STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition of MACANDREWS & FORBES HOLDINGS, INC. for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1986, 1987 and 1988.	: : : : :	DETERMINATION DTA NO. 812227

Petitioner, MacAndrews & Forbes Holdings, Inc., 38 East 63rd Street, New York, New York 10021, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the years 1986, 1987 and 1988.

A hearing was held before Marilyn Mann Faulkner, Administrative Law Judge, at the offices of the Division of Tax Appeals, Riverfront Professional Tower, 500 Federal Street, Troy, New York, on May 12, 1994 at 9:30 A.M., with all briefs due by October 6, 1994. Petitioner, represented by Ernst & Young (Kenneth T. Zemsky, Esq., of counsel), filed a brief on July 1, 1994. The Division of Taxation, represented by William F. Collins, Esq. (Robert Tompkins, Esq., of counsel), filed a brief on September 16, 1994. Petitioner filed a reply brief on October 6, 1994.

ISSUE

Whether the addback provision of Tax Law § 208.9(b)(6) applies to a nonrefundable commitment fee paid by a parent company for a loan with respect to the acquisition of a targeted company when the actual acquisition was not made.

FINDINGS OF FACT

Petitioner, MacAndrews & Forbes Holdings, Inc. ("MacAndrews"), is primarily an operating holding company that is in the business of acquiring subsidiaries. As a parent company, MacAndrews is also indirectly involved in acquiring, through its affiliates, corporate stock and corporate assets.

During the years at issue, MacAndrews consisted of two divisions, the Technicolor East Coast Division ("Technicolor") and the Corporate Division. The Corporate Division was the holding company for its subsidiaries and investments. Technicolor was involved with the development of movie negatives for large movie studios.

In 1987, MacAndrews attempted to acquire a company, referred to in the record as Gillette. In order to finance this acquisition, MacAndrews entered into an agreement with Citibank. The agreement required petitioner to pay to Citibank a nonrefundable advisory or commitment fee of $5 million in return for Citibank's commitment to loan MacAndrews $1 billion for the acquisition of Gillette and to use its best efforts to obtain further financing in the amount of $4.4 billion from other financial institutions. One of the conditions for Citibank to advance the $1 billion was that MacAndrews acquire Gillette on a "friendly basis."

As part of this agreement, MacAndrews further agreed to pay Citibank $22 million dollars in the event MacAndrews (1) merged with or otherwise acquired Gillette within one year of the date of the agreement (June 17, 1987), (2) acquired a substantial portion of Gillette's assets within one year of June 17, 1987, or (3) acquired more than 50% of Gillette's outstanding shares within one year of June 17, 1987. At hearing, Marvin Schaffer, the Assistant Vice-President of MacAndrews, testified that, if acquired, Gillette might have constituted business capital or subsidiary capital depending on whether stock or assets only had been acquired and on whether, after purchase, Gillette remained a division of MacAndrews, such as Technicolor, or was set up as a separate subsidiary under MacAndrews or as a totally-owned subsidiary of an affiliated subsidiary.

Petitioner issued to Citibank a check, dated June 18, 1987, in the amount of $5 million. Subsequently, the anticipated acquisition of Gillette failed.

On its New York State corporation franchise (Form CT-3) tax returns and its U.S. corporation income tax (Form 1120) returns for 1987 and 1988, petitioner deducted

$1,700,227.00 and $3,398,453.00, respectively, as "amortization of organizational costs."[1] Included in those amounts was the $5 million fee paid to Citibank.

The New York State Division of Taxation ("Division") commenced an audit of petitioner in 1990. The audit concluded in March of 1992. The Division issued a Notice of Deficiency, dated March 27, 1992, to petitioner for corporation franchise tax in the amount of $30,684.00, plus penalty, for 1986, $3,987.00 for 1987, and $290,268.00, plus penalty, for 1988. Included in the Division's calculation of the deficiencies was the addback of amounts petitioner deducted in 1987 and 1988 with respect to the commitment fee paid to Citibank.[2]

The Division's auditor reasoned that due to the addback effect of Tax Law § 208.9(b)(6), petitioner was not permitted to deduct the commitment fee paid to Citibank. Section 208.9(b)(6) provides that:

> "[e]ntire net income shall be determined without the exclusion, <u>deduction</u> or credit of:
>
> * * *
>
> "(6) in the discretion of the tax commission, any amount of interest directly or indirectly and <u>any other amount directly or indirectly attributable</u> as a carrying charge or otherwise to <u>subsidiary capital</u> or to income, gains or losses from subsidiary capital." (Emphasis added.)

The Division rejected petitioner's contention that the commitment fee should be classified as a business expense directly attributable to business capital. The Division took the position that because Gillette was not acquired, the commitment fee was not directly traceable to any business asset and therefore was not directly attributable to business capital. Replying on a published memorandum of the Division (TSB-M-88[5]C), the Division noted that any

[1]At hearing, Mr. Schaffer stated that this characterization of the fee was a misnomer.

[2]With respect to the addback of the deduction, there was no actual tax deficiency for the year 1987; however, the addback did have the effect of reducing petitioner's calculation of its net operating loss for 1987 that could be carried forward.

deductions not directly attributable to the three types of capital -- business, investment or subsidiary -- must by default be indirectly attributable to all three categories in accordance with the formula[3] set forth in the memorandum.

After a conciliation conference, the conferee issued a Conciliation Order, dated June 11, 1993, sustaining the statutory notice.

MacAndrews filed a petition, dated September 7, 1993, alleging the following:

> "additional tax was assessed because expenses attributable to subsidiary capital were in excess of the calculated amount by the taxpayer. The taxpayer asserts that certain expenses, the Department of Taxation and Finance used as a base for the calculation, should have been excluded. These expenses clearly were in no way related to the stewardship of subsidiary capital, but rather relate to the business of the taxpayer."

The Division filed an answer, dated November 12, 1993, affirmatively stating, inter alia, that the commitment fee was not directly attributable to business capital but was an expense to be indirectly attributed to subsidiary capital under Tax Law § 208.9(b)(6) resulting in an addition to entire net income.

SUMMARY OF THE PARTIES' POSITIONS

Petitioner argues that the issue involves a two-prong inquiry. First, whether the commitment fee at issue is "directly" traceable; and secondly, whether the expense is traceable to business capital. Petitioner contends that the commitment fee was directly attributed to a particular transaction, although not a particular asset on the taxpayer's balance sheet, and that, therefore, the only remaining question is to what type of capital can the fee be directly attributed. Petitioner notes that the only authoritative definition of business capital is provided in Tax Law § 208.7. That section defines business capital as "all assets, other than subsidiary capital, investment capital and stock issued by the taxpayer . . . ." Thus, concludes petitioner,

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[3]In the audit, the Division changed from 88% to 92% the amount of subsidiary assets in relation to the total assets in all three categories. Therefore, 92% of the commitment fee was indirectly attributed to subsidiary capital. Petitioner does not take issue with the calculation of these amounts. It objects only to the fee being indirectly attributable to subsidiary capital.

because it did not acquire Gillette, the commitment fee cannot be directly attributable to subsidiary capital, investment capital or stocks, and instead, by a process of elimination, must be directly attributable to business capital.

Petitioner asserts that to the extent that there is any ambiguity regarding the definition of business capital, the issue should be resolved in favor of petitioner. Petitioner also notes that the issue in the case is one of first impression and that the decision should be guided by Internal Revenue Code ("IRC") § 265 and Revenue Ruling 73-602. Petitioner further asserts that in the event the expense is added back, it should not be held liable for the substantial understatement penalty under Tax Law § 1085(k).

The Division argues that the definition of business capital under Tax Law § 208.7 relates only to whether certain assets are considered subsidiary capital, investment capital or business capital. The Division reasons that because the commitment fee cannot be attributed to any asset, it cannot be directly attributed to any of the three categories of capital and, thus, can only be indirectly attributed to all categories of capital in accordance with the Division's published memorandum (TSB-M-88[5]C). The Division claims that under petitioner's reasoning every analysis would begin with the definition of business capital and, thus, no expense would ever be considered "indirectly" attributed to any of the three categories of capital. The Division further contends that the purpose of the addback of deductions under Tax Law § 208.9(b)(6) was "to prevent the obvious unfairness that results from deducting expenses attributable to subsidiary capital while the income therefrom is not taxed to the parent" (Division's Brief, p. 30). The Division notes that, under Tax Law § 208(9)(a)(1), income from subsidiaries is excluded from the income of the parent company. The Division asserts that:

> "except for the technicolor lab, petitioner was primarily a holding company, holding subsidiaries and some investments. Since income that might have been received from such large subsidiary holdings would be excludable from income, fairness requires any attributable expenses to be added back" (Division's brief, p. 31).

The Division also argues that the substantial understatement penalty should be upheld.

CONCLUSIONS OF LAW

A. Tax Law § 208.9(b) provides that:

"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 or indirectly[4] attributable as a carrying charge or otherwise to subsidiary capital or to income, gains or losses from subsidiary capital." (Emphasis added.)

In October of 1988, the Division's Technical Services Bureau issued a public memorandum which discussed the direct and indirect attribution of deductions under Article 9-A. In that memorandum, the Division explained that under Tax Law § 208.9(b)(6), deductions which are directly or indirectly attributable to subsidiary capital are required to be added back to Federal taxable income in computing entire net income; and that deductions which are not directly attributable to one of the three types of capital are treated as indirectly attributable to the three types of capital in accordance with a formula.

The parties do not dispute the calculations of the adjustments with respect to the formula but instead focus on whether the commitment fee can be "directly" or "indirectly" attributable to any type of capital. The Division takes the position that the fee cannot be directly attributable to any of the three types of capital because it cannot be traced to any particular "asset" inasmuch as the acquisition, for which the fee was incurred, never took place. Petitioner opines that because the fee is directly traceable to a particular transaction, it should be directly attributable to one of the three types of capital. In determining which of the three types of capital the fee should be directly attributed, petitioner refers to the definition of business capital under Tax Law § 208.7

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4 In 1987, the Legislature added this term "indirectly" to subparagraph 6 (L 1987, ch 817, § 15). This amendment to the provision was part of the Business Tax Reform and Rate Reduction Act of 1987.

which provides that:

> "[T]he term 'business capital' means all assets, other than subsidiary capital, investment capital and stock issued by the taxpayer, less liabilities not deducted from subsidiary or investment capital which are payable by their terms on demand or within one year from the date incurred, other than loans or advances outstanding for more than a year . . . except that, subject to the provisions of subdivision six of section two hundred ten of this chapter, cash on hand and on deposit shall be treated as investment capital or as business capital as the taxpayer may elect."

Relying on this definition, petitioner concludes that because the fee cannot be directly traced to subsidiary[5] or investment capital, it must by definition be attributable to business capital.

The Division in turn asserts that capital in the definition of business capital refers to "assets" and that if there are no assets to which the expense can be directly traced, then the expense cannot be "directly" attributable to business capital, nor to subsidiary and investment capital,

and by default is indirectly attributable to all three types of capital in accordance with the formula outlined in TSB-M-88(5)C.

B. In TSB-M-88(5)C, the Division set forth the following examples, which it also stated were not exclusive, of deductible expenses which may be "directly" attributable in whole or in part to subsidiary capital:

> "(1) interest incurred to purchase subsidiary capital;
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> "(2) salaries of officers and employees engaged in the management, supervision or conservation of subsidiary capital;
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> "(3) legal expenses relating to subsidiary capital;
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> "(4) stewardship expenses relating to a subsidiary (see Treasury Regs § 1.861-8[e][4]); and
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> "(5) rent or depreciation with respect to a building, a portion of which is dedicated to the management of subsidiaries."

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[5]Subsidiary capital is defined as "investments in the stock of subsidiaries and any indebtedness from subsidiaries, exclusive of accounts receivable acquired in the ordinary course of trade or business for services rendered or for sales of property held primarily for sale to customers . . ." (Tax Law § 208[4]).

Similarly, the Division also set forth the following nonexclusive list of deductible expenses which may be "directly" attributable in whole or in part to business capital.

> "(1) rent, depreciation, repairs and maintenance with respect to production facilities;
>
> "(2) interest incurred to purchase or build a manufacturing plant;
>
> "(3) costs of shipping goods to customers;
>
> "(4) salaries of employees directly engaged in manufacturing, sales, service, etc.; and
>
> "(5) An expense the reimbursement of which, received in the form of a management fee paid by a subsidiary of the taxpayer, is included in entire net income."

Although business capital is defined in terms of assets, this definition should not be used to restrict the definition as to what deductions are "directly" attributable to business capital. Under the Division's reasoning, salaries paid to employees may be suspect because they are not directly traceable to a business asset.[6] Instead, these salaries relate only to business activities. Thus, it would appear that items which relate to business activities of subsidiary capital or business capital should be "directly" attributable to that capital. In this case, the deductible commitment fee is directly attributable to the attempted acquisition of an identifiable company. This transaction was undertaken by the parent company whose specific function and activity as a holding company was to acquire companies. If Gillette had been acquired, depending on the nature of the acquisition or other circumstances (see, Finding of Fact "4"), it would have been either a subsidiary, or like Technicolor, a division of MacAndrews. However, whether Gillette would have become a subsidiary or division is immaterial inasmuch as there was no acquisition. In any event, the fact that the fee could not be traced to an actual asset of petitioner's is insufficient to reject the notion that the fee could be "directly" attributable to business capital.

C. The cases and policy reasons cited by the Division in support of its position instead

[6] "Assets" are defined as "sufficient property to pay debts and legacies . . . the series of items on a balance sheet representing the book values at a given date of resources, rights, or items of property owned grouped under appropriate headings according to their nature" (Webster's Third New International Dictionary 131 [1986]).

support petitioner's position. In Matter of F.W. Woolworth Company v. State Tax Commn. (126 AD2d 876, 510 NYS2d 926, affd 71 NY2d 907, 528 NYS2d 537), the Court held that the purpose of the addback provision of Tax Law § 208.9(b)(6) was "to prevent a parent corporation from obtaining a double tax benefit by taking a deduction for interest payments on loans incurred for directly or indirectly financing investments in

subsidiaries while at the same time the parent's income derived from such investments is tax free."[7] The Court then found that there were objective facts and circumstances from which the tax commission could infer that the parent company's short-term and long-term debt obligations were indirectly attributable to its investments in subsidiaries. In particular, the Court noted that the tax commission could rationally conclude that the parent company "made a conscious decision to expand its investments in subsidiaries and that its borrowing was a necessary element of [its] ability to accomplish that purpose."

In Matter of Unimax Corp. v. Tax Appeals Tribunal (79 NY2d 139, 581 NYS2d 135), the Court of Appeals upheld an audit guideline which provided a method for calculating the amount of a third-party interest expense indirectly attributable to subsidiary capital. Under the guideline a parent corporation could offset loans to a subsidiary by loans to the parent from that subsidiary, on a subsidiary-by-subsidiary basis. The taxpayer argued instead that the parent corporation should be allowed to use a netting approach by aggregating all its loans to subsidiaries and offsetting them with aggregate loans from the subsidiaries to the parents. The Court upheld the subsidiary-by-subsidiary approach stating that the Legislature did not require aggregation and that this approach did not contravene the legislative objective of Tax Law § 208.9(b)(6) to prevent a parent corporation from obtaining a double tax benefit. The court noted that although the parent company in that instance may not have received a full,

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[7] Under Tax Law § 208.9(a)(1) the income, gains and losses from subsidiary capital are not included in entire net income of the parent under Article 9-A tax.

double tax windfall, some benefit may inure to the parent in the form of tax-free income to the parent. The Court stated:

> "[n]o doubt due to the fact that many loan proceeds and transactions cannot be directly or easily traced to subsidiary capital, the Legislature authorized the Department to estimate the amount of indirectly attributable interest expense to be deducted or disallowed" (id., 581 NYS2d at 139).

In both cases, the Court found it critical that there be some relationship between the deductible expense and the subsidiaries' income to satisfy the legislative purpose underlying the application of Tax Law § 208.9(b)(6). From the record, it is clear that the commitment fee was specifically related to the unsuccessful acquisition of a targeted company. Because that company was not acquired, no loan was granted to the parent that could in any way be construed to benefit its subsidiaries. Certainly if Gillette had been acquired as a subsidiary, the commitment fee could have been directly attributable to subsidiary capital; however, these series of events did not occur. Gillette was not acquired and it was uncertain whether Gillette would have been a subsidiary even if it had been acquired.

In sum, I can find no justification for adding back the deductible expense under Tax Law § 208.9(b)(6), on the basis proposed by the Division -- that because the expense does not relate to a tangible asset it must be deemed an expense indirectly attributable to the three types of capital. The commitment fee was directly attributable to a particular transaction for which the parent company was engaged. The fact that the targeted acquisition was not accomplished does not, in itself, transform the commitment fee into an expense indirectly attributable to all three types of capital. The fee was paid in exchange for a loan which may or may not have benefitted subsidiaries. However, due to circumstances, this loan did not materialize. Therefore, indirectly attributing this fee to subsidiary capital has no rational relation to the statutory purpose of Tax Law § 208.9(b)(6) -- to prevent parent corporations from obtaining a double tax benefit.

D. The petition of MacAndrews & Forbes Holdings, Inc. is granted, and the Notice of Deficiency dated March 27, 1992, for the year 1988 should be adjusted accordingly.

DATED: Troy, New York
March 16, 1995

/s/ Marilyn Mann Faulkner
ADMINISTRATIVE LAW JUDGE