STATE OF NEW YORK

TAX APPEALS TRIBUNAL

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| In the Matter of the Petition | : | |
| of | : | |
| **KNOTT HOTELS CORPORATION** | : | DECISION<br>DTA No. 806535 |
| for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1977 through 1980. | : | |

Petitioner Knott Hotels Corporation, 1973 Friendship Drive, El Cajon, California 92020, filed an exception to the determination of the Administrative Law Judge issued on August 20, 1992. Petitioner appeared by Price Waterhouse (John J. Fielding, C.P.A.). The Division of Taxation appeared by William F. Collins, Esq. (Anne W. Murphy, Esq., of counsel).

Petitioner submitted a brief in support of its exception. The Division of Taxation filed a brief in opposition. Petitioner filed a reply brief. Petitioner's request for oral argument was granted. A letter from petitioner withdrawing its request for oral argument was received by the Secretary to the Tribunal on April 9, 1993, which date began the six-month period for the issuance of this decision.

Commissioner Dugan delivered the following decision. Commissioner Koenig concurs.

## *ISSUES*

I. Whether the payment of rent and real estate taxes by petitioner as guarantor for its subsidiary under a lease agreement are properly classified as business expenses or amounts directly or indirectly attributable to petitioner's investment in its subsidiary.

II. Whether petitioner may be permitted to include its foreign subsidiary in its combined franchise tax return filed for the year 1976.

## *FINDINGS OF FACT*

We find the facts as determined by the Administrative Law Judge except for finding of

fact "7" which has been modified. The Administrative Law Judge's findings of fact and the modified finding of fact are set forth below.

On March 27, 1986, the Division of Taxation (hereinafter the "Division") issued to petitioner, Knott Hotels Corporation, four notices ofdeficiency. The notices pertained to the fiscal years ended December 31, 1977, October 31, 1978, October 31, 1979 and October 31, 1980 and set forth tax deficiencies of $25,602.00, $23,012.00, $46,126.00 and $126,146.00, respectively. The notices were based upon an audit of petitioner in which certain business expenses classified by petitioner as "bad debts" were disallowed by the Division and reclassified as losses from subsidiary capital and added back to petitioner's entire net income.

The Bureau of Conciliation and Mediation Services' Conciliation Order, dated October 28, 1988, reduced petitioner's tax liability for the fiscal years ended October 31, 1979 and October 31, 1980 to $37,822.00 and $113,471.00, respectively. The reductions were based upon petitioner's subsequently filed amended Federal income tax return for the year 1977 showing a lesser Federal taxable income than that shown on the original 1977 return. The original return was used by the Division in computing the amount of tax due for that year.

Petitioner was incorporated in the State of Delaware in 1927. Its headquarters are located in El Cajon, California and, at all relevant times herein, it has been involved in the business of operating hotels throughout the United States, including New York State.

Through the period ended December 31, 1977, petitioner filed on a combined basis in New York State with its subsidiaries doing business in New York. During 1977, the subsidiaries were merged into Knott Hotels and petitioner subsequently filed on a separate, non-combined basis. Knott Hotels, in turn, is a subsidiary of Trusthouse Forte, Inc., and it files on a consolidated basis with that corporation for Federal purposes.

Prior to the merger of the affiliated corporations into Knott Hotels, petitioner owned a corporation entitled The Westbury Chicago, Inc. ("Westbury"). On October 21, 1971, Westbury, as lessee, entered into a Lease Agreement with Lake Shore National Bank, as lessor.

On the same date, petitioner entered into a Guaranty Agreement with the lessor, whereby it guaranteed the performance of Westbury under the Lease Agreement, including the payments of real estate taxes and rental payments. During 1976, as a result of Westbury's failure to meet its obligation under the Lease Agreement, petitioner became responsible for $2,008,000.00 in real estate taxes and rental payments under the Guaranty Agreement. Petitioner classified these payments as business expenses in computing its 1976 Federal taxable income and New York State entire net income. In 1976, petitioner had incurred net operating losses which were carried forward to the fiscal years in issue.

On audit, the Division reduced the net operating loss incurred in 1976 by disallowing the business expenses claimed for the payment of the real estate taxes and lease payments pursuant to the Guaranty Agreement. The Division classified the payments as losses from subsidiary capital and added the amount back to Federal taxable income in computing petitioner's entire net income for 1976.

At the commencement of the hearing held on December 11, 1990, petitioner requested for the first time that Westbury be permitted, for the year 1976, to file on a combined basis with Knott Hotels and the other subsidiaries that operated in New York State.

We modify finding of fact "7" of the Administrative Law Judge's determination to read as follows:

> Following the taking of testimony and documentation during the hearing commenced on December 11, 1990, the record of this matter was left open to provide both parties with an opportunity to present additional documentation concerning the issues involved and to request that the hearing be reconvened to present additional testimony. The hearing was rescheduled for May 7, 1991, adjourned to allow the parties additional time to submit and review documentation relating to the combined reports issue and rescheduled again for September 23, 1991.
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> During a telephone conversation one week prior to the hearing date, the representatives for both parties advised the Administrative Law Judge that they did not wish to introduce any further evidence into the record of this matter. In a letter dated September 23, 1991, the Administrative Law Judge advised the representatives of both parties that the record of this matter was closed. Specifically, the letter, in its entirely, read as follows:
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> "Dear Mr. Fielding and Ms. Murphy:

"Pursuant to our telephone conversations of last week, this letter will serve to confirm that the hearing scheduled for September 23, 1991 at 1:15 PM has been adjourned. In addition, as the parties have indicated to me that they do not wish to introduce any further evidence, I have closed the record in this matter. Prior to closing the record, the New York State Corporation Franchise Tax Reports of Knott Hotels Corporation for the periods ended December 1977 and October 1978 were marked as petitioner's Exhibit 4 and made a part of the record.

"The parties will file concurrent briefs by November 1, 1991 and concurrent reply briefs by December 6, 1991. Due to the amount of time which has already passed since this matter was heard, I will only grant an extension for the filing of briefs under the most compelling of circumstances."

On February 3, 1992, petitioner submitted with its reply brief six exhibits relating to the issues at hand. As the record of this matter was closed on September 23, 1991, these six exhibits have not been admitted into evidence nor considered in making this determination.[1]

## *OPINION*

The Administrative Law Judge determined that petitioner's payment of real estate taxes and rental payments as guarantor under a lease agreement are amounts which represent expenses which are directly or indirectly attributable to subsidiary capital or are amounts representing income, gains or losses related to subsidiary capital. Accordingly, the amounts should be added back to petitioner's Federal taxable income to determine petitioner's entire net income for purposes of petitioner's New York franchise tax.

The Administrative Law Judge also determined that petitioner was not entitled to file on a combined basis with its foreign subsidiary since petitioner failed to prove that it complied with the criteria in the Division's regulations concerning combined reporting. In this context, the Administrative Law Judge declined to consider documentation submitted by petitioner concerning the issue of combined basis reporting on the grounds that it was submitted after the record was closed.

The Administrative Law Judge also determined that petitioner's reliance upon Matter of Autotote Ltd. (Tax Appeals Tribunal, April 12, 1990) was misplaced since in Autotote, the

[1]We modified this finding of fact to show exactly what the Administrative Law Judge communicated to the parties concerning the closing of the record.

taxpayer was the subject of an audit in which its business activities were examined and its intercorporate dealings with its subsidiaries scrutinized. Here, the Administrative Law Judge concluded the field audit conducted by the Division did not encompass an in-depth analysis of the intercorporate relationship between petitioner and its subsidiary, Westbury, for the year 1976.

On exception, petitioner asserts as follow:

> "1. We respectfully request that the lease payments made by the petitioner as guarantor under a lease agreement be found to be amounts directly related to the business activities of the petitioner and, therefore, not losses attributable to subsidiary capital under NYS Tax Law Section 208.4 nor expenses directly or indirectly attributable to subsidiary capital under NYS Tax Law Section 208.9.
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> "As guarantor under the lease agreement entered into by its subsidiary, The Westbury Chicago, Inc., the petitioner became responsible for $2,008,000 in real estate taxes and rental payments when such payments were not paid by its subsidiary. Knott was not merely assuming the payment of such expenses on behalf of its subsidiary but, rather, was legally responsible for the debts under the terms of the Guaranty Agreement. It was not uncommon for the petitioner to enter into such arrangements with its subsidiaries in order to obtain financing.
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> "2. We respectfully request that a determination be made to find that the performance of a complete and thorough field audit of Knott Hotel and Subsidiaries was performed and that such audit encompassed the review of the combined group's report as well as a determination of whether such non-combined subsidiaries should have been included in the group. As such, the auditor would have been required to consider including Knott's foreign subsidiary in Knott's combined New York State combined report for 1976 regardless of whether such inclusion would have resulted in a higher or lower assessment.
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> "Under Tax Law Section 211.4 (in part), the Tax Commission has the discretion to require or permit the making of a report on a combined basis covering any such other corporations and setting forth such information as the tax commission may require . . . provided, that no combined report covering any corporation not a taxpayer shall be required unless the tax commission deems such a report necessary because of intercompany transactions or some agreement, understanding, arrangement or transaction.
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> "As the petitioner had sufficient intercompany transactions with its affiliates to require the inclusion of its foreign subsidiary in the combined report, consideration should have been given to allowing or requiring the petitioner to file on a combined basis

with its foreign subsidiary. Significant intercompany transactions, agreements and unitary relationships existed between the petitioner and its foreign subsidiary at the time of the audit. Therefore, rather than dismissing the issue, the auditor should have pursued the existence of the unitary relationships and formal agreements between the petitioner and any and all of its subsidiaries, the existence of which, would constitute evidence that the subsidiary should have been included in the combined report.

"3. We respectfully request that the decision which rendered the documentation submitted with the reply brief on February 3, 1992 as inadmissible be reconsidered. Many of the documents had previously been submitted to the auditor and/or State as support of the arguments raised. Further, the combined reporting issue was not a new issue as the auditor was required to review the appropriateness of the petitioner's combined report and determine whether the report included the correct corporations.

"The combined reporting issue was again raised at the commencement of the hearing on December 11, 1990. Indeed, it was at that meeting and later in a letter dated April 18, 1991, that the State requested additional time to review the argument and gather evidence. At the time of the September 1991 telephone conversation with the Administrative Law Judge, the State's representative and the petitioner's representative, the issue of combined reports was discussed and the parties agreed that any other supporting arguments and documentation could be submitted with the briefs. Regardless of the September 23, letter which stated that the record was closed, it was our understanding from the earlier telephone conversation that additional information could be presented with the briefs to support the issues raised on audit and at the hearing.

"4. As discussed with Kathy Sanderson, of the Secretary to the Tax Appeals Tribunal, we respectfully reserve the right to present additional facts and expand the above discussion in the form of a written brief to be submitted within 30 days from the filing of this exception.

"5. As part of this Notice of Exception to Administrative Law Judge's Determination we wish to include our original brief and reply brief (with exhibits)" (Petitioner's exception, insert 2).

The Division urges us to affirm the determination of the Administrative Law Judge in its entirety.

The Division, relying on its brief at hearing, asserts that it is clear that:

"[p]etitioner's subsidiaries, The Westbury Chicago and The Westbury San Francisco, incurred certain losses during the 1976 report period. Ex. H,1,2. There was coloquy [sic] at formal hearing, supported in part by introduction of limited documentary evidence, suggesting that the

> amounts identified represented Petitioner's guarantee and payment of rental expenses and taxes for the subsidiary corporations in 1975 and 1976. Ex. 1,2; Tr. 17,22,28,30. It is clear that these losses were included in computation of Petitioner's federal taxable income. Ex. H. On field audit, the Division adjusted the reported federal loss to exclude those amounts, pursuant to the provisions of the Tax Law and the relevant Franchise Tax Regulations. Ex. H, Field Audit Narrative. The effect of this adjustment was to reduce the net operating loss deduction available for carry over to the period in issue. Ex. H, included schedules B-1, B-4.
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> "Petitioner is not entitled to include the losses attributable to its subsidiaries in computing its 1976 entire net loss. T.L. §208.4; 20 NYCRR §3-2.3(a)(8). It is not material that Petitioner considered these losses to be deductible "bad debts" for federal purposes. The losses represented advances made by petitioner to or on behalf of subsidiaries, and therefore represent losses attributable to subsidiary capital. T.L. §208.4. The New York statute and regulations require that the federal base (in this case a federal net operating loss) be adjusted by addition of amounts representing losses attributable to subsidiary capital. T.L. 20 NYCRR §3-2.3(a)(8). It was reasonable and appropriate for the Division to recompute Petitioner's 1976 net operating loss to include these amounts, and to reduce the available net operating loss carryforward for subsequent period" (Division's brief at hearing, pp. 6-7).

The arguments raised by petitioner on exception are fully set forth above and are essentially those presented to the Administrative Law Judge. We find that the Administrative Law Judge adequately considered all of the issues raised at hearing and correctly applied the law to the facts. Accordingly, we affirm the determination of the Administrative Law Judge for the reasons stated therein.

We feel it necessary and appropriate, however, to address two aspects of petitioner's assertions concerning the issue of combined reporting. First, we find absolutely no basis in petitioner's assertion that the Administrative Law Judge erred in not considering the materials included by petitioner with its reply brief dated January 30, 1992. The record is clear that petitioner's petition was devoid of any reference to combined reporting and that the issue was raised by petitioner for the first time at hearing on December 11, 1990. At the hearing the only evidence submitted in support of the statements by petitioner's representative that petitioner should be allowed to file on a combined basis were the guarantee document and financial statements for the years 1975 and 1976 (Exhibits "1" and "2"). Neither these documents alone

nor taken together with the oral assertions of petitioner's representative at hearing prove that petitioner meets the criteria for combined reporting. Moreover, the hearing was continued and the Administrative Law Judge left the record open for over ten months after the hearing to allow petitioner to submit any further documentation on the issue and for the Division to review such. It was decided ultimately by the parties that a hearing was not necessary. No further documentation was submitted prior to the closing of the record by the Administrative Law Judge in his September 23, 1991 letter. That letter is unequivocal; the Administrative Law Judge clearly states "I have closed the record in this matter." The documents submitted on February 3, 1992 with petitioner's reply brief were clearly submitted after the record was closed and properly not considered by the Administrative Law Judge (Matter of Schoonover, Tax Appeals Tribunal, August 15, 1991).

Next, we reject as without basis in law or fact petitioner's implication that, based upon a discussion with Counsel to the Tribunal, petitioner was entitled to "present additional facts and expand the . . . discussion [on combined reporting] in the form of a written brief" to be submitted to this Tribunal on exception (Petitioner's Exception, insert 2). While the exception process allows the party taking the exception to the determination of the Administrative Law Judge to assert that the record contains facts in addition to those found by the Administrative Law Judge, or to protest findings of fact made by the Administrative Law Judge, our decisions have made it perfectly clear that this does not mean that on exception new evidence may be added to the record made at hearing (Matter of Abex Corp., Tax Appeals Tribunal, October 8, 1992; Matter of Great Eastern Print. Co., Tax Appeals Tribunal, February 20, 1992; Matter of Schoonover, supra).

As we stated in Matter of Schoonover (supra):

> "[i]n order to maintain a fair and efficient hearing system, it is essential that the hearing process be both defined and final. If the parties are able to submit additional evidence after the record is closed, there is neither definition nor finality to the hearing. Further, the submission of evidence after the closing of the record denies the adversary the right to question the evidence on the record. For these reasons we must follow our policy of not allowing the submission of evidence after the closing of the record (see, Matter of Oggi Rest., Tax Appeals Tribunal November

> 30, 1990; Matter of Morgan Guar. Trust Co. of N.Y., Tax Appeals Tribunal, May 10, 1990; Matter of International Ore & Fertilizer Corp., Tax Appeals Tribunal, March 1, 1990; Matter of Ronnie's Suburban Inn, Tax Appeals Tribunal, May 11, 1989; Matter of Modern Refractories, Tax Appeals Tribunal, December 15, 1988)" (Matter of Schoonover, supra).

This Tribunal is charged with providing a just system for the resolution of controversies between taxpayers and the Department of Taxation and Finance. Essential to the system functioning as envisioned by the Legislature is that the parties be provided with the full opportunity at hearing to make a complete and full record. Our regulations and procedures are geared to allow this to happen. With regard to the issue of combined reporting in this case, which seems to be so critical to resolving the issue of tax liability for 1976, we cannot explain the sparse record made by petitioner at the December 11, 1990 hearing before the Administrative Law Judge, nor the failure of petitioner to take advantage of the time allowed by the Administrative Law Judge with the concurrence of the Division -- in excess of ten months -- to allow petitioner to introduce evidence on the issue of combined reporting. Stated simply, ample opportunity was provided petitioner to make a full record.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Knott Hotels Corporation is denied;
2. The determination of the Administrative Law Judge is affirmed;
3. The petition of Knott Hotels Corporation is denied; and

4. The notices of deficiency dated March 27, 1986, as modified by the Conciliation Order dated October 28, 1988, are sustained.

DATED: Troy, New York
October 7, 1993

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

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