STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	DETERMINATION
SCHLUMBERGER LIMITED	:	DTA NO. 816620
for Redetermination of Deficiencies or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1983 and 1985 through 1992.	:	

Petitioner, Schlumberger Limited, 227 Park Avenue, New York, New York 10017, filed a petition for redetermination of deficiencies or for refund of corporation franchise tax under Article 9-A of the Tax Law for the years 1983 and 1985 through 1992.

A hearing was held before Thomas C. Sacca, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on May 10, 1999 at 9:30 A.M., with all briefs to be submitted by October 18, 1999, which date began the six-month period for the issuance of this determination. Petitioner appeared by Arthur Andersen LLP (Kenneth T. Zemsky, Esq., and Michael H. Goldsmith, Esq., of counsel). The Division of Taxation appeared by Terrence M. Boyle, Esq. (Dennis A. Fordham, Esq., of counsel).

ISSUES

I. Whether petitioner, an alien corporation, is required to add back to its Federal taxable net income all foreign source income otherwise not part of its Federal tax base.

II. Whether petitioner has established that its substantial understatement of the amount of tax was due to reasonable cause and the absence of wilful neglect such that the penalties imposed may be abated.

FINDINGS OF FACT

1. On October 30, 1996, the Division of Taxation ("Division") issued to petitioner, Schlumberger Limited, the following notices of deficiency pursuant to Article 9-A of the Tax Law:

Period Ended	Assessment No.	Tax Deficiency	Balance Due
December 31, 1985	C961030701F	$19,306.00	$0.00
December 31, 1987	C961030702F	$76,984.00	$90,132.00
November 23, 1988	C961030703F	$90,744.00	$188,553.00
December 31, 1989	C961030704F	$ 5,805.00	$10,895.00
December 31, 1991	C961030705F	$27,477.00	$42,389.00
December 31, 1992	C961030706F	$435,943.00	$626,580.00

Interest and penalty (Tax Law § 1085[k]) for the substantial understatement of income were imposed for all years. The Division determined that petitioner was entitled to refunds for 1983, 1986 and 1990. These refunds were credited against the years 1985 and 1987 in determining the balance due for those periods.

On October 30, 1996, the Division issued to petitioner the following notices of deficiency representing the amount of temporary metropolitan transportation business tax surcharge pursuant to Tax Law § 209-B ("MTA") determined to be due on audit:

Period Ended	Assessment No.	Tax Deficiency	Balance Due
December 31, 1985	C961030707S	$3,282.00	$0.00
December 31, 1986	C961030708S	($1,381.00)	$0.00
December 31, 1987	C961030709S	$13,087.00	$18,151.00
November 23, 1988	C961030709S	$15,427.00	$30,513.00
December 31, 1989	C9610307010S	$987.00	$1,754.00

December 31, 1991	C9610307011S	$4,062.00	$5,860.00
December 31, 1992	C9610307012S	$64,444.00	$92,625.00

Interest was imposed for all periods under review and penalty was imposed for the years 1985, 1986 and 1992. The Division determined that petitioner was entitled to MTA refunds for the years 1983 and 1990. These refunds were credited against the years 1985, 1986 and 1987 in determining the MTA balance due for those years.

2. Between August 17, 1994 and July 29, 1996, petitioner executed eight consents extending period of limitation for assessment of corporation franchise tax under Article 9-A of the Tax Law which cumulatively had the effect of extending the date for determining the amount of additional tax due for the period January 1, 1985 through December 31, 1992 to October 31, 1996.

3. Petitioner, Schlumberger Limited, is incorporated under the laws of the Netherlands Antilles. The corporation is engaged in a worldwide business involving oil exploration and related products and services. It has dual global headquarters located in Paris and New York City.

4. On April 28, 1997, the Division issued to petitioner a Notice of Deficiency which summarized the notices of deficiency previously issued. The notice indicated that for the tax years 1985 through 1992, tax in the amount of $656,812.00, plus penalty and interest, was being assessed against petitioner.

5. The audit of Schlumberger Limited originally involved the tax years 1985 through 1990. Tax years 1991 and 1992 were later included on what the Division characterized as a "limited scope basis" because the last consent extending the period of assessment was to expire on October 31, 1996 and petitioner was not willing to grant a further extension. For the later two

years, adjustments were made by the auditor based solely upon a review of petitioner's tax returns, without review of any source documentation. The auditor discovered the following errors or made the following adjustments for the entire audit period:

- in computing its business allocation percentage ("BAP"), petitioner failed to correctly compute the average values of the property factor.
- in computing petitioner's BAP, management fees were considered to be nonallocable, so an adjustment was made to exclude said fees from the receipts factor.
- petitioner failed to correctly compute the wage factor percentages for the years under audit. Using petitioner's Employer Quarterly Federal Tax Returns (Form 941), the auditor recomputed the percentages.
- during the course of the audit, it was determined that Federal audits had been completed for the tax years 1984 through 1989. Petitioner filed the appropriate Federal changes made by the IRS to corporate taxable income (Form CT-3360) with the Division, and the auditor made adjustments pursuant to the Revenue Agent's Reports ("RAR's).
- the net operating loss deductions for the years at issue were computed on a world-wide basis.
- deductions indirectly attributable to subsidiary capital were computed by the auditor.
- penalty was imposed pursuant to Tax Law § 1085(k) for the substantial understatement of tax.

6. Following a Bureau of Conciliation and Mediation Services ("BCMS") conference held on September 17, 1997, the amount of tax due was reduced to $63,793.00. The reduction in the tax amount due was based upon three main areas of adjustment: (1) an increase from

$16,404,430.00 to $42,793,866.00 in the net operating loss deduction that was carried back from the year 1986 to the year 1983; (2) for the tax year 1992, the elimination of $8,742,000.00 as an adjustment to the entire net income base because it was previously reported by petitioner; and (3) for the tax year 1992, the elimination of an adjustment to the entire net income base in the amount of $4,059,687.00 for expenses indirectly attributable to subsidiary capital. The audit adjustments that result in the current tax deficiency of $63,793.00 include the Federal audit adjustments contained in the RAR's, the add-back of foreign taxes paid but not added back in computing New York gross income and deductions attributable to subsidiary capital. Petitioner conceded at hearing that if it was not successful on the issue involving the add-back of foreign source income, it was liable for the tax due in the amount of $63,793.00 as determined following the BCMS conference.

7. The years for which penalties remain assessed for the substantial understatement of tax are 1987, 1989 and 1992. For each of these years, the total understatement is comprised of the following adjustments:

ADJUSTMENTS	**1987**	**1989**	**1992**
RAR add-backs	$10,567,412.00	$3,027,000.00	$0.00
Subsidiary capital expense	$0.00	$3,139,028.00	$4,059,640.00
NOL deduction	$0.00	$0.00	$1,533,446.00
Other not effectively connected income	$0.00	$0.00	$3,910,680.00
Provision for foreign taxes paid	$0.00	$0.00	$0.00
TOTALS	$10,567,412.00	$6,166,028.00	$9,503,766.00

It is noted that the "provision for foreign taxes paid" is only relevant to the years 1985 and 1986. Furthermore, the category "other not effectively connected income" is an adjustment based on Schedule M-1 of petitioner's U.S. Income Tax Return of a Foreign Corporation (Form 1120F) which is not the same as the add-back category "provision for foreign taxes paid" which concerns the add-back issue involved herein.

8. According to Mr. Kevin Ward, petitioner's manager of state taxes, the cause of the improper reporting of foreign taxes paid to New York State was communication problems between his office and the overseas operations as to whether the income figures provided from the overseas operations were pre-tax or after-tax numbers. In those situations where the figure was after-tax, the add-back of foreign income was insufficient.

The problem of obtaining the correct overseas foreign source income figure to properly complete its New York State General Business Corporation Franchise Tax Return (Form CT-3) has been with petitioner since the early 1960s, when the corporation began doing business in New York. Mr. Ward has been employed by petitioner since 1980, so he has been aware of this problem since that date. Mr. Ward had thought that the problem of obtaining the pre-tax foreign source income figures had been corrected in 1985 following an audit of the year 1982. It was during this previous audit that the problem of obtaining the correct overseas figures was initially revealed. During his early years with petitioner, Mr. Ward requested of the overseas operations that they supply him with pre-tax income. This was the only time that such a request was made.

Another cause cited by petitioner of difficulty in obtaining the correct pre-tax figures from the overseas operations was the change in controllers in the foreign regions, and their ignorance of the specific reporting requirements of New York State tax law. It was the policy of the corporation to rotate controllers through the foreign operations every two or three years. Despite

this change in controllers, the New York office did not repeat its request that pre-tax income figures be provided.

9. Petitioner contends that if it should be successful on the issue involving the add-back of foreign source income, it would be entitled to a refund in the amount of $816,188.00. Petitioner and its current representatives developed the theory that foreign source income is not included in New York State income in 1998. According to petitioner, the refund was calculated using the audit workpapers, the RAR adjustments for the years 1985 through 1989, petitioner's Federal and State income tax returns and a Closing Agreement On Final Determination (Form 906) with the Internal Revenue Service. The closing agreement related to the amount of gross income earned by petitioner from the performance of wireline services in the United States outer continental shelf area which was to be included in its gross income.

10. Petitioner was previously audited for the years 1981 through 1984. As with the current audit, the Division adjusted petitioner's franchise tax by adding back the payment of foreign taxes which had been deducted in computing Federal taxable income.

CONCLUSIONS OF LAW

A. Petitioner's refund claim as contained in its petition is based on the position that paragraph (c) of Tax Law § 208(9) does not require it to add back foreign source income that was not part of its Federal taxable income. According to petitioner, a literal reading of Tax Law § 208(9) supports its position. The foreign source income at issue is not included in the starting point in determining entire net income, since it is not included in Federal taxable income. The major modification provisions of Tax Law § 208(9)(a) and the add-back provisions of Tax Law § 208(9)(b), make no mention of this type of income.

Tax Law § 208(9)(c) provides that "entire net income shall include income within and without the United States." Petitioner's refund claim directly challenges the Division's regulatory interpretation, 20 NYCRR 3-2.3(a)(9), of the statutory definition of entire net income as contained in Tax Law § 208(9). Regulation section 3-2.3(a)(9) provides that:

> [i]n computing entire net income, Federal taxable income must be adjusted by adding to it . . . [,] in the case of a taxpayer organized outside of the United States, all income from sources within and without the United States less all allowable deductions thereto, which were not taken into account in computing Federal taxable income.

B. Petitioner cites to ***Matter of Allen v. Commissioner of Taxation and Finance*** (Sup Ct, Albany County, Dec. 8, 1988, Kahn, J.) for the proposition that because the matter at issue involves the meaning of a taxing provision, doubt is to be construed in petitioner's favor. Thus, according to petitioner, the burden of proof rests with petitioner to show doubt as to the statutory meaning of the taxing provision involved herein.

Unfortunately, petitioner's reliance upon ***Allen*** is misplaced. In ***Allen***, the statutory construction issue involved was a challenge to a statutory interpretation being advanced in the Division's brief, not a challenge to a promulgated regulation as is involved in the present matter. As a properly promulgated regulation, section 3-2.3(a)(9) has the force and effect of law (***Molina v. Games Mgt. Services***, 58 NY2d 523, 452 NYS2d 615). Moreover, a regulation must be upheld if it has a rational basis and is not unreasonable, arbitrary or capricious (***Matter of Great Lakes-Dunbar-Rochester v. State Tax Commn.***, 65 NY2d 339, 491 NYS2d 605). The challenger of a regulation must establish that the regulation "is so lacking in reason for its promulgation that it is essentially arbitrary" (***Matter of Marburg v. Cole***, 286 NY 202). The interpretation given a statute by the administering agency "if not irrational or unreasonable, should be upheld" ***(Matter of Howard v. Wyman***, 28 NY2d 434, 322 NYS2d 683). As was

observed in ***Mississippi Val. Barge Co. v. United States*** (292 US 282), "[t]he judicial function is exhausted when there is found to be a rational basis for the conclusions approved by the administrative body" (***Ostrek v. Schenck***, 41 NY2d 784, 396 NYS2d 335). To prevail over the administrative construction, petitioner must establish not only that its interpretation of the law is a plausible one, but also that its interpretation is the only reasonable construction (***see, Matter of Blue Spruce Farms v. New York State Tax Commn.***, 99AD2d 867, 472 NYS2d 744***, affd*** 64 NY2d 682, 485 NYS2d 526; ***Matter of Lakeland Farms Co. v. State Tax Commn.***, 40 AD2d 15, 336 NYS2d 972).

C. It is a fundamental rule of statutory construction that a statute is to be construed as a whole, and that all parts of an act are to be read and construed together to determine the legislative intent (McKinney's Cons Laws of NY, Book 1, Statutes, § 97). Tax Law § 208(9) provides, in pertinent part, as follows:

> [t]he term "entire net income" means total net income from all sources, which shall be presumably the same as the entire taxable income . . . (i) which the taxpayer is required to report to the United States treasury department, . . ., except as hereinafter provided, and subject to any modification required by paragraphs (d) and (e) of subdivision three of section two hundred ten of this article.

Pursuant to the language of Tax Law § 208(9), Federal taxable income is to used as a starting point in computing entire net income and is then to be modified by other provisions within the section. Pursuant to the statute, Federal taxable income is modified by paragraphs (a), (b), (g) and (m) of Tax Law § 208(9). The issue in this matter concerns Tax Law § 208(9)(c), and whether it is a further modification of Federal taxable income requiring alien corporations to add back all of their foreign source income.

As there is no indication in the statute to the contrary, Tax Law § 208(9)(c) is to be read on equal status with the other paragraphs of section 208(9). Absent any statutory words of

limitation, it is appropriate to assume that section 208(9)(c) is a further modification provision. It therefore must be determined whether it is rational to read section 208(9)(c) as an add-back provision in the overall context of Tax Law § 208(9).

D. It is a general rule in the interpretation of statutes that the legislative intent is primarily to be determined from the language used in the statute, considering the language in its most natural and obvious sense. That is, where statutory language is clear and unambiguous it should be construed to give effect to the clear meaning of the words used (***Patrolmen's Benevolent Assn. v. City of New York***, 41 NY2d 205, 391 NYS2d 544; McKinney's Cons Laws of NY, Book 1, Statutes, § 94). Tax Law § 208(9)(c) states that "[e]ntire net income shall include income within and without the United States . . . ." The plain and ordinary meaning of section 208(9)(c) indicates that it is clear that the Legislature intended that all corporations, alien and domestic, include entire worldwide income within the definition of entire net income, which begins with Federal taxable net income. Since domestic corporations already include all foreign source income within their Federal entire net income, the sole effect of section 208(9)(c) is that alien corporations, like domestic corporations, are also to be taxed on their entire worldwide income, including all foreign source income not included in the Federal tax base. Thus, paragraph (c) is properly superimposed over the introduction to section 208(9), requiring the add-back of all foreign source income not part of the Federal taxable income base for alien corporations only. Therefore, 20 NYCRR 3-2.3(a), which requires alien corporations to add back all of their foreign source income, is an appropriate and reasonable interpretation of the ordinary and plain meaning of the words of Tax Law § 208(9)(c), and is properly upheld.

E. The basis for maintaining the add-back of foreign source income of alien corporations separate from the general add-backs to Federal taxable income for domestic corporations can be

found in former Article 9-A. The two relevant sections within former Article 9-A were section 208, the definition section, and section 209, the franchise tax imposition section. Tax Law former § 208 did not, in contrast to present section 208, define the Article 9-A tax base, and the language requiring the add-back of foreign source income for alien corporations was an exception within the general franchise tax imposition of former section 209.

Former Article 9-A was enacted in 1917 (L 1917, ch 726). Former section 209 made the tax base the "net income . . . upon which income such corporation was required to pay a tax to the United States." In 1918, Tax Law former § 209 was amended to provide that net income was "presumably the same as the net income upon which such corporation is required to pay a tax to the United States" (L 1918, ch 276). In the following year, former section 209 was again amended to change the imposition from "net income" to "entire net income." Although the entire net income base has been in effect since 1919, it did not include an alien corporation's foreign source income that was outside the Federal tax base.

By amendment to Tax Law former § 209, alien corporations were first taxed on their worldwide income, and not just on their entire net income as reported to the U.S. Treasury for Federal taxation purposes. The amendment to former section 209 to tax alien corporations was an exception to the general rule, that corporations were taxed on their Federal income. The amendment was accomplished by adding the following language to the end of former section 209:

> except that the entire net income of a corporation not organized under the laws of any state within the United States which shall be taken as the basis of computation by the tax commission shall be the entire net income in fact rather than the amount earned in the United States or the amount returned to the United States treasury department (L 1920, ch 640).

Since 1920, a general rule has been applied to domestic U.S. corporations and an exception rule has been applied to alien corporations.

It was not until 1931 that the add-backs found in current section 208(9)(b) appeared in Article 9-A. In that year, the precursor to the current Tax Law § 208(9)(b) became part of the Tax Law, by amendment to section 208. It is noted that when these principal add-backs were added, they were separately codified in former section 208, away from the special exception in former section 209 requiring alien corporations to add back foreign source income not part of the Federal tax base. 20 NYCRR 3-2.3(a)(9) is based on the special alien corporation add-back rule, which requires the add-back of all income from within and without the United States, as set forth in section 208(9)(c), which is separate from the general add-back provisions of section 208(9)(b).

F. The impetus behind the repeal of former Article 9-A and the enactment of current Article 9-A were the recommendations contained in a Report to Governor Dewey, dated November 12, 1943, submitted by the State Tax Commission (***see***, Governor's Bill Jacket, L 1944, ch 415). In the report, Roland Brown, Commissioner of the Department of Taxation and Finance and President of the State Tax Commission, informed Governor Dewey of the results of the survey by the State Tax Commission and the Advisory Group relating to the provisions of former Article 9-A. The specific and fundamental areas of change recommended by the Report were as follows:

> 1 - Eliminate the present "arbitrary" division of business corporations, investment trusts and holding corporations into three separate classifications, and subject them to one flexible tax designed to accord different treatment to each type of income and capital.
>
> 2 - Substitute for the State's present "unique" formula for allocating business income within and outside the State, a formula more in line with those used by other states, thereby achieving greater uniformity of treatment of corporations engaged in business in several states.

> 3 - Place corporation franchise taxation in New York State on a current basis. Under the present law, the tax is paid for a future privilege year but based on new income or capital of the preceding year.

The fundamental changes cited above do not include eliminating the Tax Law § 209 provision requiring alien corporations to include such income in their entire net income from sources within and without the United States. Furthermore, nowhere in the report or the Governor's Bill Jacket is there any recommendation that alien corporations not be taxed on their entire worldwide income. Such a change in the structure of Article 9-A would have at least been mentioned in the report had it been intended to repeal the add-back to entire net income of foreign source income by alien corporations.

There is also no evidence in the Bill Jacket that the Legislature on its own, and without the recommendation of the report, intended to give alien corporations a tax benefit by no longer taxing their entire worldwide entire net income. The Memorandum in the Bill Jacket accompanying the legislation provides ten "more important" variations in the bill from the report (***see***, ***id.*** at pp.11-14). There is no mention in these variations of the elimination of the provision to tax alien corporations on their worldwide entire net income. The Memorandum also mentions certain minor variations in the bill from the report, none of which concern the elimination of the relevant provision concerning alien corporations. Thus, nowhere in the Bill Jacket is there any support for petitioner's position that the Legislature decided to provide alien corporations with more favorable tax treatment than domestic U.S. corporations.

Further support for the Division's position can be found in the second edition of the New York State Income and Franchise Taxes treatise by Benjamin Harrow, a participant in the report. The treatise states that the new Article 9-A requires alien corporations to add back all foreign

source income to their Federal taxable income. Part 526 of the treatise, which deals specifically with Tax Law § 208(9)(c), states that:

> [t]he alien corporation may be subject to the franchise tax if it is doing business in New York State, in which case all of its income both within and outside the United States will be taken into account in determining the tax based upon entire net income.

G. A long continued course of action by a state or local administrative officer is entitled to great weight (McKinney's Cons Laws of NY, Book 1, Statutes, § 129; ***Matter of Howard Johnson Co. v. State Tax Commn.***, 105 AD2d 948, 481 NYS2d 909). Alien corporations have been required to add back all foreign source income under the current statutory scheme since the enactment of the new Article 9-A in 1944. The regulations adopted in 1945 pursuant to the new Article 9-A also require the add-back of all foreign source income by alien corporations. An interpretation given a statute by the agency charged with its enforcement is, as a general matter, given weight and judicial deference, so long as the interpretation is neither irrational, unreasonable nor inconsistent with the governing statute (***Matter of Trump-Equitable Fifth Avenue Co. v. Gliedman***, 62 NY2d 459, 478 NYS2d 846). The Legislature's failure to modify this long-standing administrative policy, by amending the statute, is significant. The legislative inaction in the face of this clear and long-standing administrative policy strongly suggests that the policy is in accord with the Legislature's intent in enacting Tax Law § 208(9)(c).

H. Although not directly on point, the New York State Court of Appeals, in ***Matter of Reuters Limited v. Tax Appeals Tribunal*** (82 NY2d 112, 603 NYS 2d 795), upheld the Division's application of its apportionment formula to the worldwide net income of a single multi-jurisdictional business enterprise, which was operating internationally, as not being in violation of the United States-United Kingdom Tax Treaty or the Foreign Commerce Clause (US

Const, art I, § 8). ***Reuters Limited*** was organized in the United Kingdom, was operating in approximately 80 countries and maintained a branch office in New York City. The corporation computed its corporate franchise taxes for the years at issue on the basis of United States income only. Following an audit, the Division issued notices of deficiency based upon the use of the worldwide net income apportionment method. The Court described the computation of the New York corporate franchise tax as follows:

> [w]hen computing the corporate franchise tax of a multi-jurisdictional international entity doing business in New York, an apportionment formula is used to determine the aliquot share of the corporation's worldwide net income attributable to New York. The first step is to calculate a "business allocation percentage," which is ascertained by comparing the value which the corporation's real and tangible personal property within New York bears to the worldwide value of the same factors (Tax Law § 210[3][a][1]). The corporation's worldwide business income is then multiplied by the business allocation percentage to arrive at the entire net income base, i.e., the portion of the taxpayer's entire net income allocable to and taxable by New York (***id.***, § 210[3][a]; [1][a]). New York's corporate franchise tax is computed at the rate of 9% of the taxpayer's entire net income base (***id.***, § 210[1][a]).

While the argument being advanced by petitioner was not decided in ***Reuters Limited***, the Court of Appeals decision upholding New York State's taxation of alien corporations on a worldwide basis assumed that 20 NYCRR 3-2.3(a)(9) is valid.

I. Petitioner's claim that entire net income is defined by the preamble to section 208(9) as modified only by the add-back and subtraction provisions of Tax Law § 208(9)(a) and (b) is unsupported by the statute itself. The preamble to section 208(9) does not so limit the modification provisions to paragraphs (a) and (b), as petitioner argues. The language which controls in this matter appears at the end of the preamble and provides the authority to modify Federal taxable income to arrive at entire net income. This language does not limit the modifications to paragraphs (a) and (b), but instead more expansively states: "except as

hereinafter provided . . . ." Nothing in the preamble confers exclusive status, as suggested by petitioner, to paragraphs (a) and (b). Instead, the above-cited language authorizes other modifications to entire net income besides those appearing in paragraphs (a) and (b), such as the modifications contained in paragraphs (c), (g) and (m).

Paragraph (g) of section 208(9) contains a subtraction provision modifying the definition of entire net income, unique to industrial waste treatment facilities or air pollution control facilities. Paragraph (m) of section 208(9) contains an add-back provision unique to emerging technology companies. These two provisions provide add-back and subtraction modifications, separate and apart from paragraphs (a) and (b), for unique classes of taxpayers. They, like paragraph (c), which is applicable to alien corporations, are consistent with the preamble to section 208(9) allowing for other modifications to entire net income.

J. Tax Law § 208(9) was amended in 1994 to exclude certain foreign source income for foreign air carriers (Tax Law § 208[9][c-1]). The 1994 amendments are in *pari materia* with respect to the previous code provisions and are thus useful in determining the original legislative intent (***Nelson v. Hanna***, 67 AD 2d 820, 413 NYS2d 62; ***Rozler v. Franger***, 61 AD2d 46, 401 NYS2d 623, ***affd*** 46 NY2d 760, 413 NYS2d 654; McKinney's Cons Laws of NY, Book 1, Statutes § 223).

Section 208(9)(c-1) exists in direct relation to section 208(9)(c). Section 208(9)(c-1) provides certain foreign air carriers an exclusion from the definition of entire net income with respect to "(ii) income without the United States which is derived from the operation of aircraft . . . ." The purpose of section 208(9)(c-1) is to prevent the add-back into entire net income of foreign source income that is not part of Federal taxable income, as would be required

by section 208(9)(c). The new section would not have been necessary if section 208(9)(c) did not require the add-back by alien corporations of all their foreign source income.

K. Tax Law § 1085(k), relating to the penalty for substantial understatement of liability, provides, in relevant part, as follows:

> [i]f there is a substantial understatement of tax for any taxable year, there shall be added to the tax an amount equal to ten percent of the amount of any underpayment attributable to such underpayment. For purposes of this subsection, there is a substantial understatement of tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of ten percent of the tax required to be shown on the return for the taxable year or five thousand dollars. . . . The tax commission may waive all or any part of the addition to tax provided by this section on a showing by the taxpayer that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith.

The substantial understatement penalty of 10% of the amount of any underpayment is imposed where a taxpayer understates on its franchise tax return the amount of tax due. The substantial understatement penalty is imposed upon an individual yearly basis. In the present matter, the substantial understatement penalty was imposed for the years 1987, 1989 and 1992.

L. In its brief, petitioner claims that the substantial understatement penalty for the tax years 1987, 1989 and 1992 is related to the inability of petitioner to obtain the correct information relating to foreign source income from its overseas operations. Petitioner also maintains that it should not be subject to the substantial understatement penalty because it had substantial authority for its position and reasonable cause existed for the understatement of the tax due and it acted in good faith.

In response to the foregoing, the Division asserts that petitioner has not shown that it relied on substantial authority in understating its tax liability. The Division also maintains that petitioner has not shown that it acted with reasonable cause or in good faith.

M. Tax Law § 1085(k) provides that the amount of the understatement is to be reduced by the portion of the understatement which is attributable to the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment. The term "substantial authority" is not defined in the statute or regulations pertaining to corporation franchise tax. However, Tax Law § 1085(k) is substantially the same as Internal Revenue Code § 6662. Therefore, it is appropriate to refer to the corresponding Federal regulations and case law (***see, Matter of Levin v. Gallman***, 42 NY 32, 396 NYS 623). The Treasury Regulations define "substantial authority," in pertinent part, in Treasury Regulation § 1.6662-4(d) as follows:

> (2) *Substantial authority standard*. The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. The substantial authority standard is less stringent than the 'more likely than not' standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard (the standard, which if satisfied, generally will prevent imposition of the penalty under section 6662(b)(1) for negligence). A return position that is arguable, but fairly unlikely to prevail in court, satisfies the reasonable basis standard, but not the substantial authority standard. The possibility that a return will not be audited or, if audited, that an item will not be raised on audit, is not relevant in determining whether the substantial authority standard (or the reasonable basis standard) is satisfied.
>
> (3) *Determination of whether substantial authority is present --(i) Evaluation of authorities*. There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists. The weight of authorities is determined in light of pertinent facts and circumstances in the manner prescribed by paragraph (d)(3)(ii) of this section. There may be substantial authority for more than one position with respect to the same item. Because the substantial authority standard is an objective standard, the taxpayer's belief that there is substantial authority for the tax treatment for an item is not relevant in determining whether there is substantial authority for that treatment.

> (ii) *Nature of analysis*. The weight accorded an authority depends on its relevance and persuasiveness and the type of document providing the authority. For example, a case or revenue ruling having some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts, or is inapplicable to the tax treatment at issue. . . .
>
> (4)(iv)(C) *When substantial authority is determined*. There is substantial authority for the tax treatment of an item if there is substantial authority at the time the return containing the item is filed or there was substantial authority on the last day of the taxable year to which the return relates.

Evaluated by the foregoing standard, petitioner has not established that it had substantial authority for substantially understating the amount of tax for the three years in which penalty was assessed. Petitioner's theory that foreign source income is not properly included in New York State income was developed in 1998, which is well after the time that the returns for the years 1987, 1989 and 1992 were due (Treas Reg § 1.6662-4[d]).

N. The Franchise Tax on Business Corporations regulation (20 NYCRR former 46.1[f][2]) dealing with the penalty for the substantial understatement of the amount of tax due and the application of reasonable cause for the abatement of such penalties is as follows:

> (2) In determining whether reasonable cause and good faith exist, the most important factor to be considered is the extent of the taxpayer's efforts to ascertain the proper tax liability. In addition to any relevant grounds for reasonable cause as exemplified in subdivision (d) of this section, circumstances that indicate reasonable cause and good faith with respect to the substantial understatement of tax, where clearly established by or on behalf of the taxpayer, may include the following:
>
> (i) an honest misunderstanding of fact or law that is reasonable in light of the experience, knowledge and education of the taxpayer;
> (ii) a computational or transcriptional error;
> (iii) the reliance by the taxpayer on any written information, professional advice or other facts, provided such reliance was reasonable and the taxpayer had no knowledge of circumstances which should have put the taxpayer on inquiry as to whether such facts were erroneous (20 NYCRR former 46.1[f][2]).

The chief reason offered by petitioner for abatement of penalties is that it has a viable argument as to whether foreign source income is properly added back in determining New York income. However, 20 NYCRR former 46, which set forth the definition of reasonable cause, required that reasonable cause be shown on the date when the tax returns were due to be filed. The facts presented in this case demonstrate that the issue of whether to add back foreign source income was never a reason for the understatement of petitioner's tax liability. The foreign source income theory was never even raised as a viable argument until after the conciliation conference, long after the returns were due. Later, long after the fact, petitioner arrived at some viable arguments, but there is no evidence that these reasons were the cause of the understatement of income.

O. As indicated in Finding of Fact "7", the understatements of income during the penalty years 1987, 1989 and 1992 are not attributable to the adjustment for the add-back of foreign source income. Petitioner's explanation that it was not receiving the correct figure from its overseas operations and was therefore improperly reporting New York income does not explain the underreporting for the penalty years and cannot constitute reasonable cause. In addition, even had the underreporting of income been attributable to the add-back of foreign source income, the minimal effort made by petitioner over the years to obtain the correct figures after this problem had been identified on a previous audit would negate a finding of reasonable cause. Petitioner was put on notice that the add-back of foreign source income was not being reported correctly during the previous audit and, coupled with the frequent turnover of overseas controllers, should have alerted petitioner to the need to specifically request pre-tax income from its foreign operations more frequently than once over a 19-year period. This lack of effort in requesting the correct figures from the overseas operations causes petitioner's argument to fail under the Division's regulations concerning reasonable cause in which it is provided that in determining

whether reasonable cause and good faith exist, the most important factor to be considered is the extent of the taxpayer's efforts to ascertain the proper tax liability (20 NYCRR former 46[f][2]). Therefore, it is determined that petitioner has failed to show reasonable cause for the abatement of the penalties imposed (***Matter of Dominion Textile [USA],*** Tax Appeals Tribunal, April 10, 1997).

P. The petition of Schlumberger Limited is denied and the notices of deficiency dated October 30, 1996, as modified following the Bureau of Conciliation and Mediation Services conference, are sustained in full.

DATED: Troy, New York
April 13, 2000

/s/ Thomas C. Sacca
ADMINISTRATIVE LAW JUDGE