STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
INTERNATIONAL NICKEL, INC. AND INCO ALLOYS INTERNATIONAL, INC.	:	DECISION DTA No. 810675
for Redetermination of Deficiencies or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1984, 1985 and 1986.	:	

Petitioners International Nickel, Inc. and Inco Alloys International, Inc., c/o Inco United States, Inc., One New York Plaza, New York, New York 10004, filed an exception to the determination of the Administrative Law Judge issued on August 11, 1994. Petitioners appeared by Price Waterhouse (John J. Fielding, C.P.A.). The Division of Taxation appeared by William F. Collins, Esq. (John O. Michaelson, Esq., of counsel).

Petitioners filed a brief on exception. The Division of Taxation filed a brief in opposition. Petitioners did not file a reply brief. Petitioners withdrew their request for oral argument on May 9, 1995, which date began the six-month period for the issuance of this decision.

Commissioner Dugan delivered the decision of the Tax Appeals Tribunal. Commissioner DeWitt concurs. Commissioner Francis R. Koenig took no part in the consideration of this decision.

ISSUES

I. Whether petitioners properly classified income received from a pension reversion as investment income.

II. Whether, if the income received from the pension reversion is properly classified as business income, petitioners should be allowed to include that income in the receipts factor of their business allocation percentage.

III. Whether petitioners have established reasonable cause for abatement of penalties.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge. These facts are set forth below.

Petitioner International Nickel, Inc., a subsidiary of a Canadian corporation, is a Delaware corporation doing business in New York as a trader of non-ferrous metals. Petitioner Inco Alloys International, Inc. is a subsidiary of International Nickel, Inc. For tax years 1984 through 1986, petitioners filed New York corporation franchise tax reports on a combined basis. Petitioners will be referred to from here on as "INCO".

As the result of a field audit, the Division of Taxation ("Division") issued to International Nickel, Inc. four notices of deficiency, dated October 19, 1990, asserting tax deficiencies as follows:

Period Ended	Corporation Franchise Tax	MTBTS*
December 31, 1984	$ 17,960.00	$1,183.00
December 31, 1985	502,395.00	
December 31, 1986	10,296.00	

* the Metropolitan Transportation Business Tax Surcharge

In addition to deficiencies in tax, the notices asserted interest and additional charges, or penalties.

The deficiencies asserted were adjusted on the faces of the notices of deficiency by crediting certain amounts paid (apparently, during or after the audit) to the total amounts of tax, penalty and interest asserted in the notices. Thus, the balances due are shown as $1,796.00 for the period ended December 31, 1984; $118.00 (MTBTS) for the same period; $134,398.00 for the period ended December 31, 1985; and $1,030.00 for the period ended December 31, 1986. INCO challenged all of the notices of deficiency in its petition; however, the only issued raised by INCO concerns its computation of 1985 income, specifically whether income from a pension reversion was properly treated by INCO as investment income. It is not known whether the

amounts asserted for 1984 and 1986 have any relationship to this issue (although it appears that they do not). It is not known whether the entire amount of the 1985 deficiency relates to the pension reversion income.

Prior to 1985, INCO and several other related companies were participants in a defined benefit pension plan known as the INCO Retirement System (the "Pension Plan"). The Pension Plan was funded entirely by employer contributions. The assets of the Pension Plan were held and managed by a trustee under a trust agreement with INCO's parent corporation; however, the parent corporation's board of directors maintained broad authority over the Pension Plan trust fund. The INCO Retirement System Rules and Regulations contain the following provisions evidencing that authority:

> "7.2 The Board of Directors shall appoint a Funding Committee which shall consist of such number of employees of the Companies as shall from time to time be determined by the Board of Directors. The members of the Funding Committee and their successors shall be appointed from time to time by the Board of Directors and shall have such tenure of office as the Board of Directors shall determine.
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> "7.3 With the advice of the actuary appointed pursuant to Section 7.8, the Funding Committee shall establish a funding policy and method consistent with the objectives of the System and requirements of the Act. The Funding Committee, either directly or through another committee designated under the System, shall cause such policy to be communicated to the person or persons responsible for determining policies in respect of investments of the Trust Fund and, under the funding method and policy then in effect, such Committee shall determine for authorization by the Board of Directors the amount of contributions to be made to the Trust Fund by the Companies to provide Pensions to Employees, Pensioners and their beneficiaries under the System.
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> "7.4 The Companies shall make such contributions to the Trust Fund as may be authorized by the Funding Committee and approved by the Board of Directors.
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> "7.5 All payments made pursuant to this Section 7 shall be paid to the Trustee under the Agreement of Trust and shall become a part of the Trust Fund. The Trust Fund shall be held and disbursed in accordance with the provisions of the System. No person shall have any interest in, or right to, any part of the Trust Fund, except as expressly provided in the System. The Trustee shall have exclusive authority and discretion to manage and control the assets of the System unless the authority to manage, acquire or dispose of such assets is delegated to one or more Investment Managers or Investment Committees pursuant to Section 7.7.
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> "7.6. The Board of Directors may remove the Trustee at any time upon notice as provided in the Trust Agreement, and, in such event or in the event any Trustee shall resign, the Board of Directors shall appoint a successor Trustee.
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> "7.7. The Board of Directors may appoint one or more Investment Managers or

> Investment Committees to manage, acquire or dispose of all or any portion of the assets of the System; provided that any Investment Manager so appointed shall qualify as such under the terms of the Act; and that the members of any Investment Committee shall be employees of the Companies. If an Investment Manager or Investment Committee shall have been appointed by the Board of Directors, the Trustees shall not invest or otherwise manage any assets of the System which are subject to the management of such Investment Manager or Investment Committee, unless otherwise directed by such Manager or Committee."

The Pension Plan was terminated as of 1985. At the time of termination, the plan was overfunded, i.e., its assets exceeded its liabilities, and the excess amount reverted to the participating companies which had initially funded the plan. As a result, INCO received income, referred to as a pension reversion, in the amount of $98,855,000.00. It included this amount in its calculation of Federal taxable income and State entire net income for the 1985 tax year.

For purposes of computing and allocating its New York entire net income, INCO treated the pension reversion income as investment income. INCO attached a rider to its 1985 corporation franchise tax report which explains the nature of what it called "Pension Investment Income" as follows:

> "This income is characterized as non-business/non-apportionable income as it is composed of dividends, interest and gains/losses from a pension plan reversion."

INCO broke down total income from the pension reversion into the following categories and amounts: dividends in the amount of $25,138,000.00; U.S. Government interest in the amount of $11,352,000.00; other interest in the amount of $15,073,000.00; and capital gains in the amount of $47,292,000.00. INCO claimed a 50 percent deduction for dividend income pursuant to Tax Law § 208(9)(a)(2). Thus, its total investment income was reported as $86,286,000.00. Its total business income was reported as $7,341,378.00.

New York State allows every corporation to allocate its investment capital and income within and without New York so that corporations are subject to tax only on the portion of their activities attributable to New York. For corporate securities, the investment allocation percentage is calculated by determining the amount of capital employed in New York by the issuing corporations. All government obligations (Federal, State and local) are deemed to have

a zero allocation percentage. The issuing corporation's allocation percentage is based on the issuer's allocation percentage, if any, indicated on the New York tax return filed by the issuing corporation. The Division publishes a listing of such percentages which can be obtained directly from the Division.

INCO calculated an investment allocation percentage for 1985 of 1.7966 percent. This was done in the following manner. INCO analyzed the Pension Plan's portfolio for 1983, 1984 and 1985 and, based on its own research, placed a market value on the corporate stock of each issuing corporation in the portfolio. INCO calculated a value for each of the three years in the analysis but used only the 1983 values to determine its 1985 investment allocation percentage. The market value of all corporate securities with a reported New York allocation percentage in 1983 was determined to be $76,442,612.00.[1] Each issuing corporation's allocation percentage was applied to the total value of that corporation's stock to determine the amount to be allocated to New York. This resulted in total market value allocated to New York of $6,010,931.00. Additional securities held by the pension fund were determined to have a market value of $258,134,496.00 and a zero allocation percentage. The allocation percentage was determined by dividing the New York amount ($6,010,931.00) by the total market value of all securities held by the pension fund in 1983 ($334,577,108.00). Thus, INCO treated the pension reversion income as though it was the owner of the underlying securities which produced that income and as if the dividends, interest and capital gains from those securities were received in 1985.

INCO's original contributions to the Pension Plan were treated as ordinary business expenses and deducted from business income. On its 1985 Federal tax return, INCO reported the income from the pension reversion as ordinary income. It reported no dividend income and no capital gain income.

On audit, the Division determined that the entire amount of the pension reversion is properly classified as business income. In addition, the Division disallowed the 50 percent

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[1]The total value of all corporate securities with a New York allocation was $76,442,612.00 in 1983, $79,093,885.00 in 1984 and $32,900,919.00 in 1985.

deduction from dividend income claimed by INCO. The Division recalculated INCO's corporation franchise tax liability in accordance with these adjustments. The Division also asserted additional charges for substantial understatement of the tax required to be reported.

INCO supplied the Division with all information requested on audit and cooperated fully with the auditors. At the time of the audit, the Division had not promulgated regulations governing the proper treatment of pension reversions. The Division's policy of treating a pension reversion as business income was not disseminated to the public through regulation or any other official document.

OPINION

We deal first with the issue of whether the "pension reversion is properly reported as investment income or business income" (Determination, conclusion of law "A").

The Administrative Law Judge determined that petitioners:

> "never directly owned the underlying stocks, bonds or other securities which generated the income which it received in the form of a pension reversion in 1985. INCO did not invest its capital in the stocks, bonds and other securities which generated the Pension Plan income. Since the pension reversion was not income from INCO's investments, it was not investment income to INCO (see, Custom Shop v. Tax Appeals Tribunal, 195 AD2d 702, 600 NYS2d 295)" (Determination, conclusion of law "B").

The Administrative Law Judge was not persuaded by petitioners' "look through" argument, i.e.,

> "Although the corporation may not have directly owned the investment assets, its parent controlled the investments and managed the fund on behalf of INCO's employees. Since Inco was entitled to the proceeds of the overfunding which was generated by investments in stocks, bonds and other securities, Inco reasonably looked through the asset to determine its character. An analogous situation would be the manner in which a corporate partner is required to look through to the underlying investments in a partnership to determine its investment capital even though the corporate partner and partnership are distinct entities" (Petitioners' brief, p. 7).

The basis for this argument was 20 NYCRR 4-6.5 which relates to allocation by a corporate partner of a partnership. The Administrative Law Judge found that this regulation:

> "has no applicability to a pension reversion. As a general matter, an entity classified as a partnership is not subject to the personal income tax under either New York or Federal law. Each partner, however, is taxed

separately in his or her individual capacity as a partner carrying on a trade or business. Thus, section 3-13.2 of the Rules and Regulations of the Department of Taxation and Finance provides as follows:

> "'**Source and character of partnership items.** Each partnership item of income, capital, gain, loss or deduction has the same source and character in the hands of a partner for article 9-A purposes as it has in its hands for Federal income tax purposes. Where an item is not characterized for Federal income tax purposes or is not required to be taken into account for Federal income tax purposes, the source and character of the item shall be determined as if such item were realized by the partner directly from the source from which realized by the partnership, or incurred by the partner in the same manner as incurred by the partnership' (emphasis added).
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> "If a pension plan trust fund were taxed like a partnership, INCO would have been required to include its share of the assets and income of the pension trust in its calculation of investment capital and investment income during all of the years previous to the Pension Plan's termination. Moreover, INCO would have been liable for Federal and State tax on that income. It was not required to do so because a pension plan trust fund is not treated like a partnership under Article 9-A of the Tax Law. Simply put, there is no legal authority for the 'look through' principle INCO employed to calculate its investment income" (Determination, conclusion of law "B").

On exception, petitioners reiterate the arguments made at hearing.

We affirm the determination of the Administrative Law Judge. Matter of Custom Shop v. Tax Appeals Tribunal (supra), relied upon by the Administrative Law Judge, is dispositive. In Custom Shop, the taxpayers were New York corporations which operated retail men's clothing stores in New York. They were members of an affiliated group of corporations which created a corporation known as the Payment Corporation to which the gross revenues of each member of the group were transferred on a periodic basis. Payment Corporation maintained a separate account for each member corporation from which Payment paid the operating expenses of each member. Excess revenues were then pooled and invested by Payment, in its own name, in common and preferred stocks, certificates of deposit and money market funds. Income and losses from the investment were allocated to the members of the group.

The petitioners asserted that the income was derived from investment capital held by Payment as the nominee or agent of the members and was investment income. The Division argued that Payment was not the nominee or agent of the group for investment purposes and

that the income received by Payment and allocated to the group was not investment income.

In affirming our decision, the Appellate Division noted that:

> "[a]lthough petitioners' argument represents a reasonable and logical interpretation of those terms, the question is whether the construction adopted by the Tribunal is rational, not whether a rational alternative construction exists" (Matter of Custom Shop v. Tax Appeals Tribunal, supra, 600 NYS2d 295, 297).

The Court went on to state that:

> "[t]he Tribunal's determination is based upon its conclusion that whether income is investment income to a specific taxpayer within the meaning of the Tax Law depends upon the taxpayer's particular relationship to the asset, not upon ascribing an absolute, unchanging character to an asset and concluding that any income derived from that asset must be investment income. Tax Law § 208(5) defines investment capital as '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.' The relevant regulation provides that 'investment capital means the taxpayer's investments in stocks, bonds and other securities' (20 NYCRR 3-4.2[a][1] [emphasis in original]). Investment income is derived investment capital (Tax Law § 208[6]), and based upon these definitions the Tribunal concluded that unless the income was actually derived from the taxpayer's investments it was not investment income to that taxpayer. The Tribunal further concluded that because the amount of the income from investments which the Payment Corporation distributed to each member of the Custom Shop Group . . . was not based upon the amount invested by each member, the distribution to each member was not actually derived from the distributee's investments and, therefore, was not investment income to the distributee" (Matter of Custom Shop v. Tax Appeals Tribunal, supra, 600 NYS2d 295, 297).

In short, the critical element is that the investments must be those of petitioners. They were not in Custom Shop, thus, the Court's conclusion that they were not investment capital. Here, the investments are not those of petitioners but the investments of the pension plan. Moreover, whereas in Custom Shop the investments were made for the benefit of the members of the group, here the investments were made for the exclusive benefit of the employees or their beneficiaries (see, Treas. Reg. § 1.401-2). Accordingly, we find Custom Shop dispositive.

We deal next with petitioners' alternative argument that if the pension reversion is business income, that the Division should exercise the discretionary authority vested in it under Tax Law § 210(8) and include the pension reversion in the business receipts factor of

petitioners' business allocation percentage.

The Administrative Law Judge rejected petitioners' alternative argument. Specifically, she found that, under the Division regulations (20 NYCRR 4-4.1[a]), business receipts are defined as the gross income received in the regular course of the taxpayer's business, provided such receipts are includable in the computation of the taxpayer's entire net income for the taxable year. She opined that:

> "[u]nder this definition, the pension reversion would not be includable in business receipts since it was not received in the ordinary course of business. INCO offers no challenge to this regulation; rather, it argues that the pension reversion should be included in the business receipts factor in order to avoid distortion of New York income (Tax Law § 210[8]). INCO offers no basis for its claim that failure to include the pension reversion in business receipts will distort the calculation of entire net income, but it seems to presume that a one-time receipt of income in such a large amount shows distortion. I cannot agree. The receipt of the pension reversion may have been anomalous, but this in itself does not establish distortion in the year in which it was received" (Determination, conclusion of law "C").

On exception, petitioners reiterate their argument at hearing. The essence of petitioners' argument is as follows:

> "[i]f the income from the pension reversion is business income generated from ordinary income, the discretionary adjustment should be applicable so that the pension reversion income is included in the denominator of the receipts factor as business income. For the pension reversion income to be business income, because ordinary pension plan deductions were made over the years and it was classified as ordinary income for federal purposes, and not to be included in the receipts factor, creates a distortion. Even though the pension reversion represents a one-time receipt of income, it represents a continuous investment from all the years in which pension plan contributions were made by INCO.
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> "In situations where there is a potential for distortion, as is the case regarding this pension reversion, we believe the Commissioner should use his discretionary power to adjust the allocation factor. An adjustment in this case would more fairly and clearly reflect the activities of INCO in New York State" (Petitioners' brief on exception, p. 3).

On exception, the Division argues that the Administrative Law Judge was correct in her determination. Specifically, the Division argues that its regulations (20 NYCRR 4-4.1) are clear that the receipt must be in the ordinary course of business in order to be considered part of the receipts factor.

The essence of petitioners' alternative argument is that application of the statutory

formula of apportionment in the manner espoused by the Division attributes New York income to petitioners in a manner disproportionate to the business transacted by petitioners in New York State. The burden of proof on petitioners is to establish by clear and cogent evidence that the gain from the pension reversion is attributable to factors other than petitioners' business activities in New York. In other words, that the operation of the apportionment formula reaches profits which are not justly attributable to transactions within the State (Matter of British Land [Maryland] v. Tax Appeals Tribunal, 85 NY2d 139, 623 NYS2d 772). The fact that the pension reversion is a one time receipt of income in a large amount which results in a one time increase in tax liability for petitioners does not, in and of itself, meet petitioners' burden of proof.[2] The Administrative Law Judge dealt fully and properly with this issue and we affirm her determination that petitioners have failed to prove that the Division's treatment of the pension reversion results in distortion for the reasons stated therein.

We deal next with the issue of penalty under Tax Law § 1085(k).[3]

The Administrative Law Judge found that petitioners were unable to cite to any legal authority to support their treatment of the pension reversion; that petitioners did not establish that their treatment of the reversion as investment income was in good faith; and that petitioners' return did not adequately disclose the relevant facts affecting the treatment of the reversion. Specifically, the Administrative Law Judge determined that:

> "[t]he return showed that the pension reversion was categorized as investment income and, on a rider to its corporation franchise tax report, INCO stated that the pension investment income it received 'is characterized as non-business/non-apportionable income as it is composed

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[2]Petitioners' tax liability for 1985, the year of the reversion, is $502,395.00, nearly 30 times larger than the tax paid in 1984 (i.e., $17,960.00) and nearly 50 times larger than in 1986 (i.e., $10,296.00).

[3]Tax Law § 1085(k) provides, in pertinent part, as follows:

> "[t]he amount of such understatement [subject to additional charges] shall be reduced by that portion of the understatement which is attributable to the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return. The tax commission may waive all or any part of the addition to tax provided by this section on a showing by the taxpayer that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith."

> of dividends, interest and gains/losses from a pension reversion plan.' All of this is a conclusory statement of INCO's position. It does not reveal the relevant facts or legal authority supporting that position. In addition, petitioners have not shown that there was a reasonable basis for treating the pension reversion as investment income. Under these circumstances, a finding that there was adequate disclosure meriting cancellation of penalties would merely invite abuse (compare, IRC § 6662[d][2][B][ii])" (Determination, conclusion of law "D").

On exception, petitioners reassert their argument that they acted in good faith in their determination that the pension reversion income was investment capital and logically applied issuer allocation percentages in allocating the income to New York.

We reverse the determination of the Administrative Law Judge on the issue of penalties.

The Division's regulations concerning waiver of penalty for substantial underreporting, in addition to the reasonable cause standard, also provide for waiver upon a showing of good faith by the taxpayer. Specifically, the regulations provide, in relevant part, that:

> "(2) In determining whether reasonable cause and good faith exist, the most important factor to be considered is the extent of the taxpayer's efforts to ascertain the proper tax liability. In addition to any relevant grounds for reasonable cause as exemplified in subdivision (d) of this section, circumstances that indicate reasonable cause and good faith with respect to the substantial understatement of tax, where clearly established by or on behalf of the taxpayer, may include the following:
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> "(i) an honest misunderstanding of fact or law that is reasonable in light of the experience, knowledge and education of the taxpayer;
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> "(ii) a computational or transcriptional error;
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> "(iii) the reliance by the taxpayer on any written information, professional advice or other facts, provided such reliance was reasonable and the taxpayer had no knowledge of circumstances which should have put the taxpayer upon inquiry as to whether such facts were erroneous" (20 NYCRR 46.1[f][2]).

Under the facts of this case, petitioners have shown that they acted in good faith as described by the Division's regulations.

First, the logic of petitioners' treatment of the reversion as investment income is apparent, i.e., the monies contributed to the pension plan were invested by the plan and formed the reversion to petitioners. As the Appellate Division noted in Custom Shop, under similar circumstances "petitioners' argument represents a reasonable and logical interpretation of" the

terms investment capital and investment income.

Second, petitioners were forthright in their treatment of reversion for tax purposes.

In their 1985 return, petitioners made full disclosure of their treatment of the reversion. The rider to the return provided that:

> "[t]his income is characterized as non-business/non-apportionable income as it is composed of dividends, interest and gains/losses from a pension plan reversion."

As the Administrative Law Judge stated in her determination:

> "INCO broke down total income from the pension reversion into the following categories and amounts: dividends in the amount of $25,138,000.00; U.S. Government interest in the amount of $11,352,000.00; other interest in the amount of $15,073,000.00; and capital gains in the amount of $47,292,000.00. INCO claimed a 50 percent deduction for dividend income pursuant to Tax Law § 208(9)(a)(2). Thus, its total investment income was reported as $86,286,000.00. Its total business income was reported as $7,341,378.00" (Determination, finding of fact "6").

Third, the observation by the Administrative Law Judge that petitioners' treatment of the reversion as investment income does not "reveal the relevant facts or legal authority supporting their position" is due in part to the fact that at the time petitioners filed the return, there was no apparent administrative or judicial precedent which dealt specifically with the treatment of a pension reversion for franchise tax purposes. Under these circumstances, we cannot conclude that petitioners acted in bad faith in their treatment of the pension reversion. Accordingly, we conclude that penalty should not be imposed.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of International Nickel, Inc. and Inco Alloys International, Inc. is granted with respect to the abatement of penalties, but in all other respects is denied;

2. The determination of the Administrative Law Judge is modified in accordance with paragraph "1" above, but in all other respects is affirmed;

3. The petition of International Nickel, Inc. and Inco Alloys International, Inc. is granted in accordance with paragraph "1" above, but in all other respects is denied; and

4. The Division of Taxation is directed to adjust the notices of deficiency, issued October 19, 1990, in accordance with paragraph "1" above, but such notices are otherwise sustained.

DATED: Troy, New York
October 19, 1995

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

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