguished from income they produce but which must be attributed and allocated to policyholders to help in funding their contractual insurance claims. The most recent prior law under which life insurance companies were taxed by the Federal government was the Life Insurance Company Income Tax Act of 1959 (IRC former §§ 801-820).

Under the 1959 Act, a life insurance company was subject to a three-phase taxable income computation (IRC former § 802[b]). Under the three-phase system, a company was taxed on the lesser of its gain from operations or its taxable investment income (IRC former § 802[b][1]). If its gain from operations exceeded its taxable investment income, 50% of such excess was added to taxable investment income and the aggregate formed the base for taxable income (IRC former § 802[b][1], [2]). Finally, the other half of the excess was taxed but only when it was distributed to shareholders or when the deferral was terminated by other causes

(IRC former §§ 802[b][3]; 815).

Thus, to calculate its LICTI, a life insurance company was required to compute both its gain (or loss) from operations and its taxable investment income. The computation of gain from operations began with the company's total income, including the company's share of investment yield, net capital gain, and the sum of certain other items (IRC former § 809[b][1]). These other items included: premiums and other considerations, decreases in insurance reserves and all other amounts (IRC former § 809[c]). From this total, a life insurance company was permitted deductions. These included deductions usually available to taxpayers for business and investment expenses with some modification (IRC former § 809[d][11]; [e]) plus certain deductions for items unique to the insurance industry (IRC former § 809[d]). These included, among others, deductions for: increases in certain reserves (IRC former § 809[d][2]); the life insurance company's share of tax-exempt interest (IRC former § 809[d][8][A][i]); and "dividends received provided by sections 243, 244 and 245...computed with respect to the life insurance company's share of the dividends received" (IRC former § 809[d][8][A][ii].

D. The framework under which life insurance companies were taxed was substantially revised by the Tax Reform Act of 1984. There were two main reasons for the changes adopted by Congress. The first is that the 1959 Act was designed at a time of low and stable interest rates and different mortality rates. With higher interest rates and lower mortality rates, the complex rules of insurance company taxation were no longer producing equitable results. The second reason is that Congress wanted to simplify the extraordinarily complex structure of insurance company taxation under the 1959 Act (Joint Committee on Taxation, HR Doc No 4170, 98th Cong, 2d Sess, P.L. 98-369, p. 577 [Dec. 31, 1984]).

LICTI is now defined as life insurance gross income reduced by life insurance deductions (IRC § 801[b]). Life insurance gross income is the sum of (1) premiums, (2) decreases in certain reserves, and (3) other amounts generally includible by a taxpayer in gross income including investment income and capital gains (IRC § 803). Life insurance company deductions are those generally allowed corporate taxpayers with some modifications (IRC

§ 805[a][8]; [b]) and general deductions for life insurance corporations (IRC § 805[a]). During the years at issue, life insurance company deductions included the 20% special life insurance company deduction (IRC § 806[a]).

E. The issue presented in this matter appears to be one of first impression. The Prudential case cited by petitioner is distinguishable from the present matter. In Prudential, the issue was whether the company, in computing the modifications to entire net income, should employ the taxable investment income percentage of Internal Revenue Code § 804 or the gain from operations percentage of Internal Revenue Code § 809. The State Tax Commission held that since the company's Federal taxable income was based upon taxable investment income and not gains from operations, the company properly used the section 804 percentage pertaining to taxable investment income in computing its modifications to entire net income, even though its New York entire net income was computed based upon the gain from operations. Unlike the Prudential case, there is no specific provision in the Internal Revenue Code which provides for the reduction in the modification items taken by petitioner.

F. Although the Prudential case is not directly on point with the present matter, it does provide some guidance with regard to the novel question presented. The State Tax Commission, in Prudential, looked to the amount of the modification items used for Federal purposes in determining the proper amount of the items for New York State purposes. Applying this approach to the issue herein leads to the conclusion that petitioner should be entitled to use for New York State purposes the same amount of the modification items used for Federal purposes. It must now be determined what amount of the modification items petitioner used for Federal purposes.

G. The Division's argument that the special life insurance company deduction only reduced LICTI by 20% but not the individual components of LICTI fails to take into account the effect of the deduction. Although not specifically stated in Internal Revenue Code § 806(a), for purposes of consistency, each item making up LICTI is effectively reduced by 20% when the special life insurance company deduction is applied. Since the Division accepts the LICTI as reduced by 20% as the starting point in computing entire net income, it follows that in making the modifications required by the same statute that the modification items also be reduced by 20%.

H. It is a well-settled principle of statutory construction that if the mandate of a statute is clear, the plain meaning of the statute should be enforced (Matter of Trump Equitable Fifth Ave. v. Gliedman, 57 NY2d 588). However, the literal language of a statute will not always be controlling where the resulting construction would make a statute unreasonable, or lead to unreasonable results (see, Le Drugstore Etats Unis v. New York State Board of Pharmacy, 33 NY2d 298; McKinney's, Cons Laws of NY, Book 1, Statutes § 143; 56 NY Jur, Statutes, § 211). Tax statutes are to be given a practical construction (Newsday, Inc. v. Town of Huntington, 103 Misc 2d 406, affd 82 AD2d 245), and to avoid an unintended result, a statute should be given a rational interpretation consistent with achieving its purpose and with justice and common sense (see, McKinney's Cons Laws of NY, Book 1, Statutes, § 96). Additionally, tax statutes should, whenever possible, be construed most strongly against the government and in favor of the citizen (Federal Insurance Company v. State Tax Commission, 146 AD2d 888). Furthermore, whenever the language of an enactment admits of two constructions, the more reasonable of the two should be adopted, and it should receive an interpretation which would not lead to unreasonable consequences. So when one interpretation works manifest inequitable results and the other one just and reasonable results, the latter must prevail (see, McKinney's Cons Laws of NY, Book 1, Statutes § 143; 56 NY Jur, Statutes, § 211). The purpose of the modifications of section 1503(b) is to place the taxpayer in the position it would have been in had it not made certain adjustments allowable under the Internal Revenue Code. That is, the modifications require a taxpayer to start with Federal LICTI, but then to add or subtract items that the taxpayer had used to reach Federal LICTI. The modifications, by disallowing or reversing certain adjustments allowed under the Internal Revenue Code, attempt to return the taxpayer to its starting point in calculating taxable income. The Division's position accepts LICTI as reduced by 20% but does not allow the modifications at the reduced amount. The effect of the Division's position is that the amounts of the modification items used to increase or reduce Federal LICTI are greater than the amounts effectively employed in computing LICTI following the application of the special life insurance company deduction. Such a result appears inequitable as compared to the result acheived when a taxpayer uses the same amount of its modification items that are employed in computing LICTI following the application of the special life insurance company deduction. As it would be inequitable and unreasonable to require petitioner to use modification items in an amount larger than that used to compute Federal LICTI and New York entire net income, petitioner's modification items should be reduced by 20%.

I. Uniformity of construction between Federal and State taxing statutes is highly desirable and entitled to great weight in determining an open question (Mosbacher v. Graves, 254 App Div 438, affd 279 NY 793). The interrelationship between the Internal Revenue Code and the Tax Law is illustrated by the numerous references in Tax Law § 1503 to the Internal Revenue Code and to terms such as "federal taxable income" and "federal income tax". Furthermore, the starting point in computing New York State entire net income is Federal LICTI. Given the interrelationship between the special life insurance company deduction, Federal LICTI and New York entire net income, the section 1503(b) modifications must be read in light of the effect of the imposition of the special life insurance company deduction on Federal LICTI and its components.

In addition, the Internal Revenue Code § 806(a) provision was not intended to tax life insurance companies at a lower tax rate but was created to avoid a sudden increase in the tax base (see, Findings of Fact "2" and "3", referring to the S. Rep. No. 169, 98th Cong., 2d Sess. 1984; H.R. Rep. No. 432, 98th Cong., 2d Sess. 1984; Senate Finance Committee Report, May 29, 1986). Consistent with such purpose is the use of the modifications at 80% in computing entire net income, which results in a lower New York State tax base than using the modifications at 100%.

Therefore, in making the Tax Law § 1503(b) modifications, petitioner is entitled to reduce the modification items that were used to compute Federal LICTI by 20%.

J. The petition of The United States Life Insurance Company in the City of New York is granted; petitioner, for the year 1984, is entitled to the refund amount indicated in Finding of Fact "8"; and the two notices of deficiency issued on April 7, 1989 for the year 1985 are to be reduced by the amount indicated in Finding of Fact "9".

DATED: Troy, New York
2/7/91

ADMINISTRATIVE LAW JUDGE