STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
CARPENTER TECHNOLOGY CORPORATION	:	DECISION DTA NO. 816680
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Fiscal Years Ended June 30, 1990 and June 30, 1991.	: :	

Petitioner Carpenter Technology Corporation, P.O. Box 14662, Reading, Pennsylvania 19612-4662, filed an exception to the amended determination of the Administrative Law Judge issued on April 13, 2000. Petitioner appeared by Dechert Price & Rhoads (Richard C. Kariss, Francis Mazzola and Debra MacPhee, Esqs., of counsel). The Division of Taxation appeared by Barbara G. Billet, Esq. (Kevin R. Law, Esq., of counsel).

Petitioner filed a brief in support of its exception. The Division of Taxation filed a brief in opposition and petitioner filed a reply brief. Oral argument, at petitioner's request, was heard on October 12, 2000 in Troy, New York.

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

ISSUE

Whether the Division of Taxation properly disallowed certain interest expense deductions claimed by petitioner in computing its entire net income tax base and added back the interest expense as interest directly attributable to subsidiary capital pursuant to 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.

On June 3, 1999 and June 14, 1999, respectively, Carpenter Technology Corporation ("Carpenter") and the Division of Taxation ("Division") entered into a written stipulation of facts. The relevant facts are substantially incorporated into the following Findings of Fact.

Carpenter is a Delaware corporation that is primarily engaged in the business of manufacturing and distributing specialty steel products. Carpenter is headquartered in Reading, Pennsylvania.

Carpenter conducts specialty steel distribution activities in New York. It operates a warehouse in Rochester, New York which is its only New York based facility.

During the 1980s, Carpenter's management decided to expand its business into foreign countries.

Carpenter's management concluded that the business in each foreign country should be conducted through entities organized under the laws of the foreign countries.

Carpenter's management concluded that conducting business using locally organized entities would achieve important objectives such as facilitating the importation of products manufactured by Carpenter, currency transactions, operations under local law and business relationships with local vendors and customers.

Carpenter's management decided that Carpenter should not directly own the foreign entities but that those entities should be owned by domestic subsidiary corporations of Carpenter.

Carpenter's management decided to form viable corporate subsidiaries to own the foreign entities in order to protect Carpenter's domestic business assets from large liabilities related to business conducted in foreign countries.

Carpenter's management decided that to protect its domestic business assets from foreign liabilities, it would form a domestic subsidiary corporation with sufficient assets to partially insulate Carpenter from foreign liabilities by becoming an owner of certain foreign entities and thereafter form a second domestic subsidiary with sufficient assets to further insulate Carpenter from foreign liabilities by holding the remaining interest in the foreign entities, thereby divesting Carpenter of any direct ownership interest in the foreign entities.

Carpenter's management considered the following risks related to conducting business in foreign countries: (a) some foreign jurisdictions did not recognize the corporate limited liability concept; (b) some foreign jurisdictions did not recognize contractual limitations with respect to consequential damages; and (c) some of the products sold in the foreign countries would be used in products associated with a high product liability risk such as surgical equipment, surgical implants (e.g., hip joint prostheses, bone plates and heart catheter wire), laser systems, petrochemical storage and processing equipment, nuclear reactors, aircraft engines, landing gears of carrier-based aircraft, automobile air bags, automobile anti-lock brakes and automobile fuel injection systems.

Carpenter's management determined that the ownership of $300 million of assets by the first domestic subsidiary corporation would provide the subsidiary with the substance to partially protect Carpenter's business assets from liabilities related to conducting business in foreign countries.

On October 12, 1989, Carpenter's Board of Directors formally considered the formation of the first domestic subsidiary corporation.

On October 13, 1989, Carpenter formed Carpenter Investments, Inc. ("CII") in Delaware as a wholly-owned viable subsidiary corporation, and Carpenter contributed capital in the amount of $300 million to CII. Thereafter, CII loaned this $300 million back to Carpenter.

After CII was formed, CII owned $300 million of assets in the form of a revolving promissory note from Carpenter.

The note between Carpenter and CII required Carpenter to pay interest to CII at an arm's-length rate.

Carpenter made timely interest and principal payments with respect to the note held by CII.

The asset owned by CII and the fact that CII became a shareholder in several foreign corporations provided CII with economic substance and met Carpenter's business objectives of partially insulating its business assets from foreign liabilities.

In accordance with its business objective, Carpenter formed a second wholly-owned domestic subsidiary corporation on September 17, 1991.

The second subsidiary corporation became a shareholder in a foreign corporation and an owner in an interest in a foreign joint venture.

The second subsidiary corporation owned sufficient assets to provide that corporation with economic substance and thus Carpenter's business assets were further insulated with respect to foreign liabilities.

Carpenter's management concluded that it was necessary to form a third domestic subsidiary corporation to further insulate Carpenter from any foreign liabilities.

Carpenter formed a third wholly-owned subsidiary corporation.

The third subsidiary corporation owned sufficient assets to provide that corporation with economic substance and thus Carpenter's business assets were further insulated with respect to foreign liabilities.

To achieve Carpenter's business objective, the third subsidiary corporation became a shareholder in several foreign corporations.

The third subsidiary corporation's ownership interest in the foreign corporations enabled Carpenter to achieve its business objective of insulating its business assets from foreign liabilities by: (a) divesting itself of any direct ownership in the foreign businesses, and (b) establishing corporate subsidiaries with sufficient assets to insulate Carpenter's business assets from liabilities arising from the ownership of foreign businesses.

The domestic subsidiaries that Carpenter formed to protect its domestic business assets did not make loans to the foreign entities in which they held investment interests.

During the fiscal year ended June 30, 1990, Carpenter's investments in subsidiaries increased by $299,950,881.00. On its Federal return for this period (Statement 12, pg. 50), Carpenter indicated that it had made investments in subsidiaries totaling $300,007,232.00.

During the fiscal year ended June 30, 1991, CII paid a dividend to Carpenter which was, in part, based upon income earned by CII from its receipt of interest paid by Carpenter. The amount of this dividend was $4,000,000.00.

During the years at issue, all of CII's income was interest income, the majority of which was the interest paid to it by Carpenter.

Carpenter timely filed tax returns for the tax years at issue and paid tax as reported due on those returns.

Carpenter filed on a consolidated basis with its affiliates for Federal income tax purposes during the tax years at issue.

Carpenter deducted its interest payments to CII on its pro-forma Federal forms 1120 as an expense in computing its separate company Federal taxable income during the years at issue.

The Internal Revenue Service examined and approved Carpenter's interest expense deductions.

Carpenter used Federal taxable income to compute its New York State tax base.

Carpenter did not add back its expense deductions as attributable to subsidiary capital in computing its tax base because, in its view, the interest expense was not incurred on behalf of Carpenter's subsidiaries.

On September 18, 1995, the Division issued a Notice of Deficiency to Carpenter asserting additional tax due in the amount of $41,251.00, plus interest of $22,083.99 and penalty of $4,125.00, for a total amount due of $67,459.99 for the fiscal year ended June 30, 1990 and asserting additional tax due of $132,971.00, plus interest of $50,768.69 and penalty in the amount of $13,297.00, for a total amount due of $197,036.69 for the fiscal year ended June 30, 1991.

Because the Division was initially unable to determine the amount of interest which Carpenter paid to CII for the period ended June 30, 1991, the Division added back all of Carpenter's interest expense. Based upon information subsequently provided by Carpenter, it was determined that the interest which Carpenter paid to CII for the period ended June 30, 1991 was $40,167,993.00. Therefore, the amount of tax for this period should be reduced by $56,341.00.

However, when issuing the Notice of Deficiency, the Division failed to impose the surcharge pursuant to Tax Law § 209-A. Therefore, the tax asserted to be due should be increased by $11,495.00. Accordingly, the net adjustment to the tax for the period ended June 30, 1991 results in a reduction in the amount of $44,846.00 ($56,341.00 - $11,495.00).

The parties agree that, except for the modification set forth above, the amounts asserted to be due pursuant to the Notice of Deficiency are not in dispute.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

In the determination, the Administrative Law Judge noted that petitioner computed its tax liability for the years in issue using the entire net income tax base within the meaning and intent of Tax Law § 208(9).

The specific transaction at the heart of this case involves the contribution of $300 million by petitioner to CII. The Administrative Law Judge stated that petitioner determined that ownership of $300 million of assets by CII would provide the subsidiary with the economic substance to partially protect petitioner's business assets from liabilities related to conducting business in foreign countries. Once petitioner contributed the money to CII, it borrowed it back. Thus, petitioner was paying interest to CII on the loan and it is these interest payments which petitioner seeks to deduct from its entire net income computation.

Relying on ***Matter of F.W. Woolworth Co. v. State Tax Commn.*** (126 AD2d 876, 510 NYS2d 926, ***affd*** 71 NY2d 907, 528 NYS2d 537), the Administrative Law Judge concluded that it is necessary to look to the facts and circumstances surrounding the transaction to determine whether expenses incurred were attributable to subsidiary capital. The Administrative Law Judge stated that although petitioner did not borrow the $300 million from a third party, Carpenter was still paying interest on the loan and the $300 million was reflected as an investment in subsidiaries on its books.

The Administrative Law Judge rejected petitioner's argument that since Carpenter's interest payments to CII were not incurred to enhance its investment in CII, that such expenses, necessarily, were not attributable to subsidiary capital. The Administrative Law Judge stated that despite Carpenter's argument that the funds loaned back to it from CII were not used to acquire or to capitalize CII or any other of petitioner's subsidiaries and did not enhance the equity of CII since CII merely exchanged its cash for a note receivable, the Administrative Law Judge found that the economic reality of the transaction did not support Carpenter's position.

Lastly, the Administrative Law Judge addressed petitioner's allegation that even if its payments to CII were attributable to subsidiary capital, the Commissioner of Taxation and Finance did not have a reasonable basis to invoke his discretion to disallow the deduction for those interest payments. Although petitioner asserted that it did not obtain a double tax benefit and that its income would not be distorted if the deduction for the payments was permitted, the

Administrative Law Judge concluded that petitioner failed to demonstrate that this was the case. The Administrative Law Judge determined that there was absolutely no evidence that there was an abuse of discretion due to irrationality or unreasonableness. Petitioner did not take an exception with respect to this conclusion made by the Administrative Law Judge.

Therefore, the Administrative Law Judge determined that the Division properly disallowed Carpenter's interest expense deductions and properly added back this interest expense to its Federal taxable income in computing entire net income, as having been directly attributable to subsidiary capital pursuant to Tax Law § 208(9)(b)(6).

ARGUMENTS ON EXCEPTION

Petitioner alleges that the fact that its interest expenses were incurred for a legitimate business purpose is sufficient to prevent the Division from treating those expenses as directly attributable to subsidiary capital. Petitioner argues that an interest deduction that is exclusively related to a taxpayer's business may not be disallowed in any respect. Thus, petitioner claims that the Administrative Law Judge erred when he concluded that those transactions that were directly related to subsidiary capital should be disallowed in their entirety.

Next, petitioner argues that the Administrative Law Judge improperly relied on ***Matter of F.W. Woolworth Co. v. State Tax Commn.*** (***supra***) in deciding this case. Petitioner points out that in ***Woolworth***, the facts dealt with certain expenses that were *indirectly* attributable to subsidiary capital, whereas, in this case, the issue is whether the interest expenses are *directly* attributable to subsidiary capital. Therefore, petitioner urges that ***Woolworth*** is inapplicable herein.

Moreover, petitioner disagrees with the Administrative Law Judge's conclusion that the economic reality of the transaction does not support its argument. Petitioner states that the economic reality behind the transaction between it and CII was to achieve its business purposes of enabling it to expand its business in foreign countries and to protect its domestic business assets from the liabilities related to that expanded foreign business.

In opposition, the Division states that petitioner's arguments are without merit. The Division argues that petitioner's assertion that it is entitled to a deduction because the interest expense is exclusively related to its business and, thus, may not be disallowed in any respect, oversimplifies the issue. While the Division concedes that petitioner had a legitimate business purpose behind its transaction with CII, this reason alone is not determinative of whether the expenses are required to be added back in computing its entire net income. Moreover, the Division points out that petitioner has not even attempted to explain how borrowing back the amount it used to capitalize CII furthers any legitimate business purpose nor did petitioner establish the purpose behind the loan transaction back to it. Thus, the Division states the Administrative Law Judge properly determined that there was no economic substance to the transaction.

The Division also explains that the step transaction doctrine dictates that the interest paid by Carpenter to CII was attributable to subsidiary capital. The Division states that pursuant to either the end result test or the interdependence test, an analysis of the facts leads to the application of the step transaction doctrine to the transactions between Carpenter and CII, and the result that the interest payments to CII were directly attributable to subsidiary capital. Therefore, the Division requests that petitioner's exception be denied.

OPINION

We affirm the determination of the Administrative Law Judge.

During the years at issue, Carpenter computed its tax liability using the entire net income tax base. Therefore, a brief review of the statutory framework regarding the computation of the franchise tax is necessary.

Tax Law § 208(9) provides that entire net income means total net income from all sources which is presumably the same as the Federal taxable income which a taxpayer is required to report to the Internal Revenue Service modified by certain additions and subtractions. Tax Law § 208(9)(a)(1) states that entire net income shall not include income, gains and losses from subsidiary capital.

Tax Law § 208(9)(b)(6) provides that *entire net income* shall be determined without excluding, deducting or crediting:

> 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.

As discussed in ***Matter of F.W. Woolworth Co. v. State Tax Commn.***, ***supra***, 510 NYS2d, at 927:

> the purpose of the exclusion under [Tax Law § 208(9)(b)(6)] 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.

Petitioner argues that ***Woolworth*** does not apply to the facts in this case since the expenses at issue in ***Woolworth*** were indirectly attributable to subsidiary capital rather than directly attributable as in this case. We find this argument completely without merit.

The term *subsidiary capital* is defined as:

> investments in the stock of subsidiaries and any indebtedness from subsidiaries . . . whether or not evidenced by written instrument, on which interest is not claimed and deducted by the subsidiary for purposes of taxation under article nine-a, thirty-two or thirty-three of this chapter, provided, however, that, in the discretion of the commissioner of taxation and finance, there shall be deducted from subsidiary capital any liabilities which are directly or indirectly attributable to subsidiary capital (Tax Law § 208[4][a]).

Therefore, the statute does not distinguish between expenses either directly or indirectly attributable and petitioner has not advanced any theory explaining why we should reject ***Woolworth*** on that basis.

Petitioner urges us to conclude that, since it had a legitimate business purpose behind the loan transaction between it and CII, this reason alone requires that the interest expenses incurred therein are entitled to deduction. This theory is rejected explicitly in ***Woolworth*** wherein it is stated that: "[c]ontrary to petitioner's contention, it is not alone sufficient to defeat disallowance of the interest deduction that the incurrence of the indebtedness can be directly attributed to a separate, bona fide business purpose" (***Matter of F.W. Woolworth Co. v. State Tax Commn.***, ***supra***, 510 NYS2d, at 928). Thus, petitioner is not entitled to a deduction solely because it had a legitimate business purpose for the loan transaction.

As discussed by the Administrative Law Judge, the court in ***Woolworth*** stated that:

> Tax Law § 208(9)(b)(6) speaks also of *indirect* attribution and, thus, envisages 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).

In our case, petitioner decided to form CII in order to protect its domestic business assets from large liabilities related to it conducting business in foreign countries. Petitioner decided that the ownership of $ 300 million of assets by CII would provide this subsidiary with the substance to partially protect petitioner's business assets from these liabilities. Thereafter, Carpenter contributed capital in the amount of $300 million to CII and, subsequently, CII loaned the $300 million right back to Carpenter. We agree with the Administrative Law Judge that although petitioner claims that CII's ownership of a $300 million promissory note allowed it to achieve the goals desired by petitioner, it is unclear how the note, as opposed to the initial cash contribution, helped petitioner to insulate itself from its expansion into foreign countries and the risks inherent therein. The Administrative Law Judge concluded, and we agree, that the only reasonable explanation for this exchange of assets was that petitioner believed that it could obtain a double tax benefit, to wit, it would not have to include the $300 million provided to CII as part of its entire net income pursuant to Tax Law § 208(9) which provides that entire net income does not include income or gains from subsidiary capital while, simultaneously, it could receive a substantial deduction for the interest payments it made to CII on the loan back from the subsidiary what essentially were the funds used to capitalize CII. Since this was exactly the scenario the Tax Law was trying to prevent, we agree with the Administrative Law Judge that given the facts and circumstances surrounding the transaction, the interest expenses incurred by petitioner were directly attributable to subsidiary capital and, thus, were properly required to be added back in computing entire net income in this case.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Carpenter Technology Corporation is denied;

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

3. The petition of Carpenter Technology Corporation is denied; and

4. The Notice of Deficiency, dated September 18, 1995, as modified in the findings of fact, is sustained.

DATED: Troy, New York
April 12, 2001

/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