

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition
of

Philip Morris, Inc.

:

:

AFFIDAVIT OF MAILING

for Redetermination of a Deficiency or a Revision :
of a Determination or a Refund of Corporation
Franchise Tax under Article 9-A of the Tax Law for :
the Years 1971, 1972, 1973, 1975, 1976 & 1977.

State of New York
County of Albany

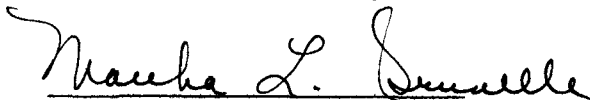
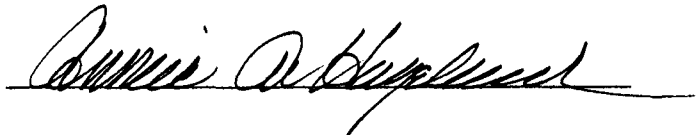
Connie Hagelund, being duly sworn, deposes and says that she is an employee of the State Tax Commission, over 18 years of age, and that on the 22nd day of November, 1983, she served the within notice of Decision by certified mail upon Philip Morris, Inc., the petitioner in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

Philip Morris, Inc.
100 Park Ave.
New York, NY 10017

and by depositing same enclosed in a postpaid properly addressed wrapper in a (post office or official depository) under the exclusive care and custody of the United States Postal Service within the State of New York.

That deponent further says that the said addressee is the petitioner herein and that the address set forth on said wrapper is the last known address of the petitioner.

Sworn to before me this
22nd day of November, 1983.



AUTHORIZED TO ADMINISTER
OATHS PURSUANT TO TAX LAW
SECTION 174

STATE OF NEW YORK

STATE TAX COMMISSION

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James W. Shea
Conboy, Hewitt, O'Brien & Boardman
20 Exchange Pl.
New York, NY 10005

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Maucha L. Drunelle

AUTHORIZED TO ADMINISTER
OATHS PURSUANT TO TAX LAW
SECTION 174

Connie Hagelund

STATE OF NEW YORK
STATE TAX COMMISSION
ALBANY, NEW YORK 12227

November 22, 1983

Philip Morris, Inc.
100 Park Ave.
New York, NY 10017

Gentlemen:

Please take notice of the Decision of the State Tax Commission enclosed herewith.

You have now exhausted your right of review at the administrative level. Pursuant to section(s) 1090 of the Tax Law, any proceeding in court to review an adverse decision by the State Tax Commission can only be instituted under Article 78 of the Civil Practice Law and Rules, and must be commenced in the Supreme Court of the State of New York, Albany County, within 4 months from the date of this notice.

Inquiries concerning the computation of tax due or refund allowed in accordance with this decision may be addressed to:

NYS Dept. Taxation and Finance
Law Bureau - Litigation Unit
Building #9 State Campus
Albany, New York 12227
Phone # (518) 457-2070

Very truly yours,

STATE TAX COMMISSION

cc: Petitioner's Representative
James W. Shea
Conboy, Hewitt, O'Brien & Boardman
20 Exchange Pl.
New York, NY 10005
Taxing Bureau's Representative

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition :
of :
Philip Morris Industrial, Inc. : AFFIDAVIT OF MAILING
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Franchise Tax under Article 9A of the Tax Law :
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Philip Morris Industrial, Inc.
P.O. Box 294
Milwaukee, WI 53201

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STATE OF NEW YORK

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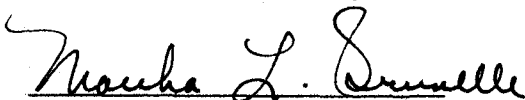
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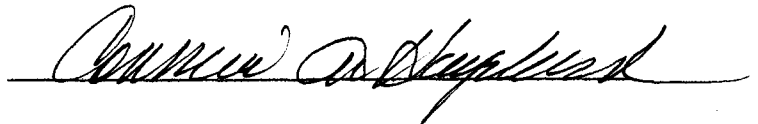
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STATE OF NEW YORK
STATE TAX COMMISSION
ALBANY, NEW YORK 12227

November 22, 1983

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20 Exchange Pl.
New York, NY 10005
Taxing Bureau's Representative

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition
of

Miller Brewing Co.

:

:

AFFIDAVIT OF MAILING

for Redetermination of a Deficiency or a Revision :
of a Determination or a Refund of Corporation :
Franchise Tax under Article 9A of the Tax Law for :
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State of New York
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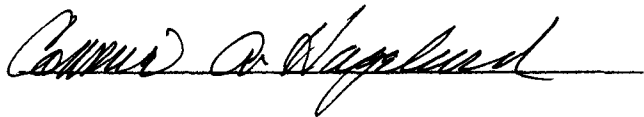
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Miller Brewing Co.
3939 W. Highland Blvd.
Milwaukee, WI 53208

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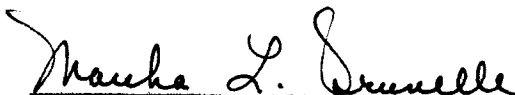
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OATHS PURSUANT TO TAX LAW
SECTION 174



STATE OF NEW YORK
STATE TAX COMMISSION
ALBANY, NEW YORK 12227

November 22, 1983

Miller Brewing Co.
3939 W. Highland Blvd.
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cc: Petitioner's Representative
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20 Exchange Pl.
New York, NY 10005
Taxing Bureau's Representative

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition :
of :
PHILIP MORRIS INCORPORATED :
for Redetermination of a Deficiency or for :
Refund of Franchise Tax on Business Corporations :
under Article 9-A of the Tax Law for the Years :
1971, 1972, 1973, 1975, 1976 and 1977. :

In the Matter of the Petition :
of :
PHILIP MORRIS INDUSTRIAL INCORPORATED :
for Redetermination of a Deficiency or for :
Refund of Franchise Tax on Business Corporations :
under Article 9-A of the Tax Law for the Years :
1976 and 1977. :

DECISION

In the Matter of the Petition :
of :
MILLER BREWING COMPANY :
for Redetermination of a Deficiency or for :
Refund of Franchise Tax on Business Corporations :
under Article 9-A of the Tax Law for the Years :
1976 and 1977. :

Petitioner, Philip Morris Incorporated, 100 Park Avenue, New York, New York 10017, filed a petition for redetermination of a deficiency or for refund of franchise tax on business corporations under Article 9-A of the Tax Law for the years 1971, 1972, 1973, 1975, 1976 and 1977 (File Nos. 20697 and 30277).

Petitioner, Philip Morris Industrial Incorporated, P.O. Box 294, Milwaukee, Wisconsin 53201, filed a petition for redetermination of a deficiency or for

refund of franchise tax on business corporations under Article 9-A of the Tax Law for the year 1977 (File No. 30278).

Petitioner, Miller Brewing Company, 3939 West Highland Boulevard, Milwaukee, Wisconsin 53208, filed a petition for redetermination of a deficiency or for refund of franchise tax on business corporations under Article 9-A of the Tax Law for the years 1976 and 1977 (File No. 30276).

A consolidated formal hearing was held before Doris E. Steinhardt, Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on November 16, 1982 at 9:25 A.M., with all briefs to be submitted by February 8, 1983. Petitioners appeared by Conboy, Hewitt, O'Brien & Boardman, Esqs. (James W. Shea, Esq., of counsel). The Audit Division appeared by Paul B. Coburn, Esq. (Irwin Levy, Esq., of counsel).

ISSUE

Whether, in its determination of interest attributable to subsidiary capital required to be added back to the entire net income of petitioner Philip Morris Incorporated pursuant to Tax Law section 208.9(b)(6), the Audit Division erroneously failed to take cognizance of royalties received from subsidiaries and includible in entire net income.

FINDINGS OF FACT

1. Petitioner Philip Morris Incorporated ("Philip Morris") is a corporation organized and existing under the laws of the Commonwealth of Virginia. It is engaged primarily in the manufacturing business, including the manufacture of tobacco products. Executive offices are maintained at 100 Park Avenue, New York, New York.

Petitioner Philip Morris Industrial Incorporated ("Industrial") is a corporation organized and existing under the laws of the State of Delaware. It

is a wholly-owned subsidiary of Philip Morris and is engaged primarily in designing and manufacturing product packaging.

Petitioner Miller Brewing Company ("Miller") is a corporation organized and existing under the laws of the State of Wisconsin. It is a wholly-owned subsidiary of Philip Morris and is engaged primarily in the manufacture, sale and distribution of beer.

2. Philip Morris timely filed franchise tax reports for the taxable years 1971, 1972, 1973 and 1975. Philip Morris, together with Industrial and Miller, timely filed combined franchise tax reports for the taxable years 1976 and 1977.

3. After audit of petitioners' books and records, the Audit Division issued to Philip Morris statements of audit adjustment and notices of deficiency, asserting additional franchise tax due under Article 9-A of the Tax Law, scheduled as follows:

<u>YEAR</u>	<u>DATE NOTICE OF DEFICIENCY ISSUED</u>	<u>TAX</u>	<u>INTEREST</u>	<u>TOTAL</u>
1971	12/15/76	\$ 72,560.00	\$ 20,680.00	\$ 93,240.00
1972	12/15/76	58,684.00 ¹	16,505.00	75,189.00
1973	12/15/76	79,274.00	16,350.00	95,624.00
1975	6/11/79	161,272.00	44,430.00	205,702.00
1976	7/21/78	883,252.00	101,309.00	984,561.00
1977	6/11/79	1,574,773.00	166,139.00	1,740,912.00

The Audit Division issued to petitioner Industrial statements of tax reduction or overpayment for the years 1976 and 1977 on the dates and in the amounts as shown below.

<u>YEAR</u>	<u>DATE STATEMENT ISSUED</u>	<u>TAX REDUCTION OR OVERPAYMENT</u>	<u>INTEREST</u>	<u>TOTAL</u>
1976	7/21/78	\$2,255.00	\$ --	\$2,255.00
1977	6/11/79	3,237.00	392.00	3,579.00

¹ Reduced to \$52,836.00 by stipulation of the Audit Division at the hearing, based upon acceptance of Philip Morris's Claim for Credit or Refund of Corporation Tax Paid for 1973.

For the taxable year 1976, the Audit Division issued to petitioner Miller a Statement of Tax Reduction or Overpayment, under date July 21, 1978, reflecting a reduction in or overpayment of franchise tax in the amount of \$34,091.00, plus interest of \$3,910.00. For the year 1977, the Audit Division issued to Miller a Statement of Audit Adjustment and Notice of Deficiency, under date June 11, 1979, asserting additional franchise tax due in the amount of \$303,218.00, plus interest of \$31,990.00, for a total due of \$335,208.00.

The Audit Division disallowed petitioners' combined reports for the years 1976 and 1977, on the ground that the corporations failed to obtain the prior permission of the Tax Commission to so file, and recomputed each petitioner's franchise tax liability on a separate basis. At the formal hearing and in petitioners' post-hearing brief, petitioners' representative conceded the adjustments arising from disallowance of the combined filing.

In addition, for each year at issue, the Audit Division disallowed interest expense of Philip Morris which the Division deemed indirectly attributable to subsidiary capital and added those amounts back to Philip Morris's entire net income.

4. During the years 1971, 1972, 1973, 1975, 1976 and 1977, Philip Morris received income from its subsidiaries in the form of dividends, interest and royalties, as follows:

<u>YEAR</u>	<u>DIVIDENDS AND INTEREST</u>	<u>ROYALTIES</u>	<u>TOTAL</u>	<u>DIVIDENDS AND INTEREST AS PERCENTAGE OF TOTAL INCOME FROM SUBSIDIARIES</u>
1971	\$ 3,836,853	\$ 5,439,867	\$ 9,276,720	41%
1972	5,868,803	7,291,416	13,160,219	45
1973	13,047,817	8,659,003	21,706,820	60
1975	9,692,167	12,262,578	21,954,745	44
1976	7,421,819	12,713,481	20,135,300	37
1977	8,214,584	17,553,969	25,768,553	32

Each year, Philip Morris included the royalties received in its computation of entire net income (upon which it paid franchise tax), and excluded therefrom the dividends and interest in accordance with Tax Law section 208.9(a)(1).

5. The Audit Division's formula in arriving at the amount of interest attributable to subsidiary capital was as follows:

$$\frac{\text{average of investments in subsidiaries}}{\text{average of total assets}} \times \text{total interest expense.}$$

The parties have agreed that the above fraction equaled 26.90%, 26.31%, 24.28%, 17.82%, 16.28% and 15.61% for the taxable years 1971, 1972, 1973, 1975, 1976 and 1977, respectively. The amount of interest expense determined in accordance with the formula and added back to Philip Morris's entire net income by the Audit Division pursuant to section 208.9(b)(6) for each of the years under consideration was as follows:

<u>YEAR</u>	<u>AUDIT DIVISION'S INTEREST ATTRIBUTION</u>	<u>INTEREST ATTRIBUTION PER PHILIP MORRIS'S FRANCHISE TAX REPORT</u>	<u>BALANCE</u>
1971	\$ 9,011,534	\$ --	\$ 9,011,534
1972	9,887,018	1,568,413	8,318,605
1973	13,419,688	3,008,450	10,411,238
1975	16,005,298	1,973,366	14,031,932
1976	15,228,937	2,500,004	12,728,933
1977	14,659,764	2,469,437	12,190,327

6. It is the position of petitioner Philip Morris that the Audit Division's determination of interest attributable to subsidiary capital was erroneous and unreasonable because the Audit Division failed to recognize the amount of interest attributable to subsidiary capital, the income (royalties) from which was includible in entire net income. Petitioner Philip Morris maintains that the interest attributable to subsidiary capital required to be added back to entire net income is properly determinable under either of the following methods:

- (a) Determine the amount of interest attributable to income from subsidiary capital which is includible in entire net income and which is excludable from entire net income. Under this method, the amounts of interest attributable to subsidiary capital, the income from which is excludable from entire net income, would equal \$3,694,473 (41% x 9,011,534), \$4,449,158 (45% x \$9,887,018), \$8,051,782 (60% x 13,419,688), \$7,042,331 (44% x \$16,005,298), \$5,634,707 (37% x \$15,228,937) and \$4,691,124 (32% x \$14,659,764) for the years 1971, 1972, 1973, 1975, 1976 and 1977, respectively.
- (b) Determine the amount of interest attributable to subsidiary capital under the Audit Division's formula. The amount so determined would apply to income from subsidiary capital which is excludable from entire net income to the extent of such income, then to income from subsidiary capital which is includible in entire net income. Under this method, the amounts of interest attributable to subsidiary capital, the income from which is excludable from entire net income would equal \$3,836,853, \$5,868,803, \$13,047,817, \$9,692,167, \$7,421,819 and \$8,214,584³ for the years 1971, 1972, 1973, 1975, 1976 and 1977, respectively.

CONCLUSIONS OF LAW

A. That Tax Law section 208, subdivision 9 furnishes the definition for and method of computing entire net income; paragraph (a), subparagraph (1) thereof provides that entire net income shall not include "income, gains and losses from subsidiary capital...". Paragraph (b) sets forth those exclusions, deductions and credits which are not permitted in the determination of entire net income and provides, in pertinent part:

"Entire net income shall be determined without the exclusion, deduction or credit of:

* * *

"(6) in the discretion of the tax commission, any amount of interest directly or indirectly and any other amount directly attributable as a carrying charge or otherwise to subsidiary capital or to income, gains or losses from subsidiary capital."

² The percentage of income from subsidiaries comprised of dividends and interest, as set forth in Finding of Fact "4".

³ These amounts represent the dividends and interest received by Philip Morris from its subsidiaries for such years.

The regulation in force for years prior to 1976 addressed the above two provisions as follows:

"After determining Federal taxable income, it must be adjusted as follows:

* * *

Deduct from Federal taxable income:

(8) All dividends, interest and gains from subsidiary capital...which were taken into account in computing Federal taxable income (less, in the discretion of the State Tax Commission, any deductions allowed in computing Federal taxable income for (1) interest which was directly or indirectly attributable, and (2) any other amounts which were directly attributable, as a carrying charge or otherwise, to subsidiary capital or to income and gains therefrom), but not any other income from subsidiaries...". Former 20 NYCRR 3.11(b).

The regulation effective for taxable years commencing on or after January 1, 1976, as amended on August 20, 1979, provides as follows:

"Adjustments: Items to be added to Federal taxable income...

(a) In computing entire net income, Federal taxable income must be adjusted by adding to it:

* * *

(7) any amount of interest directly or indirectly attributable to subsidiary capital or subsidiary income, and any other amount directly attributable as a carrying charge, or otherwise, to subsidiary capital or to income, gains or losses from subsidiary capital, except to the extent such additions are not required by virtue of an exercise of discretion by the Tax Commission;

(8) all losses from subsidiary capital which were deducted in computing Federal taxable income...". 20 NYCRR 3-2.3.

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 World Wide Volkswagen Corp., State Tax Comm., April 30, 1974. (Analogy may also be profitably drawn to Rev. Proc. 72-18, 1972-1 C.B. 740 and Rev. Rul. 63-27,

1963-1 C.B. 57, which concern allocation of interest and expenses to exempt and nonexempt income for purposes of Internal Revenue Code section 265.) Where interest expense cannot be directly traced to subsidiary capital (or after a direct tracing is employed), an indirect attribution is made, on the theory that each and every asset of the parent company, including its subsidiaries, bears a proportionate share of the parent's interest expense. (See the formula in Finding of Fact "5".)

B. That petitioners have mistakenly and misleadingly characterized royalties as income from subsidiary capital to buttress their principal argument (Finding of Fact "6"). Royalties constitute business receipts and are properly includible in entire net income, whether received by the parent or by the subsidiaries. Tax Law section 208.9 and Internal Revenue Code sections 61(a)(6) and 63(a). Moreover, royalties are included as business receipts in the computation of the business allocation formula (and were so treated by petitioners). Tax Law section 210.3(a)(2)(C).

C. That this Commission does not choose to exercise the discretion accorded to it under Tax Law section 208.9(b)(6) to allow petitioner a deduction for the amount of interest indirectly attributed to subsidiary capital. Here petitioner has had the benefit of excluding from entire net income dividends and interest received from subsidiary capital and should certainly be required to add back the indirectly attributed interest. The foregoing should not be construed, however, as requiring the existence of a double benefit to a taxpayer before such a deduction will be disallowed for the same taxable year.

D. That the petition of Philip Morris Incorporated is denied, and the notices of deficiency issued on December 15, 1976, July 21, 1978 and June 11, 1979 are sustained.

The petition of Philip Morris Industrial Incorporated is hereby denied.


The petition of Miller Brewing Company is hereby denied, and the
Notice of Deficiency issued on June 11, 1979 is sustained.

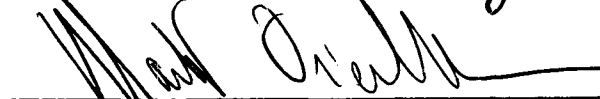
DATED: Albany, New York

STATE TAX COMMISSION

NOV 22 1983

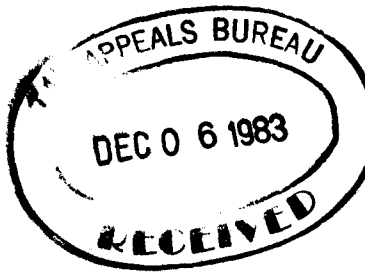

PRESIDENT


COMMISSIONER


COMMISSIONER

TA 26 (9-79)

STATE OF NEW YORK
State Tax Commission
TAX APPEALS BUREAU
STATE CAMPUS
ALBANY, N. Y. 12227

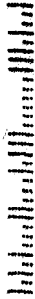


Philip Morris Industrial, Inc.
P.O. Box 294
Milwaukee, WI 53201

CERTIFIED

P 470 315 010

MAIL



STATE OF NEW YORK
STATE TAX COMMISSION
ALBANY, NEW YORK 12227

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for Redetermination of a Deficiency or for
Refund of Franchise Tax on Business Corporations :
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In the Matter of the Petition

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PHILIP MORRIS INDUSTRIAL INCORPORATED

DECISION

for Redetermination of a Deficiency or for
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under Article 9-A of the Tax Law for the Years :
1976 and 1977. :

In the Matter of the Petition

of

MILLER BREWING COMPANY

for Redetermination of a Deficiency or for
Refund of Franchise Tax on Business Corporations :
under Article 9-A of the Tax Law for the Years :
1976 and 1977. :

Petitioner, Philip Morris Incorporated, 100 Park Avenue, New York, New York 10017, filed a petition for redetermination of a deficiency or for refund of franchise tax on business corporations under Article 9-A of the Tax Law for the years 1971, 1972, 1973, 1975, 1976 and 1977 (File Nos. 20697 and 30277).

Petitioner, Philip Morris Industrial Incorporated, P.O. Box 294, Milwaukee, Wisconsin 53201, filed a petition for redetermination of a deficiency or for

refund of franchise tax on business corporations under Article 9-A of the Tax Law for the year 1977 (File No. 30278).

Petitioner, Miller Brewing Company, 3939 West Highland Boulevard, Milwaukee, Wisconsin 53208, filed a petition for redetermination of a deficiency or for refund of franchise tax on business corporations under Article 9-A of the Tax Law for the years 1976 and 1977 (File No. 30276).

A consolidated formal hearing was held before Doris E. Steinhardt, Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on November 16, 1982 at 9:25 A.M., with all briefs to be submitted by February 8, 1983. Petitioners appeared by Conboy, Hewitt, O'Brien & Boardman, Esqs. (James W. Shea, Esq., of counsel). The Audit Division appeared by Paul B. Coburn, Esq. (Irwin Levy, Esq., of counsel).

ISSUE

Whether, in its determination of interest attributable to subsidiary capital required to be added back to the entire net income of petitioner Philip Morris Incorporated pursuant to Tax Law section 208.9(b)(6), the Audit Division erroneously failed to take cognizance of royalties received from subsidiaries and includible in entire net income.

FINDINGS OF FACT

1. Petitioner Philip Morris Incorporated ("Philip Morris") is a corporation organized and existing under the laws of the Commonwealth of Virginia. It is engaged primarily in the manufacturing business, including the manufacture of tobacco products. Executive offices are maintained at 100 Park Avenue, New York, New York.

Petitioner Philip Morris Industrial Incorporated ("Industrial") is a corporation organized and existing under the laws of the State of Delaware. It

is a wholly-owned subsidiary of Philip Morris and is engaged primarily in designing and manufacturing product packaging.

Petitioner Miller Brewing Company ("Miller") is a corporation organized and existing under the laws of the State of Wisconsin. It is a wholly-owned subsidiary of Philip Morris and is engaged primarily in the manufacture, sale and distribution of beer.

2. Philip Morris timely filed franchise tax reports for the taxable years 1971, 1972, 1973 and 1975. Philip Morris, together with Industrial and Miller, timely filed combined franchise tax reports for the taxable years 1976 and 1977.

3. After audit of petitioners' books and records, the Audit Division issued to Philip Morris statements of audit adjustment and notices of deficiency, asserting additional franchise tax due under Article 9-A of the Tax Law, scheduled as follows:

<u>YEAR</u>	<u>DATE NOTICE OF DEFICIENCY ISSUED</u>	<u>TAX</u>	<u>INTEREST</u>	<u>TOTAL</u>
1971	12/15/76	\$ 72,560.00	\$ 20,680.00	\$ 93,240.00
1972	12/15/76	58,684.00 ¹	16,505.00	75,189.00
1973	12/15/76	79,274.00 ¹	16,350.00	95,624.00
1975	6/11/79	161,272.00	44,430.00	205,702.00
1976	7/21/78	883,252.00	101,309.00	984,561.00
1977	6/11/79	1,574,773.00	166,139.00	1,740,912.00

The Audit Division issued to petitioner Industrial statements of tax reduction or overpayment for the years 1976 and 1977 on the dates and in the amounts as shown below.

<u>YEAR</u>	<u>DATE STATEMENT ISSUED</u>	<u>TAX REDUCTION OR OVERPAYMENT</u>	<u>INTEREST</u>	<u>TOTAL</u>
1976	7/21/78	\$2,255.00	\$ --	\$2,255.00
1977	6/11/79	3,237.00	392.00	3,579.00

¹ Reduced to \$52,836.00 by stipulation of the Audit Division at the hearing, based upon acceptance of Philip Morris's Claim for Credit or Refund of Corporation Tax Paid for 1973.

For the taxable year 1976, the Audit Division issued to petitioner Miller a Statement of Tax Reduction or Overpayment, under date July 21, 1978, reflecting a reduction in or overpayment of franchise tax in the amount of \$34,091.00, plus interest of \$3,910.00. For the year 1977, the Audit Division issued to Miller a Statement of Audit Adjustment and Notice of Deficiency, under date June 11, 1979, asserting additional franchise tax due in the amount of \$303,218.00, plus interest of \$31,990.00, for a total due of \$335,208.00.

The Audit Division disallowed petitioners' combined reports for the years 1976 and 1977, on the ground that the corporations failed to obtain the prior permission of the Tax Commission to so file, and recomputed each petitioner's franchise tax liability on a separate basis. At the formal hearing and in petitioners' post-hearing brief, petitioners' representative conceded the adjustments arising from disallowance of the combined filing.

In addition, for each year at issue, the Audit Division disallowed interest expense of Philip Morris which the Division deemed indirectly attributable to subsidiary capital and added those amounts back to Philip Morris's entire net income.

4. During the years 1971, 1972, 1973, 1975, 1976 and 1977, Philip Morris received income from its subsidiaries in the form of dividends, interest and royalties, as follows:

<u>YEAR</u>	<u>DIVIDENDS AND INTEREST</u>	<u>ROYALTIES</u>	<u>TOTAL</u>	<u>DIVIDENDS AND INTEREST AS PERCENTAGE OF TOTAL INCOME FROM SUBSIDIARIES</u>
1971	\$ 3,836,853	\$ 5,439,867	\$ 9,276,720	41%
1972	5,868,803	7,291,416	13,160,219	45
1973	13,047,817	8,659,003	21,706,820	60
1975	9,692,167	12,262,578	21,954,745	44
1976	7,421,819	12,713,481	20,135,300	37
1977	8,214,584	17,553,969	25,768,553	32

Each year, Philip Morris included the royalties received in its computation of entire net income (upon which it paid franchise tax), and excluded therefrom the dividends and interest in accordance with Tax Law section 208.9(a)(1).

5. The Audit Division's formula in arriving at the amount of interest attributable to subsidiary capital was as follows:

$$\frac{\text{average of investments in subsidiaries}}{\text{average of total assets}} \times \text{total interest expense.}$$

The parties have agreed that the above fraction equaled 26.90%, 26.31%, 24.28%, 17.82%, 16.28% and 15.61% for the taxable years 1971, 1972, 1973, 1975, 1976 and 1977, respectively. The amount of interest expense determined in accordance with the formula and added back to Philip Morris's entire net income by the Audit Division pursuant to section 208.9(b)(6) for each of the years under consideration was as follows:

<u>YEAR</u>	<u>AUDIT DIVISION'S INTEREST ATTRIBUTION</u>	<u>INTEREST ATTRIBUTION PER PHILIP MORRIS'S FRANCHISE TAX REPORT</u>	<u>BALANCE</u>
1971	\$ 9,011,534	\$ --	\$ 9,011,534
1972	9,887,018	1,568,413	8,318,605
1973	13,419,688	3,008,450	10,411,238
1975	16,005,298	1,973,366	14,031,932
1976	15,228,937	2,500,004	12,728,933
1977	14,659,764	2,469,437	12,190,327

6. It is the position of petitioner Philip Morris that the Audit Division's determination of interest attributable to subsidiary capital was erroneous and unreasonable because the Audit Division failed to recognize the amount of interest attributable to subsidiary capital, the income (royalties) from which was includible in entire net income. Petitioner Philip Morris maintains that the interest attributable to subsidiary capital required to be added back to entire net income is properly determinable under either of the following methods:

- (a) Determine the amount of interest attributable to income from subsidiary capital which is includible in entire net income and which is excludable from entire net income. Under this method, the amounts of interest attributable to subsidiary capital, the income from which is excludable from entire net income, would equal \$3,694,473 ($41\frac{1}{2}\% \times 9,011,534$), \$4,449,158 ($45\% \times \$9,887,018$), \$8,051,782 ($60\% \times 13,419,688$), \$7,042,331 ($44\% \times \$16,005,298$), \$5,634,707 ($37\% \times \$15,228,937$) and \$4,691,124 ($32\% \times \$14,659,764$) for the years 1971, 1972, 1973, 1975, 1976 and 1977, respectively.
- (b) Determine the amount of interest attributable to subsidiary capital under the Audit Division's formula. The amount so determined would apply to income from subsidiary capital which is excludable from entire net income to the extent of such income, then to income from subsidiary capital which is includible in entire net income. Under this method, the amounts of interest attributable to subsidiary capital, the income from which is excludable from entire net income would equal \$3,836,853, \$5,868,803, \$13,047,817, \$9,692,167, \$7,421,819 and \$8,214,584³ for the years 1971, 1972, 1973, 1975, 1976 and 1977, respectively.

CONCLUSIONS OF LAW

A. That Tax Law section 208, subdivision 9 furnishes the definition for and method of computing entire net income; paragraph (a), subparagraph (1) thereof provides that entire net income shall not include "income, gains and losses from subsidiary capital...". Paragraph (b) sets forth those exclusions, deductions and credits which are not permitted in the determination of entire net income and provides, in pertinent part:

"Entire net income shall be determined without the exclusion, deduction or credit of:

* * *

"(6) in the discretion of the tax commission, any amount of interest directly or indirectly and any other amount directly attributable as a carrying charge or otherwise to subsidiary capital or to income, gains or losses from subsidiary capital."

² The percentage of income from subsidiaries comprised of dividends and interest, as set forth in Finding of Fact "4".

³ These amounts represent the dividends and interest received by Philip Morris from its subsidiaries for such years.

The regulation in force for years prior to 1976 addressed the above two provisions as follows:

"After determining Federal taxable income, it must be adjusted as follows:

* * *

Deduct from Federal taxable income:

(8) All dividends, interest and gains from subsidiary capital...which were taken into account in computing Federal taxable income (less, in the discretion of the State Tax Commission, any deductions allowed in computing Federal taxable income for (1) interest which was directly or indirectly attributable, and (2) any other amounts which were directly attributable, as a carrying charge or otherwise, to subsidiary capital or to income and gains therefrom), but not any other income from subsidiaries...". Former 20 NYCRR 3.11(b).

The regulation effective for taxable years commencing on or after January 1, 1976, as amended on August 20, 1979, provides as follows:

"Adjustments: Items to be added to Federal taxable income...

(a) In computing entire net income, Federal taxable income must be adjusted by adding to it:

* * *

(7) any amount of interest directly or indirectly attributable to subsidiary capital or subsidiary income, and any other amount directly attributable as a carrying charge, or otherwise, to subsidiary capital or to income, gains or losses from subsidiary capital, except to the extent such additions are not required by virtue of an exercise of discretion by the Tax Commission;

(8) all losses from subsidiary capital which were deducted in computing Federal taxable income...". 20 NYCRR 3-2.3.

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 World Wide Volkswagen Corp., State Tax Comm., April 30, 1974. (Analogy may also be profitably drawn to Rev. Proc. 72-18, 1972-1 C.B. 740 and Rev. Rul. 63-27,

1963-1 C.B. 57, which concern allocation of interest and expenses to exempt and nonexempt income for purposes of Internal Revenue Code section 265.) Where interest expense cannot be directly traced to subsidiary capital (or after a direct tracing is employed), an indirect attribution is made, on the theory that each and every asset of the parent company, including its subsidiaries, bears a proportionate share of the parent's interest expense. (See the formula in Finding of Fact "5".)

B. That petitioners have mistakenly and misleadingly characterized royalties as income from subsidiary capital to buttress their principal argument (Finding of Fact "6"). Royalties constitute business receipts and are properly includible in entire net income, whether received by the parent or by the subsidiaries. Tax Law section 208.9 and Internal Revenue Code sections 61(a)(6) and 63(a). Moreover, royalties are included as business receipts in the computation of the business allocation formula (and were so treated by petitioners). Tax Law section 210.3(a)(2)(C).

C. That this Commission does not choose to exercise the discretion accorded to it under Tax Law section 208.9(b)(6) to allow petitioner a deduction for the amount of interest indirectly attributed to subsidiary capital. Here petitioner has had the benefit of excluding from entire net income dividends and interest received from subsidiary capital and should certainly be required to add back the indirectly attributed interest. The foregoing should not be construed, however, as requiring the existence of a double benefit to a taxpayer before such a deduction will be disallowed for the same taxable year.

D. That the petition of Philip Morris Incorporated is denied, and the notices of deficiency issued on December 15, 1976, July 21, 1978 and June 11, 1979 are sustained.

The petition of Philip Morris Industrial Incorporated is hereby denied.

The petition of Miller Brewing Company is hereby denied, and the

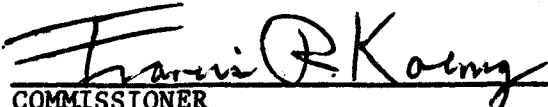
Notice of Deficiency issued on June 11, 1979 is sustained.

DATED: Albany, New York

STATE TAX COMMISSION

NOV 22 1983


PRESIDENT


COMMISSIONER


COMMISSIONER