STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition of Puritan Fashions Corporation	AFFIDAVIT OF MAILING
for Redetermination of a Deficiency or Revision of a Determination or Refund of Corporation Franchise Tax under Article 9A of the Tax Law for the Fiscal Years Ended 11/30/71 - 11/30/74.	

State of New York }
ss.:
County of Albany }

David Parchuck, being duly sworn, deposes and says that he is an employee of the State Tax Commission, that he is over 18 years of age, and that on the 18th day of January, 1984, he served the within notice of Decision by certified mail upon Puritan Fashions Corporation, the petitioner in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

Puritan Fashions Corporation
c/o Nathan Berkman & Co.
29 Broadway
New York, NY 10006

and by depositing same enclosed in a postpaid properly addressed wrapper in a post office 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
18th day of January, 1984.

David Parchuck

Authorized to administer oaths
pursuant to Tax Law section 174

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition :
of
Puritan Fashions Corporation :

AFFIDAVIT OF MAILING

for Redetermination of a Deficiency or Revision :
of a Determination or Refund of Corporation
Franchise Tax under Article 9A of the Tax Law for :
the Fiscal Years Ended 11/30/71 - 11/30/74.
:

State of New York }
ss.:
County of Albany }

David Parchuck, being duly sworn, deposes and says that he is an employee of the State Tax Commission, that he is over 18 years of age, and that on the 18th day of January, 1984, he served the within notice of Decision by certified mail upon Sheldon Singer, the representative of the petitioner in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

Sheldon Singer
Nathan Berkman & Co.
29 Broadway
New York, NY 10006

and by depositing same enclosed in a postpaid properly addressed wrapper in a post office 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 representative of the petitioner herein and that the address set forth on said wrapper is the last known address of the representative of the petitioner.

Sworn to before me this
18th day of January, 1984.

David Parchuck

Authorized to administer oaths
pursuant to Tax Law section 174

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

January 18, 1984

Puritan Fashions Corporation
c/o Nathan Berkman & Co.
29 Broadway
New York, NY 10006

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
Sheldon Singer
Nathan Berkman & Co.
29 Broadway
New York, NY 10006
Taxing Bureau's Representative

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition	:	
of	:	
PURITAN FASHIONS CORPORATION	:	DECISION
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Fiscal Years Ended November 30, 1971 through November 30, 1974.	:	

Petitioner, Puritan Fashions Corporation, c/o Nathan Berkman & Co., 29 Broadway, New York, New York 10006, 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 fiscal years ended November 30, 1971 through November 30, 1974 (File No. 27529).

A formal hearing was held before Daniel J. Ranalli, Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on June 22, 1983 at 1:30 P.M. Petitioner appeared by Nathan Berkman & Co. (Sheldon Singer, Esq. and Bernard Pomerantz, Esq., of counsel). The Audit Division appeared by John P. Dugan, Esq. (Anna Colello, Esq., of counsel).

ISSUES

I. Whether the Audit Division properly disallowed a deduction from Federal taxable income taken by petitioner for interest income received from subsidiaries.

II. Whether the Audit Division properly determined the amount of interest expense to be added back to petitioner's Federal taxable income in order to arrive at New York entire net income.

III. Whether the loss incurred by petitioner as a result of the liquidation of a subsidiary was a subsidiary capital loss and, therefore, required to be added back to Federal taxable income.

IV. Whether the Audit Division properly valued petitioner's subsidiary capital at the average fair market value for purposes of the tax on subsidiary capital.

FINDINGS OF FACT

1. On June 6, 1979, as the result of a field audit, the Audit Division issued three notices of deficiency pursuant to Article 9-A of the Tax Law against petitioner, Puritan Fashions Corporation, in the amounts of $24,726.00 plus interest of $10,818.00 for the fiscal year ended November 30, 1971, $24,535.00 plus interest of $9,262.00 for fiscal year ended November 30, 1972, and $29,084.00 plus interest of $11,543.00 for the fiscal year ended November 30, 1973.[1] A credit of $3,899.00 for the fiscal year ended November 30, 1974 was applied to the total due, on the Notice of Deficiency for the fiscal year ended November 30, 1971.

2. On audit, the Audit Division had disallowed certain adjustments, modifications, and deductions taken by petitioner on each of its returns for 1971 through 1974. The disallowances contested by petitioner include a disallowance of a discount taken in determining the fair market value of subsidiary capital, the disallowance of a deduction for interest income from subsidiaries, the recomputation of interest attributable to subsidiary capital, and the

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1 The Notice of Deficiency for the year ended November 30, 1973 contained a mathematical error in that the tax due of $29,084.00 plus interest of $11,543.00 had a total due indicated of $50,637.00. The correct total figure should have been $40,627.00.

disallowance of a deduction for a loss incurred as the result of the liquidation of a subsidiary in 1967 which loss had been carried forward to 1971 and 1972.

3. During each of the years in issue, petitioner, in determining net income, deducted from its Federal taxable income interest income received from its subsidiaries. The subsidiaries, on their own franchise tax reports, had added back to Federal taxable income 90 percent of the interest paid to petitioner. The Audit Division disallowed the deduction for interest income from subsidiary capital taken by petitioner. The disallowance was based on the proposition that, if the subsidiaries add back to Federal taxable income 90 percent of the interest paid to the parent rather than 100 percent, the interest income is no longer from subsidiary capital but from business capital and none of such interest income may be deducted from the parent's Federal taxable income. Petitioner argued that such treatment of interest between parent and subsidiary results in double taxation insofar as the 90 percent of interest paid and added back by the subsidiaries is taxable to both parent and subsidiaries.

4. With respect to the disallowance of the deduction for interest from subsidiary capital, petitioner also maintained that the disallowance was erroneous in the case of interest from two of its subsidiaries, Paraphernalia, Inc. and the Waltham Group. Petitioner presented evidence which showed that in 1972 and 1974, Paraphernalia, Inc. had added back to its Federal taxable income over 100 percent of the interest paid to petitioner. This occurred as a result of Paraphernalia inadvertently adding back 90 percent of all interest paid to all creditors during 1972 and 1974. Thus, petitioner maintained that it had actually complied with the 100 percent add-back requirement with respect to Paraphernalia, Inc. for the years 1972 and 1974 and should be allowed full deductions of $191,430.00 and $657,569.00 for the years 1972 and 1974 respectively.

The Waltham Group is a Massachusetts corporation which does not file New York franchise tax reports. Petitioner argued, therefore, that all interest income to petitioner from Waltham should be an allowable deduction. Petitioner claimed a deduction for $185,200.00 in interest income from Waltham in 1974. None was received during the other years in issue herein.

5. The Audit Division recomputed the interest expense attributable to subsidiary capital for each of the years in issue thus increasing the amount to be added back to petitioner's Federal taxable income. At a pre-hearing conference the Audit Division agreed to an adjustment of the total interest expense in the formula for computing interest expense indirectly attributable to subsidiary capital. Said adjustment resulted in a reduction of interest expense attributable to subsidiary capital as follows:

	11/30/71	11/30/72	11/30/73	11/30/74
Interest expense per field audit	157,979	133,617	134,647	371,343
Interest expense per conference	97,564	93,665	29,373	147,079
Reduction in Entire Net Income	60,415	39,952	105,274	224,264

Petitioner argued that the cost method of valuing subsidiary capital should have been used rather than the equity method for determining values to utilize in the formula. Testimony presented on behalf of the Audit Division indicated that the cost method is the normal method used. Petitioner was unable to show that the cost method was not used in its case.

6. Petitioner owned 50 percent of the stock of Mode International, Ltd. ("Mode") from its formation in 1962 until November 27, 1965 when petitioner acquired the other 50 percent interest. Mode was liquidated in 1967 at a loss of $244,584.00. Petitioner deducted the $244,584.00 as an ordinary loss on its Federal tax return for the fiscal year ended December 2, 1967. The Internal

Revenue Service disallowed the deduction as an ordinary loss but allowed it as a capital loss based on the determination that petitioner's acquisition of the remaining 50 percent of Mode in 1965 was a sham transaction entered into only for the purpose converting a capital loss into an ordinary loss. The Audit Division took the position that the 1965 transaction was valid and that, as a result, Mode was a subsidiary of petitioner in 1967 and that the loss was not allowable since New York entire net income is determined with the add back of losses from subsidiary capital. Petitioner had carried forward the loss as a capital loss to fiscal years ended November 30, 1971 and November 30, 1972 claiming that, since the Internal Revenue Service had considered the transaction a sham, Mode should not be considered a subsidiary for New York tax purposes. The Audit Division disallowed the loss deduction in full.

7. In determining the fair market value of its subsidiary capital for purposes of the tax on subsidiary capital, petitioner reduced the reported value by an adjustment for "blockage" which takes account of the fact that, if all the stock of the subsidiaries was offered for sale in a large block, the price would be substantially depressed. Petitioner alleged that the "blockage" principle was well established in Federal taxation. The Audit Division argued that, under the Tax Law, only average fair market value of subsidiary capital is allowed without adjustment for "blockage" and all of petitioner's adjustments were disallowed in determining the tax on subsidiary capital.

CONCLUSIONS OF LAW

A. That section 208.9(a)(1) of the Tax Law provides, in part, that entire net income shall not include income and gains from subsidiary capital. Section 208.4 defines subsidiary capital, in part, as investments in stock of subsidiaries and any indebtedness owed to the parent by its subsidiaries on which no interest

was claimed and deducted by the subsidiary for the purpose of any New York franchise tax. Section 208.9 (b)(5) of the Tax Law requires that 90 percent of interest on indebtedness owed to shareholders must be added back to Federal taxable income except that interest up to $1,000.00 may be deducted in any event.

B. That inasmuch as subsidiary capital includes only indebtedness on which no deductions for interest have been taken for purposes of New York franchise taxes, when petitioner's subsidiaries took the 10 percent deduction allowed by section 208.9(b)(5), such indebtedness as was owed to petitioner was no longer subsidiary capital but was business capital and, therefore, not allowed to be deducted from Federal taxable income in determining entire net income. However, in 1972 and 1974, Paraphernalia, Inc. did not avail itself of the 208.9(b)(5) deduction since it added back 100 percent of the interest paid to petitioner for those years. Therefore, the indebtedness of Paraphernalia, Inc. for 1972 and 1974 was subsidiary capital and the interest income of $191,430.00 in 1972 and $657,569.00 in 1974 received from Paraphernalia, Inc. should have been deducted from petitioner's Federal taxable income in arriving at its entire net income. Moreover, since the Waltham Group did not have to file a New York corporation franchise tax report in 1974, its indebtedness was also subsidiary capital and the interest of $185,200.00 paid by it to petitioner should have been deducted from petitioner's Federal taxable income for 1974. All other interest income from subsidiaries was properly included in entire net income.

C. That section 208.9(b)(6) of the Tax Law provides, in part, that entire net income shall be determined without the exclusion, deduction or credit of interest directly or indirectly attributable to subsidiary capital or to income, gains or losses from subsidiary capital. Since petitioner was unable to show that the equity method was used by the Audit Division or that the

method used to determine interest attributable to subsidiary capital was improper, the method of determination used by the Audit Division, as adjusted at the pre-hearing conference and discussed in Finding of Fact "5", was proper and said amounts should have been added back to Federal taxable income.

D. That section 208.9(a)(1) of the Tax Law and 20 NYCRR 3-2.3(a)(8) provide, in part, that, among the items to be added back to Federal taxable income to determine entire net income, are losses from subsidiary capital which were deducted in computing Federal taxable income. Section 208.3 of the Tax Law defines the term "subsidiary" to mean a corporation of which over 50 percent of the number of shares of stock entitling the holders thereof to vote for the election of directors or trustees is owned by the taxpayer.

E. That, although entire net income is presumed to be Federal taxable income with modifications (Tax Law, §208.9), the Tax Commission is not bound by determinations of the Internal Revenue Service. The record indicates that Mode was a subsidiary of petitioner following the acquisition of the remaining 50 percent of outstanding shares in 1965. Other than the Internal Revenue Service determination, petitioner was unable to produce any evidence which would indicate that the 1965 acquisition was anything but a valid transaction whereby Mode became a subsidiary of petitioner. Therefore, the loss incurred as a result of the liquidation of Mode in 1967 was a loss from subsidiary capital under section 208.9(a)(1) and 20 NYCRR 3-2.3(a)(8) and should have been added to Federal taxable income to determine entire net income.

F. That section 210.2 of the Tax Law and 20 NYCRR 3-6.4 provide that, for purposes of the tax on subsidiary capital imposed by section 210.1(b), the amount of subsidiary capital shall be determined by taking the average fair market value of all the assets for the taxpayer which constitute subsidiary

capital, less certain liabilities required to be deducted. Fair market value, as defined by 20 NYCRR 3-4.5, "is the price at which a willing seller, not compelled to sell, will sell and a willing purchaser, not compelled to buy, will buy." There is no allowance made, either in law, regulation or custom, for a "blockage" adjustment and the Audit Division properly disallowed such unauthorized adjustments to fair market value as were taken by petitioner.

G. That the petition of Puritan Fashions Corporation is granted to the extent indicated in Finding of Fact "5" and Conclusion of Law "B"; that the Audit Division is directed to modify the notices of deficiency issued June 6, 1979 accordingly; and that, except as so granted, the petition is in all other respects denied.

DATED: Albany, New York

JAN 18 1984

STATE TAX COMMISSION

PRESIDENT

COMMISSIONER

COMMISSIONER