STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions of SIEMENS CAPITAL CORPORATION for Redetermination of Deficiencies or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Fiscal Years Ended September 30, 1980 through September 30, 1986.	: : : : : :	DETERMINATION DTA NOS. 803815 AND 806706

Petitioner, Siemens Capital Corporation, 1301 Avenue of the Americas, New York, New York 10019, filed petitions for redetermination of deficiencies or for refund of corporation franchise tax under Article 9-A of the Tax Law for the fiscal years ended September 30, 1980 through September 30, 1986.

A hearing was held on case number 803815 before Joseph W. Pinto, Jr., Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on October 19, 1988 at 1:15 P.M. The parties agreed to join case number 806706 concerning the same taxpayer for three additional fiscal years, and submitted same for determination without hearing pursuant to a written consent executed by the Division of Taxation and petitioner on January 25, 1992 and December 23, 1991, respectively. All submissions were due by May 7, 1993 and the parties were permitted until December 15, 1993 to address a jurisdictional issue concerning the fiscal year ended September 30, 1986 raised by the Administrative Law Judge. Petitioner appeared by its vice president, Richard S. Payne. The Division of Taxation appeared by William F. Collins, Esq. (Anne W. Murphy, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation correctly adjusted entire net income, and the receipts factor of petitioner's reported business allocation percentage, to include interest income it received on financing activities performed in New York State.

II. Whether certain promissory notes to Siecor Development Corporation and Threshold Technology Corporation were correctly characterized by the Division of Taxation as items of business capital.

III. Whether the Division of Taxation erred in not reducing the amount of petitioner's interest expense indirectly attributable to subsidiary capital after reducing the valuation of petitioner's subsidiary capital for the fiscal years ended September 30, 1985 and September 30, 1986.

FINDINGS OF FACT

Petitioner, Siemens Capital Corporation ("Siemens U.S."), a wholly-owned subsidiary of Siemens Aktiengesellschaft ("Siemens A.G."), was a Delaware corporation engaged in the business of financing. It was set up to be a holding company for related United States affiliates of Siemens A.G.

Siemens U.S. carried out its financing activities through its Treasury Department. These activities included financing, cash management and foreign exchange. Petitioner has done business in New York State since 1969.

During the period in issue, the fiscal years ended September 30, 1980 through September 30, 1986, petitioner's primary objective was to pool and control corporate funds and to utilize them in the most efficient way.

Siemens U.S. also provided support and stewardship services to the United States affiliates. It borrowed money in commercial markets by issuing commercial paper and then relending it at the same interest rate plus a small percentage to cover administrative costs. All loans made by Siemens U.S. were guaranteed by Siemens A.G., thus relieving Siemens U.S. of any credit risks and the need to confirm a borrower's creditworthiness.

Siemens U.S. "funnelled" money to subsidiaries, affiliates and entities associated with

affiliates on an "as-needed" basis and upon the request of Siemens A.G. Petitioner did not operate as a separate, profit-making enterprise with respect to the loans it placed; rather, it performed a clearinghouse function, acting as a financial conduit facilitating the global operations of Siemens A.G.

Petitioner has identified five general types of financing activities: loans to first-tier subsidiaries; loans to second-tier subsidiaries; loans to foreign affiliates; loans for export financing; and miscellaneous loans. Siemens U.S. received interest income on these financing activities.

The loans listed above are more fully described as follows:

(a) Loans to First-Tier Subsidiaries. Loans to first-tier subsidiaries were not in issue and treatment of first-tier subsidiaries under New York State Tax Law was not contested by petitioner.

(b) Loans to Non-New York Second-Tier Subsidiaries. These loans were not evidenced by any official document of indebtedness. They were all accounted for through intercompany debit and credit account ledgers, with periodic reconciliations made to square accounts and calculate interest charges. The rate of interest charged corresponded with then current costs of borrowing for Siemens U.S. and no profit element was extracted from these subsidiaries. Petitioner submitted internal corporate documents which delineated the role of the Siemens' U.S. Treasury Department as a conduit for funds to the United States operating companies. (This arrangement applied to first-tier subsidiaries as well, but income from such entities is not at issue and petitioner and the Division of Taxation ["Division"] have no dispute with respect to the tax treatment of interest income from such first-tier subsidiaries.) Petitioner does not dispute that interest income from New York-based second-tier subsidiaries is properly in the numerator of the business receipts allocation formula.

(c) Loans to Foreign Affiliates. Foreign affiliates were those foreign incorporated entities which were owned directly by the German parent or indirectly through any other Siemens entity other than Siemens U.S. Loans by Siemens U.S. to such entities were referred to

as "back-to-back" or "participation" loans. Money was deposited by Siemens U.S. in a foreign bank or a foreign branch of an American bank; interest was paid to Siemens U.S. by these banks on such balances. A corresponding amount was then loaned for a short term by the foreign bank to a foreign Siemens entity which in turn paid interest to the foreign bank. The rate of interest earned by Siemens U.S. and that paid to the foreign bank was virtually identical. Petitioner contends that all such interest received by Siemens U.S. in this manner was foreign source, and was earned in furtherance of its business of being a conduit of money for the Siemens A.G. global enterprise. Occasionally, Siemens U.S. would "participate" as a lender in the loan to the foreign affiliate and then the foreign bank received interest as agent for Siemens U.S. The loans were of short duration and little or no profit was realized. All of these loans, both back-to-back and participation, were guaranteed by Siemens A.G.

(d) Loans for Export Financing. As an accommodation, Siemens U.S. loaned money to unrelated customers of Siemens' foreign or domestic affiliates to facilitate the purchase of Siemens' products. Interest on these loans was paid by foreign customers from a foreign situs. These loans were guaranteed by the German parent or the Siemens affiliate vendor, and no credit check was made of the borrower.

(e) Miscellaneous Loans. The last category of loans consisted of those made to unrelated parties in which Siemens A.G. or another Siemens affiliate had a minority stock interest, or had some other commercial relationship which conferred a privileged status on the borrower/third party. The interest rate charged was the same as that extended to Siemens-owned entities and matched the Siemens U.S. cost of borrowing. Little or no profit was realized and the loan was guaranteed by Siemens A.G. The majority of these types of loans were to entities situated outside New York State.

Also during the audit period, Siemens U.S. extended loans to Siecor Development Corporation ("Siecor") and Threshold Technology, Inc. ("Threshold"), in which it held a 50% minority ownership interest.

In 1980, Siemens U.S. loaned Siecor $9,500,000.00. By the terms of the agreement

between the corporations, a promissory note was executed whereby Siecor agreed to repay Siemens U.S. by January 18, 1983, with 8% interest. The note was issued specifically to finance the acquisition of assets; immediate repayment was required if the targeted acquisition was not consummated; and, otherwise, no acceleration of payment of principal or interest was permitted. The original loan was subordinated to 10½% notes issued by Siecor. In 1981, the loan agreement and note were amended to extend the term to four years; the interest rate was increased to 12%; and the note was further subordinated to all loans by any United States commercial bank up to an amount of $15,000,000.00. In addition, the note's terms referred to payments of principal and interest in United States dollars and the requirement that they be made to the payee or "then holder of this note."

Siecor Corporation (formerly Siecor Development Corporation) was a joint venture between Siemens U.S. and Corning Glass Works, a corporation unrelated to petitioner. Like petitioner, Corning held Siecor's note in the sum of $9,500,000.00. On October 21, 1983, petitioner and Corning each exchanged its Siecor note for 15,000 shares of Siecor preferred stock and Corning, on November 1, 1983, and Siemens, on January 1, 1985, each converted its Siecor preferred stock into Siecor common stock.

In November 1981, Siemens U.S. loaned Threshold $500,000.00 pursuant to the terms of a note and amended loan/option agreement, which called for the payment of interest at the rate of 10% per annum and a repayment date of November 9, 1983. The loan was made subordinate to "any senior debt", which was defined as the 10% subordinated convertible debenture issued by Threshold to Siemens U.S. on May 28, 1980.

These matters arose as a result of two separate audits performed by the Division. The first audit covered the years 1980 through 1983, while the second covered the years 1984 through 1986.

The first audit became the subject of Division of Tax Appeals case number 803815. The second audit was treated separately under Division of Tax Appeals case number 806706. During the pendency of the latter case, proceedings before the Bureau of Conciliation and

Mediation Services were discontinued on May 26, 1989, and a request made by petitioner to join the two cases because the issues for both audit periods were assumed to be identical.[1]

For the first audit period, 1980 through 1983, the Division made several adjustments to petitioner's reported franchise tax liability. Specifically, the Division added back interest income from non-subsidiaries, interest indirectly attributable to subsidiary capital and net capital gain from the sale of non-subsidiary securities. The Division also made consequent adjustments to the business allocation percentage and the investment allocation percentage.

Pursuant to the audit, on May 9, 1986, the Division issued to petitioner a Notice of Deficiency for the fiscal year ended September 30, 1980, setting forth tax due of $475,745.00, plus interest. Credits of franchise tax of $50,204.98 and $61,193.21 for the fiscal years ended September 30, 1982 and September 30, 1983 and a credit of MTA surcharge of $11,014.11 for the fiscal year ended September 30, 1983 were applied against the Notice of Deficiency referred to above, leaving $353,332.70 additional tax due, plus interest.

On May 9, 1986, the Division issued two additional notices of deficiency to petitioner. The first covered the fiscal year ended September 30, 1981 and set forth additional tax due of $195,300.00, plus interest. The second covered the fiscal year ended September 30, 1983 and set forth additional tax due of $18,173.00, plus interest.

At conference, the Division conceded certain mathematical errors in computation and agreed to correct them. Further, petitioner's investment capital was adjusted to conform with the "new" Division policy set forth in TSB-M-86(6)C, which conformed the Division's policy to the Court of Appeals decision in Forbes, Inc. v. Dept. of Finance (66 NY2d 243, 496 NYS2d 394, cert denied 475 US 1109, 106 S Ct 1517). Essentially, this entailed Federal paper being included in the denominator of the investment allocation percentage and, where the investment allocation percentage is zero, interest income from Federal paper not being allocated by

[1]Subsequently, other issues were raised by petitioner which only pertained to the second audit period.

petitioner's business allocation percentage. In such circumstances, income from Federal paper would not be taxable. Only interest from bank accounts and New York paper could be allocated by the business allocation percentage.

Also at conference, the conferee agreed with the Division's adjustment of the receipts factor for 1980, allocating all commission and interest income to New York since all services were deemed performed at petitioner's sole office in New York. It was noted that petitioner allocated 100% of its receipts for the fiscal years ended September 30, 1981, 1982 and 1983 to New York State.

Finally, the conferee agreed with the Division's determination that the notes from Siecor Development and Threshold were business capital and the income from such notes business income.

The second audit was a general verification of the fiscal years ended September 30, 1984, 1985 and 1986. It was noted that petitioner received interest income from its financing activities which was allocated on the basis of the situs of the borrowing company. The Division adjusted this allocation, attributing the interest income to activities performed by petitioner in New York State, and included said income in the New York portion of the receipts factor. The wages allocated to New York were also increased on audit.

Consistent with its position in the prior audit, the Division continued to characterize the Siecor note as business rather than investment capital and adjusted investment capital accordingly. This applied to the fiscal year ended September 30, 1984 only.

Finally, the Division determined that petitioner had failed to include the average value of retained earnings in the computation of average fair market value of subsidiary capital for all years in the second audit period and an adjustment was made to the value of subsidiary capital.

On November 9, 1988, the Division issued six Statements of Audit Adjustment to petitioner which set forth the following information:

Period Ended	Tax Deficiency	Interest	Additional Charge	Total
9/30/84	$ 61,439.00	$ 27,729.00	$ 6,144.00	$ 95,312.00

9/30/84 (MTBTS)[2]	10,445.00	4,714.00	1,045.00	16,204.00
9/30/85	481,218.00	140,485.00	48,122.00	669,825.00
9/30/85 (MTBTS)	81,807.00	23,882.00	8,181.00	113,870.00
9/30/86	1,089.414.00	184,472.00	108,941.00	1,382,827.00
9/30/86 (MTBTS)	185,201.00	31,360.00	18,520.00	235,081.00

Each of the statements indicated that the deficiencies were based on a recent field audit.

On November 9, 1988, the Division issued five notices of deficiency to petitioner which set forth the following:

Period Ended	Tax	Interest	Additional Charge	Total
9/30/84	$ 61,439.00	$ 27,729.00	$ 6,144.00	$ 95,312.00
9/30/84 (MTBTS)	10,445.00	4,714.00	1,045.00	16,204.00
9/30/85	481,218.00	140,485.00	48,122.00	669,825.00
9/30/85 (MTBTS)	81,807.00	23,882.00	8,181.00	113,870.00
9/30/86 (MTBTS)	185,201.00	31,360.00	18,520.00	235,081.00

Although a sixth Notice of Deficiency was allegedly issued for the period ended September 30, 1986 setting forth a base tax due of $1,089,414.00, it was not submitted into evidence with the other jurisdictional documents. The Division's brief at page 2 stated that the Division was "unable" to provide the sixth Notice of Deficiency for the period ended September 30, 1986 and conceded a lack of jurisdiction. Both parties were made aware of this fact by letter from the Administrative Law Judge dated October 14, 1993.

In accordance with the decision in the case of Matter of Scharff (Tax Appeals Tribunal, October 4, 1990, annulled on other grounds sub nom New York State Dept. of Taxation & Fin. v. Tax Appeals Tribunal, 151 Misc 2d 326, 573 NYS2d 140), the parties were given until December 15, 1993 to address this jurisdictional issue.

In response to the request, the Division was still unable to produce a complete copy of the Notice of Deficiency. The Division produced the undated affidavit of John Skorenski, supervisor of the control unit of the Bureau of Conciliation and Mediation Services, which

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[2] "MTBTS" refers to the temporary Metropolitan Transportation Business Tax Surcharge which was levied pursuant to Tax Law § 209-B for the years in issue.

described the Bureau's procedures upon receiving a request for conciliation conference and stated that, with regard to the instant matter (years 1984 through 1986), a request for conciliation conference was received, along with an incomplete Notice of Deficiency for tax due for the period ended September 30, 1986. The partial copy set forth no taxpayer and the assessment number was handwritten under the entry "official title", by an unknown author. Mr. Skorenski stated that he could not confirm that the notices were provided to the Bureau by the taxpayer because the cover letter accompanying the request for conference did not specify the enclosures.

The Division also submitted the affidavit of Daniel LaFar, principal mail and supply clerk, sworn to December 14, 1993, which set forth the mailing procedures utilized by the Division with regard to notices of deficiency. However, the affiant did not state how many notices or which particular notices were sent to petitioner on November 9, 1988. Mr. LaFar could only attest to an employee of the mail and supply room delivering "a piece of certified mail addressed to Siemens Capital Corp. . . . to the Roessleville Branch of the United States Post Office . . . ."

Finally, the Division submitted the affidavit of Mary Verald, Clerk I, sworn to December 15, 1993, who worked in the Corporation Tax Assessment Unit during the period in issue. Ms. Verald stated that she personally placed notices in envelopes with the corresponding statements of audit adjustment and sealed the envelopes. She witnessed the assignment of certified numbers and prepared a certified mail record. In this case, she stated that all the notices were sent to petitioner in a single envelope, that the same certified number was assigned to each notice and was imprinted thereon, and that from inspecting the partial Notice of Deficiency setting forth tax due of $1,089,414.00 she believed it to have been mailed with the others. However, she admitted to not having a copy of that notice (relating to assessment number C881109974F; this same assessment number also appears on the Statement of Audit Adjustment for the same period).

During the course of the proceedings herein (the second audit), several issues were

raised to which the Division has made certain concessions. The Division agreed that petitioner was entitled to offset a reported capital gain for 1982 by a net operating loss sustained in the 1980 period. The Division also agreed that in the computation of allocated entire net income, it is appropriate to include in the numerator of the business allocation percentage receipts factor, business receipts earned from services performed in New York State. The Division agreed that the findings of the first audit must therefore be adjusted to accommodate these concessions.

It is noted that the Division computed the deficiencies for 1980, 1981, 1982, 1985 and 1986 against an entire net income base and the deficiencies for 1983 and 1984 against a capital base.

On December 23, 1991 and January 25, 1992, representatives for petitioner and the Division, respectively, consented to have the controversy in case number 806706, covering the fiscal years ended September 30, 1984, 1985 and 1986, determined on submission without hearing. Previously, petitioner had withdrawn the matter from the Bureau of Conciliation and Mediation Services and agreed to have it joined with case number 803815, which dealt with an assessment for the fiscal years ended September 30, 1980, 1981, 1982 and 1983.

With regard to all notices issued for the periods ended September 30, 1984, 1985 and 1986,[3] penalty was waived by the Division on the basis that petitioner had already protested the years 1980 through 1983 which encompassed identical issues and had the same basis for adjustment.

Following submission of additional documentation by petitioner, the Division agreed that when the Siecor note was converted to stock it became an item of investment capital. Hence, the deficiencies for the fiscal years ended September 30, 1983 and 1984 should be adjusted to reflect the conversion to stock. The Division continues to argue that up until the conversion the note was an item of business capital.

[3]As stated above, the Notice of Deficiency for 1986 is not in evidence.

SUMMARY OF PETITIONER'S <u>POSITION</u>

For the first audit period, 1980 through 1983, petitioner contends that the interest income it received on loans to non-New York second tier subsidiaries, foreign affiliates, third-party customers of foreign affiliates and other non-New York unrelated third parties was business income from sources outside of New York, properly categorized as business receipts includable only in the denominator of the business allocation formula.

Petitioner also contends that the notes from Siecor and Threshold are investments and the interest received on them is properly allocated to investment income.

For the second audit period, 1984 through 1986, petitioner continues to argue that interest income from foreign and domestic obligors domiciled outside the state of New York should be considered business receipts earned outside New York for purposes of establishing the business allocation percentage.

Petitioner also argues that the Division incorrectly valued its investment capital for the fiscal year ended September 30, 1984 and erroneously did not reduce the amount of its interest expense indirectly attributable to subsidiary capital after reducing the amount of petitioner's subsidiary capital for the fiscal years ended September 30, 1985 and 1986.

Finally, petitioner argues that it should be allowed a net operating loss carry over for the fiscal year ended September 30, 1986 based upon refund claims filed with the Internal Revenue Service for each of the years 1978 through 1983, all of which are still pending. However, petitioner stated that it was only raising the issue "for consideration at a future time." Since this presents an issue not ripe for adjudication it is not addressed herein.

CONCLUSIONS OF <u>LAW</u>

A. Section 201 of the Tax Law imposes a franchise tax on the alternative base of allocated entire net income (Tax Law § 201.1[a]). The statute defines "entire net income" as follows:

> "The term 'entire net income' means 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 . . ." (Tax Law former § 208.9).

The statute provides that entire net income will be allocated to reflect apportioned business income and apportioned investment income (Tax Law § 210.3[a], [b]). Business income is apportioned by application of a "business allocation percentage" which takes into account property, receipts and wages/compensation allocated to New York State (Tax Law § 210.3[a][1], [2], [3]).

The "receipts factor" of the business allocation percentage is computed by a ratio of New York business receipts to all business receipts earned by the taxpayer (Tax Law § 210.3[a][2]). The statute specifically provides that receipts from services performed in New York will be included in the factor (Tax Law § 210.2[a][2][B]).

The regulations define "business receipts" to be "gross income received in the regular course of the taxpayer's business, provided such receipts are includible in the computation of the taxpayer's entire net income" for the period in issue (20 NYCRR 4-4.1[a]). Further, the regulations confirm that receipts from services performed in New York State are to be included in computation of the receipts factor (20 NYCRR 4-4.1[b][2]; see also, Advisory Opinion, TSB-A-88[2]C).

The facts of this proceeding establish that petitioner, in the ordinary course of its business, performed specific financing services for various related and unrelated corporations.

The Division has taken the position that the interest petitioner received on loans to second-tier subsidiaries and foreign affiliates, loans for export and miscellaneous loans was business receipts and properly includible in the numerator of the business allocation percentage. The Division did not believe that the interest had a "source" outside of New York. Rather, it characterized the interest as payment for financial services rendered in New York by Siemens U.S. On the contrary, petitioner argues that such interest was "sourced" without New York, therefore earned without New York, and not properly included in the numerator of the business allocation percentage (Tax Law § 210.3[a][2][D]).

The Division argues that the statute and regulations explicitly provide that receipts from services provided in New York are to be included in both the New York and everywhere factor

computation (20 NYCRR 4-4.1[b][2]). The question devolves to one of whether the situs of the services rendered or the source of the interest received controls.

The Division contends that the situs where the service and financing are performed is determinative of whether receipts are includable in the numerator of the business allocation percentage, not the situs of the borrower (Tax Law § 210.3[a][2]; see, Matter of Heller, State Tax Commn., November 7, 1980 [TSB-H-80(29)C]).

This, however, is not as clear as the Division's argument would have one believe, for the statute clearly envisions an allocation of receipts, where only New York receipts are to be included in the numerator (Tax Law § 210.3[a][2]). The interest received from foreign and alien obligors cannot be said to have a New York "source" or to have arisen from services performed "within the state" or receipts earned "within the state" (Tax Law §§ 184.1; 210.3[a]).

Notwithstanding the differences between the statutes governing transportation and transmission corporations and business corporations, the categorization of interest paid by a foreign or alien obligor as "sourced" in New York only because it is paid to a New York corporation is not tenable.

Petitioner's reliance upon the cases of American Telephone & Telegraph Co. v. State Tax Commn. (61 NY2d 393, 474 NYS2d 434) and Overseas National Airways v. State Tax Commn. (91 AD2d 162, 458 NYS2d 711) was appropriate for the purpose of determining the proper classification of interest paid to a New York company by a foreign or alien obligor.

In the AT&T case, the Appellate Division (93 AD2d 66, 462 NYS2d 288) and the Court of Appeals agreed that interest payments received by AT&T on advances to its out-of-state subsidiaries were not from a source within New York State and therefore should have been excluded from AT&T's gross earnings.

The Court of Appeals noted:

> "Only in the most metaphysical sense can it be said that monies paid to AT&T by out-of-state obligors, subsidiary or unaffiliated, has its source in the activities of AT&T within New York.
>
> "The contrary view ignores not only the commonly accepted meaning of the word 'source,' upon which the Appellate Division relied, but also the difference in

> language used in section 184 from that used in section 183, and the fact that the Legislature when, as with respect to the income tax on non-resident individuals (Tax Law, § 632, subd b, par 2), it sought to limit the meaning of 'source' by the concept that the income be derived 'from property employed . . . in this state,' knew how to do so" (American Telephone & Telegraph Co. v. State Tax Commn., supra, 474 NYS2d at 440-441).

Although the AT&T case involved Article 9 and the instant matter involves Article 9-A, the language of the two sections (Tax Law §§ 184, 210.3[a][21]) is very similar. Section 184 imposes a tax on "gross earnings from all sources within this state" while section 210.3(a)(2)(D) refers to "all other business receipts within the state." As petitioner pointed out in its brief, both sections are in pari materia and both deal with the subject of where interest income is earned.

The four types of loans yielding the interest herein described in Finding of Fact "6" were to companies or individuals without New York State (at least those in issue) which appear to have earnings of their own, separate from petitioner, which enhances rather than detracts from the conclusion that income from them is from an out-of-state source (American Telephone & Telegraph Co. v. State Tax Commn., supra).

A second case cited by petitioner, Overseas National Airways v. State Tax Commn., (supra), involved a Delaware corporation doing business in New York, which specifically earned interest income from loans it made to out-of-state obligors. The court reversed the State Tax Commission, saying that:

> "The earnings involved in the instant case were clearly not from sources within the state and should not be taxed as they are derived from business of an interstate character." (Id., 458 NYS2d at 713.)

The referral by the court to "interstate" character was obviously due to the nature of the corporation, i.e., a transportation company. The Division argued that there is a difference in treatment of Article 9 and Article 9-A corporations, but not on an interstate basis. Rather, the argument stems from the difference in tax bases, where Article 9 imposes a franchise tax on gross earnings and Article 9-A on entire net income. The Division argued that it was the services which generated the income, allegedly performed in New York (Tax Law § 210.3[a][2][B]), while petitioner argues that it is Tax Law § 210.3(a)(2)(D) which applies, pertaining to "all other business receipts earned within the state."

However, the Division never clearly delineated the services performed by petitioner within the State which it believed gave rise to its claim of taxability. With no other guidance in either Article 9 or 9-A, concerning the allocation of income from such financing and loan activities, it was determined prudent to seek counsel from Article 32 (Tax on Banking Corporations) which must also be considered in pari materia for purposes of a financing company which makes loans as a primary portion of its business. Tax Law § 1454 discusses the general allocation rules of a taxpayer's entire net income. Specifically, interest from loans is deemed located where the greater portion of income-producing activity related to the loan occurs (Tax Law § 1454[a][2][B]).

The regulations specify certain activities which should be used to determine where a greater portion of income-producing activities occur. These factors are solicitation, investigation, negotiation, final approval and administration (20 NYCRR 196.2[c]).

From the facts in this case, it cannot be said that petitioner solicited loans, investigated obligors (for creditworthiness), negotiated the terms of the loans (since most were wash transactions) or ultimately approved loans (parent appears to have controlled transactions). As a financing conduit for Siemens A.G., petitioner had control only over administration of the loans. Very little profit, if any, was realized by petitioner in its conduit role.

It appears that petitioner's regular business is essentially passive and that the interest received from its loans and advances does not rise to the level of interest earned from the performance of services in New York and therefore taxable in New York. It is properly considered interest income or "other receipts" which has a source without the State and is properly excluded from the numerator of the allocation percentage fraction. (Tax Law § 210.3[a][2][D]).

B. The second issue to be determined is whether the notes to Siecor and Threshold were correctly characterized as items of business capital.

Section 208(5) of the Tax Law defines the term investment capital as investments in "stocks, bonds and other securities" (Tax Law § 208[5]). The statutory phrase "other securities"

was defined by the regulation in effect during the years in issue as:

> "securities issued by governmental bodies and securities issued by corporations of a like nature as stocks and bonds, which are customarily sold in the open market or on a recognized exchange, designed as a means of investment, and issued for the purpose of financing corporate enterprises and providing a distribution of rights in, or obligations of, such enterprises . . ." (20 NYCRR former 3-4.2[c]).

In further construing the term "securities" as used in that regulation and in Tax Law § 208(5), it has been stated that an interest qualifies as a security if there is "an investment of money in a common enterprise with profits to come solely from the efforts of others" (Matter of Carret & Co. v. State Tax Commn., 148 AD2d 40, 543 NYS2d 216, 217, quoting Securities and Exchange Commn. v. Howey Co., 328 US 293, 90 L Ed 1244; see, Matter of Anametrics, Inc., Tax Appeals Tribunal, December 21, 1989). In applying that test, it is appropriate to look at the function of the security, and search for substance over form with emphasis on economic reality (see, Matter of Pohatcong Investors v. Commissioner of Taxation & Fin., 156 AD2d 791, 549 NYS2d 211 [where stock options were held not to have the essential characteristics of securities within the meaning of 20 NYCRR former 3-4.2(c)]; Matter of Mobil Intl. Fin. Corp. v. New York State Tax Commn., 117 AD2d 103, 501 NYS2d 947 [where loan instruments issued to corporate taxpayers were found not to constitute "other securities"]; Matter of Avon Prods. v. State Tax Commn., 90 AD2d 393, 458 NYS2d 278 [where banker acceptances found to constitute "other securities" within the meaning of 20 NYCRR former 3.31(c)]; see also, Matter of Carret & Co. v. State Tax Commn., supra, [where commodities future contracts were found not to constitute "other securities"]; Matter of Anametrics, Inc., supra [where income derived from the trading of precious metals contracts was held not to constitute investment income]).

Given the business of petitioner, and the discussion in Conclusion of Law "A", it is clear that loans to affiliated companies were de rigueur and a substantial part of the stated purpose of Siemens U.S., i.e., a mere conduit for the financing activities of Siemens A.G.

In Matter of C. Czarnikow, Inc. (Tax Appeals Tribunal, April 25, 1991), four requirements were set forth:

1. That the instruments are of a like nature as stocks and bonds, customarily sold in the

open market or on a recognized exchange;

2. That the instruments were designated as a means of investment from the perspective of the petitioner;

3. That the instruments were issued for the purpose of financing a corporate enterprise; and

4. That the instruments provided a distribution of rights in or obligations of the corporate enterprise.

Although the Tribunal in Czarnikow made the statement that loans can constitute other securities, it was in the context of repurchase agreements which were collateralized loans.

The Siecor promissory note was an unsecured obligation which was equated, by its terms, to other assumed loans, debts and obligations to be used to purchase the assets of another business. The Threshold note was also an unsecured note which had no specific purpose other than to provide funds to the business (Siemens U.S.' raison d'etre). In that sense, the fact that the notes had no priority over other unsecured debts diminished their similarity to stocks or bonds. Further, although the Siecor note was assignable with prior written consent, its negotiability was not certain. Petitioner stated that its failure to offer the Siecor and Threshold notes in the private placement market (concededly the only market where such notes would have been negotiable) was more a reflection of the fact that Siemens A.G., with its large cash surplus, has little need to do so. It is determined that this is not a credible theory or basis upon which a finding of negotiability can be made, since petitioner has not demonstrated by said assertion that the notes were of a nature which are customarily sold in the open market or on a recognized exchange (20 NYCRR 3-4.2[c]).

The second factor stated in Czarnikow was whether the instruments were designed as a means of investment from the perspective of petitioner. Clearly, as petitioner stated in its first brief, an investment committee, separate from petitioner, made that determination and Siemens U.S. was utilized as a conduit through which funds were channelled. To Siemens U.S., these notes were merely two more unsecured loans in the continuing business of Siemens U.S. with

obligors, backed by the guarantee of Siemens A.G. These notes were merely issued to finance affiliated corporations and therefore, also fail to satisfy the third requirement that the notes be issued to finance a corporate enterprise.

Finally, it cannot be said that the notes provided a distribution to Siemens U.S. of rights in or obligations of the two affiliates. It only received a right to receive a sum certain with stated interest on a given date.

Given the actual provisions of the notes, and their failure to meet the requirements of the regulations, economic reality dictates that they be deemed business capital and the interest received thereunder business income (Avon Prods. v. State Tax Commn., supra).

In Mobil Intl. Fin. Corp. v. New York State Tax Commn. (supra), the court stated:

> "The second group of evidences of indebtedness were described by petitioners' expert witness as being of a type of instrument which could have been but was never sold in the private placement market. However, respondent determined that they were generated, not for purposes of sale in any market, but rather to provide the obligors with funds to be used for general business purposes, such as capital expenditures or working capital. This conclusion is consistent with MIFC's stated purpose of providing financial assistance to the affiliates and subsidiaries of Mobil Oil. Since MIFC also classified these evidences of indebtedness as 'intercompany notes receivable' in its own records, and none of them were ever held by a nonaffiliate, it cannot be said that respondent's determination that the proof fell far short of that required by this court in Matter of Avon Prods. v. State Tax Comm. (supra) was irrational, unreasonable or unsupported in the record (see, Matter of Huntington T.V. Cable Corp. v. State of New York Comm. on Cable Tel., supra). In sum, the proof before respondent adequately supports the finding that the evidences of indebtedness were intercompany loans to affiliates in the regular course of their businesses rather than instruments issued for sale on securities exchanges or markets commonly dealing in investments" (Matter of Mobil Intl. Fin. Corp. v. New York State Tax Commn., supra, 501 NYS2d at 950).

The facts of the instant matter also do not support a finding that the instruments be characterized as investment capital.

C. Petitioner has raised an issue with regard to its returns for the fiscal years ending September 30, 1985 and September 30, 1986, i.e., whether the same value of subsidiary capital should have been employed by the Division for the purpose of determining the tax due on subsidiary capital and the interest expense attributed to subsidiary capital.

Subdivision 9 of section 208 of the Tax Law sets forth the method of computing entire

net income. Tax Law § 208.9(a)(1) provides that entire net income shall not include "income, gain and losses from subsidiary capital . . . ." The exclusion of income from subsidiaries was enacted in order to encourage corporations to locate their headquarters in New York (see, 2NY Tax Service § 22.61).

Tax Law § 208.9(b) sets forth the exclusions, deductions and credits which may not be considered in the determination of entire net income. This section provides, in pertinent part, as follows:

> "(b) Entire 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 attributable as a carrying charge or otherwise to subsidiary capital or to income, gains or losses from subsidiary capital" (emphasis added).

The term "subsidiary" is defined by Tax Law § 208.3 as follows:

> "The term 'subsidiary' means a corporation of which over fifty per centum of the number of shares of stock entitling the holders thereof to vote for the election of directors or trustees is owned by the taxpayer."

Tax Law § 208(former [4]) defined subsidiary capital, in relevant part, as follows:

> "The term 'subsidiary capital' means 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 . . . ." (Emphasis added.)

In accordance with Tax Law § 208.9(b)(6), it has been a consistent and long-standing policy of the Division to disallow interest expense attributable to subsidiary capital (see, Matter of World Wide Volkswagen Corp., State Tax Commn., April 30, 1974). The disallowance is imposed in order to prevent a taxpayer from receiving a double tax benefit which would otherwise occur, since section 208.9(a)(1) provides that a taxpayer may exclude income from subsidiary capital (see, Matter of Unimax Corp., Tax Appeals Tribunal, November 22, 1989, confirmed Matter of Unimax Corp. v. Tax Appeals Tribunal, 165 AD2d 476, 568 NYS2d 164, affd 79 NY2d 139, 581 NYS2d 135; Matter of F. W. Woolworth Co. v. State Tax Commn., 126 AD2d 876, 510 NYS2d 928, affd 71 NY2d 907, 528 NYS2d 537).

Petitioner minimizes the importance of the fact that the computations of subsidiary capital are for different purposes and pursuant to different provisions of the Tax Law. The value of subsidiary capital for purposes of the tax on subsidiary capital is based on the average fair market value of the assets (Tax Law § 210.2). The value of assets used in calculating the interest expense attributable to subsidiary capital is based on historical cost. Therefore, the values can be different.

In general, subsidiary capital is the total of a taxpayer's investment in the shares of stock of its subsidiaries plus the amount of indebtedness owed to the taxpayer by its subsidiaries on which the interest is not claimed or deducted for purposes of the corporation franchise tax (20 NYCRR 3-6.3[a][1], [2]). In determining subsidiary capital, certain liabilities are required to be deducted (20 NYCRR 3-6.4).

The pertinent regulatory provision states as follows:

> "Unless the Tax Commission specifically authorizes to the contrary, each item of subsidiary capital must be reduced by any liabilities of the taxpayer [parent], payable by their terms on demand or not more than one year from the date incurred, other than loans or advances outstanding for more than a year as of any date during the year covered by the report, which are attributable to that item of subsidiary capital. The reduction will be made, for example, in cases where the liabilities have been incurred in connection with the acquisition or holding of stock or securities of a subsidiary, or in the making of a loan to a subsidiary" (20 NYCRR 3-6.3[b]).

The Division's formula for interest expense indirectly attributable to subsidiary capital is based on the Division's need to calculate that portion of a taxpayer's interest expense which is indirectly attributable to subsidiary capital. The formula can be expressed as follows:

$$\frac{\text{Investment in subsidiaries}}{\text{Total assets}} \times \begin{matrix}\text{Gross}\\ \text{Interest}\\ \text{Expense}\end{matrix} = \begin{matrix}\text{Interest indirectly}\\ \text{attributable to}\\ \text{subsidiary capital}\end{matrix}$$

The numerator of this fraction was recently described by the Tax Appeals Tribunal in Matter of Unimax Corp. (supra). In its decision, the Tax Appeals Tribunal noted that the numerator of the fraction consists of two distinct components: the investment in the stock of the subsidiary and loans and advances between the parent and the subsidiary.

As stated by the Tribunal in Matter of Volt Information Systems (Tax Appeals Tribunal,

October 15, 1992), this discretionary formula is designed to do an imprecise task, i.e., it calculates the interest expense indirectly attributable to subsidiary capital and, as pointed out by the Court of Appeals in Unimax in sustaining the validity of the formula, "it reduces their investments in subsidiaries below that required by statute" (Matter of Unimax Corp. v. Tax Appeals Tribunal, supra, 581 NYS2d at 138).

Just as in Volt, there is no evidence in the record that the Division did not properly use its discretionary authority to calculate the interest indirectly attributable to subsidiary capital. Further, as the Tribunal noted in Volt, this discretionary authority found in Tax Law § 208.9(b)(6) is in stark contrast to the specific language imposing a tax on subsidiary capital (Tax Law § 210[1][b]) as a separate component of the franchise tax and the specific language defining the amount of subsidiary capital as the average fair market value of the gross assets (Tax Law § 210[2]).

Therefore, while there is information in the record that the present valuation of subsidiaries was adjusted on audit, there is no information to establish the cost component of the add-back ratio numerator. Therefore, petitioner has not established that it is entitled to adjust the reported computations of interest indirectly attributable to subsidiary capital for the fiscal years ended September 30, 1985 and 1986. It has merely objected to the different computations which, as discussed above, are warranted.

D. The Division was, in its own words, "unable to provide as an exhibit, the Notice of Deficiency of corporation franchise tax issued for the 1986 period," and it conceded that "[a]ccordingly, there is no jurisdictional basis for the deficiency asserted."

Although the parties were given time to address this issue, the existence of the Notice of Deficiency is still in doubt because a copy of the notice has not been produced. The Tax Appeals Tribunal addressed this issue in Matter of Scharff (supra), where the Division was unable to produce a copy of the Notice of Deficiency. The Tribunal stated:

> "This Tribunal is an adjudicative body of limited and statutorily created jurisdiction (see, Tax Law §§ 2008 and 681). Since the notice assertedly issued by the Division is not in evidence in this proceeding, we have no basis to determine the validity of the asserted assessment (see, Pietanza v. Commr., 92 T.C. 729;

Magazine v. Commr., 89 T.C. 321; United States v. Wright, 658 F Supp 1, 86-1 USTC ¶ 9457; Matter of Malpica, Tax Appeals Tribunal, July 19, 1990). Without proof of a valid notice of deficiency, we can reach no conclusion except that a valid assessment does not exist. Since the failure to issue the notice is jurisdictional in nature and may be raised at any time, by a party, or by the adjudicating body and may not be waived (see, United States v. Wright, supra, 86-1 USTC ¶ 9457, at 84,120-84,121), we must find that we lack the jurisdiction to reach the merits of the case.

"In reaching this conclusion we are cognizant of the fact that the regulations of the Bureau of Conciliation and Mediation Services require that a petition for a conciliation conference contain a copy of the notice (20 NYCRR 4000.3[b][vii]). Since the Bureau exercised jurisdiction in this case, perhaps the petition was in proper form when submitted to the Bureau, i.e., the notices were attached, and formed a proper basis for the Bureau's determination sustaining the assessment. However, that information is not in the record before us and any such inference by the Tribunal based on a supposition as to what was in the file before the Bureau of Conciliation would be inappropriate" (Matter of Scharff, supra).

The decision was ultimately vacated and annulled and remanded to the Tribunal for the purpose of affording the parties an opportunity to be heard on the matter. The Supreme Court held as follows:

"In this proceeding, the Tribunal in a sua sponte ruling without affording any party notice to be heard, dismissed a tax proceeding upon a ground which clearly had not been raised or litigated. Subject matter jurisdiction can, of course, never be waived and a proceeding may be dismissed by a court sua sponte (Robinson v. Oceanic Steam Nav. Co., 112 N.Y. 315, 324, 19 N.E. 625; Eaton Assoc. Inc. v. Egan, 142 AD2d 330, 535 NYS2d 998).

* * *

"The Tribunal failed to follow the procedures mandated by statute and regulations. Before deciding to dismiss the proceeding on its own motion upon the ground of a lack of subject matter jurisdiction, the Tribunal was required to give notice to the parties (Tax Law § 2006(5)). Notice was not given in this case." (New York State Dept. of Taxation & Fin. v. Tax Appeals Tribunal, supra.)

Since the court did not criticize the Tribunal's reasoning with regard to subject matter jurisdiction, only its failure to give the parties adequate notice of the issue raised sua sponte by it, it is determined that the reasoning is sound and valid and applicable herein.

Despite the partial Notice of Deficiency submitted by the Division (which contained only the date of the notice, the tax period and the tax, penalties and interest due, and a handwritten assessment number in the box entitled "official title"), and three affidavits, none definitively established the existence of the Notice of Deficiency for corporation franchise tax for the period

ended September 30, 1986. Since the notice is not in evidence, there is no jurisdictional basis to determine the validity of the asserted deficiency. With regard to the deficiency of tax as set forth on the Statement of Audit Adjustment for the period ended September 30, 1986, the petition is dismissed. Further, since the Tribunal said that without proof of a valid Notice of Deficiency a valid assessment does not exist (Matter of Scharff, supra), it follows that the Notice of Deficiency, Assessment Number C881109975S, asserting the temporary Metropolitan Transportation Business Tax Surcharge, asserted pursuant to Tax Law § 209-B, must be cancelled because it is computed at a rate of 17% of the tax imposed by the Division pursuant to Tax Law § 209. Since it has been determined that the Division did not assess additional tax for the year ended September 30, 1986, by definition no surcharge can be assessed.

E. The petition of Siemens Capital Corporation is granted to the extent set forth in Conclusion of Law "A" and the three notices of deficiency covering the fiscal years ended September 30, 1980, 1981 and 1983, dated May 9, 1986, as modified (see Finding of Fact "13"), and the four notices of deficiency, dated November 9, 1988, covering the year 1984 and 1985, as modified (see Findings of Fact "17", "20" and "21"), are to be modified accordingly, and except as so modified, are sustained.

The petition of Siemens Capital Corporation is dismissed with regard to the deficiency of corporation franchise tax for the fiscal year ended September 30, 1986 and the Notice of Deficiency for the temporary Metropolitan Business Tax Surcharge, Assessment Number C881109975S, is cancelled in accordance with Conclusion of Law "D".

DATED: Troy, New York
January 20, 1994

/s/ Joseph W. Pinto, Jr.
ADMINISTRATIVE LAW JUDGE