STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
SHIPCENTRAL REALTY, INC.	:	DETERMINATION DTA NO. 806626
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Fiscal Year Ending November 30, 1986.	:	

Petitioner, Shipcentral Realty, Inc., 41 East 42nd Street, Suite 1607, New York, New York 10017, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the fiscal year ending November 30, 1986.

A hearing was held before Catherine M. Bennett, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on February 4, 1991 at 1:15 P.M. Petitioner appeared by Curtis, Mallet-Prevost, Colt & Mosle (William L. Bricker, Jr., Esq., and D. Jeffrey Disbrow, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Anne W. Murphy, Esq., of counsel).

ISSUE

Whether the Division of Taxation properly denied petitioner's refund claim where petitioner recomputed its accelerated cost recovery system ("ACRS") modification to Federal taxable income for New York State franchise tax purposes by an allocation percentage which differed from that used to allocate partnership losses.

FINDINGS OF FACT

Petitioner, Shipcentral Realty, Inc. ("Shipcentral"), is a Delaware corporation engaged in the business of real estate doing businessin New York. Shipcentral is a general partner in the limited partnership Richfield Investment Company ("Richfield"), a partnership organized under the laws of the State of New York. Richfield entered into a partnership agreement on June 6, 1983 with Shipcentral as the general partner and Varrington Corporation, N.V. ("Varrington"), a

Netherlands Antilles corporation, as the limited partner. The capital contributions made to the partnership by Varrington and Shipcentral were $21,450,000.00 and $550,000.00, respectively, i.e., 97.5% by the limited partner and 2.5% by the general partner.

Petitioner timely filed its New York State Corporation Franchise Tax Report (Form CT-3) for the period in issue on August 14, 1987. In May 1988, Richfield filed an amended partnership return, purportedly to better reflect the partnership agreement, which included a lesser amount on the New York Schedule K-1 Equivalent for both the ACRS deduction and the allowable New York depreciation passed through to petitioner. The amended K-1 then prompted petitioner to file an amended corporation franchise tax report on or about June 28, 1988 on Form CT-8, Claim for Credit or Refund of Corporation Tax Paid. It was acknowledged as having been received by the corporate tax section of the Central Office Audit Bureau on July 6, 1988. The refund claim asserted a tax overpayment of $28,853.00 and interest due to petitioner in the amount of $1,413.00, for a total claim of $30,266.00.

Correspondence from the Division of Taxation, dated September 16, 1988, addressed the refund claim described above and provided the following explanation for its denial:

> "This is in reference to your claim for refund based on an amended franchise tax report for the period ended November 30, 1986.
>
> Regulation Section 3-2.3(a)(17) states when computing entire net income, federal taxable income must be adjusted by adding to it the amount allowable for recovery property as the accelerated cost recovery system deduction pursuant to Section 168 of the Internal Revenue Code.
>
> In computing its federal taxable income on Federal Form 1120, the corporation included 95% of the loss incurred by the partnership - Richfield Investment Company. When making the modifications required in computing entire net income, the corporation must add back the entire ACRS deduction used to compute the corresponding federal taxable income. Since the corporation used 95% of the partnership's loss to compute its federal taxable income, it must add back 95% of the ACRS deduction which was used to compute the partnership's loss. The depreciation modifications on the original Form CT-3 are proper.
>
> Your claim for refund for the period ended November 30, 1986 is denied."

While petitioner's claim for refund was being considered, the Division of Taxation ("Division") requested a copy of the Federal partnership return and supporting schedules for Richfield as originally filed for the calendar year 1985. A synopsis of the pertinent financial

information contained in the Richfield tax return is presented below:

Income			
Interest			$ 121,810
Gross rents		$8,933,859	
Less: Rental Expenses			
All expenses except depreciation	$6,933,077		
Depreciation	2,381,088	(9,314,165)	
Net Rental Loss			(380,306)
Total Income (Loss)			$(258,496)
Deductions			
Guaranteed payments to partners			(263,816)
Ordinary income (loss)			~~$(522,312)~~

The schedule K-1 information from the Richfield return pertaining to the partners' share of income, deductions and credits was reported on petitioner's corporate return for the period in question. The ordinary loss of $522,312.00 was allocated to the partners as follows:

	Loss	Allocation Percentage
Shipcentral - general partner	$496,196	95%
Varrington - limited partner	$ 26,116	5%

The partnership loss of $496,196.00 was factored into petitioner's United States Corporation Income Tax Return for the fiscal year ending November 30, 1986 which resulted in a loss before the net operating loss deduction in the amount of $442,003.00. This was the amount used as the starting point on petitioner's Form CT-3, Corporation Franchise Tax Report, in computing entire net income.

Petitioner's amended New York corporation franchise tax return, which is the subject of this claim for refund, involved a change in the calculation of entire net income. A comparison of the original return and the amended return, in pertinent part as shown below, illustrates the adjustments to depreciation that resulted in a reduction of entire net income from $298,027.00 to $(381,827.00):

CT-3 New York State Corporation Franchise Tax Report

Schedule B[1] - Computation and Allocation of Entire Net Income

	Original Return	Amended Return
Federal taxable income before net operating loss	$ (442,003)	$(442,003)
Additions		
New York State franchise tax deducted on your federal return	34,879	34,879
ACRS deduction used in the computation of federal taxable income (above)	2,262,035	59,527

[1]This schedule is abbreviated in form to highlight key elements.

Subtractions		
New York net operating loss deduction	(256,134)	--
Allowable New York depreciation	(1,300,750)	(34,230)
Entire Net Income	~~$ 298,027~~	~~$(381,827)~~

The ACRS addback on the original return was calculated using the depreciation deduction of the rental operations of Richfield, $2,381,088.00, and applying the 95% loss allocation percentage attributed to Shipcentral, the general partner. The allowable New York depreciation subtracted was based on the same percentage.

The reduction in the ACRS addback reflects petitioner's argument that the capital event allocation of 2½% to the general partner should apply to everything other than for Federal income tax purposes ($2,381,088.00 x 2½% = $59,527.00). The allowable New York depreciation on the amended return is also based on the 2½% allocation.

The partnership agreement between Shipcentral and Varrington was introduced into evidence. It sets forth and defines the following key terms:

> "3.1.1 'Profits' and 'losses' shall mean the net profits and net losses, respectively, as finally determined for each Accounting Period (as defined in subsection 3.1.5) for federal income tax purposes using the cash method of accounting. Any allocation to a Partner of a pro rata share of the profits or losses of the Partnership shall be deemed to be an allocation to that Partner of the same pro rata share of each item of income, gain, loss, expense, deduction or credit that is earned, realized, or available by or to the Partnership for federal income tax purposes.
>
> 3.1.2 'Capital Event' shall include without limitation the sale, exchange or other disposition of all or any portion of the Improvements, condemnation of all or any portion of the Improvements, refinancing of any mortgage loan on the Improvements, liquidation of the Partnership assets following a dissolution of the Partnership, the recovery of hazard or casualty insurance (other than rental interruption) proceeds in excess of amounts expended in the restoration or repair of the Improvements, and the recovery from any other voluntary or involuntary conversions of the Partnership assets.
>
> * * *
>
> 3.1.4 'Operation' or 'Operations' shall mean all transactions affecting the Partnership which are not the result of a Capital Event.
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> * * *
>
> 3.2 Allocation of Losses: The losses of the Partnership shall be allocated to the Partners in the following priority:

3.2.1 The losses from Operations of the Partnership for each Accounting Period shall be allocated in the following proportions:

General Partner
95%
Limited Partner
5%

3.2.2 The losses from a Capital Event of the Partnership for each Accounting Period shall be allocated to the Partners in the following order of priority:

3.2.2.1 To each Partner in the same proportion as their respective capital accounts shall bear to each other and up to an amount equal to the amount of their respective capital accounts immediately prior to the allocation of losses resulting from a Capital Event.

3.2.2.2 To the General Partner, all remaining losses from a Capital Event.

* * *

3.3 Allocation of Profits: The profits of the Partnership shall be allocated to the Partners in the following order of priority:

3.3.1 First, to the Partners to whom and in the same proportion as any losses from (i) Operations and (ii) a Capital Event, respectively, were previously allocated, until the aggregate profits (for all Accounting Periods) so allocated equal the aggregate losses so previously allocated to such Partners. To the extent that such profits constitute ordinary income attributable to depreciation recapture, such ordinary income shall be allocated to the General Partner in accordance with the foregoing prior to allocating any profits which would constitute capital gains for federal income tax purposes.

3.3.2 Second, in case of Capital Event profits, to the Partners with a deficit balance in their capital accounts until the balance of their capital accounts is zero. If more than one Partner has a deficit balance in their capital accounts, the profits shall be allocated in the same proportion as the deficits in their capital accounts.

3.3.3 Third, to the Partners to whom and in the same proportion as the amounts distributed to the Partners for the then Accounting Period pursuant to subsection 3.4.1 (in the case of profits from Operations) and subsection 3.4.2.5 (in the case of profits from a Capital Event)."

The parties do not dispute that a net depreciation modification must be made for the computation of New York entire net income.

SUMMARY OF THE PARTIES' POSITIONS

It is petitioner's contention that the partnership agreement is clear. For Federal income tax purposes, 95% of the losses should be allocated to Shipcentral and 5% to the limited partner. For New York and all other purposes, other than Federal income tax purposes, under

the partnership agreement, the profits, losses, distributions, etc. would be allocated in proportion to the amounts of capital contributed by the partners, i.e., 2½% to the general partner and 97½% to the limited partner. In summary, for Federal tax purposes there was a special allocation to the general partner, and for all other purposes the percentage dictated by the capital contribution should be followed.

The Division contends that Shipcentral was a 95% participant in the partnership for Federal tax purposes and, therefore, for reporting purposes must make an addback modification based on the same percentage.

CONCLUSIONS OF LAW

A. Tax Law § 208.9(b)(10) provides for a modification to "entire net income" in the form of a depreciation adjustment. The fact that a modification is required in this case is not disputed by the parties. The question is which of the two allocation percentages applies to this adjustment pursuant to the partnership agreement.

B. Tax Law § 208.9, in pertinent part, defines "entire net income" as:

> "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...."

The corresponding regulations state that:

> "(a) ...the income actually reported or the income actually determined for Federal income tax purposes is not necessarily the same as the taxable income which should have been reported for Federal income tax purposes under the provisions of the Internal Revenue Code. Ordinarily the determination of the Commissioner of Internal Revenue as to Federal taxable income is followed, but it is not binding on the Tax Commission.
>
> (b) Federal taxable income is the starting point in computing entire net income..." (20 NYCRR 3-2.2).

C. Petitioner argues that for Federal income tax purposes the losses from operations are determined in accordance with the allocation in the partnership agreement Section 3.2.1, i.e., 95% to the general partner. However, for New York and all other purposes, the amounts are allocated pursuant to Section 3.2.2 since all other activities would be deemed a capital event. The problem with this argument is that it ignores the following: (1) that the computation of

entire net income begins with Federal taxable income; (2) that the Federal taxable income of Shipcentral is a result of a 95% loss allocation from Richfield; and (3) that depreciation computed at 95% is a substantial component of that loss. If depreciation as a deduction were an item separately allocable by its nature and not an integral part of the calculation of rental operations, and Federal taxable income did not reflect this item, perhaps there could be a situation where an item is allocated according to a separate percentage. The key is that it cannot be removed from Federal taxable income by the nature of that computation. Petitioner seems to inadvertently acquiesce since the amended return also begins with Federal taxable income of $(442,003.00). Included in that loss is an ACRS deduction of $2,262,035.00 which is 95% of the depreciation ($2,381,088.00) used to compute the Richfield loss. This is the ACRS deduction used in the computation of $(442,003.00) that must be added back to compute entire net income.

D. The partnership agreement terminology "federal income tax purposes", as it relates to New York corporation franchise tax, is essentially "for New York income tax purposes" also, since the computation for New York purposes begins with a Federal amount of which depreciation is a component part. In this matter, depreciation computed at 95% falls within the express meaning of Section 3.1.1:

> "...Any allocation to a Partner of a pro rata share of the profits or losses of the Partnership shall be deemed to be an allocation to that Partner of the same pro rata share of each item of income, gain, loss, expense, deduction or credit that is earned, realized, or available by or to the Partnership for federal income tax purposes."

Clearly the partnership agreement requires that an allocation of losses is likewise an allocation of its component deductions, among other items. There is no mathematical means or theoretical support to find that the depreciation modification should be in accordance with the capital event allocation percentages.

E. It is noteworthy that had petitioner's argument been applied mathematically, even if not proper in theory, the ACRS depreciation of $2,381,088.00 from the Richfield operations would be added back to result in net income passed through to Shipcentral rather than a net loss of $496,196.00. Such net income adjusted for allowable New York depreciation would

certainly result in a modified "federal taxable income before net operating loss" that differs greatly from $(442,003.00). Petitioner did not advance this argument at the hearing or support it in any way by the amended return filed in this matter.

F. The petition of Shipcentral Realty, Inc. is denied and the refund claim for the fiscal year ending November 30, 1986 is hereby denied in its entirety.

DATED: Troy, New York

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ADMINISTRATIVE LAW JUDGE