STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :

of :

PRINCIPAL MUTUAL LIFE :
INSURANCE COMPANY DETERMINATION
: DTA NO. 815265

for Redetermination of a Deficiency or for Refund of Franchise Tax on Insurance Corporations under Article 33 : of the Tax Law for the Years 1990 and 1991.

Petitioner, Principal Mutual Life Insurance Company, 711 High Street, Des Moines, Iowa 50309, filed a petition for redetermination of a deficiency or for a refund of franchise tax on insurance corporations under Article 33 of the Tax Law for years 1990 and 1991.

A hearing was held before Catherine M. Bennett, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on April 10, 1997 at 10:15 A.M., and continued to its conclusion on September 17, 1997 at 10:15 A.M., with all briefs to be submitted by January 30, 1998, which date began the six-month period for the issuance of this determination. Petitioner appeared by Strook & Strook & Lavan LLP (Bruce H. Schneider, Esq., of counsel). The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Brian J. McCann, Esq., and James F. Connolly, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation properly included receipts reported in column six of petitioner's annual statements filed with the State Insurance Department for tax years 1990 and

1991 in petitioner's allocation fraction by its determination that such receipts fall within the definition of "premium" pursuant to Tax Law § 1504(b).

II. Alternatively, if such receipts are not considered "premiums" for such purposes, whether the Division of Taxation can invoke its discretionary authority under Tax Law § 1504(d) and adjust petitioner's allocation percentage, by including such receipts in its allocation fraction, in order to accurately reflect petitioner's income in New York State.

III. Whether the Division is entitled to apply its policy of including column six monies in the allocation fraction retroactively to the periods in issue, under either the statutory interpretation or as a matter of discretion.

FINDINGS OF FACT

1. Principal Mutual Life Insurance Company ("petitioner") is a foreign insurance company incorporated in the State of Iowa and licensed in the State of New York to engage in the sale of life, health and annuity products, with its home offices in Des Moines, Iowa. As an insurance corporation doing business in New York, petitioner was required to file Form CT-33 for tax years 1990 and 1991 to report its franchise tax liability with the New York State Insurance Department ("Insurance Department") and the New York State Department of Taxation and Finance ("Division"). In addition, petitioner is required to file an Annual Statement each year with the Insurance Department under the guidelines provided by the National Association of Insurance Commissioners ("NAIC").

2. Both the Insurance Department and the Division are involved in the audit of the franchise tax returns of insurance companies. The Insurance Department performs audits of taxable premiums, the allocation percentage, and the limitation on tax and fire tax credits. The

Division audits tax on capital and subsidiary capital using the balance sheet pages of the Annual Statement.

3. In June 1994, the Insurance Department notified the Division (specifically, Jeanette Durand, the desk audit specialist for Article 33 matters who conducted petitioner's audit) that the Insurance Department had audited petitioner's Report of Premiums, and that the "Total New York Premiums" and "Total Premiums" lines of petitioner's Form CT-33 for 1991 should be adjusted. The adjustment was based upon the ground that petitioner had erroneously excluded the category of "Annuity and Other Fund Deposits" (column six amounts) from the derivation of the New York allocation percentage. This correspondence from the Insurance Department prompted the Division to review the manner in which petitioner was reporting its premiums and led to the adjustment of petitioner's New York premiums and total premiums to include the amounts appearing under column six of Schedule T of petitioner's 1990 and 1991 annual statements ("column six"). Consistent with its practice in years before 1990, to compute its New York premiums for the Tax Law § 1504(a)(1) calculation for 1990 and 1991, petitioner added the amounts allocated to New York in columns three, four and five of petitioner's Schedule T for those years. Petitioner did not include in either the numerator (New York premiums) or the denominator (total premiums) the amounts reported in column six of petitioner's Schedule T. The adjustment from inclusion of column six amounts resulted in a change in petitioner's allocation percentage for both years, as set forth below:

	1990 As Reported	1990 As Adjusted	1991 As Reported	1991 As Adjusted

N.Y. Premiums	$171,598,515	$347,180,892	$201,778,381	$418,308,533
Total Premiums	$3,338,563,058	$4,600,928,594	$3,499,759,981	$5,004,003,108
Allocation %	4.9877%	7.15131%	5.5554%	7.89%

4. The Division issued a Notice of Deficiency to petitioner dated August 22, 1994, asserting additional tax due pursuant to Article 33, section 1505(a), in the amount of $1,417,143.09 plus interest of $357,054.17, for a total balance due of $1,774,197.26. The following explanation was provided:

> Your allocation percentage for tax years 1990 and 1991 has been adjusted. Section 3222(a) of the Insurance Law States [sic] in part, 'the issuance or delivery of a funding agreement by an insurer in this state shall constitute doing an insurance business.' Therefore, the Annuity and Fund Deposits as contained in Column 6 of Schedule T have been added to the New York and Total Premium figures. These amounts must be included in the computation of the allocation percentage to fairly and properly reflect the company's insurance activities in this state.

5. A conciliation conference was scheduled to be conducted on November 2, 1995 by the Bureau of Mediation and Conciliation Services, though according to the Conciliation Order issued (CMS No. 143466), the matter was handled by correspondence. The Conciliation Order, dated May 17, 1996, sustained the statutory notice. A timely petition, received by the Division of Tax Appeals on August 15, 1996, was filed in protest of the Order.

6. The NAIC's 1990 instruction for Schedule T of the Annual Statement suggests that Schedule T is "intended to exhibit the amount of premium and annuity considerations allocated to each state and should be the basis of premium tax calculations." The instructions further provide the types of amounts that should be reported in its component columns three through six. Column six was added to Schedule T in 1990. The NAIC instructions provided the following guidance as to what type of receipts should be recorded in column six: "Report annuity related

revenues for which annuity purchases have *not* been made for individuals or individual certificate holders." Before 1990 (years during which column six did not exist on Schedule T), the Annual Statement set forth the amounts relating to annuity and other fund deposits on Line 1A of the Summary of Operations page, which was not a schedule routinely reviewed by the Division during audits of this type, though the information was available to the Division. The Division was unaware that a line of business existed that was represented by the amounts shown on Line 1A of the Summary of Operations in years prior to 1990, and in column six beginning with 1990.

The amount reported in column six is reported as part of petitioner's life insurance taxable income for Federal purposes and had always been included in its entire net income.

7. The documents submitted into evidence, specifically the Summary of Operation and Schedule T pages from petitioner's annual statements for tax years 1986 through 1991, illustrate that the sums earned and reported as Annuity and Other Fund Deposits (the column six amounts), represented approximately one-third of the total income from operations, i.e., receipts from customers. Over the 6-year span, the percentage increased from more than 24% to over 36%.

8. Petitioner's income from Annuity and Other Fund Deposits (column six amounts) had increased between 1986 and 1991 to the point where it nearly equaled its other major source of income, Premiums and Annuity Considerations, also reported on petitioner's annual statements. In 1986, Annuity and Other Fund Deposits were about 57% of Premiums and Annuity Considerations. By 1990 and 1991, the same percentages had climbed to more than 81%[1] and 93%, respectively.

[1] The Division's proposed Finding of Fact "60" erroneously reported this percentage at 87.88%, due to an error in the recording of the amount for "Annuity and Other Deposit Income" for 1990.

9. At the hearing, petitioner introduced the testimony of its only witness, Robert Henderson, petitioner's assistant director of financial information and systems. He is responsible for the financial reporting aspects of petitioner's pension department and provided information at the hearing pertinent to petitioner's reporting of the various insurance products. Mr. Henderson was not involved in the preparation of petitioner's tax returns. Mr. Henderson discussed, for example, the characteristics of the various contracts and how each is reported on Schedule T of the Annual Statement, particularly in columns four and six. Amounts reported in column six are amounts that are not subject to the contingencies of life, but are more likely subject to investment risk. A significant portion of amounts reported by petitioner in column six are receipts from "funding agreements," vehicles by which an employer can, over the working years of an employee, create sufficient accumulation to provide a meaningful retirement income benefit for the employee. The funding agreement exists in conjunction with the employer's retirement plan and is a contract between petitioner and the employer or sponsor. Once the employee reaches retirement age under the plan, then the employee can exercise certain rights under the contract, such as the right to an annuity option, the right to receive payments for a fixed period, or the right to receive a lump sum payment. Once the accumulation phase expires, the individual becomes petitioner's customer, particularly where an annuity option is being exercised. Although the accumulation phase and the employee's rights arise under one agreement, in the case where an annuity is purchased, petitioner issues a certificate to the individual to demonstrate the company's obligation to the individual.

10. Petitioner submitted numerous contracts into evidence, of which two in particular comprised 95% of the receipts for the years in issue that petitioner recorded in column six of Schedule T: Exhibit 4, a contract for a Single Premium Deferred Annuity ("SPDA"), and Exhibit

7, a Flexible Investment Annuity Group Contract (“FIA”). Receipts from single premium deferred annuities in 1990 and 1991 comprised 47% and 51%, respectively, of the total product share of column six. Receipts from flexible investment annuities in 1990 and 1991 comprised 48% and 44%, respectively, of the total product share of column six. Contract receipts that made up the remaining 5% for both tax years were from products with substantially similar provisions that were intended to serve a different market.

11. The SPDA contract face page contains an inscription stating the following: “Monthly income payable starting on retirement date, or death benefit if annuitant or owner dies before retirement date. You have the option to change the retirement date.” The SPDA contract specifies the owner or annuitant, the annuitant’s retirement date, the amount of the owner’s single premium, and the period for which a particular interest rate of accumulation is guaranteed. Under the SPDA, petitioner promises to pay to the named annuitant equal monthly income payments beginning on the retirement date if the annuitant is still living and the contract is still in force. Under a SPDA, to determine the amount and duration of the monthly income payments to be paid, petitioner is required to apply the owner’s accumulated value to the benefit option chosen. The accumulated value is a function of the amount of the owner’s single premium payment, the interest credited, including the interest added by the guaranteed interest rate applied during the guaranteed period, less any reductions due to prior partial surrenders, which are permitted (along with total surrender) prior to the retirement date. Benefit options available for election on the retirement date include the following:

1. The Special Benefit Arrangement, which permits an individually designed benefit option approved by petitioner;

2. Fixed Income, which would be payments of a fixed amount for a fixed period;

3. Life Income, which makes payments during a person's lifetime, with a minimum guaranteed period; or

4. Two forms of Joint and Survivor Life Income, which provides income during the lifetime of two persons.

Attached to the SPDA contract are annuity tables showing, for each benefit option, the amount of the monthly income an annuitant could expect per application of a given amount of accumulated value. The SPDA contract states that the tables shown are to illustrate the guaranteed minimum benefits under each benefit option, and in fact, the benefits resulting from the annuity may be greater.

Petitioner reports receipts from the SPDA contracts in column six of Schedule T. The reason for their appearance in column six is that the contract provides for an accumulation of funds after which time an annuity may be purchased. Furthermore, the contract can be surrendered for its cash value (the accumulated value less the surrender charge, if applicable) on or before the individual's retirement date. If a benefit option is elected, the original SPDA contract is exchanged for a supplementary contract, which establishes the relationship between petitioner and the individual (contrasted with the person's employer) and will generally offer a better purchase rate than the guaranteed minimum benefit described in the original contract.

12. The FIA contracts, the receipts from which are also reported by petitioner in column six, are contracts executed between petitioner and an employer, and are designed to provide funding for retirement for the employees of such employers. Under the FIA, an employer can make a payment to petitioner and direct to which of several funds, or investment vehicles, the payment is applied. The funds include a general investment fund, guaranteed interest fund and a separate investment fund. Under the FIA, petitioner agrees to pay benefits, in the form of either a lump sum payment or an annuity, to a covered employee who becomes eligible to exercise one of

the benefit options under the employer's benefit plan. The annuity may take the form of a life annuity, a life annuity with a fixed period, a survivorship annuity with an installment refund, or a fixed period annuity. The amount of any annuity payment, established under the FIA will depend in part on the annuity purchase rate applicable on the date of purchase. However, the contract states that the annuity purchase rates used will not be less favorable to the member than the rates shown in a table attached to the contract.

A common interest guarantee in a FIA is based on a five-year term. At the conclusion of such term, the contract holder would be free to demand the return of its money and apply the funds to another purchase.

13. Another type of contract introduced into evidence that existed during 1990 and 1991 is the Single Premium Guaranteed Annuity Contract ("SPGAC") , Exhibit "M", a contract that bears an insurance risk since the payments are contingent on the continuation of a life. The contract provides for an insurance benefit and not an accumulation of funds. Under such contract, petitioner commits to pay an annuity at some future date to a specific individual listed in the contract with a specific starting date and amount. All of the benefit options under this contract are dependent upon the continuation of a life or lives, except for the Income for Certain Period Option and the Cash Option (where a single sum would be paid in lieu of all or part of benefits otherwise available). Although all the options are described in the boilerplate language of the contract, the sample submitted into evidence does not provide for the election of either of the certain period or the cash option. The receipts from the SPGACs are reported by petitioner in column four of Schedule T.

14. In conjunction with his discussion of the FIA in particular (Exhibit 7), Mr. Henderson established that there is no insurance risk associated with amounts petitioner reports in column

six. The risks associated with funding agreements are of two distinct types. During the accumulation period, and prior to annuitization, there is investment risk. In addition, particularly in a contract bearing an annuity purchase rate guarantee, where an annuity option is chosen, there is investment risk. The annuity purchase rate guarantee provides a floor rate that is applied to the accumulated amount if an annuity is chosen at the retirement date. If the investment environment demands that petitioner provide a higher, more competitive rate, then the rate applied may be higher than the floor. Likewise, if the competitive rate is less than the floor at the time of retirement, petitioner is required to meet its obligation at the higher rate. Thus, petitioner’s floor rates are kept somewhat conservative to minimize the investment risk.

The second type of risk associated with contracts of this type is insurance risk. In a case where the annuity is chosen, and the continuation of payments is contingent upon the continuation of life, petitioner takes on insurance risk. It is then (the creation of the annuity) that petitioner shifts amounts, receipts and accumulated amounts, into column four, from column six, of Schedule T.

15. Whether any of the receipts from petitioner’s FIA reported in column six ever move into column four of Schedule T depends on an employee’s qualification for a retirement benefit under the employer’s retirement plan, and then whether the employee chooses to receive an annuity. It is possible that no employees of a particular employer would qualify to exercise the right to receive annuity payments under petitioner’s group annuity contracts, depending on the makeup of an employee workforce and their relative ages to the age of retirement as set forth in the plan. To the extent an employer had a young workforce, few, if any, annuities might be purchased in a given five-year period. If the employer decides to invest with another insurance

company at the end of the five-year period, none of the monies collected by petitioner for those contracts and reported in column six would ever move over to column four.

16. The Division follows a policy of allowing taxpayers to exclude from the allocation fraction column four monies that were previously reported by the taxpayer in column six when received to avoid their inclusion twice.

17. Petitioner submitted into evidence a response issued by the then counsel to the New York State Insurance Department (dated December 6, 1994), to the request for an opinion about whether any of the agreements in issue in this matter come within the definition of "annuity." The letter, prepared by Donna Freireich, ("the Freireich letter") addressed her review of questions raised by William F. Collins, Esq., then counsel to the New York State Department of Taxation and Finance, regarding the taxation of amounts received by insurance companies in consideration of certain contracts designated by them either as funding agreements or annuity contracts. She specifically described the issue as follows:

> [w]hether deposits made pursuant to these agreements are, during the accumulation phase, 'consideration for annuity contracts' for purposes of the definition of 'premium' used to allocate net income and calculate alternative tax under sections 1504, 1505 and 1510 of the Tax Law, or whether only the amounts which have been 'annuitized' pursuant to those agreements [i.e., the amounts which have been applied by retiring employees to purchase annuities] constitute such consideration under those sections. Although this question rests ultimately upon interpretation of the cited Tax Law provisions — the jurisdiction of your Department, rather than ours — it is my hope that the information set out below may be of use in analyzing and resolving this matter.
>
> My conclusion, in brief, is that neither result would be unreasonable. I am constrained to this view due to the lack of direct evidence of legislative intent regarding this matter.

The balance of the discussion in the Freireich letter, which is several pages long, sets forth the arguments made by petitioner and the Division herein, and concludes without Ms. Freireich's taking a final position on the overall issue of the includability in the allocation formula of receipts from column six contracts.

18. With its brief, the Division submitted proposed Findings of Fact numbered "1" through "62", which have been ruled upon in the following manner:

--Proposed Findings of Fact 1-4, 8, 10, 14, 17, 18, 22, 32-34, 40, 43, 47, 49-51, and 53 are supported by the evidence in the record and have been accepted, and are substantially or wholly incorporated into the Findings of Fact herein.

--Proposed Findings of Fact 7, 9, 11, 12, 15, 20, 21, 23, 28-30, 35, 36, 39, 41, 42, 44, 48, 54, 59, 60, and 62 are modified to more properly reflect the record and to eliminate extraneous information and conclusory statements.

--Proposed Findings of Fact 5, 6, 13, 16, 19, 24-27, 31, 37, 38, 55-58 and 61 have been eliminated as irrelevant.

--Proposed Findings of Fact 45 and 52 are rejected as testimony presented in an incomplete fashion, such that the information sought to be conveyed is misrepresented. Facts related to such issues are presented in lieu of actual testimony.

--Proposed Finding of Fact 46 is rejected as not representative of the entire item of correspondence. The contents of such is summarized and set forth in Finding of Fact "17".

SUMMARY OF THE PARTIES' POSITIONS

19. Petitioner maintains that amounts received in the accumulation phase of group annuity contracts, funding agreements and like contracts are not to be included in "premiums" for purposes of Tax Law § 1504(b).

Petitioner contends that application of Tax Law § 1504(d), as the Division suggests, would be granting the Division limitless discretionary authority to adjust a taxpayer's allocation percentage, resulting in an unconstitutional delegation of power, and should not be permitted.

Lastly, petitioner argues that even if the amounts received during the accumulation phase of annuity contracts should be included within the Tax Law § 1504(a) calculation, as a new interpretation, it should not be given retroactive effect.

20. The Division argues that the contracts reported by petitioner in column six of Schedule T are annuities and, thus, the consideration received from such contracts should be classified as "premiums" under Tax Law § 1504(b) and included in the allocation fraction of Tax Law § 1504(a).

The Division maintains that the contract receipts reported in petitioner's column six, from Annuity and Other Fund Deposits, must be included in its allocation fraction to accurately reflect its income, and asserts its authority pursuant to Tax Law § 1504(d) to do so.

On the last issue, the Division asserts it is entitled to apply its policy of including column six funds in the allocation fraction to the periods at issue, since it is not a reversal of a prior policy and petitioner could have foreseen the inclusion of column six amounts in the allocation fraction, by the application of the Division's discretionary (statutory) authority.

CONCLUSIONS OF LAW

A. Petitioner challenges a deficiency assessment of franchise taxes resulting from its purported failure to correctly calculate the allocation percentage used to compute the portion of its net income attributable to New York. A brief discussion of what component determinations must be reached to formulate the allocation percentage follows.

The franchise tax on insurance corporations doing business in New York is computed pursuant to Article 33 of the Tax Law. The tax is computed by calculating the entire net income ("ENI") of the insurance company and allocating a proper portion to New York by nine-weighting a premiums factor and single-weighting a wages factor. The premiums factor is based on the ratio of the corporation's New York premiums to "total premiums" (Tax Law § 1504[a][1]). For purposes of the premium allocation fraction and this particular calculation, the term "premium" is defined by Tax Law § 1504(b) as amounts received as consideration for insurance contracts, reinsurance contracts, annuity contracts and every other compensation for such contract. In tax years prior to 1990 and 1991, the amounts that comprised the premium allocation fraction were reported by petitioner on Schedule T of petitioner's Annual Statement in columns three, four and five. The amounts reported in column six after 1990 were previously reported by petitioner on Line 1A of the Summary of Operations page and were not included in the premium fraction. Petitioner continued this practice in a consistent manner after Schedule T was revised in 1990, and did not include column six amounts in the premium fraction. During an audit by the Insurance Department, it was brought to the Division's attention that petitioner had not included column six amounts in the New York allocation percentage, and the issues described herein arose. Whether the column six amounts should have been included in the premium allocation, depends upon whether the receipts are "premiums" from insurance contracts, reinsurance contracts, or annuity contracts. There is no contention by either party that the column six amounts in question are for insurance or reinsurance contracts. Thus, to the extent that petitioner's column six receipts were for annuities, those receipts should have been included in both the numerator and denominator of the allocation fraction of Tax Law § 1504(a).

According to the evidence submitted, 95% of the receipts reported in column six for 1990 and 1991 are from two types of contracts, the SPDA (Ex. 4) and the FIA group contract (Ex. 7). The first question to be addressed is whether either of these contracts meets the definition of "annuity." Since the Tax Law does not contain a definition of "annuity", it is appropriate to turn to the Insurance Law for guidance, and read such related provisions *in pari materia* (***Guardian Life Insurance Co. of America v. Chapman***, 302 NY 226; ***CUNA Mutual Insurance Society***, Tax Appeals Tribunal, June 11, 1998). Pursuant to Insurance Law § 1113(a)(2), the term "annuities" means "all agreements to make periodical payments for a period certain or where the making or continuance of all or some of a series of such payments, or the amount of any such payment, depends upon the continuance of human life. . . ." Both the SPDA and FIA contracts have been described in some detail (see, Findings of Fact "9" through "12"). They are contracts that provide for the accumulation of funds during a pre-retirement period, where there has been no agreement to make periodic payments of such amounts. Both contracts provide for the *option* to receive periodic payments upon the exercise of an election offered to the individual at a date that occurs later than the time at which the contract is entered. Likewise, the option exists in the SPDA contracts to surrender the contract in whole or in part prior to the retirement date, and the FIA contracts allow for a lump sum payment in lieu of an annuity. In those cases, no annuity would ensue from such contracts.

Both contracts have a minimum annuity rate guarantee that represents a promise by petitioner to provide an annuity rate no less favorable than that which is specified in the contract, *if the plan member elects to receive an annuity benefit.* The Division argues that the existence of the annuity rate guarantee gives rise to a mortality risk, which qualifies the contract as an annuity for purposes of allocation under Tax Law § 1504. This argument is without merit. First, the annuity rate guarantee only arises if the annuity benefit is actually opted. The annuity rate guarantee is an undertaking by petitioner that the annuity rate will not be offered at a level less than specified by the terms of the contract. The risk that petitioner undertakes with the rate guarantee may be one of investment risk, not mortality risk if the annuity option selected is not dependent upon the continuation of life, such as an option for a period certain that is not dependent upon the number of years someone will live. At the time an annuity benefit is selected, mortality risk may be a factor if the benefit option chosen is dependent upon the continuation of one or more lives. However, the rate guarantee itself does not equate to an agreement to make periodic payments, nor does the existence of a minimum rate guarantee dictate the classification of the contract.

The Division questions petitioner's contrasted treatment of a third contract, the Single Premium Guaranteed Annuity Contract (SPGAC), since petitioner reported receipts from such contracts in column four of Schedule T, thereby including them in the allocation percentage. The Division argues that petitioner has not adequately distinguished why it treated the SPDA as column six receipts, when it recorded the SPGAC receipts in column four. At the time the SPGAC is entered into, the SPGAC is a binding agreement to make periodic payments. The annuity amount and form are defined at the time the contract is executed. The benefit options are contingent upon the life of the annuitant or some combination that includes the life of the annuitant. The contract offered into evidence was represented by petitioner as the type of SPGAC's offered by Principal and did not provide either a cash or period certain option. From the inception of the contract, a mortality risk exists. Based upon the above distinctions, petitioner's proper reporting of receipts from the SPGAC contracts in column four of Schedule T does not compel a conclusion that the receipts from the SPDA contracts should likewise be reported .

In further support of its position that there are differences between the various contracts, petitioner points out that the 1990 Annual Statement Instructions for Schedule T reflect the difference between "[annuity] considerations received for annuity contracts" (required to be reported in column 4), and "annuity related revenues for which annuity purchases have not been made for individuals or individual certificate holders" (required to be reported in column 6).

Throughout these proceedings, petitioner has maintained that the contracts whose receipts were included in column six were "funding agreements." The Division contends that the SPDA and FIA contracts cannot be funding agreements because 1) their titles do not reflect the same, 2) the only purpose for which a funding agreement can be issued to an individual is to fund an agreement in satisfaction of a claim, which is not applicable here, and 3) both contracts have an annuity rate guarantee, which gives rise to a mortality risk, contrary to Insurance Law § 3222 (which prohibits a mortality or morbidity contingency in a funding agreement). Petitioner argues that holding the title as controlling would improperly elevate form over substance; that funding agreements can also be issued for other purposes to individuals; and that the Division's argument with respect to the effect of an annuity rate guarantee erroneously presupposes that the contracts provide for payments based upon a mortality risk.

The issuance of "funding agreements," when issued or delivered by an insurer in this State, constitutes doing insurance business in New York. New York State Insurance Law § 3222 permits funding agreements to be issued to entities authorized to conduct an insurance business, as well as to entities other than persons authorized to engage in an insurance business *and to individuals* for numerous purposes, particularly to fund benefits under any employee benefit plan as defined in the Federal Employee Retirement Income Security Act of 1974 ("ERISA") (Insurance Law § 3222[b][i]). Further, the law provides that funding agreements cannot provide for payments to or by the insurer based on mortality or morbidity contingencies (Insurance Law § 3222[c]). The New York State Insurance Law does not define "funding agreements," although petitioner's reference to the term makes it clear that it has insurance industry acceptance as, at least for its use in this matter, the means to an accumulation of funds for retirement purposes. The California Court of Appeal, Second District, in ***Executive Life Insurance Company v. Aurora National Life Assurance Company*** (32 Cal App 4th 344) provided the legislative history of California Insurance Code § 10541, which was modeled after New York State Insurance Law § 3222. In its enacted version in 1988, section 10541 retained many key provisions of the New York statute, and additionally defines the term "funding agreement" as follows: "an agreement which authorizes an admitted life insurer to accept funds and which provides for an accumulation of those funds for the purpose of making one or more payments at future dates in amounts that are not based on mortality or morbidity contingencies" (***id.*** at 377). The author of the California legislation is quoted by the Court as stating: "The contract holder's payment rights under a funding agreement vary from contract to contract, and may be either in lump sum or periodic payments, but in no event are based upon life contingencies" (***id.*** at 378).

Having discussed each of the parties' pertinent arguments on this first issue, what exists in this case are contracts that clearly have two distinct component parts, and for purposes of reporting the receipts from such contacts, must be viewed as a hybrid. The accumulation phase of the contracts makes them indistinguishable from what has been described as a "funding agreement," authorized by Tax Law § 3222. The contracts were issued to entities or individuals to fund retirement plans (which presumably were ERISA plans). Neither the SPDA nor FIA contract provided for payment of the accumulated amounts based upon mortality or morbidity contingencies. The payments under the SPDA could be the result of partial or total surrender of the contract before the retirement date, or the result of applying the amounts to a benefit option that becomes available for election on the individual's retirement date. Similarly, the funds accumulated under the FIA contract may be paid when a covered employee becomes eligible to exercise one of the benefit options. The contract holder was also free to demand the return of its money at the conclusion of a term in some cases. The payment options at the conclusion of the accumulation period, triggered generally by a retirement date, were not based on a mortality or morbidity contingency. If an annuity option was selected in the next phase, a mortality contingency was then sometimes a factor. Certainly, the agreement to make periodic payments arose at the time the annuity option was selected, but not before such time. Thus, a contract with a funding agreement as a component part cannot be classified as an "annuity contract" as defined by the Insurance Law during the time that the funding agreement is effective. It follows, therefore, that the receipts from such contracts during the accumulation phase were not "premiums" under Tax Law § 1504(b), were properly reported in column six of schedule T for 1990 and 1991, and accordingly, on this basis, were properly excluded from the allocation fraction of Tax Law § 1504(a)(1). When a member elected an annuity option, petitioner then properly accounted for the entire amount of accumulated receipts from the same contracts as column four receipts on its Annual Statement and, thus, included them in its section 1504(a) allocation calculation.

B. The Division argues, alternatively, that if the column six receipts are not considered "premiums" for purposes of the allocation fraction, the Division is permitted to invoke its discretionary authority under Tax Law § 1504(d), and adjust petitioner's allocation percentage by including such receipts in its allocation fraction, in order to accurately reflect petitioner's income in New York State. The Division maintains that the funds would fall under the classification of "receipts other than premiums," pursuant to Tax Law § 1504(d)(2), and be properly included under an "adjusted" formula. Petitioner believes that the Division's reading of Tax Law § 1504(d) grants it limitless authority to adjust a taxpayer's allocation, resulting in an unconstitutional delegation of legislative power to the Division. Petitioner also identifies the fact that there has been no prior notice or rulings by the Division discussing the tax implications of the transaction adjustment in issue.

Tax Law § 1504(d) states the following:

> "If it shall appear to the tax commission that the income allocation percentage determined as hereinabove provided does not properly reflect the activity, business or income of a taxpayer within the state, the tax commission shall be authorized, in its discretion, to adjust it by:
>
> (1) excluding one or more factors therein;
>
> (2) including one or more other factors therein, such as expenses, purchases, *receipts other than premiums*, real property or tangible personal property;
>
> (3) or any other similar or different method calculated to effect a fair and proper allocation of the income and capital reasonably attirbutable [sic] to the state. The tax commission from time to time shall publish all rulings of general public interest with respect to any application of the provisions of this subdivision" (emphasis supplied).

The enactment of Tax Law § 1504(d) in 1974 was part and parcel to the addition of Article 33 to the Tax Law. Article 33 was intended to effectuate major changes in the insurance industry by equalizing the tax rates imposed on New York and foreign insurers in order to "stem the flight of domestic firms from the State, while at the same time protecting State revenue and disarming the tax retaliation threats of other states against New York insurers" (Mem of the Executive-Legislative Staff, 1974 NY Legis Ann, at 223-225). However, little attention, if any, was paid to

Tax Law § 1504(d) specifically. The Memorandum to the Governor by the counsel to the New York State Insurance Department set forth an analysis of the Article 33 provisions, and the only comment pertaining to Tax Law § 1504(d) was that the "Tax Commission is given the authority to adjust the method of allocation in order to obtain a proper result." There is no evidence that this provision has been previously applied. As a result there have been no rulings by the Division explaining the application of this provision. Despite petitioner's argument that it received no notice from the Division of its intention to invoke Tax Law § 1504(d), the Division is not required by the statute to publish any type of ruling prior to the application of the provision (Tax Law § 1504[d][3]). Petitioner raises two constitutional objections to the application of Tax Law § 1504(d) in this matter: that the Division's reading of Tax Law § 1504(d) grants the Division limitless discretionary authority to adjust a taxpayer's allocation formula, resulting in an unconstitutional delegation of legislative power to the Division; and secondly, the Division's interpretation renders the statute void for vagueness, as applied to petitioner, thereby denying petitioner due process of law.

The Division also argues that if the column six monies are not reflected in the allocation fraction in the year the funds are received, such amounts may never be reflected in the allocation fraction, implying this is an improper result. This argument is without merit. If the column six monies were intended to be included in the allocation fraction, the law would provide the same. The column six amounts are not temporarily escaping tax by being subjected to a deferral provision. They are not includable as premiums in the first instance. Thus, the mere fact that they may never be included in the allocation fraction does not compel a finding that the Division must be allowed to exercise its section 1504(d) discretion.

Petitioner challenges the authority given to the Division by the Tax Law under section 1504(d) as an unconstitutional delegation of power. As such, petitioner's challenge amounts to a facial challenge to the statute, contrasted to a debate of the propriety of the Division's action in applying the statutory language. Inasmuch as the Division of Tax Appeals lacks the jurisdiction to determine the constitutionality of a statute on its face, petitioner's contention that the exercise of the Division's discretionary authority is an unconstitutional delegation of legislative power cannot by addressed in this forum (***Matter of Consolidated Rail Corporation***, Tax Appeals Tribunal, August 24, 1995, ***confirmed*** __AD2d__, 660 NYS2d 459, ***appeal dismissed*** 91 NY2d 848, 667 NYS2d 683; ***Matter of Unger***, Tax Appeals Tribunal, March 24, 1994).

Petitioner's second constitutional challenge is that the Division's reading of the statutory language of Tax Law § 1504(d), as applied to petitioner, is void for vagueness, and denies Principal due process of law. Due process requires that a statute bear an element of definiteness as a prerequisite to its validity (20 NY Jur 2d, Constitutional Law, § 398). A statute must furnish some comprehensible guide, rule, or information as to what must be done and what must be avoided, to the end that an ordinary member of society may know how to comply with its requirements (***id***.). Under the two-pronged void for vagueness test, a statute must first be sufficiently definite to provide fair notice of the required or prohibited conduct, and second, must provide explicit and objective standards by which a violation may be determined (***id.*** § 399). The Constitution does not require impossible standards (***id.***).

Petitioner's second challenge seems to require an analysis of whether the statute on its face is vague, which ruling is prohibited by this forum (***Matter of Consolidated Rail Corporation***, ***supra; Matter of Unger, supra***). However, restricting petitioner's inquiry to that of whether the statute is vague as applied to the precise circumstances of this case, the response turns on whether the statutory language provides some standards that petitioner could follow. Specifically, Tax Law § 1504(d)(2), speaks to adjusting the allocation percentage by including receipts other than premiums as a factor, if the percentage without such factor does not properly reflect the activity, business or income of a taxpayer within the state. Petitioner has gone to great lengths to establish that the column six amounts are not "premiums." Having agreed with petitioner's analysis on that point, it would be impossible to exclude such amounts from the category "receipts other than premiums." This is the only adjustment sought to be made by the Division, and its terms, as applied are clear in this case. Furthermore, the word "properly" sets a standard by which an administrative agency can operate (***Matter of Barney's, Inc. v. Department of Finance of the City of New York***, 93 AD2d 642, 462 NYS2d 872, 875, ***affd*** 61 NY2d 786, 473 NYS2d 392) [where the Court upheld nearly identical statutory language against claims that it was unconstitutionally vague and an unconstitutional delegation of legislative power]).

Given the fact that the column six receipts reflect approximately one-third of petitioner's total income from operations, and the receipts by petitioner from such contracts were clearly becoming a major revenue component, the Division's decision to include such receipts in the allocation percentage to more properly reflect the activity, business and income of petitioner in New York State was reasonable. The Division's reading and application of Tax Law § 1504(d)(2) does not deprive petitioner of due process of law due to the application of impermissibly vague terms or standards. Accordingly, the Division properly invoked its discretionary authority to adjust petitioner's allocation percentage for the years in issue.

C. The final issue to be addressed is whether the Division is permitted to adjust the allocation percentage retroactively, by this determination, to the 1990 and 1991 tax years.

Petitioner points to the United States Supreme Court decision in ***Chevron Oil Co. v. Huson*** (404 US 97), which, as a landmark case, set out three considerations that are to be evaluated in determining whether to apply a judicial decision retroactively. The New York courts and the New York State Tax Appeals Tribunal ("Tribunal") have applied the same test in determining the retroactivity of New York State tax rulings ***(see, Hilton Hotels Corp. v. Commissioner of Finance,*** 219 AD2d 470, 632 NYS2d 56 [where the Appellate Division applied the ***Chevron*** criteria in a matter of first impression that the court believed was decided in error by the New York City Tribunal, and held that a new interpretation of the Utility Tax that amounted to a change in policy was arbitrary and capricious if applied retroactively]; ***Matter of NewChannels Corporation and Upstate Community Antenna, Inc.,*** Tax Appeals Tribunal, September 23, 1993) [where the Tribunal refused to give retroactive application to its own new interpretation of the term "transmission business" for the purpose of imposing franchise taxes, in a case of first impression and where the decision overruled a long-standing policy of the Division, based on the three-part inquiry presented in ***Chevron***]). Pursuant to the three-part test for determining the nonretroactivity of a judicial decision, enunciated in ***Chevron***, a decision must be applied prospectively (1) if it establishes a new principle of law, either by overruling clear past precedent on which litigants may have relied or by deciding an issue of first impression whose resolution was not clearly foreshadowed **(*see, e.g.*,** ***Allen v. State Board of Elections***, 393 US 544, 22 L Ed 2d 1 [where the breadth of coverage of the Voting Rights Act of 1965 to newly enacted statutory amendments involved "complex issues of first impression--issues subject to rational disagreement" whose discriminatory purpose or effect had not been determined by any court, the Court ordered that its decision be given prospective effect only]); (2) the merits of each case must be weighed by viewing the prior history of the rule in question, its purpose and effect and whether retrospective operation will further or retard its operation (***Linkletter v. Walker***, 381 US 618, 14 L Ed 2d 601), and (3) the inequity imposed by retroactive application must also be weighed, for where such decision could produce substantial inequitable results if applied retroactively, there is ample basis for avoiding the injustice or hardship by a holding of nonretroactivity (***Cipriano v.City of Houma***, 395 US 701, 23 L Ed 2d 647 [where the decision of the Supreme Court that invalidated a state statute giving only property taxpayers the right to vote in municipal utility bond approval elections, on equal protection grounds, was applied prospectively where significant hardships would be imposed on cities, bondholders, and others connected with municipal utilities if the decision was given full retroactive effect]).

Petitioner's arguments pertinent to the retroactive application of Tax Law § 1504 are couched in general terms, and reference is made generally to the retroactive application of section 1504(a), without specific reference to the inclusion of column six amounts in the section 1504(b) "premium" definition, as opposed to section 1504(d), under "receipts other than premiums." Inasmuch as the Division's attempt at inclusion of column six amounts in the allocation formula by way of section 1504(b) has been rejected herein (see, Conclusion of Law "A"), the only question to be addressed is whether section 1504(d) should be retroactively applied.

Petitioner argues that if the Division's position is accepted, inclusion of column six receipts in the section 1504(a) calculation would establish a new principle of law, or a new interpretation that was not foreshadowed by prior law. Petitioner maintains it was not the intent of the Legislature to include receipts for preannuitized benefits in the section 1504(a) calculation, nor does the failure to apply the ruling retroactively result in a taxing inequity. Lastly, petitioner points to the inequity it faces with retroactive application, where it has relied upon its own historic method of calculating the allocation percentage, which had been subjected to audit by the

Division annually. Petitioner believes that a prospective application would send the Division a message that there are limits to the exercise of discretionary authority and such powers must be exercised consistent with due process of law.

The Division first argues that petitioner's reliance on ***Chevron*** is misplaced because the Supreme Court abandoned the three-pronged test for its position in ***Harper v. Virginia Dept. of Taxation*** (509 US 86, 125 L Ed 2d 74), establishing a fundamental rule of retroactive application of judicial decisions. The Division supports this argument by noting that when the New York State Court of Appeals in ***Varrington v. New York City Dept. of Finance*** (85 NY2d 28, 623 NYS2d 534) addressed the issue of retroactivity of a regulation that amounted to a change in policy, the Court did not apply the full ***Chevron*** test, but rather noted that the question turned on a balancing of the equities, which is addressed under the third ***Chevron*** element. The Division has misinterpreted ***Harper*** on this point. Adoption by the New York courts of the ***Chevron*** analysis to resolve issues of retroactivity is not affected by the Supreme Court's decision in ***Harper,*** because ***Harper*** is limited to questions of *Federal* law (***Harper v. Virginia Dept. of Taxation, supra; NewChannels Corporation and Upstate Community Antenna, Inc***., Tax Appeals Tribunal, September 23, 1993). Thus, ***Chevron*** remains alive with respect to the retroactivity of judicial decisions as to state law. The fact that the Court of Appeals in ***Varrington*** did not apply Chevron is more likely to be because ***Varrington*** dealt with the retroactivity of a regulation and not a judicial decision. Nonetheless, absent evidence of the Court's purpose for not applying ***Chevron,*** no conclusion can be drawn from the lack of such discussion.

Under the Division's alternative argument, in its application of the ***Chevron*** factors, the Division concluded that the first element of the ***Chevron*** analysis is not satisfied, since the

Division's decision to include column six monies in the allocation formula did not establish a new principle of law, and there was no reliance on existing law superceded by a new pronouncement, since the Division has never before taken a position on the inclusion of column six receipts. Additionally, the Division argues that when it interprets a tax statute to reach certain transactions as it did in this case, its ruling is foreshadowed by the statute itself, citing ***Gurnee v. Aetna Life & Casualty Company*** (55 NY2d 184, 448 NYS2d 145, ***cert denied*** 459 US 837, 74 L Ed 2d 79). As to the second ***Chevron*** factor, the Division states that section 1504(d) by its very nature requires retroactive application because it deals with *changes* to the allocation fraction, and the Division's decision to include column six amounts in the allocation formula carries out the purpose of the statute. Turning to the final ***Chevron*** factor, the relative equities, the Division notes that its decision was not the reversal of a well-established rule or policy, and that petitioner was calculating its allocation fraction without reference to any position from the Division as to how to treat the contracts discussed herein. The Division maintains that petitioner has not adequately established any inequity, and by relying upon its own interpretation, petitioner advanced at its own risk. Along the same line, the Division notes that petitioner did not avail itself of the opportunity to request an advisory opinion regarding the receipts in question.

Addressing the merits of the ***Chevron*** factors discussed by the parties, there was no new principle of law established by the Division's inclusion of column six amounts under section 1504(d)(2). The statute has existed in that form since its enactment in 1974. Although these questions are addressed in an administrative setting, the Court of Appeals has held that a judicial decision construing the words of a statute does not constitute the creation of a new legal principle (***Gurnee v. Aetna Life & Casualty Company, supra***). The language of the statute is clear, and there is no ambiguity that a body of receipts by an insurance company, that did not meet the "premium" definition may be included as an additional factor in the allocation formula as a receipt other than a premium, if necessary to properly reflect a taxpayer's activity, business and income in the State. At the heart of petitioner's argument that the column 6 amounts were not "premiums", is that they were receipts other than premiums. Such amounts must be one or the other. Although the issue of including column 6 amounts in the allocation formula by a section 1504(d)(2) adjustment is one of first impression, the resolution of that issue, i.e., the fact that inclusion was a possibility, even a probability, as well as the financial consequences resulting therefrom, was clearly foreshadowed. The legislative memorandum pertaining to the enactment of section 1504(d) was certainly brief, but it too was clear that the purpose of the adjustment provision was to effectuate a proper result in the allocation formula, i.e., one that reflects the business, income and activity of a taxpayer within the State. Thus, the first ***Chevron*** element is not met.

As to the second ***Chevron*** test, the only history which precedes the application of Tax Law § 1504(d)(2) herein is its enactment, and the brevity of the comments pertaining thereto has already been mentioned. Regarding the purpose and effect of the provision, it is clear that the provision was to serve as a remedy in the event the allocation formula provided by section 1504(a) was not properly reflective of activity, business and income within the State. Certainly the purpose of a statute in existence, with clear language, which provides the discretion to adjust a formula such as this one, is furthered by retroactive application. Furthermore, prospective application would serve to undermine the effect of the discretion provided by the Legislature to the Division. Thus, analysis of the second element does not support nonretroactivity.

The final ***Chevron*** element addresses a "balancing of the equities." If substantial inequitable results could be the consequence of retroactive application, there may be ample basis for avoiding the injustice or hardship by a holding of nonretroactivity. The section 1504(d)(2) adjustment results in a significant additional tax liability that was, though somewhat unexpected, not unforseen given the existence of the discretionary provision in terms that were not ambiguous. The Division had never adopted or advocated a position with regard to the contracts which produced the column six receipts. Petitioner never sought a ruling which would have made the Division's position clear. The discretionary provision existed for the entire period of time that these contracts were a growing part of petitioner's business. The fact that petitioner was audited annually and such amounts were not uncovered by the Division, does not mean that the Division accepted the treatment petitioner chose. The only reliance petitioner can show is upon its own interpretation of the taxation of its column six receipts. The State has foregone tax revenue in years prior to 1990 to which it was potentially entitled, and thus the inequity to petitioner is counterbalanced by such unrealized revenue. Retroactivity of a tax statute, for a short period, is generally permitted, and has been sanctioned by the courts (***Matter of Varrington Corporation v. City of New York Department of Finance, supra*** at 536).

Having discussed the Chevron elements, it is concluded that the Division appropriately applied the section 1504(d)(2) adjustment to tax years 1990 and 1991 in this case.

D. Although ***Chevron*** is frequently discussed in the context of determining retroactivity of a *judicial decision*, its analysis to this case seems to escape legal error particularly because this matter addresses an issue of first impression. However, it may be helpful to review the issue of retroactivity in this case on the basis of the analysis developed from Supreme Court principles set forth in ***SEC v. Chenery Corp***. (332 US 194, 91 L Ed 1995).

Retroactive application of newly adopted administrative rules or interpretations is not per se arbitrary (***E.L. Wiegand Division v. National Labor Relations Board***, 650 F2d 463, ***cert***

denied 455 US 939, 71 L Ed 2d 649). Instead, retroactivity must be balanced against the mischief of producing a result which is contrary to a statutory design or to legal and equitable principles (***id.***, citing ***SEC v. Chenery, supra***). The courts must analyze whether the inequity of retroactive applications is counterbalanced by sufficiently significant statutory interests (***id.***, citing ***Retail, Wholesale and Department Store Union v. NLRB***, 466 F2d 380). In ***Retail***, based on principles derived from the Supreme Court in ***Chenery,*** the Circuit Court of Appeals enumerated the following factors to be considered in resolving the problem of retroactive application of an administrative (NLRB) holding:

> (1) whether the particular case is one of first impression, (2) whether the new rule represents an abrupt departure from well established practice or merely occupies a void in an unsettled area of law, (3) the extent to which the party against whom the new holding is applied in fact relied on the former rule, (4) the degree of the burden imposed, and (5) the statutory interest in application of this new rule (***id.*** at 390).

The five-factor analysis of ***Chenery*** is substantively no different from the three-factor analysis of ***Chevron*** (***Dole v. East Penn Manufacturing Co., Inc.,*** 894 F2d 640; ***International Association of Bridge, Structural and Ornamental Iron Workers, Local 3 v. National Labor Relations Board,*** 843 F2d 770, cert denied 488 US 889, 102 L Ed 2d 213). ***Chenery,*** however has been applied exclusively to administrative agency adjudications (***International Association of Bridge, Structural and Ornamental Iron Workers, Local 3 v. National Labor Relations Board, supra,*** citing***, E.L. Weigand Division v. NLRB***, 650 F2d 463). As noted by the Circuit Court of Appeals (the same circuit that decided ***E.L. Weigand Division v. NLRB, supra, International Association of Bridge, Structural and Ornamental Iron Workers, Local 3 v. National Labor Relations Board, supra,*** and ***Dole v. East Penn Manufacturing Co., Inc., supra***) in ***Laborers' International Union of North America, AFL-CIO v. Foster Wheeler***

Corporation (26 F3d 375), the key discrepancy between the ***Chevron*** and ***Chenery*** inquiries is that:

> Whereas Chevron Oil focuses on the reasonable expectations of the class of persons who will be adversely affected by retrospective application of the newly announced rule of law, Chenery concentrates on the actual reliance on the prior rule by the particular adversely affected party before the court . . . .This difference in application flows from the elemental dissimilarity between the two doctrines; Chevron Oil dealt with the question of pure prospectivity--i.e., whether the rule should have future effect as to all parties (citation omitted)--whereas Chenery dealt with the question of selective prospectivity--i.e., roughly, whether a rule otherwise applied retrospectively should not apply retrospectively to the particular parties before the court (citations omitted) (***id.*** at 389).

Having clarified that the result of the Division's action might have been viewed differently under a ***Chenery*** analysis, in this particular case, an independent analysis under either test would reach the same result. Turning briefly to the five factors, clearly the case is one of first impression, and perhaps even fills a void in an unsettled area of law. Certainly, it is an area of change and growth for the insurance industry, the ramifications of which are now being addressed by the Division. However, factors three, four and five do not fall in petitioner's favor in order to command prospectivity. There was no reliance on a "former rule", but rather continued interpretation of an existing statutory provision. The burdens imposed upon each of the parties have been discussed above in the balancing of equities portion of the ***Chevron*** analysis. The burdens are not overweighted in petitioner's favor. Likewise, the statutory interest in application of the rule is clear from its language--proper reflection of the activity, business or income of petitioner within the State. Accordingly, the same conclusion is reached. Retroactive application of the section 1504(d)(2) adjustment to petitioner's allocation formula for tax years 1990 and 1991 was proper.

E. The petition of Principal Mutual Life Insurance Company is hereby denied and the Notice of Deficiency dated August 22, 1994 is sustained.

DATED: Troy, New York
July 30, 1998

/s/ Catherine M. Bennett
ADMINISTRATIVE LAW JUDGE