STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
PREMIER NATIONAL BANCORP, INC.	:	DETERMINATION
for Redetermination of a Deficiency or for Refund of Franchise Tax on Banking Corporations under Article 32 of the Tax Law for the Years 1998 and 1999.	:	DTA NO. 819746

Petitioner, Premier National Bancorp, Inc., c/o M & T Bank, One M & T Plaza, Buffalo, New York 14203, filed a petition for redetermination of a deficiency or for refund of franchise tax on banking corporations under Article 32 of the Tax Law for the years 1998 and 1999.

A hearing was held before Catherine M. Bennett, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on September 8, 2004 at 9:15 A.M., with all briefs in this matter due to be submitted by July 29, 2005, which date began the six-month period for the issuance of this determination. The six-month period was extended for an additional three months pursuant to Tax Appeals Tribunal Rules of Practice and Procedure § 3000.15(e)(1). Petitioner appeared by Hodgson Russ LLP (Christopher L. Doyle, Esq., and Timothy P. Noonan, Esq., of counsel). The Division of Taxation appeared by Christopher C. O'Brien, Esq. (Nicholas A. Behuniak, Esq., of counsel).

ISSUES

I. Whether it was appropriate for the Division of Taxation to make a discretionary adjustment, pursuant to Tax Law § 1462(g), to Premier National Bancorp, Inc.'s combined income by including the income earned and reported on the Article 9-A return of Premier National Investment Company, its subsidiary.

II. Whether the Division of Taxation met its burden of proving that it properly increased the notice of deficiency.

III. Whether the Division of Taxation properly asserted substantial understatement penalties against petitioner.

FINDINGS OF FACT

1. Petitioner, Premier National Bancorp, Inc. ("Holding"), was formed after a July 1998 merger of Progressive Bank, Inc. ("Progressive") with Hudson Charter Bancorp., Inc. ("Hudson"), two previously existing bank holding companies. At the same time, Pawling Savings Bank ("Pawling"), a subsidiary of Progressive, merged with First National Bank of Hudson Valley ("FNBHV"), a subsidiary of Hudson, to form Premier National Bank ("Bank"). After the mergers, Bank was a wholly-owned subsidiary of Holding.

2. Hudson Charter Realty, Inc. was also a wholly-owned subsidiary of Holding during 1998 and 1999, the years in issue. Neither Holding nor Hudson Charter Realty, Inc. had any employees.

3. Holding was a bank holding company engaged in business activity solely within New York State. Bank was engaged in a variety of commercial lending activities and deposit gathering activities solely within southeastern New York State. During 1998 and 1999, Holding, Bank and Hudson Charter Realty filed Form CT-32-A, a Banking Corporation Combined Franchise Tax Return, pursuant to Tax Law Article 32.

4. Prior to the mergers in July 1998 to form Holding and Bank, FNBHV had been investigating ways to minimize New York State income taxes with the use of Article 9-A companies and increase the after tax return on its excess liquidity. In March 1997, an analysis conducted by FNBHV, premised solely on minimizing New York State income taxes, included a

discussion of Delaware investment subsidiaries, real estate investment trusts and Article 9-A subsidiaries of a bank. Under the Article 9-A subsidiary of a bank option, the report stated the following:

> In 1985, New York State created a grandfather provision for passive investment companies to be taxed under Article 9A vs. Article 32 (Bank Tax Treatment). There are a limited number of companies that filed the proper elections in 1985. We are aware of several, and in particular, Republic bank has stated that we could purchase one of several that it has acquired over the years. Our accountants, Deloitte & Touche, as well as sources from Peat Marwick, both agreed that the tax treatment is favorable. The law was passed in 1985 to avoid companies that existed from moving operations to move [sic] favorable tax states such as Delaware.

FNBHV's analysis further stated,

> We believe that we could move between $75 million to $100 million of securities to this subsidiary and save permanent taxes of approximately $150,000-$200,000 and deferred indefinitely another $100,000 to $125,000 (based upon the 40% taxation of eventual dividends).

5. In May 1998, FNBHV (then still a subsidiary of Hudson) acquired the stock of Gare Ventures, Ltd. ("Gare") from Republic National Bank of New York for $250,000.00. Gare was incorporated in Nevada in 1980 as a subsidiary of Metropolitan Savings Bank, and began doing business in New York in August 1980. At the time of the acquisition, Gare had no employees and virtually no assets. However, Gare had unique tax status, making the company an attractive investment. On or before the due date for filing its 1985 tax return, Gare had made the one-time election under Tax Law § 1452(d) to continue to be taxable pursuant to Article 9-A of the Tax Law ("the grandfather election").[1] Thus, despite its being owned by a banking corporation, it was permitted to be taxable under Article 9-A of the Tax Law.

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[1] Solely for purposes of this proceeding, the parties stipulate that Gare was eligible to make this election and the election remained in effect up to and including the 1998 and 1999 tax years.

Between 1985 and 1997, Gare filed annual tax returns in New York State under 9-A of the Tax Law. After the merger of FNBHV and Pawling to form Bank, Gare became a wholly-owned subsidiary of Bank. Holding thereafter changed the name of Gare to Premier National Investment Company ("Investment Company").

6. In June 1998, at a meeting of FNBHV's investment committee, the issue concerning excess capital, i.e., liquid assets in excess of those required to be maintained by bank regulators, created by the upcoming merger was discussed. A decision was made to schedule a later meeting to review the investments and possible restructuring of the portfolio and approve new policies for the new bank. After the merger, Bank had a significant amount of additional cash and assets on hand, approximately $300 million in capital.

Investment Company Operations

7. After the acquisition of Gare, Bank held its annual shareholder's meeting on September 21, 1998. In addition to changing Gare's name to Investment Company, Bank appointed seven new directors and appointed the accounting firm of Deloitte and Touche as Investment Company's independent auditors.

On the same date, Investment Company's new board of directors also met and passed several resolutions. First, the board approved a resolution providing for a minimum annual management fee of $25,000.00 to Bank to compensate it for the provision of treasury management services. Although there was no pricing study or written agreement in place with respect to the management fee, there was a methodology for computing the fee based on the expected amount of time and expense that Bank would expend on a monthly basis to provide the management services. The fee was estimated to cover 10-20 hours of work each month at a billing rate of $100.00 an hour, rounded to a minimum of $25,000.00, and was intended to pay

petitioner for running Investment Company and account for a pro-rata share of corporate overhead. Paul Maisch was the employee responsible for carrying out Bank's obligations under the unwritten management agreement.

The resolutions also called for the appointment of new officers, including Mr. Maisch as executive vice president, chief financial officer and investment officer. The board also adopted as its own the compensation and benefit plans that were then in effect for Bank and authorized Investment Company to enter into a Safekeeping Agreement with M&T Bank's Trust Department for the delivery and maintenance of its securities. Another resolution authorized Investment Company to enter into a tax sharing agreement with Holding, under which Investment Company agreed, along with Bank and Hudson Charter Realty, to share the tax liabilities among the intercorporate family. This type of intercompany tax allocation agreement was required by the Office of the Comptroller of the Currency (the "OCC") because Investment Company was a subsidiary of Bank.

At its September 21, 1998 meeting, the board of directors of Investment Company also approved a resolution authorizing petitioner to use all of the investments held by Investment Company as collateral for petitioner's borrowings with the Federal Home Loan Bank.

At this same meeting the board also authorized the adoption of the "Investment Policy for Premier National Investment Company." This policy, dated September 24, 1998, called for significant oversight and control by Holding, as is indicated by the following statements in the introductory section: "All investment activities of [Investment Company] will be also conducted within overall Premier National Bancorp Group [Group] policy, and this policy will be monitored and controlled on a consolidated basis." Petitioner established that this type of control was required by the OCC to ensure that Bank could monitor its subsidiaries' investment

activity. The OCC has a separate handbook for bankers and bank examiners entitled "Related Organization" that demonstrates the control required. In the interest of properly assessing a variety of risks and in the interest of protecting the interests of the bank, the OCC handbook states:

> The bank's relationships with its related organizations should be subject to robust risk management and control systems. Policies and procedures are of particular importance when the bank conducts new or complex activities within a subsidiary or affiliate.

8. Investment Company did not pay any compensation, wages or other benefits to Mr. Maisch or any of its other officers. Investment Company did not pay any salaries, stipends, director's fees or other money to any of the members of Investment Company's board of directors.

9. For the years at issue the securities held by Investment Company were utilized by Bank in calculating Bank's capital adequacy requirements as such are reported on Bank's respective consolidated reports of condition and income ("Call Reports") filed with the Federal Financial Institutions Examination Council ("FFIEC"). Pursuant to the Instructions for Preparation of Consolidated Reports of Condition and Income (FFIEC 031, 032, 033, and 034), Bank was required to utilize the securities held by Investment Company and any other significant majority-owned subsidiary in calculating Bank's capital adequacy requirements.

10. As a national bank, petitioner is regulated by the OCC and is required to make filings with that agency through the Federal Deposit Insurance Corporation ("FDIC"). The Community Reinvestment Act ("CRA") requires each federal financial supervisory agency, in this case the OCC, to use its authority when examining financial institutions to assess the institution's record of meeting the credit needs of it its entire community, including low and moderate income

neighborhoods, consistent with safe and sound operation of the institution. Upon conclusion of such examination, the OCC must prepare a written evaluation of the CRA performance of Bank. The CRA Report expressly states that Investment Company (referred to as PIC in the CRA Report) "holds a portion of the bank's investment securities for tax purposes." No further explanation is provided to the OCC, petitioner's regulator, concerning the fact that Investment Company holds certain investments. The CRA Report also states that petitioner "requested that investments of PIC [Investment Company] be considered in our [the OCC's] evaluation." According to the report, Investment Company does not impact Bank's ability to meet the CRA needs of its assessment areas.

11. In September 1998, Paul Maisch, chief financial officer ("CFO") of Holding and Bank, former CFO of FNBHV and CFO and Investment Officer of Investment Company, made recommendations to petitioner's investment committee concerning the funding and capitalization of Investment Company. The memorandum stated:

> In order to properly capitalize the Investment Subsidiary approval is requested to invest in Premier National Investment Company, Inc. in the form of cash or contributed securities, up to $2,000,000,000 as paid in capital (surplus).
>
> Such funds represent excess liquidity of the Bank over policy limits. Such securities will be managed under the investment policy approved for Premier National Investment Company, Inc. Which policy is further governed by that of the Premier National Bancorp, Inc. and Subsidiaries group investment policy.
>
> Such investment should, on an annual basis, permanently save approximately $500,000 in New York State taxes for each $200,000,000 invested at 6% and should defer an additional $300,000 in New York State taxes (after Federal taxes).
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> Additional funds will be invested by selling existing Bank securities and reinvesting the proceeds in qualifying securities in the 9A Company. Such securities will enjoy a tax equivalent yield of approximately 40 basis points higher than comparable securities owned by the Bank.

12. Petitioner submitted a copy of Investment Company's "Investment Policy" which stated that "all investment activities of this corporation [Investment Company] would be conducted within overall Premier National Bancorp ('Group') Policy, and this policy will be monitored and controlled on a consolidated basis." Bank's senior credit officer played a role with respect to security investments that did not meet the rating criteria established by the policy. The Investment Committee of the Group, services performed by Holding and Bank, was responsible for quarterly review of the investment portfolio and investment strategy. One of the objectives of Investment Company's investment portfolio is to support the Group's need for liquidity.

13. Petitioner submitted a copy of the "Investment Policy" for Holding and Bank into the record ("Holding's Policy"). There were several significant differences between Holding's policy and Investment Company's policy. Different investment considerations came into play as between Investment Company's investments and Holding and Bank's investments. For example, Investment Company had four primary investment objectives listed in its policy, those being safety, liquidity, gap management and profits. Holding's investment policy had two additional objectives, those being pledging and local community support, both of which relate to the banking business, which Investment Company did not have to consider since it was not a bank. Although both Holding's and Investment Company's policies did permit a 100% investment in direct obligations of the U.S. Treasury, there were several significant differences in the types of "permissible investments." For example, while Holding's policy allowed a 50% investment in only certain federal agency securities, Investment Company's policy allowed a 100% investment in all direct obligations of a federal agency and sponsored agencies. Holding's policy allowed for a 50% investment in state, county and municipal general obligation or similar revenue bonds,

while Investment Company's policy allowed for the investment in taxable municipal general obligation bonds. In addition, Investment Company's policy allowed for investment in direct obligations of corporations, while Holding's policy did not. Holding's policy also allowed investment in certificates of deposit and time deposits, banker's acceptances, commercial paper, corporate bonds, industrial revenue bonds, and non-federal agency mortgage-backed securities. None of these investments were permissible under Investment Company's investment policy.

With the change in ownership of the assets came the elimination of an important investment consideration related to the interest rate risk. There is a substantial discussion of the interest rate risk issue in Holding's investment policy, but no such discussion in Investment Company's policy. Since Bank's assets included loans and deposits, it was required to monitor interest rate risk and manage it within certain policy parameters. None of these parameters are included in Investment Company's policy, since it was not a bank, and did not have loans or deposits.

14. After these initial measures were taken, the board had to determine how much to invest in the new company. On October 1, 1998, Bank made a capital contribution of approximately $147 million to Investment Company. This capital contribution consisted of approximately $100 million in investment securities and the remainder in cash. The securities transferred consisted of U.S. Treasuries, corporate and agency bonds, etc. After the initial transfer, in 1999, there was an additional infusion of $50 million in cash from Bank to Investment Company. Prior to the transfer of investments to Investment Company, petitioner had managed the subject investments.

Bank had the capacity to make this transfer because of the excess capital created by the merger of Pawling and FNBHV, which created a 1.5 billion dollar bank. This merger raised

Bank's excess liquidity, cash available to invest, to an exceedingly high amount, which dropped significantly after the transfer. Bank computed its excess liquidity separate from Investment Company. The Resolution for the Funding and Capitalization of Premier Investment Company, Inc., adopted by petitioner, noted that the funds used to capitalize Investment Company represented the excess liquidity of petitioner over and above policy limits. The asset transfer left Holding and Bank with less of a financial cushion and forced them to run lean, as they had in the past.

15. In December 1998, after receipt of the assets and cash, Investment Company opened up a custodial account with M&T Trust Department and signed an agreement allowing M&T to act as custodian for the account. Thereafter, Investment Company received monthly statements of its own, referencing the trading activity of the assets it owned. These statements reported the income and activity only of Investment Company. In addition, Investment Company maintained separate books and records from Bank and Holding and included its investment assets on its own general ledger, and not on the books of Bank and Holding.

16. During the years at issue Investment Company never had any employees of its own, did not have any physical office facilities of its own, and did not have its own telephone line. The only written intercompany agreement between petitioner and Investment Company provided to the Division was a tax sharing agreement.

17. All income reported by Investment Company on its 1998 and 1999 New York tax returns was received by Investment Company from the issuers of the securities it owned. Investment Company did not make any loans to Bank, nor did it pay any dividends to Bank during 1998, 1999 or 2000. No dividends were paid by Investment Company until after Holding, Bank and Investment Company were acquired by another company.

18. The investments transferred to Investment Company were not managed in the exact same way that they would have been if they were held by petitioner. Management of these investments was different because, in part, of the 22.5% interest exclusion for Treasuries and agency obligations available under Article 32 which is not available to taxpayers under Article 9-A.

19. Both Paul Maisch and John Loewer, vice president of corporate tax administration at M&T Bank, explained some of the ramifications created as a result of the transfer of assets to Investment Company and the different considerations that needed to be analyzed as part of the decision to have securities held by Investment Company. For example, the Federal tax treatment of income and losses differs significantly depending on what type of entity owns the assets. For a banking corporation, income or losses from investment assets such as debt securities are treated as ordinary income or ordinary losses. When securities at Bank are sold or traded at a loss, this has the beneficial Federal tax effect of creating an ordinary loss for Bank, which may be used to offset ordinary income. However, investment gains or losses in the hands of a nonbanking corporation such as Investment Company receive different treatment. These gains and losses are treated as capital gains and losses, meaning that any losses incurred by Investment Company could be applied only against any capital gains realized during the same tax year. Since banks rarely generate significant capital gains, any capital losses generated by Investment Company may not be utilized in any way by Investment Company. At Bank, where such losses receive ordinary treatment, any investment losses could be utilized to reduce Bank's significant ordinary income.

A loss of $100.00 on Bank's security would have a net economic effect of only a $60.00 loss (assuming a 40% tax rate) because the loss would be ordinary and applied to reduce Bank's

ordinary income. A $100.00 loss on Investment Company's security would have a net economic effect of $100.00. If it could not be used to offset capital gains, there would be no benefit to this loss. This could create a problem if, for whatever reason, Bank had a liquidity problem and needed to liquidate certain of its assets or Investment Company's assets in order to generate cash. If that happened, Investment Company would need to liquidate some of its investments to fund the dividend. If Investment Company realized a net loss from the liquidation, that loss could not be utilized to offset Investment Company's ordinary income, or the ordinary income of the affiliated group of corporations filing together with Investment Company and Bank on a Federal consolidated income tax return.

20. During the years at issue, Investment Company had no other assets except for those received from Bank and those it acquired for itself as a result of cash contributions received from Bank, and it conducted no other business operations except those related to its investment assets.

21. Investment Company was an Article 9-A taxpayer and was required to file returns reporting its earned income from its investment assets under Article 9-A of the Tax Law for the years 1998 and 1999. Total income reported in 1998 was $1,832,063.00. Investment Company allocated $93,149.99 of this investment income to New York State by applying its investment allocation percentage of 5.0844%. Total income reported in 1999 was $11,325,479.00. Investment Company allocated $470,031.00 of this investment income to New York State by applying its investment allocation percentage of 4.1737%.

Holding and its subsidiaries, Bank and Hudson Charter Realty, filed New York State banking corporation combined franchise tax returns under Article 32 of the Tax Law for the years 1998 and 1999, on September 15, 1999 and September 14, 2000, respectively. All of its income on these returns was allocated to New York State.

Petitioner, along with Investment Company, filed consolidated Federal tax returns. Even without the proposed discretionary adjustment, all of the income of Investment Company and petitioner is reflected on returns submitted to New York State. However, there are differences between the articles of the Tax Law under which petitioner (Article 32) and Investment Company (Article 9-A) are taxed.

22. In 1998, Division employees exchanged e-mails about a taxpayer inquiry which addressed the issue of whether a corporation that had made the grandfather election to be taxed under Article 9-A would lose its grandfather status if it were purchased by a bank. The conclusion of that e-mail exchange was that so long as the corporation was owned by an Article 32 bank, the change in ownership would not make the subsidiary lose its grandfather status.

23. In late December 2000, the Division began an audit of petitioner for the 1997 through 1999 tax years. During the initial stages of the field audit, the Division's auditor noticed that Bank was receiving a management fee from Investment Company. This triggered a further investigation into the relationship between the two companies. The Division did not conduct a separate audit of Investment Company. The Division made no adjustment to Investment Company's 1998 or 1999 tax returns.

24. The Division's auditors attempted to look at all avenues in order to correct what they deemed problematic in this case. Initially, the auditors considered requiring Investment Company to file on petitioner's combined report, but they determined upon consultation with field audit management that this was prohibited by the Tax Law. The auditors also considered whether a revocation of Investment Company's grandfather election was appropriate because it was inactive for several years before 1998, and they sought an opinion of counsel on this issue. This approach was also abandoned upon consultation with field audit management, although the

Division did raise it again at the Bureau of Conciliation and Mediation Services conference. The Division also looked into the possibility of making an adjustment to Investment Company's investment allocation percentage, which is permitted under Tax Law § 210(8). This provision would have allowed the Division to exclude certain assets from Investment Company's investment allocation percentage, but the auditors decided this was not a good option because it required that the income from the assets also be excluded.

Ultimately, these approaches were abandoned in favor of a discretionary adjustment under Tax Law § 1462(g). After considering all the facts, the auditor made this discretionary adjustment to correct what the Division believed was an incorrect or improper reflection of tax liability as well as to correct a distortion and an inaccurate reflection of income between the two entities.

25. The Division issued petitioner a Notice of Deficiency dated May 6, 2002, asserting additional tax in the amount of $837,655.00,[2] plus interest and a substantial understatement penalty pursuant to Tax Law § 1085(k). The tax liability asserted in the notice was based on the inclusion of 60% of Investment Company's income in petitioner's Article 32 tax calculation. This amount was used by the auditor because, had Bank received a dividend from Investment Company in an amount equal to Investment Company's investment income, Bank would have been entitled to exclude 60% of the amount from income as a dividend from subsidiary capital.[3]

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[2] $41,116.00 of this asserted tax liability related to a mortgage tax credit adjustment, which petitioner has already agreed to and paid.

[3] Based on the Division's reasoning, and the testimony of its auditor (transcript p. 88), Bank should have been taxed on 40% of Investment Company's income, if the Division's adjustment intended to include Investment Company's income less the 60% dividend received from subsidiary capital. This correction is addressed in Conclusion of Law "H."

Investment Company never paid any dividends to petitioner during the years in issue. After a BCMS conference, a conciliation order issued August 8, 2003 sustained the notice in full.

26. A petition was received by the Division of Tax Appeals on November 5, 2003, protesting the conciliation order. After the petition was filed, the Division, pursuant to Tax Law § 1089(d)(1), increased the amount of the deficiency to $1,279,769.00, plus penalty and interest. The increased deficiency was based on the Division's inclusion of 100% of Investment Company's income and assets in petitioner's New York tax calculation. The Division increased the assessment because Investment Company did not pay any dividends to Bank in 1998 or 1999, and it was the collective decision of the Audit Division to amend the deficiency and increase it to 100%. The Division represented at the hearing that it would try to make an accommodation, presumably to petitioner's tax liability, at some later date when dividends are actually paid and the Division becomes aware of them.

27. In 2003, the Division's field audit management group solicited the Division's district offices to determine the extent of their case inventory where combination would be an option for Article 9-A nongrandfathered subsidiaries of banks that may be "doing a banking business," Article 9-A subsidiaries of banks that may be doing a banking business but combination is prohibited due to their grandfather status, and for nontaxpayer subsidiaries of banks that may be "doing a banking business" and combination is an option. The purpose of the inquiry was in part to create an awareness of situations involving Article 9-A subsidiaries that were "merely a carve-out of the bank, and should more appropriately be filing as part of the Article 32 combined return." The field office management group also indicated to the Division's district offices that "the law as written, allows for these types of tax avoidance schemes, or 'loopholes.'" The Division was considering a legislative proposal "which would remove the 9-A grandfather status

of these investment company tax shelters and allow the Department to combine them with their banking parent under Article 32."

28. The Division recommended a legislative amendment on the grandfathered Article 9-A issue in an attempt to close the perceived loophole permitted by the provisions. The proposal called for an amendment to Tax Law § 1452(d)(3) to include a clause that nullified the grandfather Article 9-A election if the grandfathered corporation became inactive, had a change of ownership, had a change in business purpose, or was a party "to an inter-company transaction of the type referred to in Tax Law § 1462(g) of the Tax Law." The legislation did not pass in 2003, and although the Division gave consideration to its resubmission in 2004, the Division did not believe it had the necessary support because it related to a financial modernization project and did not attempt a 2004 proposal.

29. On January 23, 2004, Alyce Fahrenkopf of the Division was corresponding by email with Bonnim Tanzman, another member of the Division's field audit management group about the Premier National Bank Audit. Mr. Tanzman was one of the individuals responsible for consulting with the auditor about this matter, and was present at the hearing. In the first e-mail Ms. Fahrenkopf forwarded a six-year old e-mail to Mr. Tanzman (the substance of which is set forth in Finding of Fact "22"), specifically referring to the conclusion relating to the survival of the Article 9-A election upon purchase by an Article 32 bank. The second e-mail forwarded to Mr. Tanzman was sent to Ms. Fahrenkopf by Robert Beattie, the auditor's supervisor, regarding the Division's use of the discretionary adjustment in petitioner's case.

M&T BANK MERGER

30. In 2001, petitioner was taken over by M&T Bank Corporation. In this transaction, Holding was merged into the M&T Bank holding company and Bank merged into the M&T

Bank operating subsidiary, Manufacturers and Traders Trust Company ("M&T Bank"). Following this transaction, M&T Bank was the sole shareholder of Investment Company. M&T Bank also owned an additional 35 to 40 other companies, and some of the subsidiary companies had employees. M&T Bank treated this as it would any other subsidiary acquisition; new bylaws were created for Investment Company and new officers and directors were appointed.

31. In late December 2001, a dividend was declared by Investment Company to M&T Bank of $125 million. While this had no effect for Federal tax purposes, this dividend did have a New York tax effect and was included in the taxable income of M&T Bank.

32. Petitioner submitted 37 proposed findings of fact, which were dealt with in the following manner: Proposed findings of fact 1-5, and 7-9 represented facts of historical and legislative background, and are included in the Conclusions of Law as Historical Background; proposed findings of fact 6, 10-24, 26-37 are included as Findings of Fact; and proposed finding of fact 25 is accepted with a slight modification to more accurately reflect the record.

33. The Division made a request for 70 findings of fact which were dealt with in the following manner: proposed findings of fact 1-13, 15 and 16 were those included in a stipulation of facts executed between the parties, and are included as Findings of Fact; proposed finding of fact 14 also part of the stipulation of facts, was accepted but modified, merely substituting "Bank" for "petitioner" to more accurately reflect the record; proposed findings of fact 17-19, 21-23, 27-35, 37, 39-45, 48, 51, 56-70 are included as Findings of Fact; proposed findings of fact 14, 20, 25, 26, 36, 49 and 50, are accepted with modifications to more accurately reflect the record; proposed finding of fact 24 is modified by the rejection of the second sentence as not relevant; proposed finding of fact 38, is modified by the elimination of the last sentence which is not factual; proposed findings of fact 46, 47, 52, are rejected as not supported by the record;

proposed finding of fact 53 is rejected as partially redundant and as not supported by the record; and proposed findings of fact 54 and 55 are rejected as irrelevant.

SUMMARY OF THE PARTIES' POSITIONS

34. It is petitioner's position that the Division has abused the discretion granted to it under Tax Law § 1462(g) by attempting to use its discretionary authority to supplant and supercede existing statutory law, creating a proposed adjustment that creates a double or triple taxation of the same income. Alternatively, petitioner maintains that by its very terms, Tax Law § 1462(g) does not permit the Division to include Investment Company's income and assets in petitioner's tax calculation. The statute permits a discretionary adjustment under only three distinct circumstances, and petitioner contends none are present in this case.

Petitioner also argues that the Division has failed to meet its burden of proof to establish that its assertion of an increased deficiency is proper, and further, that the substantial understatement penalty is not warranted in this case.

35. Petitioner presented the testimony of Professor James Redwood, a professor and attorney, who focused his prior practice of law on securities fraud and antitrust matters. Currently at Albany Law School, Professor Redwood teaches business organization, securities regulation, law and literature, and constitutional law.

Professor Redwood's analysis of this case relates to the concepts of piercing the corporate veil under corporation law and parent/subsidiary relationships. In general terms, he provided his opinion that it is to be expected that a parent corporation would exercise control over its subsidiary, that the performance of services between a parent and subsidiary is common, and that is it not necessarily problematic if corporations within a corporate family did not have separate employees.

Professor Redwood did not provide a written report, and did not give authoritative cites during his testimony. Subsequent to the conclusion of the hearing Professor Redwood submitted a list of cases pertaining to the concept of piercing the corporate veil under corporate law in support of his position, without any detailed case analysis.

36. The Division maintains that tax avoidance was the motivation behind the purchase of the grandfathered Article 9-A subsidiary and the transfer of investments to Investment Company; that Investment Company relied completely upon petitioner for all operations relating to the subject investments; that the investments held by Investment Company were subject to complete domain by petitioner; that the investment strategy of Investment Company exposed the parties to the potential of increased financial losses; that the arm's-length nature of the management arrangement is illusory; that the transfer of investments to Investment Company had little or no effect on petitioner, and as a result of these facts, the Division should be permitted to exercise its Tax Law § 1462(g) discretionary adjustment.

CONCLUSIONS OF LAW

The Grandfather Election: Historical Background

A. In 1985, the New York State Legislature enacted sweeping changes to the franchise tax applicable to banking corporations (L 1985, ch 298). The purpose of these amendments, as clearly stated in the legislative history, was to make the Article 32 Franchise Tax on Banking Corporations (the "Bank Tax") more closely resemble the Article 9-A Franchise Tax on General Business Corporations (the "Article 9-A Tax") (***see also,*** Memo in Support of Assembly Bill No. A 3434, at 2, 9 & 10). Further, the new law was also designed to make the calculation of tax more predictable and less likely to be the subject of an adjustment upon audit (***id*** at 10). Of particular note, the 1985 legislation expanded the definition of "banking corporation" under Tax

Law § 1452(a) to include most subsidiaries of banks and of bank holding companies. Under the new rules, any 65% or more owned subsidiary of a bank was classified as a banking corporation so long as it was principally engaged in a business which might be conducted by a banking corporation or which was closely related to banking or managing or controlling banks (Tax Law § 1452[a][9]). The result of these changes was that many corporations that were taxable under other franchise taxes, such as Article 9-A, would now be taxable under the Bank Tax instead.

The change in classification had a significant impact on nonbank subsidiaries of banking corporations, particularly with respect to whether the taxation of investment income is subject to Article 9-A tax or the Bank Tax. Under the Bank Tax, banking corporations are required to allocate all of their income, including investment income, based on a three-factor apportionment percentage reflecting the relative New York portions of the banking corporation's receipts, deposits and payroll (Tax Law § 1454[a]). Thus, a banking corporation with a 100% apportionment percentage must allocate all of its investment income to New York. A corporation taxable under the Article 9-A Tax, however, is required to break its income into categories, and allocate its investment income using an "investment allocation percentage." This percentage is based on the "issuer's allocation percentages" of the investments in its portfolio (Tax Law § 210[3][b]). Since the issuer's allocation percentage reflects the relative presence in New York of the issuer of the securities, an Article 9-A taxpayer located solely in New York State and having a 100% business allocation percentage might still be entitled to allocate its investment income at less than 100%.

B. As a result of the 1985 legislation, many subsidiaries of banking corporations could no longer compute their taxes under Article 9-A. However, the Legislature added a special provision under Tax Law § 1452 (d) that allowed certain bank subsidiaries that were taxable

under Article 9-A prior to 1985 to make a one-time election to continue to be taxed under Article 9-A in lieu of the Bank Tax. This election, which is generally referred to as the "grandfather 9-A election," was required to be made by a corporation on or before the due date of its 1985 tax return. Once made, the taxpayer could continue to file and be subject to taxation under Article 9-A unless and until it revoked the election (Tax Law § 1452[d]).

Since the 1985 legislation permitting the grandfather 9-A election, the Division has addressed its application on a limited number of occasions. The Division's bank tax audit guidelines merely restate the provisions of Tax Law § 1452(d). In the mid-1990s, the Division issued the following series of advisory opinions on various subjects relating to the survival of a corporation's grandfather election, despite corporate restructuring or other changes in business operations. In each instance, the Division ruled that grandfather 9-A elections survived certain corporate restructuring or other changes in business operations. For example, in ***Matter of Robert J. Buckley*** (TSB-A-94[8]C), the Division determined that the takeover and sale of the stock of a corporation's bank parent by the Federal Deposit Insurance Corporation (FDIC) does not affect the subsidiary's election to be taxed under the general corporation franchise tax rather than the franchise tax on banking corporations. In ***Matter of Apple Bank for Savings*** (TSB-A-96[7]C), the Division stated that, having made the election to continue being subject to the business corporation franchise tax rather than the bank tax, the acquisition of a bank's parent by another bank did not revoke the election. Furthermore, the election was not revoked by the expansion of the line of business of the subsidiary, since the activities of the corporation are not considered in determining whether the election is revoked unless the activity of the corporation changes so that it can no longer be properly classified as a business corporation. In ***Matter of Barclay's Business Credit, Inc.*** (TSB-A-96[26]C) the Division decided that the taxpayer's

election to be taxed under Article 9-A, rather than the franchise tax on banking corporations, was not affected by its acquisition of a subsidiary. The merger, with the petitioner as the surviving entity, and the subsequent change in that petitioner's activities to be principally engaged as a registered broker/dealer and as a primary dealer in U.S. government securities, did not affect the petitioner's election (***see also***, ***Matter of BT Partners, Inc.,*** TSB-A-97[11]C).

Division employees continued discussions about issues surrounding the grandfathered Article 9-A companies (***see***, Finding of Fact "22"), particularly the issue of whether a previously inactive Article 9-A subsidiary acquired by an Article 32 taxpayer would continue being taxed under Article 9-A (***see, Roberts and Holland LLP***, TSB-A-98[10]C). In ***Roberts***, the Division held that the election shall continue in effect until revoked, such as by the filing of a tax return pursuant to Article 32 of the Tax Law. In 1999, the Division issued three more advisory opinions involving similar situations, i.e., where a previously inactive grandfathered Article 9-A subsidiary was acquired by an Article 32 taxpayer (***see, Sutdex Real Estate Corp.***, TSB-A-99[11]C; ***Pendex Real Estate Corp.***, TSB-A-99[10]C; ***Namco Asset Management***, TSB-A-99[23]C). In each of these opinions, the Division ruled that the grandfathered Article 9-A subsidiary would continue to be taxed under Article 9-A so long as it remained a surviving entity in a series of mergers, did not change its activities to that of a banking corporation or otherwise revoke its election.

The Division began the audit of petitioner in late 2000, and at that time it changed its posture toward corporations that had made the grandfather election and examined all possible avenues to counterbalance the benefits of Investment Company's corporate structure (***see,*** Finding of Fact "24"), leading ultimately to a decision by the Division in this case to impose its discretionary adjustment under Tax Law § 1462(g), for the first time in this context. The focus

by the Division appeared to be the reduced tax revenue which resulted from the corporate structure of Holding, Bank and Investment Company.

In 2003, the Division's field office management identified what it considered abuses in the grandfathered Article 9-A subsidiary context and discussed the same with its district offices, which ultimately led to the introduction of legislation to close the perceived loophole; the legislation did not pass and was not subsequently revived (***see,*** Finding of Fact "28").

C. Tax Law § 1462(g) provides as follows:

> In case it shall appear to the tax commission that any agreement, understanding or arrangement exists between the taxpayer and any other corporation or any person or firm, whereby the activity, business, income or assets of the taxpayer within the state is improperly or inaccurately reflected, the tax commission is authorized and empowered, in its discretion and in such manner as it may determine, to adjust items of income or deductions in computing entire net income or alternative entire net income and to adjust assets, and to adjust wages, salaries and other personal service compensation, receipts or deposits in computing any allocation percentage, provided only that entire net income or alternative entire net income be adjusted accordingly and that any asset directly traceable to the elimination of any receipt be eliminated from assets so as to accurately determine the tax ["improper reflection clause"]. If however, in the determination of the tax commission, such adjustments do not, or cannot effectively provide for the accurate determination of the tax, the commission shall be authorized to require the filing of a combined report by the taxpayer and any such other corporations ["combination clause"]. Where (1) any taxpayer conducts its activity or business under any agreement, arrangement or understanding in such manner as either directly or indirectly to benefit its members or stockholders, or any of them, or any person or persons directly or indirectly interested in such activity or business, by entering into any transaction at more or less than a fair price which, but for such agreement, arrangement or understanding, might have been paid or received therefor, or (2) any taxpayer enters into any transaction with another corporation on such terms as to create an improper loss or net income, the tax commission may include in the entire net income or alternative entire net income of the taxpayer the fair profits which, but for such agreement, arrangement or understanding, the taxpayer might have derived from such transaction ["fair profits clause"].

The regulations at 20 NYCRR 18-1.3 provide the following guidance:

> (a) In case it shall appear to the Tax Commission that any agreement, understanding or arrangement exists between the taxpayer and any other corporation or any person or firm, whereby the activity, business, income or

assets of the taxpayer within New York State is improperly or inaccurately reflected, the Tax Commission may, in its discretion, make such adjustments as it deems necessary in order to accurately reflect the tax liability of the taxpayer. In exercising its discretion, the Tax Commission is empowered to adjust:

(1) items of income or deduction in computing entire net income or alternative entire net income;

(2) assets; and

(3) wages, salaries and other personal service compensation, receipts or deposits in computing any allocation percentage, provided only that entire net income or alternative entire net income be adjusted accordingly and that any asset directly traceable to the elimination of any receipt be eliminated from taxable assets so as to accurately determine the tax.

If, however, in the determination of the Tax Commission, such adjustments do not or cannot effectively provide for the accurate determination of the tax, the Tax Commission shall be authorized to require the filing of a combined return by the taxpayer and any such other corporations. Thus, the Tax Commission is not required to exercise its authority under this section and, in lieu thereof or in addition thereto, a combined return may be required or permitted pursuant to the provisions of Subpart 21-2 of this Title.

(b) The Tax Commission may include in the entire net income or alternative entire net income of the taxpayer the fair profits which, but for an agreement, arrangement or understanding as described in subdivision (a) of this section, the taxpayer might have derived from any transaction:

(1) where any taxpayer conducts its activity or business under any agreement, arrangement or understanding in such manner as either directly or indirectly to benefit its members or stockholders, or any of them, or any person or persons directly or indirectly interested in such activity or business, by entering into any transaction at more or less than a fair price which, but for such agreement, arrangement or understanding, might have been paid or received therefor; or

(2) where any taxpayer enters into any transaction with another corporation on such terms as to create an improper loss or net income.

(c) In determining whether an agreement, understanding or arrangement between the taxpayer and any other corporation or any person or firm results in an improper or inaccurate reflection of the activity, business, income or assets of the taxpayer within New York State, consideration is given to such factors as:

(1) whether the taxpayer controls or is controlled by such other corporation, person or firm, or whether the taxpayer and such other corporation, person or firm are controlled by the same interest;

> (2) whether the agreement, understanding or arrangement in question would have been entered into, or whether the terms and conditions would have been the same, had the element of control been absent and had the parties been dealing at arm's length; and
>
> (3) whether the agreement, understanding or arrangement in question has a reasonable business purpose, or whether it appears to be arbitrary or to have been motivated principally by a tax avoidance purpose.
>
> (d) In applying the provisions of subdivision (a) of this section, the Tax Commission will consider, and may utilize in making adjustments or determining a fair price or fair profit, the principles and rules contained in sections 1.482-1 and 1.482-2 of the Federal income tax regulations (26 CFR 1.482-1; 26 CFR 1.482-2) to the extent that they are relevant and can be made applicable to the provisions of this section.

D. Petitioner acknowledges that the Division has discretionary authority pursuant to Tax Law § 1462(g) to make certain adjustments. However, petitioner believes that the Division has abused its discretionary authority in this case in three ways:

1. By superceding the statute, petitioner maintains, the Division is trying to use its discretionary authority to do that which it may not do under the Tax Law, i.e., revoke Investment Company's valid grandfather election, and effect a combination of a grandfathered Article 9-A subsidiary and a banking corporation;

2. By flawed reasoning, the Division has attempted to use its discretionary adjustment to properly reflect the activity, business, income or assets of petitioner; and

3. By its inconsistent and arbitrary actions concerning both its audit of petitioner and its handling of grandfathered 9-A issues generally.

Discretionary provisions in the Tax Law appear in a variety of statutes (***see***, ***e.g.,*** Tax Law § 210[8]; § 211[5]; § 1504[d]; § 1515[f]). A reasonable amount of discretionary authority is the relief mechanism that allows the Division to rectify unintended results that occur where it is difficult or impractical for the Legislature to lay down a definite, comprehensive rule (***Matter of Barneys, Inc. v. Department of Finance***, 93 AD2d 642, 462 NYS2d 872; ***affd*** 61 NY2d 786, 473 NYS2d 392). However, where such a rule could have easily been set forth in a statute, the case law dictates that discretionary authority cannot be used as a substitute for amending that law

or providing for a new rule (***id; see also***, ***Matter of Swalbach v. State Liquor Authority***, 7 NY2d 518, 200 NYS2d 1; ***Matter of Picone v. Commr. of Licenses***, 241 NY 157). In addition, such discretion is not unlimited, and the reasons for invoking it must be supported by the record. The Division is attempting to utilize its discretionary authority to change the tax effect herein, though it is clear that it would not have been either impractical or difficult for the Legislature to compose a definite, comprehensive rule which would have addressed the Division's concerns under these facts. This is not a series of facts involving multiple levels of corporate entities or facts that cannot be untangled. It concerns one corporation, allowed by law to make an election which dictated how it was taxed, and its parent owner, taxed under a different article of the Tax Law. When the grandfather provision was enacted in 1985, the Legislature could have simply limited the circumstances under which the Article 9-A corporation would retain its grandfather status, much like the proposed 2003 legislation. Instead, it was drafted without such limitations and allowed to remain as such for over 20 years. The record revealed that one of the reasons for the enactment of the grandfather provision was to discourage companies that would have been affected adversely from the change without such election from moving to other states such as Delaware where they may have received tax-favored treatment. The Legislature made a decision to enact a provision to preserve the existence of corporate presence in New York, and could have easily considered then, or at some point in the last 20 years, the tangential issues that have arisen as a result of the grandfather provision, and modified the law as it stands. This was not done, however. Instead the Division is attempting to utilize its discretionary authority to essentially supplant the two statutes which govern this case.

First, the Division, if allowed to use its discretionary authority in this manner will effectively nullify Investment Company's grandfather election, a valid election made by

Investment Company's predecessor and recognized by the Division as such. The grandfather election permits nonbank subsidiaries to continue to be taxed as general business corporations under Article 9-A. This allows banks and nonbank subsidiaries that do not have the benefit of the election, corporations that must allocate their investment income on a three-factor apportionment, to potentially reduce the tax generated from investment activities by having those activities carried out by their nonbank, grandfathered Article 9-A subsidiaries. The Division believes this creates an improper reflection of income, though all income has been reported to New York, and has sought to exercise it discretionary authority by including Investment Company's income and assets in petitioner's New York tax calculation. The effect of this adjustment is to impermissibly disregard Investment Company's valid election, and the Division cannot use its discretionary authority as a substitute for amending the Tax Law to alter the effect of this election.

Second, petitioner argues that the Division cannot use its discretionary authority to force a prohibited combination of Investment Company and petitioner. Tax Law former § 1462(f)(4)(iii) explicitly prohibits the inclusion of a grandfathered Article 9-A subsidiary in an Article 32 combined report as follows:

> *In no event* shall a corporation which has made an election pursuant to subsection (d) of section fourteen hundred fifty-two of this article to be subject to the tax imposed by article nine-a of this chapter be included in a combined return for those taxable years for which it is subject to the tax imposed by article nine-a of this chapter (emphasis supplied).

This provision is contrasted with other anticombination provisions in Tax Law § 1462 that do contain exceptions to the prohibition on combination, such as Tax Law § 1462(f)(2)(i)(B) which states the following:

> Provided, however, that no banking corporation or bank holding company not a taxpayer shall be subject to the requirements of this subparagraph *unless the tax commission deems that the application of such requirements is necessary in order to properly reflect the tax liability under this article, because of intercompany transactions or some agreement, understanding, arrangement or transaction of the type referred to in subsection (g) of this section (*emphasis supplied).

By applying its discretionary authority, the Division creates a de facto combination, which clearly exceeds its discretion.

The Division has also abused its discretionary authority by flawed reasoning, inasmuch as it does not show how its adjustment more properly reflects petitioner's activity, business, income or assets in New York, with an end result of the Division's actions being multiple layers of taxation. There is no dispute that Investment Company reported all of its income from its investment assets on its 1998 and 1999 returns and paid all applicable taxes (the first level of taxation). The Division ultimately used all of Investment Company's income and assets to compute petitioner's Article 32 tax liability, in making its adjustment, creating a second level of taxation. Although a dividend was not paid by Investment Company to Bank during the audit years, had it taken place, as after the M&T merger (***see,*** Finding of Facts "31" and "32"), the income would again be reported by petitioner on its New York returns, creating yet a third potential level of tax paid. The Division clearly recognized the problem it had created, but made no attempt to reflect this in its discretionary adjustment. Instead, the Division admitted that it had amended the deficiency from its original amount to the increased 100% of the income and assets of Investment Company (***see,*** Finding of Facts "25" and "26"), not because of improper reflection, but because there was no dividend paid to Bank. Further, the Division stated it would later accommodate petitioner with some adjustment when dividends are actually paid at a later date and the Division is aware of such payment. However, the Division did not

quantify this potential future adjustment or present evidence of a formula it might use to accomplish the same. Nor did the Division identify how it would become aware of the payment of dividends and whether petitioner would be responsible for such notification or how that would be done. These results and this undefined and ambiguous standard clearly result from the Division's exceeded discretionary authority and cannot be allowed.

Petitioner lastly suggests that the Division's continually changing legal theories with respect to Investment Company's grandfather election demonstrates an arbitrary and capricious application of its Tax Law § 1462(g) powers. Finding of Fact "24" sets forth the various theories considered by the Division to solve what it perceived to be a problem. Certainly the Division is free to apply whatever theory of taxation fits the facts of a case and is rationally applied. It would seem reasonable that in doing so a taxpayer should be able to anticipate such taxation. Even the Division's auditor agreed that given these circumstances, a taxpayer would not know when a Tax Law § 1462(g) adjustment should be made, and could not plan for the same. For this reason also, the Division's actions are an abuse of discretion.

E. Abuse of the Division's discretionary authority is but one argument made by petitioner. Even more important is the issue of whether the Division's exercised discretion fits the statutory framework of Tax Law § 1462(g). To simplify its analysis, petitioner divided Tax Law § 1462(g) into three clauses, and presented an analysis of the inapplicability of each segment of the statutory framework (***see,*** Conclusion of Law "C").

Improper Reflection Clause

The improper reflection clause requires a showing that there is an improper reflection of a taxpayer's activity, business, income or assets within the State, and absent such a showing by the Division, no such discretionary authority adjustments are permitted (***Matter of Barclays***

Group, Inc. [USA] & Affiliates, Tax Appeals Tribunal, January 27, 2005). Petitioner suggests that the discretion permitted by this clause is exercisable only to correct distortion that arises when a taxpayer improperly shifts the recognition of income outside the State. Thus, petitioner argues that the Division could not show that the discretionary adjustment is necessary to more clearly reflect the activity, business, income and assets of Investment Company in New York when all the activity, business, income and assets were located in New York and were reported to New York by Investment Company in the first place. Petitioner's argument is flawed. Although a primary purpose of this clause may have been to correct the distortion created by income or assets shifted outside the State, it could also address arrangements where the activity, business, income and assets within New York are not properly reflected as between the companies within the State, as here. However, the Division must still show what is improperly reflected and that its discretionary authority is necessary to correct such improper reflection.

Petitioner maintains that the Division has tried to show that its adjustments were necessary only to insure a proper reflection of tax liability. Petitioner accurately points out that the Division's auditor made a significant number of references in his testimony to correcting an improper reflection of tax liability, and the Division's actions in this matter point heavily to its focus on the tax savings resulting from the corporate advantage gained by the existence of Investment Company and the taxes saved by the group, rather than the proper reflection of activity, business, income and assets. A difference in tax burden does not necessitate the use of the discretionary adjustment, and the Tax Law empowers the Commissioner to make such an adjustment only if the assets are improperly or inaccurately reflected on the return (***Matter of Barclays Group, Inc. [USA] & Affiliates***, ***supra***). However predominant, the Division's focus was not exclusively related to the tax savings in this case. Nonetheless, negative consequences

in the form of higher tax liability are not an indication that the activity, business, income and assets assets of Investment Company were improperly or inaccurately reflected on its original returns. Whether the Division has shown that there is such an improper reflection remains in issue.

The facts of this case are quite clear. Through a series of corporate mergers (***see,*** Findings of Fact "1" and "5"), Investment Company, a company bearing a grandfather election under Tax Law § 1452(d), became the wholly-owned subsidiary of Bank. Bank transferred assets to Investment Company pursuant to a corporate resolution authorized by Bank's board of directors, after which time Investment Company reported the income and activity concerning its assets. The contribution of capital to Investment Company by its parent is an arm's length transaction by virtue of the benefits and value retained by the parent corporation in its investment in subsidiaries. The business purpose for such transfer was to produce a greater after-tax yield on its investments, thereby increasing the profits of the Premier group, an analysis which petitioner discussed with and sought the approval of two of the nation's top professional accounting firms. After the transfer of assets, Bank no longer owned or had use of the assets. They were not leased or loaned back to Bank. There was no evidence that Bank had need for the assets after their transfer. Although Bank could have properly received a dividend from Investment Company, one was not paid to Bank during the years in issue. Upon receipt of the cash and securities, Investment Company opened up a custodial account with M&T Trust Department, thereafter receiving monthly account statements referencing the trading activity of its assets. Investment Company maintained its own books and records reflecting such assets, income and business activity. Investment Company had its own investment policy, one which differed significantly from petitioner's policy, particularly with regard to the issue of risk.

Investment Company reported the income from its assets, derived from transactions with unrelated third parties, on its own New York Article 9-A returns. The economic reality of Investment Company's operations was clear and properly reflected.

It is common in a parent-subsidiary relationship that the parent will exercise significant control over the subsidiary's operations. In fact, in the context of the banking industry, it is not only expected but required. This does not mean that the subsidiary's corporate structure or operations should be ignored as though they did not exist. Corporate direction from Bank or Holding would be commonplace and the Division's criticism of the parent/subsidiary interaction in this matter does not undermine Investment Company's structure and business purpose.

The Division avers that "the statute and regulations clearly empower the Division to make the adjustments to the Petitioner's assets and income in order to properly reflect a taxpayer's financial position. The case in hand falls squarely under the circumstances specified in NYCRR § 18-1.3" (Division's Brief pp. 26-27). But the Division does not identify what it believes is creating the improper reflection of activity, business, income and assets. The Division only states, "[it] is not on a crusade to attack grandfathered 9-A corporations but rather is opposed to the abusive nature of the transaction and arrangement the Petitioner and Investment Company engaged in, and if certain assets and income would more appropriately be represented on another party's tax return the Division will seek to make such and [sic] adjustment (Division's Brief pp. 27-28)." Again, the Division does not specify what transaction or which arrangement is so abusive that it creates an improper reflection of activity, business, income and assets. That is the extent to which the Division addresses Tax Law § 1462(g) in its brief, and we are left to make assumptions about which transaction and arrangement the Division is referring to. The choices are few: the arrangement whereby Bank purchased and became parent to a

grandfathered Article 9-A corporation; the capitalization of Investment Company by Bank; the earning and recording of Investment Company's investment income and assets on its own set of books, records, general ledger and tax returns; or the payment of the management fee by Investment Company to Bank.

The parties uniformly recognize that the grandfather election by Investment Company is a valid one during the years under audit. The capitalization of Investment Company was properly handled and does not improperly reflect any portion of activity, business, income and assets herein. The earning and recording of Investment Company's income and assets on its own set of books and tax returns is more properly reflected respecting its separate corporate existence, and the Division has not shown an improper reflection of any portion of activity, business, income and assets. The payment of the management fee by Investment Company, however, has been criticized by the Division as illusory, not necessary, yet inadequate. In this regard, it must be noted that Investment Company was not audited at any time by the Division. Thus, the nature and extent of its operations were established by the testimony of Paul Maisch, as chief financial officer and investment officer of Investment Company, and the then chief financial officer of Holding and Bank. His testimony, forthright, credible and knowledgeable, described the details of the capitalization of Investment Company and the oversight provided by him and others in the Premier group, in the context of a parent-subsidiary relationship in the banking industry, after the transfer of assets to Investment Company. Prior to the transfer of investments to Investment Company, petitioner had managed the existing investments. Investment Company began its investment activities with many investments established and transferred to it as such. Pursuant to its new investment policy, it would make new investments or change existing ones over time. There were no daily operations of Investment Company in

the traditional sense of running a company. There were no employees to supervise and no physical facilities to be concerned with. The investment committee of the Group, services provided by Holding and Bank, provided a quarterly review of the investment portfolio and investment strategy. M&T provided a more daily custodial management function. Mr. Maisch, was the employee responsible for carrying out Bank's obligations in the nature of management services to Investment Company. He openly admitted that the method used by the new board of directors of Investment Company to establish the minimum annual fee of $25,000.00 for treasury management services was developed in a somewhat rudimentary manner, but there was a methodology. At no time, however, did he waiver about the sufficiency of the minimum amount established, which had the ability to be reviewed and increased if deemed necessary. Based on the foregoing, I cannot agree with the Division's characterizations of the management fee as either illusory or inadequate. Accordingly, the Division has not established that the management fee arrangement between Investment Company and Bank creates an improper reflection of activity, business, income and assets.

I do not find an improper reflection of activity, business, income and assets of petitioner and Investment Company under the facts of this case, or any of the individual segments of the entire arrangement as delineated above. The Division has not established that there is an improper reflection of a taxpayer's activity, business, income or assets within the State, and accordingly, has not shown it has properly applied its discretionary authority under the "improper reflections clause" of Tax Law § 1462(g).

Combination Clause

The combination clause allows the Division to require the filing of a combined report by two corporations where Tax Law § 1462(g) adjustments do not provide for an accurate

determination of the tax. However, pursuant Tax Law § 1462(f)(2)(iii), the combination of a grandfathered Article 9-A company and Article 32 corporations is strictly prohibited with no exceptions. Accordingly, under the facts of this case, the Division is not permitted to exercise its discretionary authority under the "combination clause" of Tax Law § 1462(g).

Fair Profits Clause

By its terms, this clause requires an agreement or arrangement, and a transaction at more or less than a fair price which, but for such agreement or arrangement, might have been paid or received therefor, or a transaction creating an improper loss or net income. With that criteria met, the Division may include in entire net income the fair profits which, but for the agreement or arrangement, might have been derived from such transaction.

Again, the Division does not specifically address which agreement, arrangement or transaction might require a "fair profits" adjustment. The choices are the same as discussed above: the arrangement whereby Bank purchased and became parent to a grandfathered Article 9-A corporation; the capitalization of Investment Company by Bank; the earning and recording of Investment Company's investment income and assets on its own set of books, records, general ledger and tax returns; or the payment of the management fee by Investment Company to Bank. Clearly, the purchase of Investment Company's predecessor and the capitalization of Investment Company did not produce "profits" in the context used by this section 1462(g) clause. The earnings resulting from Investment Company's investments were all with unrelated third parties, and there is no evidence of pricing more or less than would have otherwise existed under similar facts. Thus, we are left again with the management fee discussion. Since I already determined that the credible testimony of Paul Maisch established no impropriety or inadequacy of the

management fee arrangement, there would be no basis for an adjustment under this clause of Tax Law § 1462(g).

F. The Division's only references to how Tax Law § 1462(g) applies to this matter have been described above. The Division also makes an argument that essentially calls the arrangement between petitioner and Investment Company an abusive tax shelter, attempts to show that it has no economic substance and contends it should be disallowed. The Division maintains that the Legislature did not intend for taxpayers to transfer investments to an Article 9-A grandfathered subsidiary solely in order to avoid taxes, while transacting illusory arrangements which lack economic substance. The Division's argument fails in two ways. First, the sole motivation was not to avoid taxes, despite the fact that it is well established by petitioner's own testimony that it was an important, and perhaps the primary, consideration. Such a narrow viewpoint misses the larger picture here. After saving taxes, Investment Company's after-tax yield was much greater, leaving Investment Company, and ultimately the Premier Group, in a stronger financial position. Clearly the profit potential existed and economic gain was a realistic goal. It would seem incongruent if tax considerations were not allowed to be a part of such a financial plan.

The next argument made by the Division was that petitioner entered into transactions with illusory arrangements which lack economic substance. Since the Division is not specific to which arrangements it is referring, I can only assume its use of the term "illusory," used in conjunction with a discussion about the management fee paid by Investment Company, again refers to the same fee arrangement. Since I determined above that the fee arrangement was not illusory or inadequate (***see,*** Conclusion of Law "E,"), I will not again revisit this issue.

The Division relied upon recent litigation in an attempt to support its tax shelter characterization of petitioner's relationship with Investment Company and the transactions in issue ***(see, Long Term Capital Holdings v. United States of America***, 330 F Supp 2d 122). Even the mention of a case like ***Long Term Capital Holdings*** is absurd. This was a case where the economic substance of a privately organized pooled investment vehicle, or hedge fund, was challenged. The transactions in issue involved nine multi-party cross border lease-stripping transactions, utilizing master lease, wrap lease or sale/leaseback structures for the sole purpose of generating tax losses. The structure of the transactions was very complex and in no way similar to the facts of this case. The Court's finding that the transactions in ***Long Term Capital Holdings*** should be recharacterized, or disregarded in their entirety, was based on sheltered income, the generation of phony losses, artificially increased basis, and manufactured tax deductions. None of those factors are present here. In fact, none of the Internal Revenue Service's ("IRS") tax shelter factors, as set forth in the IRS Audit Technique Guide on Abusive Tax Shelters, Transactions, issued May 24, 2005, are found in this case: a lack of meaningful economic risk of loss or potential for gain; inconsistent financial and accounting treatment; presence of tax-indifferent parties; complex transactions or structures; unnecessary steps or novel investments; promotion or marketing of the shelter products; confidentiality agreements whereby promoters attempt to limit expropriation of shelter ideas, which have prevented or delayed discovery by the IRS of the shelter's existence or terms; unusually high transaction costs borne substantially by the corporate beneficiary; and risk reduction fees, structured to reduce the cost and risk of the shelter to the participants. The Division's suggestion that the corporate structure and transactions be disallowed on the basis of its characterization as a tax shelter is rejected.

Lastly, the Division has attempted to characterize acceptable tax planning as the type of tax avoidance that rises to the level of tax evasion. This simply is not the case here. Tax avoidance is not synonymous with tax evasion (***Matter of J.C. Penney Co., Inc.***, Tax Appeals Tribunal, April 27, 1989). To the extent that the Tax Law allows parties to structure transactions in such a way that tax is lawfully avoided, no impropriety should be read into what is otherwise prudent business-like conduct (***id., citing Helvering v. Gregory***, 69 F2d 809, 810, ***affd*** 293 US 465, 79 L Ed 2d 596); ***Stewart v. Commissioner***, 714 F2d 977, 987-88). The fact that petitioner's management was diligent in its research, and creative in its application, and used clever and sophisticated tax planning to reduce its overall tax liabilities, in itself does not constitute prohibited tax avoidance, and certainly does not rise to the level of tax evasion. Petitioner's sound business decisions bore economic substance with a business purpose. "A 'business purpose' does not mean a reason for a transaction that is free of tax considerations. Rather a transaction has a 'business purpose'. . . as long as it figures in a bona fide, profit seeking business. This concept of 'business purpose' is a necessary corollary to the venerable axiom that tax planning is permissible. . . .To conclude otherwise would prohibit tax-planning." (***United Parcel Service of America, Inc. v. Commissioner of Internal Revenue***, 254 F3d 1014). Any tax avoidance motivation was neutralized by Investment Company's business purpose.

Under the facts of this case, the Division did not meet the statutory criteria to properly apply its discretionary authority pursuant to Tax Law § 1462(g). Nor did the Division establish that the arrangement between petitioner and Investment Company or any of the transactions herein be characterized as a tax shelter and disallowed. Accordingly, the Notice of Deficiency, as originally issued and amended, should be canceled.

G. Assuming *arguendo* that the Division's exercise of its Tax Law § 1462(g) discretionary authority were found to be proper, the next question to address is whether the Division was justified in increasing the notice of deficiency to impute to petitioner 100% of Investment Company's income, rather than 60% as originally reflected in the notice as issued.

Tax Law § 1089(e)(3) provides that, where the Division asserts a greater deficiency after a notice of deficiency has been mailed and a petition filed, the burden of proof will be on the Division.

The Division originally issued petitioner a Notice of Deficiency which included 60% of Investment Company's income in petitioner's Article 32 tax calculation, the basis of which is the Division's proposed Tax Law § 1462(g) discretionary authority adjustment. Petitioner protested the notice before BCMS; however, the notice was sustained by the issuance of a conciliation order. Thereafter, petitioner filed a petition with the Division of Tax Appeals, protesting the conciliation order. The Division next increased the amount of the deficiency by inclusion of 100% of Investment Company's income and assets in petitioner's New York tax calculation. The reason given by the Division for the increase was because Investment Company did not pay a dividend to Bank, implying there was no need to account for the dividend received deduction by petitioner. The Division promised a "later accommodation" when dividends are actually paid. Petitioner argues that the conciliation order is final and the Division must be bound by it, citing Tax Law § 170, which is in fact, true, unless and until petitioner timely files a petition for a hearing after the issuance of the order (Tax Law § 1089[d][1]), at which time the Division has the power to determine a greater deficiency than asserted in the notice. Thus, the Division acted properly in asserting a greater deficiency at the time it did.

The next question to address, however, is whether the Division carried its burden of proof to show that the deficiency should be increased. In this regard, the Division has failed. The

Division's reasoning (***see,*** Finding of Fact "26") is not rational, and it has not sustained its burden of proof to show the deficiency should be increased (Tax Law § 1089[e][3]). Accordingly, if the Division's discretionary authority were permitted, the liability would not be increased as amended by the Division.

H. There are two final issues with regard to the Notice of Deficiency, one of which is not raised by the parties, and a second that is briefly addressed.

The first concerns a correction that should be acknowledged should it be determined that the Division's discretionary authority was proper. The Division's explanation for including 60% of Investment Company's income in petitioner's Article 32 tax calculation is flawed. The Division acknowledged that this percentage was used by the auditor because had Bank received a dividend from Investment Company in an amount equal to Investment Company's investment income, Bank (and petitioner) would have been entitled to an exclusion from income pursuant to Tax Law § 1453(e)(11)(ii) of 60% of dividend income from subsidiary capital. The corollary to this is that Bank would have been taxed on 40% of Investment Company's income, not 60% as the notice reflects. Since the computation of the tax liability was in error (see, Division's Exhibit "Y", pages A-23, A-20 and A-18), the Division must correct this accordingly to reflect inclusion of 40% of Investment Company's income if the Division's discretionary authority is allowed.

The second issue concerns another Article 32 deduction, allowed by Tax Law § 1453(e)(12), which permits a deduction from entire net income for 22 ½% of interest income on obligations of New York State or any political subdivision thereof, or of the United States. Investment Company asserted that it had as part of its assets New York municipal obligations and United States Treasury obligations which, if taxed to Bank (or petitioner) under the

Division's discretionary adjustment, qualified for such deduction. The Division agreed that such deduction should have been taken into account, and pending proof by petitioner that Investment Company had such qualifying investments, the Division would make such adjustment to the tax liability. Accordingly, the Division's discretionary adjustment, if upheld, as adjusted above, should also be reduced by the deduction allowed pursuant to Tax Law § 1453(e)(12) upon petitioner's proof of qualifying assets, some of which can be easily identified by Investment Company's balance sheets and custodial statements.

I. Although the issue of penalty is moot given Conclusion of Law "F", for purposes of affording a two-tier level of review of this issue, it is determined that even if the Division's discretionary authority were upheld, penalties would have been abated. Tax Law § 1085(k) provides for a penalty to be imposed for substantial understatement of tax in the amount of ten percent of the amount of any underpayment attributable to the understatement. The same section provides that the penalty may be waived if the taxpayer demonstrates reasonable cause for the underpayment or that it acted in good faith.

In this case, the only reason there is any "understatement" is due to the Division's exercise of its discretionary authority under Tax Law § 1462(g), which only the Division could make, and could only be made after the filing of petitioner's returns. Petitioner did not understate any of the tax required to be shown on its Article 32 tax returns. Furthermore, petitioner acted in good faith, consulted with accounting professionals and relied upon the advice of quality advisors to assess the appropriateness of its tax planning. Accordingly, the penalty was erroneously imposed, or at the very least, should be abated based upon reasonable cause and petitioner's good faith efforts.

J. The petition of Premier National Bancorp, Inc. is granted, and the Notice of Deficiency, as issued dated May 6, 2002, and thereafter adjusted (***see,*** Finding of Fact "26") is canceled.

DATED: Troy, New York
April 27, 2006

/s/ Catherine M. Bennett
ADMINISTRATIVE LAW JUDGE