STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
EMIGRANT BANCORP, INC.	:	DETERMINATION DTA NO. 820059
for Redetermination of a Deficiency or for Refund of Franchise Tax on Banking Corporations under Article 32 of the Tax Law for the Years 1998 and 1999.	: :	

Petitioner, Emigrant Bancorp, Inc., 5 East 42nd Street, New York, New York 10017, filed a petition for redetermination of a deficiency or for refund of franchise tax on banking corporations under Article 32 of the Tax Law for the years 1998 and 1999.

A hearing was held before Brian L. Friedman, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on April 21, 2005 at 10:30 A.M., with all briefs to be submitted by September 30, 2005, which date began the six-month period for the issuance of this determination. Petitioner appeared by Thatcher Proffitt & Wood, LLP (Patrick J. Boyle and Jonathan D. Forstot, Esqs., of counsel) The Division of Taxation appeared by Christopher C. O'Brien, Esq. (Nicholas A. Behuniak, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation properly computed the balance of the reserve for losses on qualifying real property loans maintained by a wholly-owned subsidiary of petitioner as of December 31, 1995, thereby resulting in a modification to petitioner's taxable income and a resulting tax deficiency for the years at issue.

II. Whether a Consent to Field Audit Adjustment signed by the controller of petitioner, wherein petitioner purportedly agreed to reserve balances for years 1991 through 1995, renders moot the matter at issue.

FINDINGS OF FACT

In its brief submitted on August 22, 2005, the Division of Taxation ("Division") submitted 7 proposed findings of fact, each of which has been substantially incorporated into the following Findings of Fact except for proposed finding of fact 7 which is irrelevant to this proceeding.

1. Emigrant Bancorp, Inc. ("petitioner") is a banking corporation which files New York State franchise tax returns under Article 32 of the Tax Law on a combined basis with its wholly owned subsidiary, Emigrant Savings Bank (the "Bank") and with other first-tier and lower-tier subsidiaries.

2. The Bank is a "thrift institution" within the meaning of Tax Law § 1453(h). As such, the Bank is required to maintain reserves including a reserve for losses on qualifying real property loans (Tax Law § 1453[h][6][A]) and is allowed a deduction in computing entire net income for the amount of a reasonable addition to its reserve for bad debts (Tax Law § 1453[h][3]).

3. In July 2001, the Division commenced an audit of petitioner. On October 30, 2001, April 29, 2002 and September 29, 2002, petitioner, by its Senior Vice President and Controller, Francis R. May, executed a series of consents extending the period of limitation for assessment of corporation franchise tax under Article 32 of the Tax Law whereby the amount of tax due for the year 1998 could be determined or assessed at any time on or before June 30, 2003.[1]

[1] The consents also extended the period of limitation for assessment of tax due for the year 1997 as well; however, the issues pertaining to the year 1997 are not the subject of this proceeding.

4. Pursuant to the audit, the Division, on March 17, 2003, issued a Notice of Deficiency to petitioner which asserted total tax due in the amount of $3,428,474.00, plus interest of $779,896.55, less payments or credits of $279,856.00, for a total amount due of $3,928,514.55 for the years 1998 and 1999. The tax due consisted of $779,166.00 in franchise tax on banking corporations pursuant to Tax Law § 1451(a) and $132,458.00 in temporary metropolitan transportation business tax surcharge ("MTBTS") pursuant to Tax Law § 1455-B for the year 1998 and $2,151,154.00 in franchise tax and $365,696.00 in MTBTS for the year 1999.

5. The basis for the issuance of the Notice of Deficiency was the determination by the Division that petitioner incorrectly computed the amount allowable as a deduction pursuant to Tax Law § 1453(h)(3) in computing its entire net income. The Division determined that petitioner overreported its allowable deduction under Tax Law § 1453(h)(3) which resulted in the deficiencies of tax asserted in the Notice of Deficiency.

6. Based upon an adjustment which related to section 481 of the Internal Revenue Code ("IRC"), the Division, on or about April 7, 2005, provided amended schedules[2] to petitioner which reflected an amended amount of tax due of $2,372,754.00 rather than the amount of $3,428,474.00 as asserted in the Notice of Deficiency.

At the hearing, the Division introduced further amended schedules dated April 19, 2005 (Division of Taxation's Exhibit "J") which on page 4 thereof reflect a "charge off" of $1,826,216.00 for 1999 rather than $2,336,522.00 as indicated in the amended schedules provided on April 7, 2005. Petitioner's representatives indicated that they would indicate, in writing, if they agreed with this latest adjustment which would increase total tax due from

[2] These schedules are contained in petitioner's hearing memorandum (Division of Taxation's Exhibit "G" as Exhibit "11" therein).

$2,372.754.00 (as provided in the amended schedules of April 7, 2005) to $2,423,246.00. In footnote "1" of petitioner's brief submitted June 27, 2005, petitioners agreed with the April 19, 2005 schedules and accordingly, the total amount of tax at issue in this proceeding is $2,423,246.00, plus interest.

At the hearing, it was agreed by the parties that if the Division prevails in this proceeding, the amount of tax due from petitioner will be the revised amount, i.e., $2,423,246.00, plus interest, and if petitioner prevails in this proceeding, there shall be no tax deficiency for the audit period.

7. At the hearing, the Division introduced into evidence a Consent to Field Audit Adjustment dated September 4, 2001. In addition to the consent which was signed by petitioner's Senior Vice President and Controller, Francis R. May, on September 10, 2001, there were eight additional pages of schedules prepared on various dates by the Division's auditors. The last page (page 9) sets forth a schedule, dated July 11, 2001, which purports to be petitioner's bad debt deductions for the years 1991 through 1996 as computed by the auditors.

On page 1, the actual consent signed by Mr. May, the summary of taxes for the years 1993 through 1996 indicates that for these years a refund in the amount of $206,183.00 was due. There was no evidence that any of the other pages of schedules were attached to the consent at the time it was signed by Mr. May or that he consented to the calculations of the bad debt deductions made by the Division.

SUMMARY OF THE PARTIES' POSITIONS

8. The position of petitioner is as follows:

a. The Division erred in computing the reserve balances for the losses on qualifying real property loans (the "Bad Debt Reserve") that were maintained by the Bank as of

December 31, 1995 and in subsequent years, which errors resulted in the incorrect application of a statutory limitation on petitioner's deduction from entire net income ("ENI") of additions to such reserves for the years 1998 and 1999. It was the Division's partial disallowance of petitioner's bad debt deductions for 1998 and 1999 which form the basis of the tax deficiencies asserted;

b. The Division's assertion of tax deficiencies for the years at issue is based upon its position that prior to 1996, Tax Law § 1453(h)(1) was not part of the bad debt deduction statute and did not affect the annual increase to the Bad Debt Reserve but was, instead, a part of a separate tax scheme. The result, petitioner contends, is that petitioner's annual increase to the Bad Debt Reserve far outpaces actual bad debt deductions that were taken. This undermines the real purpose of the statute which was to limit the bad debt deductions to a maximum amount equal to six percent of outstanding loans. Petitioner states that the six percent limitation on the deductions would never have been reached if it had been based on real reserve balances. The Division calculated petitioner's reserve balances for the years 1991 through 1995 relying on increased and incorrect amounts which did not account for either the language of the statute or the amounts that the Bank actually deducted for bad debts in each of those years.

c. Petitioner asserts that its Bad Debt Reserve balances were as follows:

DATE	RESERVE BALANCE
December 31, 1995	$183,196,889.00
December 31, 1996	$213,547,225.00
December 31, 1997	$236,818,385.00
December 31, 1998	$251,070,152.00
December 31, 1999	$269,036,579.00

According to the Division's schedules (both the schedules dated April 7, 2005 and the final amended schedules dated April 19, 2005), six percent of the Bank's qualifying loans for 1998 was $276,848,880.00. Petitioner states that the correct six percent limitation on the amount which should have been permitted as a bad debt deduction under Tax Law § 1453(h) is $40,030,495.00 ($276,848,880.00 minus $236,818,385.00 [the Bad Debt Reserve balance from the previous year]). Since the Bank's bad debt deduction was $15,344,950.00, the six percent limitation was not reached and no portion of the deduction should have been disallowed.

For 1999, six percent of the Banks's qualifying loans was $275,788,814.00. The correct six percent limitation which should have been permitted under Tax Law § 1453(h) is $24,718,662.00 ($275,788,814.00 minus $251,070,152.00 [the Bad Debt Reserve balance from the previous year]). Since the Bank's bad debt deduction for 1999 was $20,625,810.00, the six percent limitation was again not reached and no portion of the deduction should have been disallowed.

d. Petitioner states that the Division's computation of its Bad Debt Reserve balance was based upon an erroneous assumption that the reserve balance was increased annually in an amount equal to 40 percent of the Bank's ENI (minus charge offs for each taxable year) as computed for purposes of the Federal income tax bad debt deduction. Petitioner maintains that the correct amount of the increase in the Bad Debt Reserve balance should have properly taken into account that the full 40 percent was not and could not have been applied to the Bank's ENI. The Division's use of the 40 percent deduction from the Bank's ENI, without regard for the amounts which were to be excluded from income in accordance with Tax Law § 1453(h)(1), resulted in an unwarranted increase in the Bad

Debt Reserve balance that, in turn, resulted in an unwarranted decrease in the amount permitted to be deducted by reason of the annual 6 percent limitation.

e. In summary, petitioner points to the following as the basis for the entire deficiencies asserted by the Division:

(1) Prior to 1996, Federal tax law permitted a thrift institution to compute a bad debt deduction on the basis of a percentage (basically, eight percent) of its taxable income ("the PTI method") if that method produced a larger deduction than one based upon the institution's actual experience (the "experience method"). The New York State Tax Law then permitted a thrift institution to take a bad debt deduction that was computed on the basis of the institution's Federal deduction.

(2) Under both Federal and State law, a thrift institution was required to maintain and make appropriate annual adjustments to its Bad Debt Reserve. Pre-1996 Tax Law § 1453(h)(3) required a taxpayer that used the PTI method to establish a Bad Debt Reserve for qualifying real property loans and also to increase such reserve annually by an amount permitted as a deduction under pre-1996 Tax Law § 1453(h)(2). Pre-1996 section 1453(h)(2) calculated the bad debt deduction by multiplying the Federal deduction for qualifying and nonqualifying loans by five, then subtracting any Federal nonqualifying deduction. Petitioner contends that, at this stage of the computation, the New York State deduction was essentially equal to 40 percent of ENI.

(3) In accordance with pre-1996 Tax Law § 1453(h)(1), however, this 40 percent deduction was not permitted to be taken against the Bank's ENI since that statute provided that an institution using the PTI method for Federal income tax purposes must exclude from the computation of New York ENI the Federal deduction for qualifying loans *plus* 20 percent of the amount by which (i) the sum of the amount determined under pre-1996 Tax

Law § 1453(h)(2) and the amount of the Federal deduction for nonqualifying loans exceeds (ii) the amount that would have been allowable as a deduction had the institution maintained its bad debt under the actual experience method. It is petitioner's position that the Division's computations and schedules fail to account for this section 1453(h)(1) provision and, therefore, essentially delete the statute after the word "plus." In applying the provisions of Tax Law § 1453(h)(1), the Bank, on its returns, was required to and did reduce its New York bad debt deduction below 40 percent of its ENI.

(4) The pre-1996 statute must be read such that the Bad Debt Reserve balance was to increase in the same amount as that of the New York State bad debt deduction. The Division's position would result in the Bad Debt Reserve balance increasing by a full 40 percent of the Bank's ENI (less charge-offs) even though the Bank was never able to derive that deduction, a limitation which was placed upon the Bank by the terms of pre-1996 section 1453(h)(1). This position of the Division is in contrast to the Internal Revenue Code which makes it clear that the entirety of the amounts placed into the Bad Debt Reserve are tax deductible (IRC §585[a]; § 593[a]).

(5) When the entire statute, i.e., pre-1996 section 1453(h) is read in its full context, the 20 percent add-back provision must be interpreted to require those taxpayers computing their bad debt deduction pursuant to section 1453(h)(2) to reduce such deduction by the sums mandated in section 1453(h)(1) and to increase the Bad Debt Reserve balance by the amount computed by the entire statute.

(6) Both pre-1996 and post-1996 Tax Law provisions allow a taxpayer to take a bad debt deduction of approximately 32 percent. Under pre-1996 law, a taxpayer utilizing the PTI method for State tax purposes is entitled to a deduction equal to approximately 32 percent of taxable income. This 32 percent deduction is arrived at by adding back 8

percent (20 percent times 40 percent = 8 percent) to the 40 percent (40 percent minus 8 percent = 32 percent). In 1996, Tax Law § 1453(h) was amended to allow a bad debt deduction in "an amount equal to thirty-two percent of the entire net income for such year." (Tax Law § 1453[h][4][a].) The 1996 amendments omit the pre-1996 add-back of 20 percent (Tax Law § 1453 former [h][1]). The 1996 amendments to section 1453(h) were intended to simplify New York's bad debt deduction by providing a 32 percent bad debt deduction up front rather than requiring the taxpayer to go through the two-step process of backing into that percentage through the 20 percent add-back provision.

(7) If taxpayers were allowed a full 40 percent bad debt deduction pre-1996 rather than the 32 percent deduction which is undisputed for years 1996 and thereafter, New York State would have to have expected an increase in bank tax revenues after 1995 as a result of a reduction in the allowable deduction. That, however, was not the case as the post-1996 amendments were viewed as revenue neutral. Therefore, it is clear that pre-1996 section 1453(h) allowed for a deduction and an addition to the Bad Debt Reserve of approximately 32 percent, which is net of the pre-1996 section 1453(h)(1) 20 percent add-back provision, rather than 40 percent as contended by the Division.

(8) Current law allows a PTI deduction of 32 percent and specifically allows an increase to the Bad Debt Reserve balance to the same extent. Section 1453(h)(6)(C) provides that the reserve for losses shall be increased by the amount provided in section 1453(h)(3)(B) which sets forth the provisions for deduction allowed on qualifying real property loans including that the deduction shall not exceed the amount determined under subparagraph (4); section 1453(h)(4)(a) establishes the bad debt deduction of 32 percent of ENI. Petitioner contends that for the entire premise of the statute to be effective, these

numbers must always be the same and the 1996 amendments represent no change at all in this regard.

9. The Division asserts the following:

a. The Division asserts that petitioner's Bad Debt Reserve Balances for the corresponding periods (***see***, Paragraph "8[c]" for petitioner's calculations) are as follows:

DATE	RESERVE BALANCE
December 31, 1995	$213,410,670.00
December 31, 1996	$243,761,006.00
December 31, 1997	$267,032,186.00
December 31, 1998	$281,283,933.00
December 31, 1999	$299,250,360.00

b. Pre-1996 section 1453(h)(1) requires an adjustment to ENI which, in essence, may result in an add-back equal to approximately 20 percent of the pre-1996 section 1453(h)(2) deduction to ENI. Pre-1996 section 1453(h)(2) provides for a separate adjustment to ENI. Both provisions impact ENI; however, each is its own adjustment.

c. In pre-1996 section 1453(h)(2)(A)(i), the amount determined under IRC § 593(b)(1)(B) is approximately eight percent of Federal taxable income. Section 1453(h)(2)(A)(ii) required taxpayers to multiply the amount determined under section 1453(h)(2)(A)(i) by five. This is where petitioner arrives at the approximately 40 percent figure, i.e., 8 percent x 5 = 40 percent. However, there is a limitation contained in the statute under section 1453(h)(2)(B) which specifies that no matter what the raw calculation provided in subparagraph (A) amounts to, the adjustment is not allowed to exceed the amount necessary to increase the balance of the Bad Debt Reserve account to six percent of qualifying real property loans outstanding (the "Six Percent Limitation"). The Bad

Debt Reserve Account balance is increased only by that adjustment to ENI which is determined pursuant to pre-1996 section 1453(h)(2). Petitioner seeks to add language to the statute to require that the Bad Debt Reserve account balance must also be adjusted for that amount by which ENI is adjusted pursuant to pre-1996 section 1453(h)(1).

d. Petitioner seeks to force a combination of pre-1996 section 1453(h)(1) and (h)(2) whereby the 20 percent add-back provision in (h)(1) must be incorporated into the adjustment found in (h)(2). There is, however, no authority in the plain language of the statute to support that interpretation. The statute is very clear that pre-1996 section 1453(h)(1) and (h)(2) are modifications to the calculation of ENI and they do not combine together into one single deduction. Pre-1996 section 1453(h) does not contain language stating that the adjustment calculated pursuant to section 1453(h)(2) must be modified by section 1453(h)(1) thereby resulting in a new section 1453(h)(2). The relevant statute provides that the annual adjustment to the Bad Debt Reserve account balance is based solely on the section 1453(h)(2) adjustment. In support of its position, the Division asserts that in order to calculate the pre-1996 section 1453(h)(1) adjustment, the adjustment in section 1453(h)(2) must be calculated first because that figure is used in the (h)(1) calculation. There is a clear and unambiguous reference in pre-1996 section 1453(h)(3)(C) which is limited to the effects of only (h)(2). The Division concedes that the adjustment pursuant to (h)(1) ultimately affects ENI by a reference to bad debts and that (h)(2) also ultimately affects ENI by a reference to bad debts. However, the Division contends that, by statute, they are separate adjustments and the annual adjustment to the Bad Debt Reserve balance only permits increases for the adjustment required by section 1453(h)(2). Pre-1996 section 1453(h)(2) is a direct deduction in computing ENI while pre-1996 section 1453(h)(1) is an addback to ENI directly, not a modification of the deduction calculated under section 1453(h)(2).

e. Petitioner argues that there are "internal cross-references" in pre-1996 section 1453(h) to the 20 percent addback provision which, therefore, supports that section's inclusion in the section 1453(h)(3) Bad Debt Reserve calculation. The Division states, however, that the internal cross-references in (h)(1), (h)(2) and (h)(3) are limited to identifying that all three are applicable to taxpayers who compute their Federal bad debt deduction pursuant to the PTI method and, otherwise, they are all modifications to a taxpayer's ENI. It is logical that the (h)(1) computation would be included within the same section of law as the (h)(2) computation because the (h)(1) computation, in part, utilizes the results of the (h)(2) computation and it is also logical that (h)(3) and (h)(2) would be under the same section because they impact one another. This does not, however, justify an inference that the (h)(1) computation should now be combined with the (h)(2) computation for purposes of the (h)(3) computation. Form CT-32-B, the New York State Banking Corporation Franchise Tax Return, contains separate lines for the (h)(1) and (h)(2) adjustments which indicates that the Division is correct in its assertion that they are separate adjustments even though both lines on the return do refer to the term "bad debt" and both emanate from the same statute.

f. The 1996 amendments served to decouple Article 32 of the Tax Law from the Internal Revenue Code and to maintain a tax preference for thrift institutions in New York State. Tax Law § 1453(h) was revised to eliminate the provisions of pre-1996 Tax Law § 1453(h)(1) which required a 20 percent addback to ENI and renumbered the provisions for calculations of adjustments to ENI and the calculation of the Bad Debt Reserve balance additions. Tax Law § 1453(h)(4)(A) states that a thrift institution shall be allowed a bad debt deduction in calculating its ENI equal to 32 percent of the ENI for the year and Tax Law § 1453(h)(6)(A) states that thrift institutions shall establish and maintain a New York Bad Debt Reserve for losses on qualifying real property loans. While the language in the legislative history of chapter 411 of the Laws of 1996 (which amended section 1453[h]) states that New York intended to maintain preferential treatment of thrift institutions, it did not state that the Legislature was enacting a statute that was the mirror image of pre-1996 IRC § 593.

CONCLUSIONS OF LAW

A. Chapter 817 of the Laws of 1987 amended Tax Law § 1453 by, among other things, renumbering the former subsection (h) and adding a new subsection (h). The new subsection (h) was later amended for taxable years 1996 and thereafter. However, for taxable years beginning before 1996, Tax Law former § 1453(h) provided, in pertinent part, as follows:

> (1) A taxpayer which computes all or a portion of its bad debt deduction pursuant to section 593(b)(1)(B) of the internal revenue code using the percentage of taxable income method set forth in section 593(b)(2) of such code, must exclude from the computation of its entire net income
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> (A) any amount allowed as a deduction for federal income tax purposes pursuant to such section 593(b)(1)(B) plus
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> (B) twenty percent of the amount by which (i) the sum of the amount determined in paragraph two of this subsection plus the amount allowed as a deduction for federal income tax purposes pursuant to section 593(b)(1)(A) of such code exceeds (ii) the amount which would have been allowable as a deduction had such institution maintained its bad debt reserves for all taxable years on the basis of actual experience.
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> (2) In the case of a taxpayer described in paragraph one of this subsection, there shall be allowed as a deduction in computing entire net income an amount determined pursuant to this paragraph.
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> (A)(i) Ascertain the amount deducted for federal income tax purposes pursuant to section 593(b)(1)(B) of the internal revenue

code and add it to the amount, if any, deducted for federal income tax purposes pursuant to section 593(b)(1)(A).

(ii) Multiply the amount determined in clause (i) of this subparagraph by five.

(iii) Subtract from the amount determined in clause (ii) of this subparagraph, the amount deducted for federal income tax purposes pursuant to section 593(b)(1)(A).

(B) The amount determined under subparagraph (A) of this paragraph shall not exceed the amount necessary to increase the balance at the close of the taxable year of the New York reserve for losses on qualifying real property to six percent of such loans outstanding at such time.

(C) The amount determined under subparagraph (A) of this paragraph shall in no case be greater than the larger of

(i) the amount determined under section 593(b)(3) of the internal revenue code for the taxable year, or

(ii) the amount which, when added to the amount determined under section 593(b)(1)(A) of such code for the taxable year, equals the amount by which twelve percent of the total deposits or withdrawable accounts of depositors of the taxpayer at the close of such year exceeds the sum of its surplus, undivided profits, and reserves at the beginning of such year (taking into account any portion thereof attributable to the period before the first taxable year beginning after December thirty-first, nineteen hundred fifty-one).

(3)(A) Each taxpayer described in paragraph one of this subsection shall establish and maintain a New York reserve for losses on qualifying real property loans. Such reserve shall be maintained for all subsequent taxable years. The balance of the New York reserve for losses on qualifying real property loans at the beginning of the first day of the first taxable year the taxpayer becomes subject to this subsection shall be the same as the balance at the beginning of such day of the reserve for losses on qualifying real property loans maintained for federal income tax purposes.

(B) All debts which are charged or credited to the reserve for losses on qualifying real property loans maintained for federal income tax purposes must be charged or credited to the New York reserve for losses on qualifying real property loans. No other debts may be charged or credited to such New York reserve.

> (C) The New York reserve for losses on qualifying real property loans shall be increased by the amount determined under paragraph two of this subsection or the amount determined under section 593(b)(1)(B) of the internal revenue code if such amount was determined using the experience method set forth in section 593(b)(3) of such code.

B. On November 19, 1987, the Division's Technical Services Bureau issued a memorandum (TSB-M-87[17]C) which explained the provisions of chapter 817 of the Laws of 1987 known as the Business Tax Reform and Rate Reduction Act of 1987, which amended Article 32 of the Tax Law pertaining to the franchise tax on banking corporations. With respect to thrift institutions, the memorandum stated, in relevant part, as follows:

> New subsection (h) of Section 1453 allows a thrift institution (one subject to IRC Section 593) which computes all or a portion of its bad debt deduction using the percentage of taxable income method for federal income tax purposes to subtract from federal taxable income a New York State bad debt deduction. This bad debt deduction is nearly equal to the amount which was allowed as a deduction for federal income tax purposes prior to 1987. A taxpayer which subtracts a New York State bad debt deduction from federal taxable income must add to such income the following:
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> 1. Any amount allowed as a deduction for federal income tax purposes pursuant to IRC Section 593(b)(1)(B) plus
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> 2. 20 percent of the amount by which (i) the sum of the amount allowed a New York State bad debt deduction plus the amount allowed as a deduction for federal income tax purposes pursuant to IRC Section 593(b)(1)(A) exceeds (ii) the amount which would have been allowable as a deduction had the thrift institution maintained its bad debt reserve for all taxable years on the basis of actual experience.

Therefore, TSB-M-87(17)C explained pre-1996 Tax Law § 1453(h) by stating that a taxpayer which claims a New York State bad debt deduction must first add back the amount calculated in paragraph (1) of pre-1996 Tax Law § 1453(h), i.e., it must add back to its Federal taxable income, its Federal bad debt deduction for losses on qualifying real property loans plus 20 percent of the amount by which its New York State bad debt deduction plus its Federal bad debt deduction for losses on nonqualifying loans exceeds the deduction that would have been allowed if the actual experience method had been used. Essentially, this provision in pre-1996 Tax Law § 1453(h)(1) is a reduction or limitation on the amount that can be claimed as a New York State bad debt deduction.

C. Pursuant to IRC § 593(b)(2)(A), the "percentage of taxable income method," or PTI method, is defined as an amount equal to eight percent of the taxable income for the year, subject to certain reductions or limitations.[3] The "experience method" is defined in IRC § 593(b)(3) as the amount computed in the same manner as is provided with respect to additions to the reserves for losses on loans of banks under IRC § 585(b)(2).[4]

D. In 1996, IRC § 593(f) was added by Pub L 104-188 for tax years beginning after December 31, 1995. This provision repealed the reserve method of accounting for bad debts of qualified thrift institutions, thereby eliminating the bad debt deduction provided to thrift institutions by IRC § 593. Previously, from 1987 to 1995, Article 32 of the Tax Law relied on the Federal calculation of the Bad Debt Reserve as the starting point for determining the allowable New York State deduction for additions to the Bad Debt Reserve by these thrift institutions. Because the elimination of the Federal starting point would cause New York State thrift institutions to lose their State tax benefits, the New York State Tax Law was amended on July 30, 1996 to maintain a tax preference for these institutions. The Division's Technical Services Bureau, on November 6, 1996, issued a memorandum (TSB-M-96[1]C) to explain these

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[3] The eight percent of taxable income must be reduced (but not below zero) by the amount determined to be a reasonable addition to the Bad Debt Reserve on nonqualifying loans (IRC § 593[b][2][B]) and the eight percent of taxable income shall not exceed the amount necessary to increase the Bad Debt Reserve on qualifying real property loans to six percent of such loans outstanding (IRC§ 593[b][2][C]).

[4] This IRC section sets forth a highly technical ratio formula which is of little or no relevance to this proceeding.

and other corporation tax law changes. As pertains to thrift institutions, the memorandum stated as follows:

> Federal law, Public Law 104-188, enacted on August 20, 1996, repealed the bad debt deduction provided to thrift institutions by section 593 of the Internal Revenue Code (IRC) for periods beginning after December 31, 1995. Accordingly, thrift institutions will now be required for federal income tax purposes to account for their losses from loans in the same manner as commercial banks. Therefore, thrift institutions that qualify as large banks will be required to use the direct charge off method. Thrift institutions that qualify as small banks will be able to continue to use the reserve method but their allowable deduction must be computed using the experience method.
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> The New York State Tax Law was amended on July 30, 1996 to essentially maintain the level of deduction provided to thrifts under state law by, in general, replicating in section 1453(h) the provisions of section 593 of the IRC. Section 593 of the IRC allowed thrift institutions a bad debt deduction in computing federal taxable income which was based, in general, on the larger of the percentage of taxable income method or the experience method. Before the New York State amendment was enacted, the calculation of the New York State bad debt deduction for thrifts was tied to the deduction provided under section 593 of the IRC.
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> In addition the amendment provides that any amount a thrift institution is required to include in federal taxable income as a recapture of a portion of its bad debt reserve, either because of certain distributions of property to shareholders or because of the recovery of the bad debt reserve required by the aforementioned federal legislation, will not be included in entire net income.

E. As noted in TSB-M-96(1)C, the IRC was amended to repeal the percentage of taxable income ("PTI") method. The New York State Legislature, however, preserved the PTI method for thrift institutions by means of amendments to Tax Law § 1453 made by chapter 411 of the Laws of 1996. Some of these amendments will be considered herein.

Tax Law § 1453(h) was amended to eliminate the provisions of pre-1996 Tax Law § 1453(h)(1) which required a 20 percent addback to ENI and renumbered the provisions for calculations of adjustments to ENI and for the calculation of the Bad Debt Reserve balance additions.

Tax Law § 1453(h)(6)(A) provides that a thrift institution (such as petitioner) shall maintain a New York Bad Debt Reserve for losses on various types of loans.

Tax Law § 1453(h)(3) states that a thrift institution shall be allowed as a deduction in computing ENI the amount of a reasonable addition to its Bad Debt Reserve.

Tax Law § 1453(h)(4)(A) provides that the deduction allowed in computing ENI "shall be an amount equal to thirty-two percent of the entire net income for such year" subject to certain limitations, one of which is set forth in Tax Law § 1453(h)(4)(C) which states that the "amount determined under this paragraph shall not exceed the amount necessary to increase the balance at the close of the taxable year of the reserve for losses on qualifying real property loans to six percent of such loans outstanding at such time." This limitation shall hereinafter be referred to as the "Six Percent Limitation."

Tax Law § 1453(h)(6)(A)(iii) sets forth the method for determining the opening balance of a thrift institution's Bad Debt Reserve balance as of January 1, 1996 which, in the case of petitioner, is the balance of its Bad Debt Reserve account as of December 31, 1995.

F. The Memorandum in Support of chapter 411 of the Laws of 1996 by the New York State Senate stated the purpose of this law to be as follows:

> The purpose of this bill is to decouple from federal tax law the current provisions in the State bank tax law that prescribe the treatment of reserves for loan losses by qualifying thrift institutions. The bill incorporates and assimilates relevant current federal provisions, which are anticipated to be repealed, while maintaining the preferential current State tax law treatment of loss reserves for real property loans afforded to thrifts. As such, the bill achieves consistent tax treatment for thrifts and revenue neutrality for the State (Mem of NY Senate, 1996 McKinney's Session Laws of NY, at 2356).

G. As can be ascertained from the provisions of Tax Law § 1453(h)(6)(A)(iii), it is apparent that the Bad Debt Reserve balance carried forward from years prior to the 1996 year directly affects the balance in the Bad Debt Reserve account for subsequent years and the balance of this account affects the amount of the bad debt deduction permitted in any given year.

It is petitioner's position that the Division incorrectly calculated the Bad Debt Reserve Account of one of its wholly owned subsidiaries (the Bank) as of December 31, 1995 which, as a result thereof, caused the Bad Debt Reserve account balances for succeeding years to be overstated and, therefore, erroneously limited petitioner's claimed bad debt deductions for the years at issue, to wit, 1998 and 1999. The parties have agreed that if the Division is correct in its interpretation and application of pre-1996 Tax Law § 1453(h), the amounts of the deficiencies asserted in the Notice of Deficiency, as later revised by schedules provided by the Division on April 7, 2005 and on April 19, 2005 (***see***, Finding of Fact "6"), are correct and if, on the other hand, petitioner is correct in its interpretation and application of that section of the Tax Law that there are no deficiencies of tax for the years at issue, it is apparent that there is no issue concerning the statutory interpretation of post-1996 Tax Law § 1453(h). Therefore, while keeping in mind petitioner's assertions that the post-1996 statute must be analyzed because the post-1996 statute brought about no change since the increase to the Bad Debt Reserve balance must always equal the amount of the deduction, it is clear that to resolve this matter, pre-1996 Tax Law § 1453(h) must be closely examined to determine whether petitioner or the Division properly calculated petitioner's Bad Debt Reserve Balance for the years immediately prior to the years at issue.

H. As petitioner, in its reply brief, correctly noted, nowhere in the statute is the clear intent of the Legislature manifested nor are there "plain words" which the Division contends must be applied and given effect in order to interpret this very complex statute.

The title of pre-1996 Tax Law § 1453 is "Computations of entire net income." Paragraph (1) of subsection (h) requires a taxpayer which computes all or a portion of its bad debt deduction pursuant to IRC § 593(b)[5] using the PTI method in IRC § 593(b(2) to exclude (i.e., make a subtraction) from its ENI of:

> (A) the amount allowed as a deduction for Federal income tax purposes pursuant to IRC § 593(b)(1)(B) for additions to the Bad Debt Reserve for losses on qualifying real property loans subject to certain limitations, *plus*
>
> (B) 20% of the amount by which (i) the sum of the amount determined in Tax Law former § 1453(h)(2) *plus* the amount allowed as a deduction for Federal income tax purpose pursuant to IRC § 593(b)(1)(A) (which refers to amounts determined to be a reasonable addition to its reserve for losses on nonqualifying loans) exceeds (ii) the amount which would have been allowable as a deduction had the thrift institution maintained its Bad Debt Reserve for all taxable years on the basis of actual experience.

It is clear that before the calculation required by Tax Law § 1453 former (h)(1) is made, a calculation must be made pursuant to former subsection (h)(2).

I. Tax Law former § 1453 (h)(2) states that it applies to taxpayers described in former paragraph (1), i.e., it applies to taxpayers who compute all or a portion of their bad debt deduction pursuant to the PTI method in IRC § 593(b). Former paragraph (2)(A) then sets forth the means by which the New York bad debt deduction is calculated. This amount is calculated as follows:

> (i) Add the amount deducted for Federal income tax purposes for amounts determined to be a reasonable addition to the reserve for losses on nonqualifying loans to the amount deducted for Federal income tax purposes for amounts determined to be a reasonable addition to the reserve for losses on qualifying real property loans, then

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[5] As noted in Conclusion of Law "C", Pub L 104-188 added a new subsection (f) to IRC § 593 which provided that subsections (a), (b), (c) and (d) shall not apply to any taxable year beginning after December 31, 1995. Since those subsections were not repealed but were made inapplicable only to taxable years beginning after December 31, 1995, the subsections shall not be referred to as "former subsections."

> (ii) Multiply the amount determined in (i) by five, then
>
> (iii) Subtract from the amount determined in (ii) the amount deducted for Federal income tax purposes for amounts determined to be a reasonable addition to the reserve for losses on nonqualifying loans.

Former paragraph (2)(B) then puts a limitation on the deduction calculated under former subparagraph (A) by providing that this amount cannot exceed the amount necessary to increase the balance at the close of the taxable year of the New York reserve for losses on qualifying real property to six percent of such loans outstanding at that time (the Six Percent Limitation).

Former subparagraph (C) adds a further limitation to the subparagraph(A) New York bad debt deduction by providing that the subparagraph(A) deduction *cannot be greater than the larger of*:

> (i) the amount of the Federal addition to the Bad Debt Reserve determined under the experience method pursuant to IRC § 593(b)(3), or
>
> (ii) the amount which when added to the amount added to the reserve for losses on nonqualifying loans equals the amount by which 12% of the total deposits or withdrawable accounts of depositors of the taxpayer at the close of the year exceeds the sum of its surplus, undivided profits plus its reserves at the beginning of the year.

J. Tax Law former § 1453(h)(3) sets forth the requirements for maintaining a New York reserve for losses on qualifying real property loans, i.e., the Bad Debt Reserve. First, it states, in subparagraph (A), that each taxpayer described in paragraph (h)(1), i.e., a taxpayer which computes its bad debt deduction pursuant to the PTI method, must establish and maintain a Bad Debt Reserve and that the balance of the Bad Debt Reserve shall, in essence, be the same as the balance maintained for Federal income tax purposes.

Former subparagraph (B) states all debts charged or credited to the Bad Debt Reserve for losses on qualifying real property loans for Federal purposes must be charged or credited to the

New York Bad Debt Reserve for losses on such loans and that no other debts may be charged or credited to the New York Bad Debt Reserve.

Former subparagraph (C) provides that the New York Bad Debt Reserve for losses on qualifying real property loans shall be increased by the amount of the New York bad debt deduction determined under paragraph (2) of Tax Law former § 1453(h) *or* the amount of the addition to the Bad Debt Reserve determined for Federal purposes under IRC § 593(b)(1)(B) if that amount was determined using the experience method set forth IRC § 594(b)(3).

K. A careful analysis of the relevant provisions of Tax Law former § 1453(h) reveals that a thrift institution which subtracts a New York State bad debt deduction from its Federal taxable income is first required to exclude from its computation of entire net income (and, therefore, add back) to its Federal taxable income, the amount of its Federal bad debt deduction (Tax Law former § 1453[h][1][A]) and then may compute its New York State bad debt deduction using the experience method or the PTI method. The bad debt deduction, using the PTI method (which is the method at issue in this proceeding), is computed at 40 percent of taxable income (subject to the adjustments as set forth in Tax Law former § 1453[h][2][B], [C], which are the six percent limitation and the Federal addition to the Bad Debt Reserve). Then, however, pursuant to the provisions of Tax Law former § 1453(h)(1)(B), the New York State bad debt deduction is subject to a reduction equal to 20 percent of the amount by which the actual bad debt deduction exceeds the amount computed using the actual experience method.

While, as the Division asserts, the calculations set forth in Tax Law former § 1453(h)(1) are not part of the actual calculation of the bad debt deduction which is computed pursuant to Tax Law former § 1453(h)(2), it is apparent that the amount of the bad debt deduction is clearly affected by former paragraph (1). In 2 New York Tax Service, § 41.84, in addressing the pre-1996 New York bad debt deduction, it was stated:

> The percentage of taxable income bad debt deduction is computed at 40 percent of taxable income (before the bad debt deduction), subject to various statutory adjustments. The bad debt deduction is subject to a reduction equal to 20 percent of the amount by which the actual bad debt deduction exceeds the amount computed using actual experience.

As noted in Conclusion of Law "B", the language in pre-1996 Tax Law former § 1453(h)(1) is essentially a reduction or limitation on the amount that can be claimed as a New York State bad debt deduction. Since Tax Law former § 1453(h)(3)(C), i.e., pre-1996 section 1453(h)(3)(C), provides that the New York Bad Debt Reserve shall be increased by the amount of the New York bad debt deduction determined under pre-1996 section 1453(h)(2), which deduction it has been heretofore determined is reduced by the computations contained in pre-1996 section 1453(h)(1), it is apparent that petitioner's interpretation of the statute is correct.

As stated by petitioner, the Division's increasing of the reserve balance in an amount equal to 40 percent of the Bank's ENI (minus charge offs) was excessive since it is apparent that the Division's use of the 40 percent deduction from the Bank's ENI, without regard for the amounts which were to be excluded from income in accordance with pre-1996 Tax Law § 1453(h)(1) resulted in an excessive increase in the Bad Debt Reserve balance and, in turn, an unwarranted decrease in the amount permitted to be deducted by reason of the annual 6 percent limitation. Since the Bank, on its returns, was required to and did reduce its New York bad debt deduction below 40 percent of its ENI based upon the provisions of Tax Law former § 1453(h)(1), this was the amount that should have been used by the Division in calculating the Bank's Bad Debt Reserve. This position is consistent with the Federal statutes which provide that the entirety of the amounts placed into the Bad Debt Reserve are tax deductible (IRC § 585[a]; § 593[a]).

In addition, as petitioner correctly asserts, post-1996 section 1453(h) permits a taxpayer to take a bad debt deduction of approximately 32 percent and, if the provisions of pre-1996 section 1453(h)(1) are properly factored into the computation of the bad debt deduction under pre-1996 section 1453(h)(2), the bad debt deduction pre-1996 was also approximately 32 percent. While the post-1996 statute omits the add back contained in pre-1996 section 1453(h)(1), the result is the same, i.e., the 32 percent deduction is now an up-front deduction without the necessity of the two-step computation contained in the pre-1996 statute.

Certainly, a factor which substantiates the correctness of petitioner's position is enumerated in the Division's own TSB-M-96(1)C where it is stated that the 1996 amendments to the Tax Law "essentially maintain the level of deduction provided to thrifts under state law." Moreover, the Memorandum in Support of chapter 411 of the Laws of 1996 by the New York State Senate stated that "the bill achieves consistent tax treatment for thrifts and revenue neutrality for the State." Obviously, as petitioner notes, if the post-1996 amendments reduced the New York State bad debt deduction to 32 percent from a pre-1996 deduction of 40 percent, the State would reasonably be expected to derive additional tax revenues due to the decrease in the deduction permitted to these thrift institutions. "Revenue neutrality" more than implies that no change in the deduction was made by the 1996 amendments.

Since it was agreed by the parties that if petitioner's statutory interpretation was determined to be correct that there would be no tax deficiency for the audit period, based upon the foregoing, it is hereby determined that the deficiency of tax asserted by the Division to be due from petitioner is hereby canceled.

L. As correctly noted by petitioner in its Reply Brief, the Division, in its brief, did not refute petitioner's position that it never consented to the Division's Bad Debt Reserve balances for the audit period and for those years prior thereto. Petitioner contends that the issue of this consent was never raised by the Division until the hearing when, for the first time, it was made aware of the consent. Since there has been no evidence presented by the Division to show that the officer of petitioner actually saw and consented to the Division's computations, made in July

2001, of the Bad Debt Reserve balances for the years 1991 through 1996, it cannot be found that the mere execution of a consent which indicates that petitioner was due a tax refund for the years 1993 through 1996 should preclude petitioner from contesting the tax deficiency asserted by the Division by means of a statutory notice issued nearly two years after the Bad Debt Reserve computations.

M. The petition of Emigrant Bancorp, Inc. is granted and the Notice of Deficiency dated March 17, 2003 is hereby canceled.

DATED: Troy, New York
March 30, 2006

/s/ Brian L. Friedman
ADMINISTRATIVE LAW JUDGE