

STATE OF NEW YORK
TAX APPEALS TRIBUNAL

In the Matter of the Petition :
of :
CUSTOM SHOP FIFTH AVENUE CORP. :
for Redetermination of a Deficiency or for :
Refund of Corporation Franchise Tax under :
Article 9-A of the Tax Law for the Fiscal Years :
Ended July 31, 1984 through July 31, 1986. :

In the Matter of the Petition :
of :
CUSTOM SHOP LEXINGTON AVENUE CORP. :
for Redetermination of a Deficiency or for :
Refund of Corporation Franchise Tax under :
Article 9-A of the Tax Law for the Fiscal Years :
Ended July 31, 1984 through July 31, 1986 :

In the Matter of the Petition :
of :
CUSTOM SHOP RECTOR STREET CORP. :
for Redetermination of a Deficiency or for :
Refund of Corporation Franchise Tax under :
Article 9-A of the Tax Law for the Fiscal Years :
Ended July 31, 1984 through July 31, 1986 :

In the Matter of the Petition :
of :
CUSTOM SHOP SIXTH AVENUE CORP. :
for Redetermination of a Deficiency or for :
Refund of Corporation Franchise Tax under :
Article 9-A of the Tax Law for the Fiscal Years :
Ended July 31, 1984 through July 31, 1986 :

DECISION
DTA Nos. 806553,
806554, 806555, 806556,
806557, 806558

In the Matter of the Petition :

of :

CUSTOM SHOP WALL STREET CORP. :

for Redetermination of a Deficiency or for :

Refund of Corporation Franchise Tax under :

Article 9-A of the Tax Law for the Fiscal Years :

Ended July 31, 1984 through July 31, 1986 :

In the Matter of the Petition :

of :

CUSTOM SHOP 44th STREET CORP. :

for Redetermination of a Deficiency or for :

Refund of Corporation Franchise Tax under :

Article 9-A of the Tax Law for the Fiscal Years :

Ended July 31, 1984 through July 31, 1986 :

Petitioners Custom Shop Fifth Avenue Corp., Custom Shop Lexington Avenue Corp., Custom Shop Rector Street Corp., Custom Shop Sixth Avenue Corp., Custom Shop Wall Street Corp. and Custom Shop 44th Street Corp. all bearing the mailing address of 402-412 Rt. 23, Franklin, New Jersey 07416 filed exceptions to the determination of the Administrative Law Judge issued on May 3, 1990 with respect to their petitions for redetermination of deficiencies or for refund of corporation franchise tax under Article 9-A of the Tax Law for the fiscal years ending July 31, 1984 through July 31, 1986. Petitioners appeared by DeGraff, Foy, Conway, Holt-Harris and Mealey, Esqs. (James H. Tully, Jr., Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (James Della Porta, Esq., of counsel).

Each party filed a brief on exception. Oral argument was heard at petitioner's request on February 20, 1991.

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

ISSUES

I. Whether the Division of Taxation properly determined that income received by petitioners from an affiliated company which resulted from the investment of petitioners' excess cash by such affiliate, constituted business income for the purpose of the corporation franchise tax.

II. Whether the penalty imposed under Tax Law § 1085(a)(3) should be abated.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for finding of fact "4" which has been deleted¹ and 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.

Petitioners are New York State corporations which operate retail stores in New York City. They are part of a group of affiliated corporations (hereinafter referred to as "Custom Shop Corporations"), with general and executive offices located in Franklin, New Jersey.

Mortimer Levitt holds 89% of the stock ownership of the petitioners with the remaining 11% held by Customer Payment Corporation which is owned 100% by Mr. Levitt.

Custom Shop Payment Corporation, incorporated in the State of New Jersey, was created in an effort to manage the excess funds generated by the various Custom Shop Corporations.

Payment Corporation is essentially a cash management vehicle with its primary functions being investment of funds and payment of bills. It has no assets of its own, maintains no office for its own use and retains no excess funds.

Payment Corporation invests the funds it receives in items such as common and preferred stock, certificates of deposit and money-market funds. All investments are held in the name of Payment Corporation on behalf of the various Custom Shop Corporations.

¹To the extent that finding of fact "4" of the Administrative Law Judge's determination indicated that petitioners sent their excess funds to Custom Shop Payment Corporation, it has been deleted because this statement was inconsistent with the record and finding of fact "7" which stated that petitioners each remit their gross sales revenue to Custom Shop Payment Corporation. The other statements contained in finding of fact "4" have been incorporated in modified finding of fact "7."

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

Each corporation remits its gross sales revenues directly to Payment Corporation which first pays each petitioner's operating expenses and invests the excess funds in various investments. Petitioners recorded the excess funds on their balance sheet as "other investments." Payment Corporation maintains separate accounts for the amounts contributed by the various corporations and that which is disbursed on behalf of each corporation. Payment Corporation reflected the funds it received on its financial statements as funds received from other corporations, not as loans.²

The controversy in this case is centered around the accounting procedures and classification of the income generated by the investments made by Payment Corporation. Each of the Custom Shop Corporations reported on its tax returns as taxable income for the years in question its allocable share of investment income based upon the amount of excess net funds as reflected in Payment Corporation's records. These net funds were in turn pooled toward the purchase of various securities in the portfolio. The investment income earned by Payment Corporation was designated on the tax returns of Customer Shop Corporations by references such as "allocations from the central office" "shares of the joint venture" and "allocations from associated companies".

Petitioners filed New York State corporation franchise tax reports for all periods in question. On each of these tax returns, each petitioner reported on its balance sheet investments which were allocated to it by Payment Corporation and reported an allocation of capital gain

2

Finding of fact "7" of the Administrative Law Judge's determination read as follows:

"7. Each corporation remits its gross sales revenues directly to Payment Corporation which first pays each petitioner's operating expenses and invests the excess funds in various investments. Payment Corporation maintains separate accounts for the amounts contributed by the various corporations and that which is disbursed on behalf of each corporation.

We modified this fact to incorporate some of the statements contained in the Administrative Law Judge's finding of fact "4" (see footnote 1).

income from its affiliate. Each petitioner further claimed a 50% dividend deduction based upon dividends from non-subsidiary companies.

As a result of an audit of Morley Shirt Company, the corporation which is the manufacturer of various retail products sold by petitioner as well as an affiliate corporation, petitioners were subsequently audited. The auditor concluded that income received by petitioners from Payment Corporation did not constitute investment income for purposes of the franchise tax and computed additional tax due on the premise that the income constituted business income. On November 27, 1987, notices of deficiency were issued to the various Custom Shop Corporations as follows:

NOTICES OF DEFICIENCY

11/27/87	<u>Period Ended</u>	<u>Tax</u>	<u>Interest</u>	<u>Additional Charge</u>	<u>Total Due</u>
Custom Shop 5th Ave. Corp.	7/31/84	7,102.00	2,579.00	355.00	10,036.00
	7/31/84	1,128.00	410.00	56.00	1,594.00
	7/31/85	8,936.00	1,922.00	2,302.00	13,160.00
	7/31/85	1,268.00	273.00	200.00	1,741.00
	7/31/86	32,838.00	3,138.00	6,495.00	42,471.00
	7/31/86	4,693.00	449.00	550.00	5,692.00
Custom Shop 6th Ave. Corp.	7/31/84	1,798.00	653.00	90.00	2,541.00
	7/31/84	306.00	111.00	15.00	432.00
	7/31/85	1,905.00	410.00	300.00	2,615.00
	7/31/85	324.00	70.00	51.00	445.00
	7/31/86	6,008.00	574.00	1,188.00	7,770.00
	7/31/86	1,022.00	98.00	100.00	1,220.00
Custom Shop 44th Street Corp. ³	7/31/84	2,722.00	989.00	136.00	3,847.00
	7/31/84	463.00	168.00	23.00	654.00
	7/31/85	2,679.00	576.00	422.00	3,677.00
	7/31/85	456.00	98.00	72.00	626.00
	7/31/86	11,781.00	1,126.00	2,330.00	15,237.00
	7/31/86	2,003.00	191.00	196.00	2,390.00
Custom Shop Lexington Ave. Corp.	7/31/84	2,903.00	1,054.00	145.00	4,102.00
	7/31/84	493.00	179.00	25.00	697.00
	7/31/85	3,152.00	678.00	497.00	4,327.00

Notices contained the date July 13, however, it is presumed that the fiscal year end of the corporation July 31, was intended for each of the dates.

7/31/85	536.00	115.00	85.00	736.00
7/31/86	9,202.00	879.00	182.00	11,901.00 ⁴
7/31/86	1,565.00	150.00	153.00	1,868.00

Custom Shop Rector Street Corp.	7/31/84	5,540.00	2,012.00	277.00	7,829.00
	7/31/84	942.00	42.00 ⁵	47.00	1,331.00
	7/31/85	2,902.00	560.00	410.00	3,872.00
	7/31/85	493.00	1 04.00	54.00	651.00

Custom Shop Wall Street Corp.	7/31/84	2,773.00	1,007.00	139.00	3,919.00
	7/31/84	471.00	171.00	24.00	666.00
	7/31/85	2,735.00	588.00	431.00	3,754.00
	7/31/85	465.00	100.00	73.00	638.00
	7/31/86	8,220.00	786.00	1,626.00	10,632.00
	7/31/86	1,397.00	134.00	137.00	1,668.00

Totals		131,221.00	22,394.00 ⁶	19,186.00	174,739.00 ⁷
--------	--	------------	------------------------	-----------	-------------------------

THE AUDIT

During the course of the audit, the auditor worked closely with Mr. Nettis, who held the titles of secretary, treasurer and comptroller of Morley Shirt Company, as well as with Mariann Cilurso, Assistant Comptroller. Ms. Cilurso, an employee of the affiliated group for 19 years, performed various bookkeeping and internal accounting functions. It is from these individuals that information regarding Morley Shirt Company and the various Custom Shop Corporations was obtained. Only Ms. Cilurso appeared as a witness at the hearing.

The auditor made a verbal request to these individuals during the audit for access to store records of the petitioner corporations for the years in issue. Also requested were books and

4

Total should be \$10,263.00.

5

Interest should be \$342.00.

6

Total should be \$22,694.00.

7

Total should be \$173,101.00.

records for Payment Corporation which received funds from the various other Custom Shop Corporations. It appears from the record that the request was initially denied as an irrelevant portion of the subject audit. However, it is not clear whether the auditor eventually obtained information for Custom Shop Payment Corporation.

The auditor concluded that the investment income generated by Payment Corporation was allocated to each of the retail stores based on sales. The source of her information was the representation on the balance sheets of the Federal tax returns, Form 1120.

OPINION

The Administrative Law Judge concluded that petitioners did not establish that Payment Corporation held the investments either as nominee or agent for petitioners. The Administrative Law Judge did conclude, however, that the existence of Payment Corporation should be disregarded and the corporation treated as a mere conduit, resulting in the allocation of the income back to petitioners. The income allocated back to petitioners did not retain its character as investment income, the Administrative Law Judge determined, because the investments were not the "taxpayers' investments" within the meaning of 20 NYCRR 3-4.2(a). Finally, the Administrative Law Judge upheld the imposition of penalty, finding that petitioners had not met their burden to prove reasonable cause with respect to their nonpayment of tax.

On exception, petitioners argue that if petitioners are required to report an allocable share of income derived from the investments, then they must be considered the actual owners of the investments. Petitioners assert that to hold otherwise results in the internal inconsistencies present in the Division's argument and the Administrative Law Judge's determination. Petitioners assert that the record establishes that Payment Corporation was a mere nominee who held bare legal title to the investments on behalf of petitioners.

In response, the Division suggests that petitioners have withheld information that does not support their position. The Division also argues that the former State Tax Commission decision in the Matter of Custom Shop Rector Street Corp. (July 10, 1985) controls the outcome

of this case under the doctrine of stare decisis. The Division next argues that no indication of agent or nominee status exists in the present case. The Division also asserts that the character of the income in issue need not remain constant when distributed by Payment Corporation to petitioners. Finally, the Division asserts that the penalty should not be abated because petitioners did not cooperate on audit, they attempted to restrict review of the relevant facts at the hearing and they were on notice that their characterization of the income as investment income was incorrect due to the prior State Tax Commission decision.

We affirm the determination for the reasons stated below.

"Investment income" pursuant to Tax Law § 208(6) is defined as income, including capital gains in excess of capital losses, from investment capital, to the extent included in computing entire net income less items not applicable to the issue in question.

In pertinent part, Tax Law § 208(5) states as follows:

"The term 'investment capital' means investments in stocks, bonds and other securities, corporate and governmental, not held for sale to customers in the regular course of business, exclusive of subsidiary capital and stock issued by the taxpayer . . ."

Regulations at 20 NYCRR 3-4.2(a) amplify Tax Law § 208(5) as follows:

"The term investment capital means the total of the average fair market value of the taxpayer's investments in stocks, bonds and other securities issued by any corporation (other than the taxpayer, a subsidiary or a DISC) or by the United States, any state, territory or possession of the United States, the District of Columbia, or any foreign country, or any political subdivision or governmental instrumentality of any of the foregoing . . ." (emphasis added).

First, we reject petitioners' argument that if the income in issue is income to petitioners, it must be investment income. The case law interpreting the law (Tax Law § 208[5]) and the regulations (20 NYCRR 3-4.2) make it clear that whether an asset is investment capital, as an "other security," with respect to a specific taxpayer depends upon that taxpayer's particular relationship to the asset (see, Matter of Pohatcong Investors v. Commissioner of Taxation and Fin., 156 AD2d 791, 549 NYS2d 211; Matter of Avon Products v. State Tax Commn., 90 AD2d 393, 458 NYS2d 278). Similarly, the determination of whether income is investment income to a specific taxpayer must depend upon that taxpayer's particular relationship to the asset and is

not resolved, as petitioners suggest, by ascribing an absolute, unchanging character to an asset and claiming that income in any way derived from this asset must be investment income. Thus, the question that is before us is whether the income at issue is traceable to assets that were investment capital with respect to petitioners.

We agree with the Division that the most compelling indication that the income was not derived from investment capital is the failure of petitioners to establish that the income was allocated to each of them based on the amount of their individual investment. Petitioners' witness testified that the income earned from the investments was allocated to petitioners based on each store's net income, i.e., its gross revenues less expenses (Tr., pp. 56-59). However, the witness was unable to state whether the allocation each taxable year reflected the actual total contribution of each petitioner over the years or was made simply based on the net income during the reporting period (Tr., pp. 58-69). Clearly, an allocation based on the latter would not accurately reflect the total investment of each petitioner because it would not bear any necessary relationship to the particular amounts that each corporation had invested in prior years and the amounts that had been earned on those prior investments. Since petitioners have not been able to suggest, much less prove, that the instant income was allocated based on each corporation's actual contribution, we conclude that they have not established that the investment income claimed by each operating corporation was traceable to the investment capital of each corporation.

Since business income is by statutory definition a residual category, i.e., business income is all entire net income that is not investment income (Tax Law § 208[8]), the conclusion that the income at issue is not investment income means that the Division properly classified it as business income. We find absolutely no basis for petitioners' contention that if the income that was admittedly received by petitioners is not investment income, it is not income to petitioners at all.⁸

⁸Petitioners argue that if the income is not investment income to them, it is income only to Payment Corporation and not subject to New York State taxation. The question of how Payment Corporation should have reported this income is not before us. The only question that is before us is whether petitioners proved that all or any portion of

Lastly, we address the question of abating the penalty imposed for petitioners' failure to pay tax. To have the penalties abated, the taxpayer must establish facts that indicate that the failure to pay was based on reasonable cause and was not due to willful neglect (Tax Law § 1085[a][3]); see also, Matter of John Grace & Co., Tax Appeals Tribunal, May 10, 1990; Matter of McDonnell Douglas Corp., Tax Appeals Tribunal, May 4, 1989). The record before us reveals nothing about the basis upon which petitioners decided to characterize the instant income as investment income. Accordingly, we have no basis upon which to decide that the decision was reasonable and no grounds to abate penalty. Given that petitioners continued reporting the income as investment income for the periods ending July 31, 1985 and July 31, 1986, in spite of the State Tax Commission's decision to the contrary in Matter of Custom Shop Rector Street Corp. (State Tax Commn., July 10, 1985), petitioners' characterization is certainly not reasonable on its face.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exceptions of Custom Shop Fifth Avenue Corp., Custom Shop Lexington Avenue Corp., Custom Shop Rector Street Corp., Custom Shop Sixth Avenue Corp., Custom Shop Wall Street Corp. and Custom Shop 44th Street Corp. are denied;
2. The determination of the Administrative Law Judge is affirmed;
3. The petitions of Custom Shop Fifth Avenue Corp., Custom Shop Lexington Avenue Corp., Custom Shop Rector Street Corp., Custom Shop Sixth Avenue Corp., Custom Shop Wall Street Corp. and Custom Shop 44th Street Corp. are denied; and

the income was investment income to them. Since we have concluded that they have not established this, all of the income must be treated as business income.

4. The notices of deficiency dated November 27, 1987, as modified by the mathematical corrections noted by the Administrative Law Judge in finding of fact "10",⁹ are sustained.

DATED: Troy, New York
August 1, 1991

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

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

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

⁹The Administrative Law Judge's reference to finding of fact "9" was incorrect.