STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition of State Farm Mutual Automobile Insurance Co.	:	AFFIDAVIT OF MAILING
for Redetermination of a Deficiency or Revision of a Determination or Refund of Franchise Tax on Insurance Corporations under Article 27 & 33 of the Tax Law for the Year 1977.	:	

State of New York }
ss.:
County of Albany }

David Parchuck, being duly sworn, deposes and says that he is an employee of the State Tax Commission, that he is over 18 years of age, and that on the 31st day of January, 1984, he served the within notice of Decision by certified mail upon State Farm Mutual Automobile Insurance C, the petitioner in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

State Farm Mutual Automobile Insurance Co.
c/o David L. Buchanan
One State Farm Plaza
Bloomington, IL 61701

and by depositing same enclosed in a postpaid properly addressed wrapper in a post office under the exclusive care and custody of the United States Postal Service within the State of New York.

That deponent further says that the said addressee is the petitioner herein and that the address set forth on said wrapper is the last known address of the petitioner.

Sworn to before me this
31st day of January, 1984.

David Parchuck

Authorized to administer oaths
pursuant to Tax Law section 174

STATE OF NEW YORK
STATE TAX COMMISSION
ALBANY, NEW YORK 12227

January 31, 1984

State Farm Mutual Automobile Insurance Co.
c/o David L. Buchanan
One State Farm Plaza
Bloomington, IL 61701

Gentlemen:

Please take notice of the Decision of the State Tax Commission enclosed herewith.

You have now exhausted your right of review at the administrative level. Pursuant to section(s) 1090 & 1519 of the Tax Law, a proceeding in court to review an adverse decision by the State Tax Commission may be instituted only under Article 78 of the Civil Practice Law and Rules, and must be commenced in the Supreme Court of the State of New York, Albany County, within 4 months from the date of this notice.

Inquiries concerning the computation of tax due or refund allowed in accordance with this decision may be addressed to:

NYS Dept. Taxation and Finance
Law Bureau - Litigation Unit
Building #9, State Campus
Albany, New York 12227
Phone # (518) 457-2070

Very truly yours,

STATE TAX COMMISSION

cc: Taxing Bureau's Representative

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition	:	
of	:	
STATE FARM MUTUAL AUTOMOBILE INSURANCE COMPANY	:	DECISION
for Redetermination of a Deficiency or for Refund of Franchise Tax on Insurance Corporations under Articles 27 and 33 of the Tax Law for the Year 1977.	:	

Petitioner, State Farm Mutual Automobile Insurance Company, One State Farm Plaza, Bloomington, Illinois 61701, filed a petition for redetermination of a deficiency or for refund of franchise tax on insurance corporations under Articles 27 and 33 of the Tax Law for the year 1977 (File No. 29456).

On August 18, 1981, petitioner waived a formal hearing and consented, in writing, to submission of this matter to the State Tax Commission.

Petitioner and the Audit Division, by their attorneys, David L. Buchanan, Assistant Tax Counsel, and Paul A. Lefebvre, Esq., respectively, executed an Agreed Statement of Facts, which is incorporated into and made a part of this decision.

ISSUES

I. Whether the portion of petitioner's 1972 underwriting income deferred for purposes of federal income taxation by the operation of Internal Revenue Code section 824(a)(1) and included in petitioner's 1977 federal taxable income by the operation of Internal Revenue Code section 824(d)(1)(D) must be included in petitioner's 1977 entire net income for purposes of the franchise tax on insurance corporations.

II. Whether petitioner's request for leave to amend its petition should be granted.

III. If so, whether salvage and subrogation proceeds relating to petitioner's pre-1974 losses incurred deduction and included in petitioner's 1977 federal taxable income must be included in petitioner's 1977 entire net income for purposes of the franchise tax on insurance corporations.

FINDINGS OF FACT

1. Petitioner, State Farm Mutual Automobile Insurance Company ("State Farm"), is a mutual insurance company incorporated in Illinois on March 29, 1922, which began business in New York on December 28, 1951.

2. On or about March 9, 1978, State Farm filed with the Audit Division an Application for 3-Month Extension for Filing Tax Return for the year 1977.

On or about June 12, 1978, State Farm filed with the Internal Revenue Service an Application for Additional Extension of Time to File Corporation Income Tax Return to September 15, 1978, which application was granted by the Service on July 12, 1978.

3. On or about September 14, 1978, State Farm filed its New York Franchise Tax Return for Insurance Corporations (Form CT-33) for the year 1977.

4. In 1972 petitioner deferred $51,067,022.00 of underwriting income pursuant to Internal Revenue Code section 824(a)(1). This is reflected in Schedule B-3 of petitioner's 1972 federal Mutual Insurance Company Income Tax Return (Form 1120M).

5. In 1972 petitioner paid a franchise tax on premiums pursuant to former section 187 of the Tax Law (repealed 1974) for the privilege of carrying on business within New York.

6. Petitioner's 1977 federal taxable income as reported on federal Form 1120M was $332,828,036.00.

For 1977 State Farm included in its federal taxable income $29,861,098.00 representing the portion of the underwriting income earned and deferred in 1972 which was required to be brought back into income by Internal Revenue Code section 824(d)(1). This amount is shown on line 3, page 1 of petitioner's 1977 Form 1120M. Petitioner subtracted this amount of $29,861,098.00 from its federal taxable income for 1977 to calculate New York entire net income pursuant to Tax Law section 1503. This computation is reflected in the difference between 1977 federal taxable income of $332,828,036.00 as reported on line 6, page 1 of Form 1120M and the amount of $302,966,938.00 reported on line 24, Schedule B (Computation of Tax and Allocation of Entire Net Income) of petitioner's 1977 Form CT-33. The difference was revealed by petitioner in Schedule 6 captioned, "Exhibit Supporting Form CT-33, Page 2, Schedule B, Item 1" attached to its 1977 Form CT-33.

7. On April 15, 1980, the Audit Division issued to State Farm a Notice of Deficiency, asserting additional taxes due under Article 33 for the year 1977 in the amount of $42,615.71, plus interest. The Audit Division included the $29,861,098.00 of Internal Revenue Code section 824(d)(1)(D) income in petitioner's entire net income and recomputed petitioner's tax liability.

8. On or about May 23, 1980, State Farm filed a petition in protest of the aforementioned deficiency.

9. The various insurance contracts State Farm writes provide that petitioner has the right to any salvage and subrogation with respect to any claims that it pays. For petitioner, as well as other casualty insurance companies, salvage consists of amounts recouped by the insurance company from the sale of damaged property to which it has taken title as a result of paying claims. Subrogation represents amounts that a casualty insurance company recovers from third

parties who are ultimately found to be legally responsible for claims it has paid. At all times, petitioner reported its salvage and subrogation using the cash receipts and disbursements method of accounting. Under this method, petitioner did not recognize any income from salvage or subrogation at the times its salvage or subrogation rights arose. Instead, and in accordance with applicable state law and procedures prescribed by the National Association of Insurance Commissioners, petitioner deferred recognition of income until actual receipt of salvage and subrogation proceeds. Thus, each year petitioner reduced its deduction for losses incurred by cash collections from salvage and subrogation during the year.

10. Petitioner is required to calculate federal taxable income and the losses incurred deduction without estimating salvage and subrogation recoverable in accordance with Continental Insurance Co. v. United States, 474 F.2d 661, 73-1 U.S.T.C. ¶9234 (Ct. Cl. 1973) and Revenue Ruling 76-487, 1976-2 C.B. 210. Since the New York franchise tax imposed before January 1, 1974 was not based on federal taxable income but rather on direct written premiums under former section 187 of the Tax Law, the losses incurred deduction did not affect the amount of franchise tax petitioner paid in the years prior to 1974. In 1977 petitioner received various salvage and subrogation proceeds with respect to its pre-1974 losses incurred deduction which totaled $3,322,921.00. These proceeds decreased petitioner's losses incurred deduction under Internal Revenue Code section 832(b)(5) and accordingly increased petitioner's federal taxable income in 1977. Petitioner did not reduce its federal taxable income by the $3,322,921.00 of salvage and subrogation in calculating New York entire net income in 1977. If entire net income had not included the aforementioned collected salvage and subrogation, entire net income would have been reduced,

and the franchise tax as reported and paid by petitioner would be reduced $4,822.00.

11. On or about July 24, 1981, State Farm filed with the State Tax Commission a request for leave to amend its petition and an amendment to its petition, seeking refund of the sum of $4,822.00 plus interest for the year 1977. Since petitioner did not receive a tax benefit from the losses incurred deduction for the years prior to 1974 for purposes of the New York franchise tax, petitioner claimed that the salvage and subrogation received in 1977 should not have been included in its 1977 entire net income.

12. After audit of petitioner's Report of Premiums for 1977 and 1978, the New York State Insurance Department determined that Schedule E, line 56 (Computation of Allocation Percentage, Total premiums) of petitioner's 1977 franchise tax report should be increased from $4,049,304,231.00 to $4,058,778,663.00, thereby decreasing petitioner's allocation percentage.

CONCLUSIONS OF LAW

A. That mutual insurance company taxable income is defined by section 821(b) of the Internal Revenue Code as the amount by which the sum of (A) the taxable investment income, (B) the statutory underwriting income and (C) the amounts required by section 824(d) to be subtracted from the protection against loss account exceeds the sum of (A) the investment loss, (B) the statutory underwriting loss and (C) the unused loss deduction.

B. That in determining statutory underwriting income, section 824(a)(1) of the Internal Revenue Code permits a deduction from underwriting income equal to the sum of (A) 1 percent of losses incurred during the taxable year, and (B) 25 percent of the underwriting gain for the year (plus an additional percentage of underwriting gain of concentrated risk companies, not relevant here). An

amount equal to the amount of said special deduction is required to be added to the protection against loss account for each taxable year, which account is available only for the purpose of offsetting losses. If the amount has not been exhausted by the end of the fifth succeeding taxable year, a certain portion thereof must be subtracted from the account and included in taxable income: "any amount remaining which was added to the account for the fifth preceding taxable year, minus one-half of the amount remaining in the account for such taxable year which was added by reason of section 824(a)(1)(B)...". Treas. Reg. §1.824-1(b)(3)(i)(d). The residue remains in the account but is subject to a ceiling. Treas. Reg. §1.824-1(b)(3)(ii).

For the year at issue, petitioner included in its federal taxable income $29,861,098.00 as required by section 824(d)(1) of the Code, but excluded such amount from its New York entire net income, as derived from transactions and insurance contracts entered in years prior to the effective date of Article 33.

C. That entire net income is defined for purposes of Article 33 as "total net income from all sources which shall be presumably the same as the... mutual insurance company taxable income... which the taxpayer is required to report to the United States treasury department, for the taxable year...". Tax Law section 1503(a).

D. That under the so-called "tax benefit" rule, as codified in the Internal Revenue Code (section 111) and judicially developed (see, e.g., Dobson v. Commissioner, 320 U.S. 489 (1943), rehearing denied, 321 U.S. 231 (1944); Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct. Cl. 1967)), gross income does not include income attributable to the recovery during the taxable year of a bad debt, prior tax or delinquency amount, to the extent such bad debt, prior tax or delinquency amount did not result in a prior

reduction of the taxpayer's tax. Treasury Regulation section 1.111-1 extends the rule of exclusion to all other losses, expenditures and accruals made the basis of deductions in prior taxable years, with the exception of depreciation, depletion, amortization and amortizable bond premiums. Thus, it has been held that where a corporation which availed itself of deductions for stamp taxes paid in 1930, obtained a judgment that the taxes had been erroneously assessed and in 1939 the amount thereof was refunded to it, the corporation was entitled to the recovery exclusion in the subsequent year. The taxpayer was a member of an affiliated group of corporations which had filed a consolidated return in 1930, reflecting a net loss for income tax purposes. Corporation of America, 4 T.C. 566 (1945).

It has also been held that taxpayers exempt from federal taxation at the time an otherwise deductible expense was incurred are eligible for tax benefit treatment. For example, where a taxpayer, which was an agricultural marketing cooperative, derived no federal income tax benefit from processing and floor stock taxes paid in 1934 and 1935 because it was at that time wholly exempt from federal taxation, refund of such taxes to it in 1953 (when it was subject to regular corporate taxes) constituted the return of capital and not taxable income. California and Hawaiian Sugar Refining Corp. v. United States, 311 F.2d 235 (Ct. Cl. 1962). See also Home Savings and Loan Co., 39 T.C. 368 (1962).

As aforesaid, in 1972, State Farm paid New York franchise tax measured by gross direct premiums and therefore realized no New York tax benefit from the federal deduction taken pursuant to section 824(a)(1) of the Internal Revenue Code. Accordingly, the recovery of this deduction in 1977 by operation of Code section 824(d)(1) did not constitute New York entire net income in that year.

While nice distinctions might be drawn between the instant case and those cited above, since petitioner herein was required by federal statute to add back the underwriting income in question, they should not be invoked to subject to Article 33 taxation in 1977 underwriting income earned prior to the effective date of said article. Moreover, paragraphs (4), (5), (6) and (7) of section 1503(b) evince a legislative intent to adjust entire net income for items of income and loss incurred prior to January 1, 1974.

E. That a petition for redetermination of a deficiency may also raise a claim for refund for the same taxable year (or years). Tax Law section 1089(b). The amendment to State Farm's petition constituted a claim for refund for 1977, founded upon exclusion from entire net income of certain salvage and subrogation proceeds. The amendment was filed over one year prior to the execution of the stipulation and the submission of petitioner's brief, thereby affording the Audit Division an opportunity to respond to the claim raised in said amendment by an answer, an answering brief or such other means as it might deem appropriate. Thus, the amendment did not work to the prejudice of the Audit Division (20 NYCRR 601.6(c)), and petitioner's request to amend its pleading is hereby granted.

F. That salvage and subrogation proceeds with respect to pre-1974 losses received by petitioner in 1977 should be excluded from 1977 entire net income in accordance with the rationale of Conclusion of Law "D". American Financial Corporation, 72 T.C. 506 (1979).

G. That the petition of State Farm Mutual Automobile Insurance Company is hereby granted; that the Notice of Deficiency issued April 15, 1980 is cancelled in full; that petitioner's claim for refund in the amount of $4,822.00 is

granted; and that petitioner's allocation percentage is to be adjusted in accordance with Finding of Fact 12.

DATED: Albany, New York
JAN 31 1984

STATE TAX COMMISSION

PRESIDENT

COMMISSIONER

COMMISSIONER