STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition of NEW YORK LIFE INSURANCE COMPANY AND SUBSIDIARY for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 33 of the Tax Law for the Year 1984.	: : : : :	DETERMINATION DTA NO. 810612[1]

Petitioner, New York Life Insurance Company and Subsidiary, 51 Madison Avenue, Room 604, New York, New York 10010, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 33 of the Tax Law for the year 1984.

On November 24, 1992 and December 3, 1992, respectively, petitioner, appearing by Louis P. Gilbert, Esq., and the Division of Taxation, appearing by William F. Collins, Esq. (Kenneth J. Schultz, Esq., of counsel), consented to have the controversy determined on submission without hearing. On January 11, 1993, the parties submitted an executed stipulation of facts dated November 24, 1992. On January 28, 1993, the Division of Taxation submitted documentary evidence. Petitioner submitted a brief on February 12, 1993. The Division of Taxation submitted a letter brief on April 27, 1993. Petitioner submitted a reply brief on May 7, 1993. Petitioner appeared by Michael M. Oleske, Esq., officer and associate tax counsel, with respect to the stipulation of facts and petitioner's briefs. After due consideration of the record, Timothy J. Alston, Administrative Law Judge, renders the following determination.

ISSUE

Whether petitioner properly calculated its deduction for 50 percent of dividends received pursuant to Tax Law § 1503(b)(1)(B) by including in the base of such calculations total

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[1]A review of the Division of Tax Appeals file indicates that, at some point in this proceeding, the parties erroneously associated DTA# 810613 with the instant matter.

dividends received (other than from subsidiaries) or whether the Division of Taxation properly adjusted said deduction by excluding from the base of such calculations the policyholders' share of such dividends and including only the company's share of such dividends.

FINDINGS OF FACT

As noted above, on January 11, 1993 the parties, by their respective representatives, submitted an executed stipulation of facts dated November 24, 1992. This stipulation is reproduced here in its entirety as Findings of Fact "1" through "12". Said stipulation has been modified only to change references to "the taxpayer" and "the company" to "petitioner" and "Department of Taxation and Finance" to "Division of Taxation".

Petitioner, New York Life Insurance Company, is a New York life insurance company engaged in the sale of life, health and annuity products.

For the year 1984, petitioner filed a combined report with its wholly-owned subsidiary, New York Life Insurance and Annuity Corporation, a Delaware corporation.

On December 7, 1989, a Notice of Deficiency (Assessment No. C891207000F) was issued to petitioner assessing additional franchise taxes and interest for the year 1984 in the amounts of $63,704.00 and $36,590.00, respectively.

On December 7, 1989, a Notice of Deficiency (Assessment No. C891207001S) was issued to petitioner assessing additional MTA [Metropolitan Transportation Business Tax Surcharge] taxes and interest for the year 1984 in the amounts of $8,046.00 and $4,621.00, respectively.

The tax increases in the notices are attributable to an adjustment to petitioner's deduction for dividends received from non-subsidiary corporations.

On January 17, 1990, petitioner filed a Request for Conciliation Conference with the Bureau of Conciliation and Mediation Services.

On January 17, 1992, a Conciliation Order (CMS No. 102445) was issued, sustaining the statutory notices.

On its Federal income tax return (Form 1120-L), petitioner reported that it had received

dividends on stock of non-subsidiary corporations in 1984 in the amount of $39,199,047.00.

For Federal income tax purposes, petitioner claimed a dividends- received deduction on its original Federal income tax return for the year 1984 in the amount of $12,664,739.00. Subsequently, petitioner submitted to the Internal Revenue Service an amended Federal income tax return for the year 1984 (amended form 1120-L) claiming a dividends-received deduction in the amount of $13,015,073.00. In each case, the amount represented a deduction for the "company's share" of dividends received, in accordance with Internal Revenue Code § 805(a)(4).

In computing its entire net income, petitioner determined its deduction for dividends received as an amount equal to 50 percent of the dividends received from corporations other than subsidiaries, pursuant to Tax Law § 1503(b)(1)(B). The amount of said deduction claimed on Form CT-33 was $19,599,524.00.

Upon audit of petitioner's return, the Division of Taxation ("Division") determined that petitioner's deduction for dividends received should be limited to 50 percent of the "company's share" of dividends received, i.e., $7,501,683.00 (50 percent times $15,003,366.00).[2]

The net effect of the proposed adjustment is to increase petitioner's entire net income in the amount of $12,097,841.00.

SUMMARY OF THE PARTIES' POSITIONS

While the Division noted that certain 1984 amendments to the Internal Revenue Code (see, Public Law 98-369) resulted in the inclusion, without allocation, of all dividends received in life insurance company gross income, the Division contended that the deduction for increases in reserves resulted in the deduction of the policyholders' share of dividends received from life insurance company taxable income ("LICTI"). The Division thus contended that only the company's share of dividends was included in LICTI, the starting point for determining entire net income ("ENI") under Article 33, and that, therefore, the 50 percent dividends-received

[2]The difference between this $15,003,366.00 amount for the company's share of dividends received and the amount listed in Finding of Fact "9" is not explained in the record.

deduction under Tax Law former § 1503(b)(1)(B) is properly limited to the company's share of such dividends.

The Division further contended that the 1987 amendment to Tax Law § 1503(b)(1)(B) (see, L 1987, ch 817) constituted a clarifying amendment to the statute and that the statute, as amended, can be read consistently with the law in effect prior to 1984 which, as the parties hereto agree, applied only to the company's share of dividends received.

Petitioner contended that the effect of the 1984 amendments to the Internal Revenue Code was the inclusion of all dividend income within life insurance company gross income and the inclusion of the policyholders' share of dividend income in LICTI. Consequently, petitioner contended, during 1984 the dividends-received deduction under Tax Law § 1503(b)(1)(B) was properly applicable to all dividends received and was not restricted to the company's share. Petitioner further contended that the Division's assertion that the deduction for increases in reserves resulted in the deduction of the policyholders' share of dividends received from LICTI was erroneous. Petitioner contended that the deduction for increases in reserves was entirely unrelated to and had no effect on the policyholders' share of dividends received which was included in LICTI. Finally, petitioner contended that the 1987 amendment to the Tax Law constituted a substantive change and was not a mere clarification of prior law. Petitioner further contended that such amendment was not retroactive since its effective date was August 7, 1987.

CONCLUSIONS OF LAW

A. Article 33 of the Tax Law imposes a franchise tax on insurance corporations doing business in New York State. Pursuant to Tax Law § 1502, this franchise tax is calculated on the basis of a taxpayer's "entire net income" ("ENI"). The starting point for computing entire net income is "life insurance company taxable income" ("LICTI") (see, Matter of The United States Life Ins. Co., Tax Appeals Tribunal, April 2, 1992, confirmed ___ AD2d ___, 599 NYS2d 168). Tax Law § 1503(a) defines "entire net income", in part:

> "The entire net income of a taxpayer shall be its total net income from all sources which shall be presumably the same as the life insurance company taxable

> income . . . which the taxpayer is required to report to the United States treasury department, for the taxable year . . . except as hereinafter provided."

ENI is then calculated by adjusting Federal LICTI for certain modifications set forth in Tax Law § 1503(b).

B. At issue herein is the modification to Federal LICTI set forth in Tax Law § 1503(b)(1)(B) which, during the year at issue, provided that "entire net income shall not include: fifty percent of dividends other than from subsidiaries." As noted, petitioner contended that, consistent with its returns filed for 1984, this provision allowed for the deduction from ENI of 50 percent of its total dividends received (other than from subsidiaries). The Division contended that the relevant provision limited the deduction available to petitioner to 50 percent of the company's share of gross dividends other than from subsidiaries. To place this controversy in context, some discussion of the Federal income taxation of life insurance companies is necessary.

Prior to 1984,[3] life insurance companies were taxed under a three-phase system of taxable income computation. Under this system, a life insurance company was taxed on the lesser of its gain from operations or its taxable investment income (see, IRC former § 802[b][1]), and if its gain from operations exceeded its taxable investment income, then 50 percent of such excess (see, IRC former § 802[b][1], [2]). The other 50 percent of such excess was accounted for as part of a policyholders' surplus account and was taxed only when distributed to shareholders or upon dissolution (see, IRC former § 802[b]; see generally, Mertens, Law of Federal Income Taxation § 44A.02).

Accordingly, under prior Federal law, in order to calculate LICTI, a life insurance company was required to calculate both its gain from operations and its taxable investment income. To determine taxable investment income, the life insurance company first calculated its "investment yield", defined as gross investment yield less certain expense deductions and

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[3]See, Internal Revenue Code ("IRC") former §§ 801-802 (the Life Insurance Company Act of 1959, P.L. 86-69), generally effective for taxable years beginning after December 31, 1957.

excluding the "policyholders' share" of investment yield. From this amount the company was allowed to deduct the company's share of the tax-exempt interest and the company's share of the deduction for dividends received.

To compute gain from operations, the company determined its total income which included the company's share of investment yield, net capital gain, premiums, decreases in reserves and all other amounts (IRC former § 809[b], [d]). From this total, the company was allowed deductions. These included deductions usually available to taxpayers for business and investment expenses with some modifications, plus certain deductions for items unique to the insurance industry (IRC former § 809[d]). Such deductions included deductions for: increases in reserves; the company's share of tax-exempt interest; and dividends received computed with respect to the company's share.

The terms "company's share" and "policyholders' share" refer, generally, to the allocation of income made by the company pursuant to IRC former §§ 804 and 809 whereby income produced by the company is attributed to (1) policyholders for the purpose of funding the company's contractual insurance claims ("policyholders' share") as distinguished from (2) income attributable to the company itself ("company's share").

As may be observed, under prior law, whether the basis of LICTI was gain from operations or taxable investment income, the policyholders' share of investment income was excluded from LICTI. Accordingly, since LICTI, the base from which the New York tax was calculated (Tax Law § 1503[a]), did not include the policyholders' share of dividends received, it is clear that, prior to 1984, the New York subtraction for dividends received provided under Tax Law § 1503(b)(1)(B) could apply only to the company's share of such dividends.

C. This conclusion may plainly be seen upon review of the entire statute. Specifically, Tax Law § 1503(b)(2)(B) provided that ENI was to be calculated without the exclusion of "any part of any income from dividends or interest on any kind of stock, security or indebtedness" except for the exclusion of 50 percent of dividends as provided in Tax Law § 1503(b)(1)(B) (and a second exception not pertinent herein). Tax Law § 1503(b)(2)(B) was modified by

section 1503(b)(2)(I), which provided that "the provisions of subparagraph (B) of this paragraph shall not apply to the policyholders' share of the items described in such subparagraph." Subparagraph (I) then defined "policyholders' share" as:

> "the amount . . . of each such item excludable in determining taxable investment income or gain or loss from operations under sections eight hundred four or eight hundred nine, respectively, of the internal revenue code."

Under this statutory framework, then, subparagraphs (B) and (I) of section 1503(b)(2) required the inclusion of the company's share of dividends received in ENI while specifically excluding the policyholders' share from ENI. Consistent with this framework, prior to 1984, only the company's share of dividends was included in LICTI. It is, therefore, very clear that only the company's share of dividends was available for the 50 percent dividends-received deduction provided by Tax Law former § 1503(b)(1)(B).

D. The Tax Reform Act of 1984 (Public Law 98-369) made substantial revisions in the Federal taxation of life insurance companies. Such changes were generally effective for taxable years commencing after December 31, 1983. Hence, commencing with the year at issue, life insurance companies were taxed on their LICTI under a single-phase system. LICTI is now defined as life insurance gross income less life insurance deductions (IRC § 801[b]). Life insurance gross income is the sum of premiums, decreases in certain reserves, and other amounts generally includible by a taxpayer in gross income, including income from investments and capital gains (IRC § 803). Life insurance gross income thus includes investment income without allocation between company's share and policyholders' share.

Under the 1984 Act, life insurance company deductions are those generally available to corporate taxpayers with some modifications (IRC § 805[a][8], [b]) and deductions available only to life insurance companies (IRC § 805[a]). Among the life insurance company deductions is the dividends-received deduction which, pursuant to IRC § 805(a)(4)(A)(ii) and (b)(6), is limited to the company's share of such dividends (except with respect to "100 percent dividends" as defined in IRC § 243). For purposes of the dividends-received deduction, the term "company's share" is defined at IRC § 812 as the percentage of investment income

allocable to the company pursuant to a formula similar to that used to calculate the company's share and policyholders' share of investment yield under prior law (see, IRC former § 804).

Also among the life insurance company deductions is the deduction for net increases in life insurance company reserves which is provided for in IRC § 805(a)(2). IRC § 807(c) provides that the items to be taken into account in calculating reserves are: (1) life insurance reserves as defined in IRC § 816(b); (2) unearned premiums and unpaid losses included in total reserves; (3) discounted liabilities for insurance or annuity contracts not currently involving life, health or accident contingencies; (4) dividend accumulations and other amounts held at interest in connection with insurance and annuity contracts; (5) advanced premiums and premium deposit fund liabilities; and (6) reasonable special contingency reserves under contracts of group term life insurance or group accident and health insurance which are established and maintained for the provision of insurance and retired life, for premium stabilization or for a combination thereof. Each of the foregoing items are reserves or are in the nature of reserves (see, 8 Federal Tax Coordinator 2d [RIA] ¶ E-4952) and are computed pursuant to IRC § 807(d) by reference to prescribed tables of mortality and morbidity and rates of interest (see, IRC § 816[b]). The reserves are amounts needed by the insurance company to meet its obligations to policyholders (see, 8 Federal Tax Coordinator 2d [RIA] ¶ E-4951).

IRC § 807(b) provides that the excess of the taxable year closing balance of the six items listed above reduced by "the policyholders' share of tax-exempt interest" (plus another item not relevant herein) over the opening balance of such items constitutes the net increase in reserves deductible under IRC § 803(a)(2).

IRC § 812 defines "policyholders' share", for purposes of section 807, as the percentage of investment income allocable to policyholders in a manner similar to the proration formula used under prior law (see, IRC former § 804).

E. The changes in the Internal Revenue Code pursuant to TEFRA discussed above resulted in changes to Article 33 of the Tax Law. Under the Business Tax Reform and Rate Reduction Act of 1987 (L 1987, ch 817), Tax Law § 1503 was amended effective August 7,

1987. Tax Law § 1503(b)(1)(B) now permits the following subtraction from ENI:

> "fifty percent of dividends other than from subsidiaries except that in the case of a life insurance company, such modification shall apply only with respect to the company's share of such dividends, which share means the percentage determined under paragraph one of subsection (a) of section eight hundred twelve of the internal revenue code."

Regarding this amendment, it is noted that the State Executive Department Memorandum which accompanied the bill that became law states the amendment was intended to clarify the existing statute (see, Letter from Roderick G. W. Chu, Commissioner of Taxation and Finance, to Honorable Mario M. Cuomo, July 20, 1987, Governor's Bill Jacket, L 1987, ch 817).

F. The first point of dispute to be resolved herein is whether, during 1984, LICTI included the policyholders' share of dividends received. As noted, commencing in 1984, life insurance company gross income included all dividends received without allocation. Accordingly, the policyholders' share must be included in LICTI unless the Code provides for a deduction or exclusion from LICTI for such share. The Code does not specifically provide for such a deduction. The Division, however, contended that the deduction for increases in life insurance company reserves resulted in the deduction of the policyholders' share of dividends from LICTI. The Division provided no statutory analysis to support this contention. Upon review of the deduction for increases in reserves (IRC § 807[b]; see, Conclusion of Law "D"), it is concluded that the Division's contention is erroneous. The deduction for increases in reserves appears to be unrelated to the policyholders' share of dividends. It is concluded, therefore, that LICTI included the policyholders' share of dividends received during the year at issue.

G. Having found that LICTI included the policyholders' share of dividends received, the effect of this conclusion on petitioner's franchise tax liability must next be determined. As noted, during 1984 Tax Law § 1503(b)(1)(B) allowed for a deduction of "50% of dividends" and petitioner interpreted this phrase as meaning that 50 percent of all dividends received by the life insurance company were deductible from ENI. Petitioner's interpretation, however, fails to consider all modifications to ENI pertaining to the dividends-received deduction. Tax Law § 1503(b)(2)(B) and (I) also relate to modifications to ENI and the dividends-received

deduction. These three provisions must be considered as an integrated whole to properly determine the Legislature's intent (see, Rankin on Behalf of Bd. of Ed. City of New York v. Shanker, 23 NY2d 111, 295 NYS2d 625, 628; see also, McKinney's Cons Laws of NY, Book 1, Statutes § 97).

Looking at these three provisions together reveals, first, that Tax Law § 1503(b)(2)(B) calls for the inclusion of all dividends received in ENI except for the 50 percent exclusion provided by Tax Law § 1503(b)(1)(B). Tax Law § 1503(b)(2)(I) further modifies section 1503(b)(2)(B) by restricting the application of said section to the company's share of dividends (i.e., said section "shall not apply to the policyholders' share"). Thus, taken together, subparagraphs (B) and (I) required the inclusion in ENI of the company's share of dividends received and specifically excluded the policyholders' share from inclusion in ENI. It follows, therefore, that the 50 percent dividends-received deduction under Tax Law § 1503(b)(2)(A) is properly limited to the dividends included in ENI pursuant to section 1503(b)(2)(B) and (I). Accordingly, it must be concluded that, during 1984, the 50 percent dividends-received deduction provided for in section 1503(b)(1)(B) applied only to the company's share of dividends received.

H. Petitioner contended that the inclusion of the policyholders' share of dividends received in LICTI must necessarily result in the allowance of a dividends-received deduction under Tax Law § 1503(a)(1)(A) in the amount of 50 percent of all dividends received. With respect to this contention, it is noted that:

> "While the starting point for determining entire net income under Tax Law § 1503 is the taxable income which the taxpayer is required to report for Federal income tax purposes, the tax then deviates from the Federal tax by providing its own inclusions and exclusions from the tax base (Tax Law § 1503[b]). The specific statutory language 'except as hereinafter provided,' in Tax Law § 1503(a) clearly indicates that the Legislature intended that the Federal number was to be only the starting point in computing entire net income for State tax purposes. Thus, Tax Law § 1503 requires that consistency with Federal income taxation apply with respect to the preliminary computation of entire net income in § 1503(a) and not to the modifications in § 1503(b) unless specifically indicated" (Matter of The United States Life Ins. Co., supra).

Accordingly, notwithstanding the inclusion of the policyholders' share of dividends

received in LICTI, the modifications set forth in Tax Law § 1503(b) (specifically, the combined operation of section 1503[b][1][B], [b][2][B] and [b][2][I]) serve to limit the dividends-received deduction to 50 percent of the company's share of such dividends.

I. It is further noted that, contrary to petitioner's assertion, this conclusion is supported by the 1987 amendment to Tax Law § 1503(b)(1)(B). As discussed herein, this statute, prior to its amendment, is properly interpreted as allowing a deduction for only the company's share of dividends received. Following the 1987 amendment, the statute provided for the same deduction. Since the statute in its original form can be read consistently with the statute as amended, the amendment must be viewed as a clarification of the Legislature's previous intent (see, Conclusion of Law "C"; Mayblum v. Chu, 67 NY2d 1008, 1010, 503 NYS2d 316).

J. The petition of New York Life Insurance Company and Subsidiary is in all respects denied and the notices of deficiency, dated December 7, 1989, are sustained.

DATED: Troy, New York
October 21, 1993

/s/ Timothy J. Alston
ADMINISTRATIVE LAW JUDGE