STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions of THE AETNA CASUALTY AND SURETY COMPANY for Redetermination of a Deficiency or for Refund of Franchise Tax on Insurance Corporations under Article 33 of the Tax Law for the Years 1986 and 1987.	:	
In the Matter of the Petition of AETNA LIFE INSURANCE AND ANNUITY COMPANY: for Redetermination of a Deficiency or for Refund of Franchise Tax on Insurance Corporations under Article 33 of the Tax Law for the Year 1986.	:	DETERMINATION DTA NOS. 809867, 809868, 809869 AND 810589
In the Matter of the Petition of THE AUTOMOBILE INSURANCE COMPANY OF HARTFORD, CONNECTICUT for Redetermination of a Deficiency or for Refund of Franchise Tax on Insurance Corporations under Article 33 of the Tax Law for the Year 1986.	:	

Petitioner The Aetna Casualty and Surety Company, 151 Farmingdale Avenue, Hartford, Connecticut 06156, filed petitions for redetermination of a deficiency or for refund of franchise tax on insurance companies under Article 33 of the Tax Law for the years 1986 and 1987.

Petitioner Aetna Life Insurance and Annuity Company, One City Place, Tax Department YF7F, Hartford, Connecticut 06156, filed a petition forredetermination of a deficiency or for refund of franchise tax on insurance corporations under Article 33 of the Tax Law for the year

1986.

Petitioner The Automobile Insurance Company of Hartford, Connecticut, One City Place, Tax Department YF7F, Hartford, Connecticut 06156, 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 year 1986.

A consolidated hearing was held at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on March 26, 1992 at 9:15 A.M., with stipulations and briefs to be submitted by August 10, 1992. Petitioners filed a brief and a reply brief on May 18, 1992 and August 11, 1992, respectively. The Division of Taxation filed a brief on July 28, 1992. Petitioners appeared by Jill W. Bauer, Esq., and Seth L. Rosen, Esq. The Division of Taxation appeared by William F. Collins, Esq. (Kenneth J. Schultz, Esq., of counsel).

ISSUES

I. Whether under Tax Law § 1503(b)(4) a New York net operating loss deduction carried forward or back from a given year must arise from the same loss year as the net operating loss deducted on the insurance corporation's Federal income tax return for the corresponding year.

II. Whether under the aggregation rule of 20 NYCRR 3-8.5 petitioners were entitled to aggregate New York net operating losses of two or more years.

III. Whether the interpretation of Tax Law § 1503(b)(4) set forth by the Division of Taxation offends the equal protection clauses of the United States and New York State constitutions.

IV. Whether, under the theory of equitable recoupment, Aetna Casualty and Surety Company is entitled to a refund otherwise barred by the statute of limitations.

FINDINGS OF FACT

Petitioners and the Division of Taxation ("Division") executed four stipulations of fact, one for each petition. The stipulated facts are adopted and incorporated into the following Findings of Fact.

Petitioners, The Aetna Casualty and Surety Company ("Casualty"), Aetna Life Insurance and Annuity Company ("Life") and The Automobile Insurance Company of Hartford,

Connecticut ("Auto"), are all Connecticut corporations licensed to do business in New York and subject to the franchise tax on insurance corporations, article 33 of the Tax Law.

Petitioners were members of a consolidated group of corporations of which The Aetna Life and Casualty Company was the common parent and, for Federal income tax purposes, they joined in the consolidated return of that group. Each petitioner timely filed New York State franchise tax returns for the years in issue, on a separate basis.

Each petitioner properly computed its net operating losses and net operating loss deductions for the subject years as if it were filing on a separate basis for Federal income tax purposes.

Casualty

The following chart represents Casualty's Federal and New York State net income or loss as reported on its State corporation franchise tax returns for the years 1977 through 1987, without regard to any loss carryovers or carrybacks from other years:[1]

Casualty's Separate Federal and New York Net Income (Loss) as Reported on Casualty's New York Returns

	Federal	New York
1977	$171,888,149	$281,877,420
1978	121,611,251	281,089,931
1979	42,563,698	226,903,957
1980	(154,290,719)	73,517,470
1981	(366,253,401)	(69,563,062)
1982	(373,752,364)	(97,630,538)
1983	(240,013,658)	(28,289,380)
1984	(328,477,566)	(144,013,517)
1985	(229,689,325)	(98,693,037)
1986	160,326,363	306,978,127
1987	218,760,815	288,786,198

A mathematical error was made in calculating Casualty's net New York loss for 1981 on

[1]Federal income is calculated as if Casualty had filed a Federal return on a separate basis and New York State income or loss as shown is before application of the New York allocation factor. These same statements apply to all future references to Federal or State income or loss for Casualty, Life and Auto for all years in issue, as well as references to Federal and State net operating loss deductions for all petitioners.

the return as filed. In calculating net income on Casualty's 1981 franchise tax return, total deductions were added to total income rather than subtracted. Casualty's net loss before deductions was ($88,469,646.00) and the total deductions were $18,906,584.00, resulting in a correct net operating loss of $107,376,230.00 for 1981.

Casualty's 1986 New York net income as reported on its New York return, without regard to any deduction attributable to net operating loss carrybacks or carryforwards ("NOL deduction"), was accepted upon audit by the Division.

Casualty claimed a New York NOL deduction of $306,978,127.00 on its 1986 New York State corporation franchise tax return. Casualty's 1986 Federal NOL deduction was $160,326,363.00.

Casualty had a New York State net operating loss in 1981 of $69,563,062.00 and income of $281,089,931.00 in 1978. Casualty never carried back its 1981 net operating loss to 1978.

Upon audit of Casualty's 1986 return, the Division determined that Casualty was required to carry back its 1981 net operating loss to reduce its 1978 New York income. The effect of this required carryback was to use up the entire amount of the 1981 New York State loss.

Casualty had a Federal net operating loss of $366,253,401.00 in 1981 and Federal income of $121,611,251.00 in 1978, $42,563,698.00 in 1979, and $160,326,363.00 in 1986. On audit, the Division carried back or forward the 1981 Federal net operating loss to reduce Casualty's 1978, 1979 and 1986 Federal income to zero. This left a balance to carry forward of $41,752,089.00.

The Division disallowed Casualty's entire 1986 New York State NOL deduction on the ground that the State and Federal NOL deduction must flow from the same source year, in this case 1981. The Federal 1981 net operating loss was used to reduce Casualty's 1986 Federal income to zero; however, Casualty was required to carry forward its State net operating loss

from 1981 to reduce its 1986 State income. Since its 1981 net operating loss was used up by carrying it back to 1978, there was no remaining loss to carry forward.

The Division issued to Casualty two notices of deficiency for 1986, dated August 25, 1989, asserting a deficiency of corporation franchise tax in the amount of $4,440,733.00, plus interest and additional charges, and a deficiency of the metropolitan transportation business tax surcharge in the amount of $440,434.84, plus interest and additional charges.

A Statement of Audit Adjustment issued at the same time as the notices of deficiency contained the following explanation:

> "[Casualty's] 1981 New York loss was used up in 1978. Since no other loss was applied to 1986 for federal purposes, no other loss can be applied to 1986 for New York purposes either."

The statute of limitations for filing a refund claim that would have permitted Casualty to carry back its 1981 New York State net operating loss to offset its 1978 taxable income expired on September 15, 1985, without Casualty filing a refund claim for such carryback.

Had Casualty timely carried back its 1981 net operating loss to offset its 1978 taxable income, Casualty would have received a refund. As Casualty did not carry back its 1981 net operating loss to 1978, Casualty did not receive a refund for such loss.

Casualty paid $4,481,323.00 in tax plus interest of $1,987,652.00 on January 23, 1991 in full payment, as recomputed by the Division, of the asserted tax deficiency and applicable interest.

Casualty timely filed a Claim for Refund of Corporation Tax Paid on Form CT-8 with respect to the assessed deficiency for tax of $4,468,870.00 and interest of $1,982,127.00 on July 17, 1991.

By letter dated July 23, 1991, the Division denied Casualty's refund request.

Casualty's 1987 New York net income as adjusted upon field audit by the Division, without regard to any NOL deduction, was $249,473,977.00.

Casualty claimed a New York NOL deduction on its 1987 New York State corporate franchise tax return, in the amount of $131,211,407.00.

Casualty's 1987 Federal NOL deduction, as calculated on a separate return basis for New York purposes, was $218,760,815.00.

Upon a field audit of Casualty's 1987 return, the Division asserted that Casualty's 1987 NOL deduction should have been comprised only of losses from 1981 and 1982 ($97,630,538.00) and not from the years 1984 and 1985 as claimed on Casualty's 1987 New York corporation franchise tax return.

The Division asserted an additional tax of $502,946.00 (plus any Metropolitan Transit District Tax and applicable interest related to this issue) as a result of such disallowance.

Casualty paid $502,946.00 of tax (plus any Metropolitan Transit District Tax and applicable interest) on December 10, 1991 as an offset against refunds due to Casualty as a result of the field audit, in full payment of the asserted tax deficiency and applicable Metropolitan Transit District Tax and interest.

Casualty timely filed a Claim for Refund of Corporation Tax Paid on Form CT-8 with respect to the amount at issue on December 10, 1991.

By letter dated December 24, 1991, the Division denied Casualty's refund request.

From 1978 through 1986, Casualty reported interest income on State and municipal debt obligations which was includible in net income for New York purposes and exempt from Federal tax in the following amounts:

	Casualty's Interest Income from State and Municipal Bonds
1978	$148,034,019
1979	171,543,263
1980	199,482,729
1981	208,037,826
1982	207,915,511

1983	178,247,573
1984	159,673,038
1985	113,857,331
1986	110,078,200
1987	147,690,095

Life

The following chart presents Life's Federal and New York State net income or loss as reported by Life on its New York State corporate franchise tax returns, without regard to any net operating loss carryover or carryback from other years, for the years 1978 through 1986:

Life's Separate Federal and New York Net Income (Loss) as Reported on Life's New York Returns

	Federal	New York
1978[2]	($ 4,393,052)	($ 2,338,612)
1979	14,569,419	16,800,312
1980	27,453,841	29,395,044
1981	(105,994,205)	(103,215,996)
1982	(182,359,051)	(179,765,807)
1983	(168,585,947)	(167,369,091)
1984	(35,231,343)	(28,936,259)
1985	(18,353,921)	(12,571,210)
1986	55,612,270	61,654,495

Life's 1986 New York net income as adjusted upon audit by the Division, without regard to any deduction attributable to net operating loss carryovers or carrybacks was $62,015,472.00. The adjustment was due to a decrease upon audit of the 50% dividends received deduction reported on line 36 of the return from $6,136,599.00 to $5,775,622.00.

Life claimed an NOL deduction of $61,654,495.00 on its 1986 New York State corporate franchise tax return, reducing its New York State 1986 income to

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[2] For tax years 1978 through 1983, Life's separate Federal income is calculated by adding line 27 or line 28 (as appropriate) to line 23 or 24 (as appropriate) of the return to conform to the method for computing Federal income as reported on line 23 of the return for all other taxable years.

zero.

Life's 1986 Federal NOL deduction, as calculated by Life on a separate return basis for New York purposes, was $55,612,275.00.

Upon audit of Life's 1986 return, the Division disallowed Life's 1986 New York State NOL deduction to the extent of $7,774,882.00 ($61,654,495.00 - $53,879,613.00). In statements of audit adjustment dated August 4, 1989, the Division asserted a tax deficiency of $40,853.00, plus applicable interest, as a result of the NOL deduction disallowance.

The Division's adjustment to Life's 1986 NOL deduction was calculated as follows. The Division reduced Life's New York State NOL deduction to the Federal amount available to carry forward from 1981 to 1986. For Federal purposes, Life had a net operating loss balance of $1,732,662.00 from the years 1975 through 1978 available to carry forward to 1986.[3] This amount was carried forward to reduce Life's 1986 Federal net income to $53,879,613.00. The Division then carried forward from Life's 1981 Federal net losses ($105,994,205.00) the amount necessary to reduce Life's 1986 Federal net income to zero ($53,879,613.00). Life's New York State NOL deduction was then reduced to the Federal amount carried forward from 1981 or $53,879,613.00.

The Statement of Audit Adjustment states:

> "The entire New York loss is used. After deducting $1,732,662 of 1978 loss, the balance of income $53,879,613 is used up by the
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> 1981 loss; therefore for New York State purposes, [Life's] deduction is limited to $53,879,613 too."

Life paid $40,969.00 in tax, plus interest of $18,171.00, on January 23, 1991 in full payment, as recomputed by the Division, of the asserted tax deficiency and applicable interest.

Life timely filed a Claim for Refund of Corporation Tax Paid on Form CT-8 with respect to the asserted deficiency for tax of $40,916.00 and interest of $18,147.00 on July 17,

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[3]Life had no New York State net operating losses available to carry forward from years prior to 1981.

1991. By letter dated July 23, 1991, the Division denied Life's refund request.

From 1978 through 1986, Life reported interest income on State and municipal debt obligations which was includible in income for New York State purposes and exempt from Federal tax in the following amounts:

	Life's Interest Income from State and Municipal Bonds
1978	-0-
1979	-0-
1980	-0-
1981	$ 9,254.00
1982	60,878.00
1983	85,009.00
1984	6,794.00
1985	3,276.00
1986	111,485.00

Auto

The following chart presents Auto's Federal and New York State net income or loss as reported on its New York State corporate franchise tax returns, without regard to any net operating loss carryover or carryback from other years, for the years 1982 through 1986:

Auto's Separate Federal and New York Net Income (Loss) as Reported on Auto's New York Returns

	Federal	New York
1982	($1,148,942)	$3,143,125
1983	(524,260)	3,098,322
1984	(2,376,371)	1,142,340
1985	(9,280,712)	(6,879,101)
1986	3,528,158	6,533,442

Auto's 1986 New York net income as reported on Auto's New York return, without regard to any deduction attributable to net operating loss carrybacks or carryforwards was accepted upon audit by the Division.

Auto claimed an NOL deduction of $6,533,442.00 on its 1986 New York State corporate franchise tax return.

Auto's 1986 Federal NOL deduction, as calculated on a separate return basis for New York purposes, was $3,528,158.00.

Upon audit of Auto's 1986 return, the Division disallowed Auto's entire 1986 New York State NOL deduction. In statements of audit adjustment dated December 15, 1989, the Division asserted a tax deficiency of $582,525.00, plus applicable interest, as a result of such disallowance.

One Statement of Audit Adjustment asserts that Auto's "1986 federal income is used up by [its] 1982, 1983 and 1984 losses. None of [its] 1985 loss is carried to 1986. Since none of [its] 1985 federal loss is carried to 1986, none of [its] New York loss can be carried to 1986 either. Federal taxable income can only be reduced to zero."

The Division issued to Auto two notices of deficiency dated February 2, 1990, asserting a deficiency of corporation franchise tax in the amount of $527,273.00 and a deficiency of metropolitan transportation tax surcharge in the amount of $55,252.00.

On May 10, 1991, a Conciliation Order was issued by the Bureau of Conciliation and Mediation Services with respect to this matter which recomputed the statutory notices received by Life to assert a deficiency of $153,818.00, plus interest computed at the applicable rate.

Life paid $153,818.00 in tax, plus interest of $73,867.00, on April 16, 1991 in full payment of the asserted tax deficiency and interest computed at the applicable rate and now seeks a refund of the amount paid.

From 1982 through 1986 Auto reported interest income on State and municipal debt obligations which was includible in income for New York purposes and exempt from Federal tax in the following amounts:

	Auto's Interest Income from State and Municipal Bonds
1982	$3,373,871
1983	2,850,539
1984	2,729,310
1985	1,515,816
1986	1,258,293

SUMMARY OF THE PARTIES' POSITIONS

The Division's adjustments to petitioners' NOL deductions are premised on the principle that a taxpayer's New York net operating loss deduction for a given year must originate in the

same source year and be no greater in amount than the Federal net operating loss deduction taken in the same year. Petitioners maintain that there is no statutory or judicial support for this position.

Even if source year conformity is required, petitioners argue that under the aggregation rule contained in 20 NYCRR 3-8.5 Casualty and Life are each entitled to a larger NOL deduction than calculated by the Division. The Division takes the position that the aggregation rule does not apply in either situation.

Petitioners note that, as a result of the amount and source year conformity rule, taxpayers who earn income which is includible in New York taxable income, but excluded from Federal gross income, have a reduced opportunity to utilize net operating loss carryforwards and are therefore subject to a higher effective rate of tax than taxpayers who earn the same amount of income from sources that the Federal government chooses to tax. Petitioners argue that there is no rational basis for this distinction and, therefore, that the amount and source year conformity rule violates the Equal Protection Clause of the United States and New York State Constitutions. It is the Division's position that any loss disallowances produced by the source year conformity rule are the result of differences in State and Federal taxing schemes and that the rule itself is not rendered unconstitutional because of this result.

Petitioners maintain that under the theory of equitable recoupment Casualty is entitled to carry back its 1981 losses to 1978 and to receive a refund for that year. The Division takes the position that any refund claim based upon a carryback from 1981 is barred by the statute of limitations.

CONCLUSIONS OF LAW

A. Article 33 of the Tax Law imposes a franchise tax on insurance companies. The rules to be used by an insurance corporation to compute entire net income are set forth in Tax Law § 1503. This computation begins with the taxpayer's taxable income for Federal purposes for the taxable year (Tax Law § 1503[a]). The Federal amount is then modified for New York purposes by the provisions of section 1503(b). Among these modifications are the adjustments

for net operating losses required under section 1503(b)(4) which provides, as pertinent here, that:

> "Any 'net operating loss deduction' or 'operations loss deduction' allowable under sections one hundred seventy-two or eight hundred ten of the internal revenue code, respectively, which is allowable to the taxpayer for federal income tax purposes:
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> "(A) shall be adjusted to reflect the modifications required by the other paragraphs of this subdivision;
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> "(B) shall not, however, exceed any such deduction allowable to the taxpayer for the taxable year for federal income tax purposes . . . ."

A taxpayer which reports as part of a consolidated group for Federal income tax purposes but on a separate basis for purposes of article 33 computes its net operating loss deduction as if it were filing on a separate basis for Federal income tax purposes (20 NYCRR 3-8.1[a]).[4]

B. Section 1503(b)(4)(B) has been interpreted to mean that a New York net operating loss deduction may not exceed the amount of the Federal net operating loss absorbed in the same year (Matter of Royal Indemnity Company v. Tax Appeals Tribunal, 75 NY2d 75, 550 NYS2d 610), and that the Federal and State net operating loss deduction must arise from the same source year (see, Lehigh Valley Industries, Tax Appeals Tribunal, May 5, 1988, citing Matter of Eveready v. State Tax Commn., 129 AD2d 958, 515 NYS2d 339, lv denied 70 NY2d 604, 519 NYS2d 1027). Petitioners concede that the decision in Lehigh Valley is a direct precedent which supports the Division's requirement of Federal and State source year conformity; however, they argue that the decision of the Tax Appeals Tribunal in Lehigh Valley is incorrect. Their position is based primarily on the claim that the

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[4]Tax Law § 1519 provides that the provisions of Article 27 of the Tax Law, which relate generally to corporate tax procedures, shall apply to the provisions of Article 33. Upon enactment of Article 33, the Legislature stated: "That the provisions of such article which are the same as or are substantially identical with those in Article nine-a of the Tax Law shall be regarded as being in pari materia and shall be construed in a like manner" (L 1974, ch 649, § 12). The net operating loss provisions of Article 33 (Tax Law § 1503[b][4]) are substantially identical to the net operating loss provisions of Article 9-A (Tax Law § 208.9[f]). Consequently, the regulations and case law construing section 208.9(f) are equally applicable to section 1503(b)(4) (see, Matter of Royal Indemnity Company, Tax Appeals Tribunal, February 19, 1988, confirmed 148 AD2d 845, 539 NYS2d 510, affd 75 NY2d 75, 550 NYS2d 610).

Lehigh Valley decision is premised on a faulty reading of Matter of Eveready v. State Tax Commn. (supra). I agree with the Division that Lehigh Valley is a binding precedent on all Administrative Law Judge determinations; therefore, petitioners' arguments as to the correctness of that decision will not be addressed here.

C. 20 NYCRR 3-8.5 describes the method for aggregating the carryforward of net operating losses of two or more years:

> "When the net operating losses of two or more years, or the portions of net operating losses of two or more years, are carried back or carried forward to be deducted from the income of one particular taxable year, the Tax Commission requires that an aggregate method of deducting the losses be used. The taxpayer must compute the aggregate of the Federal net operating losses to be carried to the particular taxable year, and, also, compute the aggregate of the net operating losses under article 9-A for such year.
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> "After computing the two aggregate figures, whichever of the two (Federal or State) is the smaller is the aggregate net operating loss which is allowable as a carry back or carry forward to the particular taxable year. The limitations described in subdivisions (b), (c) and (d) of section 3-8.2 of this Subpart apply in deducting the aggregate of losses."

In Lehigh Valley, the petitioner argued that this regulation supported his claim that a State net operating loss need not originate in the same year as the Federal net operating loss deduction. The Tribunal found that since the petitioner did not have net operating losses from two or more years that it was seeking to carry back or forward the rule of section 3-8.5 was not applicable to determining petitioner's entire net income. Addressing an example in the regulations which petitioner cited in support of its position, the Tribunal stated:

> "With regard to the origin of net operating losses, this example illustrates, at the most, that when net operating losses from two or more years are required by the regulation to be aggregated, the losses lose their identity as arising from the separate years and are considered to have arisen from all of the years involved." (Emphasis added.)

Petitioners claim that Casualty and Life had net operating loss carryforwards "to 1986 that arose from multiple source years for both state and federal purposes and are entitled to rely on 20 NYCRR § 3-8.5" (Petitioners' Brief, p. 34). Petitioners apparently mean that they are entitled to avoid the source year conformity rule by aggregating State net operating losses without regard to the degree to which it is necessary to aggregate Federal losses.

The ordering rules for net operating loss carryforwards and carrybacks under Article 9-A

are found at 20 NYCRR 3-8.1. It applies the Federal ordering rules to State losses and is equally applicable to section 1503(b)(4). Basically, section 3-8.1(c) requires that a taxpayer use a net operating loss carryover in a sequential manner. In the case of Casualty, it was required to carry back its 1981 net operating loss to the earliest of the three taxable years preceding, or in this case, 1978.[5] The effect of this carryback was to exhaust the 1981 State operating loss. After carryback of the 1981 Federal loss to offset Federal income for 1978 and 1979, Casualty had an unused Federal 1981 net loss of $202,078,452.00 which was larger than the amount required to reduce its 1986 Federal income to zero. Consequently, Casualty was not required to aggregate Federal loss years to offset its 1986 Federal income. As the Division notes in its brief, petitioners' attempt to apply the aggregation rule of section 3-8.5

under these circumstances is simply a method of circumventing the source year conformity rule.

For tax year 1987, Casualty was required to aggregate the unused portion of its Federal 1981 net operating loss and its Federal 1982 net operating loss. This yields an aggregate Federal net operating loss of $575,830,816.00. Casualty's 1981 State loss was used up entirely (by carryback to 1978), thus aggregation of the 1981 and 1982 State losses yields an amount equal to the 1982 loss. Since the New York aggregate loss for 1981 and 1982 ($97,630,538.00) is less than the Federal aggregate loss, the maximum allowable net operating loss deduction is $97,630,538.00, as calculated by the Division.

The same analysis applies to the calculation of Life's 1986 net operating loss deduction. The unused amount of Life's Federal net operating losses for the years 1975 through 1978 were carried forward to reduce its Federal 1986 income from $55,612,275.00 to $53,879,613.00. This amount was then carried forward from 1981 to reduce Life's 1986 Federal net income to

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[5]20 NYCRR 3-8.1(d) permits a taxpayer "to waive the entire carryback period with respect to a net operating loss for any taxable year ending after December 31, 1975", provided that the election be made in writing by the due date for filing a report for the taxable year of the net operating loss. Since Casualty filed no such election, it was required to make the carryback to 1978.

zero. For State purposes, the aggregate of net operating losses for the years 1975 through 1978 and 1981 was $103,215,996.00 (the loss available for the year 1978 and prior years was zero). Consequently, the maximum net operating loss available for 1986 is $53,879,613.00, the lesser of the Federal and State amounts.

D. Tax Law § 1503(b)(2) requires the taxpayer to make certain modifications to Federal taxable income in order to determine New York entire net income. Tax Law § 1503(b)(2)(B) requires the taxpayer to "add back" to Federal income federally tax exempt municipal bond interest income. As a result of this add back, petitioners' Federal taxable income generally was smaller than their New York income, and their Federal net operating losses were greater than their New York net operating losses. Petitioners note that the add back requirement caused them to have "a reduced opportunity to utilize NOL carryovers" and subjected them "to a higher effective rate of tax than taxpayers who earn the same amount of New York taxable income from sources that the federal government chooses to tax, such as interest on corporate obligations." (Petitioners' Brief, pp. 36 - 37.)

Petitioners claim that the different treatment of municipal bond holders like themselves and taxpayers holding investments not exempt from Federal taxation violates the equal protection clauses of the Federal Constitution (US Const, 14th Amend) and of the State Constitution (NY Const, art I, § 11). Petitioners do not claim that any of the provisions of section 1503 are unconstitutional as written; rather they claim that the administrative interpretation of Tax Law § 1503(b)(4) which requires amount and source year conformity results in an unconstitutional application of the statute and is contrary to the intent of the Legislature.

Petitioners cite the case of Allegheny Pittsburgh Coal Co. v Webster County (488 US 336, 102 L Ed 2d 688) to support their position (see also, Nordlinger v. Hahn, ___ US ___, 120 L Ed 2d 1). In Allegheny, the United States Supreme Court found unconstitutional a real property taxing scheme employed by Webster County of West Virginia. The West Virginia Constitution establishes a general principle of uniform taxation so that all property, real and

personal, is to be taxed in proportion to its value. Between 1975 and 1986, the Webster County tax assessor assessed recently purchased real property on the basis of its most recent purchase price but made only minor modifications to the tax assessments of land that had not been recently sold. This practice resulted in gross disparities in the assessed value of generally comparable property and was found to deny the petitioners equal protection of the laws (id. at 338-339, 102 L Ed 2d at 693-694).

In its opinion, the Supreme Court restated the general principle that "[t]he Equal Protection Clause 'applies only to taxation which in fact bears unequally on persons or property of the same class'" (id. at 343, 102 L ED 2d at 697 quoting Charleston Fed. Saving & Loan Assn. v. Alderson, 324 US 182, 190). The States have broad powers to impose different tax rates on different classes of property or upon different trades or professions. As long as the selection or classification is based on some reasonable consideration of difference or policy, there is no denial of equal protection (id. at 344, 102 L Ed at 697).

According to petitioners, the amount and source year conformity rule leads to disparate treatment of similarly situated taxpayers in the same way that Webster County's assessment scheme led to disparate treatment of real property owners. They argue that municipal bond investors, like themselves, are denied the use of New York net operating losses, while other persons holding bonds not exempt from Federal taxation are allowed to reap the full advantage of such losses. The Division argues that the disparity perceived by petitioners is a result of a legislative decision to tax municipal bond income which the Federal government has elected not to tax. Citing to Matter of Kreiss v. New York State Tax Commn. (61 NY2d 916, 474 NYS2d 717), the Division maintains that any inequity perceived by petitioners results from a dissimilarity between the Federal and State statutes and is not a matter which implicates the equal protection clause of the Federal or State constitutions.

Petitioners state that their claim of unconstitutionality is not based on the results of the modification to income required by Tax Law § 1503(b)(2)(B), but rather on the Division's interpretation of Tax Law § 1503(b)(4) which contains modifications to Federal income for net

operating losses. According to petitioners, "the Division's interpretation has imposed an additional burden on Petitioners by imposing, in effect, two taxes, the tax on the income itself plus the loss disallowance resulting from the source and amount year conformity rules" (Petitioners' Reply Brief, p. 14).

I cannot see that the disparity perceived by petitioners results from anything other than the Legislature's decision to tax municipal bond income. The requirement of State and Federal amount and source year conformity does no more than further the policy choice of the Legislature. The addback generally causes New York net income to be greater than Federal taxable income in any year resulting in a net gain. In a loss year, it causes the New York net operating loss to be less than the Federal net operating loss. This is a perfectly consistent result. Petitioners' equal protection argument is premised on a comparison of investors holding two different kinds of investments, i.e., municipal bond holders like petitioners and other bond holders. These investors are differently situated as a result of legislative choices. There is no remedy in the equal protection clause for the inequity petitioners perceive (see, Matter of Trump v. Chu, 65 NY2d 20, 489 NYS2d 455, appeal dismissed 474 US 915.

E. In 1978 Casualty paid New York State franchise taxes of $3,903,549.00. When a New York net operating loss arose in 1981, Casualty did not file for a refund of taxes paid. The parties agree that if Casualty had filed a refund claim, carrying back its 1981 losses to offset 1978 income, it would have been entitled to a refund of tax. The statute of limitations for filing such a refund claim expired on September 15, 1985, or three years from the time the return was due (including extensions of time to file) for the taxable year of the loss (Tax Law § 1087[d]). Petitioners now claim that Casualty is entitled to a refund of tax paid for the year 1978 under the doctrine of equitable recoupment.

The essence of the doctrine of equitable recoupment was stated in Bull v. United States (295 US 247, 35-1 US Tax Cas ¶ 9346): "recoupment is in the nature of a defense arising out of some feature of the transaction upon which the plaintiff's action is grounded." (Id. at 262.) This general principle has been applied in both Federal and State tax cases (see, id.; Stone v. White,

301 US 532, 37-1 US Tax Cas ¶ 9303; National Cash Register v. Joseph, 299 NY 200, 90 NYS2d 200). In Rothensies v. Electric Storage Battery Co. (329 US 296, 47-1 US Tax Cas ¶ 9106), however, the Supreme Court severely narrowed the application of the doctrine in tax litigation to claims in which the same transaction constitutes the taxable event upon which the deficiency and the claim for recoupment are premised. The Division argues that equitable recoupment should be given the same limited application in State tax litigation. In Casualty's case, the tax year for which refund is sought is 1978. Since the 1978 tax year was not the subject of the audit which resulted in deficiency notices being issued, the Division argues that the prerequisites for equitable recoupment do not exist here.

Petitioners take a broader view. Based upon the case of National Cash Register v. Joseph (supra), petitioners argue that equitable recoupment is appropriate when the following factors exist: (1) The deficiency claim and the recoupment claim must arise from a single transaction or taxable event. (2) Equitable recoupment cannot be used as an independent ground to reopen time-barred years but only as a defense [to a deficiency claim]. (3) The amount subject to recoupment may not exceed the amount of the asserted deficiency. (4) The payment of the erroneous tax was made during the period under review. Petitioners note that the Division's calculation of a tax deficiency for 1986 results in part from the carryback of a 1981 loss to 1978; thus, they deem the 1978, 1981, and 1986 tax years to be part of a single transaction or taxable event.

I do not agree that Casualty is entitled to an equitable recoupment of taxes paid in 1978. In the case of National Cash Register, the court noted that the City of New York had assessed a sales tax deficiency against a vendor for the period of September 1, 1935 to December 31, 1940, and held:

> "The vendor, as we think, was thereby given an equitable right to plead against the city a recoupment claim for taxes of the same type which the vendor (as it alleges) had erroneously paid to the comptroller in the same period." (National Cash Register Co. v. Joseph, supra, 90 NYS2d at 203.)

There are sound reasons for confining the National Cash Register case to allow recoupment only for the period for which a deficiency has been asserted. The statute of

limitations for filing a refund claim where the overpayment is premised on a carryback of a net operating loss is three years from the time the return was due for the taxable year of the loss (Tax Law § 1087[d]). Petitioners' view of what constitutes a "single transaction" is so broad that its adoption would seriously weaken the statute of limitations in matters involving the carryover of net operating losses (cf., Rothensies v. Electric Storage Battery Co., supra [where the Court in confining the doctrine of equitable recoupment to transactions occurring in the same period noted that a broader view would undermine the statute of limitations in tax matters since "[i]n many, if not most, cases of asserted deficiency the items which occasion it relate to past years closed by statute"]). Furthermore, there are strong policy considerations which discourage equitable claims against the state in tax matters. As stated by the Supreme Court in Kavanagh v. Noble (332 US 535, 539, 48-1 US Tax Cas ¶ 9114), it is not the province of the judiciary to undermine legislatively imposed statutes of limitation in an attempt to achieve equity (see also, Matter of Turner Construction Co. v. State Tax Commn., 57 AD2d 201, 394 NYS2d 78). Casualty's loss of the benefit which it might have received by carrying back its 1981 losses to its 1978 tax year was occasioned by its own failure to file a refund claim within the statutory period of limitation, and it must bear the consequences of that failure.

F. The petitions of Aetna Casualty and Surety Company, Aetna Life Insurance and Annuity Company and The Automobile Insurance Company of Hartford, Connecticut are denied in all respects.

DATED: Troy, New York
May 6, 1993

/s/ Jean Corigliano
ADMINISTRATIVE LAW JUDGE