STATE OF FLORIDA
DEPARTMENT OF REVENUE

IN RE:	)	
PETITION OF	)	CASE NO. 94-4-DS
LIFE INSURANCE COMPANY OF VIRGINIA a Virginia corporation,	)	

DECLARATORY STATEMENT

Petitioner seeks a declaratory statement, concerning whether a departure from the applicable method of apportionment required under the provisions of §§220.15 or 220.151, F.S., pursuant to §220.152, F.S., will be permitted under the facts described herein. The request for Declaratory Statement was filed June 28, 1994.

ISSUE

Whether the Petitioner should be allowed to include an additional factor pursuant to §220.152(3), F.S., which modifies the apportionment method specified in §220.151(1), F.S., in order to fairly represent the taxpayer's tax base attributable to this state.

FACTS

Petitioner is a Virginia corporation, whose address is 123 North Wacker Drive, 26TH Floor, Chicago, Illinois 60606. Petitioner operates as a life insurance company under the guidance of the

National Association of Insurance Commissioners ("NAIC") and conducts business throughout the United States.

Petitioner files its federal income tax return as a member of a consolidated group and files a separate Florida Corporate Income/ Emergency Excise Tax return. Petitioner also files an NAIC Annual Statement with each of the state insurance commissioners in those states where it is licensed to do business. It is the income and expense reported in this NAIC filing which serves as the basis for computing federal taxable income, which then serves as the basis for computing Florida taxable income.

The Petitioner's Florida Corporate Income/Emergency Excise Tax returns for the years ended December 31, 1988, through December 31, 1992, were examined by the Florida Department of Revenue. In the examining agent's report, adjustments were made to Florida taxable income as a result of changes made to the method of apportioning taxable income to the State of Florida on the originally filed returns. The scope of this petition is to address the method of apportioning income on a prospective basis, that is for tax years beginning after December 31, 1992.

Included in the NAIC Annual Statement is an analysis, Schedule T, Premiums and Annuity Considerations Allocated by States and Territories. Schedule T details the premiums and annuity considerations by state and territory, in the following categories:

(1) Life Insurance Premiums;

(2) Annuity Considerations;

(3) Accident and Health Insurance Premiums (Including Policy Membership, and Other Fees); and,

(4) Deposit-Type Funds.

These premium and annuity considerations are netted against the appropriate expenses and ultimately included in net income as presented in the NAIC Annual Statement. The Department's position is that only the premiums and annuity considerations contained in the first three categories (collectively referred to as "direct premiums written") are to be considered for purposes of computing the Florida apportionment factor for life insurance companies. However, operating revenues (including net investment income earned on the premium and annuity considerations) from all four categories of premium and annuity considerations are included in apportionable "adjusted federal income". For taxable years ended December 31, 1991, 1992, and 1993, the percentage of premium and annuity considerations (as reported in Petitioner's "Schedule T - Premiums and Annuity Considerations" as illustrated at Attachments I, II, III, and IV of the petition) attributable to "Deposit-Type Funds" represented 23.19%, 37.02%, and 40.49% respectively, of total premium and annuity considerations.

The Petitioner asserts that the prescribed method of apportionment pursuant to §220.151, F.S., which excludes "Deposit-Type Funds" from the apportionment factor results in inequitable treatment for insurance companies, such as Petitioner, which write a large amount

of "Deposit-Type Fund" business. Petitioner asserts that the prescribed method of apportioning income to Florida does not fairly represent (i.e., overstates) the extent of its tax base attributable to Florida.

ANALYSIS

Section 220.15(1), F.S., provides that "[e]xcept as provided in ss. 220.151 and 220.152, adjusted federal income as defined in s. 220.13 shall be apportioned to this state by multiplying it by an apportionment fraction..." This section then goes on to articulate the "three-factor" (sales, payroll and property) apportionment methodology. Insurance companies apportion their income to Florida using a "single-factor" ("direct premiums written") methodology specified in §220.152(1), F.S., which provides that:

> (a) Except as provided in paragraph (b), the tax base of an insurance company for a taxable year or period shall be apportioned to this state by multiplying such base by a fraction the numerator of which is the direct premiums written for insurance upon properties and risks in this state and the denominator of which is the direct premiums written for insurance upon properties and risks everywhere. For purposes of this paragraph, the term 'direct premiums written' means the total amount of direct premiums written, assessments, and annuity considerations, as reported for the taxable year or period on the annual statement filed by the company with the commissioner of insurance in the form approved by the National Convention of Insurance Commissioners or such other form as may be prescribed in lieu thereof.
> (b) If the principal source of premiums written by an insurance company consists of premiums for reinsurance accepted by it, the tax base of such company shall be apportioned to this state by multiplying such base by a fraction the numerator of which is the sum of:
> 1. Direct premiums written for insurance upon properties and risks in this state, plus
> 2. Premiums written for reinsurance, accepted in respect to properties and risks in this state,

and the denominator of which is the sum of direct premiums written for insurance upon properties and risks everywhere plus premiums written for reinsurance accepted in respect to properties and risks everywhere.

Section 220.152, Florida Statutes, states that:

> If the apportionment methods of ss. 220.15 and 220.151 do not fairly represent the extent of a taxpayer's base attributable to this state, the taxpayer may petition for, or the department may require, in respect to all or any part of the taxpayer's tax base, if reasonable:
> (1) Separate accounting;
> (2) The exclusion of one or more factors;
> (3) The inclusion of one or more additional factors which will fairly represent the taxpayer's tax base attributable to this state; or
> (4) The employment of any other method which will produce an equitable apportionment.

The Petitioner asserts that it is being subjected to tax on income that is out of all proportion to the amount of business being conducted in Florida and, therefore, seeks to use one of two alternate methods of apportionment. Under Petitioner's proposed Method 1, as illustrated in Attachments XII, XIII, and XIV of its petition, the apportionment methodology is the same as set forth in §220.151, F.S., except that the meaning of "direct premiums written" is broadened so as to include amounts identified as "Deposit-Type Funds" in Column 6 of Schedule T (as illustrated in Attachments II, III, and IV of the petition). Under Petitioner's proposed Method 1, the Petitioner's 1991, 1992, and 1993 Florida apportionment factors would have been 10.39%, 17.88%, and 15.38%, respectively, versus the Department's figures (using the statutory apportionment methodology) of 13.4%, 25.66%, and 22.15%, respectively.

The Petitioner's proposed Method 2 apportionment methodology, as illustrated in Attachments XV, XVI, and XVII to its petition, involves separating Florida taxable income into two components. The first component is the percentage of income which the Petitioner asserts is attributable to "Deposit-Type Funds" (Part A) times a fraction whose numerator is "Florida Deposit-Type Funds" and whose denominator is "Deposit-Type Funds" everywhere. The second component is the percentage of income attributable to all the remaining life insurance business (Part B) times a fraction whose numerator is direct premiums written for insurance upon risks in Florida and whose denominator is direct premiums written upon risks everywhere. These two components are then added together to arrive at the apportionment factor. This apportionment factor is then multiplied by the tax base to yield apportioned Florida taxable income to which the Florida income tax rate is applied. Under this methodology, the Petitioner's 1991, 1992, and 1993 Florida apportionment factors are 7.81%, 19.88%, and 17.37%, respectively, versus the Department's figures (using the statutory apportionment methodology) of 13.44%, 25.66%, and 22.15%, respectively.

The Petitioner's assertion that the first component of Florida taxable income of its proposed Method 2 is attributable to "Deposit-Type Funds" is imprecise. The item which Petitioner identifies as "income attributable to Deposit-Type Funds" is actually "net gain from operations after dividends to policy

holders and before federal income taxes" (hereinafter "net gain from operations") attributable to annuities (see line 29, column 8 of "Analysis of Operations by Lines of Business" at attachments V, VI, and VII of the petition). "Deposit-Type Funds" is but one item of several in the "annuities" column which produces "net gain from operations" (which Petitioner imprecisely identifies as "net income from Deposit-Type Funds"). For example, "net investment income" (line 4, column 8 of "Analysis of Operations by Lines of Business") is a significant component of annuity income (39%, 25%, and 18.44% for 1991, 1992, and 1993, respectively) which generates "net gain from operations". Therefore, the income for a specified period which Petitioner calls "income from Deposit-Type Funds" which Petitioner seeks to apportion using "Deposit-Type Funds" in the apportionment factor in its proposed Method 2 is not entirely attributable to the "Deposit-Type Funds" identified on the Petitioner's related Schedule T for the same period. "Deposit-Type Funds" represent 57%, 74%, and 81% of "annuities" income which generates "net gain from operations" for 1991, 1992, and 1993, respectively.

The Florida apportionment factors computed by the Department for the Petitioner's 1991, 1992, and 1993 tax years using the statutory method were 13.44%, 25.66%, and 22.15%, respectively. For these three years, the <u>average</u> amount by which the statutory apportionment factor computed in accordance with §220.151, F.S., exceeds the Petitioner's proposed Method 1 and Method 2 is 5.87%

(20.42% minus 14.55%) and 5.4% (20.42% minus 15.02%), respectively. Alternatively, this variance can be expressed in the following manner: the Department's method is 40.34% (20.42% vs. 14.5%) greater than Petitioner's proposed Method 1 and 35.9% (20.42% vs. 15.02%) greater than Petitioner's proposed Method 2.

In Norfolk & W.R. Co. v. Missouri State Tax Com., 390 U.S. 317 (1968) [hereinafter, Norfolk], the Court found the application of the apportionment formula unconstitutional where the taxing State imposed an ad valorem property tax on the railroad rolling stock, using the familiar single-factor mileage formula apportionment basis. The taxpayer presented evidence showing that the actual inventory of rolling stock in Missouri on tax day was less than half (approximately $7,600,000 versus assessed value of $19,981,000) the value assessed using Missouri's apportionment formula. The taxpayers further demonstrated that their calculation of the tax-day value was representative of the value of rolling stock located within the state throughout the year and in the preceding year. The Court in Norfolk (p. 329) noted that it is not necessary for a state to demonstrate that its use of the mileage formula yields an exact measure of value. However, the Court further stated that:

> [w]hen a taxpayer comes forward with strong evidence tending to prove that the mileage formula will yield a grossly distorted result in its particular case, the State is obliged to counter that evidence or to make the accommodations necessary to assure that its taxing power is confined to its constitutional limits. If it fails to do so and if the record shows that the taxpayer has sustained the burden of proof to show that the tax is so

excessive as to burden interstate commerce, the taxpayer must prevail.

The Court in Norfolk found that the taxpayer sustained its burden and that Missouri had in this case exceeded its constitutional power to tax, as defined by the Due Process and Commerce Clauses. As noted infra, the three-year average apportionment percentage used by Florida for Petitioner's tax years 1991, 1992, and 1993 is only 40.34% (20.42% vs. 14.55%) greater than Petitioner's proposed Method 1 and only 35.95% (20.42% vs. 15.02%) greater than Petitioner's proposed Method 2. In Norfolk (p. 327), the taxpayer was able to demonstrate that the state's apportionment formula:

> resulted in postulating that N & W's rolling stock in Missouri constituted 8.2824% of its rolling stock. But appellants showed that the rolling stock usually employed in the State comprised only about 2.71% by number of units (and only 3.16% by cost-less-depreciation value) of the total N & W fleet.

In Norfolk the difference between the State's apportionment percentage (8.2824%) and either of the taxpayer's proposed apportionment percentages of 2.71% or 3.16% was 205.62% or 162.1%, respectively. Furthermore, Norfolk is a property tax case using a single-factor apportionment formula whereby all the rolling stock of a railroad is apportioned by a formula which has as the numerator the number of miles of railroad within the state over the number of miles of railroad controlled by the railroad everywhere. It was a relatively easy matter for the taxpayer to conduct a physical inventory of its rolling stock located in the state and compare it with the value determined using Missouri's apportionment

formula. However, the apportionment of income of an insurance company is more abstract and, therefore, less amenable to the type of presentation used by the taxpayer in Norfolk to overturn Missouri's apportionment method as it was applied to them in its particular case.

In Hans Rees' Sons, Inc. v. North Carolina Ex Rel. Maxwell, 283 U.S. 123 (1931) [hereinafter, Hans Rees'], the State of North Carolina attempted to apportion income of a manufacturing concern using a formula based on the ratio of the value of the taxpayer's real and tangible personal property located in North Carolina over the value of its real and tangible real property located everywhere times its entire income. The taxpayer was able to demonstrate that such a one-factor (property) apportionment formula "operated unreasonably and arbitrarily" in attributing income to the state that was "out of all proportion" to the taxpayer's activities in the state. The type of distortion present in Hans Rees' is largely remedied today by use of a three-factor apportionment formula which provides a better measure of the activities of a manufacturing or mercantile business in a state. The three factors now generally used by states to apportion income of a manufacturing or mercantile business (like the taxpayer in Hans Rees') to their state are sales, property, and payroll. The income of insurance companies, however, is generally apportioned by use of a one-factor formula that uses "direct premiums written" in the state in the numerator over "direct premiums written" everywhere in the denominator.

Indeed, the Petitioner is not arguing that the one-factor formula is distortive but rather is seeking to have the formula include, in the numerator and denominator, "Deposit-Type Funds" in addition to the three categories of "direct premiums written" which are presently a part of Florida's apportionment formula.

The "Deposit-Type Funds" that the Petitioner seeks to include in the apportionment formula are deposits by policy holders or contract holders which will, in large part, be used to purchase "annuity considerations" in the future or they are funds deposited by a contract holder with the insurer to be invested and, at a later date, either withdrawn or converted into a life or annuity contract. The deposits by policy holders are essentially prepayments and as such represent both an asset and liability to the Petitioner. Therefore, the portion of the "Deposit-Type Funds" which represent prepayments should, at a later date, be reflected in one of the three categories of "direct premiums written" now used by the Department in its apportionment formula. Furthermore, it is likely that some of the "Deposit-Type Funds" which represent deposits by contract holders will be converted into life or annuity contracts at a later date and at such time should, also, be reflected in one of the three categories of "direct premiums written" now used by the Department in its apportionment formula. Accordingly, it appears that some of what are presently categorized as "Deposit-Type Funds" should be included, at a later date, in one of the three categories of "direct premiums written" now used by

the Department in its apportionment formula. To include "Deposit-Type Funds" currently in the apportionment formula double-counts these funds to the extent they are later converted into one of the three categories of "direct premiums written" now used by the Department in its apportionment formula. Therefore, it would be premature, duplicative, and distortive to include such "Deposit-Type Funds" in Florida's apportionment formula. Since some of the "Deposit-Type Funds" are, over time, converted into one of the three "direct premium written" categories included in Florida's apportionment formula, these "Deposit-Type Funds" are largely reflected in Florida's apportionment formula in subsequent reporting periods.

Also, even if none of the "Deposit-Type Funds" converted over time into one of the three "direct premium written" categories included in Florida's apportionment formula, the average percentage of "Deposit-Type Funds" to the total of "Deposit-Type Funds" plus the three "direct premium written" categories included in Florida's apportionment formula is only 33.57% for the taxable years ending December 31, 1991, 1992, and 1993. As demonstrated earlier, the variance between either of the taxpayer's proposed apportionment methods and the Department's statutory apportionment method are relatively small when compared to the variance demonstrated by the taxpayer in Norfolk. Accordingly, even if none of the "deposit-Type Funds" converted into one of the three "direct premium written" categories (an implicit assumption in both of the

Petitioner's proposed methods), the exclusion of "Deposit-Type Funds" from Florida's apportionment formula does not result in inequitable treatment for the Petitioner by overstating the extent of its tax base attributable to Florida. Therefore, the statutory apportionment method does fairly apportion the Petitioner's income to Florida.

CONCLUSION

Based on the foregoing analysis it is determined that the Petitioner has not demonstrated that the applicable apportionment formula, as specified in §220.151, F.S., leads to a grossly distorted result, results in extraterritorial values being taxed, or operates unreasonably and arbitrarily in attributing to Florida a percentage of income which is out of all proportion to business transacted in Florida. Accordingly, the Petitioner is not authorized to use either of the two methods (Method 1 and Method 2) of apportionment proposed in its petition.

JUDICIAL REVIEW

Any party whose substantial interests are determined by this Declaratory Statement has the right to seek judicial review of the Declaratory Statement pursuant to s. 120.68, F.S., by filing a Notice of Appeal pursuant to Rule 9.110, Florida Rules of Appellate Procedure, with the Clerk of the Department in the Office of the

General Counsel, Room 202, Carlton Building, Tallahassee, Florida 32301, and by filing a copy of the Notice of Appeal accompanied by the applicable filing fees with the appropriate District Court of Appeal. The Notice of Appeal must be filed within thirty (30) days of the date this Declaratory Statement is filed with the Clerk of the Department.

DONE AND ORDERED this 14th day of October, 1994, at Tallahassee, Leon County, Florida.

L. H. Fuchs
Executive Director

Filed with the Agency Clerk and served on the parties this 14th day of October, 1994.

Agency Clerk

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