STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
GRUMMAN CORPORATION	:	DETERMINATION DTA NO. 813147
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1987 through 1989.	:	
	:	

Petitioner, Grumman Corporation, 1111 Stewart Avenue, Bethpage, New York 11714, 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 1987 through 1989.

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 August 14, 1995 at 9:15 A.M., with all briefs due by February 1, 1996. Petitioner, represented by McDermott, Will & Emery (Peter L. Faber, Esq. and Diann L. Smith, Esq., of counsel), filed a brief on November 17, 1995. The Division of Taxation, represented by Steven U. Teitelbaum, Esq. (Andrew J. Zalewski, Esq., of counsel), filed a brief on January 12, 1996. Petitioner filed a reply brief on February 1, 1996, which date commenced the six-month period for issuance of this determination.

ISSUE

I. Whether a $40 million payment to settle a lawsuit against a parent corporation and its subsidiaries was an expense that was directly or indirectly attributable as income, gains or losses from subsidiary capital within the meaning of Tax Law § 208(9)(b)(6).

II. Whether Grumman's deduction of the environmental tax it paid under Internal Revenue Code § 59-A should be added back under Tax Law § 208(9)(b)(3).

FINDINGS OF FACT

1. Petitioner, Grumman Corporation ("Grumman"), was principally engaged in the business of designing and manufacturing aircraft and aerospace products during the years in question. Founded in 1929, it built a reputation for quality products and became known for the manufacturing of naval aircraft including the Hellcat and Wildcat fighters of World War II and the Avenger bomber and F-14. During World War II, the phrase "Grumman Ironworks" became popular in reference to Grumman's aircraft that could sustain damage due to heavy fire in battle and still return safely to the aircraft carriers, in contrast to damaged Japanese aircraft. Grumman also built the lunar module that landed on the moon and other major components that were used in the Apollo 13 mission which enabled the astronauts to successfully return from the moon.

2. During the 1980s, petitioner's main customers were the United States Government, Boeing, United Parcel Service, and the Japanese Government. Grumman's business was highly competitive. Its main competitors were Lockheed, Northrop, McDonnell Douglas, and General Dynamics, all of whom were highly regarded in the industry. About 90 percent of Grumman's gross revenues was from United States Government contracts.

3. As the Apollo program was winding down in the 1970s, John Bierwirth, Grumman's chairman of the board and chief executive officer, recognized that Grumman would not be able to maintain the highly trained technical personnel on the basis of the waning naval aircraft business and therefore needed to expand its sales base in order to support its engineering capabilities. Mr. Bierwirth made contact with the Secretary of the Air Force concerning Grumman's capabilities to compete in the government contract bidding process and subsequently was successful in obtaining a contract for an electronic jamming aircraft.

4. Most of Grumman's business resulted from government contracts for specific projects through a competitive bidding process, and in order to successfully compete for these projects, it was essential to maintain a reputation not only for quality products but also for honesty and integrity. The bidding process involved either an "invitation to bid", where a

formal, advertised request for a bid set forth specific requirements and guidelines, or a "request for proposals", which allowed a contractor to tell the government what it could offer to fulfill the government's requirements. Also, contractors could make unsolicited proposals in which the contractor explained how a certain piece of equipment was valuable to the government. All bids would be in writing and would contain information indicating the contractor's technical capabilities and facilities to manufacture the product, as well as cost and pricing data. Any inaccuracies, misrepresentations or fraudulent information in these written bids would be subject to serious sanctions including criminal liability, suspension or disqualification from future contracts.

5. The government contracting process is subject to Congressional oversight in the performance of its authorization and appropriations function through various committees such as the Armed Services Committees and the Appropriations Committees of both the House and Senate. Maintaining a reputation for technical excellence and honesty among the members of Congress was essential to Grumman's ability to compete in bidding for government contracts.

6. In the late 1970s, Grumman determined that the Federal budget problems and the winding down of the Cold War, made it essential for Grumman to diversify by expanding its business into commercial areas. It analyzed commercial fields where it thought there was a possibility of using the skills it acquired in its defense work. During this time it expanded into the computer services business, the environmental business (aerial surveys and mapping), and built fire apparatus trucks, sewage treatment plants, and solid waste plants that converted garbage into energy.

7. As part of its diversification efforts, Grumman became involved in the designing and manufacturing of buses. In January of 1978, Grumman bought the assets of an operating bus manufacturing business from Rohr Industries for $55 million. Grumman put the assets into a new corporation called Grumman Flxible Corporation ("Flxible"). Flxible became a wholly owned subsidiary of Grumman Allied, which was a wholly owned subsidiary of Grumman.

8. At the time Grumman bought the assets from Rohr Industries, Rohr was building and designing a modern looking transit bus or intracity bus called a "New Look Bus". The company was also preparing and building a new design in response to the Federal government's request for transit buses that were both fuel efficient and accessible to the handicapped. The new design was known as the Flxible Model 870. This model included wheelchair lifts, was lighter and lower to the ground and had the ability to lower the front of the bus for easy access. Rohr represented to Grumman that the Model 870 had been thoroughly tested. It showed Grumman a film about the rigorous testing of buses on Rohr's test track. Rohr represented to Grumman that the buses being tested in the film were the Model 870s when, in fact, the buses in the film were the "New Look Buses". After the acquisition of the bus assets, Grumman discovered that the Model 870 was experiencing significant structural problems on the test tracks due to its design. The Model 870 did not have a standard bus chassis where two rails along the length of the bus provide the structural support for the bus. Instead, it had a new monocoque structure where the whole structure was integrated and provided the structural support for the bus. As a result, stress cracks developed at weld points throughout the entire structure of the bus.

9. Prior to discovering this structural defect, Flxible had sold the Model 870 buses to transportation authorities in Atlanta, Connecticut, New Jersey, New York, Houston, Southern California, San Francisco, and Ohio. On March 30, 1979, Flxible entered a contract with the New York City Transit Authority and the Manhattan and Bronx Surface Transit Operating Authority (referred to collectively as the Metropolitan Transit Authority or MTA in this determination) selling to the MTA 1,013 Model 870 buses for approximately $110,000.00 per bus. Grumman was not a party to the contract; however, it posted a performance bond guaranteeing that the buses would be built and delivered at the agreed price.

10. In late 1979, the MTA's general counsel, Richard Bernard, telephoned Grumman's general counsel, Thomas Genovese, to inform him that there were structural problems with the Model 870 buses delivered to the MTA. Mr. Bernard had not talked to anyone at Flxible concerning these structural problems even though Flxible had its own legal staff, and instead,

insisted on talking directly about these problems to Grumman's general counsel. According to Mr. Genovese's testimony at hearing, this phone call was the first indication to Grumman that there were any problems with the design of the Model 870 buses.

11. After several meetings between the MTA and Grumman, Grumman used its experts and those with aerospace experience to analyze the structural problems and put together a repair plan. Grumman assumed the responsibility for solving the structural problems because it felt that its reputation was at stake. During this period of time, the New York newspapers carried stories of the controversy between Grumman and the MTA with such headlines as "A Setback Cracks Grumman's Image", "Deadly New Disclosures on the Gruesome Grummans", "Grumman Reinforcing its Defective Buses", "New York's Grumman Bus Fiasco", and "MTA Ready to Give Up on its Grumman Buses". This situation also inspired political cartoons and viewpoints such as one with the subtitle "How could LI's major aerospace firm help get men to the moon, but fail to design a bus that could make it from Queens to 42nd Street?"

12. On January 8, 1981, Grumman and Flxible entered into a settlement agreement with the MTA wherein Grumman guaranteed the obligation of Flxible to repair and warrant the buses already delivered to the MTA through a comprehensive corrective action plan. Flxible did the repairs in accordance with the corrective plan developed by Grumman at Flxible's facilities; however, because the task was too big for Flxible alone, other repair facilities were established through Grumman. This agreement provided as follows:

> "Grumman . . . agrees that should Flxible fail to perform any of such obligations, the Authorities may assert directly against Grumman all claims and remedies that it could have asserted against Flxible under this Agreement by reasons of such failure and that Grumman shall not be relieved of any liability in connection therewith by reason of any waiver, extension of time, amendment or other course of dealing between the Authorities and Flxible, with or without notice thereof to Grumman."

13. In 1982, Grumman determined that it would sell the bus operation because it was unprofitable. In fact, John Bierwirth, Grumman's chief executive officer and chairman of the board, characterized Grumman's venture in the bus business as "a terrible catastrophe". On

June 23, 1983, Flxible sold its assets, including its name, to General Automotive Corporation.[1] Flxible reported the sale on its 1983 tax returns.

14. Flxible's name was changed to Grumman Ohio Corporation. Grumman Ohio retained the accounts receivable because General Automotive did not want to be involved in any potential litigation relating to those receivables. Grumman Ohio did not continue operating a bus manufacturing business. The company remained open only to do the warranty administration. Grumman Ohio's assets consisted of the accounts receivable, the note and preferred stock in Flxible. In 1984, Grumman received a dividend from Grumman Ohio of $10,925,000.00 which represented the liquidation of the receivables. Prior to this payment, Flxible had never paid any dividend or interest to Grumman. According to the testimony of Douglas Dahlgard, director of taxes at Grumman, Grumman lost approximately $250 million with respect to its investment in Flxible which included the cost of operation, the repair expenses and the loss on the eventual sale. In 1978 through 1982, Flxible reported on its U.S. corporation income tax returns that it had negative taxable income. Similarly, Grumman Ohio reported on its U.S. corporation income tax return for 1983 through 1987 that it had negative taxable income.

15. On April 19, 1983, Grumman brought a lawsuit against Rohr Industries alleging that Rohr had misrepresented and failed to disclose material facts relating to the testing of the Model 870's design. On October 31, 1984, the United States Circuit Court affirmed the District Court's dismissal of Grumman's complaint (Grumman Allied Industries, Inc. and Grumman Corporation v. Rohr Industries, Inc., 748 F2d 729 [2d Cir]). The court found that Rohr had not disclosed to Grumman cracks it discovered in the rear A-frame of the Model 870 during endurance testing. Despite Rohr's failure to disclose, however, the court held that Grumman had specifically disclaimed, in the purchase contract with Rohr, any reliance on certain

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[1]According to the purchase contract, the purchase price was $40 million, plus or minus certain adjustments. Grumman had issued a press release stating that the purchase price was $41 million, of which approximately $14 million was cash down and the balance divided equitably between a 10-year note and an issue of preferred stock in Flxible Corporation. At the hearing, Mr. Genovese testified that the purchase price was approximately $26 million. In its brief, Grumman stated that the Flxible assets sold for $28 million.

representations by Rohr concerning the design and testing of the prototypes. Therefore, concluded the court, Grumman could not subsequently claim that it had been fraudulently induced to enter into the contract by the very representations it had disclaimed in the contract. The court further noted that:

> "[a]t all stages, Grumman was represented by a sophisticated group of counsel, executives and engineers. Grumman enjoyed unrestricted access to all the facilities, personnel and records of Rohr, and despite its knowledge that the Model 870 was undergoing endurance testing in late 1977, Grumman neither inquired into the results of that testing, nor asked to scrutinize testing reports." (Id. at 737.)

16. In early 1984, a new administration was appointed at the MTA. The new MTA chairman concluded that the repairs on the Model 870 buses were unsatisfactory. As a result, on February 7, 1984, the MTA took the approximately 850 repaired buses out of service and parked them on a pier located on the Hudson River. MTA's action became a media event for the newspapers and TV news. Inasmuch as the purchase of the City's buses was subsidized by the Federal government, the MTA's action also instigated Congress to hold hearings concerning the disuse of these buses.

17. On May 10, 1984, the New York City Transit Authority ("City") commenced a lawsuit in New York State Supreme Court, New York County, against Grumman Corporation, Grumman Allied Industries Inc. and Grumman Flxible Corporation. The complaint contained five causes of action: the first claim was against all three defendants for fraud and conspiracy to defraud; the second claim was against Flxible for breach of contract; the third claim was against all defendants for negligent misrepresentation; the fourth claim was against Flxible for breach of implied warranty of merchantability; and the fifth claim was against Flxible for breach of implied warranty of fitness for a particular purpose. The City requested over $1 billion in damages. The complaint contained 101 paragraphs, 65 of which were devoted to the first claim against all the defendants for fraud and conspiracy to defraud. In that claim, the City alleged that;

> "prior to 1979 and thereafter, defendants determined, and took steps, to impose the defective Grumman buses upon plaintiffs in exchange for an undeserved, multi-million dollar consideration by (a) repeatedly making fraudulent misrepresentations to plaintiffs, and fraudulently concealing material facts from

> plaintiffs, with respect to the adequacy of the design, manufacturing quality, testing, reliability and/or safety of the Model 870 bus and (b) purporting to implement 'fixes' of various defects in the Grumman buses which defendants knew would not enable such buses to comply with plaintiffs' contractual and other requirements because of the fundamental design and other inadequacies of the Model 870 bus."

The City referred to the unsuccessful lawsuit Grumman had brought against Rohr Industries and also alleged that Grumman and Grumman Allied employed their wholly-owned subsidiary, Flxible, which they dominated and controlled, as their instrumentality to implement their fraudulent scheme.

18. During the course of the lawsuit, the City focused exclusively on Grumman, deposing for ten days Grumman's general counsel, Mr. Genovese, but not deposing Flxible's general counsel. Negotiations with the City were conducted by Grumman and not the other defendants. Grumman believed that it was the primary target for the lawsuit because it had significant assets compared with the other two defendants. At that time, Grumman had approximately $700 million in assets; Grumman Allied had approximately $80 million in assets; and Flxible/Ohio had a negative worth.

19. Grumman became so concerned about the negative publicity it was receiving that it engaged a firm, Opinion Research Corporation, to evaluate the possible affect the publicity would have on the jury pool in New York City. Based on its survey, Opinion Research concluded that 85% of the people living in New York County were biased against Grumman on the bus issue. Concerned that it was not going to get a fair trial, Grumman moved for a change of venue from New York County. The Court denied the motion.

20. The negative publicity surrounding the lawsuit also captured the attention of several of Grumman's customers such as the U.S. Defense Department, Boeing and the United Parcel Service. In their conversations with John Bierwirth, Grumman's chief executive officer, Grumman was often the object of jokes concerning the lawsuit, some of which Mr. Bierwirth described as not "too barbed" and others which he described as "perhaps less gentle and more pointed". Mr. Bierwith was convinced that part of the City's strategy in the lawsuit was to create so much negative publicity that Grumman would settle the case.

21. Fearing that a highly publicized trial would seriously undermine Grumman's credibility and reputation, and that there was a possibility that Grumman could lose the case based on the results of the survey concerning jury bias and the Rohr lawsuit, Grumman's Board of Directors determined that a settlement was in Grumman's best interest. This decision was also driven by the Board's concern that if there was a finding that Grumman was guilty of fraudulent conduct, this finding might result in a liability greater than Grumman's net worth, result in a shareholder's lawsuit against Grumman, and risk serious damage to its ability to secure contracts with the Federal government in the future. Mr. Genovese testified that he was concerned that if Grumman were found guilty of active fraud in the sale of a product to a governmental authority, Grumman "would become pariahs in terms of any future government business."

22. On February 19, 1988, the City entered into a settlement agreement with all three defendants which the City referred to collectively in the agreement as the "Grumman parties". In that agreement, the Grumman parties were to pay to the plaintiffs $40 million - $10 million initially and five consecutive installment payments of $6 million each. According to the agreement:

> "all amounts paid pursuant to paragraph 1 hereof shall constitute payments in settlement of the SECOND CLAIM, relating to breach of contract, of the Complaint in the Lawsuit. The parties hereto further agree that no part of the amounts paid pursuant to paragraph 1 hereof constitutes a payment with respect to any tort claim or claim for punitive damages."

Grumman had insisted that the $40 million payment be allocated solely to the breach of contract claim so that there was no implication that Grumman had committed a fraud or was guilty of negligence, misrepresentation or any other intentional tort. Grumman was convinced that its reputation would have been irreparably damaged if the settlement was viewed as a compromise on a fraud claim whereas it felt that a settlement on a breach of contract claim would be viewed as resolving a normal commercial dispute.

Therefore, the agreement also provided that the settlement operated "to satisfy, discharge, waive, settle and release any and all rights, liabilities, claims or demands, known or unknown,

of the New York parties . . . against the Grumman parties"; that the agreement was executed for "the sole purpose of settling matters involved in this dispute" and that nothing in the agreement should be construed "as evidencing or indicating in any degree an admission by any party hereto of the truth or correctness of any claims or counterclaims asserted or issues in dispute in the Lawsuit or otherwise"; and that each of the obligations of the Grumman parties pursuant to the agreement shall be "joint and several".

23. Grumman filed a combined New York State franchise tax return for 1988 that included Grumman Aerospace and other subsidiaries, but not Grumman Allied or Grumman Ohio. Grumman Allied filed a separate New York State return and Grumman Ohio did not file a New York State return for 1988 because it had not done business in New York State in that year. In its return, Grumman deducted the $40 million settlement as a business expense in 1988 for both Federal and State tax purposes.

24. The Division conducted an audit of Grumman for the years 1987 through 1989. It disallowed the $40 million deduction on the ground that it was an expense directly related to subsidiary capital. The auditor based this determination on the following reasons: that Grumman did not manufacture the buses or perform any warranty work; that the expense directly resulted from Grumman's ownership of Grumman Ohio; that there must be a matching of the expense associated with certain revenue and therefore Grumman Ohio should have taken the expense as a deduction because it received and recognized the revenue of $92 million on the sale of the buses to the City; that Grumman's deduction of the expense for which it never recognized any revenue would create a distortion; that Grumman's involvement in the lawsuit constituted the performance of stewardship duties that could have been billed as management fees if Grumman Ohio had any assets to pay those expenses; that the settlement agreement stated that the $40 million payment related to the breach of contract claim; and that Grumman's expense resulted from its guarantee in 1981 of the subsidiary's performance.

25. The auditor also added back, in its calculation of Grumman's entire net income for State tax purposes, Federal environmental tax payments that Grumman had deducted in computing its Federal net income.

26. The Division issued to Grumman a Notice of Deficiency, dated March 4, 1993, for franchise tax due for the period 1987 through 1989, in the amount of $1,384,124.00 plus interest, resulting in the total amount due of $2,041,005.44.

27. After a conciliation conference, the conferee issued a conciliation order, dated June 24, 1994, sustaining the Notice of Deficiency.

28. Grumman filed a petition, dated September 16, 1994, alleging that the $40 million payment settled Grumman's own liability and accomplished its own business objective and was not attributable to subsidiary capital; that the deduction did not result in a double tax benefit because the subsidiary had ceased operations several years before the settlement and Grumman had not received any income from the subsidiary in four years; and that the Division erred in adding back the Federal environmental tax payment because the tax was not the type of Federal tax excluded under New York Tax Law § 208(9)(b).

29. The Division filed an answer, dated December 1, 1994, affirmatively stating that Grumman had the burden of proving that the determination of the Division was invalid. The Division filed an amended answer, dated December 13, 1994, alleging that the settlement payment was allocated solely against the breach of contract claim against the subsidiary, and therefore, the auditor properly disallowed the deduction of the $40 million paid by Grumman on behalf of the subsidiary; and that pursuant to section 208(9)(b)(3) of the Tax Law, the Federal environmental tax paid by Grumman was measured by income and therefore not deductible or excludible from entire net income.

SUMMARY OF THE PARTIES' POSITIONS

30. In brief, petitioner argues that the $40 million settlement payment was deductible by Grumman because the payment was made solely to accomplish Grumman's own business objectives of preserving its net worth and its reputation for technical excellence and honesty and

had nothing to do with Grumman's former investment in Flxible; that even if the settlement payment was attributable to subsidiary capital, the Division should have exercised its discretion under the statute to allow its deduction because it bore no relationship to any receipt of tax-free income from subsidiary capital; and that the Federal environmental tax imposed under Internal Revenue Code § 59-A is not a tax on or measured by profits or income, and thus, is not a tax required under Tax Law § 208(9)(b) to be added back in computing Grumman's New York entire net income.

31. The Division argues that the $40 million settlement payment was directly attributable to Grumman's subsidiary capital; that the Tax Appeals Tribunal's decision in Knott Hotels Corporation (October 7, 1993) supports the Division's disallowance of the $40 million deduction by Grumman; that Grumman's subjective intent as to whether the $40 million payment was a necessary and ordinary business expense is insufficient to defeat the Division's disallowance of the deduction; and that the Federal environmental tax under IRC § 59-A is a tax on or measured by profits or income, and therefore, Grumman's payment of the tax should be added back in calculating New York entire net income under Tax Law § 208(9)(b)(3).

CONCLUSIONS OF LAW

A. In calculating its New York State corporation franchise tax, a corporation must add back certain deductions taken on its general income tax return. Tax Law § 208(9)(b) provides that for State tax purposes entire net income shall be determined without the deduction of:

> "(6) in the discretion of the tax commission, any amount of interest directly or indirectly[2] and any other amount directly or indirectly attributable as a carrying charge or otherwise to subsidiary capital or to income, gains or losses from subsidiary capital."

The statute defines "subsidiary capital" 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, whether or not evidenced by written instrument, on which

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[2] In 1987, the Legislature added the 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.

> interest is not claimed and deducted by the subsidiary for purposes of taxation under article nine-a, thirty-two or thirty-three of this chapter, provided, however, that, in the discretion of the commissioner of taxation and finance, there shall be deducted from subsidiary capital any liabilities which are directly or indirectly attributable to subsidiary capital" (Tax Law § 208[4][a]).

In October of 1988, the Division's Technical Services Bureau issued a public memorandum (TSB-M-88[5]c) which discussed deductions that are directly or indirectly attributable to subsidiary, business or investment capital under Article 9-A. In that memorandum, the Division listed examples, although not exclusive, of deductible expenses which may be directly attributable in whole or in part to subsidiary capital as follows:

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

The Division argues that the $40 million settlement payment was directly attributable to subsidiary capital based on the language of the settlement agreement wherein the settlement payment was to be allocated to the breach of contract claim against Flxible. The Division notes that only Flxible was named as a defendant to the breach of contract claim because Grumman was never a party to the contract for the sale of the buses to the MTA. The Division further notes that contrary to petitioner's claim that Flxible was no longer in business at the time of the settlement, Grumman Ohio was a viable entity left with the responsibility of fulfilling the warranty obligations. Relying on the Tax Appeals Tribunal's decision in Matter of Knott Hotels Corporation (October 7, 1993) and the Court's decision in Matter of F.W. Woolworth Company v. State Tax Commission (126 AD2d 876, 510 NYS2d 926, affd 71 NY2d 907, 528 NYS2d 537), the Division contends that the objective facts and circumstances indicate that the settlement payment was directly connected to the subsidiary and Grumman's subjective intent concerning its motivation for settling the City's lawsuit is not controlling.

Petitioner argues that although the settlement payment was nominally allocated to a claim brought against Flxible/Grumman Ohio, it was not attributable to this subsidiary because the payment "was solely to further Grumman's own business objectives of preserving its reputation and assets and not to save a long defunct subsidiary" (Petitioner's brief, p. 20; emphasis in original). Grumman argues that it did not make the payment to release its subsidiary from the lawsuit but to release itself from the lawsuit which threatened its reputation for quality and integrity. Grumman contends that its reputation was an important asset critical to its very survival and that the continuation of the lawsuit threatened its ability to survive. Citing Matter of F.W. Woolworth Company v. State Tax Commission (supra), Grumman claims that the settlement payment fits squarely within the principle established in that case -- that "payments made for 'direct operational purposes' of the parent are not attributable to subsidiary capital and are deductible" (Petitioner's brief, p. 27).

In Matter of F.W. Woolworth Company v. State Tax Commission (supra), the Court held that the taxpayer could not deduct the interest expense on long- and short-term loans because the loans indirectly related to investments in subsidiaries. In making this determination, the court noted that the purpose of the exclusion under section 208(9)(b)(6) is "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". The Court rejected the taxpayer's argument that because the loans were used for meeting recurrent operational needs of the taxpayer's business, the deduction was allowed. The Court held that a parent corporation could have a dual purpose in borrowing and the fact that the loans can be directly attributed to a separate, bona fide business purpose does not in itself defeat the disallowance under the statute. The Court found that there were also objective facts and circumstances from which the Tax Commission could infer that the taxpayer's short- and long-term debt obligations were "indirectly" attributable to its investments in subsidiaries. Specifically, the Court noted that the taxpayer had increased its investments in the subsidiaries and in fact had made actual cash

advances to one subsidiary; that the size of the taxpayer's holdings in its subsidiaries as a principal form of its entire assets alone supported the inference of an inextricable connection between the taxpayer's decisions as to these investments and its financing practices; that there was "no showing that the increase in investment in subsidiaries was necessitated by the reasonable needs of [the taxpayer's] retailing business operations", which was a discrete business entity from the subsidiaries (id., 510 NYS2d, at 928); and 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" (id.).

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 taxpayers argued that rather than a subsidiary-by-subsidiary approach, 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 receive a full, 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 Woolworth and Unimax, the courts 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).

In this case, the Division raises the issue of whether the settlement payment constitutes legal expenses relating to subsidiary capital, an expense identified in the Division's public memorandum as an example of an expense that may be attributable to subsidiary capital. The Division also relies on the Tax Appeals Tribunal's decision in Matter of Knott Hotels Corp. (Tax Appeals Tribunal, October 7, 1993), wherein the Tribunal held that a parent corporation's payment of real estate taxes and rental payments, as guarantor under a lease agreement by its subsidiary, represented expenses that are directly or indirectly attributable to subsidiary capital or are amounts representing income, gains or losses related to subsidiary capital.

Technical Service Bureau Memoranda are statements which are informational in nature designed to aid the taxpayer in keeping as informed as possible about the Division's interpretation of the law. However, these memoranda do not have any definitive legally binding effect as might be afforded a rule or regulation ("Developing and Communicating Interpretations of the Tax Law", a report to the Governor and the Legislature reviewing Department of Taxation and Finance Policies and Practices, March 1989). The Division has not expanded on how the settlement payment should be considered legal fees relating to subsidiary capital other than the fact that in the settlement agreement the payment was allocated to the breach of contract claim against Grumman's subsidiary and therefore, the payment is traceable to subsidiary capital.

Similar to the situation in Knott Hotels, if Grumman paid the settlement payment as guarantor of the bus contract, the payment would appear to represent an expense that is directly or indirectly attributable to losses from subsidiary capital. However, the settlement payment does not simply represent Grumman's obligation under the 1981 warranty agreement with the MTA or its obligations as a parent corporation. Grumman was a separately named defendant in the claim for fraud and conspiracy to defraud and the claim for negligent misrepresentation. Although the $40 million settlement payment was allocated to the breach of contract claim against Flxible only, one must look at the entire settlement, and not just the words concerning the allocation of the payment, in order to determine the nature of the payment for tax purposes

(cf, Matter of Stat Equipment Corporation, Tax Appeals Tribunal, January 25, 1996 [proper classification of business activities for tax purposes is to be determined by the nature of the business and not by the words in its certificate of incorporation]).

Clearly, the purpose of the $40 million payment was not simply to settle the breach of contract claim, it was also paid to release Grumman from claims of fraud and misrepresentation and all the risks and consequences associated with litigating those claims. There is little doubt that the litigation was aimed primarily at Grumman. From the time the City discovered the defect in the buses, the City sought recourse from Grumman's general counsel and not from the general counsel of Flxible. Moreover, the focus of the lawsuit was against Grumman as indicated in the City's course of dealing in negotiations and in deposing only Grumman's general counsel (see, Finding of Fact "18"). There is credible evidence that Grumman requested the $40 million to be allocated to the breach of contract claim in order to protect itself from any taint of wrongdoing that might have been implied if the payment had been allocated to the fraud or misrepresentation claims. In any event, the settlement agreement also stated that the sole purpose of settling matters should not be construed as evidencing or indicating an admission by any party as to the truth of any claim asserted in the lawsuit. This disclaimer presumably also applied to the breach of contract claim. Therefore, there is little reason to view the settlement payment as relating exclusively to a claim against the subsidiary. The settlement agreement also provided that all the parties were jointly and severally liable for the $40 million payment.

Contrary to the situation in Woolworth, the objective facts and circumstances in the case indicate that the payment by Grumman was not made to enhance or protect its investment in the subsidiary. Although the subsidiary continued to exist under the name of Grumman Ohio at the time the lawsuit was commenced, it was no longer operational as a bus manufacturer. The only purpose for Grumman Ohio's existence at that time was to provide the warranty work and to collect the accounts receivable, which were liquidated in 1984. Grumman did not make the payment to bail out its subsidiary Grumman Ohio because, contrary to the Division's contention,

it was no longer a viable bus manufacturing business. Grumman made the settlement payment to protect its own separate business reputation and future earning potential.

Petitioner cites several cases for the proposition that a party may deduct an expense paid on behalf of another if that expense furthers a business objective of the party paying the expense (Gould v. Commissioner, 64 TC 132; Milbank v. Commissioner, 51 TC 805; Lohrke v. Commissioner, 48 TC 679; Dinardo v. Commissioner, 22 TC 430). In Lohrke, the taxpayer was an individual who received a substantial amount of royalty income from a patent he owned on a process used in the synthetic fiber industry. He also owned stock in a corporation that used this process in the conversion of synthetic fibers into fabric. A customer sued the corporation alleging that the corporation had shipped to it defective products. Aware that the corporation was in poor financial condition, the customer agreed to keep the product and accept delivery of products in transit if the taxpayer agreed to be personally responsible for any loss the customer might suffer. The customer eventually sent an invoice for damages and the taxpayer satisfied this debt by sending his personal check. The Tax Court determined that the taxpayer was entitled to deduct the payment made on behalf of the corporation because the taxpayer's purpose in making the payment was to protect his own personal licensing business, and therefore, the payment was proximately related to the taxpayer's own business. The court noted that the licensing business was profitable whereas the corporation was unprofitable and would most likely remain so.

In all the cases cited by petitioner, the Tax Court held that if the taxpayer's primary purpose in making a payment on behalf of another was to enhance or preserve his own interest in a separate business venture, then the taxpayer was entitled to the deduction even though the transaction giving rise to the expenditure originated with another person and would have been deductible by that person if that person had made the payment.

This caselaw therefore, stands for the proposition that a person may, in certain circumstances, take a tax deduction for payments made on behalf of another; however, in the present context, the statute permits the Commissioner of Taxation and Finance to disallow the

deduction if the expense is directly or indirectly attributable to income, gains or losses from subsidiary capital in order to prevent the parent corporation from obtaining a double tax benefit. Notwithstanding this statute, directly or indirectly attributing the settlement payment to the subsidiary capital of Grumman Ohio does not have a rational relation to the statutory purpose of Tax Law § 208(9)(b)(6) inasmuch as the deduction would not result in a double tax benefit to Grumman. Neither Flxible nor Grumman Ohio had taxable income for the years 1978 through 1987. Inasmuch as Grumman Ohio no longer had assets to protect, Grumman's only purpose for settling the case was to protect its own assets. Thus, in contrast to the situations in Woolworth and Unimax, from the objective facts and circumstances in this case, one cannot infer that the settlement payment was undertaken by Grumman to preserve or expand Grumman's investment in its subsidiary Grumman Ohio. The payment was clearly made to preserve the assets and future business of the parent corporation. Tax Law § 208(9)(b)(6) was not intended to be applied against a parent corporation in the very unique circumstances of this case.

At the very least, given the underlying purpose of the statute, the Commissioner should have exercised his discretion by allowing the deduction in these circumstances. In interpretations of a statute, the Commissioner must be mindful of the spirit and purpose of the statute and of the objects to be accomplished by the act (see, People v. White, 73 NY2d 468, 541 NYS2d 749, cert denied, 493 US 859, 107 L Ed2d 127; Ferres v. City of New Rochelle, 68 NY2d 446, 510 NYS2d 57; Matter of Coleco Industries, Inc. v. State Tax Commission, 92 AD2d 1008, 461 NYS2d 462, affd 59 NY2d 994, 466 NYS2d 682). Inasmuch as there is no basis for a finding that Grumman would be obtaining a double tax benefit in these particular circumstances, and the Division has not indicated with any specificity how the legislative purpose of the act would be carried out by disallowing Grumman's deduction, there does not appear to be any rational basis for disallowing the deduction pursuant to Tax Law § 208(9)(b)(6).

B. The second issue in this case is whether the Division properly added back to Grumman's entire net income the environmental tax it paid pursuant to Internal Revenue Code ("IRC") § 59A. Tax Law § 208(9)(b)(3) defines "entire net income" for State tax purposes as the entire net income the taxpayer is required to report in his Federal tax returns without the deduction of taxes on or "measured by profits or income paid or accrued to the United States". Therefore, the question is whether IRC § 59A is a tax on, or is measured by, profits or income.

IRC § 59A(a) imposes an environmental tax on corporations equal to 0.12 percent of the excess of the modified alternative minimum taxable income of the corporation for the taxable year over $2 million. Subsection (b) of the statute defines the "modified" alternative minimum taxable income as the alternative minimum taxable income without regard to the deductions for the alternative tax energy preference or the environmental tax imposed under section 59A(a).

The Division's argument in support of disallowing the deduction of the environmental tax to Grumman was stated in a single sentence. This sentence read as follows:

> "The specific and detailed references [in IRC § 59A] to 'taxable income' in computing the environmental tax evidences that such tax is measured on income or profits and is paid or accrued to the United States."

The Division also refers to the fact that the Division has consistently treated the environmental tax as a tax measured by income and has stated this policy in its "Guidelines, Procedures and User Manuals, Corporation Tax, Insurance Tax, Income and Entire Net Income Plus Compensation Bases, Additions to Federal Taxable Income, Part 'L'".

The taxpayer bears the burden of demonstrating entitlement to a claimed deduction by showing that its interpretation of the law is the only reasonable one (Matter of Felmont Oil Corporation, Tax Appeals Tribunal, May 9, 1996, citing Matter of Howes v. Tax Appeals Tribunal, 159 AD2d 813, 552 NYS2d 972). Petitioner argues that the Federal environmental tax does not fall within section 208(9)(b)(3) because it is an excise tax calculated on a base that is very different from a taxpayer's gross or taxable income. Petitioner contends that this base bears only a superficial resemblance to income because 23 adjustments to income are made in its calculation. Petitioner asserts that the State Legislature did not intend for the phrase "on or

measured by profits or income" to be so broadly construed, otherwise it would have used the additional language of the add-on provision of section 208(9)(3-a), wherein entire net income includes deductions made with respect to "taxes on or measured by profits or income, or which include profits or income as a measure" (emphasis added). Thus, argues petitioner, although income may be a factor in calculating the tax base of the environmental tax, it is not the actual base itself. Petitioner further argues that the legislative intent underlying the environmental tax indicates that the tax should be viewed as a generic excise tax that was intended to apportion to large businesses the general clean-up costs that were not covered by one of the other excise taxes (IRC §§ 4611, 4661, and 4671) on specific products that create hazardous waste. Petitioner contends that the environmental tax is a tax on doing business and not a tax on income.

IRC § 59A was enacted as part of the Superfund Revenue Act of 1986 to provide additional funding for the Superfund program to clean up hazardous waste sites by broadening the tax base. Prior to this Act, the Superfund was financed by excise taxes on petroleum and feedstock chemicals which expired on September 30, 1985. The House bill had proposed financing the Superfund through excise taxes on petroleum, feedstock chemicals, a new tax on imported chemical derivatives, and a new waste management tax (HR Rep No.99-499, 99th Cong, 2d Sess 319, reprinted in 5 US Code Cong and Admin News 3412). The Senate proposed to finance the Superfund through excise taxes on petroleum, feedstock chemicals, and a new Superfund excise tax on manufacturers (id. at 3413). Under the Conference Agreement, the Superfund financing sources were described as excise taxes on petroleum and feedstock chemicals, a new excise tax on imported chemical derivatives, and a "new environmental income tax" (id. at 3413) based on corporate alternative minimum taxable income. The Conference Agreement also noted that "the rules for estimated tax, penalties, and refunds that apply to the corporate income tax also apply to the environmental tax" (id. at 3428).

In approving the reauthorization legislation of the Superfund program, President Reagan made the following statement:

> "I have always been opposed to any broad-based tax as a new revenue source for Superfund. Therefore, I have carefully studied the taxing provisions of the current Superfund legislation. First, it is not a general tax on all American businesses, but affects only larger corporations that have to pay the alternative minimum tax -- that is, corporations who, because of special deductions, exemptions, etc. do not pay the normal tax rate which under the tax reform act will be 34%.[3] Additionally, this tax applies only to corporations with an alternative minimum tax of $2 million and over, and this tax is deductible from regular taxable income." (Id. at 3441.)

Thus, the legislative history refers to the environmental tax as a tax based on income, in contrast to an excise tax levied on a commodity such as petroleum or feedstock chemicals. Contrary to petitioner's claims, the fact that the environmental tax was adopted in place of a Senate proposal that there be an excise tax on the sale, lease, or transfer of tangible personal property, or that the environmental tax was adopted along with other excise taxes to finance the cleanup costs of hazardous waste sites, does not transform the environmental tax into a generic-type of excise tax. In any event, even a tax labeled an excise tax may be measured by income or profits (Matter of Felmont Oil Corporation, supra [windfall profit tax is an excise tax measured by profits or income]).

Moreover, the fact that the alternative minimum taxable income is used as a base rather than the corporation's actual income does not indicate that the environmental tax is not a tax measured by income. As noted in the President's statement in signing the Superfund amendments of 1986, the reason for calculating the tax on the basis of the alternative minimum taxable income was to affect only larger corporations that were not subject to the normal tax rate. Even though the base used for calculating the tax is subject to a number of adjustments, and as a result, the tax only affects larger corporations, the environmental tax is nonetheless measured by Grumman's income within the meaning of Tax Law § 208(9)(b)(3-a) (see, Matter of Felmont Oil Corporation, supra). In conclusion, petitioner has not carried its burden of demonstrating that its interpretation of the law is the only reasonable interpretation.

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[3] IRC § 55 provides that the alternative minimum tax imposed be 20% of the alternative minimum taxable income which is determined by a number of adjustments and increased by certain items of tax preferences.

C. The petition of Grumman Corporation is granted to the extent indicated in Conclusion of Law "A" and is otherwise denied; the Notice of Deficiency, dated March 4, 1993, is modified in accordance with Conclusion of Law "A" and is otherwise sustained.

DATED: Troy, New York
July 11, 1996

/s/ Marilyn Mann Faulkner
ADMINISTRATIVE LAW JUDGE