

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :
of :
CUSTOM SHOP FIFTH AVENUE CORP. :
for Redetermination of a Deficiency or for :
Refund of Corporation Franchise Tax under Article :
9-A of the Tax Law for the Fiscal Years Ended :
July 31, 1984 through July 31, 1986. :

In the Matter of the Petition :
of :
CUSTOM SHOP LEXINGTON AVENUE CORP. :
for Redetermination of a Deficiency or for :
Refund of Corporation Franchise Tax under :
Article 9-A of the Tax Law for the Fiscal Years :
Ended July 31, 1984 through July 31, 1986. :

DETERMINATION

In the Matter of the Petition :
of :
CUSTOM SHOP RECTOR STREET CORP. :
for Redetermination of a Deficiency or for :
Refund of Corporation Franchise Tax under Article :
9-A of the Tax Law for the Fiscal Years Ended :
July 31, 1984 through July 31, 1986. :

In the Matter of the Petition :
of :
CUSTOM SHOP SIXTH AVENUE CORP. :
for Redetermination of a Deficiency or for :
Refund of Corporation Franchise Tax under Article :
9-A of the Tax Law for the Fiscal Years Ended :
July 31, 1984 through July 31, 1986. :

In the Matter of the Petition :
of :
CUSTOM SHOP WALL STREET CORP. :

for Redetermination of a Deficiency or for :
Refund of Corporation Franchise Tax under Article :
9-A of the Tax Law for the Fiscal Years Ended :
July 31, 1984 through July 31, 1986. :

In the Matter of the Petition :
of :
CUSTOM SHOP 44TH STREET CORP. :

for Redetermination of a Deficiency or for :
Refund of Corporation Franchise Tax under Article :
9-A of the Tax Law for the Fiscal Years Ended :
July 31, 1984 through July 31, 1986. :

Petitioners, Custom Shop Fifth Avenue Corp., Custom Shop Lexington Avenue Corp., Custom Shop Rector Street Corp., Custom Shop Sixth Avenue Corp., Custom Shop Wall Street Corp., and Custom Shop 44th Street Corp., all bearing the mailing address of 402-412 Rt. 23, Franklin, New Jersey 07416, 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 July 31, 1984 through July 31, 1986 (File Nos. 806553, 806554, 806555, 806556, 806557 and 806558).

A consolidated hearing was held before Catherine M. Bennett, Administrative Law Judge, at the offices of the Division of Tax Appeals, Riverfront Professional Tower, 500 Federal Street, Troy, New York, on August 29, 1989 at 10:00 A.M., with all briefs to be submitted by December 4, 1989. Petitioners appeared by DeGraff, Foy, Conway, Holt-Harris and Mealey, Esqs. (James H. Tully, Jr., Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (James Della Porta, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation properly determined that income received by petitioners from an affiliated company and having been generated by investment of petitioners' excess cash by such affiliate, constituted business income for the purpose of corporation franchise tax.

II. Whether the Division of Taxation properly imposed the penalty under Tax Law § 1085(a)(3).

FINDINGS OF FACT

Petitioners are New York State corporations which operate retail stores in New York City. They are part of a group of affiliated corporations (hereinafter referred to as "Custom Shop Corporations"), with general and executive offices located in Franklin, New Jersey.

Mortimer Levitt holds 89% of the stock ownership of the petitioners with the remaining 11% held by Customer Payment Corporation which is owned 100% by Mr. Levitt.

Custom Shop Payment Corporation, incorporated in the State of New Jersey, was created in an effort to manage the excess funds generated by the various Custom Shop Corporations.

On a frequent basis petitioners sent their excess funds to Custom Shop Payment Corporation (hereinafter referred to as Payment Corporation) and recorded such funds on their balance sheets as "other investments". Payment Corporation reflected the funds it received on its financial statements as funds received from other corporations, not as loans.

Payment Corporation is essentially a cash management vehicle with its primary functions being investment of funds and payment of bills. It has no assets of its own, maintains no office for its own use and retains no excess funds.

Payment Corporation invests the funds it receives in items such as common and preferred stock, certificates of deposit and money-market funds. All investments are held in the name of Payment Corporation on behalf of the various Custom Shop Corporations.

Each corporation remits its gross sales revenues directly to Payment Corporation which first pays each petitioner's operating expenses and invests the excess funds in various investments. Payment Corporation maintains separate accounts for the amounts contributed by the various corporations and that which is disbursed on behalf of each corporation.

The controversy in this case is centered around the accounting procedures and classification of the income generated by the investments made by Payment Corporation. Each of the Custom Shop Corporations reported on its tax returns as taxable income for the years in question its allocable share of investment income based upon the amount of excess net funds as reflected in Payment Corporation's records. These net funds were in turn pooled toward the purchase of various securities in the portfolio. The investment income earned by Payment Corporation was designated on the tax returns of Customer Shop Corporations by references such as "allocations from the central office" "shares of the joint venture" and "allocations from associated companies".

Petitioners filed New York State corporation franchise tax reports for all periods in question. On each of these tax returns, each petitioner reported on its balance sheet investments which were allocated to it by Payment Corporation and reported an allocation of capital gain income from its affiliate. Each petitioner further claimed a 50% dividend deduction based upon dividends from non-subsidiary companies.

As a result of an audit of Morley Shirt Company, the corporation which is the manufacturer of various retail products sold by petitioner as well as an affiliate corporation, petitioners were subsequently audited. The auditor concluded that income received by petitioners from Payment Corporation did not constitute investment income for purposes of the franchise tax and computed additional tax due on the premise that the income constituted business income. On November 27, 1987, notices of deficiency were issued to the various Custom Shop Corporations as follows:

NOTICES OF DEFICIENCY

11/27/87	Period Ended	<u>Tax</u>	<u>Interest</u>	Additional Charge	Total Due
Custom Shop 5th Ave. Corp.	7/31/84	7,102.00	2,579.00	355.00	10,036.00
	7/31/84	1,128.00	410.00	56.00	1,594.00
	7/31/85	8,936.00	1,922.00	2,302.00	13,160.00
	7/31/85	1,268.00	273.00	200.00	1,741.00
	7/31/86	32,838.00	3,138.00	6,495.00	42,471.00
	7/31/86	4,693.00	449.00	550.00	5,692.00
Custom Shop 6th Ave. Corp.	7/31/84	1,798.00	653.00	90.00	2,541.00
	7/31/84	306.00	111.00	15.00	432.00
	7/31/85	1,905.00	410.00	300.00	2,615.00
	7/31/85	324.00	70.00	51.00	445.00
	7/31/86	6,008.00	574.00	1,188.00	7,770.00
	7/31/86	1,022.00	98.00	100.00	1,220.00
Custom Shop 44th Street Corp. ¹	7/31/84	2,722.00	989.00	136.00	3,847.00
	7/31/84	463.00	168.00	23.00	654.00
	7/31/85	2,679.00	576.00	422.00	3,677.00
	7/31/85	456.00	98.00	72.00	626.00
	7/31/86	11,781.00	1,126.00	2,330.00	15,237.00
	7/31/86	2,003.00	191.00	196.00	2,390.00

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Notices contained the date July 13, however, it is presumed that the fiscal year end of the corporation July 31, was intended for each of the dates.

Custom Shop					
Lexington Ave. Corp.	7/31/84	2,903.00	1,054.00	145.00	4,102.00
	7/31/84	493.00	179.00	25.00	697.00
	7/31/85	3,152.00	678.00	497.00	4,327.00
	7/31/85	536.00	115.00	85.00	736.00
	7/31/86	9,202.00	879.00	182.00	11,901.00 ²
	7/31/86	1,565.00	150.00	153.00	1,868.00
Custom Shop					
Rector Street Corp.	7/31/84	5,540.00	2,012.00	277.00	7,829.00
	7/31/84	942.00	42.00 ³	47.00	1,331.00
	7/31/85	2,902.00	560.00	410.00	3,872.00
	7/31/85	493.00	104.00	54.00	651.00
Custom Shop					
Wall Street Corp.	7/31/84	2,773.00	1,007.00	139.00	3,919.00
	7/31/84	471.00	171.00	24.00	666.00
	7/31/85	2,735.00	588.00	431.00	3,754.00
	7/31/85	465.00	100.00	73.00	638.00
	7/31/86	8,220.00	786.00	1,626.00	10,632.00
	7/31/86	1,397.00	134.00	137.00	1,668.00
Totals		131,221.00	22,394.00 ⁴	19,186.00	174,739.00 ⁵

THE AUDIT

During the course of the audit, the auditor worked closely with Mr. Nettis, who held the titles of secretary, treasurer and comptroller of Morley Shirt Company, as well as with Mariann Cilurso, Assistant Comptroller. Ms. Cilurso, an employee of the affiliated group for 19 years, performed various bookkeeping and internal accounting functions. It is from these individuals that information regarding Morley Shirt Company and the various Custom Shop Corporations was obtained. Only Ms. Cilurso appeared as a witness at the hearing.

The auditor made a verbal request to these individuals during the audit for access to store records of the petitioner corporations for the years in issue. Also requested were books and records for Payment Corporation which received funds from the various other Custom Shop Corporations. It appears from the record that the request was initially denied as an irrelevant

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Total should be \$10,263.00.

3

Interest should be \$342.00.

4

Total should be \$22,694.00.

5

Total should be \$173,101.00.

portion of the subject audit. However, it is not

clear whether the auditor eventually obtained information for Custom Shop Payment Corporation.

The auditor concluded that the investment income generated by Payment Corporation was allocated to each of the retail stores based on sales. The source of her information was the representation on the balance sheets of the Federal tax returns, Form 1120.

SUMMARY OF THE PARTIES' POSITIONS

Petitioners contend that as actual owners of a proportionate share of the investments held by Payment Corporation in nominee status that petitioners have properly classified the income derived from the investments as investment income. To substantiate this contention, petitioners entered into evidence an agreement between Custom Shop Payment Corporation and the various Custom Shop corporations which depicted a relationship characterizing Payment Corporation as nominee with regard to its retention and investment of assets on behalf of the corporations. It is their argument that a party other than a record holder of an asset may be considered "owner" for tax purposes. It is this agreement so executed that petitioners contend creates a clear and formal agency relationship with Payment Corporation. The position of agent is argued to be consistent with the purpose of Payment Corporation to function as an investment conduit for a large group of identically-owned affiliated corporations.

Petitioners argue in the alternative that if they are not deemed to be the owners of a share in the investments from which such income was allocated, then the end result is that petitioners have no income to report for New York State franchise tax purposes.

Petitioners further contend that reasonable cause exists for their classification of certain income as investment income and as a result penalties should be abated.

The Division of Taxation first contends that petitioners failed to meet their burden of proving that an agency relationship existed between Payment Corporation and the Custom Shop Corporations, since they failed to present any accounting records or witnesses with reliable knowledge at the hearing. The Division of Taxation further relies on the prior State Tax Commission decision in the Matter of Custom Shop Rector Street Corp., (July 10, 1985 [TSB-H-85(30)C]), in which proceeding the same issue was litigated. The Division of Taxation further contends that petitioners failed to present any evidentiary proof of the existence of agency or nominee status. In support of its argument, the Division argues that the most compelling indication that the relationship did not rise to agency status was the method by which the income was allocated back to the various corporations.

The Division of Taxation also argues that the income earned by Payment Corporation does not necessarily constitute investment income in the hands of the petitioner corporations. As to the penalty issue, the Division points out that petitioners exhibited a lack of cooperation during the audit as well as attempted to restrict the view of the relevant facts at hearing. Furthermore, since the prior decision in Custom Shop Rector Street Corporation addressed the characterization of the income in issue, and petitioners failed to further litigate that issue, they were placed on notice of the appropriate method of reporting such income.

CONCLUSIONS OF LAW

A. "Investment income" pursuant to Tax Law § 208(6) is defined as income, including

capital gains in excess of capital losses, from investment capital, to the extent included in computing entire net income less items not applicable to the issue in question.

B. In pertinent part, Tax Law § 208(5) states as follows:

"The term 'investment capital' means investments in stocks, bonds and other securities, corporate and governmental, not held for sale to customers in the regular course of business, exclusive of subsidiary capital and stock issued by the taxpayer...."

C. Regulations at 20 NYCRR 3-4.2(a) amplify Tax Law § 208(5) as follows:

"The term 'investment capital' means the total of the average fair market value of the taxpayer's investments in stocks, bonds and other securities issued by any corporation (other than taxpayer, a subsidiary or a DISC) or by the United States, any state, territory or possession of the United States, the District of Columbia, or any foreign country, or any political subdivision or governmental instrumentality of any of the foregoing." (Emphasis added.)

D. The issue in this case is whether it can be determined that the investments entered into, held and maintained by Payment Corporation can be deemed "taxpayer's investments" for the purpose of proper classification of the income therefrom absent prima facie evidence of such ownership characteristics.

E. A review of the evidentiary proof submitted by petitioners shows it is scant at best. In support of petitioners' contention, what has been submitted on the record was testimony by an assistant comptroller who has been with the corporation for 19 years. Not only was her testimony somewhat inconsistent but her knowledge of the corporation appeared questionable and at times during the hearing, the testimony appeared to reach a level of evasiveness. It would seem that no one would be in a better position to testify as to the purpose of an affiliated corporation than its owner and/or the company's accountants. Petitioners did not present owner Mortimer Levitt nor its accountants to testify. In their absence no affidavits were submitted. In fact the only relevant document submitted for consideration and in support of the nominee theory was an agreement between Payment Corporation and some of the petitioner Custom Shop Corporations named in this hearing. Aside from the fact that a grandfather provision attempts to include corporations that were organized after the signing of this agreement, there is some question as to the validity and credibility of the agreement. There is testimony by the assistant comptroller that the agreement was yellow with age and that the first time she saw it was soon after she started her tenure with the Custom Shop Corporations. Although a request was made to produce the original document, petitioners were unable to do so. The photocopy of the purported original document does not appear to be a photocopy of a document nearly 30 years old, and there is some question as to when this document was actually prepared. There is no notarization of the signature of the president of the corporations. In addition, the president, Mortimer Levitt, did not appear at the hearing to authenticate the signature or to support the credibility of this document. Certainly when the credibility of documentary evidence is questioned, the weight to be given to it is severely diminished.

It is interesting to note that the most significant evidence offered by petitioners to support and solidify their contention of nominee status, i.e. the 1961 agreement, was presumably never offered or even mentioned in the 1985 decision in the Matter of Custom Shop Rector Street Corporation (*supra*).

F. If the nominee status of Payment Corporation cannot be conclusively determined by independent review and verification of the agreement purportedly executed, the relationship

between Payment and the Custom Shop corporations must be couched in alternate terms. It seems appropriate at this point to review the general principles of an agency relationship. In the case of an agency relationship, the primary element which distinguishes this relationship from others is the factor of control. It is generally quite evident that the agent has agreed to act under the control and direction of a principal party. Frequently the relationship is established in a compensatory form, the agent uses the principal's materials or tools to perform the functions for the principal, the activity of the agent is frequently supervised, the agent generally has no opportunity to delegate its responsibility and the agent will generally represent himself as an agent rather than as a party acting on its own behalf in dealing with third parties. The agency relationship need not rest upon an express agreement, but may be implied from the acts, words and conduct of the parties and the circumstances of a particular case (see, Mertens, Law of Federal Income Taxation § 17.15). National Carbide Corporation v. Commissioner (336 US 422) established and set forth four indicia and two requirements of a principal-agency status, the sum of which has become known in Federal Income Tax Law as the "Six National Carbide Factors". Those factors are as follows:

- (1) whether the corporation (agent) operates in the name and for the account of the principal;
- (2) whether the agent binds the principal by its actions;
- (3) whether the agent transmits money received to the principal;
- (4) whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal;
- (5) if the corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case; and
- (6) the business purpose of the agent must be the carrying on of the normal duties of an agent.

The genuineness of the agency relationship and an indication that the elements of such relationship actually exist is a burden placed upon petitioners. There has been testimony that the primary purpose for the existence of Payment Corporation has been to act as an agent of the Custom Shop corporations with respect to investment of excess funds and payment of bills. In order to determine whether Payment Corporation met the business purpose of carrying on the normal duties of an agent, one must look to the activities of the corporation and the manner in which it conducted such activities. The testimony has been that Payment Corporation was acting as an agent under the guise of a "nominee" as to the investment assets obtained pursuant to a written agreement which had been executed before the time at which the assets were acquired. The authenticity of such agreement in this case, however, remains a serious issue. In its analysis of the National Carbide factors, the court in Commissioner of Internal Revenue v. Bollinger, Jr., (485 US 340) determined:

"that the genuineness of the agency relationship is adequately assured, and tax-avoiding manipulation adequately avoided, when the fact that the corporation is acting as agent for its shareholders with respect to a particular asset is set forth in a written agreement at the time the asset is acquired, the corporation functions as agent and not as principal with respect to the asset for all purposes, and the corporation is held out as the agent and not principal in all dealings with third parties relating to the asset."

In the present case, the written agreement submitted into evidence carried negligible credence,

the corporation did not hold itself out as agent with respect to the assets, nor did the corporation deal with third parties as an agent. No evidence was submitted with respect to establishing the principles that are so clearly embedded in the tax law today. Having disregarded petitioners' contentions that Payment Corporation rises to the level of nominee or meets the indicia of an agency relationship, consideration must be given to whether to apply a general theory of "conduit" where Payment Corporation would be disregarded as a corporate entity and an allocation of income and deductions to the Custom Shop corporations would result.

G. Within the context of the Tax Law, a corporate entity is sometimes disregarded when the functions of the corporation are such that it is essentially no more than the alter ego of the shareholders or its formation is a sham. A question frequently arises as to whether the corporation was formed for the purpose of carrying on a "business activity". The corporation may not be disregarded if a bona fide intention in creating it was that the corporation should have a substantial business function. However, in the absence of such intent or business activities the corporation may be disregarded with respect to taxation events. The intended or actual business function of the corporation and not the taxpayer's aim to be accomplished by way of the corporation should be the primary focus. It has been held that after a corporation which was formed to serve a distinct business purpose had accomplished that purpose, it may be disregarded thereafter where it is a mere conduit (see, Mertens Law of Federal Income Taxation § 38.06). Should the corporation be disregarded as a mere conduit, it is fair to say that the income from items attributable to its affiliated corporations must be allocated back to such corporations. Such is the situation in the instant case.

H. The mere fact that such items of income and deductions must be allocated does not lead to the ultimate conclusion, however, that the character of such items will necessarily remain the same in the hands of the corporation to whom such allocations were made. The Tax Law with respect to investment income under Article 9-A is an exception that must be recognized here.

Having carefully considered the various arguments raised by the parties, it appears as though the investment income did not retain its character merely by an allegation that a special relationship existed between the affiliated corporations. The Division of Taxation properly concluded that the investments were not the "taxpayer's investments" within the meaning of 20 NYCRR 3-4.2(a), and thus the income therefrom was properly categorized as business income (see, The Custom Shop Rector Street Corporation, supra).

I. Petitioners have not met their burden of proof to show reasonable cause and lack of willful neglect with respect to the nonpayment of tax and their actions in this case. Therefore, the penalty as imposed by the Division of Taxation will be upheld.

J. The petitions of Custom Shop Fifth Avenue Corporation, Custom Shop Lexington Avenue Corporation, Custom Shop Rector Street Corporation, Custom Shop Sixth Avenue Corporation, Custom Shop Wall Street Corporation and Custom Shop 44th Street Corporation are denied and the November 27, 1987 notices of deficiency, as modified by the mathematical corrections noted in Finding of Fact "9", are hereby sustained.

DATED: Troy, New York
May 3, 1990

/s/ Catherine M. Bennett
ADMINISTRATIVE LAW JUDGE