STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
H & S HOLDINGS LIMITED	:	DECISION DTA No. 813573
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Fiscal Year Ended July 31, 1993.	: :	

Petitioner H & S Holdings Limited, 808 Seneca Street, Buffalo, New York 14210, filed an exception to the determination of the Administrative Law Judge issued on November 7, 1996. Petitioner appeared by Nathan Ostroff, Esq. The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Kenneth J. Schultz, Esq., of counsel).

Petitioner filed a brief in support of its exception. The Division of Taxation filed a brief in opposition. Oral argument was not requested.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision. Commissioner Jenkins took no part in the consideration of this decision.

ISSUE

Whether the Division of Taxation properly denied petitioner's claim for investment tax credit.

FINDINGS OF FACT

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

The record in this matter is rather sparse. Neither the Division of Taxation (the "Division") nor petitioner presented any witnesses. Only the Division submitted documentary evidence into the record.

981617 Ontario, Inc. ("Ontario") is a Canadian corporation whose principal place of business is located at 7030 Woodbine Avenue, Suite 102 Markham, Ontario L3R 6G2.

During the period in issue, all of Ontario's issued and outstanding stock was owned by Jack Slatter and Joel Hoffman.[1]

Incorporated on February 27, 1992, petitioner H & S Holdings Limited (petitioner or "Holdings") is a New York corporation. Its principal place of business is located at 808 Seneca Street, Buffalo, New York 14210.

During the period in issue, Ontario owned one hundred percent of petitioner's equity and voting power.

Thorner Press Inc. ("Thorner"), also incorporated on February 27, 1992, is a New York corporation located at 808 Seneca Street, Buffalo, New York 14210.

During the period in issue, Thorner was petitioner's wholly-owned subsidiary.[2]

During the period in issue, Joel Hoffman was president of both petitioner and Thorner.

Statement #5 attached to the Form AU-2.1 request (Division's Exhibit "G") included descriptions of both petitioner's and Thorner's business activities. Review of this statement reveals that petitioner's only business activities consisted of "leasing printing equipment and lending money to its wholly-owned subsidiary, Thorner"; while Thorner engaged in the printing business and leased all of its printing equipment from petitioner. According to the statement, all of Thorner's sales were to unrelated third parties.

On April 6, 1992, petitioner, as lessor, and Thorner, as lessee, entered into a "Master Equipment Lease" agreement ("master lease") for the rental of equipment described as "print plant equipment purchased by Lessor from Uniform Corp. as per Schedule A."[3] Review of the

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[1]According to Statement #1 FORM AU-2.1, GENERAL INFORMATION-CORPORATION 3, attached to Form AU-2.1 Request for Permission to File a Combined Report or to Change an Existing Combined Group ("Form AU-2.1 request") (Division's Exhibit "G"), filed for the taxable year ended July 31, 1993, both Jack Slatter and Joel Hoffman were nonresident Canadians. Mr. Hoffman owned twenty percent of Ontario's equity and voting power (20 shares), while Mr. Slatter owned eighty percent of Ontario's equity and voting power (80 shares).

[2]At that time, petitioner owned 100 shares of Thorner's voting common stock.

[3]An attached 4 page schedule entitled "SCHEDULE I(a) TO BILL OF SALE" which lists various pieces of equipment appears to be the Schedule A referenced above.

terms of the master lease indicates that the lease term was one year.[4] The terms and conditions of the master lease included inter alia the following:

> "4) RENEWAL: This Agreement shall be automatically renewed on a month-to-month or year-to-year basis upon the expiration of the initial term, upon the same terms and conditions set forth herein, unless cancelled by either party as provided in paragraph 10 hereof.
>
> * * *
>
> "6) USE, REPAIR AND ALTERATIONS: The Lessee agrees to use the equipment in a reasonable, prudent and careful manner, and the Lessee agrees to keep the equipment in good repair, condition and working order, at its own expense, and to furnish all parts and labor required for that purpose. The Lessee shall not make any material alterations or improvements to the equipment without the Lessor's prior written consent.
>
> "7) LOSS, THEFT AND DAMAGE: The Lessee shall bear the entire risk of loss, theft and damage of the equipment from any cause whatsoever, and no loss, theft or damage of the equipment shall relieve the Lessee of the obligation to pay rent under the terms and conditions of this Agreement. At the Lessor's option, the Lessee shall either repair the equipment to its previous condition, or if lost, stolen or damaged beyond repair, reimburse the Lessor for the full replacement value of the equipment.
>
> "8) TITLE AND OWNERSHIP: All title and ownership of the equipment and any replacement equipment shall at all times remain in the Lessor, and the Lessee shall have no right, title or interest in the equipment, except as expressly set forth in this Agreement.
>
> * * *
>
> "12) CONSTRUCTION: This Agreement shall in all respects be governed by and construed in accordance with the laws of the State of New York.
>
> "13) ENTIRE AGREEMENT: This Agreement constitutes the entire agreement between the parties. All prior negotiations have been merged into this Agreement, and there are no understandings, representations or agreements, oral or written, express or implied, other than those set forth herein. This Agreement cannot be modified or amended except by a writing, signed by both parties. . . ." (See, Division's Exhibit "E".)[5]

Review of the master lease agreement indicates that Mr. Hoffman executed this agreement as president of both petitioner/lessor and Thorner/lessee.

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[4]The payment terms were 12 payments of $17,306.67 each for a total payment of $207,680.00.

[5]The master lease agreement is an attachment to petitioner's petition which is the Division's Exhibit "E."

Addendums to the master lease were made on November 1, 1992, March 1, 1993, April 1, 1993, May 5, 1993, October 1, 1993 and November 4, 1993.[6] In each of these addendums, various pieces of print plant equipment, purchased by petitioner, were leased to Thorner. In addition, the rental schedule on each addendum listed the master lease monthly payments, as well as the monthly payments due for all prior addendums.

By letter dated August 24, 1993, the Division granted petitioner tentative permission to file a combined report with Thorner. The Division's representative, Henry I. Lowenski, Jr., wrote, in pertinent part:

> "This tentative permission may be revised or revoked on audit of the combined returns as provided by New York State Tax Regulation Section 6-2.4(c). To ensure a proper determination on audit, please complete the financial data for the entire tax period on the enclosed Form AU-2.1 and attach it to your combined return.
>
> "Each corporation included in the combined report is required to file a separate return on Form CT-3. In addition, the taxable corporation, H & S Holdings Limited #16-1412816, is responsible for paying the combined tax and must file a Combined Franchise Tax Return, Form CT-3A."

The Division's Exhibit "G" is the 1992 CT-3-A Combined Franchise Tax Return with attachments filed by petitioner for fiscal year ended July 31, 1993. Review of page 1 of the Form CT-3-A reveals that petitioner computed the combined tax as follows:

Combined tax before tax credits	$2,225.00	
Tax Credits[7]		---
Balance		2,225.00
Combined minimum for one taxable subsidiary	325.00	
Total combined tax		2,550.00
Tax surcharge rate 15%		383.00
Total combined tax and tax surcharge		2,933.00
First installment for next period - line 16b	733.00	
Total tax, surcharge and required installment	$3,666.00	

[6]Addendum 1 is dated November 1, 1992; Addendum 2 is dated March 1, 1993; Addendum 3 is dated April 1, 1993; Addendum 4 is dated May 5, 1993; Addendum 5 is dated October 1, 1993; Addendum 6 is dated November 4, 1993.

[7]

The box next to Form CT-46 was checked.

It is noted that on this Form CT-3-A, petitioner claimed a refund of unused investment tax credit of $21,928.00.[8]

Included as part of the Division's Exhibit "G" is petitioner's 1992 Form CT-46 Claim for Investment Tax Credit and Employment Incentive Credit for the period August 1, 1992 through July 31, 1993. Schedule A of this form describes the New York property eligible for the investment tax credit as follows: printing presses, acquired in November 1992, having a ten-year life, with an investment credit base of $511,873.00 and an investment tax credit of $25,594.00.

Also included as part of the Division's Exhibit "G" is petitioner's 1992 Form CT-46.1 Claim for Refund of Unused Investment Tax Credit by a New Business ("Form CT-46.1") for the period August 1, 1992 through July 31, 1993. The following computation of the refund of unused investment tax credit appeared on the attachment to Form CT-46.1:

"INVESTMENT TAX CREDIT FROM FORM CT-46	$25,594
LESS TAX DUE, LINE 11 of FORM CT-3A	(2,225)
LESS COMBINED MINIMUM TAX ON SUBSIDIARIES, LINE 12 CT-3A	(325)
LESS TAX SURCHARGE, LINE 14 CT-3A	(383)
LESS FIRST REQUIRED INSTALLMENT, LINE 16B CT-3A	(733)
TOTAL TAX, SURCHARGE AND REQUIRED INSTALLMENT	(3,666)
NET REFUND REQUESTED PER FORM CT-46.1 AND INSTRUCTIONS FOR FORM CT-46.1 AMOUNT TO LINE 29, CT-3A	$21,928"

During the period in issue, Holdings received rental income from Thorner in the aggregate amount of $273,537.00 (***see***, Division's Exhibit "G").

Review of the Division's Exhibit "G" reveals that petitioner claimed "depreciation of tangible property placed in service after 1986" in the amount of $108,786.00.

On February 22, 1994, the Division issued a Notice of Disallowance to petitioner concerning its "claim for investment tax credit, resulting in a claim for refund," for the period

[8]There was a reference to an attached schedule to Form CT-46.1 for the computation of the adjusted refund.

ended July 31, 1993. In the notice, the Division representative, Mr. John O'Hanlon, wrote in pertinent part:

> "Section 210.12(b)(i) of the New York Tax Law states in part that the tangible property must be principally used by the taxpayer in the production of goods. Section 210.12(a) provides that in the case of a combined report the term investment credit base shall mean the sum of the investment credit base of each corporation included on such report. In effect, each corporation must meet the criteria on its own in order to qualify for the investment tax credit.
>
> "Sec. 208.2 of the New York State Tax Law states that a 'taxpayer' means any corporation subject to tax under Article 9-A. Per Tax Regulation 6-2.1, each corporation is required to file a separate franchise tax report, pertaining to its own business, although it might be in a combined report.
>
> "As each corporation is treated as a separate taxable entity under Article 9-A of the Tax Law, and since the Tax Law does not contain a provision that allows the combined group to be treated as an individual entity in regards to investment tax credit, each corporation in a combined group must individually qualify for the investment tax credit.
>
> "Section 210.12(d) states in pertinent part, that a taxpayer shall not be allowed a credit on such property, which it leases to any other person or corporation.
>
> "In light of the above, because H & S Holdings Limited leases the property in question to Thorner Press, Inc., H & S Holdings Limited is not eligible for the claimed investment tax credit nor is it allowed a refund of $21,928.00 for unused investment tax credit for the property shown on the Form CT-46." (See, Division's Exhibit "B".)

On June 2, 1994, the Division issued Notice of Deficiency (L-008706536-4) to Holdings for corporation franchise taxes due in the amount of $2,933.00,[9] interest due of $132.26, zero penalty for a total amount due of $3,065.26 for the fiscal year ended July 31, 1993.[10]

After a conciliation conference, the conferee issued a Conciliation Order (CMS No. 139257), dated December 16, 1994, sustaining the statutory notices -- the Notice of Disallowance and the Notice of Deficiency (L008706536).

Petitioner filed a petition dated February 10, 1995, which requested a redetermination of a deficiency of corporation franchise tax for the fiscal year ended July 31, 1993 in the amount of $2,933.00 and also sought a refund of tax in the amount of $24,861.00. Petitioner is

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[9]As noted above, petitioner on its Form CT-3-A reported self-assessed tax of $2,225.00; $325.00 in minimum tax for a subsidiary and a tax surcharge of $383.00 before the application of the investment tax credit.

[10]The June 2, 1994 notice referenced an original notice sent to Holdings on April 22, 1994 which contained a "detailed computation of the additional amount due." The April 22, 1994 notice is not part of the record.

challenging the Division's disallowance of the investment tax credit which it had claimed on Form CT-46 and Form CT-3-A for the period in issue. In the petition, it asserted that it is entitled to the investment tax credit because the combined group is the taxpayer. Petitioner also asserted that if it, as the parent corporation, did not elect to be taxed under Tax Law § 211(4), and if it had shown taxable income, the income would have been considered passive.

The Division, in its answer, dated April 14, 1995, stated ***inter alia*** that its determination "was in all respects proper and correct" since petitioner leased tangible personal property to Thorner and therefore petitioner was not eligible for the claimed investment tax credit nor was it allowed a refund "for unused investment tax credit for the property shown on the Form CT-46."

Petitioner submitted eleven proposed findings of fact. In accordance with State Administrative Procedure Act § 307(1), all the proposed findings of fact have been incorporated into the Findings of Fact herein except number two which has been modified to more accurately reflect the record; and numbers seven and eight which are not reflected in the record.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

In her determination below, having reviewed the lease provisions pertaining to the equipment which is the subject of the investment tax credit ("ITC"), the Administrative Law Judge determined that petitioner, as lessor of the property, failed to qualify for the investment tax credit in accordance with Tax Law § 210(12)(d). In addition, the Administrative Law Judge rejected petitioner's contention that Thorner is the beneficial owner of the equipment and, therefore, entitled to the investment tax credit.

The Administrative Law Judge also concluded that the Division properly interpreted Tax Law § 210(12)(a) and determined that where a taxpayer is a part of a combined group, each individual corporation must calculate its own investment credit base. Petitioner's argument that combination created a single entity which both owned and used the equipment and, therefore, qualified such items for the ITC was rejected by the Administrative Law Judge.

ARGUMENTS ON EXCEPTION

Petitioner maintains that the purported lease between petitioner and Thorner is not a lease, but really a sale, placing ownership with Thorner, resulting in the property being eligible for the ITC. Petitioner contends that by filing a combined report, petitioner and Thorner created a single entity which is eligible for the ITC. Petitioner additionally argues that the public policy behind the ITC of encouraging investment in plant and equipment is frustrated by the denial of the ITC. These were the same arguments presented before and considered by the Administrative Law Judge.

OPINION

We affirm the determination of the Administrative Law Judge.

Petitioner first argues that for tax purposes the transaction in question is not a lease, but is instead a sale pursuant to which Thorner owns and uses the equipment. In order to make the determination of whether the transaction is a lease or a sale, petitioner refers us to Revenue Ruling 55-540 (1955-2 C.B. 39). The Division disagrees with petitioner's assertion that the transaction should be viewed as a sale for the following reasons: (1) petitioner provides no explanation for the existence of the lease transaction; (2) petitioner does not establish that the lease transaction was without economic substance; and (3) the documents which are most critical to this determination, the lease agreement and the tax returns, support a determination that petitioner entered into a lease and not a sale arrangement.

Revenue Ruling 55-540, relied upon by petitioner, discusses many aspects of a transaction which are to be considered in determining, for Federal income tax purposes, the treatment of leases of equipment used in the trade or business of the lessee. Most relevant to this case is Sec. 4 of the Revenue Ruling, "Determination Whether An Agreement Is A Lease Or A Conditional Sales Contract," which states the following:

> "[w]hatever interest is obtained by a lessee is acquired under the terms of the agreement itself. Whether an agreement, which in form is a lease, is in substance a conditional sales contract depends upon the intent of the parties as evidenced by the provisions of the agreement, read in the light of the facts and circumstances existing at the time the agreement was executed. In ascertaining such intent no single test, or any special combination of tests is absolutely determinative. No general rule, applicable to all cases, can be laid down. Each case must be decided in the light of its particular facts. However, from the decisions cited below it

> would appear that in the absence of compelling persuasive factors of contrary implication an intent warranting treatment of a transaction for tax purposes as a purchase and sale rather than as a lease or rental agreement may in genrael [sic] be said to exist if, for example, one or more of the following conditions are present:
>
> (a) Portions of the periodic payments are made specifically applicable to an equity to be acquired by the lessee [citations omitted].
>
> (b) The lessee will acquire title upon the payment of a stated amount of 'rentals' which under the contract he is required to make [citations omitted].
>
> (c) The total amount which the lessee is required to pay for a relatively short period of use constitutes an inordinately large proportion of the total sum required to be paid to secure the transfer of the title [citation omitted].
>
> (d) The agreed 'rental' payments materially exceed the current fair rental value. This may be indicative that the payments include an element other than compensation for the use of property [citations omitted].
>
> (e) The property may be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared with the total payments which are required to be made [citations omitted].
>
> (f) Some portion of the periodic payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest [citation omitted]."

Petitioner attempts to apply Revenue Ruling 55-540 to conclude that petitioner and Thorner did not have a reasonable rental arrangement. Petitioner argues that given the potential indefinite term of the lease, the payment of the stated amount is not reasonable. The term of the lease is set forth in the Master Lease. It states: "[t]he term of this Agreement commences upon the execution of the same by both parties and terminates upon the expiration of the specified number of months or years, on the last day of the final contract month." The Master Lease bears a column for the number of years each of the payment segments are to run for the Master Lease and each addendum. In addition, there is a provision for renewal of the Agreement. It provides as follows: "[t]his Agreement shall be automatically renewed on a month-to-month or year-to-year basis upon the expiration of the initial term, upon the same terms and conditions set forth herein, unless cancelled by either party as provided in paragraph 10 hereof."

Petitioner's characterization of the lease as "indefinite" is accurate, inasmuch as the lease was renewed automatically, without negotiation (***see, Borchers v. Commissioner***, T.C. Memo 1988-349, 55 TCM 1469, ***affd*** 943 F2d 22, 91-2 USTC ¶ 50,416). However, this alone does not establish that the rental arrangement was unreasonable, especially since petitioner has failed to provide proof of the useful life of the equipment which is the subject of the credit. If the contract provided for the right to lease or use the equipment for all its useful life, it would be more likely to qualify as a purchase, rather than a lease of the equipment (***Mertens Law of Federal Income Taxation***, § 6A.76). Such is not the case here. Although the renewal could extend the lease beyond the useful life, there was no manner in which to evaluate the probability of such an occurrence, especially absent such pertinent information as the useful life period. In addition, without the useful life information, there is insufficient information to determine whether petitioner received a reasonable rate of return on the equipment, a fact which may affect the assessment of the reasonableness of the lease.

Likewise, petitioner failed to establish any of the other Revenue Ruling 55-540 factors set forth above, such as the acquisition by Thorner of title or an equity interest, the existence of a purchase option, or the interest equivalent payment. There was nothing presented which addressed the intention of the parties or particular fact and circumstances existing at the time the agreement was executed to conclude that the transaction was other than its form, i.e., a lease.

Petitioner also maintains that to classify the transaction as a lease it must have a business purpose and economic substance, citing ***Frank Lyon Co. v. United States*** (435 US 561, 55 L Ed 2d 550) and ***Rice's Toyota World v. Commissioner*** (81 TC 184, ***affd*** in part, revd in part 752 F2d 89, 85-1 USTC ¶ 9123), respectively. Petitioner claims that the indefinite term of the lease negates both the business purpose and the economic substance. The United States Supreme Court in ***Frank Lyon*** stated:

> "[i]n short, we hold that where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance

> features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes" (***Frank Lyon Co. v. United States***, ***supra***, 55 L Ed 2d, at 567).

The existence of the lease agreement, the provisions contained therein, the tax return as filed, and petitioner's failure to prove that the lease was without substance, all contribute to the conclusion that the lease was created for some business purpose now undisclosed by petitioner. It is not without economic substance and, therefore, it is the form which governs the tax consequences.

Having determined that the lease will stand, the consequence of Tax Law § 210(12)(d) is abundantly clear. That section provides, in pertinent part, that:

> "[a] taxpayer shall not be allowed a credit under this subdivision with respect to tangible personal property and other tangible property, including buildings and structural components of buildings, which it leases to any other person or corporation. For purposes of the preceding sentence, any contract or agreement to lease or rent or for a license to use such property shall be considered a lease."

Accordingly, the Administrative Law Judge correctly determined that petitioner, as lessor, fails to qualify for the investment tax credit (Tax Law § 210[12][d]; 20 NYCRR 5-2.3; ***Matter of Three C Realty Corp.***, State Tax Commn., October 2, 1981).

The next argument made by petitioner speaks to beneficial ownership of the property, rather than focusing on who has title. However, the regulation cited by petitioner references the <u>lessee</u> as the beneficial owner of the property subject to the credit (20 NYCRR 5-2.3; ***see***, ***Matter of Mitnick***, Tax Appeals Tribunal, January 25, 1991). This provision is intended to encompass a typical sale-leaseback transaction, where the seller/lessee retains the incidence of ownership and is, thus, entitled to the tax benefits, rather than the buyer/lessor who actually has title (***see***, ***Mertens Law of Federal Income Taxation***, § 27.80). Further, the regulation states that the lessee is entitled to the ITC not only because it is considered the beneficial owner, but also because it is entitled to take the Federal depreciation deduction on the property subject to the ITC.

First, petitioner is not the lessee in this matter. If the transaction remains a lease, petitioner is the lessor. If the transaction is deemed a sale, petitioner is merely the seller. Thus, any reference to a benefit inured to the lessee does not apply in this case to petitioner. Secondly, the lessee would have to prove beneficial ownership, resulting from some aspect of the lease agreement, such as the risk of loss, in order to maintain its entitlement to the Federal depreciation deduction. Such proof, however, still does not place the ITC benefit with petitioner. Accordingly, petitioner's arguments pertaining to beneficial ownership are disregarded.

Petitioner next maintains that, together with Thorner, it filed a combined report for the tax period in issue which created a single entity which both owned and used the equipment. The Division contends that a corporation must individually qualify for the ITC, which is confirmed by the language of Tax Law § 210(12)(a) requiring that "[i]n the case of a combined report the term investment credit base shall mean the sum of the investment credit base of each corporation included on such report."

Pursuant to Tax Law § 211(4), the Commissioner may permit or require the filing of a combined report of two or more corporations if certain conditions are met, not at issue herein. Such provision addresses certain elements of income to be combined, and other transactions to be eliminated in the combination process. The investment tax credit is not an item handled separately by Tax Law § 211, but is covered along with the computation of tax under Tax Law § 210. Tax Law § 210(12)(d) clearly disqualifies the credit when a taxpayer has leased the otherwise qualifying property to another. There is no provision of the Tax Law that indicates that combination should grant the benefits of the ITC when petitioner alone would not qualify. This conclusion is supported by the language of Tax Law § 210(12)(a) quoted above. Accordingly, the conclusion of the Administrative Law Judge on this issue will also stand.

Petitioner offers as its final argument that denial of the ITC to petitioner frustrates the public policy of allowing the ITC to encourage investment in new equipment. Petitioner simply did not meet the Tax Law requirements to qualify for the ITC, which are clear and straightforward. This conclusion was reached without any discretionary reasoning and does not in any way infringe upon the policy which encourages such investment in equipment in New York State.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of H & S Holdings Limited is denied;

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

3. The petition of H & S Holdings Limited is denied; and

4. The Notice of Disallowance dated February 22, 1994 and the Notice of Deficiency dated June 2, 1994 are sustained.

DATED: Troy, New York
September 11, 1997

Donald C. DeWitt
President

Joseph W. Pinto, Jr.
Commissioner