





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

May 2, 1984

Berkey Photo, Inc.  
1 Water St.  
White Plains, NY 10607

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, a proceeding in court to review an adverse decision by the State Tax Commission may be instituted only 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  
Warner Lowey  
Brout & Company  
380 Madison Ave.  
New York, NY 10017  
Taxing Bureau's Representative

STATE OF NEW YORK

STATE TAX COMMISSION

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In the Matter of the Petition :  
of :  
BERKEY PHOTO, INC. : DECISION  
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 :  
1966, 1967, 1968 and 1970. :

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Petitioner, Berkey Photo, Inc., 1 Water Street, White Plains, New York 10607, 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 1966, 1967, 1968 and 1970 (File No. 33388).

A formal hearing was held before Doris Steinhardt, Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on August 10, 1983 at 9:15 A.M. Petitioner appeared by Brout & Company (Warner Lowey, CPA). The Audit Division appeared by John P. Dugan, Esq. (William Fox, Esq., of counsel).

ISSUES

I. Whether petitioner is entitled to carry over to 1970 \$972,948.00 of a net operating loss incurred in 1967 by Atlas-Rand Corporation, an entity merged into petitioner in 1970.

II. Whether the Audit Division improperly disallowed petitioner's exclusion from its entire net income of interest paid to it by three subsidiaries, Berkey Graphic, Photo Tech and L & L Eastern Effects.

FINDINGS OF FACT

1. On December 17, 1980, following a field audit, the Audit Division issued to petitioner, Berkey Photo, Inc. ("Berkey"), four notices of deficiency,

asserting additional franchise tax due under Article 9-A of the Tax Law for the years 1966, 1967, 1968 and 1970 in the respective amounts of \$68,246.00, \$20,062.00, \$85,973.00 and \$35,709.00, plus interest. A series of 17 consents, duly executed by an officer of Berkey, had extended the periods of limitation for assessment of franchise tax for the years under consideration to July 31, 1981.

2. On May 6, 1967, Berkey acquired all the outstanding capital stock of Atlas Warner Corp., a corporation organized under the laws of New Jersey and doing business in that state and the parent of the following three corporations:

- (a) Atlas-Rand Corporation, a New York corporation engaged in the distribution of photographic equipment and accessories, with offices located at 34 McQueston Parkway South, Mount Vernon, New York;
- (b) Sentry Industries, Inc., a New York corporation engaged in the distribution of blank and prerecorded magnetic tapes, tape recorders and related accessories, also with offices situated at 34 McQueston Parkway South; and
- (c) Al Gitelman Corporation, a Texas corporation doing business in that state.

A combined balance sheet prepared as of April 30, 1967 for Atlas Warner Corp. and its three above-named subsidiaries reflects a deficit in retained earnings of \$115,398.00.

3. Immediately after the acquisition, the operations of the three second tier subsidiaries were assumed by Atlas Warner Corp., which changed its name to Atlas-Rand Corporation ("Atlas-Rand"); subsequently, on September 29, 1967, these three subsidiaries merged into Atlas-Rand. Atlas-Rand continued the respective businesses of the former Atlas-Rand Corporation and Sentry Industries, Inc. under its own aegis at Mount Vernon, until December 31, 1967, at which time these operations were moved to Atlas Rand's place of business in Paramus,

New Jersey. (Atlas-Rand also continued the business of Al Gitelman Corporation in Texas).

4. The 1967 federal corporation income tax return filed by Atlas-Rand shows a loss sustained in that year of \$1,169,908.00. Atlas-Rand also filed a 1967 New York franchise tax report, stating that it began business in this state on January 1, 1967 and reporting a loss of \$1,088,346.00 (the net of the amount of the federal loss, interest paid to stockholders in the amount of \$81,555.00, and New York franchise tax deducted on the federal return).

5. Atlas-Rand merged into Berkey sometime in the early part of 1970, but nonetheless before June 30. Petitioner claimed a 1970 federal net operating loss deduction, resulting by carryover of Atlas-Rand's 1967 net operating loss. Petitioner maintains that for New York franchise tax purposes, it is entitled to carry over that portion of Atlas-Rand's 1967 net operating loss which arose after the acquisition date of May 6, 1967 (and the date Atlas-Rand commenced doing business in New York):

Total New York loss	\$1,088,346
Portion of loss arising before 4/30/67	( 115,398)
Portion of loss claimed	<u>\$ 972,948</u>

During the course of the field audit, the corporation tax examiner allowed the carryover of 50 percent of the total federal loss, or \$584,954.00.

6. By the terms of the agreements between Berkey and its lending institutions, only the parent corporation was permitted to borrow from outside sources. Berkey therefore borrowed funds and in turn, made loans to its subsidiaries, imposing on the subsidiaries the same rate of interest that Berkey itself was charged by its lenders. Petitioner thus asserts that it functioned merely as a conduit, passing through the interest expense to its subsidiary corporations.

7. For the years at issue, between 25 and 30 Berkey subsidiaries submitted franchise tax reports, wherein all but three of the subsidiaries added back to entire net income 100 percent of the interest paid to their parent (on the "pass-through" loans above-described). Berkey Graphic, Photo Tech and L & L Eastern Effects inadvertently neglected to make the add-back; consequently, the corporation tax examiner disallowed petitioner's exclusion from its entire net income of the interest received from these subsidiaries. The disallowances (representing increments to petitioner's entire net income) are set forth below.

	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1970</u>
Berkey Graphic	--	--	\$ 7,122	\$5,607
Photo Tech	\$10,082	\$13,273	--	--
L & L Eastern Effects	--	47,067	48,000	--
	<u>\$10,082</u>	<u>\$60,340</u>	<u>\$55,122</u>	<u>\$5,607</u>

Petitioner maintains that: the adjustments should more properly have been made on the subsidiaries' reports, disallowing the deductions for interest paid; or, in the alternative, since petitioner acted merely as a conduit for the borrowed funds, Berkey Graphic, Photo Tech and L & L Eastern Effects should be permitted the interest deductions and their debts to Berkey eliminated from subsidiary capital.

8. At the formal hearing, counsel for the Audit Division made the following concessions:

- (a) The corporation tax examiner erroneously disallowed \$64,303.00 in interest expense deducted by petitioner on its 1970 franchise tax report. (It had appeared from a schedule submitted by petitioner at the time of audit that Berkey Processing was a subsidiary of petitioner, thus the auditor had required the add-back of the interest expense. Berkey Processing, however, was a division of petitioner.)
- (b) Petitioner mistakenly reduced the amounts of income from subsidiary capital, which it excluded from its entire net income, by interest paid to its divisions.

Interest, dividends and capital gains from subsidiary capital excluded from petitioner's entire net income at line 7, schedule B of its 1966, 1967, 1968 and 1970 franchise tax reports should thus be increased by \$34,815.00, \$20,704.00, \$6,000.00 and \$168,803.00, respectively.

CONCLUSIONS OF LAW

A. That Tax Law section 208, subdivision 9, paragraph (f) permits a corporation subject to tax under Article 9-A a net operating loss deduction "which shall be presumably the same as the net operating loss deduction allowed under section one hundred seventy-two of the internal revenue code of nineteen hundred fifty-four,...except that...such deduction shall not include any operating loss sustained...during any taxable year in which the taxpayer was not subject to the tax imposed by this article...". Under the limitation of this provision, petitioner's 1970 net operating loss deduction can only embrace the net operating loss sustained by Atlas-Rand during that portion of 1967 when Atlas-Rand was subject to Article 9-A taxation, namely, May 6 through December 31.

Total 1967 NOL	\$1,169,908
NOL sustained 1/1-4/30	115,398
NOL sustained 5/1-12/31	<u>\$1,054,510</u>

Portion of NOL sustained 5/1-12/31 on a daily basis:

$\$1,054,510 / 245 \text{ days} = \$4,304/\text{day}$

NOL sustained 5/6-12/31:

$\$4,304 \times 240 \text{ days} = \$1,032,960$

B. That the above computation does not dispose of the first issue, however, insofar as it does not consider other conditions and limitations upon the carryover, especially those imposed by Internal Revenue Code section 381(c)(1). Code section 381 provides that a corporation which acquires the assets of another corporation in certain liquidations and reorganizations, including statutory mergers and consolidations, may succeed to and take into



account certain tax items of the distributor or transferor corporation, including net operating loss carryovers. As previously mentioned, subdivision (c), paragraph (1) sets forth the rules which must be applied in determining the carryover of the transferor's loss; subparagraph (B) states:

"In determining the net operating loss deduction, the portion of such deduction attributable to the net operating loss carryovers of the distributor or transferor corporation to the first taxable year of the acquiring corporation ending after the date of distribution or transfer shall be limited to an amount which bears the same ratio to the taxable income (determined without regard to a net operating loss deduction) of the acquiring corporation in such taxable year as the number of days in the taxable year after the date of distribution or transfer bears to the total number of days in the taxable year."

Simply stated, the carryover of the predecessor's losses to the successor's first taxable year ending after the transfer is limited to the successor's taxable income attributable to the portion of the year after the transfer. Petitioner has failed to establish the date of the transfer and the amount of its taxable income attributable to the portion of 1970 after the transfer, information essential to calculate this limitation; accordingly, petitioner has failed to establish its entitlement to carry over more than \$584,954.00 of Atlas-Rand's loss (the amount of carryover permitted on audit).

C. That, proceeding to the second issue, the Audit Division disallowed petitioner's exclusion from its entire net income of interest paid to it by three subsidiaries, for the subsidiaries' failure to add back such interest expenses to their respective entire net incomes. Petitioner contends, first, that any necessary adjustments should have been made on the subsidiaries' franchise tax reports. This argument is without merit. Neither petitioner nor any of the three subsidiaries concerned elected to file an amended report, correcting this situation, within the time limitations prescribed by Tax Law

section 1087, subdivision (a). Petitioner contends, second, that it functioned as a conduit, passing borrowed funds from outside lenders through to the three subsidiaries; and that consequently, the subsidiaries' deductions for their interest expenses on such loan amounts were properly taken. Tax Law section 208, subdivision 9, paragraph (b), subparagraph (5) states, in pertinent part:

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

\* \* \*

(5) ninety percentum of interest on indebtedness directly or indirectly owed to any stockholder or shareholder (including subsidiaries of a corporate stockholder or shareholder), or members of the immediate family of an individual stockholder or shareholder, owning in the aggregate in excess of five percentum of the issued capital stock of the taxpayer, except that such interest may, in any event, be deducted

(i) up to an amount not exceeding one thousand dollars,..."

This modification to federal taxable income disallows 90 percent of a corporation's federal deduction for interest paid to a shareholder owning more than five percent of the taxpayer's stock and must be read in conjunction with section 208.9(a)(1) which provides for the exclusion from (a parent corporation's) entire net income of income, gains and losses from subsidiary capital. Petitioner seeks to have its subsidiaries avail themselves of the interest deductions and to eliminate the corresponding debts from subsidiary capital. Assuming this course of action would be permissible under the relevant provisions, petitioner has nonetheless failed to establish a crucial element in its conduit theory: that the funds "passed through" were utilized to meet the subsidiaries' ordinary business and working capital needs and did not serve as a substitute for investments in the subsidiaries' stock.

D. That the petition of Berkey Photo, Inc., is denied; the notices of deficiency issued on December 17, 1980 are to be modified in accordance with the concessions made by counsel to the Audit Division (Finding of Fact "8"); and except as so modified, the deficiencies are in all other respects sustained.

DATED: Albany, New York

MAY 02 1984

STATE TAX COMMISSION

  
PRESIDENT

  
COMMISSIONER

  
COMMISSIONER