

STATE OF NEW YORK

DIVISION OF TAX APPEALS

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In the Matter of the Petition	:	
	:	
of	:	
	:	
ROYAL INDEMNITY COMPANY	:	DETERMINATION
	:	
for Redetermination of a Deficiency or for	:	
Refund of Corporation Franchise Tax under	:	
Article 33 of the Tax Law for the Years 1976	:	
and 1977.	:	

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Petitioner, Royal Indemnity Company, 150 William Street, New York, New York 10038, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 33 of the Tax Law for the years 1976 and 1977 (File No. 31061).

On October 15, 1986, petitioner, by its duly authorized representatives Everett, Johnson & Breckinridge, Esqs. (Eugene Chester, Esq., of counsel), waived a hearing and submitted its case for determination based upon the Division of Taxation file, with all briefs to be submitted by November 17, 1986. After due consideration, Dennis M. Galliher, Administrative Law Judge, renders the following determination.

ISSUES

I. Whether the Audit Division properly reduced the amount of net operating loss deductions claimed by petitioner for the years 1976 and 1977.

II. Whether the Audit Division properly required petitioner to include in income for 1976 and 1977 certain amounts representing the amortization of discount on State and local government obligations.

## FINDINGS OF FACT

1. Petitioner, Royal Indemnity Company ("Royal")<sup>1</sup>, is an insurance corporation organized under the laws of the State of Delaware and engaged in the insurance business in New York State as a property and casualty insurer.

2. On May 8, 1980, the Audit Division issued to Royal a Notice of Deficiency asserting additional franchise tax due for 1976 under Tax Law Article 33 in the amount of \$12,045.62, plus interest. On August 20, 1980, the Audit Division issued to Royal a Notice of Deficiency pertaining to 1977 and asserting additional tax due in the amount of \$33,184.71, plus interest.

3. Royal timely filed New York State franchise tax returns under section 187 of the Tax Law for the years prior to 1974 and under Article 33 for the taxable years 1974 through 1977.

4. Royal incurred net operating losses in the taxable years 1974 and 1975 for Federal and New York State tax purposes.

5. Royal's New York State net operating losses for the taxable years 1974 and 1975 amounted to \$4,233,861 and \$3,289,089, respectively.

6. Royal's Federal 1974 net operating loss amounted to \$6,213,184, all of which for Federal income tax purposes was carried to years prior to 1974 and was utilized in full as a Federal net operating loss deduction in such years.

7. Royal's Federal 1975 net operating loss amounted to \$5,178,628 of which \$3,620,028 was carried, for Federal income tax purposes, to years prior to 1974 and utilized as a Federal net operating loss deduction in such years. The balance of Royal's Federal 1975 net operating loss, (\$1,541,210) was carried over for Federal income tax purposes to the taxable year 1976 and deducted as a net operating loss deduction in said year.

8. Under New York law Royal could not utilize any part of its 1974 and 1975 New York State net operating losses as a deduction in years prior to 1974.

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<sup>1</sup>In addition to petitioner, thirteen other taxpayers have petitions pending which raise issues identical to those presented herein. Each of these thirteen taxpayers (see Appendix "A"), has joined with the Audit Division in executing a stipulation agreeing to be bound by the final judicial decision reached in the instant matter.

9. Royal's 1976 Federal income tax return reflected a net loss of \$1,101,563, after subtracting the net operating loss deduction carry forward of \$1,541,210. In effect, for 1976 Royal utilized \$439,647.00 of its \$1,541,210.00 available Federal loss carry forward to reduce its 1976 taxable income to zero.

10. In its New York State franchise tax return for the year 1976 Royal claimed a New York net operating loss deduction of \$7,522,950, being the sum of its 1974 and 1975 New York State net operating losses (\$4,233,861 plus \$3,289,089).

11. Royal's 1977 Federal income tax return reflected taxable income of \$4,644,463 after subtracting a net operating loss deduction of \$1,101,563. Royal's 1977 federal net operating loss deduction (\$1,101,563.00) represented the carryover of the balance of Royal's 1975 federal net operating loss (\$5,161,238) less the portion thereof (\$3,620,028) carried back to and utilized in years prior to 1974 and less the portion thereof (\$439,647) carried forward to and utilized in 1976.

12. In its New York State franchise tax return for the year 1977 Royal claimed a New York net operating loss deduction of \$4,952,295. This amount represents the \$1,633,206 balance of Royal's 1974 New York net operating loss<sup>2</sup> plus the amount of its 1975 New York net operating loss (\$3,289,089).

13. In the audit of Royal's 1976 return the Audit Division reduced the amount of Royal's New York State net operating loss deduction for said year to \$439,647, the amount of its 1976 Federal income before subtraction of the amount of its 1976 Federal net operating loss deduction (\$1,541,210). In effect, Royal's 1976 New York net operating loss deduction was reduced to equal the amount necessary to reduce its Federal taxable income to zero.

14. Statements of Audit Adjustment issued to Royal by the Audit Division and dated May 8, 1980 explain that Royal's New York State net operating loss deductions in 1976 and 1977 could

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<sup>2</sup>\$1,633,206 is the difference between Royal's 1974 loss (\$4,233,861) and its 1976 New York State income before subtraction of the net operating loss deduction (\$2,570,655).

not exceed the amount of the 1974 and 1975 losses carried over and deducted in 1976 and 1977 for Federal income tax purposes.

15. The Statement of Audit Adjustment dated May 8, 1980 and pertaining to 1976, indicates that the amount of the 1976 New York net operating loss deduction was limited to \$439,647 on the theory that a New York net operating loss deduction is limited to the amount necessary to reduce Federal taxable income to zero.

16. In the audit of Royal's 1977 return the Audit Division reduced the amount of Royal's net operating loss deduction for said year to \$1,101,563, an amount equal to the amount of its 1977 Federal net operating loss deduction.

17. Petitioner admits that since Article 33 was not effective until January 1, 1974, New York State net operating losses, such as those realized by Royal during the calendar years 1974 and 1975, could not be carried back to years prior to 1974 for New York State franchise tax purposes. Thus, petitioner asserts that if it is prevented from carrying over the amount of its 1974 net operating loss and that portion of its 1975 net operating loss which was carried, for federal income tax purposes, to years prior to 1974, it will be deprived of any New York deduction for all of its 1974 and most of its 1975 New York State net operating losses. Petitioner maintains that the fact that for Federal income tax purposes, Royal's 1974 net operating loss and a portion of its 1975 net operating loss were carried back and deducted in years prior to 1974 is irrelevant for purposes of determining the net operating loss deduction allowable under Article 33.

18. In the audit of Royal's 1976 and 1977 returns, the Audit Division also increased Royal's income in the amounts of \$42,273 and \$6,163, respectively, based upon inclusion in entire net income of the full amount of exempt interest income reported per petitioner's Federal returns (at Schedule M). These increases represent, more specifically, the annual amounts of amortization of discount on State and local governmental bonds, purchased by petitioner at less than par value, the interest on which obligations is exempt from Federal income taxation.

19. The Audit Division also asserts, in similar fashion, that petitioner improperly reduced entire net income for 1976 by the amount of \$172,517 (representing discount amortized for such

year on certain obligations generating non-exempt interest income). According, the Audit Division asserts that the deficiency for 1976 should be increased by the effect of adding back such amount to entire net income.

20. It is petitioner's position that entire net income, as defined under Article 33, does not include amortization of discount on either State and local governmental obligations or on other (taxable) obligations. Petitioner maintains that where such obligations are purchased at a discount, the adjusted basis of the obligations (an asset to the holder) is not increased to reflect the annual amortization of discount, and thus when the bond is sold, redeemed, or otherwise disposed of the benefit of the discount is realized and reported for both Federal and New York State tax purposes as gain. Accordingly, petitioner asserts that inclusion of amortization of discount in entire net income would result in double taxation by New York State.

#### CONCLUSIONS OF LAW

A. That for taxable years commencing on or after January 1, 1974, insurance corporations are subject to two franchise taxes imposed by Article 33 of the Tax Law. Tax Law § 1501 imposes a franchise tax similar to that which is imposed on business corporations by Article 9-A. Pursuant to Tax Law § 1502, the tax is the greatest amount yielded from four alternative bases, the first being the portion of the taxpayer's entire net income allocated to New York. Tax Law § 1510 imposes an additional franchise tax, similar to that imposed by former Tax Law § 187, measured by the taxpayer's premiums.

B. That the Audit Division properly limited petitioner's net operating loss deduction to the amount of the deduction allowable for Federal income tax purposes. (Tax Law § 1503[b][4][B]; Matter of Gurney v. Tully, 52 NY2d 818; Matter of Sheils v. State Tax Commission, 52 NY2d 954; Matter of American Employer's Insurance Co. v. State Tax Commission, 114 AD2d 736.)

C. That for Federal income tax purposes, the market discount on bonds such as those at issue is not amortized annually by stock property and casualty insurers such as petitioner. Rather, such discount is reported as taxable gain (to the extent realized) in the taxable year of sale,

maturity or other disposition of the bond(s) [Rev. Rul, 60-306, 1960-2 CB 211; see also Federal Taxation of Insurance Companies, K. Tucker and D. Van Mieghem, pp. 1202-1205 (1982)]. Thus, the Audit Division's inclusion, in entire net income, of such discount as was amortized (for financial statement purposes) by petitioner in 1976 and 1977 was improper. Accordingly, the portion of each deficiency attributable to such inclusion is hereby cancelled. Likewise, the Audit Division's assertion of a greater deficiency for 1976 (see Finding of Fact "19") is denied.

D. That the petition of Royal Indemnity Company is granted to the extent indicated by Conclusion of Law "C", but is otherwise denied and the notices of deficiency dated May 8, 1980 as modified in accordance herewith are sustained.

DATED: Albany, New York  
February 19, 1988

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ADMINISTRATIVE LAW JUDGE

## APPENDIX "A"

The following taxpayers having executed stipulations to be bound by the ultimate judicial decision rendered in the Matter of Royal Indemnity Co. (TAB No. 31061):

<u>Taxpayer</u>	<u>TAB Nos.</u>
AMICA Mutual Ins. Co.	34896
American Manufacturers Mutual Ins. Co.	30297
American Motorists Ins. Co.	30298
Atlantic Mutual Ins. Co.	30576
Centennial Ins. Co.	31743
Globe Indemnity Co.	31059
Hartford Accidents Indemnity Co.	39079
Hartford Fire Ins. Co.	35435
The Home Ins. Co.	28820
Pacific Indemnity Co.	32023, 32520
Statewide Ins. Co.	31522, 43443, 49476
Unigard Mutual Ins. Co.	31523
Vigilant Ins. Co.	31062