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New York upholds forced combination for income distortion

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Authored by: Dorothy Lo

The New York Tax Appeals Tribunal (TAT) affirmed a decision to force the combination of a bank and its subsidiary because an interest deduction attributable to assets held by the subsidiary resulted in distortion of income.[*Interaudi Bank F/K/A Bank Audi (USA)*, New York Tax Appeals Tribunal, DTA No. 821659, April 14, 2011]

Background

Interaudi Bank, a commercial banking corporation organized and chartered in New York, formed and transferred its investment portfolio to a passive investment holding subsidiary, BA (USA) Investments Inc., domiciled in Delaware. BA Investments limited its activities to the management and maintenance of marketable securities. For each of the years at issue, Interaudi and all of its subsidiaries, including BA Investments, filed a federal consolidated return. With respect to its New York tax returns however, Interaudi filed on a combined basis with all of its subsidiaries except BA Investments. Interaudi claimed interest expense deductions based on investment expenses incurred for BA Investments. BA Investments did not file any tax returns in New York during the years at issue.

Upon audit, the New York Division of Taxation determined that the transfer of the investment portfolio was a distortive arrangement, noting that BA Investments' income accounted for more than 90 percent of the income of the federal consolidated group and that Interaudi's expenses increased to 96 percent of income following the transfer. Further, the Division found that Interaudi and not BA investments was managing the portfolio, the portfolio was an integral part of Interaudi's capital requirements, and that Interaudi was incurring the costs of the portfolio instead of BA Investments. The auditors concluded that inclusion of BA Investments in petitioner's combined report was necessary to cure the asserted distortion.

Interaudi appealed the Division's Notice of Deficiency determination and stated that, in the absence of substantial intercorporate transactions between the combined group and BA Investments, the Division bears the burden of proving the existence of distortion before it can require that BA Investments, a New York non-taxpayer, be included in the combined report. Interaudi asserted that the Division failed to meet its burden of proof of distortion.

The Division countered that forced combination was necessary because the sole purpose of BA Investments was to avoid New York state and local taxes and there was no economic or substantive purpose for its existence

The Administrative Law Judge (ALJ) upheld the Division's forced combination, ruling that Interaudi distorted its income by claiming an interest expense deduction in its combined report attributable to assets held by BA Investments. Interaudi had either overstated its deductions or understated its income, and thus, BA Investments must be included in the combined report to eliminate the distortion, the ALJ stated.

Interaudi appealed the ALJ's decision, asserting that the Division did not meet its burden of proof for distortion, the ALJ improperly allowed testimony, that the New York law relied on by the Division violates the Commerce Clause and Equal Protection and lastly, that the Division improperly imposed a substantial understatement penalty.

TAT Ruling

Distortion. The TAT affirmed the ALJ determination. The TAT reiterated that under N.Y. Tax Law Sec. 1462(f)(2)(I) , "any banking corporation or bank holding company which is exercising its corporate franchise or doing business in this state in a corporate or organized capacity and (A) which owns or controls, directly or indirectly, 80 percent or more the voting stock of one or more banking corporations or bank holding companies, or (B) whose voting stock is 80 percent or more owned or controlled, directly or indirectly, by a banking corporation or a bank holding company, must file a combined New York bank franchise tax return with such corporations described in (A) or (B)," unless the taxpayer or the tax commission shows that the inclusion of such a corporation in the combined return fails to properly reflect the tax liability of the corporation.

Under Regulation Section 21-2.6(a), in order to require combination of a banking corporation or bank holding company which is not a taxpayer, the Division must demonstrate that there were intercorporate transactions or the existence of some agreement, understanding or arrangement between the taxpayer and that corporation, whereby the activity, business, income or assets of the taxpayer is improperly or inaccurately reflected. Also, if there are substantial intercorporate transactions among the banking corporations or bank holding companies engaged in a unitary business, it will be presumed that the tax liability of the taxpayer will be improperly reflected when the taxpayer reports on a separate basis. The substantial intercorporate transaction test may be met where as little as 50 percent of a corporation's receipts or expenses are from one or more qualified activities described in the regulation.

Agreeing with the ALJ, the TAT stated that the intercorporate transactions between the combined group and BA Investments were so insignificant and limited that they clearly did not rise to the level of 50 percent. Accordingly, no presumption was created such that inclusion of BA Investments in the combined group was deemed necessary in order to properly reflect the tax liability of Interaudi.

Nevertheless, the TAT ruled that the ALJ properly concluded that Interaudi created a distortion in its net income by claiming a significant interest expense deduction in its combined report attributable to assets held by its subsidiary, BA Investments that was not in the combined report. The TAT pointed out that the Division demonstrated that the transfer of Interaudi's investments to BA investments was an arrangement whereby expenses incurred in order to fund the purchase of assets were left with Interaudi, but the assets themselves (and associated income generated from such assets) were transferred to BA investments. The TAT explained that when Interaudi invested $100 million in BA Investments, Interaudi used funds borrowed from depositors, creating an arrangement under which the expenses of obtaining the funds was allocated to New York State, while the income earned on such funds was allocated outside of New York State. This arrangement created a mismatching of related income and expenses and lead to Interaudi either overstating its deductions or understating its income. By including BA Investments' income in the combined report, the distortion was properly eliminated.

Testimony. The TAT dismissed Interaudi's argument that the Division did not lay an appropriate foundation for its expert testimony, that the testimony lacked reliability and credibility, and the testimony should not have been admitted into evidence or, if allowed, should not have been accorded any weight. The TAT stated that the ALJ did not specifically rely on the expert testimony or report in arriving at the determination, since there was other sufficient evidence on record.

Interstate Commerce. Interaudi also argued that the assessment provided under New York Tax Law section 1462(d) and (g) discriminated against interstate commerce, violating both the Commerce Clause and the Equal Protection Clause of the U.S. Constitution. However, the TAT noted that arguments that a statute is invalid on its face do not fall within the purview of the Division of Tax Appeals and all of the challenged statutes were presumed to be valid at this level of review.

Substantial Understatement Penalty. The TAT noted that penalties are imposed under specific circumstances and it is the burden of the taxpayer to demonstrate that reasonable cause exists for the waiver of penalties. Therefore, the TAT upheld the penalty, since Interaudi failed to demonstrate reasonable cause.

PwC Observes

"Although the taxpayer lost this case, a closer reading of the decision may imply a narrow application," says John Verde SALT Managing Director with PwC in Albany.

"The TAT affirmed the ALJ's decision since the evidence showed that 'petitioner used funds which it had borrowed from its depositors, creating an arrangement whereby the expenses of obtaining such funds (the interest paid to depositors) was allocated to New York State, while the income earned on such funds was allocated outside of New York State.' However, as the ALJ noted in his decision, 'if, on the other hand, petitioner used funds for which petitioner incurred no expense (e.g., paid-in capital or undistributed profits), then it is hard to see where there is any mismatching of income and expenses which would cause distortion.' In such a case, there should be an argument that there is no distortion since there would not be any mismatching of income and expenses. This suggests that when a well-capitalized parent contributes funds to a subsidiary for which the parent incurred no expense, it may not necessarily be a basis for combination," observes Verde.

Finally, concludes Verde "the conclusion that the mismatching of income and expense results in distortion necessitating a combined filing could be used against the Division in the numerous situations where they deny combination based on a lack of substantial intercompany transactions."

For more information, please do not hesitate to contact:

John Verde	*(646) 471-1804*	*john.a.verde@us.pwc.com*
Peter Michalowski	*(646) 471-5259*	*peter.michalowski@us.pwc.com*
Jack Kramer	*(646) 471-2640*	*jack.kramer@us.pwc.com*
Greg Lee	*(646) 471-2654*	*gregory.a.lee@us.pwc.com*
Jonathan Robin	*(646) 471-0509*	*jonathan.robin@us.pwc.com*
Dorothy Lo	*(202) 346-5141*	*dorothy.lo@us.pwc.com*