STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
THE UNIMAX CORPORATION	:	DETERMINATION
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1975 through 1979.	:	

Petitioner, The Unimax Corporation, 54 East 64th Street, New York, New York 10021, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the years 1975 through 1979 (File Nos. 800076 and 800303).

A hearing was held before Sandra Heck, Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on June 5, 1986 at 9:30 A.M. and continued before the same Hearing Officer and at the same location on June 6, 1986 at 9:15 A.M. The hearing was reopened for additional argument before Robert F. Mulligan, Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on February 4, 1987 at 10:15 A.M., with all briefs submitted by April 30, 1987. Petitioner appeared by Paul, Weiss, Rifkind, Wharton & Garrison (Richard J. Bronstein, Esq., of counsel) and Peat, Marwick, Mitchell & Co. (John N. Bush, CPA). The Audit Division appeared by John P. Dugan, Esq. (Anne W. Murphy, Esq., of counsel).

ISSUES

I. Whether, in computing interest expense indirectly attributable to subsidiary capital, loans and advances made to a parent corporation by a subsidiary may be netted against loans and advances made by the parent to the subsidiary to reduce said loans and advances from the parent to an amount less than zero.

II. Whether advances to and investments in insolvent subsidiaries should constitute part of "subsidiary capital".

III. Whether the Audit Division properly subtracted a note payable to Utilities and Industries Corporation from petitioner's total assets in computing the denominator of the fraction used to determine interest expense indirectly attributable to subsidiary capital.

IV. Whether the cost of Richmond Hill Laboratories, Inc. was $1.00 rather than $100,000.00.

V. Whether the Audit Division substantially overstated the cost of Barry's Jewelers, Inc. and whether an advance from petitioner to Barry's Jewelers, Inc. of $356,201.00 was properly included for purposes of determining subsidiary capital.

VI. Whether the Audit Division incorrectly included reimbursements purportedly paid to an employee, Robert Dresler, pursuant to an employment agreement, as interest expense.

VII. Whether the Audit Division erroneously failed to subtract the amount of the "Master Eagle Loan" from the numerator and denominator of the fraction used to determine interest expense indirectly attributable to subsidiary capital.

FINDINGS OF FACT

1. Petitioner, The Unimax Corporation, is a Delaware corporation with headquarters in New York City.

2. Prior to March 11, 1969, petitioner was known as Riker Corporation ("Riker"). On March 11, 1969, Riker and Maxson Electronics Corporation merged, with Riker as the survivor. Riker's name was changed to Riker-Maxson Corporation. Riker-Maxson Corporation's name was subsequently changed to The Unimax Group, Inc. and eventually to The Unimax Corporation.

3. Petitioner is a holding corporation with numerous subsidiaries. The subsidiaries had been owned by either Riker Corporation or Maxson Electronics Corporation prior to the 1969 merger, or were acquired by petitioner after the merger. The subsidiaries are engaged primarily in the manufacture and sale of electrical components, in the graphic arts business, in the manufacture and sale of metal products and in the retail jewelry business.

4. Petitioner filed New York State corporation franchise tax reports for each of the years at issue, on which it deducted the full amount of interest it paid to third parties in computing its entire net income. The reports for 1975, 1976 and 1977 indicated no allocated net income and tax was computed as the minimum tax plus tax on allocated subsidiary capital. For 1978, petitioner reported a loss and computed tax as the minimum tax plus tax on allocated subsidiary capital. For 1979, petitioner computed franchise tax due on allocated net income plus allocated subsidiary capital.

5. (a) On January 8, 1979, pursuant to a desk audit, the Audit Division issued the following notices of deficiency to petitioner:

YEAR	TAX DUE	INTEREST	TOTAL
1975	$141,045.63	$34,082.80	$175,128.43
1976	80,085.00	12,544.82	92,629.82

(b) On July 29, 1982, pursuant to a field audit, the Audit Division issued the following notices of deficiency to petitioner:

YEAR	TAX DUE	INTEREST	TOTAL
1977	$122,399.69	$55,497.24	$177,896.93
1978	152,271.99	56,098.52	208,370.51
1979	128,029.45	36,284.83	164,314.28

(c) The deficiencies were based, as is pertinent to this proceeding, on adjustments with respect to petitioner's subsidiary capital. Interest expense deemed to be indirectly attributable to

subsidiary capital was added back to entire net income. The Audit Division then essentially disallowed loans and advances made to petitioner by a subsidiary to the extent that they would reduce loans and advances from petitioner to such subsidiary to an amount less than zero for purposes of the formula for determining the portion of interest indirectly attributable to subsidiary capital.[1] It also substituted fair market value of subsidiary capital for book value shown on petitioner's Federal corporation tax returns. Other adjustments were made based on disallowance or partial disallowance of net operating loss deductions, however, petitioner has withdrawn its opposition to such adjustments.

(d) The notices of deficiency were timely protested by petitioner and, after several conferences, the deficiencies were revised to the following amounts:

YEAR	ADDITIONAL TAX DUE
1975	$100,966.00
1976	54,553.00
1977	91,177.00
1978	152,436.00
1979	123,456.00

6. The adjustments at issue are based on the Audit Division's use of a formula designed to determine the portion of petitioner's interest expense which was indirectly attributable to subsidiary capital and thus not deductible for the purposes of computing "entire net income" pursuant to Tax Law § 208.9(b)(6). The formula utilized by the Audit Division may be expressed as follows:

Investment in subsidiaries / Total assets x Gross interest expense = Interest indirectly attributable to subsidiary capital

For purposes of the formula, "Investment in Subsidiaries" is comprised of the cost of stock, plus paid-in capital and loans and advances.

Petitioner's Position

7. Petitioner does not contest the use of the above formula to determine the portion of its interest expense which is indirectly attributable to investments in subsidiaries. It does, however, object to the Audit Division's treatment of loans and advances made to petitioner by certain subsidiaries as equal to zero, claiming rather that such loans and advances should be netted

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[1]The auditor had found that advances to petitioner from its subsidiaries exceeded advances to subsidiaries in all years at issue except 1977:

Year	Net Advances from Subsidiaries
1974	$1,313,588.00
1975	4,421,090.00
1976	3,921,896.00
1977	(300,491.00)
1978	721,961.00
1979	$3,690,509.00

against the investments made by petitioner in its other subsidiaries. It also maintains that the Audit Division failed to treat petitioner's investments in worthless subsidiaries as zero.

Petitioner claims that if it should prevail on these issues, the numerator of the disallowance fraction would be reduced to zero and no interest expense would be indirectly attributable to subsidiary capital. In the event that petitioner should not so prevail, it claims in the alternative that the Audit Division erred in its treatment of certain specific items and that the following are correct:

(a) The cost of Richmond Hill Laboratories, Inc. was $1.00 and not $100,000.00.

(b) The cost of Barry's Jewelers, Inc. was substantially overstated and an advance in 1976 was "double-counted".

(c) Employee reimbursements to Robert Dressler were incorrectly treated as interest expense.

(d) The amount of the "Master Eagle Loan" should have been subtracted from the numerator and denominator of the disallowance fraction.

(e) The amount of a note to Utilities and Industries Corporation should not have been subtracted from the denominator of the disallowance fraction.

Offset of Loans and Advances

8. There is no provision in the Tax Law or the regulations which specifically prohibits the use of loans and advances to a parent corporation from a subsidiary so as to reduce loans and advances from the parent to an amount less than zero when calculating investment in subsidiaries. The prohibition represents long-standing policy of the Audit Division which was formalized in Corporation Tax Audit Guidelines dated June 1, 1983. Section 314.2 A 2 of the written guidelines, dealing with investment in subsidiaries, provides, in pertinent part, as follows:

> "In determining the amount of loans and advances, loans and advances to the parent by one of its subsidiaries may be offset against loans and advances to such subsidiary. At no time may loans and advances from a subsidiary reduce loans and advances from the parent to an amount lower than zero (0). Loans and advances to the parent may not be offset against capital stock or against loans and advances to any other subsidiary."

Investments in Insolvent Subsidiaries

9. The consolidated income statements and balance sheets attached to petitioner's Federal income tax returns show that three of petitioner's subsidiaries, Longview Precision, Inc., Riker Information Systems, Inc. and Stemes Liquidating Corp., appear to have been relatively inactive, i.e., no sales or no employee compensation paid, for 1975 and 1977 through 1979, and that the liabilities of said subsidiaries were substantially in excess of their assets for all of the years at

issue.[2] Longview Precision, Inc. and Riker Information Systems, Inc. were not completely dormant, however, as each had items of income, i.e., rent, interest or other income, and/or deductions for said years. Stemes Liquidating Corp. does appear to have been dormant, at least for 1975, 1977 and 1979.[3] The income statements and balance sheets also show that another subsidiary, Richmond Hill Laboratories, Inc., appears to have been relatively inactive (no sales or employee compensation) in 1978 and 1979 and that its liabilities substantially exceeded its assets for said years. It did, however, have negative net sales in 1978, "other income" in 1979 and substantial deductions in both years.

The balance sheets for each of the above subsidiaries reported loans from stockholders or affiliates and also showed capital stock and, where appropriate, paid in or capital surplus.

10. The auditor did not treat advances to and investments in the aforementioned subsidiaries, referred to by petitioner as "insolvent" or "worthless" subsidiaries, any differently than advances to and investments in petitioner's other subsidiaries. Accordingly, advances to and investments in said subsidiaries were included in the numerator of the disallowance fraction.

Richmond Hill Laboratories, Inc.

11. Petitioner acquired all of the issued and outstanding stock of Richmond Hill Laboratories, Inc. from Richmond Hill Laboratories, Ltd. of Scarborough, Ontario, on August 31, 1977 in consideration of $1.00. The $1.00 was applied against an indebtedness of $1,445,129.99 owed by Richmond Hill Laboratories, Ltd. to petitioner.

12. The Audit Division treated the cost of petitioner's subsidiary, Richmond Hill Laboratories, Inc., as $100,000.00 in the years 1977, 1978 and 1979, based on a statement made to the auditor by Warren Kaplan, a former officer of petitioner. Mr. Kaplan told the auditor that petitioner contributed furniture and fixtures worth approximately $100,000.00 to Richmond Hill Laboratories, Inc.

13. The balance sheet of petitioner for the year ending December 31, 1977 shows that Richmond Hill Laboratories, Inc. had buildings and other fixed depreciable assets of $358,431.00. It also shows that said subsidiary had a negative net worth of $616,526.00.

Barry's Jewelers, Inc.

14. Petitioner acquired slightly more than 80 percent of the stock of Barry's Jewelers, Inc. ("BJI") from David Blum and Gerson I. Fox pursuant to a stock purchase agreement dated November 18, 1976. The balance of the shares was acquired from BJI's minority stockholders in exchange for petitioner's stock. The transaction was effectuated as follows:

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[2]Exhibits 2(a)-(d). It is noted that the 1976 income statement is not in the record.

[3]Income statements for 1976 and 1978 for this subsidiary are not in the record. However, the balance sheets for said years indicate no changes and thus appear to be consistent with inactivity.

(a) Barry's Purchasing Corp. ("BPC"), a wholly-owned subsidiary of petitioner, was named as "Buyer" under the stock purchase agreement. BJI and Messrs. Fox and Blum were named as "Sellers". Petitioner was also a party to the agreement.

(b) Under the agreement, Buyer was to pay Seller the following:

(i) $100,000.00 cash, at closing;

(ii) promissory notes in the principal amount of $400,000.00, guaranteed by petitioner, at closing;

(iii) 20,000 shares of petitioner's common stock, at closing;

(iv) $500,000.00 in cash upon approval of the transaction by petitioner's shareholders;

(v) on April 30, 1977, cash and stock of petitioner equal to 70 percent of BJI's pre-tax profit for the period commencing on the closing date and ending on December 31, 1976;

(vi) on April 30, 1978, 1979 and 1980, payments equal to 70 percent of BJI's pre-tax profit for the prior fiscal year (ending December 31) in cash and petitioner's common stock;

(vii) on April 30, 1981 and 1982, payments equal to 45 percent of BJI's pre-tax profit for the prior fiscal year (ending December 31) in cash and petitioner's common stock.

(c) Petitioner, BJI and Barry's Merger Corp. ("BMC"), another wholly-owned subsidiary of petitioner, but not a party to the stock purchase agreement, were to enter into a merger agreement. BJI and BPC were to enter into a second merger agreement. The terms of the merger agreements are not in the record and the mechanics of the merger process are not entirely clear.[4] In any event, after the merger, BJI became a wholly-owned subsidiary of petitioner and was primarily responsible for the payments specified under Finding of Fact "14(b)". Petitioner was guarantor of said obligations.

(d) Petitioner paid the $100,000.00 initial cash payment and the $400,000.00 promissory note specified in Finding of Fact "14(b)". The $500,000.00 was at first recorded in the investment in subsidiaries account. This entry was later changed by recording an advance to BJI in the amount of $352,201.00 and reducing its investment account in the stock of BJI by the same amount. (This was done because the transaction had not closed by the end of 1976.) The Audit Division included both the $500,000.00 and the $352,201.00 in the numerator of the disallowance fraction.

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[4]The process is ostensibly stated in paragraph 3(a)(ii) of the affidavit of Tom Scheinman, petitioner's president and chief executive officer (petitioner's Exhibit 9). It is noted, however, that Mr. Scheinman's statement that BMC was a wholly-owned subsidiary of BPC is inconsistent with section 1.10.1 of the stock purchase agreement (Exhibit 7) which states that BMC was a wholly-owned subsidiary of petitioner.

The Dressler Payments

15. Robert Dressler, president and chief executive officer of Riker, purchased 20,000 shares of Riker common stock at $20.00 per share in June 1968. Riker advanced the funds on Dressler's behalf. Subsequently, Dressler borrowed funds and repaid Riker $400,000.00. Under the terms of an employment agreement, Riker agreed to repay Dressler the interest charges he incurred in connection with said loan.

16. The Audit Division disallowed the following interest expense payments paid to Chemical Bank in connection with the "Dressler Loan":

YEAR	AMOUNT
1975	$22,531.00
1976	9,838.00
1977	1,062.00

17. The auditor did not see the note payable. He based his determination on statements made by Warren Kaplan, the former officer of petitioner. The auditor's written notations with respect to his conversation with Mr. Kaplan were described in the auditor's testimony as follows:

> "I have reference to a Dressler loan on a note payable of Unimax and another liability referred to settlement employment contract, related to the Dressler loan."[5]

18. The auditor took the position that there may have been two loans, but that in any event the disallowed funds were paid to Chemical Bank by petitioner, not to Dressler and the liability appeared on petitioner's books.

The Master Eagle Loan

19. The auditor disallowed interest directly attributable to a loan characterized as "Chemical Master Eagle Loan". Interest of $21,324.00 was disallowed for 1975 and $3,283.00 was disallowed for 1976. The interest was excluded by the auditor in calculating interest indirectly attributable to subsidiary capital.

20. The loan was noted as being for $500,000.00 and related to New York State franchise tax. The auditor deducted $500,000.00 from total assets for 1974 in determining adjusted total assets. Although interest expense was subtracted from total interest expense for 1975 and 1976 (Finding of Fact "19"), the auditor did not make a similar adjustment to total assets for said years. His reasoning was as follows: "I believe I have information, some workpapers that indicate the amounts were zero on that date, again, as provided by the taxpayer." When asked again if he disallowed the interest expense and did not make the adjustment, he replied "Well, I was told it was zero."

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[5]Transcript of hearing June 6, 1986, page 20. The auditor was reading his notes from Exhibit H for identification. The document itself is not in evidence.

The Utilities and Industries Loan

21. The auditor excluded from interest expense the following interest payments made to Utilities and Industries Corporation, a corporation which owned more than five percent of petitioner's common stock:

YEAR	AMOUNT
1975	$ 8,021.00
1976	13,750.00
1977	13,397.00
1978	-0-
1979	11,070.00

It appears that this exclusion was made pursuant to Tax Law § 208.9(b)(5). The auditor also subtracted the amount of the note payable to Utilities and Industries Corporation from total assets. The subtractions were as follows:

YEAR	AMOUNT
1974	$222,499.00
1975	230,520.00
1976	244,270.00
1977	-0-
1978	352,400.00
1979	-0-

Petitioner claims that it was incorrect for the Audit Division to subtract the amount of the note payable from petitioner's total assets as per the consolidated balance sheet.

CONCLUSIONS OF LAW

A. That during the years at issue, Tax Law § 208.9 provided, in pertinent part, that the term "entire net income" meant "total net income from all sources, which shall be presumably the same as the entire taxable income which the taxpayer is required to report to the United States treasury department", except for certain exclusions, addbacks and modifications, which will be discussed infra.

B. That Internal Revenue Code § 163(a) provides as follows:

> "GENERAL RULE. -- There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

Accordingly, the starting point for entire net income, as noted in Tax Law § 208.9 (Conclusion of Law "A" above), reflects interest deducted by a taxpayer on its Federal return.

C. That as an exclusion, Tax Law § 208.9(a)(1) provides, in pertinent part, that entire net income shall not include income, gains and losses from subsidiary capital.

D. That as an addback, Tax Law § 208.9(b)(6) provides that entire net income shall be determined without the exclusion, deduction or credit of:

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

E. That the intent of the legislature in enacting Tax Law § 208.9(b)(6) was "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 investment is tax free." (F. W. Woolworth Co. v. State Tax Commn. 126 AD2d 876, 877, affd 71 NY2d 907; see Letter from Mortimer M. Kassell to Hon. Averell Harriman and Letter from Sen. S. Wentworth Horton to Daniel Gutman, Esq., Counsel to the Governor, Bill Jacket, Laws of New York 1955, ch 715).

F. That expenses directly attributable to a subsidiary are ordinarily readily identifiable. It has been the long-standing policy of the Audit Division to determine interest expense indirectly attributable to subsidiary capital by presuming that each asset owned by a corporation bears a proportionate share of the cost of the corporation's borrowings (Matter of Worldwide Volkswagen, State Tax Commn., April 30, 1974). Specifically, the Audit Division determines the portion of interest expense indirectly attributable to subsidiary capital through the ratio by which the cost of each subsidiary and the advances made to each subsidiary bear to the parent's total assets (Finding of Fact "6").

As noted in Finding of Fact "7", petitioner does not object to the Audit Division's formula, however, it disagrees with the Audit Division's position that advances from a subsidiary to its parent may not be used to reduce the cost of the particular subsidiary to less than zero.

G. That petitioner's position with respect to netting of loans and advances to a parent corporation is correct. There is nothing in the Tax Law which requires the interest indirectly attributable to each subsidiary to be calculated separately. Funds borrowed by a parent corporation from one or more of its subsidiaries clearly reduce the need of the parent to borrow from outside sources. Failure to recognize this by limiting net advances from a subsidiary to a parent to "zero" is nothing but an arbitrary measure designed to reap the highest amount of tax possible.

H. That petitioner's argument that advances to and investments in insolvent subsidiaries should not be treated as part of subsidiary capital is without merit. The fact that a subsidiary is unprofitable or insolvent is no reason to exclude it from subsidiary capital (U.S. Summit Corporation, State Tax Commission, May 23, 1985). Petitioner has attempted to characterize four subsidiaries as "insolvent" and "inactive and worthless" during the years at issue. As noted in Finding of Fact "9", however, three of said subsidiaries had some activity during each of the years at issue and were not totally dormant. Moreover, the balance sheets of each subsidiary reported loans from stockholders or affiliates and also showed capital stock and in some cases paid in or capital surplus. Petitioner's motives for maintaining such subsidiaries are irrelevant. What is important is that the four corporations continued to exist as subsidiaries of petitioner and petitioner's investments in them continued through the years at issue. Accordingly, such investments are to be treated as subsidiary capital.

I. That the Audit Division's treatment of the amounts due on the Utilities and Industries

Corporation notes for the years at issue was correct. Tax Law § 208.9(b)(5) provides (with certain exceptions which are not pertinent hereto) that entire net income is to be determined without the exclusion, deduction or credit of 90 percent of interest on indebtedness owed to a holder of more than 5 percent of a taxpayer's stock. As noted in Finding of Fact "21", the auditor apparently excluded such interest expense under said provision. The interest payable to Utilities and Industries Corporation was directly traceable; accordingly, cash equal to the balances due on the notes was properly subtracted from petitioner's total assets.

J. That with respect to the factual issues presented herein (Issues IV through VII), it is noted that petitioner's case consisted, for the most part, of attacking the audit rather than adducing affirmative proof as to the actual transactions. Careful examination of the record reveals certain inconsistencies (e.g., Finding of Fact "14[c]") and also shows that certain documentation should have been produced (e.g., Conclusion of Law "J [3], [4]") in order for petitioner to sustain its burden of proof under Tax Law § 1089(e). Said issues are hereby determined as follows:

(1) Petitioner sustained its burden of proof to show that Richmond Hill Laboratories, Inc. should be valued at $1.00. The statement attributed to Mr. Kaplan that petitioner contributed approximately $100,000.00 worth of furniture and fixtures to said subsidiary was an insufficient basis for disregarding the $1.00 cost shown on petitioner's books.

(2) Petitioner sustained its burden of proof to the extent that it showed that the cost of Barry's Jewelers, Inc. was inflated by $352,201.00 due to double counting.

(3) Petitioner failed to sustain its burden of proof with respect to the interest expense payable to Chemical Bank shown in Finding of Fact "16" ("the Dressler payments"). The disallowance here, while based in part on a conversation with Mr. Kaplan, is something which petitioner should have readily been able to overcome by documentary or other evidence but did not do so.

(4) That the Audit Division correctly omitted the amounts of the Master Eagle loan principal for 1975 and 1976. The auditor found that interest had been paid for said years but purportedly disallowed deductions of principal on his being told that the loan balances were zero. While the auditor's explanation (Finding of Fact "20") is vague and it would seem that if interest was paid an obligation must have been outstanding, petitioner has not shown what the loan balances, if any, actually were in 1975 and 1976. Again, petitioner failed to sustain its burden of proof on this issue.

K. That the petition of The Unimax Corporation is granted to the extent indicated in Conclusions of Law "G", "J(1)" and "J(2)". Except as so granted, the petition is denied and the notices of deficiency issued on January 8, 1979 and July 29, 1982 are otherwise sustained.

DATED: Albany, New York

September 29, 1988

/s/ Robert F. Mulligan
ADMINISTRATIVE LAW JUDGE