STATE OF NEW YORK

DIVISION OF TAX APPEALS

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In the Matter of the Petition :

of :

THE BROOKLYN UNION GAS COMPANY :

DETERMINATION

for Redetermination of a Deficiency or for :
Refund of Corporation Tax under Article 9 of
the Tax Law for the Years 1981, 1982 and 1983. :

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Petitioner, The Brooklyn Union Gas Company, 195 Montague Street, Brooklyn, New York 11201, filed a petition for redetermination of a deficiency or for refund of corporation tax under Article 9 of the Tax Law for the years 1981, 1982 and 1983 (File No. 802538).

At a hearing held at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on January 4, 1988 at 3:00 P.M., the parties agreed to submit the case for determination based on a stipulation of facts and other documentation, with all briefs to be filed by April 15, 1988. Petitioner appeared by Cullen and Dykman (Orrin E. Tilevitz, Esq., and Martha E. Stark, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Anne Murphy, Esq., of counsel).

## ISSUES

I. Whether, in calculating the excess dividends tax under section 186 of the Tax Law, petitioner overstated the amount of its paid-in capital during the years in issue.

II. Whether the Division's acceptance of petitioner's returns for a period of over 20 years was tantamount to its acceptance of petitioner's position regarding paid-in capital as revealed on the reports.

## FINDINGS OF FACT

Petitioner, The Brooklyn Union Gas Company ("BUG"), and the Division of Taxation ("Division") entered into a Stipulation of Facts which has been incorporated into this determination as Findings of Fact "1" through "13". The stipulation has been modified by omission of references to exhibits.

1. The Brooklyn Union Gas Company, a New York State corporation which was organized under the Transportation Corporations Law of the State of New York on September 9, 1895, was for the years at issue in this petition principally engaged in supplying gas and gas services to customers in the Counties of Kings, Queens and Richmond, and was subject to the supervision of the New York State Department of Public Service.

2. On January 11, 1957, pursuant to an agreement dated August 22, 1956, The Kings County Lighting Company ("Kings County") and The New York and Richmond Gas Company

("Richmond") were combined with BUG. Under the terms of the agreement, all 440,000 outstanding shares of Kings County stock were converted into 210,000 shares of BUG stock and all 15,000 outstanding shares of Richmond stock were converted into 90,000 shares of BUG stock.

3. On June 1, 1959, pursuant to an agreement dated February 9, 1959, The Brooklyn Borough Gas Company ("Brooklyn Borough") was combined with BUG. Under the terms of the agreement, all 200,000 outstanding shares of Brooklyn Borough were converted into 150,000 shares of BUG stock.

4. On January 15, 1957, the market value of the 300,000 shares of BUG stock into which the Kings County and Richmond shares were converted was $35.25 per share, or $10,575,000.00. This was the amount of additional paid-in capital BUG recorded for purposes of the tax imposed by section 186 of the Tax Law. On June 1, 1959, the market value of the 150,000 shares of BUG stock into which Brooklyn Borough shares were converted was $53.00 per share, or $7,950,000.00. This was the amount of additional paid-in capital BUG recorded for purposes of the tax imposed by section 186 of the Tax Law.

5. Immediately prior to each consolidation, the outstanding preferred stock of Kings County, Richmond, and Brooklyn Borough, respectively, was redeemed, reducing the paid-in capital of each company for financial statement purposes.

6. BUG recorded all three acquisitions for financial statement purposes in accordance with the Public Service Commission's requirement that the "pooling of interest method of accounting" be utilized. Therefore, the historical financial statements of Kings County, Richmond and Brooklyn Borough were combined into BUG's financial statement as though the companies had always been commonly owned. The historical book value of paid-in capital after the merger represented an increase of $5,444,000.00. The book value of Kings County, Richmond and Brooklyn Borough stock immediately prior to each merger was $2,544,000.00, $900,000.00 and $2,000,000.00, respectively.

7. For the years at issue herein, section 186 of the New York State Tax Law imposes a tax of:

> "four and one-half per centum upon the amount of dividends paid during each year...which is in excess of four per centum upon the actual amount of paid-in capital employed in this state by such corporation...."

8. On August 17, 1985, the Audit Division of the State of New York, Department of Taxation and Finance ("Division") issued five statements of audit adjustment and notices of deficiency to BUG for the following base tax amounts:

| Period ending | Base Tax Amount |
|---|---|
| December 31, 1981 | $50,119.00 |
| December 31, 1982 | $46,531.00 |
| | $ 8,376.00 (MTA Surcharge Tax) |
| December 31, 1983 | $45,298.00 |
| | $ 7,701.00 (MTA Surcharge Tax) |

9. The notices mentioned in paragraph 8 were issued following a 1985 field audit which examined BUG's books and records for the periods 1981 through 1983, in light of the requirements of section 186 of the Tax Law.

10. On or about July 2, 1985, BUG paid under protest $207,179.00 to the New York State Department of Taxation and Finance, which amount represented BUG's alleged liability, including interest, as determined by the Audit Division following the 1985 field audit. Simultaneously with paying the tax, BUG duly requested a refund. This refund request is the subject of the instant proceeding.

11. For purposes of computing the tax under section 186 of the Tax Law, BUG on each tax report filed from the acquisition of Kings County, Richmond, and Brooklyn Borough, respectively, through the periods at issue in this petition, valued the actual amount of paid-in capital at the value of the BUG stock into which the stock of each company was converted, valued at the date of issuance. For the years 1957 through 1979, BUG clearly indicated on each tax report to the State that the paid-in capital on the tax report was computed using the fair market value of the stock issued to acquire the above-mentioned companies. According to petitioner, BUG ceased so indicating only because doing so was burdensome, and the State has no evidence to the contrary.

12. The Audit Division of the Department of Taxation and Finance, in valuing "the actual amount of paid-in capital" for purposes of section 186 of the New York State Tax Law for the periods ending December 31, 1981, December 31, 1982, and December 31, 1983, utilized the historic paid-in capital, $5,444,000.00, of Kings County, Richmond and Brooklyn Borough and not the fair market value, $18,525,000.00, of BUG stock issued at the time of the mergers.

13. Other than as set forth herein and the exhibits attached hereto, there are no facts material to the determination of the refund claim.

## CONCLUSIONS OF LAW

A. Section 186 of the Tax Law imposes a franchise tax on water, gas, electric or steam heating, lighting and power companies at the rate of three quarters of one percent on gross earnings plus four and one-half percent on the amount of dividends paid "in excess of four per centum upon the actual amount of paid-in capital employed in this state" (Tax Law § 186). The second portion of the tax is sometimes referred to as an "excess dividends" tax. The Division has issued a guideline defining "actual paid-in capital" as "that part of the equity that was invested in the business enterprise by shareholders" (Memorandum of Technical Services Bureau, Division of Taxation, February 18, 1982 [TSB-M-82(8)C]), and BUG has accepted this as a working definition.

B. It is BUG's position that, upon acquisition, the paid-in capital of the three acquired companies was properly measured by the fair market value of the BUG stock given in consideration for the companies. BUG argues that its position is supported by the plain language of the statute, the legislative intent expressed in the statute and the economic reality underlying the transactions. Alternatively, BUG argues that the Division is precluded from disallowing BUG's valuation of its paid-in capital because the Division accepted BUG's tax reports for approximately 25 years and failed during that time to challenge BUG's clearly disclosed position. Finally, BUG argues that any doubt as to the meaning of the statute must be resolved in BUG's favor.

BUG's position ultimately rests on the proposition that the actual amount invested in BUG by the shareholders of the acquired companies was the value of the stock they held in the acquired companies. As BUG sees it, the shareholders of the acquired companies gave their shares of stock in those companies to BUG in exchange for the newly issued BUG stock; thus, their actual investment in BUG was the value of the stock they held in the acquired companies, and the proper measure of the value of that stock was the consideration given for it, i.e., the BUG stock at its fair market value at the time of the exchange.

BUG acknowledges that the paid-in capital of the now combined utility companies is recorded in BUG's financial statements at its historical book value, that is, the book value of each utility company's paid-in capital at the time the companies were combined. However, it contends that the financial statements result from certain requirements of the Department of Public Service and do not reflect the economic realities of the transactions. BUG argues that, after the exchange of the newly issued BUG stock for the stock of the acquired utility companies, BUG was in the same position as if it had: (1) issued stock for an amount of cash equal to the fair market value of the stock of the acquired companies; (2) used the proceeds from the sale of the newly issued stock to purchase the stock of the acquired companies at its fair market value; and (3) merged the acquired companies' operations and properties into BUG's. Had BUG actually purchased the acquired companies in this manner, its paid-in capital would have increased by the fair market value of its newly-issued stock, the same amount that is at issue here.

C. To fully address BUG's arguments, it is first necessary to review the language of section 186 and the existing case law. The term "actual paid-in capital", as it is used in the statute and defined in the Division's Memorandum of 1982 (supra_____), carries with it its generally accepted meaning: the amount of owner's equity invested by the owners (see, e.g., Welsh, Zlatkovich and Harrison, Intermediate Accounting, at 470 [6th ed 1982]). The amount invested by the owners is the historic book value of the stock, or the amount invested in the corporation by the initial stockholders when the corporation first issued the stock. While stock may be traded for prices greater or less than its book value, the book value remains constant.

Owner's equity in a corporation consists of two parts: (1) the total amount paid in to the corporation by the owners (or "actual paid-in capital") and (2) retained earnings, also called surplus earnings. In Matter of Rochester Gas and Electric Corp. v. State Tax Commn. (28 AD2d 631, affd 25 NY2d 857), the court held that for purposes of calculating the excess dividends tax a corporation is not permitted to increase its paid-in capital by combining it with retained earnings. The court's rationale in that case is instructive here. The issue before the court was whether a stock dividend is a dividend for purposes of Tax Law § 186. A stock dividend does not change the assets of the issuing corporation, as does a cash dividend which is paid out from the corporation's retained earnings. Rather, the issuance of a stock dividend causes a transfer of an amount from retained earnings to permanent capital accounts; to phrase it differently, it increases paid-in capital by capitalizing a portion of retained earnings. Because the issuance of a stock dividend does not decrease (or increase) owner's equity, plaintiffs argued that no true dividend was issued. By ruling that a stock dividend is a dividend under Tax Law § 186, the court upheld the proposition that a corporation may not transfer amounts from retained earnings to paid-in capital and thereby increase the amount of dividends not subject to the excess dividends tax. With these principles in mind, the facts of this case and BUG's arguments can be evaluated.

The method of accounting used by BUG to combine its business with that of the acquired companies is called the "pooling of interests" method. Under this method the shareholders of the acquiring and acquired companies are presumed to have fused their ownership interests in such a manner that each group becomes an owner of the combined, enlarged business. To accomplish this fusing, the acquiring company issues common stock as consideration for the acquired business. Under the pooling of interests concept, the fair market value of the consideration given and the current value of the acquired company's net assets are irrelevant. The basis for recording the "cost" of the transaction to the acquiring company is the book value of the acquired company's net assets. As a result, the assets and liabilities of the acquired company are reported at their historical costs in the consolidated financial statements (Pahler and Mori, Advanced Accounting Concepts and Practices, at 207-208 [2d ed 1985]). Because BUG used the pooling of interests method of accounting, the paid-in capital of the combined utility companies is recorded in BUG's financial statements at its historical book value.

In evaluating BUG's argument that the pooling of interest method does not accurately reflect the underlying economic reality of the transactions, it must be remembered that BUG used this method for all purposes except calculating its excess dividends tax. This methodology does not mask another reality; it accurately describes the method by which these companies were combined. Had BUG actually acquired the other utility companies through purchase, a completely different set of transactions would have occurred, and the tax consequences flowing from the transactions would also have been different. For example, if BUG had purchased assets and stock for cash, their holders would have recognized capital gains (or losses) and been subject to tax on any gains. As BUG did not purchase the utility companies for cash, its hypothetical purchase scenario does not represent the underlying economic reality of the transactions.

Having used the pooling of interest method of accounting to combine these utility companies (whether by choice or in compliance with the rules of a regulatory agency), BUG and its shareholders are bound to accept all of the tax consequences of that method. The concept underlying the pooling of interests method of accounting is essentially the same concept as that in the Internal Revenue Code provisions governing tax-free reorganizations. In a tax-free reorganization no sale is deemed to have occurred, rather the equity interests of the combining companies are considered to have merged into a new business entity. As a result, neither the businesses involved nor their shareholders report gains or losses in the year of the merger. It follows as a corollary to the nonrecognition of gain, that there is no increase in basis (IRC §§ 351-368; see generally, Advanced Accounting Concepts and Principles, supra at 57-59).

Here, BUG takes the position that the proper measure of the amount invested in BUG by the shareholders of the acquired companies is the fair market value of the BUG stock they received, or $18,525,000.00, and that under Tax Law § 186, BUG is entitled to issue dividends equal to four percent of that amount before being subject to the excess dividends tax. This is an untenable position. In essence, BUG is attempting to step up its paid-in capital by valuing it in accordance with the stock it issued in consideration for the businesses which were combined with BUG. But BUG did not receive cash or property in exchange for its stock. It brought about the merging of the equity interests of the combining companies. To allow BUG to increase its paid-in capital for purposes of calculating its excess dividends tax would be inconsistent with the pooling of interest method of accounting used to combine the companies, one of the most basic concepts of tax law, that nonrecognition of gain goes hand in hand with no increase in basis, and BUG's own financial statements. Contrary to BUG's arguments, precluding BUG from increasing its paid-in capital is not unfair to the shareholders of the acquired companies. It is apparent that before the combining of the companies occurred the paid-in capital of the combined companies bore little relationship to the fair market value of the companies' outstanding stock. There is no reason why it should have been otherwise, since the book value of actual paid-in capital is not in any way tied to the fair market value of outstanding stock. After the combining of the companies, BUG's shareholders held stock with a fair market value in excess of the paid-in capital of the newly formed enterprise. It is difficult to perceive how the shareholders were penalized by this result.

As the foregoing discussion has made clear, Tax Law § 186 requires that "actual paid-in capital" be valued at its historical book value. When these utility companies combined, they merged their interests into a new enterprise. No event occurred which increased the total paid-in capital of this new enterprise beyond that which existed before the combining of the businesses. BUG would like to apply the four percent exclusion of section 186, not to its actual paid-in capital, but to the fair market value of the BUG stock issued in consideration for the merging of the companies. The statute does not allow such a result.

D. Finally, there is no merit to BUG's argument that the Division's failure to challenge its reports for a period of years is tantamount to its acceptance of BUG's position regarding paid-in capital, as revealed in those reports. Mere acceptance of the reports by the Division cannot be construed as an expression by the Division as to the propriety of the reports (Matter of Davies Lake Hotel, Inc., Tax Appeals Tribunal, January 20, 1989). Furthermore, there is no ambiguity in the language of the statute. The term "paid-in capital", as it is used in the statute and defined in the Division's Memorandum of February 18, 1982 (supra_____), denotes its generally accepted meaning: the amount of owner's equity invested by the owners (see, e.g., Welsch, Zlatkovich and Harrison, Intermediate Accounting, supra, at 470).

E. The petition of The Brooklyn Union Gas Company is denied.

DATED: Albany, New York
March 23, 1989

/s/ Jean Corigliano
ADMINISTRATIVE LAW JUDGE