STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :

of :

DELTA FINANCIAL CORPORATION AND SUBSIDIARIES : DETERMINATION DTA NO. 820677

:

for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1999, 2000 and 2001. :

Petitioner, Delta Financial Corporation, c/o Richard F. Schneider, Vice President, 1000 Woodbury Road, Suite 200, Woodbury, New York 11797, 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 1999, 2000 and 2001.

A hearing was held before Joseph W. Pinto, Jr., Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on April 4, 2006 at 10:30 A.M., with all briefs submitted by September 29, 2006, which date began the six-month period for the issuance of this determination. Petitioner appeared by Richard W. Goldstein, Esq. The Division of Taxation appeared by Mark F. Volk, Esq. (Clifford M. Peterson, Esq., of counsel).

*ISSUE*S

I. Whether Delta Financial Corporation and Subsidiaries (collectively "petitioner") properly reported its entire net income to New York State for the years 1999, 2000 and 2001.

II. Whether petitioner's federal taxable income, as modified by the excess inclusion adjustment applicable to income from real estate mortgage investment conduits and codified in IRC § 860(E), was properly reflected on line "28" of the Federal form 1120 and, thus, included accurately in the calculation of New York entire net income.

III. Whether penalties imposed under Tax Law § 1085(k) should be abated.

FINDINGS OF FACT

Subsequent to the hearing, and pursuant to 20 NYCRR 3000.15(d)(7), both parties submitted proposed changes to the stenographic transcript of proceedings. After a careful review, it was determined that the inaccuracies and alleged inaccuracies in the transcript were not "inaccurate in any material respect" and no corrections have been made.

Each party has submitted proposed findings of fact pursuant to the Rules of Practice and Procedure of the Tax Appeals Tribunal, 20 NYCRR 3000.15(d)(6), and State Administrative Procedure Act § 307(1).

The proposed findings submitted by petitioner have been incorporated into the findings of fact below, with the following exceptions: proposed finding "1", which incorporates the Stipulation of Facts, will be dealt with below as a joint submission; proposed finding of fact "2" is not an appropriate finding of fact; official notice is taken of New York State and Federal tax forms and their instructions, eliminating the need for proposed findings "3", "4", "5", "7" through "16", "18" through "31" and "33" through "39"; official notice is taken of the New York State Department of Taxation and Finance, Technical Services Bureau Memoranda, eliminating the need for proposed findings "40" through "45"; proposed finding "6" is rejected for being overly broad; and official notice is taken of the Division of Taxation's audit guidelines, eliminating the need for proposed findings "17" and "32".

The proposed findings of fact submitted by the Division of Taxation have been incorporated into the findings of fact below, where consistent with the record, with the following exceptions: proposed finding of fact "13" constitutes argument and is not a proper finding of fact; proposed finding "23" is a restatement of a document in the record and is rejected; proposed finding "25" has been modified to more accurately reflect the record; proposed findings "26", "27" and "28" are argument and not proper findings of fact; proposed finding "31" does not reflect the record and is rejected; proposed findings, "36", "38" and "39" are not relevant and are rejected; and proposed findings "35" and "37" are restatements of unweighted testimony, not facts, and can not be incorporated as proposed.

On April 4, 2006, the parties entered into a three-page stipulation of facts which has been incorporated into the facts below with the exception that references to page numbering have been excluded.

1. Delta Financial Corporation ("Delta") is a specialty consumer finance company that originates, securitizes and sells nonconforming mortgage loans, which are primarily secured by first mortgages on one-to-four-family residential properties, lending to individuals who generally do not satisfy the credit, documentation or other underwriting standards set by more traditional sources of mortgage credit.

2. Delta Funding Corporation ("Delta Funding") was a wholly-owned subsidiary of Delta, incorporated in New York. DF Special Holdings Corporation ("DFSH") was a wholly-owned subsidiary of Delta Funding, incorporated in Delaware in 1997 and located there. The two companies share some common officers and directors, all located in New York State, and Delta Funding controls the majority of DFSH's board of directors, as well as managing its business activities. The companies concluded that DFSH had minimal substance in Delaware.

3. In early 2002, Delta Funding, through its representative, Richard Goldstein, Esq., contacted the Division of Taxation in correspondence dated January 22, 2002 and February 11, 2002, in order to voluntarily disclose certain information regarding DFSH and gain permission to include DFSH in the combined report filings in which Delta Funding was included for the years 1999, 2000 and 2001 (the "years in issue"). Mr. Goldstein revealed in this correspondence that the combined group, of which Delta Funding was a member, had not been audited by the Division for the years 1997 through 2001.

4. In the January 22, 2002 letter to the Division, Mr. Goldstein stated that Delta Funding had created a Real Estate Mortgage Investment Conduit ("REMIC") which provided regular and residual interests, the former sold to unrelated third parties and the latter contributed to DFSH. The income from the REMIC was the only source of income for DFSH and the excess inclusion was reported for Federal income tax purposes on line "30" of Federal form 1120.

5. Delta Funding and DFSH were part of a Federal consolidated group which filed under a taxpayer identification number other than that of Delta Funding or DFSH and which had been audited by the Internal Revenue Service ("IRS").

6. The terms of the Voluntary Disclosure Agreement (the "Agreement") were summarized in a letter to Mr. Goldstein from the Division, dated March 8, 2002. The letter first responded to Mr. Goldstein's letter of January 22, 2002, in which he requested voluntary disclosure, and expressed the Division's position that DFSH was subject to New York franchise tax. The letter then summarized the facts presented by Mr. Goldstein in his letters of January 22, 2002 and February 11, 2002, in addition to facts ascertained from conversations with Division staff.

7. Most of the facts set forth in the letter are those recited in the findings above, with the following additions:

a) the passive activities of DFSH are managed and controlled by its parent corporation from New York State from within the Metropolitan Commuter Transportation District;

b) the corporation treats its REMIC interests as business capital and any income earned as business income; REMIC property, receipts, and payroll factors flow through to DFSH;

c) Delta Funding will file amended returns, providing they are within the statute of limitations, on a combined basis with DFSH and the business allocation percentage of DFSH will be combined with that of Delta Funding; any additional tax due will be paid by Delta Funding with interest;

d) DFSH had not been contacted by the Division regarding taxability or sent a notice of audit and had not been audited by a government agency that exchanges information with the Division which might be sending information to the Division in the near future; and

e) DFSH had not been authorized to do business in New York.

8. Based on the facts disclosed in the Voluntary Disclosure Agreement, the Division agreed to permit the filing of amended corporation franchise tax returns for the years 1999, 2000 and 2001, including DFSH in the combined group. In addition, DFSH was required to file a report of a company included in a combined franchise tax return, or CT-3-A/C. In consideration for filing these returns, the Division agreed to abate any applicable penalties for the years in issue and reduce interest to the minimum. The returns and any payments due were required to be filed within 30 days of March 8, 2002, which date was subsequently extended.

9. The Agreement specified that the returns filed would be reviewed for accuracy and that additional tax and interest might result from such review. Further, the Agreement did not preclude the Division from auditing the returns to “determine if such returns were completed in accordance with existing law and regulations.”

10. On or about May 3, 2002, pursuant to the Agreement, amended Form CT-3-A, General Business Corporation Combined Franchise Tax Return, and amended Form CT-3M/4M, General Business Corporation MTA Surcharge Return, for tax years 1999 and 2000 and a Form CT-3-A and Form CT-3M/4M for 2001 (collectively, the "Combined Returns") were filed.

11. The corporations included in the Combined Returns were as follows (The corporations listed in boldface type were New York State taxpayers.):

1999 Return

NAME	EIN
Delta Financial Corporation	11-3336165
Delta Funding Corporation	11-2609517
Fidelity Mortgage Inc.	11-3360263
DF Special Holdings Corporation	11-3374284
DFC Financial Corporation	11-3481915
DFC Funding Corporation	11-3453533
Continental Property Management Corp.	11-3515130
DFC 1999-A-Corp.	11-3528911

2000 Return

NAME	EIN
Delta Financial Corporation	11-3336165
Delta Funding Corporation	11-2609517
Fidelity Mortgage Inc.	11-3360263
DF Special Holdings Corporation	11-3374284
DFC Financial Corporation	11-3481915
DFC Funding Corporation	11-3453533
Continental Property Management Corp.	11-3515130
DFC 1999-A-Corp.	11-3528911
DFC Servicing Receivables Corp.	11-3592440
DFC Holdings-A Inc.	52-2249674
DFC 2000-B Corp.	11-3592441

2001 Return

NAME	EIN
Delta Financial Corporation	11-3336165
Delta Funding Corporation	11-2609517
Fidelity Mortgage Inc.	11-3360263
DF Special Holdings Corporation	11-3374284
DFC Financial Corporation	11-3481915
DFC Funding Corporation	11-3453533
Continental Property Management Corp.	11-3515130
DFC 1999-A-Corp.	11-3528911
DFC Servicing Receivables Corp.	11-3592440
DFC Holdings-A Inc.	52-2249674
DFC 2000-B Corp.	11-3592441
Renaissance Mortgage Acceptance Corp.	52-2356399
DFC Acceptance Corp.	11-3632729

12. Prior to the Agreement, DFSH was not included in a combined New York return.

13. An amended Form CT-3-A and Form CT-3M/4M including the entities listed in Finding of Fact "11" for the year 2001 was filed on or about October 10, 2002.

14. On forms CT-3-A for the tax years in issue, income of the holders of the residual interests in the REMIC's was reported as business income.

15. Delta filed its U.S. Corporation Income Tax Return, Federal form 1120, on a consolidated basis for the tax years 1999, 2000 and 2001.

16. Delta reported taxable income for the combined group on its Federal forms 1120 for the years in issue as follows:

Line	Caption	1999	2000	2001
28	Taxable income before NOL's and Special Deductions	$3,109,773	-$10,492,669	-$72,675,304
29	Less: NOL's & Spec Deductions	-21,134,770	-14,510,609	-73,316,141
30	Taxable Income	24,244,543	4,017,940	640,837

Petitioner added the parenthetical "Per IRC 860E(a)(1)" on line "30" of the forms 1120. The excess inclusion for each of the years in issue was $24,244,543 in 1999, $3,948,586 in 2000 and $640,837 in 2001. The amount stated on line "29" was the add-back of deductions necessary to make taxable income equal to the excess inclusion.[1]

17. The amounts listed on line "28" of the Federal forms 1120 were used as the starting point for the calculation of combined entire net income on line "1" of the New York combined returns. No explanation was noted on the New York returns for utilizing the line "28" amount rather than the line "30" amount for taxable income and there were no "statements" attached to

[1]There was no explanation offered by either of the parties for the disparity between the taxable income and the amount of excess inclusion occurring in 2000.

any of the Federal forms 1120 attached to the New York combined returns explaining petitioner's treatment of its excess inclusion or the amounts reported on lines "29" or "30".

18. During the years 1999 and 2000, DFSH and Delta Funding held residual interests in REMIC's. During the year 2001, Delta Acceptance Corp., DFSH and Delta Funding held residual interests. A REMIC is defined in IRC § 860D(a) as a fixed mortgage pool that issues debt-like regular interests and a single class of residual interests, the former deemed debt and the latter equity interests. REMIC's themselves were exempt from taxation by the State and Federal governments. However, the holders of both regular and residual interests were not exempt from taxation or on the income from such interests.

The rationale behind creating REMIC's as a viable investment vehicle was to control cash flow of the payments of mortgages in the REMIC such that two classes of investors are created, "fast pay" and "slow pay." The "fast pay," or regular interest holders, received the principal payments first and, when retired, the payments were directed to the "slow pay" or residual interest holders. The rates of interest were lower for the regular interest holders because these securities matured more quickly, while the longer term residual interests had higher rates of interest. The resultant mismatch in timing between the payments to the classes created "phantom" income, producing positive taxable income for the REMIC in the early years and negative taxable income in the later years. Over the life of the investments, however, the negative and positive income netted to zero.[2]

19. On its Combined Returns and the attached Federal forms 1120, Delta did not avail itself of net operating loss deductions or claim special deductions. On the original combined

[2] This background information was provided by James Peaslee, Esq., an expert in REMIC's who testified at the hearing.

returns for the years 1999 and 2000 and the attached forms 1120, Delta did not avail itself of a net operating loss deduction or claim special deductions. Although there are negative amounts listed on the 1120s for NOL deductions, it was assumed to be a required adjustment in order to comply with the Internal Revenue Code provisions with respect to excess inclusion income.

20. Although there are many references to explanatory “statements” on the Federal forms 1120, and several attached to those in evidence, there were several statements omitted, including those concerning the excess inclusion adjustment.

21. The Division audited petitioner for the years in issue beginning in June of 2003 and concluded in June of 2005. The auditor, Wen Chen, and his supervisor, Roy Bowman, found, in addition to the background in Finding of Fact “1”, that Delta originated loans in 27 states through a network of 1,500 brokers and the company’s Fidelity Mortgage retail branches and also purchased loans from a network of approximately 120 correspondents.

22. During the audit of the Combined Returns, the Division made the determination that the income of REMIC residual interest holders in the Combined Group was not properly reported in that the excess inclusion was not accounted for because Delta used the taxable income reported on line “28” of the Federal form 1120 as the starting point for computing New York entire net income and not the amount on line “30,” which had been adjusted to accommodate the rules of the Internal Revenue Code for taxation of the excess inclusion of the residual interest holders in REMIC’s.

23. The auditor adjusted federal taxable income by adding back REMIC excess inclusions for each of the years in issue based on the Division’s interpretation of IRC § 860(a)(1) and its own TSB-M-87(22)C. It also adjusted the net operating losses for 2000 and 2001 by adding back REMIC excess inclusions pursuant to the same authorities.

24. Based upon its audit and adjustments, the Division issued a Notice of Deficiency to Delta Financial Corporation, notice number L-025636089-7, dated June 30, 2005, which asserted additional tax of $1,545,792.00, interest of $690,616.13 and penalty of $154,426.00. As stated above, the deficiency was based on the Division's adjustments from its interpretation and application of Tax Law §§ 8, 208(9); IRC § 860E(a)(1) and TSB-M-87(22)C. The penalty asserted was pursuant to Tax Law § 1085(k) for substantial understatement of liability.

SUMMARY OF THE PARTIES' POSITIONS

25. Petitioner maintains that the excess inclusion adjustment is a limitation on the use of federal deductions in the current tax year which New York has not adopted, thus merely creating a timing difference in the utilization of current net operating losses for federal and New York tax purposes. Petitioner believes that the adjustment is properly included on line "30" of the form 1120 because adjustments can occur between line "28" and line "30" which would render line "30" less than "28," frustrating the federal policy intention that taxable income not be less than excess inclusion. Therefore, contrary to the Division's position, petitioner's use of line "28" as the starting point for determining New York franchise tax was proper in light of its declaration of excess inclusion in calculating line "28" and the absence of any New York provision limiting the use of deductions which would allow taxable income to be less than the excess inclusion.

Petitioner contends that there is absolutely no basis for the Division's claim that New York had adopted the federal adjustment and that evidence of such an adjustment can be found in the Tax Law, regulations and TSB-M-87(22)C. Petitioner also argues that, even if it is assumed that New York had adopted the excess inclusion adjustment, that would engender many problems that have not been addressed by the Legislature. Petitioner hypothesized that if New York had adopted the adjustment, when applied, there would be Federal taxable income and Federal net operating losses in the same year and all provisions of the New York Tax Law pertaining to entire net income and net operating losses would apply, causing multiple conflicts in New York's mandatory adjustments to those items. Petitioner maintains that it is not realistic to believe that the Legislature would have enacted the excess inclusion adjustment without any concern or provision for the issues it would have created in other sections of the Tax Law.

26. Petitioner argues that the Division was precluded from asserting that the excess inclusion adjustment be included on line "28" because it knew from the Voluntary Disclosure Agreement ("VDA") that the excess inclusion adjustment had been made on line "30". Further, petitioner does not believe that the Division's right to inspect and audit the returns filed pursuant to the VDA bestowed upon it the right to raise its argument concerning the excess inclusion adjustment which had been plainly disclosed by petitioner.

27. Finally, petitioner contends that it should not be liable for penalty asserted under Tax Law §1085(k) because it disclosed the adjustment it had made in the VDA, followed the instructions to Form CT-3-A in computing its entire net income and it made a thorough review of the relevant Tax Law and found no basis for believing that IRC § 860E had been adopted by New York.

28. The Division of Taxation argues that by not providing for a modification to New York entire net income for residual interest holders, the Legislature adopted excess inclusion as provided for in IRC § 860E as a floor beneath which taxable income was not permitted to drop. The Division reasons that since Tax Law § 8 was enacted long after Tax Law §§ 208(9) and 211(4), it should be presumed it acted with the understanding that when the residual interest holder's federal taxable income was its excess inclusion, the starting point for computing the residual interest holder's entire net income would be its excess inclusion and that Tax Appeals

Tribunal case law supports this interpretation. The Division believes that Tax Law §§ 8 and 208(9) and IRC § 860E, when read together, yield federal taxable income for a New York corporation/residual interest holder that is at least the corporation's excess inclusion.

29. The Division maintains that its interpretation furthers the purpose of Tax Law § 211(4) by seeking to avoid distortion of petitioner's income by including the entire net income of all the combined group's members, while adoption of petitioner's methodology would underreport federal taxable income.

30. The Division equates Delta's treatment of the IRC § 860E(a)(1) excess inclusion adjustment to a request for an exemption because it seeks to have its combined entire net income modified from the taxable income it reported to the Federal government. As such, the Division claims that petitioner did not demonstrate that its interpretation was the only reasonable one, i.e., that line "28" was the appropriate starting place to calculate entire net income for New York purposes.

31. The Division contends that petitioner's assertion of an alleged excess inclusion adjustment is merely a straw man and that neither the IRC nor the Treasury Regulations provide for an adjustment and no line appears on the Federal form 1120 to accommodate such an adjustment.

32. The Division argues that the terms of the Voluntary Disclosure Agreement were clear and did not preclude the Division from assessing additional tax. It contends that Delta's disclosure of reporting excess inclusion on line "30" was not a term of the VDA and such disclosure was rejected, in any event, when the VDA provided for further review and auditing of any returns filed and the possibility of additional tax and interest.

33. Finally, the Division denies that petitioner has demonstrated that penalties should be abated since it has failed to cite substantial authority for its interpretation of the Tax Law and did not adequately disclose its position in a statement attached to the returns filed so that the Division could identify the controversy in issue.

CONCLUSIONS OF LAW

A. Tax Law § 209(1) provides that

> [f]or the privilege of exercising its corporate franchise, or of doing business, or of employing capital . . . in this state . . . every domestic . . . corporation . . . shall annually pay a franchise tax, upon the basis of its entire net income base, or upon such other basis as may be applicable . . . .

Tax Law § 208(9) defines the term "entire net income" as

> total net income from all sources, which shall be presumably the same as the entire taxable income (but not alternative minimum taxable income)
> (i) which the taxpayer is required to report to the United States treasury department . . . .

In fact, the instructions for line "1" to the general business corporation franchise tax returns for the years in issue request that the taxpayer "[e]nter your taxable income (before net operating loss and special deductions) as required to be reported to the U.S. Treasury Department." (***See Dreyfus Special Income Fund, Inc. v. State Tax Commission*****,** 126 AD2d 368, 514 NYS2d 130, ***affd*** 72 NY2d 874, 532 NYS2d 356.) The interplay among the plain words of the statute, the Federal form 1120 and the Internal Revenue Code provisions for REMIC's is determinative of the issues in this case and is discussed below.

B. One item of petitioner's income was from residual interests in REMIC's. A REMIC is defined in IRC § 860D(a) as any entity for which a REMIC election has been made in which all interests are regular interests or one class of residual interests and substantially all of the assets of which are qualified mortgages and other permitted investments. More succinctly, a REMIC is a fixed mortgage pool that issues debt-like regular interests and a single class of residual interests. Regular interests were deemed to be debt and the residual interests were deemed to be equity interests. For federal purposes, REMIC's were exempt from taxation. Tax Law § 8 provides a similar exemption from tax for REMIC's upon their capital stock, franchises or income. However, neither the holders of interests nor the income therefrom was exempt from taxation.

As previously noted in Finding of Fact "18", James Peaslee, Esq., an expert in REMIC's, explained that a resulting problem associated with the mismatch in timing between the fast and slow pay classes was the creation of phantom income. This produced the scenario of constant income and deferred expense, with a positive taxable income in the early years and a negative taxable income later, all of which netted to zero at maturity.

C. At the time the REMIC statute was enacted in 1986, the federal government wanted to match the deductions being taken by the mortgagors of the mortgages in the REMIC's with the positive taxable income which occurred in the early years. The federal government developed excess inclusion rules which attempted to define the phantom income of the REMIC. This was done by comparing the income of the residual interest holder against a "normal" interest rate (120% of the long-term federal rate). If the residual interest holder was making more than the "normal" rate, it was deemed phantom income. Where the residual interest did not have significant economic value, the most common form of residual interest, then entire income from the interest was deemed excess inclusion and the entire amount was required to be included in taxable income. This was the case for the interest income received by petitioner herein.

D. IRC § 860E(a)(1) provides that the taxable income of any holder of a residual interest in a REMIC for any taxable year in no event shall be less than the excess inclusion for such year.

In addition, all members of an affiliated group filing a consolidated return are treated as one taxpayer for purposes of the section. (IRC § 860E[a][2].) In essence, what this rule did was limit a taxpayer's ability to use unrelated deductions to offset the excess inclusion income. Thus, for the years in issue, as stated in Finding of Fact "16", the excess inclusion, or minimum taxable income, for each of the years in issue was $24,244,543 in 1999, $3,948,586 in 2000 and $640,837 in 2001.

The excess inclusion rule is not provided for in the New York Tax Law. However, as noted above, for federal reporting purposes, all of petitioner's income from its residual interests in REMIC's was included in the computation of its taxable income on line "28" of form 1120. The floor that is required to be applied to this amount pursuant to the provision of the excess inclusion rules of IRC § 860E is obtained by operation of law at this point on the return, i.e., line "28." Although there is no guidance with respect to the timing of the application of the excess inclusion rule to be found in the law, regulations or tax return instructions on either the federal or New York State levels (other than before arriving at federal taxable income), the rationale for this conclusion is that all deductions from income, other than net operating losses and special deductions have been taken prior to line "28" and a taxpayer would be well aware of whether the amount stated was below the excess inclusion. Regardless of when a taxpayer chooses to make the adjustment after that point, it remains that by operation of IRC § 860E the taxable income must be at least the same as the excess inclusion. Therefore, although petitioner chose to place its "add back" on line "29a," specified on form 1120 to be for net operating loss deductions, such placement was arbitrarily selected for its convenience only. As the Division pointed out in the February 14, 2005 letter to petitioner's representative, "the excess inclusion is a floor for the amount of net taxable income reportable on From 1120 by the holder of a residual interest in a

REMIC. As such, it is neither a net operating loss nor a special deduction . . . . [It] is merely a mathematical convenience performed by the return preparer to add back an amount necessary to comply with IRC 860E(a)(1)."

For all of petitioner's efforts to demonstrate that New York had not adopted the excess inclusion adjustment, it appears that there was never a need for such legislation since, by operation of law, IRC § 860E automatically modified form 1120 line "28," which is the starting point for the computation of New York entire net income.

For New York State purposes, if there are further federal modifications beyond line "28" for net operating loss and special deductions, it would not affect the outcome. An example by Mr. Peaslee is a good illustration of why this is so. If a corporation has $100 in dividend income, $100 in income from an interest in a REMIC and $100 in expenses, it would yield $100 in income on line "28" and no modification would be necessary under IRC § 860E. If, however, there was a special deduction for dividends on line "29b," and $70 was eliminated, taxable income listed on line "30" would be $30 and an adjustment for excess inclusion necessary. Seventy dollars would be added back to the sum on line "30," and net operating loss of $70 would be created. Note, however, that this modification has no effect on line "28" or the starting point for the calculation of entire net income for New York purposes. In fact, for each of the three years in issue, there were no net operating loss or special deductions and petitioner was well aware by the time it calculated line "28" on the Federal form 1120 that it would be subject to the excess inclusion adjustment and that its federal taxable income and starting point for calculating New York entire net income (Tax Law § 208[9]) would be its income from its REMIC investments for each day of the taxable year it held said interest. (IRC § 860[c][a][1].)

E. The Internal Revenue Code's provisions for REMIC's is a self-contained set of definitions and guidelines which, when read as a whole, clearly intend that federal taxable income would never be less than the excess inclusion. Read in conjunction with Tax Law § 208(9), New York entire net income would necessarily be the federal taxable income after the adjustment required by IRC § 860E(a)(1). As determined above, this was the amount that should have been reflected on line "28."

F. The Voluntary Disclosure Agreement between the parties, more fully discussed in the facts above and summarized in the March 8, 2002 letter from the Division to petitioner's representative, provided that the agreement did not preclude the Division from checking the returns filed for accuracy and determining additional tax and interest. In addition, the Division clearly stated that the agreement did not preclude it from auditing the returns to determine if "such returns [were] completed in accordance with existing law and regulations."

Petitioner contends that its disclosure in the letter of January 22, 2002 from its representative to the Division which informed the Division that the unnamed subsidiary stated its excess inclusion on line "30" of Federal form 1120 was incorporated by reference in the Voluntary Disclosure Agreement. Petitioner argues that the March 8, 2002 letter was based, in part, on the facts in the January 22, 2002 letter that contained the assertion concerning the placement of the excess inclusion adjustment on the form 1120.

First, it is determined that the Division reserved explicitly the right to audit the returns, verify compliance with the Tax Law and regulations and assess additional tax and interest. Even if the Agreement had specifically included the fact that the subsidiary had placed the excess inclusion adjustment on line "30" of form 1120, it would not have precluded the Division from challenging the propriety of doing so in compliance with the Tax Law and regulations pertinent thereto since the Division had yet to see and analyze how this reporting method would affect tax liability. It simply was not reasonable for petitioner to believe that based on a two-line assertion in a letter without production of the returns affected, that the Division would be charged with the responsibility of understanding the full breadth of this complex issue.

Second, the language of the March 8, 2002 letter, which the parties stipulated was a summary of the Agreement, did not state that the entire contents of Mr. Goldstein's letters of January 22, 2002 and February 11, 2002 had been incorporated into the Agreement, only that they presented facts (along with conversations with Audit staff) from which the facts presented in the letter were chosen. Notably, the information concerning the subsidiary's placement of the excess inclusion on the 1120 was not mentioned in the March 8, 2002 letter.

Finally, in light of the Division's ultimate determination and the discussion above, there is no evidence that the Division ever agreed with petitioner's interpretation of IRC § 860E(a)(1) or the specific method by which it chose to comply.

G. A penalty was imposed by the Division pursuant to Tax Law § 1085(k), which provides that where there is a substantial understatement of tax for any taxable year, i.e., where the substantial understatement exceeds the greater of ten percent of the tax required to be shown on the return or $5,000.00, ten percent of the underpayment attributable to the understatement will be added to the tax due.

Tax Law § 1085(k) also provides, in pertinent part, as follows:

> The amount of such understatement shall be reduced by that 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, or any item with respect to which the relevant facts affecting the items's tax treatment are adequately disclosed in the return or in a statement attached to the return. 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.

Initially, it must be noted that the Voluntary Disclosure Agreement, as summarized by the terms of the March 8, 2002 letter from the Division to petitioner's representative, Mr. Goldstein, clearly states that in consideration for filing the returns specified, including the combined returns, forms CT-3-A, the "Department is willing to impose only interest that is required by statute and abate any applicable penalties for these periods." In addition, the Agreement provided that the returns would be reviewed for accuracy and might result in additional tax and interest, and that the returns might be audited to assure that the returns were completed in accordance with the law and regulations. Therefore, the Division's clearly stated intent was to waive the imposition of penalties even if there was an audit involving a legal issue which resulted in additional tax.

Given these provisions and the specific representations made, it is determined that the Division was bound by the terms of the Agreement and was precluded from asserting the penalty pursuant to Tax Law § 1085(k). Therefore, all penalties are canceled.

In the alternative, if it is found that the terms of the VDA are not dispositive of the penalty issue, then it is determined that petitioner has demonstrated that the understatement was due to reasonable cause and that it acted in good faith. (20 NYCRR 2392.1[g][1].) In this case of first impression, petitioner first alerted the Division to its reporting methodology for the REMIC income and application of the excess inclusion rule in its January 22, 2002 letter as part of its preliminary disclosure in connection with the VDA. Then, in what was an obvious "red flag," petitioner entered large negative sums on line "29a" of the forms 1120 in its attempt to reflect the adjustment required in IRC § 860E(a)(1). This add-back adjustment resulted in a vast difference between the taxable income upon which tax was paid to the New York and federal governments. However, petitioner was plainly informing the Division of its intent and practice when it noted on line "30" of the form 1120 that the federal taxable income had been calculated "per IRC 860E(a)(1)." Petitioner was not practicing deception, rather, it was merely filing its returns to the best of its ability despite very little guidance provided by the New York Tax Law, regulations and instructions to the returns.

Therefore, it is determined that petitioner acted in good faith and, on this alternative basis, has demonstrated that penalty should be abated.

H. The petition of Delta Financial Corporation and Subsidiaries is granted to the extent that all penalties are canceled consistent with Conclusion of Law "G", but in all other respects the petition is denied, and the Notice of Deficiency, dated June 30, 2005, is sustained. Further, the Division of Taxation is directed to examine the disallowed deductions resulting from the application of the excess inclusion adjustment and make appropriate modifications as necessary to preserve petitioner's rights with respect to same.

DATED: Troy, New York
March 29, 2007

/s/ Joseph W. Pinto, Jr.
ADMINISTRATIVE LAW JUDGE