STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition

of

CONDEC CORPORATION

DECISION

for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Period Ending July 31, 1980.

Petitioner, Condec Corporation, 233 South Wacker Drive, 6300 Sears Tower, Chicago, Illinois 60606, 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 period ending July 31, 1980 (File No. 45445).

A formal hearing was held before Joseph W. Pinto, Jr., Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on December 12, 1986 at 10:00 A.M., with all briefs to be submitted by April 3, 1987. Petitioner appeared by its Tax Manager, Brian J. Hanigan. The Audit Division appeared by John P. Dugan, Esq. (Anne W. Murphy, Esq., of counsel).

ISSUES

I. Whether the Audit Division's refusal to offset interest expense by a certain portion of "home office expense'' was proper.

II. Whether petitioner is liable for additional tax due on entire net income resulting from a recomputation of interest indirectly attributable to subsidiary capital.

FINDINGS OF FACT

1. Based upon a desk audit of petitioner's corporation franchise tax report for the period ending July 31, 1980, the Audit Division issued a Statement

of Audit Adjustment dated February 2, 1983, indicating a tax deficiency of $18,295.46 and interest of $5,879.98 for a total amount due of $24,175.44. Although the additional tax was attributed to several factors, the issue of interest indirectly attributable to subsidiary capital is the only issue which remains in dispute. The Statement of Audit Adjustment presented its explanation of the issue as follows:

> "Interest indirectly attributable to subsidiary capital has been computed in accordance with Section 208.9(b)(6) of Article 9A of the Tax Law, The amount of interest expense that is indirectly attributable to subsidiary capital is determined by dividing the average fair market value of subsidiary capital (exclusive of subsidiaries in the combined group) by the average fair market value of total assets (exclusive of subsidiaries in the combined group). The resulting percentage is then multiplied by the total interest expense of the combined group to determine the amount of interest which is indirectly attributable to subsidiary capital."

2. On July 7, 1983, the Audit Division issued to petitioner, Condec Corporation, a Notice of Deficiency which stated additional tax due of $18,295.46 plus interest of $6,937.64 for a total balance due of $25,233.10.

3. Petitioner was incorporated in the State of New York on May 15, 1942 and began doing business in the State on the same date. Petitioner described its principal business activity as manufacturing.

4. Upon audit, several adjustments were made with regard to the Corporation Franchise Tax Return filed for the period ending July 31, 1980, including a deduction for contributions, adjustment of entire net income to reflect inclusion of 100% of the DISC income and an exclusion of the deemed DISC dividend, an adjustment of investment tax credit and an adjustment to the claim for DISC export credit. However, these items were not contested by the taxpayer and the only issue which remained was that of interest indirectly attributable to

subsidiary capital. The formula used by the Audit Division in arriving at interest indirectly attributable to subsidiary capital was as follows:

$$\frac{\text{Investment in and Advances to Subs}}{\text{Total Assets}} \times \text{Total Interest Expense}$$

The Audit Division netted out of the numerator and denominator the value of petitioner's investments in the two subsidiaries in the combined group, Condiesel Power Corp. and Consolidated Diesel Electric Corp. Said value was $789,807.00. The resulting subsidiary asset ratio was 79.4572%.[1] The ratio was then applied to total interest expense of $9,240,825.00, which was reported by petitioner for Federal tax purposes. The resulting interest indirectly attributable to subsidiary capital was $7,342,501.00. This figure was ultimately reduced to $7,292,859.00 because the Audit Division added back the value of the assets of the subsidiaries in the combined group to the total assets in the above formula.

5. The interest indirectly attributable to subsidiary capital was then added back to the Federal taxable income thereby modifying the New York entire net income and ultimately the total amount of corporation franchise tax due from petitioner.

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1 It should be noted that the Audit Division erred in its computation of the subsidiary asset ratio in that its calculation of the denominator incorrectly included the asset values of the subsidiaries in the combined group and the DISC. In Matter of Federated Department Stores, Inc., (State Tax Commission, August 14, 1981), it was stated that no portion of a subsidiary's interest expense deduction was disallowed pursuant to Tax Law § 208.9(b)(6) because said company did not have any subsidiaries. In the instant case, neither the two subsidiaries in the combined group nor the DISC have subsidiaries or investments in subsidiaries. The assets of the subsidiaries and DISC should have been excluded from the denominator. Hence, petitioner's ultimate tax liability would have been higher. However, since the Audit Division failed to make a motion at hearing to raise the amount of the deficiency, no such modification is made herein.

6. Petitioner contends that it should be given an offset against its interest expense for an item entitled "home office expense" which was included in an item listed in petitioner's balance sheet entitled "other income". The home office expense was incurred by the parent corporation on behalf of its subsidiaries. Petitioner contends that 64% of the total corporate expenses for fiscal year ended July 31, 1980 consisted of $8,946,174.00 in interest. It contends that all of this interest is charged to subsidiaries and as such should be netted against the allocated expenses since these amounts are directly attributable to subsidiary activities. Petitioner further contends that it bills out interest expense to all the operating subsidiaries by a formula consisting of subsidiary net working capital and net fixed assets multiplied by Condec's cost of capital.

7. Upon examination of the actual advances to and investments in subsidiaries by the parent for the fiscal year ended July 31, 1980, provided by the taxpayer in a letter to the Commission dated October 9, 1984, it is apparent that there was an excessive fluctuation in interest rates charged to subsidiaries, that many subsidiaries were allocated home office expenses but received no advances and, in one case, a subsidiary with the the second highest allocation of home office expense did not even appear on a list of investments attached to the above-referenced letter in Exhibit E attached thereto.

8. The Audit Division asserts that the inconsistencies evident from the figures provided by petitioner including the large fluctuation in interest charged to subsidiaries, the fact that some subsidiaries were allocated home office expense even though no advances to the subsidiary were made and the omission of Conflow Manufacturing, Inc., a subsidiary with the second highest

allocation of home office expense, do not substantiate interest directly attributable to subsidiary capital.

CONCLUSIONS OF LAW

A. That Tax Law § 208.9 furnishes the definition for and method of computing entire net income. Section 208.9(a)(1) provides that entire net income shall not include "income, gains and losses from subsidiary capital...." Section 208.9(b) provides, in pertinent part:

> "Entire net income shall be determined without the exclusion, deduction or credit of:
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> * * *
>
> (6) in the discretion of the tax commission, any amount of interest directly or indirectly and any other amount directly attributable as a carrying charge or otherwise to subsidiary capital or to income, gains or losses from subsidiary capital."

Generally speaking, the interest expense attributable to subsidiary capital is disallowed as a deduction in order to prevent the taxpayer from reaping a double benefit, inasmuch as the taxpayer is permitted to exclude income from subsidiary capital in the calculation of its entire net income (Matter of Federated Department Stores, Inc., State Tax Commission, August 14, 1981).

B. That the Audit Division properly refused to offset the interest expense of petitioner with the "home office expense" included in the "other income" category listed in petitioner's financial statements for the fiscal year ended July 31, 1980. There was no credible evidence introduced which indicated that the allocation of home office expense to subsidiaries, was based on any indebtedness between the parent and the subsidiaries.

C. That the home office expense was not assessed on any recognizable proportionate basis, nor was it based upon the actual amount borrowed by any particular subsidiary or the amount of income generated by petitioner's investment in each subsidiary (Colt Industries, Inc. v. New York City Department of Finance, 66 NY2d 466). Therefore, the offset against interest expense sought by petitioner cannot be granted.

D. That petitioner failed to demonstrate any error in the formula used by the Audit Division to attribute interest indirectly to subsidiary capital. The values were taken directly from petitioner's own New York Corporate Franchise Tax Return for the period ending July 31, 1980 and further reflected in the balance sheets of petitioner's Federal Corporation Income Tax Return attached to the New York return.

E. That the petition of Condec Corporation is denied, and the Notice of Deficiency issued on July 7, 1983 is sustained together with such additional interest as may be lawfully due and owing.

DATED: Albany, New York

AUG 14 1987

STATE TAX COMMISSION

Roderick G. W. Chu

PRESIDENT

Francis R. Koenig

COMMISSIONER

COMMISSIONER