

STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
SUBURBAN CARTING CORPORATION	:	DECISION
	:	DTA NO. 813842
for Redetermination of a Deficiency or for Refund of	:	
Corporation Franchise Tax under Article 9-A of the Tax	:	
Law for the Years 1989 and 1990.	:	

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on January 9, 1997 with respect to the petition of Suburban Carting Corporation, 524 Watervliet Avenue, Mamaroneck, New York 10543. Petitioner appeared by Hodgson, Russ, Andrews, Woods & Goodyear (Christopher L. Doyle, Esq., of counsel). The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (James P. Connolly, Esq. and Laura J. Witkowski, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception. Petitioner filed a brief in opposition. Oral argument, at the request of both parties, was heard on November 12, 1997 in Troy, New York.

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

ISSUE

Whether interest expenses incurred by petitioner in connection with certain loans are indirectly attributable to petitioner's subsidiary capital within the meaning of Tax Law § 208(9)(b)(6).

FINDINGS OF FACT

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

Petitioner, Suburban Carting Corporation ("Suburban"), is a corporation doing business in New York State. Following an audit of Suburban's tax returns for the years 1989 and 1990, the Division of Taxation ("Division") issued to Suburban a Notice of Deficiency dated August 9, 1993, asserting tax deficiencies of \$195,522.00 plus penalty and interest.

Petitioner requested and was granted a conference in the Division's Bureau of Conciliation and Mediation Services ("BCMS"). As a result of the conference, the tax deficiency asserted by the Division was reduced to \$76,777.00 for the years 1989 and 1990, and all penalties were canceled. BCMS issued a Conciliation Order dated February 17, 1995 reflecting these adjustments.

The entire amount of the deficiency asserted in this proceeding (\$76,777.00) results from the Division's addback of certain interest expenses which Suburban deducted in calculating its entire net income for the years in issue. Those interest expenses were incurred primarily in connection with Suburban's redemption of the outstanding shares of stock of a single shareholder, Alfred DeMarco. Suburban entered into a redemption agreement with DeMarco on February 3, 1989 in which it agreed to purchase all of DeMarco's stock for \$15,706,465.00. At the closing of the redemption transaction, DeMarco received: (1) a cash payment of \$2,250,000.00, (2) a self-liquidating promissory note in the amount of \$6,000,000.00 and (3) a balloon promissory note in the amount of \$7,456,465.00.

The cash payment to DeMarco was made with a portion of the proceeds of a \$10,300,000.00 loan Suburban received from the Royal Bank of Pennsylvania ("Royal Bank") on

February 7, 1989. Suburban also borrowed money from an individual named Thomas Milo to help finance the DeMarco stock redemption.

As a result of the BCMS conference, the Division determined that petitioner had incurred the following interest expenses in connection with the redemption of the DeMarco stock:

	<u>1989</u>	<u>1990</u>
Thomas Milo loan	\$ 55,842.33	\$ -0-
DeMarco notes	1,063,524.64	1,156,846.00
Royal Bank loan	<u>296,154.76</u>	<u>292,593.00</u>
Totals	\$ 1,415,521.73	\$1,449,439.00 ¹

Suburban deducted the interest expense amounts shown above in its calculation of entire net income for the years in issue. It was the Division's position on audit, and remains its position in this proceeding, that all of the interest expenses shown above are indirectly attributable to subsidiary capital and subject to indirect attribution pursuant to Tax Law § 208(9)(b)(6). That statute provides, as pertinent, that:

"[e]ntire net income shall be determined without the exclusion, *deduction* or credit of:

* * *

"(6) in the discretion of the tax commission, any amount of interest directly or indirectly and any other amount directly or indirectly attributable as a carrying charge or otherwise to subsidiary capital or to income, gains or losses from subsidiary capital." (Emphasis added.)

Relying on a State Tax Commission decision (*Matter of Worldwide Volkswagen*, State Tax Commn., April 30, 1974) and a published memorandum of the Division (TSB-M-88[5]C),

¹For 1990, the Division determined additional interest expenses attributable to subsidiary capital in the amount of \$77,858.00, resulting in an addback to entire net income of \$16,464.48. Petitioner concedes the correctness of this adjustment.

the Division asserted that any interest expense not directly traceable to one of the three types of capital--business, investment or subsidiary--must, by default, be attributed to all three. The Division determined the amount of the deductions indirectly attributable to subsidiary capital (thus, subject to addback) in accordance with a formula set forth in the memorandum.

At the time the DeMarco stock redemption agreement was entered into, Carmine Mascia, Suburban's comptroller, was responsible for overseeing Suburban's financial transactions. Mr. Mascia, who provided testimony at hearing on behalf of Suburban, was personally involved in making the financial arrangements necessary to accomplish the redemption of the DeMarco shares.

The Royal Bank loan was taken for the specific purpose of financing the purchase of the DeMarco shares. Of the \$10,300,000.00 received by Suburban from Royal Bank, \$2,250,000.00 was used to make the cash payment to DeMarco required by the redemption agreement. An additional \$300,000.00 was used to pay a commitment fee to Royal Bank and for legal expenses incurred in connection with the DeMarco stock redemption.

The Division agrees that \$7,750,000.00 of the Royal Bank proceeds was used to purchase the stock of nonsubsidiary affiliates from DeMarco and to fund a covenant not to compete. The Division also agrees that these assets constituted part of Suburban's business capital. Accordingly, the Division asserts that only \$2,550,000.00 of the Royal Bank loan proceeds are indirectly attributable to subsidiary capital and subject to indirect attribution.

To facilitate the stock redemption, Royal Bank was instructed to wire transfer \$6,550,000.00 directly to DeMarco on the day of the closing. Of this total, \$2,250,000.00 was for the cash payment for the Suburban stock redemption; \$4,000,000.00 was for the covenant not to compete; and the remaining \$300,000.00 was for the commitment fee and legal expenses.

There is no evidence that Suburban made any additional investments in its subsidiaries in 1989, the year in which the Royal Bank loan was made and the DeMarco notes were issued. Suburban's cumulative ledger for the period January 1, 1989 through December 31, 1989 shows that the beginning of the year and end of the year balances in Suburban's "Investments in Subsidiaries" account remained unchanged.

In the month of February 1989, i.e., the month when the DeMarco and Royal Bank transactions occurred, there was no increase in Suburban's "Advances to Subsidiaries" account.

The Division offered no evidence to show a change in Suburban's subsidiary capital during the years in issue.

Prior to hearing, the parties executed a Stipulation of Facts. The stipulated facts deemed necessary to a resolution of this controversy have been incorporated into this determination.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

In her determination, the Administrative Law Judge concluded that with the exception of \$300,000.00, the loan proceeds in question were used to redeem the DeMarco shares of stock. The remaining \$300,000.00 was expended to facilitate that redemption. Since Suburban's stock does not meet the statutory definition of subsidiary capital (Tax Law § 208[4]), the loan proceeds associated with the stock redemption cannot be directly attributable to subsidiary capital.

The Administrative Law Judge further concluded that there was no evidence in the record to support a factual conclusion that the loan proceeds in question were indirectly attributable to subsidiary capital. Since there is no evidence of any increase in Suburban's "Investment in Subsidiaries" account and no increase in Suburban's "Advances to Subsidiaries" account during the relevant period, there are no facts in the record from which it may be inferred that any of the loan proceeds were indirectly attributable to subsidiary capital.

As to the Division's position that since the loan proceeds cannot be attributed directly to business capital, investment capital or subsidiary capital, they must be *indirectly* attributable to all three, the Administrative Law Judge concluded that the purpose of the section 208(9)(b)(6) addback provision is "to prevent a parent corporation from obtaining a double tax benefit by taking a deduction for interest payments on loans incurred for directly or indirectly financing investments in subsidiaries while at the same time the parent's income derived from such investments is tax free"² (Determination, conclusion of law "C"). Based on the decisions in *Matter of F.W. Woolworth Co. v. State Tax Commn.* (126 AD2d 876, 510 NYS2d 926, *affd* 71 NY2d 907, 528 NYS2d 537) and *Matter of Unimax Corp. v. Tax Appeals Tribunal* (79 NY2d 139, 581 NYS2d 135), the Administrative Law Judge concluded that in order to indirectly attribute interest expense to subsidiary capital, it was necessary that objective facts and circumstances exist from which the Division could infer that petitioner's debt obligations were indirectly attributable to its investments in subsidiaries.

The Administrative Law Judge noted that the administrative determinations cited by the Division do not go so far as to indirectly attribute interest expenses to subsidiary capital where no facts exist from which a connection between the debt incurred and subsidiary capital may be inferred. A literal reading of *Matter of Worldwide Volkswagen* (State Tax Commn., April 30, 1974), relied on by the Division in this proceeding, would lead to the conclusion that a proportionate share of all interest expenses, even those directly attributable to business or investment capital, must be attributed to subsidiary capital. The Administrative Law Judge found that an attribution of a pro rata share of all borrowings to each type of capital would be contrary

²Income, gains and losses from subsidiary capital are not included in the parent's calculation of entire net income (Tax Law § 208[9][a][1]).

to the statute and to the Division's policy as expressed in the Technical Services Memorandum (TSB-M-88[5]C). Thus, to the extent that the dicta in *Worldwide Volkswagen* suggests that this is a correct method of attributing interest expenses, the Administrative Law Judge concluded that it was wrong. Moreover, the Administrative Law Judge noted that the decision in *Worldwide Volkswagen* does not rely on this interpretation of the statute to support its result. In *Worldwide Volkswagen*, the State Tax Commission found that interest expenses on certain loans incurred to acquire stock of a deceased shareholder should not have been allowed as a deduction in computing the amount of interest expense attributable to subsidiary capital. However, the Commission also found that in the years at issue the petitioner's "average cost of investments in the capital stock of the subsidiaries plus average advances to subsidiaries" increased from \$7,134,104.00 in 1968 to over \$10 million in 1971. From this and other facts, the Commission could reasonably conclude that there was a connection between the petitioner's borrowings and its increase in subsidiary capital.

ARGUMENTS ON EXCEPTION

On exception, the Division requests additional findings of fact that petitioner's investments in its subsidiaries increased in both 1989 and 1990 and that petitioner made substantial advances to its subsidiaries during each of those years. Further, the Division requests a finding that even though petitioner changed its method of accounting during its fiscal year ending December 31, 1989, this change accounts for only a portion of the increase in investment in petitioner's subsidiaries for that year.

The Division argues that the formula used to calculate the amount of indirect attribution to subsidiary capital set forth in its Technical Services Memorandum (TSB-M-88[5]C) must be found to be a valid interpretation of Tax Law § 208(9)(b)(6). To do otherwise, argues the

Division, puts a burden on the Division to make a showing of facts that would support an inference that a particular interest expense is indirectly attributable to subsidiary capital. However, the burden should appropriately be placed on petitioner to show either a direct or indirect connection between interest expense and either business or investment capital. Absent meeting that burden of proof, the expense should be attributable to all three types of capital. The Division argues that it need only establish that there is a rational basis for the assessment, which it has done in this case. The Division argues that, given the fungibility of money, a decision by petitioner to fund a business purpose with third party borrowings while maintaining its level of subsidiary capital means that petitioner has incurred a carrying charge for maintaining its level of subsidiary capital within the meaning of Tax Law § 208(9)(b). The Division argues that this logic is supported by numerous State Tax Commission decisions as well as the decision of the Appellate Division in *Matter of F.W. Woolworth Co. v. State Tax Commn.* (*supra*). In addition, the Division argues that the loans used to repurchase the DeMarco stock relate to each type of capital and are, therefore, appropriate for proportionate attribution to each type of capital. The Division argues that while it is not necessary to show that petitioner's investments in its subsidiaries increased during the tax years in question or that petitioner made advances to its subsidiaries during those years, the Administrative Law Judge erroneously concluded that these factors were not present in the instant case. Notably, petitioner provided no evidence on this issue for 1990. For 1989, although petitioner attributed the increase in its subsidiary investments to an accounting change, the Division argues that this explains only a portion of the increase.

In opposition, petitioner argues that the Administrative Law Judge correctly determined that the interest expenses at issue were not attributable to subsidiary capital. Petitioner contends that no case has gone so far as to find an interest expense indirectly attributable to a taxpayer's

subsidiary capital where the purposes for which the taxpayer incurred the indebtedness have no relationship to its subsidiary activities; the proceeds of the indebtedness are directly traceable to non-subsidiary transactions; and there is no substantial increase in the taxpayer's investments in or advances to its subsidiaries during the period in which the indebtedness was incurred.

Petitioner argues that in order for interest to be indirectly attributable to subsidiary capital, there must be a substantial basis for such an inference. Petitioner points out that it never received loan proceeds as a result of its incurring indebtedness on the DeMarco notes. Petitioner argues that there is no evidence of any increase in Suburban's "Investment in Subsidiaries" account and no increase in Suburban's "Advances to Subsidiaries" account during the relevant period. Therefore, argues petitioner, there are no facts in the record from which it may be inferred that any portion of the interest on the DeMarco notes is indirectly attributable to subsidiary capital.

OPINION

Tax Law § 209(1) imposes a franchise tax on every corporation doing business in New York. The tax is calculated on the basis of the corporation's entire net income, which is presumably the same as the entire taxable income reported for Federal tax purposes, with certain exceptions. One such exception is at issue in the present case. Although a taxpayer is generally allowed a deduction for interest expenses for Federal tax purposes, Tax Law § 208(9)(b)(6) provides that in the discretion of the Tax Commission, entire net income shall be determined without the deduction of "any amount of interest directly or indirectly and any other amount directly or indirectly attributable as a carrying charge or otherwise to subsidiary capital or to income, gains or losses from subsidiary capital." Tax Law § 208(4) defines subsidiary capital as "investments in the stock of subsidiaries and any indebtedness from subsidiaries . . . on which

interest is not claimed and deducted by the subsidiary for purposes of taxation under articles nine-a . . . of this chapter"

The Tax Appeals Tribunal held in *Matter of Atlantic & Hudson Ltd. Partnership* (Tax Appeals Tribunal, January 30, 1992) that:

Although a determination of tax must have a rational basis in order to be sustained upon review (*see, Matter of Grecian Sq. v. New York State Tax Commn.*, 119 AD2d 948, 501 NYS2d 219), the presumption of correctness raised by the issuance of the assessment, in itself, provides the rational basis, so long as no evidence is introduced challenging the assessment (*see, Matter of Tapolacci v. State Tax Commn.*, 77 AD2d 759, 431 NYS2d 174; *Matter of Leogrande*, Tax Appeals Tribunal, July 18, 1991, *confirmed Matter of Leogrande v. Tax Appeals Tribunal*, 187 AD2d 768, 589 NYS2d 383, *lv denied* 81 NY2d 704, 595 NYS2d 398).

The formula used by the Division to calculate the interest expense indirectly attributable to subsidiary capital was sustained by the Court of Appeals in *Matter of Unimax Corp. v. Tax Appeals Tribunal* (*supra*, 581 NYS2d, at 139). In that decision, the Court of Appeals stated:

No doubt due to the fact that many loan proceeds and transactions cannot be directly or easily traced to subsidiary capital, the Legislature authorized the Department to estimate the amount of indirectly attributable interest expense to be deducted or disallowed. That measurement is necessarily imprecise. The formula adopted by the Department measures the amount of interest expense deemed indirectly attributable to subsidiary capital by looking to the manner in which the corporation allocated its assets; namely, its investments in subsidiaries compared to its total assets.

In the present matter, the Division determined that the loans at issue were not directly attributable to either business or investment capital. The Division also determined that during both 1989 and 1990, petitioner's investments in and advances to its subsidiaries had increased substantially.

Therefore, the Division applied the formula of TSB-M-88[5]C to calculate that portion of interest

expense indirectly attributable to subsidiary capital. We find that there was a rational basis for the Division's indirect attribution of a portion of petitioner's interest expense to its subsidiary capital and its assessment of additional corporate franchise tax for 1989 and 1990 to petitioner.

In *Matter of Volt Information Sciences* (Tax Appeals Tribunal, October 15, 1992), we stated that: "[i]n order to defeat the disallowance of the interest deduction [pursuant to Tax Law § 208(9)(b)(6)], petitioner must establish that the indebtedness was not directly or indirectly attributable to subsidiary capital." Petitioner's witness testified that petitioner's 1989 cumulative ledger had an identical balance for investment in subsidiaries at the beginning and at the end of 1989. Petitioner's witness also testified that while there were advances made to petitioner's subsidiaries in 1989, no such advances were in the nature of investments in those subsidiaries. Further, petitioner's witness testified that the numerical differences shown on petitioner's December 31, 1989 Balance Sheet in subsidiary investment amounts during that year were attributable to a change from the cost to the equity accounting method. This testimony was not challenged by the Division on cross examination nor was it refuted or contradicted by other evidence. It is only on exception that the Division argues that the change in accounting method did not fully account for the subsidiary investment differential.

In *Matter of F.W. Woolworth Co. v. State Tax Commn.* (*supra*), the Court rejected the petitioner's contention that the disallowance of the interest indebtedness might be defeated by a showing that the incurrence of the indebtedness could be attributed to a bona fide business purpose. The Court reasoned that the statute was intended to apply to situations "where the parent corporation may have had a *dual* purpose in borrowing and where the requisite connection between the debt and the investment in subsidiaries is only inferable from other facts and circumstances surrounding the pertinent transactions" (*Matter of F.W. Woolworth Co. v. State*

Tax Commn. (*supra*, 510 NYS2d, at 928, emphasis added). In *Woolworth*, the Court found that "objective facts and circumstances" existed from which the Division could infer that the petitioner's debt obligations were indirectly attributable to its investments in subsidiaries. That is what the Administrative Law Judge concluded was not present in this case and we agree, at least for that portion of the assessment attributable to 1989. We find no support in the record for the Division's argument that petitioner significantly increased its investment in its subsidiaries for 1989. As a result, we agree with the Administrative Law Judge's conclusion that "[s]ince there is no evidence of any increase in Suburban's 'Investment in Subsidiaries' account and no increase in Suburban's 'Advances to Subsidiaries' account during the relevant period, there are no facts in the record from which it may be inferred that any of the loan proceeds are indirectly attributable to subsidiary capital" (Determination, conclusion of law "C") insofar as it relates to 1989.

In calculating the additional tax asserted due for 1990, the Division determined that petitioner's investment in its subsidiaries and advances to its subsidiaries increased significantly. However, unlike 1989, petitioner failed to introduce any documentary or testimonial evidence to explain or refute the Division's determination or to rebut the presumption of correctness as to that portion of the assessment. An inference could be made that since the loan proceeds were not shown to have had an indirect effect on subsidiary capital for 1989, there was similarly no effect in 1990. However, such an inference is not sufficient to meet petitioner's burden of proof in this regard. Thus, as to 1990, the un rebutted presumption of correctness raised by the issuance of the assessment, in itself, provides the rational basis for the assessment of additional tax for that year. To hold otherwise would be in irreconcilable conflict with the principles that the Division does not bear the burden to demonstrate the propriety of its assessment (*see, Matter of A & J Gifts Shop v. Chu*, 145 AD2d 877, 536 NYS2d 209, *lv denied* 74 NY2d 603, 542 NYS2d 518; *Matter*

of Blodnick v. New York State Tax Commn., 124 AD2d 437, 507 NYS2d 536; *Matter of Scarpulla v. State Tax Commn.*, 120 AD2d 842, 502 NYS2d 113) and that petitioner has a heavy burden to prove the assessment erroneous (*see, Executive Land Corp. v. Chu*, 150 AD2d 7, 545 NYS2d 354, *appeal dismissed* 75 NY2d 946, 555 NYS2d 692). Thus, for the year 1990, petitioner has “surrendered to the statutory presumption of correctness” and the subject assessments must be sustained (*see, Matter of Tavalacci v. State Tax Commn., supra*).

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is granted with respect to that portion of the Notice of Deficiency concerning 1990 but is otherwise denied;
2. The determination of the Administrative Law Judge is reversed with respect to that portion of the Notice of Deficiency concerning 1990, but is otherwise affirmed;
3. The petition of Suburban Carting Corporation is granted to the extent provided in conclusion of law “E” of the Administrative Law Judge’s determination and in accordance with paragraph “2” above, but is otherwise denied; and
4. The Notice of Deficiency, as modified above, is sustained.

DATED: Troy, New York
May 7, 1998

/s/Donald C. DeWitt

Donald C. DeWitt
President

/s/Carroll R. Jenkins

Carroll R. Jenkins
Commissioner

/s/Joseph W. Pinto, Jr.

Joseph W. Pinto, Jr.
Commissioner