STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
U.S. TRUST CORPORATION	:	DECISION DTA No. 810461
for Redetermination of a Deficiency or for Refund of Franchise Tax on Banking Corporations under Article 32 of the Tax Law for the Years 1985, 1986 and 1987.	: :	

The Division of Taxation and petitioner U.S. Trust Corporation, 114 West 47th Street, New York, New York 10036-1537, each filed an exception to the determination of the Administrative Law Judge issued on December 22, 1994. Petitioner appeared by Griffith & Yost (Edward M. Griffith, Jr., Esq., of counsel). The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (John O. Michaelson, Esq., of counsel).

Petitioner and the Division of Taxation each filed a brief in support of their exception and a reply brief. Oral argument was heard on October 12, 1995 and began the six-month period for the issuance of this decision.

Commissioner Dugan delivered the decision of the Tax Appeals Tribunal. Commissioners Koenig and DeWitt concur.

ISSUES

I. Whether petitioner must include U.S. Trust of Delaware, Inc., a Delaware corporation not doing business in New York, in its combined franchise tax returns for the years 1985, 1986 and 1987.

II. Whether, if the combination of petitioner and U.S. Trust of Delaware is required, the Division of Taxation properly included the receipts of U.S. Trust of Delaware as New York receipts for purposes of allocating income to New York.

III. Whether petitioner's eligible business facility credit must be calculated on a combined basis with its subsidiaries included in its combined report.

IV. Whether, if the eligible business facility credit must be calculated on a combined basis, the imposition of a penalty for substantial understatement of tax should be cancelled.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for finding of fact "40" which has been modified. The Administrative Law Judge's findings of fact and the modified finding of fact are set forth below.

Petitioner, U.S. Trust Corporation ("U.S. Trust"), and the Division of Taxation (the "Division") entered into a stipulation of facts which was made part of the record of this proceeding. After the completion of the hearing, petitioner submitted 42 proposed findings of fact. The stipulated facts and the proposed findings of fact have been incorporated into this determination.

The Division issued to U.S. Trust six notices of deficiency, asserting tax deficiencies under Article 32 of the Tax Law for the years 1985, 1986 and 1987 as follows:

Date of Notice	Year	Tax	Additional Charge
12/14/89	1985	$ 331,099.00	$ -0-
12/14/89	1985	56,415.00	-0-
8/31/90	1986	568,627.00	39,673.00
8/31/90	1986	96,887.00	6,744.00
8/31/90	1987	1,024,798.00	86,370.00
8/31/90	1987	174,386.00	14,683.00

The notices of deficiency were issued as a result of an audit which was conducted on a joint basis by New York State and New York City auditors. New York City's auditor performed all of the field work and acted as the lead auditor.

U.S. Trust is a bank holding company registered under the Federal Bank Holding Company Act of 1956 (the "BHCA"). Its principal asset is a subsidiary, U.S Trust of New York ("UST New York"), a New York commercial bank and trust company and a member of the Federal Reserve System. U.S. Trust specializes in trust and agency services. Principally through its subsidiary, UST New York, U.S. Trust provides a broad range of banking services and financial management and fiduciary services to individuals, corporations, pension funds and other institutions.

For the audit years, U.S. Trust filed combined franchise tax returns with three of its subsidiaries, UST New York, U.S. Trust Advisory Company, Inc., and Financial Technologies International, Inc. Upon audit of those returns, the Division redetermined the tax due in several areas, only two of which are in issue here.

(a) U.S. Trust calculated an eligible business facility credit on a separate basis using only UST New York's income and allocation factors. The Division determined that this credit should be recalculated on a combined basis and recalculated the amount of the credit accordingly. As a result of this computation, the Division determined a tax deficiency of $114,345.00 for the year ending December 31, 1985 and a total tax deficiency of $1,260,434.00 for the years 1986 and 1987. A penalty was added for substantial understatement of tax, computed at 10% of the amount of the underpayment attributable to the understatement. This penalty was applied only to the understatement attributable to the calculation of the eligible business facility credit and not to other adjustments.

(b) U.S. Trust did not include one of its subsidiaries in its combined reports, U.S. Trust of Delaware ("UST Delaware"). The Division determined that U.S. Trust was required to file its corporation franchise tax report on a combined basis with UST Delaware and recomputed U.S. Trust's tax liability accordingly. This resulted in a tax deficiency of $180,982.00 for the year ending December 31, 1985 and a total deficiency of $282,783.00 for the years 1986 and 1987.

Because U.S. Trust challenged many of the factual conclusions reached by the Division on audit regarding combination with UST Delaware, it is worthwhile to quote the entire discussion on combination as it appears in the audit reports (there are two reports, one for 1985 and one for 1986 and 1987, but the narrative portions are almost identical).

> "As previously mentioned, the taxpayer was filing on a combined basis with several of its' [sic] subsidiaries. Upon audit, it was discovered that the taxpayer had a 100% owned subsidiary (U.S. Trust Company of Delaware 51-0262277) that qualified for inclusion in the combined return.
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> "This corporation was set up to hold the stock of a banking corporation operating in Florida (U.S. Trust Company of Florida 59-2188338). U.S. Trust of Delaware is a passive holding company with its' [sic] only office in Delaware. The subsidiary only holds title to the stock of the Florida company and does not perform any substantial services or financing to this company. This subsidiary has only two part-time employees, a clerical person and an officer. The corporation is merely a shell company.
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> "The taxpayer has channeled large amounts of its' [sic] excess cash to U.S. Trust of Delaware in the form of additional paid in capital for the purpose of having U.S. Trust of Delaware, rather than themselves, invest this cash in investments. These investments mostly involve government obligations. The taxpayer has stated that all investment decisions and transactions are made by the taxpayers' [sic] employees in New York.
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> "U.S. Trust of Delaware is very profitable and has only limited expenses. It appears that 100 per cent of its' [sic] gross income is from its' [sic] investment activities, which have been funded by the taxpayer through the transfer of interest free funds to U.S. Trust of Delaware. The taxpayer has transferred the record keeping activities of these investments from New York to the Delaware Subsidiary. This is not an arms-length transaction.
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> "This combination is being required because of the agreement, arrangement and transaction which transferred the record keeping activities of certain investments from New York to the Delaware Subsidiary and caused the activity, business, income and assets of the taxpayer within New York State to be improperly and inaccurately reflected.
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> "This combination is in accordance with Tax Law § 1462(f)(2)(i)(B) and Regulation §§ 21-2.6 and 21-2.3(b)(4) . . . ."

To counter the Division's conclusion that UST Delaware was nothing more than a shell corporation used by its parent to channel capital and income out of New York, U.S. Trust provided a history of UST Delaware from its formation in 1981 to its dissolution in 1990.

During the 1970's, UST New York found that its customer base was beginning to shift outside of New York to Florida and some of the sunbelt states. U.S. Trust wanted to expand its banking, trust and investment advisory business into Florida, California, Texas and other states in order to continue to service UST New York customers, attract new customers from those states and develop a national presence in the banking and trust industry.

U.S. Trust's plan to expand its operations outside of New York faced two primary legal obstacles. First, the McFadden Act prohibited UST New York from establishing branches in states other than New York. In addition, the Douglas Amendment to the BHCA (12 USC § 1842[d][1]) prohibited Federally-registered bank holding companies (like U.S. Trust) from owning banks in states other than their homes states, unless the laws of the other state expressly authorized such ownership.

Sometime in the 1970's, U.S. Trust established an investment advisory office in Florida. Kenneth Walsh, U.S. Trust's general counsel and a senior vice president during the audit years, described the Florida office as a hand-holding operation for UST New York customers located in Florida. Because the Florida office could not offer investment or trust services to its customers, it risked losing them to local institutions; consequently, U.S. Trust began actively seeking ways to expand its Florida operations.

In about 1980, U.S. Trust applied for and received a state charter from the State of Florida to convert its Florida operation to a trust company, U.S. Trust of Florida, Inc. ("UST Florida"). In June 1982, U.S. Trust applied to the Comptroller of the Currency to convert UST Florida from a state-chartered trust company into a national association. This application was approved in August 1983. Subsequently, U.S. Trust's legal department determined that U.S. Trust might avoid the Douglas Amendment's prohibition against interstate ownership of banks through the use of the "non-bank bank" loophole of the BHCA. The BHCA defines a "bank" as an institution that both accepts time and demand deposits and engages in the business of making commercial loans (12 USC § 1841[c]); a non-bank bank is one which does not engage in both of these activities.

U.S. Trust determined that if its advance into the Florida market was to be successful, it would be preferable to vest the ownership of UST Florida in a non-bank corporation, not incorporated in New York. There were several reasons for this decision. First, local banks and bank regulators were hostile to the encroachment into their market by out-of-state banks, especially those from New York. U.S. Trust believed that direct ownership of UST Florida and other interstate entities by a non-New York corporation would reduce that hostility. In addition, those states into which U.S. Trust considered expanding, Florida, California and Texas, are unitary taxing jurisdictions and might require combination of U.S. Trust and its New York subsidiaries with any subsidiary in their jurisdictions. On the advice of tax counsel, a non-New

York State holding company was deemed advisable to attempt to insulate New York income, activities and property from tax in those states. In addition, U.S. Trust believed that if the Federal Reserve Board rejected its proposal for a non-bank bank, a corporation not registered under the BHCA (i.e., not a bank holding company under that law) might still avoid the interstate prohibition of the Douglas Amendment. Finally, U.S. Trust's legal advisors believed that UST Florida's parent should restrict its investments so as not to run afoul of the Federal Reserve Board's broad definition of commercial lending. U.S. Trust believed that it would be easier to accomplish this in a newly-formed corporation than to conform U.S. Trust's existing investment policies and investments.

In November 1981, U.S. Trust formed UST Delaware under the laws of the State of Delaware as a wholly-owned subsidiary. In December 1981, U.S. Trust contributed all of the shares of UST Florida to UST Delaware as a contribution to capital.

In November 1983, U.S. Trust applied to the Federal Reserve System Board of Governors for approval to expand the non-banking activities of UST Florida to include the acceptance of deposits and the granting of consumer loans. The application was approved in March 1984; however, the Federal Reserve Board noted that the application raised significant issues with the potential for undermining the policies of the BHCA and recommended legislation to close the non-bank bank loophole. U.S. Trust's proposal was opposed by the State of Florida, the Florida Bankers Association, the Conference of State Bank Supervisors, and the Sun Bank/Palm Beach.

In April 1984, the Florida Department of Banking and Finance, the Florida Banker's Association and the Sun Bank/Palm Beach commenced an action against the Federal Reserve Board of Governors in Federal court for a review of the Board's order approving the expansion of UST Florida's powers. This action was finally decided in U.S. Trust's favor in 1986 in Florida Dept. of Fin. v. Board of Governors (800 F2d 1534, on remand from the Supreme Court of the United States, 474 US 1098).

From as early as 1981, U.S. Trust had actively considered the feasibility of moving certain of UST New York's operations out of New York State to either New Jersey or Delaware. U.S. Trust began its own internal studies focusing on the possibility of relocating UST New York's corporate trust and unit trust divisions from New York City to Delaware. In 1984, Fantus Company was hired to perform a feasibility study. It determined that the corporate trust and unit trust divisions were the prime candidates for relocation and that Delaware offered the most favorable operating environment.

Delaware's interstate banking provisions required that a certain amount of capital be placed within the state if the trust units were to be transferred to UST Delaware. Moreover, Federal banking laws and regulations would require that UST Delaware obtain substantial capital before either or both operations could be transferred to it.

U.S. Trust contributed substantial amounts of capital to UST Delaware during the period 1982 through 1986 in anticipation of interstate banking acquisitions, the need for additional capital in operating subsidiaries, and the contemplated move of segments of UST New York's business to Delaware. UST New York was the major source of income for the U.S. Trust Group. Because of dividend restrictions under the Federal banking laws and regulations, it took several years to build up capital and pass it up from UST New York to U.S. Trust and then down to UST Delaware. From July 1, 1982 through December 19, 1986, U.S. Trust made capital contributions to UST Delaware as follows:

Date	Amount	Cumulative
7/1/82	$ 2,001,000.00	$ 2,001,000.00
8/9/82	4,038,064.01	6,039,064.01
1/28/83	2,625,000.00	8,664,064.01
11/15/83	5,015,622.81	13,679,686.82
4/24/84	19,200,000.00	32,879,686.82
4/24/85	3,000,000.00	35,879,686.82
12/19/86	8,000,000.00	43,879,686.82

During the period from June 1982 to October 1986, UST Delaware made the following capital contributions to UST Florida:

Date	Amount
6/24/82	$2,000,000.00
6/19/84	1,000,000.00
2/19/86	1,000,000.00
8/20/86	1,000,000.00
10/29/86	2,518,437.00
Total	$7,518,437.00

In 1983, UST Delaware and a number of Saudi Arabian investors formed Saudi-U.S. Trust Company Limited ("Saudi-UST"), to provide investment management and fiduciary services to residents of middle eastern countries. During the period 1983 through 1986, UST Delaware contributed $5,000,000.00 to the capital of Saudi-UST. Saudi-UST did not prove profitable and was liquidated in June 1986.

Throughout the 1980's, U.S. Trust actively sought to expand its banking, trust and investment advisory activities into California, Texas and other states. Acquisitions were made in California and Texas and considered in St. Louis, Missouri; Portland, Oregon; Boston, Massachusetts and Wilmington, Delaware.

In October 1986, UST Delaware acquired the assets of Summit Management Company, Inc. ("Summit"), a California-based investment advisory company, for $4,350,630.00. The assets of Summit were later merged into U.S. Trust of California, Inc. ("UST California"), a newly-formed wholly-owned subsidiary of UST Delaware. After the merger, UST California became a state-chartered trust company and was later converted to a national association with limited banking powers.

During the period from November 1987 to January 1990, UST Delaware made the following capital contributions to UST California:

Date	Amount
11/13/87	$1,000,000.00
1/4/88	3,000,000.00
2/18/89	450,000.00
1/13/90	450,000.00
Total	$4,900,000.00

In 1989, UST Delaware formed a wholly-owned subsidiary, UST Deltex, Inc. ("Deltex"), a Delaware corporation, to hold the shares of its Texas subsidiaries. This was done because Texas counsel thought it advisable to insulate UST Delaware from the Texas operations for Texas franchise tax reasons. In June 1989, Deltex acquired the shares of Denker and Goodwin, a Texas investment advisory company, for $3,700,000.00. Thereafter, U.S. Trust of Texas ("UST Texas") was formed as a state-chartered trust company and was made a subsidiary of Denker and Goodwin. To provide UST Texas with required capital, Denker and Goodwin downstreamed all of its assets to UST Texas.

In 1989 and 1990, UST Delaware made the following capital contributions to Deltex:

Date	Amount
6/26/89	$ 3,000.00
7/2/89	3,700,000.00
7/12/89	500,000.00
8/3/90	500,000.00
Total	$4,703,000.00

In January 1990, U.S. Trust placed itself on the Federal Deposit Insurance Corporation's ("FDIC") failed bank list and began receiving invitations from the FDIC to bid on failed Texas banks.

In December 1990, USTLPO Corp., a wholly-owned Delaware subsidiary of U.S. Trust, acquired certain of the assets of First National Bank of Rowlett, Texas, and later placed those assets in U.S. Trust Company of Texas N.A. UST Texas, the state-chartered trust company, was later merged into U.S. Trust of Texas N.A.

U.S. Trust liquidated UST Delaware in December 1990. The decision to liquidate was brought about by both legal and economic considerations. UST Delaware was not registered as a bank holding company under the BHCA. Before 1990, the Federal Reserve Board allowed UST Delaware to own UST Florida because it took the view that non-bank banks were not "banks" within the meaning of the BHCA.

In 1987, Congress enacted legislation amending the definition of a "bank" under the BHCA to include all non-bank banks which accepted insured deposits ("the Amendment"). The Amendment contained certain "grandfather provisions" for both bank holding companies and non-bank holding companies. Petitioner believed that the grandfather provisions relating to bank holding companies applied to it and excluded non-bank banks acquired before March 5, 1987, the effective date of the Amendment. In the years after the Amendment, U.S. Trust believed that the Federal Reserve agreed with its interpretation. However, in October 1990, in connection with an attempted acquisition of certain assets of a Texas bank by UST Delaware, the Federal Reserve advised that UST Delaware could not acquire these assets because UST Delaware fell within the grandfather provisions relating to non-bank holding companies (12 USC § 1843[f]) which precluded such an acquisition. Under this view, U.S. Trust believed that UST Delaware's continued ownership of UST Florida would be in violation of the BHCA.

In addition, the Federal Reserve Board, as well as certain credit rating institutions, such as Standard and Poor's and Moody's, were concerned with U.S. Trust's "double leverage" (the relationship between U.S. Trust's equity and the equity in its subsidiaries). Unless improved, this double leverage problem would adversely affect U.S. Trust's credit rating, customer confidence and possibly its cost of borrowing. U.S. Trust was able to cure UST Delaware's possible violation of the BHCA and substantially improve its double leverage problem by liquidating UST Delaware.

During the audit period, UST Delaware had offices in Wilmington, Delaware. Its only full-time employee was Peter W. McNeily who served as executive vice president and chief investment officer of UST Delaware from 1984 until the corporation's liquidation in 1990. Mr. McNeily had a substantial amount of banking and investment experience. In 1970 he began working for American Express Credit Corporation as its president and served in that capacity until his retirement in 1984. The credit corporation was the financing arm of the credit card company and was responsible for finding sources of money with which to purchase the cash receivables of the credit card operation. The other officers of UST Delaware were Trowbridge Callaway, President; James Brasco, Comptroller; and Kenneth Walsh, Corporate Secretary. Mr. Callaway was president of UST Florida and a member of UST Delaware's board of directors. Mr. Brasco was the comptroller of U.S. Trust, and, as noted, Mr. Walsh was general counsel of U.S. Trust.

In 1985, UST Delaware's board of directors included, in addition to Mr. Callaway: H. Marshall Schwartz, Edwin A. Heard, Thomas Killefer, Edwin D. Etherington, Howard L. Clark, and Chester W. Nemitz, Jr.; Mr. Nemitz was replaced by Brent M. Abel in 1986; the other board members served throughout the audit period. All of these individuals, except Mr. Callaway, were also directors of U.S. Trust. Mr. Schwartz and Mr. Heard were employees of U.S. Trust and received no compensation for their service as members of the board of directors. The outside directors of UST Delaware (those not employed by U.S. Trust or one of its subsidiaries) were compensated by UST Delaware.

As noted above, U.S. Trust's legal advisors believed that the immediate parent of UST Florida would be required to follow a very restrictive investment policy to avoid violating the Federal Reserve's definition of commercial lending. One of U.S. Trust's reasons for forming UST Delaware was to create a parent corporation for UST Florida which could follow such an investment policy. The investment policy of UST Delaware was adopted by the UST Delaware board of directors.

UST Delaware's investment securities were physically located in New York City pursuant to a custodial agreement between UST Delaware and UST New York. The custodial agreement provides that UST New York is to provide the following services to UST Delaware:

"1. SAFEKEEPING

You will provide for the physical safekeeping of property, making use of other depositories as you consider advisable. Registered securities are to be held in the name of a nominee maintained by you or by any such depository.

"2. TRANSACTIONS

You are to process security transactions upon receipt of authorized telex, written instruction or oral instruction confirmed in writing. Brokers will be instructed to send you confirmations of security transactions.

<u>Trading Facilities</u>

Subject to your policies and procedures and with your consent, security transactions may be processed through your trading facilities.

"3. INCOME COLLECTION

You are to collect and credit to this account all income, holding it subject to authorized instructions.

"4. REPORTS

You are to provide:

Pt A monthly statement of security transactions and cash receipts and disbursements.
Pt A list of property in the account, quarterly.
Pt Advices of security transactions, on actual settlement dates.
Pt Notification of calls, maturities, redemptions, or retirement of any of the securities.

"This material should be sent to the following individuals:

Mr. T. Callaway
Mr. E. Heard

"5. YOUR COMPENSATION

<u>Basic Custody Services</u>

See Schedule A"

UST Delaware paid UST New York fees of about $25,000.00 annually for the services provided under the custodial agreement. The fees paid were determined according to a rate schedule which was also used for unrelated third-party clients with similar size security portfolios during the years in issue. The fees were determined based on safekeeping charges and security transaction charges. The fees paid by UST Delaware amounted to about 10 percent of UST Delaware's expenses in each of the years in issue and were a small percentage of UST New York's receipts in each of the years in issue.

It was not uncommon for UST New York, acting as custodian of a trust account, to execute investment transactions within specific parameters established by the client. For instance, a client might instruct the custodian to reinvest money from a maturing Treasury Bill in another 90-day Treasury Bill. UST New York's traders executed these transactions through established brokerage houses, but they did not make the underlying investment decisions. UST New York did not charge its custodial customers a separate fee for executing transactions within a specific set of guidelines.

The board of directors of UST Delaware adopted investment guidelines for that corporation consistent with the goal of avoiding investments which might violate the Federal Reserve Board's definition of commercial loans. Mr. McNeily described his primary duty as ensuring that investments selected by the UST New York traders were consistent with the policies established by the UST Delaware board of directors. Although Mr. McNeily was not a member of the board, he attended board meetings to report on UST Delaware's investments. Mr. McNeily usually received information regarding any trades or investments made by the UST New York traders on the following day. These generally consisted of brokerage statements. Petitioner offered in evidence a group of Prudential-Bache brokerage statements showing U.S. Trust of Delaware, Inc. as the customer and addressed to Mr. McNeily in Delaware.

In addition to monitoring UST Delaware's investments, Mr. McNeily, assisted by a part-time clerical staff member, performed administrative and bookkeeping tasks. He maintained a ledger of transactions, including the investment transactions; prepared income and loss statements, balance sheets and other financial statements; and maintained the local office, using a Delaware checking account for office expenses. Payroll checks for Mr. McNeily and his assistant were prepared by UST New York, which acted as paymaster for all of the U.S. Trust subsidiaries. It was also Mr. McNeily's responsibility to act as the public face of U.S. Trust in Delaware. Beginning when he worked for American Express and subsequently when he was employed by UST Delaware, he was a member of the board of directors of Winterhur Corporation Council, a group of about 50 local firms that raised money for the Winterhur Museum. In addition, he attended meetings with U.S. Trust and Delaware officials to discuss the possible relocation of some UST New York business operations to Delaware.

In September 1984, members of U.S. Trust's senior management, together with Peter McNeily as an officer of UST Delaware, met with Delaware's Lieutenant Governor, Delaware's Superintendent of Banks, the Mayor of Wilmington and other government and community leaders to discuss relocating certain of U.S. Trust's business operations to Delaware.

In the long run, none of UST New York's business operations were relocated to Delaware. U.S. Trust determined that the transfer would face legal obstacles under New York law. In addition, the Fantus study concluded that it would not be feasible to transfer the necessary number of trained and experienced employees to Delaware. Finally, U.S. Trust concluded that it was not in a position to make the necessary long-term capital commitment to UST Delaware to support the corporate unit trust and unit trust operations.

There is no evidence that UST Delaware had an office or employees in New York State or owned property in New York State other than securities which were in the possession of UST New York for safekeeping under the terms of the custodial agreement. UST Delaware did not do business in New York.

We modify finding of fact "40" of the Administrative Law Judge's determination to read as follows:

> This was a joint audit by the City of New York and New York State. It results from efforts by the State Legislature to encourage uniformity in the regulations implementing the tax and the interpretations by the tax administrators by requiring both parties to "use their best efforts both to promulgate joint regulations and to take such steps as are appropriate to ensure that identical regulations and statutes are applied and interpreted uniformly and consistently" (L 1985, ch 298, § 47). To this end, the Legislature authorized the City and State to agree "(1) [to] a single audit . . . or (2) where appropriate, a consistent determination and conclusion with respect to factual matters and interpretations of law whenever such determinations and conclusions relate to substantially identical provisions" of the law (L 1985, ch 298, § 47). The direction by the Legislature made clear that any such agreement between the State and the City was to relate solely to audit and not to any action taken on the basis of any joint audit. The audit is the basis of assessments issued by the State and the City, each of which has been contested by petitioner, on the same grounds, through the separate adjudicatory procedures available to it under the Charter of the City of New York, section 168 and Article 40 of the State Tax Law.
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> The examination of the books and records of U.S. Trust was performed in New York City by Irving Milstein, a New York City auditor. Based on information provided by U.S. Trust, the Division arrived at several conclusions. It concluded that the officers and boards of directors of UST Delaware and U.S. Trust were so intertwined that all decision-making was actually being made by U.S. Trust, in New York, for UST Delaware. Based on records showing a regular pattern of telephone calls made by Mr. McNeily to U.S. Trust in New York and even more telephone calls to Mr. McNeily by persons in New York, the Division concluded that investment decisions were all being made in New York and that Mr.

> McNeily was not involved with the purchase or sale of securities. Mr. Milstein never spoke directly with Mr. McNeily during the course of the audit. Mr. Milstein saw payments made to attorneys for what he described as work performed for UST Florida and UST California. He identified these as payments made by U.S. Trust on behalf of UST Delaware, and he saw no evidence of reimbursement. Mr. Milstein also noted that U.S. Trust prepared the payroll checks for UST Delaware.[1]

In conducting its audit, the Division reviewed the Federal consolidated corporation income tax returns of U.S. Trust for fiscal years 1985, 1986 and 1987. Details of the 1986 return are selected here as exemplary of the returns for the three audit years. On the 1986 return, UST Delaware is shown as having gross income of $3,364,565.60, primarily from interest on its investments, and expenses of $317,272.43. Schedule M of the return shows a reconciliation of income per books with income per tax returns for 1986. Under the category of expenses recorded in the books of UST New York but not deducted on the group's consolidated tax return was an expense in the amount of $425,666.91 for capital acquisition costs associated with Summit (a subsidiary of UST Delaware).

The witnesses for the Division (Mr. Milstein and another auditor, Michael Shanahan) testified that the Division considered making adjustments to U.S. Trust's income or expenses in order to cure any distortion in New York income identified by the Division, but concluded that it would be too difficult to make such adjustments. The possibility of making remedial adjustments to cure distortion was not discussed with representatives of U.S. Trust. The field audit report and workpapers make no reference to the possibility of performing remedial adjustments. An internal Division memorandum, dated August 25, 1988, and the narrative portion of the Field Audit Report(s) cite to the Division's statutory authority to combine U.S. Trust and UST Delaware, but neither document refers to the statutory provisions which authorize the Division to make remedial adjustments to cure distortion of income.

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[1] We modified this finding of fact by adding the first paragraph in order to more fully reflect the record.

UST Delaware's tax returns were prepared by the tax department of U.S. Trust. U.S Trust was not reimbursed by UST Delaware for that service. The tax manager for U.S. Trust, Michael Scarpinato, testified that all legal bills paid by U.S. Trust are listed on a schedule attached to U.S. Trust's Federal income tax return. The tax department analyzed the bills to determine whether they were properly those of U.S. Trust or a subsidiary. The expense was reported on the return of the subsidiary that incurred the expense so that taxable income for each subsidiary properly reflected legal fees paid. Mr. Scarpinato explained the tax treatment of the $425,000.00 expense incurred by UST New York in connection with the acquisition of Summit by UST Delaware (see, Finding of Fact "41"). UST New York's income per books was reduced by $425,000.00 to reflect that expense. Since UST Delaware did not reimburse UST New York, the incurring of the expense would result in a reduction of UST New York's income. However, UST New York did not treat the expense as a deduction from income for Federal tax purposes, effectively increasing its Federal net income by $425,000.00. Since Federal net income is the starting point for calculating New York taxable income, this reconciliation would result in an accurate reflection of New York taxable income.

Petitioner filed a Claim for Tax Credit-Eligible Business Facility (Form CT-45) for each of the years in issue. Petitioner calculated the eligible business facility credit on a separate basis in each year, identifying UST New York as the taxpayer. The credit is calculated as a factor of the banking corporation franchise tax otherwise due and is comprised of the average of two percentages -- the eligible property percentage and the eligible wage percentage. In calculating these percentages, petitioner used only the property and wages of UST New York, apparently on the theory that UST New York was the actual owner of the property which qualified as an eligible business facility. Attached to the CT-45's were certificates of eligibility. The employer identification number shown on each certificate is that of U.S. Trust and U.S. Trust is identified as the qualifying employer in each case.

Line 5 of the CT-45 states: "Tax before credit - Schedule A, Form CT-3, CT-32 or CT-33." For tax year 1985, petitioner entered the separate tax liability of UST New York taken from the CT-32 filed by UST New York.[2] The separately computed tax credit percentage was applied to

this amount to compute the tax credit. The amount of the credit was then entered on the combined report, Form CT-32A, on line 6, and a CT-45 was attached.

OPINION

Article 32 of the Tax Law imposes a franchise tax on every banking corporation for the privilege of exercising its corporate franchise or doing business in New York State (Tax Law § 1451[a]). Whether a corporation is doing business in New York State is determined by the facts in each case (20 NYCRR 16-2.7[b]).

Each banking corporation or bank holding company is a separate taxable entity and must file its own return. However, certain affiliated corporations, including bank holding companies, are mandated to file returns on a combined basis with affiliated corporations taxable under Article 32 of the Tax Law (Tax Law § 1462[f][2][1]; 20 NYCRR 16-1.1).[3]

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[2]Each banking corporation subject to the franchise tax on banking corporations is required to file an annual return (Form CT-32) (Tax Law § 1462[a]). Affiliated taxpayer corporations in which there is 80% or more control or ownership of voting stock must file combined returns (Form CT-32A) (Tax Law § 1462[f][i]-[iii]). Thus, each of the U.S. Trust corporations subject to the franchise tax was required to file a separate return and was properly included in U.S. Trust's combined return. For the years 1986 and 1987, the Division placed in evidence the Form CT-32A combined return only. For 1985, the separate returns of each of the affiliated New York corporations were placed in evidence by the Division. Petitioner placed in evidence copies of the separate return of UST New York (Form CT-32) for 1985, 1986 and 1987. Since the filing of the separate returns was not raised as an issue on audit or at hearing, it will be concluded that the required returns were all properly filed with the Division.

[3]Tax Law § 1462(f)(2)(i) provides as follows:

> "[a]ny banking corporation or bank holding company which is exercising its corporate franchise or doing business in this state in a corporate or organized capacity, and
>
> "(A) which owns or controls, directly or indirectly, eighty percent or more of the voting stock of one or more banking corporations or bank holding companies, or
>
> "(B) whose voting stock is eighty percent or more owned or controlled, directly or indirectly, by a banking corporation or a bank holding company,
>
> "shall make a return on a combined basis under this article covering itself and such corporations described in

The Administrative Law Judge first addressed the issue of whether UST Delaware is a taxpayer, i.e., doing business in New York, since that determines whether it is subject to tax in New York (Tax Law § 1450[a]) and, thus, mandated by section 1462(f)(2)(1) to be included in the combined return of U.S. Trust unless U.S. Trust carries the burden imposed on it by section 1462(f)(2)(1) of showing that the inclusion of UST Delaware "fails to properly reflect the liability of [U.S. Trust] under [Article 32]."[4]

The Administrative Law Judge determined that while there was functional integration and centralization of management between U.S. Trust and UST Delaware, i.e., they were engaged in a unitary business as required by the Division's regulations (20 NYCRR 21-2.3[b][1]), there was no evidence that UST Delaware was exercising its corporate franchise or doing business in New York[5] (cf., Matter of U.S. Trust Corp. & Subsidiaries, New York

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> clause (A) or (B) and shall set forth such information as the [Commissioner of Taxation] may require unless the taxpayer or the [Commissioner of Taxation] shows that the inclusion of such a corporation in the combined return fails to properly reflect the tax liability of such corporation under this article. Provided, however, that no banking corporation or bank holding company not a taxpayer shall be subject to the requirements of this subparagraph unless the [Commissioner of Taxation] deems that the application of such requirements is necessary in order to properly reflect the tax liability under this article, because of intercompany transactions or some agreement, understanding, arrangement or transaction of the type referred to in subsection (g) of this section" (Tax Law § 1462[f][2][i]).

[4]The regulation creates a presumption that where the 80% stock ownership criterion is met, the tax liability of the affiliated taxpayers will be properly reflected when they report on a combined basis. This presumption may be rebutted by any member of the group or the Division by showing that "the inclusion of [the corporation] in the combined return fails to properly reflect [its] tax liability . . . under article 32 of the Tax Law" (20 NYCRR 21-2.2[b]).

Tax liability may be deemed to be improperly reflected because of a) intercorporate transactions or b) some agreement, understanding, arrangement or transaction between the taxpayer and any other corporation in the affiliated group whereby the activity, business, income or assets of the taxpayer within New York State is improperly or inaccurately reflected (20 NYCRR 21-2.2[b]).

[5]The Division's regulations provide that in determining whether a corporation is doing business in New York State:

> "[c]onsideration is given to such facts as:
>
> "(1) the nature, continuity, frequency and regularity of the activities of the corporation in New York State;
> "(2) the purposes for which the corporation was organized;
> "(3) the location of its offices and other places of business;
> "(4) the employment in New York State of agents, officers and

City Tax Appeals Tribunal-Administrative Law Judge Division, December 14, 1995 [where the Administrative Law Judge concluded, based on similar factors, that UST Delaware was doing business in New York City]). Consequently, UST Delaware was not a taxpayer during the audit years, was not mandated to file a return under Article 32 (20 NYCRR 21-1.1) and was not required to file a tax return on a combined basis with U.S. Trust unless combined reporting was necessary to properly reflect U.S. Trust's Article 32 tax liability because of intercompany transactions or some agreement, understanding, arrangement or transaction of the type referred to in Tax Law § 1462(g) (see also, 20 NYCRR 21-2.6).

The Division concedes on exception that:

> "[t]he ALJ was correct in stating that this matter does not concern mandatory combination [required by statute] as only UST New York is a New York taxpayer. The Division believes that [it] has discretionary authority to require a combined report in this situation because there exists an . . . agreement, understanding or arrangement . . . between the taxpayer and any other corporation or any person or firm, whereby the activity, business, income or assets of the taxpayer within the state is improperly or inaccurately reflected (Tax Law § 1462[g])" (Division's brief, p. 21).

We agree with the analysis and conclusion of the Administrative Law Judge and with the concession of the Division on exception that UST Delware is not a taxpayer and, thus, this matter does not concern mandatory combination as required by statute.

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employees; and
"(5) the location of the actual seat of management or control of the corporation.

"(c) Examples of activities of a corporation which would constitute doing business in New York State include the following:

"(1) operating a branch in New York State;
"(2) operating a loan production office in New York State;
"(3) operating a representative office in New York State; or

"(4) operating a bona fide office in New York State" (20 NYCRR 16-2.7[b] & [c]).

The Administrative Law Judge next addressed the issue of whether the Division carried its burden, under the statute, of showing that UST Delaware, a nontaxpayer, was required to be included in the combined return of U.S. Trust.

Since UST Delaware is 100% owned by U.S. Trust, it is presumed to be part of a unitary business, a presumption which UST Delaware does not rebut (20 NYCRR 21-2.3[b][1]). In order to include UST Delaware in a combined report, the Division must show that because of intercorporate transactions or some agreement, understanding, arrangement or transaction between U.S. Trust and UST Delaware, U.S. Trust's liability will not be properly reflected (20 NYCRR 21-2.2).

We deal first with the custodial agreement identified in the audit report as a non-arm's length intercorporate transaction causing petitioner's tax liability to be inaccurately reflected. The Administrative Law Judge concluded that petitioner showed that the terms of the agreement were consistent with similar agreements between UST New York and unrelated third parties. In short, it was an arm's length transaction. We agree. The Division offered no evidence to overcome petitioner's showing that the custodial agreement was an arm's length transaction. Nor is there any other evidence in the record which provides a basis for this Tribunal to conclude that the agreement was not arm's length. Consequently, we conclude that petitioner has overcome any presumption of distortion which might be said to have arisen because of the custodial agreement.

The Administrative Law Judge next concluded that the infusion of capital into UST Delaware was a contribution of capital and not an intercorporate transaction as asserted by the Division. On exception, the Division asserts that the infusions of capital were intercompany loans and intercorporate transactions for purposes of combined reporting (Division's brief, p. 31). The Division challenges only that portion of the Administrative Law Judge's rationale concerning Internal Revenue Code § 1502 and its related regulations asserting they are not relevant in determining distortion. In the alternative, the Division argues that assuming that the regulations are relevant, that "intercorporate distributions are treated as intercompany transactions pursuant to proposed Treas. Reg. § 1.1502-13(b)(1)(I)" (Division's brief, p. 33) which the Administrative Law Judge did not consider in reaching her determination.

We affirm the determination of the Administrative Law Judge. First, there is nothing in the record which indicates that these infusions of capital were "loans," as the Division asserts. Second, the Administrative Law Judge relied on the Division's own regulations in reaching her conclusion that contributions to capital are not intercorporate transactions. These regulations provide that "the [Commissioner of Taxation] will consider transactions directly connected with the business conducted by such corporations," i.e., corporations in the unitary group (20 NYCRR 21-2.3[b][3][i]). We agree with the Administrative Law Judge that "[c]learly, U.S. Trust cannot be considered to be in the business of making capital contributions nor can UST Delaware be considered to have been in the business of receiving such contributions" (Determination, conclusion of law "D"). Accordingly, the contributions to capital are not intercorporate transactions as asserted by the Division.

The Administrative Law Judge next addressed the Division's assertion that "the vast majority of intercorporate transactions at issue . . . were not taken at arm's length . . . [and that] there was no attempt by UST Delaware to compensate [U.S. Trust] for services which [U.S. Trust] provided [such as] the selection, management strategy and legal services for the acquisition and management of subsidiaries of UST Delaware" (Determination, conclusion of law "D").

The Administrative Law Judge observed that the intercorporate transactions "cavalierly referred to in the Division's brief" were not identified as grounds for combination on audit and that the Division's assertions were not substantiated at hearing. She concluded that "there is insufficient evidence in the record to support a finding that U.S. Trust's tax liability was inaccurately reported because of unspecified services it performed in connection with the acquisition of subsidiaries by UST Delaware" (Determination, conclusion of law "D").

On exception, the Division makes the same broad assertions made in its post-hearing brief referred to by the Administrative Law Judge.

Additionally, the Division asserts that it is not mandated to state each and every item of distortion that might possibly exist. "Rather, the Division is required to establish a rational basis for its determination and, thereafter, the burden of proof rests with the taxpayer to establish that the intercorporate transactions do not lead to the distortion in the franchise tax liability of the New York taxpayer" (Division's reply brief, p. 5). We cannot agree. First, the Division's argument is contrary to its own regulations which place the onus on the Division to identify the substantial intercorporate transactions which give rise to the presumption. Specifically, they provide that if there are substantial intercorporate transactions among the corporations engaged in the unitary business, it will be presumed that the tax liability of the taxpayer will be improperly reflected when the taxpayer reports on a separate basis (20 NYCRR 21-2.3[b][3][i]).

In determining whether there are substantial intercorporate transactions, the Division:

> "will consider transactions directly connected with the business conducted by such corporations, such as:
>
> "(a) performing services for other corporations in the group;
>
> "(b) providing funds to other corporations in the group; or
>
> "(c) performing related customer services using common facilities and employees" (20 NYCRR 21-2.3[b][3][i]).

Second, we agree with the logic of the Administrative Law Judge that "if a taxpayer is to be asked to overcome a presumption of distortion, it is incumbent upon the Division to first identify those intercorporate transactions which it claims give rise to the distortion" (Determination, conclusion of law "D"). Third, we agree with the Administrative Law Judge that there is insufficient evidence in the record to support the Division's assertion.

Next, the Administrative Law Judge addressed the issue of whether U.S. Trust's New York tax liability may be deemed to be distorted because of some agreement, understanding or arrangement between it and UST Delaware.[6]

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[6]The Division's regulations provide as follows:

> "(c) In determining whether an agreement, understanding or

The Administrative Law Judge characterized the specific arrangement identified by the Division on audit as follows:

> "[o]n audit, the Division concluded that an arrangement existed between U.S. Trust and UST Delaware which was motivated primarily by a tax avoidance purpose . . . . The Division determined that UST Delaware served as a vehicle which allowed U.S. Trust (or UST New York) to channel large sums of capital outside of New York. It was the Division's understanding that UST Delaware served three functions: (1) to hold the stock of UST Florida; (2) to hold in its own name the investments made with the capital contributed to it by U.S. Trust; and (3) to provide U.S. Trust with an accounting of the money invested and the interest and dividends earned, essentially a bookkeeping function. Based on this understanding of the relationship between U.S. Trust and UST Delaware, the Division made the determination that UST Delaware was "merely a shell company"; that U.S. Trust "channeled large amounts of its cash to U.S. Trust of Delaware in the form of additional paid in capital <u>for the purpose of having U.S. Trust of Delaware, rather than themselves, invest this cash in investments</u>" (emphasis
>
> added); and that U.S. Trust transferred the recordkeeping activities of these investments from New York to Delaware (presumably to remove those activities from New York). The Division concluded that this transaction was not at "arms-length" and was the kind of "agreement, understanding, arrangement or transaction" which under the law and regulations gives rise to a presumption of distortion" (Determination, conclusion of law "E").

The Administrative Law Judge concluded that petitioner proved that the audit assumptions which formed the basis for the assessment have no factual underpinnings. She determined that UST Delaware was not a shell corporation as alleged by the Division but was formed for valid business purposes.

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arrangement between the taxpayer and any other corporation or any person or firm results in an improper or inaccurate reflection of the activity, business, income or assets of the taxpayer within New York State, consideration is given to such factors as:

"(1) whether the taxpayer controls or is controlled by such other corporation, person or firm, or whether the taxpayer and such other corporation, person or firm are controlled by the same interest;

"(2) whether the agreement, understanding or arrangement in question would have been entered into, or whether the terms and conditions would have been the same, had the element of control been absent and had the parties been dealing at arm's length; and

"(3) whether the agreement, understanding or arrangement in question has a reasonable business purpose, or whether it appears to be arbitrary or to have been motivated principally by a tax avoidance purpose" (20 NYCRR 18-1.3[c]).

The Division raises the same assertions on exception as it raised before the Administrative Law Judge. We find no reason to alter the determination of the Administrative Law Judge. The facts are clear. The capital contributions made by U.S. Trust to UST Delaware were not for the purpose of having UST Delaware earn income which would otherwise be included in U.S. Trust's New York income. UST Delaware was formed primarily for the purpose of holding the stock of UST Florida and with the intention of having it serve as the holding company for the stock of other banks, trust companies and investment advisory services incorporated in states other than New York. U.S. Trust made a decision to use a subsidiary as the vehicle for its expansion into other states because it believed that local bank regulators and out-of-state banks would be less hostile to a non-New York holding company. U.S. Trust also recognized that those states where it intended to enter into business -- Florida, California and Texas -- were unitary tax jurisdictions, and it believed that U.S. Trust would be vulnerable to combination in those jurisdictions if it directly owned the stock of the businesses operating in those states. U.S. Trust also believed that, in order to exploit the non-bank bank loophole in the BHCA, it would be necessary for the parent company of UST Florida to follow an extremely restrictive investment policy. To accomplish this, it was necessary for the parent to be a corporation other than U.S. Trust. U.S. Trust contributed approximately $19,000,000.00 in capital to UST Delaware in anticipation of the move of the corporate and unit trust divisions of UST New York from New York to Delaware.

The out-of-state expansion anticipated by U.S. Trust actually occurred. In October 1986, UST Delaware acquired the shares of Summit for $4,350,630.00. In 1989, Deltex (a wholly-owned subsidiary of UST Delaware) acquired shares of Denker and Goodwin, a Texas investment advisory company. UST Delaware made significant contributions of capital to its operating subsidiaries from the period June 1982 through August 1990: $7,518,437.00 to UST Florida; $5,000,000.00 to Saudi-UST; $4,900,000.00 to UST California; and $4,703,000.00 to Deltex.

We also reject the Division's assertion that "[t]he only conclusion which can be reached is that the petitioner and UST Delaware are so intertwined that for all practical purposes they appear to the outside world to be the same organization and thus a unitary business" (Division's brief, p. 24). This argument is grounded in the Division's belief the elements which go into establishing a unitary relationship, i.e., functional integration, centralization of management and economies of scale, are alone sufficient to require combination. That is just not the case. The Division's regulations require the existence of a unitary business in order for the Division to require or permit combination and create a presumption that a unitary business relationship exists where the 80% stock ownership criterion is met (20 NYCRR 21-2.3[b][1]). However, the regulations and the statute require more of the Division in order for it to require combination. The Division must specify transactions or arrangements between petitioner and UST Delaware which are of such a nature as to distort petitioner's income in New York. We agree with the well-reasoned determination of the Administrative Law Judge that the Division has not carried its burden here.

> "It can be concluded from the evidence that the board of directors of UST Delaware made decisions and adopted policies in conjunction with U.S. Trust's board of directors (with the exception of Mr. Callaway, all members of the UST Delaware board were members of the U.S. Trust board). It is also apparent that there was a flow of value from U.S. Trust to UST Delaware. U.S. Trust's contributions to the capital of UST Delaware clearly demonstrate a flow of value. However, I cannot agree with the Division that these contributions constitute an intercorporate transaction not undertaken at arm's length. The capitalization of a subsidiary by its parent is not the equivalent of a loan as the Division seems to suggest. In return for its capital, the parent receives an ownership interest in the subsidiary. The fact that UST Delaware paid no dividends to its parent during the audit period does not establish that the contribution to capital was not an arm's length transaction. As petitioner notes, the benefits received by U.S. Trust from its subsidiaries exist in the form of the increased value of those subsidiaries and will be realized on sale or liquidation of the subsidiaries. Finally, it is undisputed that UST Delaware is in the same business as U.S. Trust, the banking business. <u>All of this serves to prove that U.S. Trust and UST Delaware were engaged in a unitary business enterprise, a proposition which has never been in issue. It does not show that U.S. Trust's income was improperly reflected by separate filing.</u> There is not substantial evidence in the record to support a conclusion that combined filing is necessary to properly reflect petitioner's tax liability; therefore, tax asserted on this basis

> shall be cancelled" (Determination, conclusion of law "E," emphasis added).

We deal next with the issue of the proper construction of Tax Law § 1462(g).

Tax Law § 1462(g) provides, in pertinent part:

> "[i]n case it shall appear to the [Commissioner of Taxation] that any agreement, understanding or arrangement exists between the taxpayer and any other corporation or any person or firm, whereby the activity, business, income or assets of the taxpayer within the state is improperly or inaccurately reflected, the [Commissioner of Taxation] is authorized and empowered, <u>in its discretion</u> and in such manner as it may determine, to adjust items of income or deductions in computing entire net income or alternative entire net income and to adjust assets, and to adjust wages, salaries and other personal service compensation, receipts or deposits in computing any allocation percentage, provided only that entire net income or alternative entire net income be adjusted accordingly and that any asset directly traceable to the elimination of any receipt be eliminated from assets so as to accurately determine the tax. <u>If however, in the determination of the [Commissioner of Taxation], such adjustments do not, or cannot effectively provide for the accurate determination of the tax, the [Commissioner of Taxation] shall be authorized to require the filing of a combined report by the taxpayer and any such other corporations</u>" (emphasis added).

The Division's regulations provide that the Commissioner of Taxation is not required to exercise his authority under section 1462(g) and 20 NYCRR 18-1.3 and, in lieu thereof or in addition thereto, a combined return may be required or permitted (20 NYCRR 18-1.3[a][3]).

The Administrative Law Judge divided her analysis of the section into two questions: "(1) whether Tax Law § 1462(g) obliges the Division to make a determination that remedial adjustments do not, or cannot, cure distortion before requiring combination and, if so, (2) what level of effort is required of the Division to show that its determination is reasonable" (Determination, conclusion of law "B").

The Administrative Law Judge concluded that the Legislature did not intend that the remedial adjustment provisions of section 1462(g) be a condition precedent to combination. Specifically, the Administrative Law Judge pointed out that under the section the Division is authorized and empowered in its discretion to make certain adjustments to items of income and deductions so as to accurately determine the tax due. The Administrative Law Judge found that this wording indicates that the Commissioner is authorized to make such adjustments to correct distortion, but is not required to do so. The Administrative Law Judge rejected petitioner's argument that the second sentence of the section controls the interpretation of the section. "Taken out of context, the second sentence might appear to have the meaning ascribed to it by petitioner. But when read with the language surrounding it, as it must be, it is clear that section 1462(g) is intended as a grant of authority to the Commissioner to make remedial adjustments, in his discretion, not as a legislative directive requiring the Commissioner to attempt such adjustments before resorting to combination" (Determination, conclusion of law "B").

Petitioner, in its Notice of Exception:

> "disagrees with the Administrative Law Judge's conclusion that the Division was not obligated to attempt to cure any perceived distortion through the application of remedial adjustments provided for in Tax Law § 1462(g) before requiring U.S. Trust of Delaware's inclusion in U.S. Trust's combined returns for calendar years 1985, 1986 and 1987" (Petitioner's exception, ¶ 1).

The crux of petitioner's argument is that the second sentence in section 1462(g) was added to require the Division to first address the possibility of remedial adjustments to cure distortion before requiring combination. Petitioner argues that if Article 32 was only intended to provide two separate alternatives, as concededly exists under Article 9-A, then this language, which is not present in section 211(5), would not be necessary.

> "The sentence in question must have been added for a reason and a meaning must be ascribed to it. It is submitted that it was added to require the Division to make remedial adjustments to attempt to cure perceived distortion before resorting to the more drastic measure of requiring a combined return with another corporation" (Petitioner's brief, p. 26).

The Administrative Law Judge agreed with petitioner's assertion that the Division never attempted to make remedial adjustments before requiring combination in this case. Based on the review of the record, she concluded that the Division did not give serious consideration to the possibility of making remedial adjustments and never attempted such adjustments.

We affirm the determination of the Administrative Law Judge. The authority for the Division to require combination of a nontaxpayer banking corporation or bank holding company is Tax Law § 1462(f)(2)(I). The authority is conditioned <u>only</u> upon the Division finding that combination is necessary to "properly reflect . . . tax liability because of intercompany transactions or some agreement, understanding, arrangement or transaction of the type referred to in subsection (g) of this section." In short, nothing in this section requires the Division to attempt remedial adjustments under section 1462(g) as a condition precedent to the requirement of combination by the Division. The reference to (g) is merely to describe the nature of the agreement, understanding or arrangement which forms the basis for the Division's determination to require combination, i.e., "[a]ny agreement, understanding or arrangement . . . between the taxpayer and any other corporation . . . whereby the activity, business, income or assets of the taxpayer within the state is improperly or inaccurately reflected" (Tax Law § 1462[g]).

The plain meaning of section 1462(g) is that the Division has the authority, in its discretion, to make remedial adjustments to achieve an accurate determination of tax where such arrangements are found to exist. "If, however . . . such adjustments do not, or cannot effectively provide for the accurate determination of the tax, the [Commissioner of Taxation] shall be authorized to require the filing of a combined report by the taxpayer and any such other corporations" (Tax Law § 1462[g]). We find nothing in this language which requires the Division to first attempt remedial adjustments as a condition to requiring combination. We note that nothing in the history of the legislation enacting section 1462(g) clarifies the matter. In fact, the views expressed by the Division and petitioner in this case were expressed by the Division and the New York State Banker's Association when the bill was before the Governor for action in 1985 (see, Letter to Counsel to the Governor from Roderick G. W. Chu, Commissioner of Taxation & Finance, dated August 16, 1985; Letter to Counsel to the Governor from New York State Bankers Association, dated July 8, 1985).

Next, we address the issue of the eligible facility credit.[7] The Administrative Law Judge rejected petitioner's assertion that it properly calculated the credit on a separate basis rather than on a combined basis as asserted by the Division. She found no evidence that the Legislature intended to exempt the eligible business facility credit from the general rule of combination (in section 1462).

On exception, petitioner:

> "disagrees with the Administrative Law Judge's conclusion that the Division was authorized to recompute for the years in issue the eligible business facility credit of United States Trust Company of New York, which corporation owned the eligible business facilities, on a combined basis, taking the wages, property and tax liabilities of corporations not owning eligible business facilities into consideration" (Petitioner's exception, ¶ 2).

In essence, petitioner argues that the credit should be claimed and granted to the taxpayer eligible to receive the credit under section 1456(b] and that corporations in the affiliated group which do not own the eligible facility should not receive the benefit of the credit. Since UST New York owns the facility, it alone should benefit from the credit.

We affirm the determination of the Administrative Law Judge.

First, we point out, as did the Administrative Law Judge, that the certificate of eligibility was issued to U.S. Trust and not to UST New York. Second, the basis of combined reporting under the statute is that the tax liability of the affiliated group is properly reflected by reporting on a combined basis. We find no exception in section 1462 which would allow this credit to be reported on a separate basis by a member of the affiliated group.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

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[7]Tax Law § 1456(b)(1) provides:

> "[o]n or after April first, nineteen hundred eighty-three, a credit against the tax imposed by this article shall be allowed only to a taxpayer owning or operating an eligible business facility, where such taxpayer has received a certificate of eligibility for tax credits, or a renewal or extension thereof, for such facility from the New York state job incentive board prior to April first, nineteen hundred eighty-three, or has received a certificate of eligibility for tax credits, or a renewal or extension thereof, for such facility from the state tax commission subsequent to such date pursuant to paragraph eight of this subsection, and only with respect to such facility, to be computed as hereinafter provided."

1. The exception of U.S. Trust Corporation is denied;

2. The exception of the Division of Taxation is denied;

3. The determination of the Administrative Law Judge is affirmed;

4. The petition of U.S. Trust Corporation is granted to the extent indicated in conclusion of law "I" of the Administrative Law Judge's determination, but in all other respects is denied; and

5. The Division of Taxation is directed to modify the notices of deficiency for the years 1985, 1986 and 1987 in accordance with paragraph "4" above, but in all other respects the notices are sustained.

DATED: Troy, New York
April 11, 1996

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

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

/s/Donald C. DeWitt
Donald C. DeWitt
Commissioner