

STATE OF NEW YORK

DIVISION OF TAX APPEALS

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In the Matter of the Petition	:	
of	:	
<b>SUBURBAN CARTING CORPORATION</b>	:	DETERMINATION
for Redetermination of a Deficiency or for	:	DTA NO. 813842
Refund of Corporation Franchise Tax under	:	
Article 9-A of the Tax Law for the Years 1989	:	
and 1990.	:	

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Petitioner, Suburban Carting Corporation, 524 Watervliet Avenue, Mamaroneck, New York 10543, 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 1989 and 1990.

A hearing was held before Jean Corigliano, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on March 22, 1996 at 9:15 A.M., with all briefs to be submitted by August 9, 1996, which date began the six-month period for the issuance of this determination. Petitioner appeared by Hodgson, Russ, Andrews, Woods & Goodyear (Christopher L. Doyle, Esq., of counsel). The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (John O. Michaelson, Esq., of counsel).

***ISSUE***

Whether interest expenses incurred by petitioner in connection with certain loans are directly or indirectly attributable to petitioner's subsidiary capital within the meaning of Tax Law § 208(9)(b)(6).

***FINDINGS OF FACT***

1. Petitioner, Suburban Carting Corporation ("Suburban"), is a corporation doing business in New York State. Following an audit of Suburban's tax returns for the years 1989 and 1990, the Division of Taxation ("Division") issued to Suburban a Notice of Deficiency dated August 9, 1993, asserting tax deficiencies of \$195,522.00 plus penalty and interest.

2. Petitioner requested and was granted a conference in the Division's Bureau of Conciliation and Mediation Services ("BCMS"). As a result of the conference, the tax deficiency asserted by the Division was reduced to \$76,777.00 for the years 1989 and 1990, and all penalties were cancelled. BCMS issued a Conciliation Order dated February 17, 1995 reflecting these adjustments.

3. The entire amount of the deficiency asserted in this proceeding (\$76,777.00) results from the Division's addback of certain interest expenses which Suburban deducted in calculating its entire net income for the years in issue. Those interest expenses were incurred primarily in connection with Suburban's redemption of the outstanding shares of stock of a single shareholder, Alfred DeMarco. Suburban entered into a redemption agreement with DeMarco on February 3, 1989 in which it agreed to purchase all of DeMarco's stock for \$15,706,465.00. At the closing of the redemption transaction, DeMarco received: (1) a cash payment of \$2,250,000.00, (2) a self-liquidating promissory note in the amount of \$6,000,000.00 and (3) a balloon promissory note in the amount of \$7,456,465.00.

4. The cash payment to DeMarco was made with a portion of the proceeds of a \$10,300,000.00 loan Suburban received from the Royal Bank of Pennsylvania ("Royal Bank") on February 7, 1989. Suburban also borrowed money from an individual named Thomas Milo to help finance the DeMarco stock redemption.

5. As a result of the BCMS conference, the Division determined that petitioner had incurred the following interest expenses in connection with the redemption of the DeMarco stock:

	<u>1989</u>	<u>1990</u>
Thomas Milo loan	\$ 55,842.33	\$ -0-
DeMarco notes	1,063,524.64	1,156,846.00
Royal Bank loan	<u>296,154.76</u>	<u>292,593.00</u>
Totals	\$ 1,415,521.73	\$1,449,439.00 <sup>1</sup>

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<sup>1</sup>For 1990, the Division determined additional interest expenses attributable to subsidiary capital in the amount of \$77,858.00, resulting in an addback to entire net income of \$16,464.48. Petitioner concedes the correctness of this adjustment.

6. Suburban deducted the interest expense amounts shown above in its calculation of entire net income for the years in issue. It was the Division's position on audit, and remains its position in this proceeding, that all of the interest expenses shown above are indirectly attributable to subsidiary capital and subject to indirect attribution pursuant to Tax Law § 208(9)(b)(6). That statute provides, as pertinent, that:

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

7. Relying on a State Tax Commission decision (Matter of Worldwide Volkswagen, State Tax Commn., April 30, 1974) and a published memorandum of the Division (TSB-M-88[5]C), the Division asserted that any interest expense not directly traceable to one of the three types of capital--business, investment or subsidiary--must, by default, be attributed to all three. The Division determined the amount of the deductions indirectly attributable to subsidiary capital (thus, subject to addback) in accordance with a formula set forth in the memorandum.

8. At the time the DeMarco stock redemption agreement was entered into, Carmine Mascia, Suburban's comptroller, was responsible for overseeing Suburban's financial transactions. Mr. Mascia, who provided testimony at hearing on behalf of Suburban, was personally involved in making the financial arrangements necessary to accomplish the redemption of the DeMarco shares.

9. The Royal Bank loan was taken for the specific purpose of financing the purchase of the DeMarco shares. Of the \$10,300,000.00 received by Suburban from Royal Bank, \$2,250,000.00 was used to make the cash payment to DeMarco required by the redemption agreement. An additional \$300,000.00 was used to pay a commitment fee to Royal Bank and for legal expenses incurred in connection with the DeMarco stock redemption.

10. The Division agrees that \$7,750,000.00 of the Royal Bank proceeds was used to purchase the stock of nonsubsidiary affiliates from DeMarco and to fund a covenant not to compete. The Division also agrees that these assets constituted part of Suburban's business capital. Accordingly, the Division asserts that only \$2,550,000.00 of the Royal Bank loan proceeds are indirectly attributable to subsidiary capital and subject to indirect attribution.

11. To facilitate the stock redemption, Royal Bank was instructed to wire transfer \$6,550,000.00 directly to DeMarco on the day of the closing. Of this total, \$2,250,000.00 was for the cash payment for the Suburban stock redemption; \$4,000,000.00 was for the covenant not to compete; and the remaining \$300,000.00 was for the commitment fee and legal expenses.

12. There is no evidence that Suburban made any additional investments in its subsidiaries in 1989, the year in which the Royal Bank loan was made and the DeMarco notes were issued. Suburban's cumulative ledger for the period January 1, 1989 through December 31, 1989 shows that the beginning of the year and end of the year balances in Suburban's "Investments in Subsidiaries" account remained unchanged.

13. In the month of February 1989, i.e., the month when the DeMarco and Royal Bank transactions occurred, there was no increase in Suburban's "Advances to Subsidiaries" account.

14. The Division offered no evidence to show a change in Suburban's subsidiary capital during the years in issue.<sup>2</sup>

15. Prior to hearing, the parties executed a Stipulation of Facts. The stipulated facts deemed necessary to a resolution of this controversy have been incorporated into this determination.

### ***CONCLUSIONS OF LAW***

A. Section 209(1) of the Tax Law imposes a corporation franchise tax on every corporation doing business in New York calculated on the basis of

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<sup>2</sup>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].)

its entire net income. Generally, entire net income is the same amount reported as Federal taxable income, modified by certain additions to and subtractions from Federal taxable income, as prescribed by statute. To compute Federal taxable income, a taxpayer is allowed a deduction for interest expenses (Internal Revenue Code § 163[a]).

Tax Law § 208(9)(b) provides that:

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

As relevant, Tax Law § 208(4) defines subsidiary capital as:

"investments in the stock of subsidiaries and any indebtedness from subsidiaries . . . on which interest is not claimed and deducted by the subsidiary for purposes of taxation under articles nine-a . . . of this chapter . . . ." (Emphasis added.)

In October 1988, the Division issued a Technical Services Bureau Memorandum which expresses the Division's policy regarding the direct and indirect attribution of deductions under Article 9-A. Pursuant to that policy, the first step for calculating the correct amount of the deduction requires the taxpayer to "determine which deductions are directly traceable, whether in whole or in part, to subsidiary capital, investment capital and business capital" (Technical Services Memorandum, October 14, 1988 [TSB-M-88(5)C]). Any deductions which are not directly traceable to one of the three types of capital are treated as indirectly attributable to all three. Thus, a proportional share of a corporation's interest expense on borrowings is attributed to subsidiary capital and results in an adjustment to determine entire net income.

B. Petitioner concedes that the Division has broad discretion to deny interest expense deductions which are directly or indirectly attributable to a taxpayer's subsidiary capital. However, it argues that in order to deny the deduction, there must be at least a minimal connection between the interest expense and the taxpayer's subsidiary capital, as the latter term is defined by statute. Petitioner contends that the Division has exceeded its grant of authority in

this case where: (1) the taxpayer incurred the indebtedness for purposes which have no relationship to its subsidiary activities; (2) the loan proceeds are directly traceable to a particular transaction which has no relationship to petitioner's subsidiaries; and (3) neither the taxpayer's investments in its subsidiaries nor its indebtedness from its subsidiaries increased substantially during the periods when the loans were incurred. It takes the position that "permitting the Commissioner to expand his discretion in this direction would frustrate the statute's purpose and would be in excess of the authority granted the Commissioner in Tax Law 208(9)(b)(6)" (Petitioner's brief, pp. 13-14).

The Division asserts that it is appropriate to attribute a proportional share of the loans used to redeem the DeMarco shares to subsidiary capital. It states:

"A corporation issues stock in order to raise funds to be used in the operation of its business. These funds are used in the acquisition of various assets, including the investment in its subsidiaries. When a corporation borrows money to repurchase that stock, they are, in effect, replacing one form of financing with another. They are replacing corporate equity with corporate debt. It is for this reason that the indirect attribution portion of the interest expense for the subsidiary capital should be added back to federal taxable income in arriving at New York entire net income." (Division's brief, p. 6).

The Division also relies on its long-standing policy that each asset held by a corporation shares a portion of the cost of its borrowings (Matter of Worldwide Volkswagen, State Tax Commn., April 30, 1974).

C. The interest expenses in issue are not directly attributable to subsidiary capital. With the exception of \$300,000.00, the loan proceeds in question (see, Finding of Fact "11 ") were used to redeem the DeMarco shares of stock. The remaining \$300,000.00 was expended to facilitate that redemption. Since Suburban's stock does not constitute subsidiary capital, the loan proceeds associated with the stock redemption cannot be directly attributable to subsidiary capital.

There is no evidence in the record to support a factual conclusion that the loan proceeds in question are indirectly attributable to subsidiary capital. Petitioner points out that it never received loan proceeds as a result of its incurring indebtedness on the DeMarco notes. Also, that portion of the Royal Bank loan proceeds used to redeem Suburban's corporate stock was

wired directly to DeMarco, and so petitioner never directly received those proceeds in its accounts. The additional \$300,000.00 was paid to Royal Bank for a commitment fee and for legal fees. Since there is no evidence of any increase in Suburban's "Investment in Subsidiaries" account and no increase in Suburban's "Advances to Subsidiaries" account during the relevant period, there are no facts in the record from which it may be inferred that any of the loan proceeds are indirectly attributable to subsidiary capital.

The Division does not dispute any of petitioner's factual contentions. Rather, it takes the position that since the loan proceeds cannot be attributed directly to business capital, investment capital or subsidiary capital, they must be indirectly attributable to all three.

The Division asserts that the statements in its Technical Services memorandum must be found to be a valid interpretation of Tax Law § 208(9)(b)(6) because the memorandum explains a long-standing policy. This assertion is not supported by the legal authority cited by the Division in its brief.

In Matter of Friesch-Groningsche Hypotheekbank, (Tax Appeals Tribunal, December 28, 1990, confirmed 185 AD2d 466, 585 NYS2d 867, lv denied 80 NY2d 761, 592 NYS2d 670), the Tax Appeals Tribunal, quoting from a Division publication, described the weight to be accorded to Technical Service memorandums as follows:

"Technical Services Bureau Memoranda are statements of an informational nature issued to advise taxpayers of significant changes in the law, to disseminate the Division's interpretation of the Tax Law, and to notify the public of current audit policy and guidelines (see, Developing and Communicating Interpretations of the Tax Laws: A Report to the Governor and the Legislature Reviewing Department of Taxation and Finance Policies and Practices, March 1989, at 20). . . . [B]ecause [technical services memoranda do] not meet the statutory notice and filing requirements, [they] cannot, in and of [themselves], purport to have any definitive legally binding effect."

The Tribunal went on to state that "to the extent that the memorandum states a correct and straightforward interpretation of the governing statute" it may serve as an effective vehicle for informing the public of any change in the Division's policy (Matter of Friesch-Groningsche Hypotheekbank, supra; emphasis added). The Tribunal never suggested, as the Division urges,

that a memorandum is entitled to be considered a valid interpretation of the governing statute merely because it restates a long-standing policy.

The cases cited by the Division support petitioner's claim that in order to indirectly attribute an interest expense to subsidiary capital there must be a connection between the indebtedness and the taxpayer's investments in or indebtedness from subsidiaries, even if that connection can only be inferred from the facts and circumstances of the individual case.

The purpose of the section 208(9)(b)(6) addback provision 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."<sup>3</sup> (Matter of F.W. Woolworth Company v. State Tax Commn., 126 AD2d 876, 510 NYS2d 926, affd 71 NY2d 907, 528 NYS2d 537). In Woolworth, the Court upheld a tax assessment which was based, in part, on the Division's disallowance of a portion of the petitioner's interest expenses on long-term and short-term debt. The disallowance was calculated by the ratio of the adjusted cost of subsidiary capital to the petitioner's total assets, the same formula used here. However, the facts upon which the Court relied in sustaining the Division's assessment are distinguishable from the facts of this case.

The Court rejected the petitioner's contention that the disallowance of the interest indebtedness might be defeated by a showing that the incurrence of the indebtedness could be attributed to a bona fide business purpose. Since Tax Law § 208(9)(b)(6) speaks specifically of indirect attribution, the Court reasoned that the statute was intended to apply to situations "where the parent corporation may have had a dual purpose in borrowing and where the requisite connection between the debt and the investment in subsidiaries is only inferable from the facts and circumstances surrounding the pertinent transactions" (Matter of F.W. Woolworth Company v. State Tax Commn., supra, 510 NYS2d at 928; emphasis added). The Court concluded that "objective facts and circumstances" existed from which the Division could infer

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<sup>3</sup>Income, gains and losses from subsidiary capital are not included in the parent's calculation of entire net income (Tax Law § 208[9][a][1]).



that the petitioner's debt obligations were indirectly attributable to its investments in subsidiaries. The administrative hearing record showed evidence of a pattern of business borrowing "to meet the petitioner's foreseeable, recurrent needs for working capital" (id.). The petitioner incurred substantial long-term debt obligations merely to replace short-term debts. In 1977, the petitioner's liability per month on short-term borrowings was \$276 million. Yet, from 1967 the petitioner increased its investment in subsidiaries by approximately \$235 million in undistributed earnings from those subsidiaries. Based on those facts and circumstances, the Court found that the Division could rationally conclude that the "petitioner made a conscious decision to expand its investment in subsidiaries" through its long-term and short-term borrowings (id.).

In Matter of Unimax Corp. v. Tax Appeals Tribunal (79 NY2d 139, 581 NYS2d 135), the only issue was whether an audit guideline which provides a method for calculating the amount of the parent corporation's investment in subsidiaries is arbitrary and capricious. The guideline allows a parent corporation to offset loans to a subsidiary by loans from that subsidiary to the parent, on a subsidiary by subsidiary basis. The petitioner sought to aggregate all loans to its subsidiaries and offset them with aggregate loans from subsidiaries, thus reducing its investments in subsidiaries to less than zero. The Court upheld the reasonableness of the audit guideline stating that the subsidiary-by-subsidary approach does not contravene the language of the statute and is consistent with the legislative intent of preventing a parent company from obtaining a double tax benefit. Although Unimax might not have reaped a double tax benefit from aggregation, the Court noted that some benefit might inure to the parent in the form of tax-free income.

Thus, in both Woolworth and Unimax the Court concluded that objective facts and circumstances existed from which the Division could infer that the petitioner's debt obligations were indirectly attributable to its investments in subsidiaries.

The administrative determinations cited by the Division support petitioner's contention that no determination has gone so far as to indirectly attribute interest expenses to subsidiary

capital where no facts exist from which a connection between the debt incurred and subsidiary capital may be inferred.

In Matter of Worldwide Volkswagen (*supra*), the State Tax Commission first stated the principle relied on by the Division in this proceeding:

"[A] taxpayer's investments in the stock of and advances to subsidiaries constitute subsidiary capital pursuant to Section 208 of the tax law. A corporation acquires its assets over the years by borrowings, other forms of liabilities, sale of capital stock, earned surplus from operations, and capital surplus. Each asset held by the taxpayer bears its pro rata share of such borrowings, other liabilities and net worth. Accordingly, a proportionate part of the interest expense on borrowings is indirectly attributable to subsidiary capital to the extent of the percentage arrived at by dividing average subsidiary capital assets by average total assets." (Emphasis added.)

A literal reading of this passage would lead to the conclusion that a proportionate share of all interest expenses, even those directly attributable to business or investment capital, must be attributed to subsidiary capital. Attribution of a pro rata share of all borrowings to each type of capital would be contrary to the statute and to the Division's policy as expressed in the Technical Services memorandum (TSB-M-88[5]C). To the extent that the dicta in Worldwide Volkswagen suggests that this is a correct method of attributing interest expenses, it is wrong. Moreover, the decision in Worldwide Volkswagen does not rely on this interpretation of the statute to support its result. In Worldwide Volkswagen, the State Tax Commission found that interest expenses on certain loans incurred to acquire stock of a deceased shareholder should not have been allowed as a deduction in computing the amount of interest expense attributable to subsidiary capital. However, the Commission also found that in the years at issue the petitioner's "average cost of investments in the capital stock of the subsidiaries plus average advances to subsidiaries" increased from \$7,134,104.00 in 1968 to over \$10 million in 1971. From this and other facts, the Commission could reasonably conclude that there was a connection between the petitioner's borrowings and its increase in subsidiary capital.

Other administrative determinations relied on by the Division are inapposite or distinguishable. The Division correctly states that for many years it has used the same formula to indirectly attribute interest expense to subsidiary capital, and the cases it cites confirm that

point. But petitioner is not challenging the Division's formula. Rather, petitioner argues that the formula should not be employed because the interest expenses incurred to redeem the DeMarco shares are not subject to attribution in the first place. None of the cases cited by the Division directly address this issue (see, Matter of Condec, State Tax Commn., August 14, 1987 [where the petitioner was not allowed to offset its interest expense with a home office expense because "[t]here was no credible evidence introduced which indicated that the allocation of home office expense to subsidiaries, [sic] was based on any indebtedness between the parent and the subsidiaries"]; Matter of Usinor, State Tax Commn., April 15, 1986 [where the petitioner argued that the interest attributable to subsidiary capital should have been computed by using the actual fair market value of subsidiary capital rather than the cost or book value of stock of subsidiary capital]; Matter of Braka, State Tax Commn., July 6, 1984 [in the absence of evidence that petitioner's borrowings were directly attributable to business capital, it was reasonable to infer that a portion of the borrowings was used to acquire 100 percent of the voting stock of a subsidiary]; Matter of Sam Goody, State Tax Commn., July 6, 1984 [where the taxpayer's exclusion of income from subsidiary capital in the year the interest deduction was taken was found not to be a prerequisite to the disallowance of the interest expense deduction]; Matter of Phillip Morris, State Tax Commn., December 31, 1983 [where the Commission held that royalty income received from subsidiaries is properly treated as business receipts and not as income from subsidiary capital]; Matter of Texaco, State Tax Commn., December 22, 1971 [where the Commission held that a portion of the petitioner's interest expense was attributable to subsidiary capital because its borrowings were "used to make investments in and advances to subsidiaries"]).

The cases discussed support petitioner's contention that "the Division is permitted to indirectly attribute interest expense to subsidiary capital only where the totality of facts and circumstance support an inference that the indebtedness giving rise to the interest expense is attributable to subsidiary capital" (Petitioner's brief, p. 18).

The Division states that the courts will "not depart from the administrative interpretation of a statute unless it is clearly irrational or unreasonable." It takes the position that its policy regarding the indirect attribution of interest expense to subsidiary capital must be upheld in every case, unless the policy itself is found to be irrational. By this argument, the Division suggests that the standard of review appropriate to a court is also appropriate to the Division of Tax Appeals. This position has been soundly rejected by the Tax Appeals Tribunal, most recently in Matter of 300 East 74th Owners Corp. (Tax Appeals Tribunal, July 25, 1996). Quoting from Matter of OK Petroleum Products Corp. (Tax Appeals Tribunal, November 1, 1990) the Tribunal reaffirmed that an administrative law judge's determination is not limited to questions of whether the administrative action was arbitrary and capricious and held that "the proper standard of review to be applied by the Administrative Law Judge is a de novo review" (id.).

The question presented in this case is whether the interest expenses directly connected to the DeMarco stock redemption may be indirectly attributed to subsidiary capital. The facts adduced at hearing show that the loan proceeds in question may be directly traced to one particular transaction, the redemption of the DeMarco stock. There are no facts from which it may be inferred that petitioner's borrowings are connected to subsidiary capital. Therefore, under the unique facts and circumstances of this case, application of the policy stated in the Division's Technical Services memorandum is contrary to the language and intent of Tax Law § 208(9)(b)(6).

D. Petitioner concedes that for the year ended December 31, 1990, its entire net income must be adjusted by an addback of interest expense in the amount of \$16,464.48 (see, Finding of Fact "5" and footnote "1").

E. The petition of Suburban Carting Corporation is granted except with respect to the adjustment conceded in Conclusion of Law "D", and the Notice of Deficiency dated August 9, 1993 will be modified accordingly.

DATED: Troy, New York  
January 9, 1997

/s/ Jean Corigliano  
ADMINISTRATIVE LAW JUDGE