STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions	:	
of	:	
AMERICAN ZURICH INSURANCE COMPANY, UNIVERSAL UNDERWRITERS INSURANCE COMPANY, MARYLAND CASUALTY CO., NORTHERN INSURANCE COMPANY OF NY, ZURICH AMERICAN INSURANCE COMPANY AND AMERICAN GUARANTEE & LIABILITY INSURANCE COMPANY	:	DETERMINATION DTA NOS. 822840, 822841, 822842, 822843 822849 AND 822906
for Redetermination of Deficiencies or for Refunds of Franchise Tax on Insurance Corporations under Article 33 of the Tax Law for the Tax Years 2003, 2004 and 2005, as applicable.[1]	:	

Petitioner, American Guarantee & Liability Insurance Company, et al, filed petitions for redetermination of deficiencies or for refunds of franchise tax on insurance companies under Article 33 of the Tax Law for the years 2003, 2004 and 2005, as applicable.

A hearing was held before Dennis M. Galliher, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on August 11, 2009 at 9:15 A.M., with all briefs to be submitted by February 1, 2010, which date began the six-month period for the issuance of this determination. By a letter dated July 22, 2010, this six-month period was extended for an additional three months (Tax Law § 2010[3]). Petitioners appeared by McDermott, Will & Emery LLP (Arthur R. Rosen, Esq., and Lance E. Rothenberg, Esq., of

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[1] In addition to the captioned petitioner, American Guarantee & Liability Insurance Company (AGLIC), the following entities are also petitioners herein: American Zurich Insurance Company (AZIC) (DTA NO. 822841), Maryland Casualty Company (MCC) (DTA NO. 822842), Northern Insurance Company of New York (NIC) (DTA NO. 822843), Universal Underwriters Insurance Company (UUIC) (DTA NO. 822849) and Zurich American Insurance Company ((ZAIC) (DTA NO. 822906). This group of six entities shall be referred to collectively as petitioners, and may sometimes be known, individually, as petitioner or by reference to their particular foregoing parenthetical acronym.

counsel). The Division of Taxation appeared by Daniel Smirlock, Esq. (Clifford M. Peterson, Esq., of counsel).

ISSUE

Whether deductible reimbursements accrued or received by petitioners from their insured policyholders in connection with New York claims under workers' compensation deductible policies constitute "premiums" for purposes of Tax Law § 1510(c)(1).

FINDINGS OF FACT

1. Petitioners, who are affiliated with each other, are all duly licensed to conduct an insurance business in New York State, and each does so, offering policies that cover New York workers' compensation exposures. As is particularly relevant here, each petitioner is qualified to and does offer workers' compensation insurance policies known as deductible policies (or large deductible policies), and does so via deductible policy forms, which are essentially identical in all relevant respects and which have been reviewed and approved as to rules, rates and form by the New York State Insurance Department (Insurance Department).

2. Each petitioner is subject to Tax Law Article 33 (Franchise Tax on Insurance Corporations), and each timely filed insurance corporation franchise tax returns for the years at issue. The Division of Taxation (Division) audited petitioners' tax returns, and determined that petitioners did not include in their computation of taxable premiums the amounts of payments they had made to claimants or providers which, pursuant to deductible endorsements in their policies, they had thereafter received back (or accrued) as reimbursements from their policyholders. The Division adjusted each of the petitioners' taxable premiums so as to include these amounts.

3. As a consequence of the foregoing, each petitioner received a Notice of Deficiency from the Division asserting that each owes additional tax under Tax Law Article 33. In addition, ZAIC and AGLIC each received related refund denials or adjustments. A Joint Stipulation of Facts and Exhibits was executed by the parties and accepted in evidence as Exhibit "1." This stipulation sets forth specific information concerning each petitioner in this matter, as follows:

> a) the issuance of the specific notices of deficiency and the refund denials or adjustments;
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> b) computational facts related thereto;
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> c) matters relating to the procedural progress of the subject appeal by each petitioner;
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> d) background corporate factual materials;
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> e) representative sample documents (New York Deductible Workers' Compensation Insurance Policy and Deductible Endorsement, New York Annual Statement, New York State Page and New York Supplement, and External Auditor Audited Statutory Financial Statements) generically applicable to each petitioner; and
>
> f) certain additional documents (Exhibits).[2]

This Joint Stipulation of Facts and Exhibits includes some 125 numbered and agreed upon facts encompassing, as noted, undisputed procedural and computational facts. Section IV of Exhibit 1 is titled Tax Computational Facts, and includes stipulated facts numbered 82 through 116. These stipulated facts set forth, for each of the petitioners, the dollar amounts of premium

[2] Upon petitioners' request, it has been agreed as unnecessary to disclose of the name of the insured entity listed on the representative policy (Ex. I-A), and such name, as well as the identifying information contained therein regarding that insured party, shall remain confidential.

tax, MTA surcharge, and retaliatory tax credit refunds that would result depending upon which of the parties prevails on the issue presented in this case.[3]

4. As a basic starting point, insurance involves the contractual transfer of identified risk of loss from one individual or entity to another for a particular period of time in exchange for a payment known as a premium. This payment of a known cost (premium) in exchange for financial protection from an unknown, potentially severe, and financially damaging loss is known as "insurance risk" or "underwriting risk." This potential risk of loss is unpredictable since the event that occasions such a loss is largely fortuitous. That is, insurance risk, hazard or peril is triggered by an accident or other event that is unexpected and unintended. The unpredictable or fortuitous nature of the risk distinguishes "insurance risk" from other types of risk, such as "credit risk."

5. When an insurance company accepts the transfer of insurance risk from a very large number of policyholders (i.e., thousands or even millions of policyholders), it becomes situated so as to "pool" the incidence of the types of risks being accepted and thereby financially manage those risks in the aggregate. While the insurance risk or likelihood that an unexpected occurrence (i.e., injury or accident) will happen, and the severity of that occurrence (in financial terms), is very difficult to accurately assess (or predict) with respect to any particular individual, the same risk is much more predictable on an aggregate basis. This phenomenon is known as the Law of Large Numbers, a statistical science theorum stating that an unexpected occurrence becomes more predictable in the aggregate when examining a large number of possible

[3] Certain adjustments unrelated to the issue herein were also made by the Division upon audit. These adjustments were agreed to by each petitioner, as applicable, and these unrelated adjustments are not in dispute.

occurrences. Thus, while it is difficult for an individual to predict and budget for the risk of occurrence and the possible severity of the expense of such an event, an insurance company, by pooling and contractually assuming the risks of many policyholders together, can predict with some certainty both how many accidents or injuries from within the pool of policyholders will occur and the severity (minor or substantial) thereof. While the insurance company cannot necessarily predict which specific entity or individual will be involved in an accident or sustain an injury, it can statistically determine the percentage of its policyholders that will be involved in an accident or sustain injury and the likely costs thereof. Further, by collecting premiums from many policyholders, an insurance company can spread the costs associated with the occurrence of a particular accident or injury across the entire large pool of policyholders. As a consequence of shifting, pooling and spreading insurance risk, predictability is possible for groups of events that are not predictable on an individual basis.

6. Petitioners are all for-profit corporations and accept the transfer of insurance risk in exchange for the payment of premiums. While very specifically defined in the Tax Law, the term "insurance premium" means generally the fee that an insurance company charges a policyholder in exchange for assuming the responsibility for the policyholder's insurance risk. Premium consists, generally, of three components:

> –an amount sufficient to fund anticipated losses in the aggregate for a certain policy type,
> –an amount sufficient to pay for expenses associated with the policy (overhead), and
> – an amount for profit.

Based on statistical experience, insurance underwriters can evaluate a policyholder's anticipated risk profile and determine the appropriate amount of premium. The rate filings

utilized by petitioners herein were approved by the Insurance Department. In developing and calculating the amount of premium for the policies at issue, petitioners did not include a cost to cover the premium tax, which would be payable on amounts received as deductible reimbursements (if such amounts are held to be taxable premiums).

7. A common feature of some insurance policies, including those in question here, is the inclusion of a deductible endorsement, whereby an agreement made a part of the policy is that a certain dollar portion of the insurance risk of loss that would otherwise be transferred to the insurance company is instead retained by the policyholder. Thus, under a deductible policy, the insured policyholder retains responsibility for the risk and the cost of loss up to and including the amount of the deductible, with the risk and responsibility for the cost of loss amounts exceeding the deductible limit transferred to the insurance company. In effect, under a policy containing a deductible endorsement, less risk (or cost exposure) is transferred to the insurance company than under an equivalent policy not containing a deductible endorsement. As a consequence of the reduction of the insurance company's cost obligations under a deductible policy, the insurance company can, accordingly, charge a lower premium amount.

8. In the context of workers' compensation, as here, policyholders who elect to retain a portion of the cost of their risks of loss in exchange for a lower policy premium may better manage their overall workers' compensation expenses. Further, the retention of financial responsibility for a portion of a loss, by a deductible endorsement, can provide an economic incentive for policyholders to improve workplace safety and reduce or avoid the incidence of accidents or injuries. At the same time, since such accidents and injuries are unexpected and essentially unpredictable (on an individual basis) policyholders with deductible endorsements

still require insurance protection against severe and financially damaging losses that exceed the amount of the loss retained pursuant to the deductible limit, and so still transfer the risk of loss in excess of that retained via the deductible endorsement to the insurance company in exchange for the payment of premium. As with the rate filings noted above, the deductible endorsements in each deductible policy at issue in this matter have been reviewed and approved by the Insurance Department.

9. This matter concerns workers' compensation insurance, a form of property and casualty insurance. Workers' compensation insurance is intended to protect employers from and compensate workers for economic losses arising from injury, disability or death occurring on the job (***see*** Insurance Law § 1113[a][15]). Workers' compensation insurance is state-mandated and, with few exceptions, employers are required by the State of New York to obtain insurance to cover their obligations to provide workers' compensation benefits to their injured employees (Workers Compensation Law § 10, NY Const, art I, § 18). There is no dispute between the parties that the underlying premise and objective of workers' compensation insurance is to ensure, as a matter of strong public policy, that an injured worker, generally regardless of fault, receives appropriate medical care and associated economic protections without administrative or other delay.

10. In 1991, New York State first authorized insurance companies operating in the state to offer workers' compensation insurance policies with an accompanying deductible endorsement (Insurance Law § 3443). Under such policies, an employer retains for itself a portion, up to the dollar amount of the deductible endorsement, of the cost of the risk of workplace injury. At the same time, and notwithstanding the presence of a deductible endorsement, insurance companies

are required to pay compensable claims on a "first dollar" basis, so as to preserve the protections afforded workers by providing medical treatment and other compensation without regard to inability or unwillingness to pay or delay on the part of an employer-policyholder (***see*** Insurance Law § 3443[a], [f]).

11. Pursuant to the foregoing authority, petitioners wrote workers' compensation policies including deductible endorsements such as those at issue herein. The policies are sometimes referred to as "large" or "high" deductible workers' compensation policies, a descriptive consequence of the size (dollar amount) of the deductible, which typically involves a deductible amount of $100,000.00 or higher. The deductible endorsement in these policies contains the following typical language:

> This deductible endorsement applies between you [the policyholder] and us [the insurance company]. It does not affect or alter the rights of others under the policy. You will reimburse us for the deductible amounts that we pay on your behalf.
>
> The first Named Insured shown on the Information Page is authorized to pay all deductible amounts on behalf of the Named Insureds and to reimburse us [the insurance company] for any such amounts we [the insurance company] advance.

The terms of such deductible endorsements typically provide (as to the "Effect of Deductible on Limits of Liability") that "[i]n the event of a claim, our obligation to pay is the amount available for benefits or damages that remains after the application of the specific loss reimbursement [i.e., deductible] amount" (***see*** Workers Compensation and Employers Liability Insurance Policy, Joint Stipulation Exhibit A [ref. ¶ 125] at pp. 17, 18 ¶¶ B-2, D-3[a]).

12. Employers who elect to accept an insurance deductible as part of their workers' compensation policies execute an election by a form containing the following typical language:

> The intended use of the Benefits Deductible Program is to assist policyholders who are not qualified as self-insurers but possess the financial ability to handle some of the losses that they incur. Use of the benefit deductible program allows a policyholder to establish an amount of loss that can be absorbed financially, and subsequently permit the *purchase of insurance for losses above the predetermined deductible amount*.
>
> If you choose to accept a benefits payable deductible plan you have agreed to accept *liability* for the amount of the deductible for benefits paid for each compensable claim of work injury by an employee. As the insurer we shall pay all of the deductible amount to the person or provider who is entitled to the benefits. We shall seek reimbursement for payment of the applicable deductible amount from you, the policyholder.
>
> With the payment of benefits by the policyholder, the policyholder is given a percentage reduction in the total estimated premium before policy experience rating and premium discount. *The deductible benefits paid by a policyholder will not be included as total benefits paid in the calculation of experience rating*.
>
> * * *
>
> You are not required to choose a deductible program. However, if you do so choose, it is to be understood that we will administer and pay all claims and that you will reimburse us for payments we make within the amount of deductible selected. Failure to reimburse us for such deductible amounts within 30 days can result in cancellation of coverage.

13. As an example of the foregoing, under circumstances where an employee is injured while on the job, seeks medical treatment, and as a result incurs compensable lost wages and medical treatment expenses in the aggregate amount of $200,000.00, the result does not vary as to the injured worker regardless of whether or not the employer has a traditional workers' compensation policy or a workers' compensation policy including a deductible endorsement. In either case, the medical providers will bill the insurance company directly and the insurance company will pay (up front and directly) the full $200,000.00 consisting of the expenses billed by the medical providers plus the injured employee's compensable lost wages. In the case of a

traditional workers' compensation policy, the process essentially ends at such point. In contrast, in the case of a workers' compensation policy that includes a $100,000.00 deductible endorsement, the insurance company will still pay (up front and directly) the full $200,000.00 for the expenses billed by the medical providers plus the injured employee's compensable lost wages. In turn, however, and notwithstanding such $200,000.00 initial up front and direct payment by the insurance company, since the policyholder is liable and responsible for the first $100,000.00 of such losses pursuant to the terms of the deductible endorsement, the policyholder is required to reimburse the insurance company up to the amount of the deductible endorsement, i.e., $100,000.00.

14. Under a workers' compensation policy with a deductible endorsement where the policyholder retains responsibility for losses below the deductible amount, the insurance company has effectively reduced its ultimate financial exposure to insurance risk by the extent of the deductible amount retained by the policyholder and has, as a consequence, lowered the policyholder's premium accordingly. However, since under such a policy, the insurance company remains obligated to initially pay the full compensable amount of a claim and then seek reimbursement from the policyholder, as above, the insurance company is exposed to the possibility that the policyholder will, for some reason, default on its obligation under the deductible endorsement and not reimburse the insurance company in part or in full to the extent of the chosen deductible layer under the policy. This potential for default and nonreimbursement constitutes "credit risk" (i.e., risk of nonrepayment), as opposed to "insurance risk" (i.e., risk of exposure to liability as the result of a fortuitous event). To mitigate against this exposure to credit risk, insurance companies (including each petitioner herein) typically require collateral

guaranteeing the amounts of reimbursement due by the policyholder (i.e., the amount to cover the policyholder's deductible reimbursements under the policy). Such collateral typically takes the form of a bank letter of credit, which is a binding commitment from a bank approved by the National Association of Insurance Commissioners, or a collateral trust agreement guaranteeing payment of the deductible reimbursements under the given policy in the event of default or nonpayment. This presence of adequate collateral effectively eliminates the credit risk to which the insurance company is otherwise exposed. The letters of credit and collateral trust agreements used by petitioners herein are based upon forms that are approved by the Insurance Department.

15. Insurance companies doing business in New York State must file certain accounting and financial statements with the Insurance Department, including the Annual Statement and two supporting statements, the New York State Page and the New York Supplement. The Annual Statement is the primary financial statement to assist regulators, including the Insurance Department, in ensuring that companies are solvent and meeting their regulatory requirements. The Annual Report and supporting statements must be prepared, subject to any specific state required departures therefrom, in accordance with the requirements of Statutory Accounting, the set of accounting standards governing the insurance industry as promulgated by the National Association of Insurance Commissioners (NAIC). NAIC is an organization comprised of insurance regulators, including the Insurance Department, from the 50 states.

16. As noted, NAIC has adopted Statutory Accounting as the standard for insurance matters, and publishes an Accounting Practices and Procedures manual setting forth the rules of statutory accounting. As is relevant to this matter, Statement of Statutory Accounting Principles

(SSAP) Number 65 provides, with respect to High Deductible Policies such as those at issue herein, at paragraph 36, the following:

> 36. If the policy form requires the reporting entity to fund all claims including those under the deductible limit, the reporting entity is subject to credit risk, not underwriting risk. Reimbursement of the deductible shall be accrued and recorded as a reduction of paid losses simultaneously with the recording of the paid loss by the reporting entity.

SSAP Number 53 provides, in relevant part with respect to "premium" and the recording thereof (at paragraphs 3 and 4), as follows:

> 3. Except as provided for in paragraph 4, written premium is defined as the contractually determined amount charged by the reporting entity to the policyholder for the effective period of the contract based on the expectation of risk, policy benefits, and expenses associated with the coverage provided by the terms of the insurance contract . . . .
>
> 4. For workers' compensation contracts, which have a premium that may periodically vary based upon changes in the activities of the insured, written premiums may be recorded on an installment basis to match the billing to the policyholder. Under this type of arrangement, the premium is determined and billed according to the frequency stated in the contract, and written premium is recorded on the basis of that frequency.

17. The Insurance Department has, per Regulation 172 (***see*** 11 NYCRR 83.1 - 83.4), adopted statutory accounting with departures therefrom only as specified. Under statutory accounting standards, deductible reimbursements are not treated as premiums, when received, but rather are accounted for as "reduction of paid losses." While the superintendent has specified certain departures from statutory accounting rules, the area of deductible reimbursements is not among such departures.

18. In addition to the regulation of insurance matters in New York State, the Insurance Department shares administration of the taxation of the insurance industry in New York State with the Division of Taxation (***see*** Tax Law § 1510[e]). The Division's treatment of deductible

reimbursements received or accrued by petitioners herein as "premium" subject to tax follows the opinion set forth by the Insurance Department in a "Circular Letter" (Circular Letter No. 10), dated April 13, 2001 and issued to all insurers authorized to write workers' compensation insurance in New York State (Circular Letter 2001-10). This Circular Letter provides, in relevant part, as follows:

> It is the position of both the Insurance Department and the Department of Taxation and Finance that premium tax must be collected and paid on [workers' compensation policies containing deductibles]. The Department of Taxation and Finance, in support of this position, stated in a July 2, 1991 letter to the Insurance Department that the amount of the deductible paid by the policyholder to the insurer should be treated as a premium paid to the insurer for the purpose of § 1510 of the New York Tax Law
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> In 1993, in response to numerous inquiries, the Insurance Department stated its position that the premium upon which premium tax is to be calculated is "the premium as calculated at the beginning of the policy period plus all of the losses and accompanying expenses for which the company is ultimately reimbursed by the insured." This opinion was published in the March 1993 issue of the Insurance department Bulletin.
>
> . . . The Department has found that some companies are not complying with the requirement to collect and pay premium tax on the deductible portion of the premium. The purpose of this Circular Letter is to once again alert all insurers of their duty to pay premium tax as required. All premium and reimbursements from the insured should be declared as premium . . . Incurred losses should be on a "first dollar" basis and should include losses expected to be recovered from the insured.

CONCLUSIONS OF LAW

A. Tax Law § 1502-a provides that every domestic insurance corporation, every foreign insurance corporation, and every alien insurance corporation, other than those transacting the business of life insurance must, for the privilege or exercising its corporate franchise or for carrying on its business in a corporate or organized capacity within New York State, annually pay

tax on all gross direct premiums, less premiums returned thereon, on all risks located or resident in this state. For purposes of this tax, "premium" is defined at Tax Law § 1510(c)(1) as follows:

> The term "premium" includes all amounts received as consideration for insurance contracts or reinsurance contracts, other than for annuity contracts, and shall include premium deposits, assessments, policy fees, membership fees, any separate costs by carriers assessed upon their policyholders and every other compensation for such contract.

B. Insurance Law § 3443 allows insurers issuing workers' compensation policies to offer, as part of such policies or by endorsement thereto, "deductibles optional to the policyholder for benefits payable under the policy, subject to approval by the superintendent and subject to underwriting by the insurer, consistent with the following standards or factors":

> (a) claimants' rights are properly protected and claimants' benefits are paid without regard to any such deductible;
>
> (b) appropriate premium reductions reflect the type and level of any deductible approved by the superintendent and selected by the policyholder;
>
> (c) premium reductions for deductibles are determined before application of any experience modification, premium surcharge, or premium discount;
>
> (d) recognition is given to policyholder characteristics, including size, financial capabilities, nature of activities, and number of employees;
>
> (e) if the policyholder selects a deductible, the policyholder is liable to the insurer for the deductible amount in regard to benefits paid for compensable claims;
>
> (f) the insurer pays all of the deductible amount, applicable to a compensable claim, to the person or provider entitled to benefits and then seeks reimbursement from the policyholder for the applicable deductible amount; and
>
> (g) failure to reimburse deductible amount by the policyholder to the insurer is treated under the policy in the same manner as nonpayment of premiums.

C. The only issue presented in this matter is whether reimbursements accrued or received by petitioners from their insured employer-policyholders (policyholders) as repayments of (New

York) workers' compensation compensable claims initially paid by petitioners, as required per Insurance Law § 3443(a), (f) in the case of workers' compensation policies with deductible endorsements, constitute "premiums" for purposes of Tax Law § 1510(c)(1). The parties agree that petitioners computed their premium tax after excluding deductible reimbursements accrued or received, that the Division determined such amounts should be included in petitioners' computation of their gross direct premiums, and that the Division advised petitioners of this determination by issuing the notices of deficiency (and the refund denials or adjustments in the case of ZAIC and AGLIC) at issue herein (***see*** Findings of Fact 2 and 3).

D. In support of the foregoing, the Division relies upon the Insurance Department's longstanding interpretation that such reimbursements are taxable premiums under Tax Law § 1510(c)(1), as set forth in the Department's Circular Letter No. 10 (2001), and upon the Division's own 1991 interpretation of the same statutory section in the same manner (***see*** Finding of Fact 18).[4] The Division's position seems to be that, notwithstanding the presence of a deductible endorsement, there is no modification or reduction of the stated insurance coverage which is required to be provided *by the insurer* under the workers' compensation policy. That is, the insurer is obligated to pay the full amount of each loss from the first dollar of any compensable claim up to the limit of liability under the policy. The Division's position, as expressed in Circular Letter No. 10 and through its witness at hearing, is that since the insurer is

[4] The Division would accord substantial weight and deference to the Insurance Department's Circular Letter No. 10 and certain prior letter opinions noted therein concluding that deductible reimbursements constitute premiums subject to tax (***see*** Finding of Fact 18). However, it must be noted that Circular Letters, like advisory opinions issued by the Division of Taxation, are not duly promulgated and adopted regulations and do not carry the force and effect of law (***see Downey v. Allstate Ins. Co.***, 638 Fed Supp 322 [SDNY 1986]; ***Matter of AIL Systems, Inc.***, Tax Appeals Tribunal, May 4, 2006; ***Matter of Stuckless and Olsen [Stuckless II]***, Tax Appeals Tribunal, August 17, 2006.) Accordingly, neither Circular Letter No. 10 nor the prior letters which set forth the opinion that deductible reimbursements (or paid loss recoveries) constitute premiums subject to tax, are entitled to be accorded significant weight or deference.

responsible for all losses on a "first dollar" basis, without limitation, the amount of premium received by the insurer is the premium calculated at the beginning of the policy period plus all reimbursements (or recoveries) of any losses paid by the insurer (the deductible layer losses) as required under its overall obligation to fund all losses, i.e., to provide insurance coverage without regard to the existence of a deductible (Insurance Law § 3443[a]). Under this approach, the Division's position is that the subject reimbursements result from each insurer's statutory (and contractual) obligation to provide insurance coverage for all losses, without limitation, under the insurance contract into which it has entered. This, in turn, leads to a conclusion that the reimbursements in question constitute premiums (under the Division's view) as "amounts received as consideration for insurance contracts" or as "[every] other compensation for [insurance contracts]," rather than as assessments, policy fees, membership fees or any of the other items set forth under the definition of "premium" in Tax Law § 1510(c)(1). However, as detailed below, requiring that an insurer must pay compensable claims expeditiously and directly in the first instance, regardless of the presence of a deductible, with the policyholder thereafter obligated to repay such outlays for losses via reimbursement does not, as the Division argues, mean that such repayments constitute premiums paid to the insurer.

E. Tax Law § 1510(c)(1) provides a very specific definition of what constitutes a "premium," consisting of eight separate identified items, as follows:

1) "amounts received as consideration for insurance contracts,"
2) "[amounts received as consideration for] reinsurance contracts,"
3) "premium deposits,"
4) "assessments,"
5) "policy fees,"
6) "membership fees,"
7) "any separate costs by carriers assessed upon their policyholders," and
8) "every other compensation for [insurance or reinsurance] contracts."

Review of this list in light the Division's premise for treating deductible reimbursements as premiums (i.e., as consideration or compensation received for insurance contracts) makes clear that six of the eight items (Items 2 through 7) specified above within the definition of the term premium under Tax Law § 1510(c)(1), are simply not implicated under the Division's premise for treating deductible reimbursements as premiums (***see*** Conclusion of Law D), and may be eliminated as such. Specifically, with regard to such items:

"Reinsurance contracts" (Item 2) concern a specialized type of insurance contract that involves the insurance of one insurer by another insurer or insurers (the reinsurers) so as to distribute or redistribute the risk undertaken by the initial insurer. Such contracts are clearly not present in this matter and do not relate to the workers' compensation deductible reimbursements in question.

Premium deposits" (Item 3) are initial deposits or "down payments" made to put an insurance policy into force and effect, with the balance of the premium payment, as potentially subject to adjustment, due thereafter (***see, Matter of DeStefano v. State Ins. Fund***, 43 AD2d 180 [1973]; Barron's Dictionary of Insurance Terms 132 [8th ed 2000]). Since deductible reimbursements are made by the insured *after* the insurer directly pays the injured claimants and medical providers, as required by statute (Insurance Law § 3443[a],[e],[f]), the subsequent reimbursement of such payments (to the extent of the deductible limit) cannot be considered an *initial* or *down* payment to put the policy into force and effect.

"Assessments" (Item 4) are fees that are imposed upon policyholders for a loss that needs to be made whole such that the insurer may continue to operate, and may be imposed (for example) by mutual insurance companies and fraternal benefit societies upon their policyholders

(as the owners of such entities) because these entities have no other way of raising capital so as to remain whole or solvent. Such assessments have no apparent relationship to the deductible reimbursements at issue in this matter.

"Policy fees" (Item 5) represent a variety of different amounts charged by an insurer, such as fees for processing policies, fees for administrative expenses, or charges for allowing an insured to pay its premiums over a period more frequently than might ordinarily be the case (e.g., quarterly payments versus annual payments). Deductible reimbursements are clearly not policy fees.

"Membership fees" (Item 6) are costs imposed as a prerequisite for obtaining insurance benefits from a particular organization. Deductible reimbursements are not prerequisite fees to be paid in order to obtain insurance benefits from a particular insurer, and hence membership fees have no relationship to the matter at hand.

Finally, with respect to "any separate costs by carriers assessed upon their policyholders" (Item 7), Insurance Law § 9109(b) and Tax Law § 1510(c)(1) contain identical definitions of "premium" except for this item, which is not contained in Insurance Law § 9109(b). The Division considers both the Tax Law and the Insurance Law definitions as equally including deductible reimbursements within those items constituting taxable premiums. Since the "any separate costs by carriers assessed upon their policyholders" language is, and was during the years in issue, found only in the Tax Law definition of premium, and was the only difference between the two statutory definitions of premium, this language could not have been relied upon by the Division as the part of the definition of "premium" pursuant to which deductible reimbursements may be considered taxable premium.

F. Treating deductible reimbursements (or paid loss recoveries) as premiums upon the premise that such amounts are consideration or compensation for insurance contracts (Tax Law § 1510[c][1], Items 1 and 8) is not supported by either the relevant statutory language or by the contracts of insurance between the parties. Insurance Law § 1101(a)(1) defines an "insurance contract" as "any agreement or other transaction whereby one party, the 'insurer,' is obligated to confer a benefit of pecuniary value upon another party, the "insured" or "beneficiary," depending upon the happening of a fortuitous event in which the insured or beneficiary has, or is expected to have at the time of such happening, a material interest that will be adversely affected by the happening of such event." A "fortuitous event" is in turn defined at Insurance Law § 1101(a)(2) as "any occurrence or failure which is, or is assumed by the parties to be, to a substantial extent beyond the control of either party." Thus, to the extent that the definition of "premium" includes "all amounts received as consideration for insurance contracts," the same means those amounts received in exchange for undertaking "insurance risk," that is the risk of loss resulting from the occurrence of a fortuitous event (***see*** Finding of Fact 4). Notwithstanding that petitioners have the obligation to pay for or "fund" all compensable losses under the contracts of insurance and under the Insurance Law regardless of whether or not there is a deductible endorsement (Insurance Law § 3443[a],[f]), it remains that the financial risk of loss and the liability therefor is, by statute and by contract, reserved to and remains with the policyholder to the extent of the chosen deductible amount (Insurance Law § 3443[e]; ***see*** Findings of Fact 11 and 12).

G. In the case of a workers' compensation insurance policy, regardless of whether or not there is a deductible endorsement, the insurer receives premiums for (among other obligations) undertaking the obligation to fund all compensable losses. The critical distinction between a

policy without a deductible endorsement versus a policy with a deductible endorsement is that the amount of the premium received (the consideration for the insurance contract) is lower in the latter instance. This specifically reflects the fact, statutorily recognized, that while the insurer is still obligated to fund all compensable losses, it is likewise contractually and statutorily entitled to recover such funded (or paid) losses to the extent of the deductible endorsement amount. This distinction results from the premium reduction statutorily afforded to a policyholder (Insurance Law § 3443[b],[c]) who has retained ultimate responsibility for the compensable losses within the deductible layer (Insurance Law § 3443[e],[f]). Treating the reimbursement of deductible amounts as a premium or additional premium essentially ignores the premium reduction contemplated within the Insurance Law, as well as the legislative aims of cost containment and improved workplace safety pursuant to which workers' compensation policies with deductible endorsements were authorized (***see*** Findings of Fact 8 and 10)

H. The Division posits that since the insurer is obligated to pay all compensable losses under the policy, then such obligation remains a "retained risk" to the insurer, with the policyholder's reimbursement of such payment constituting the premium received by the insurer in exchange for such "retained risk." The Division acknowledges that the deductible, in the workers' compensation context, represents both a retained risk to the insurer, and a transferred risk to the policyholder to the extent the policyholder is ultimately obligated to repay the insurer for losses within the deductible layer. However, the legislation authorizing insurers to offer workers' compensation policies with deductibles specifically calls for "premium reductions [to] reflect the type and level of any deductible" and for "premium reductions for deductibles." (Insurance Law § 3443[b],[c].) It is not disputed that insurers in fact receive lower premium

amounts for policies with deductibles reflecting the lower risk of loss they undertake. It follows that the "compensation" and "consideration" for such policies is the reduced premium so calculated and paid to the insurer by the policyholder. In light of the entire statutory framework concerning workers' compensation deductible policies, it is inapposite to conclude that the benefit of lowered premium amounts required as part of the Legislature's authorization of deductible policies (Insurance Law § 3443[b],[c]) may be offset by a conclusion that the reimbursement of such deductible amounts constitutes premiums subject to tax. If, despite the apparent inconsistency, the Legislature had desired such a result, it could have specified "paid loss recoveries" or "deductible reimbursements" within and among the items constituting "premium" per Tax Law § 1510(c)(1). It did not do so.

I. The foregoing conclusion is supported by recognizing and reconciling the legislative aims of allowing workers' compensation policies with deductible endorsements. That is, policies with deductible endorsements afford employers the ability to reduce their premium costs for providing statutorily required insurance coverage (***see*** Finding of Fact 10), and provide incentive for employers to better manage workplace safety so as to limit exposure to risk and expense from employee injury. At the same time, requiring that payments to claimants must first be made by the insurer, as opposed to being made by the policyholder protects the aim of ensuring that when an employee is injured, care is provided and the injured claimant and medical providers are paid in an expeditious manner without regard to any agreements (or possible disagreements) between the employer and the insurance company. The most reasonable manner of harmonizing these competing aims is to maintain liability for all risks on the insurer including the obligation of requiring the insurer to pay "up front," without regard to the presence of a deductible

endorsement, with the attendant obligation of reimbursement of such payments thereafter by the policyholder. This simple expedient of a flow of funds requirement, with the accompanying remedy for failure to follow this required pay and reimburse flow (Insurance. Law § 3443[g]) balances and achieves all of these aims. This result matches what the policyholder retains by selecting a policy with a deductible endorsement, i.e., some exposure to the financial liability and risk of loss due to employee injury, with what the insurer who has accepted a lower premium amount is exposed to upon its initial responsibility to pay compensable claims, i.e., the credit risk that its policyholder will not make repayment. The insurer remains obligated by statute (and by contract) to pay the claimants directly, as a consequence of a public policy decision, and is statutorily entitled to be repaid so as to recover the amount it has directly paid or "fronted," dollar-for-dollar, on behalf of the insured to the extent of the liability for the cost of the loss retained by the insured via the deductible amount. The risk of nonrepayment of a deductible amount under this situation is a credit risk, and its repayment is simply not compensation or consideration for an insurance contract. The insurer receives no discernible benefit upon reimbursement of that which it has paid out, other than that it is restored to its original cash position vis-a-vis its insured. Hence, the insurer is not being compensated via the reimbursements it receives and such reimbursements are not compensation constituting premiums per Tax law § 1510(c)(1).[5]

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[5] The fact that insurers writing workers' compensation deductible policies collateralize their exposure to the risk of nonrepayment in "an attempt to mitigate the risk of collecting" the deductible reimbursement amounts from policyholders lends no support for the proposition that deductible reimbursements are premiums. Obtaining security in the form of collateral (whether or not a "pre-condition" to the approval of a deductible workers' compensation policy) seems simply an entirely prudent business practice with respect to the "credit risk" to which petitioners are exposed by virtue of the funding of deductible amounts, but has no apparent bearing on the question of what constitutes premiums.

J. Subsections (a), (e), (f) and (g) of Insurance Law §3443, read together, further clarify the conclusion that deductible reimbursements are not taxable premiums. Subsections (a) and (f) require that insurers provide adequate protections for claimants by mandating the initial payment of benefits for compensable claims by the insurer without regard to any deductible. In turn, subsections (e) and (f) create a resulting *liability* and specific right to reimbursement owed by the policyholder to the insurer to the extent of the deductible amounts paid. Finally, subsection (g) provides a specific remedy in the event a policyholder fails to reimburse its liability for such deductible amount, by treating such unpaid liability *in the same manner as* nonpayment of premiums (carrying therewith the insurer's right to terminate the underlying insurance policy and its coverage). This provision, with cancellation of a policy for nonpayment of deductible reimbursements *in the same manner* as for nonpayment of premiums, requires only a 10-day notice of cancellation as opposed to the 30-day notice of cancellation otherwise applicable (***see*** Workers' Compensation Law § 54[5]). By so doing, this provision sets forth both the right to terminate the contract and the prescribed minimum time frame for doing so. As petitioners point out, if the reimbursement amounts were in fact premiums, this subdivision and its remedy would be redundant, for the failure to pay premiums always results in an insurer's right to cancel an insurance policy. Combining the foregoing subsections with the remaining subsections of Insurance Law § 3443, which specify that deductible policies shall result in premium *reductions* (Insurance Law § 3443[b], [c], [d]) clearly supports the conclusion that the Legislature's aim was to provide premium cost relief to employers in the area of statutorily mandated workers' compensation insurance, foster and encourage employers' interest and efforts at enhanced workplace safety with the attendant benefit of potential cost savings to employers who are

successful in such efforts, while at the same time protecting the goal of assuring that claimants are paid without delay. The system in place simply results in a policyholder ultimately paying one hundred percent of the portion of the compensable claim for which it is responsible (i.e., the deductible layer of risk it has retained) with the insurer accepting a reduced premium reflecting the same, while still leaving the policyholder covered via the premium it does pay to its insurer for accepting ultimate liability for the cost of exposure on compensable claims exceeding the chosen deductible layer. In sum, this result is entirely consistent with the aims sought to be accomplished by Insurance Law § 3443 in allowing deductible policies (insurance cost containment and employer workplace safety awareness and enhancement) without compromising claimant protections (expeditious payment of compensable claims).[6]

K. The Division's brief does not address petitioner's arguments concerning the impact of statutory accounting. However, the Insurance Law directly adopts the rules of statutory accounting as such are issued by the NAIC, specifically through the enactment of Regulation 172 (11 NYCRR 83), which governs financial statement filings and accounting practices and procedures before the Insurance Department. Under Regulation 172, such matters are governed by the NAIC's Accounting Practices and Procedures Manual (and its Statements of Statutory Accounting Principles [SSAP's], except for instances where there are particular exceptions thereto on a state-by-state basis, as follows:

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[6] Treating deductible reimbursements as premium, as the Division proposes, leaves the amount of such premium received by the insurer equal to 100% of the actual liability for losses that are *not* ultimately borne by that insurer, but rather are borne by the policyholder as the result of its choice to select a policy with a deductible and thereby retain ultimate liability for losses within the deductible layer. Such a result is not only inconsistent with the legislative scheme, as outlined above, but is also somewhat ironic given that the deductible policy is offered in exchange for a *reduction* in the amount of premium to be received by the insurer in light of the liability it avoids by virtue of such deductible.

> The Financial Statements of all authorized insurers . . . shall be completed in accordance with statutory accounting practices and procedures as prescribe by applicable provision of the Insurance Law and this Title . . . Pursuant to Sections 307 and 308 of the Insurance Law, Financial Statements required to be submitted to the superintendent shall be in a form prescribed by the superintendent and shall be prepared in accordance with instructions prescribed by the superintendent . . . Except as provided in Section 83.4 of this Part or where the Accounting Manual conflicts with any provision of the Insurance Law or this Title, the Accounting Manual is adopted in its entirety, subject to such conflicts and exceptions, and an insurer shall follow the accounting practices and procedures prescribed by the Accounting Manual. The Accounting Manual does not preempt states' legislative or regulatory authority. The Accounting Manual is intended to establish a comprehensive basis of accounting to be adhered to if not in conflict with the state statutes or regulations, or when the state statutes or regulations are silent. (11 NYCRR 83.3[a]-[c])

L. Tax Law § 1510(c)(1), for its part, adopts statutory accounting by reference by stating "[t]he reporting of premiums for the purpose of the tax imposed by this section shall be on a written basis or on a paid-for basis *consistent with the basis required by the annual statement filed with the superintendent of insurance pursuant to section three hundred seven of the insurance law*" (emphasis added). Since the Annual Statement required to be filed with the Insurance Department (Insurance Law § 307[a][2]), is required to be filed on the basis of statutory accounting, subject only to particular state specified exceptions and conflicts with state statutes or regulations, it follows that the determination of premiums reported thereon must be based on statutory accounting principles unless such determination is subject to exception or otherwise conflicts with New York State statutes or regulations.

M. The NAIC's Rules of Statutory Accounting, at SSAP No 53, paragraphs 3 and 4, address the recording and recognition of "premium." SSAP No. 65, paragraph 36, in turn, addresses deductible policies and the recording of deductible reimbursements. (***see*** Finding of Fact 16.) Petitioners reported premiums per SSAP No. 53, paragraphs 3 and 4, such that "cash"

or "premium receivable" was debited and "direct written premiums" was credited. Such recorded premium was reported on Schedule T of the Annual Report ("Exhibit of Written Premiums") and on the New York State Page. As so recorded and reported, the term premium excluded any amount representing deductible reimbursements. When a loss (i.e., claim) is paid, the same is recorded as a "paid loss," via a credit to "cash" and a debit to "paid loss." In turn, when a deductible reimbursement is accrued or received, it is recorded, per SSAP No. 65, paragraph 36, as a "reduction of paid loss," and accounts concerning premiums were not involved. Deductible reimbursements are not specifically reported on the Annual Statement, although the aggregate amount thereof is included as a write-in for noninvested assets. Ultimately, under this method, petitioners' premiums were accounted for as such and its deductible reimbursements were accounted for as reductions to paid losses as opposed to premiums. This method of reporting is consistent with the NAIC Rules of Statutory Accounting pertaining to premiums and deductible reimbursements and with the application thereof for New York State purposes. In this latter regard, Regulation 172 (11 NYCRR 83) makes no modification to either of the relevant SSAP's (Nos. 53 and 65) insofar as the same pertain to premiums and to deductible reimbursements. Specifically, 11 NYCRR 83 does not identify SSAP No. 53 at all (either to modify or to specify that it is not adopted), and while identifying certain paragraphs of SSAP No. 65, does not list paragraph 36 or any other paragraph relevant to recording deductible reimbursements (either to modify the foregoing treatment or to specify its nonadoption.) Hence, the conclusion that deductible reimbursements do not constitute premiums and are not subject to tax as such is fully consistent with the required manner of accounting for

and reporting reimbursements and such accounting and reporting treatment provides additional support for this conclusion.

N. The petitions of American Guarantee & Liability Insurance Company, et al, are hereby granted, and the notices of deficiency and the related refund denials or adjustments in the case of ZAIC and AGLIC are (in accord with the manner specified in the parties' Joint Stipulation of Facts [Exhibit I, section IV, nos. 82 through 116]; ***see*** Finding of Fact 3) cancelled.

DATED: Troy, New York
October 14, 2010

/s/ Dennis M. Galliher
ADMINISTRATIVE LAW JUDGE