STATE OF NEW YORK

TAX APPEALS TRIBUNAL

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| In the Matter of the Petition | : | |
| of | : | |
| **FRIESCH-GRONINGSCHE HYPOTHEEK BANK REALTY CREDIT CORPORATION** | : | DECISION |
| for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Year 1984. | : | |

The Division of Taxation (the "Division") filed an exception to the determination of the Administrative Law Judge issued on December 21, 1989 granting the motion for summary determination filed by Friesch-Groningsche Hypotheek Bank Realty Credit Corporation, 342 Madison Avenue, New York, New York 10173, with respect to the petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the year 1984 (File No. 806461). Petitioner appeared by Breed, Abbott & Morgan (Edward H. Hein, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (James Della Porta, Esq., of counsel).

The Division filed a brief in support of its exception. Petitioner filed a responding brief to the exception. Oral argument was heard at the Division's request on May 25, 1990.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

## *ISSUES*

I. Whether it has been sufficiently established that there exists no material and triable issue of fact so that the Administrative Law Judge properly granted petitioner's motion for summary determination under 20 NYCRR 3000.5(c)(1).

II. Whether the Administrative Law Judge properly concluded that the conduit exception to Tax Law § 208(9)(b)(5) must be applied until February 1985.

## *FINDINGS OF FACT*

We find the facts as determined by the Administrative Law Judge and make additional findings of fact. The Administrative Law Judge's findings of fact and the additional findings of fact are set forth below.

Petitioner, Friesch-Groningsche Hypotheek Bank Realty Credit Corporation, a Delaware corporation formed February 13, 1981 and doing business in New York, is engaged in the business of mortgage lending.

Petitioner's parent corporation, Friesch-Groningsche Hypotheek Bank N.V., owned 90% of petitioner's issued and outstanding stock from its inception until September 1984.

Another corporation, FGH-Finance N.V., whose stock is entirely owned by petitioner's parent, was formed for the purpose of providing financing to the parent company and its affiliates.

During the years 1981 through 1984, FGH-Finance borrowed funds from independent banks and other lending sources which were lent to petitioner. These funds were subsequently loaned by petitioner to mortgagees.

On April 11, 1988, the Division of Taxation issued to petitioner, Friesch-Groningsche Hypotheek Bank Realty Credit Corporation notices of deficiency in the amounts of $723,088.00 and $122,925.00 plus interest and penalty. Of these deficiencies, $694,355.00 and $118,040.00, respectively, are attributable to an audit adjustment adding to entire net income 90% of interest paid or accrued by petitioner during the first eight months of 1984 to FGH-Finance N.V. Petitioner concedes it owes the difference of $33,618.00 and this amount is not in issue.

Both parties have agreed to stipulate that the conduit criteria set forth in two advisory opinions issued by the former State Tax Commission (TSB-H-81[20]C; TSB-H-81[21]C) have been met for 1984.

In addition to the facts found by the Administrative Law Judge, we find the following:

The Division had a long standing policy of recognizing an exception to the addback requirement of section 208(9)(b)(5). Where a "stockholder" of a corporation borrowed money from an unrelated source, and subsequently lent the borrowed funds to such corporation, some or all of the interest paid to such "stockholder" by that corporation was deemed to have been paid merely as a conduit, and the addback provisions of section 208(9)(b)(5) of the Tax Law were not applied. Recognition of the conduit exception began in the 1950's and was originally limited to a finance company and its subsidiary. Over the years the Division expanded the application of the theory to a larger number of transactions and specified criteria which had to be met by a taxpayer seeking the benefit of the Department's policy.

On audit, petitioner was allowed the benefit of the conduit exception for the years 1982 and 1983 and was not required to add back interest on petitioner's borrowings from its affiliates for these years. However, for the period commencing January 1, 1984, 90% of such interest was required to be added back.

***OPINION***

Underlying the instant controversy is Tax Law § 208(9)(b)(5) which states, in pertinent part:

> "Entire net income shall be determined without the exclusion, deduction or credit of:
>
> * * *
>
> (5) ninety per centum of interest on indebtedness directly or indirectly owed to any stockholder or shareholder (including subsidiaries of a corporate stockholder or shareholder), or members of the immediate family of an individual stockholder or shareholder, owning in the aggregate in excess of five per centum of the issued capital stock of the taxpayer...."

This provision disallows 90% of a corporation's Federal deduction for interest paid or accrued on indebtedness to a "shareholder" owning more than 5% of the stock of that company, with several exceptions inapplicable in this case.

As stated in the facts, for a long period of time the Division recognized an exception to this addback requirement. However, in TSB-M-83(24)C, the Division changed its policy and rejected the use of the conduit exception in the following manner:

> "On several occasions in the past, taxpayers have requested a full deduction for such interest where it was found that a more than 5% shareholder of a corporation (usually a parent corporation) had borrowed money solely to re-lend to such corporation (usually a subsidiary corporation) so that the interest paid by such corporation to the shareholder was considered to have been 'passed through' the shareholder, as through a 'conduit', to the outside lender. Since such interest does not fall within the ambit of the exceptions to the add back rule, it must be added back pursuant to section 208.9(b)(5) of the Tax Law.
>
> "To the extent any prior publications of this Department are not in accord with the foregoing statements, they are overruled."

In the matter before us, the Administrative Law Judge ruled that the Division could not deny petitioner the benefit of the conduit exception for the calendar year 1984. Procedurally, the Administrative Law Judge granted petitioner's motion for summary determination after a hearing on the motion and the submission of supporting affidavits from the Division. With respect to the merits of this case, the Administrative Law Judge determined that Technical Services Bureau Memoranda (hereinafter "TSB-M") fall within the exception delineated in State Administrative Procedure Act § 102(2)(b)(iv). The Administrative Law Judge held that this provision insulated TSB-M-83(24)C and its repudiation of the conduit exception from the formal notification requirements mandated by State laws. The Administrative Law Judge also determined that the State Tax Commission sanctioned the conduit policy as a permissible exception to Tax Law § 208(9)(b)(5) in Matter of Mix 'N' Match of Miami (State Tax Commn., January 18, 1985) and that this decision was the first official pronouncement of the effective date for the discontinued recognition of that policy. The Administrative Law Judge concluded that since Mix 'N' Match was made public on February 5, 1985, that was the earliest date that discontinuance of the conduit exception was to be recognized. Thus, petitioner was entitled to the use of the conduit exception for 1984.

On exception, the Division maintains that the procedural prerequisites for granting summary determination motion have not been met. Specifically, the Division points out that there are factual questions relating to whether petitioner had in fact detrimentally relied on the Department's previous policy. On this basis, it asserts, it was improper for the Administrative Law Judge to grant petitioner's motion for summary determination and to reach a decision on

the merits in the absence of an administrative hearing. The Division also argues that its refusal to recognize an exception to the interest addback rule is a correct interpretation of Tax Law § 208(9)(b)(5) because it is consistent with the clear language of the statute and its legislative intent. Finally, the Division contends that there is no basis for estopping it from changing its policy to require the addback.

Petitioner in response argues that its motion for summary determination was appropriately granted as no material, triable issues of fact have been identified by the Division. Turning to the merits of the case, petitioner asserts that the Division's repudiation of the conduit principle is contrary to law. Petitioner also contends that the Technical Services Bureau Memorandum at issue (TSB-M-83[24]C) is of no legal effect. Petitioner insists that the instant case does not involve an issue of estoppel but one of New York administrative law. Citing Mix 'N' Match, petitioner argues that repudiation of the conduit principle should not be retroactively applied. Since the record contains unrefuted evidence that TSB-M-83(24)C was not published until well into 1984, petitioner asserts that it cannot be applicable prior to that date.

We modify the determination of the Administrative Law Judge.

The first issue before us is whether the motion for summary determination was properly granted. The procedure for summary determination is described in section 2006(6) of the Tax Law and in the Tribunal's rules of practice at 20 NYCRR 3000.5(c). These provisions required the Administrative Law Judge to grant the motion for summary determination if she found, upon all the papers and proof submitted, that no material and triable issue of fact was presented.

In essence, the Division argues that the Administrative Law Judge's legal conclusion requires as a material fact that petitioner detrimentally relied on the conduit policy in 1984. Since this fact was not even asserted in the papers before the Administrative Law Judge, the Division argues that it is a triable issue of fact and that summary determination was inappropriate.

We do not agree that the fact of petitioner's detrimental reliance on the policy was material to the Administrative Law Judge's legal conclusion. The issue before the

Administrative Law Judge was when did the Division effectuate its change of policy and abandon the conduit exception. This is the issue because of the principle that the Division is free to change its interpretation of the Tax Law based on "new wisdom born of experience", but such a change can be prospective only (see, Matter of National Elevator Indus. v. New York State Tax Commn., 49 NY2d 538, 427 NYS2d 586, 591). Once the policy of the Division is established, petitioner is entitled to be treated in accordance with this policy without establishing that it detrimentally relied on the policy (see, Matter of Howard Johnson Co. v. State Tax Commn., 65 NY2d 726, 492 NYS2d 11).

Our analysis indicates that the Administrative Law Judge's determination that the conduit policy must be applied to petitioner for the year 1984 was based on her conclusion as to two material facts: 1) that TSB-M-83(24)C, announcing the abandonment of the conduit policy, was not issued to the public until March 1984 at the earliest and 2) that the decision in Mix 'N' Match was issued on February 5, 1985 and contained the first statement of the January 1, 1984 effective date for the abandonment of the conduit policy. To determine if summary determination was properly granted, we must then determine whether there was any triable issue raised with respect to these facts on the record before the Administrative Law Judge (Tax Law § 2006[6]).

With respect to the publication date of the TSB-M, petitioner, through its president, pleaded in paragraph 13 of its petition: "TSB-M-83(24)C bears the date September 30, 1983, but was not issued before March 1984. CCH New York State Tax Reporter Paragraph 9-928." In an affidavit in support of petitioner's motion, petitioner's representative stated that true copies of material published in the New York Tax Services of Commerce Clearing House were attached (Affidavit of Edward H. Hein, ¶ 4). These attachments stated that TSB-M-83(24)C was issued March 1984.

Tax Law § 2006(6) provides that the motion for summary determination shall be denied if any party shows facts sufficient to require a hearing of any issue of fact. In its answer to the petition, the Division responded to petitioner's allegation that TSB-M-83(24)C was not issued

until March 1984 as follows: "LACKS knowledge or information sufficient to form a belief as to the truth of the factual allegations contained in paragraphs ...(13)..." (Division's answer ¶ 11). In its affidavit in response to petitioner's motion for summary determination, the Division does not amplify this point: it merely states that the TSB-M-83(24)C was dated September 30, 1983 without mentioning when it was actually issued. Further, this point is not addressed in any of the affidavits submitted by the Division after the oral argument on the motion before the Administrative Law Judge.

With respect to the Mix "N" Match decision, petitioner asserted in its petition that:

> "In Petition of Mix 'N' Match of Miami, Inc., dated January 18, 1985 and published as TSB-H-85(6)C dated February 5, 1985, the State Tax Commission held that the Audit Division's refusal to continue to recognize the 'conduit' or 'pass-through' theory should not be applied to payments of interest made or accrued prior to January 1, 1984 '[i]nasmuch as petitioner and numerous other corporations have structured their loan arrangements to comply with established Audit Division policy...'" (Petitioner's petition ¶ 14).

In response, the Division did not deny any of the facts in this paragraph and stated "[a]dmits so much of paragraph (14) of Attachment, which reflects the language of the State Tax Commission decision in Matter of Petition of Mix 'N' Match of Miami, Inc., TSB-H-85(6)(c)" (Division's answer, ¶ 8). Subsequently, the Division acknowledged that the Mix "N" Match decision was signed on January 18, 1985 and published by the Taxpayer Services Division Technical Services Bureau on February 5, 1985 (Division's Affidavit in Opposition, p. 19).

We conclude that on this record the Administrative Law Judge correctly found that the facts necessary to her legal conclusion were not in issue. With respect to the date that the Mix "N" Match decision was issued, this conclusion is indisputable because the Division agreed with the fact. With respect to the date the TSB-M was published, we conclude that the Division's statement that it lacked sufficient information to form a belief was not a sufficient denial to make the fact controverted and summary determination inappropriate. Under CPLR

3212[1], merely pleading ignorance of the facts alleged by the moving party is not sufficient to defeat the motion for summary judgment, unless the ignorance was unavoidable, e.g., the information is exclusively within the knowledge of the movant (Overseas Reliance Tours & Travel Serv. v. Sarne Co., 17 AD2d 578, 237 NYS2d 416). Thus, if information is available from public records or third parties to contradict the fact alleged by the movant, a claim of ignorance based on the opponent's inaction will not be sufficient to place the fact in controversy (Kenworthy v. Town of Oyster Bay, 116 AD2d 628, 497 NYS2d 712). Where, as here, the fact asserted - the publication date of TSB-M-83(24)C - was exclusively in the knowledge of the opponent of the summary determination, it seems particularly clear that a mere statement of lack of information should not be allowed to defeat the motion for summary determination. Further, no where in the record before the Administrative Law Judge does the Division assert or offer any evidence tending to show that TSB-M-83(24)C was issued prior to March 1984. Although the Division has asserted this fact on exception, it has not identified any basis for this assertion in the material presented to the Administrative Law Judge. Accordingly, we conclude that the Administrative Law Judge properly concluded that the fact that the TSB-M was not issued until March 1984 was not controverted and could form the basis for a motion for summary determination.

We must next decide if the Administrative Law Judge's legal conclusion, that the conduit exception had to be recognized at least until February 5, 1985, because this was the first public announcement of the January 1, 1984 effective date, is correct. This conclusion is clearly based on the idea that the Division could not abandon the conduit exception until it explicitly stated the effective date for the abandonment.

We disagree with the Administrative Law Judge's reasoning and believe that the issuance of TSB-M-83(24)C in March 1984 was sufficient to announce the Division's change of policy on the conduit exception. Although this document can be criticized for its omissions (i.e., it

[1]Since the language of section 2006(6) of the Tax Law defines the motion for summary determination in language that closely follows CPLR 3212, it is appropriate to look to case law under the latter for guidance.

fails to explicitly acknowledge that the Division had previously accepted the conduit exception and it does not state the effective date for the change of policy nor the transitional rules to implement the new policy), we conclude that it performed the basic function of advising taxpayers that they could not continue to rely on the Division's policy of accepting the conduit exception. Further, the TSB-M on its face suggests at least an immediate effective date, as of March 1984, since it is dated September 30, 1983. The immediate effective date is also indicated by the concluding sentence of the TSB-M which states that any prior publications of the Division are overruled to the extent they are inconsistent with the TSB-M. Since we find nothing that requires the Division to provide a future effective date for a policy change, we conclude that the issuance of TSB-M-83(24)C in March 1984 was effective to remove the conduit principle as an exception to the interest addback requirement of section 208(9)(b)(5) of the Tax Law beginning April 1, 1984 and, therefore, interest paid or accrued on or after such date is subject to the addback requirement.

As revealed by the above discussion, we do not accept petitioner's contention that the Division's change in its interpretation of Tax Law § 208(9)(b)(5) was contrary to law. Petitioner argues that the conduit principle is an integral part of the substance over form approach commonly invoked by the courts to characterize transactions for tax purpose. As a result, petitioner argues, the Division is required as a matter of law to recognize the conduit exception to the addback requirements of Tax Law § 208(9)(b)(5).

We disagree. In instances where the transaction falls "within the form which the statute has made taxable, it is no answer to say that it is indistinguishable in substance from a transaction in a different form which could have accomplished the same result in a non-taxable manner" (Sverdlow v. Bates, 283 App Div 487, 129 NYS2d 88). Moreover, the substance over form doctrine cannot be invoked by the taxpayer where the language of the governing statute plainly indicates that form should control (see, Matter of W.H. Morton & Co. v. New York State Tax Commn., 91 AD2d 1080, 458 NYS2d 91, affd 59 NY2d 690, 463 NYS2d 437; Matter of Ter Bush & Powell, Inc. v. State Tax Commn., 58 AD2d 691, 395 NYS2d 762, lv denied 43

NY2d 644, 402 NYS2d 1025). Tax Law § 208(b)(5) unambiguously provides for the addback of 90% of any interest paid on indebtedness owed to related shareholder-creditors for computing the entire net income on which this State's franchise tax is based. Related creditors are clearly defined to include a corporate stockholder, including subsidiaries of a corporate stockholder, owning in the aggregate more than 5% of the issued capital stock of the taxpayer (Tax Law § 208[b][5]). In enacting these specific provisions, the Legislature intended that the form rather than substance of a transaction should govern its tax consequences (see, New York State Legislative Commission on the Modernization and Simplification of Tax Administration and the Tax Law, the Article 9-A Franchise Tax; the Interest Addback Rule, Staff Report, January 20, 1984, 51 Alb L Rev 524 [1987]).

Petitioner also contends that TSB-M-83(24)C failed to comply with the procedural requirements for its publication as stated in the State Constitution, State Administrative Procedure Act and the State Executive Law. Since the memorandum was not duly promulgated and filed in accordance with New York law, petitioner asserts, it must be deemed a legal nullity. We cannot agree.

Technical Services Bureau Memoranda are statements of an informational nature issued to advise taxpayers of significant changes in the law, to disseminate the Division's interpretation of the Tax Law, and to notify the public of current audit policy and guidelines (see, Developing and Communicating Interpretations of the Tax Laws: A Report to the Governor and the Legislature Reviewing Department of Taxation and Finance Policies and Practices, March 1989, at 20). As such, they clearly come within the exception of "forms and instructions, interpretative statements and statements of general policy which in themselves have no legal effect but are merely explanatory" specifically excluded from the formal promulgation requirements governing rulemaking by administrative agencies (State Administrative Procedure Act § 102[2][b][iv] [emphasis added]; see, Matter of Hawkes v. Bennett, 155 AD2d 766, 547 NYS2d 704; Leichter v. Barber, 120 AD2d 776, 501 NYS2d 925). To be sure, because TSB-M-83(24)C does not meet the statutory notice and filing requirements, it cannot, in and of itself,

purport to have any definitive legally binding effect. However, to the extent that the memorandum states a correct and straightforward interpretation of the governing statute, we hold that the Technical Services Bureau Memorandum constitutes an effective administrative vehicle for informing taxpayers of the change.

Relying on Matter of Charles A. Field Delivery Serv. v. Roberts (66 NY2d 516, 498 NYS2d 111), petitioner also argues that TSB-M-83(24)C is invalid as a means to effectuate a policy change because it does not state the reasons for the change. We disagree. In the memorandum at issue, the Division states that the interest paid or accrued on indebtedness in a "conduit" situation "does not fall within the ambit of the exceptions to the addback rule [and therefore] must be added back pursuant to section 208.9(b)(5) of the Tax Law." It can hardly be more plain that the reason for the Division's withdrawal of its previously recognized conduit doctrine was that it was inconsistent with the explicit language of the statute. As we have discussed earlier, the Division's new policy represents a reasonable interpretation of the statute consistent with New York's mechanical approach to the governing section.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is granted to the extent that interest petitioner paid or accrued on or after April 1, 1984 is subject to the addback requirement of section 208(9)(b)(5) of the Tax Law but is otherwise denied;

2. The determination of the Administrative Law Judge is modified to the extent indicated in paragraph "1" above but is otherwise affirmed;

3. The petition of Friesch-Groningsche Hypotheek Bank Realty Credit Corporation is denied to the extent indicated in paragraph "1" above but is otherwise granted; and

4. The Division of Taxation is directed to modify the notices of deficiency dated April 11, 1988 in accordance with paragraph "1" above but such notices are otherwise sustained.

DATED: Troy, New York
December 28, 1990

/s/John P. Dugan
John P. Dugan
President

/s/Francis R. Koenig
Francis R. Koenig
Commissioner

/s/Maria T. Jones
Maria T. Jones
Commissioner