STATE OF NEW YORK

TAX APPEALS TRIBUNAL

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| In the Matter of the Petition | : | |
| of | : | |
| **THE BROOKLYN UNION GAS COMPANY** | : | DECISION |
| for Redetermination of a Deficiency or for Refund of Corporation Tax under Article 9 of the Tax Law for the Years 1981, 1982 and 1983. | : | |

Petitioner, The Brooklyn Union Gas Company, 195 Montague Street, Brooklyn, New York 11201, filed an exception to the determination of the Administrative Law Judge issued on March 23, 1989 with respect to its petition for redetermination of a deficiency or for refund of corporation tax under Article 9 of the Tax Law for the years 1981, 1982 and 1983 (File No. 802538). Petitioner appeared by Cullen and Dykman (Orrin E. Tilevitz, Esq. and Joseph P. Stevens, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Anne Murphy, Esq., of counsel).

Petitioner submitted a brief on exception. The Division submitted a letter in lieu of a brief. Oral argument was held, at the request of petitioner, on November 15, 1989.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

## *ISSUES*

I. Whether, in calculating the excess dividends tax under section 186 of the Tax Law, petitioner overstated the amount of its paid-in capital during the years in issue.

II. Whether the Division's acceptance of petitioner's returns for a period of over 20 years was tantamount to its acceptance of petitioner's position regarding paid-in capital as revealed on the reports.

***FINDINGS OF FACT***

We find the facts as determined by the Administrative Law Judge and such facts are stated below.

Petitioner, The Brooklyn Union Gas Company ("BUG"), and the Division of Taxation ("Division") entered into a Stipulation of Facts which has been incorporated into the following findings of fact. The stipulation has been modified by omission of references to exhibits.

The Brooklyn Union Gas Company, a New York State corporation which was organized under the Transportation Corporations Law of the State of New York on September 9, 1895, was for the years at issue in this petition principally engaged in supplying gas and gas services to customers in the Counties of Kings, Queens and Richmond, and was subject to the supervision of the New York State Department of Public Service.

On January 11, 1957, pursuant to an agreement dated August 22, 1956, The Kings County Lighting Company ("Kings County") and The New York and Richmond Gas Company ("Richmond") were combined with BUG. Under the terms of the agreement, all 440,000 outstanding shares of Kings County stock were converted into 210,000 shares of BUG stock and all 15,000 outstanding shares of Richmond stock were converted into 90,000 shares of BUG stock.

On June 1, 1959, pursuant to an agreement dated February 9, 1959, The Brooklyn Borough Gas Company ("Brooklyn Borough") was combined with BUG. Under the terms of the agreement, all 200,000 outstanding shares of Brooklyn Borough were converted into 150,000 shares of BUG stock.

On January 15, 1957, the market value of the 300,000 shares of BUG stock into which the Kings County and Richmond shares were converted was $35.25 per share, or $10,575,000.00. This was the amount of additional paid-in capital BUG recorded for purposes of the tax imposed by section 186 of the Tax Law. On June 1, 1959, the market value of the 150,000 shares of BUG stock into which Brooklyn Borough shares were converted was $53.00 per share, or

$7,950,000.00. This was the amount of additional paid-in capital BUG recorded for purposes of the tax imposed by section 186 of the Tax Law.

Immediately prior to each consolidation, the outstanding preferred stock of Kings County, Richmond, and Brooklyn Borough, respectively, was redeemed, reducing the paid-in capital of each company for financial statement purposes.

BUG recorded all three acquisitions for financial statement purposes in accordance with the Public Service Commission's requirement that the "pooling of interest method of accounting" be utilized. Therefore, the historical financial statements of Kings County, Richmond and Brooklyn Borough were combined into BUG's financial statement as though the companies had always been commonly owned. The historical book value of paid-in capital after the merger represented an increase of $5,444,000.00. The book value of Kings County, Richmond and Brooklyn Borough stock immediately prior to each merger was $2,544,000.00, $900,000.00 and $2,000,000.00, respectively.

For the years at issue herein, section 186 of the New York State Tax Law imposes a tax of:

> "four and one-half per centum upon the amount of dividends paid during each year...which is in excess of four per centum upon the actual amount of paid-in capital employed in this state by such corporation...."

On August 17, 1985, the Audit Division of the State of New York, Department of Taxation and Finance ("Division") issued five statements of audit adjustment and notices of deficiency to BUG for the following base tax amounts:

| Period ending | Base Tax Amount |
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| December 31, 1981 | $50,119.00 |
| December 31, 1982 | $46,531.00 |
| | $ 8,376.00 (MTA Surcharge Tax) |
| December 31, 1983 | $45,298.00 |
| | $ 7,701.00 (MTA Surcharge Tax) |

The notices mentioned above were issued following a 1985 field audit which examined BUG's books and records for the periods 1981 through 1983, in light of the requirements of section 186 of the Tax Law.

On or about July 2, 1985, BUG paid under protest $207,179.00 to the New York State Department of Taxation and Finance, which amount represented BUG's alleged liability, including interest, as determined by the Audit Division following the 1985 field audit. Simultaneously with paying the tax, BUG duly requested a refund. This refund request is the subject of the instant proceeding.

For purposes of computing the tax under section 186 of the Tax Law, BUG on each tax report filed from the acquisition of Kings County, Richmond, and Brooklyn Borough, respectively, through the periods at issue in this petition, valued the actual amount of paid-in capital at the value of the BUG stock into which the stock of each company was converted, valued at the date of issuance. For the years 1957 through 1979, BUG clearly indicated on each tax report to the State that the paid-in capital on the tax report was computed using the fair market value of the stock issued to acquire the above-mentioned companies. According to petitioner, BUG ceased so indicating only because doing so was burdensome, and the State has no evidence to the contrary.

The Audit Division of the Department of Taxation and Finance, in valuing "the actual amount of paid-in capital" for purposes of section 186 of the New York State Tax Law for the periods ending December 31, 1981, December 31, 1982, and December 31, 1983, utilized the historic paid-in capital, $5,444,000.00, of Kings County, Richmond and Brooklyn Borough and not the fair market value, $18,525,000.00, of BUG stock issued at the time of the mergers.

Other than as set forth herein and the exhibits attached hereto, there are no facts material to the determination of the refund claim.

***OPINION***

Tax Law § 186 imposes a franchise tax on water, gas, electric or steam heating, lighting and power companies at the rate of three quarters of one percent on gross earnings plus four and one-half percent on the amount of dividends paid "in excess of four percentum upon the actual amount of paid-in capital employed in this state" (Tax Law § 186, emphasis added). The second portion of this tax is referred to as the "excess dividends tax".

In the determination below the Administrative Law Judge decided that, during the years in issue, BUG overstated the amount of its actual paid-in capital in the calculation of its excess dividends tax pursuant to Tax Law § 186. Specifically, it was concluded that the proper amount by which BUG should have increased its paid-in capital was an amount equal to the historic paid-in capital of the companies combined with it, i.e., Kings County, Richmond and Brooklyn Borough, rather than an amount equal to the fair market value of BUG's stock which was issued to the shareholders of such companies in exchange for all of such companies' stock. Further, it was concluded that the failure of the Division to challenge BUG's reports as filed for a period of years did not amount to an acceptance by the Division of petitioner's position as revealed in such reports.

On exception, BUG's central argument is that its acquisition of the three companies called for an increase in its paid-in capital which was properly measured by the fair market value of the BUG stock given in consideration for the stock issued at the time of the mergers of the three companies into BUG. The basis for this position is the proposition that the actual amount invested in BUG by the shareholders of the acquired companies was the value of the stock they held in the acquired companies. The proper measure of the value of that stock, it is asserted, was the consideration given for it, i.e., the BUG stock at its fair market value at the time of exchange. As support for its position, petitioner argues that: (1) present day accounting and federal income tax treatment are not relevant when construing a statute substantially unchanged since 1896, (2) prior judicial interpretation of Tax Law § 186 suggests that accounting and federal income tax treatment are not relevant considerations in construing this section, (3) the treatment of these transactions by petitioner is dictated by economic reality and the intent of Tax Law § 186 and (4) petitioner's position is supported by the Division's tacit acceptance of such position.

In response, the Division argues that the determination of the Administrative Law Judge should be sustained in its entirety. Specifically, the Division would have us value the actual paid-in capital of BUG as it is recorded in BUG's financial statements. These statements are maintained according to the "pooling of interests" accounting method as required of BUG by the

Department of Public Service. The pooling of interests method operates in a manner which treats the shareholders of the acquiring and acquired companies as though they were and continue to be owners of the combined, enlarged business. This assumption is accomplished by combining the assets and liabilities of the acquired companies with those of the acquiring company at their historical costs in the consolidated financial statements. Since BUG was required to use this method of accounting, the paid-in capital of the combined utilities was recorded on BUG's financial statements at its historical book value. The Division argues that this requires petitioner to compute the excess dividends tax using this historical cost as well. The Division continues by asserting that the carrying of the paid-in capital by petitioner on its financial statements at its historic value is an indication of the value which petitioner places upon its actual paid-in capital. Lastly, the Division submits that there is no statutory or regulatory basis for accepting petitioner's "economic realities" arguments.

We reverse the determination of the Administrative Law Judge.

The issue before us is how to measure "the actual amount of paid-in capital" as required by § 186. There are no regulations or case law which interpret the language of the statute. The Division has, however, issued guidelines defining the term "actual paid-in capital", as it is used in Tax Law § 186, as "that part of the equity that was invested in the business enterprise by shareholders" (TSB-M-82[8]C). This definition is in accord with that found in current accounting texts and both petitioner and the Division have accepted this as an appropriate definition (see, Meigs & Meigs, Financial Accounting, at 443 [5th ed 1987]). As a result, we will utilize this definition to guide our analysis as it directs us to determine the actual amount of equity invested by the shareholders in the business enterprise.

In the present case, there is no dispute that the issuance of stock by BUG to the shareholders of the acquired companies is an event which called for an increase in the paid-in capital of BUG to reflect the shareholders' equity investment.[1] Thus, the only issue before us is

[1]The issuance of stock for property is one of a number of transactions which calls for an increase in paid-in capital according to basic corporate finance principles (see, Brealey and Meyers, Principles of Corporate Finance, at 304 [3d ed 1988]).

the proper amount of this increase. The simple facts relevant to this issue are that the shareholders of the acquired companies invested the stock owned by them in such companies to obtain the BUG stock. The value of this investment was equal to the value of the BUG stock received by the shareholders in exchange for their investment. The amount was $18,525,000.00 at the time of the mergers. Thus, the shareholders of the acquired companies contributed stock with a value of $18,525,000.00 in order to acquire their interest in BUG. An application of the plain words of the statute, and the interpretation of the statute offered by the Division in TSB-M-82(8)C to this straightforward view of the facts, compels the conclusion that $18,525,000.00 is the amount of equity which was invested by the former shareholders of the acquired companies in BUG. Stated alternatively, we conclude that it is appropriate to value the increase to stated capital at the time the event triggering the increase occurs.

Our conclusion is further supported by the statute's use of the term actual in conjunction with paid-in capital in § 186. The specific use of the term actual by the Legislature in enacting this statute must be given proper recognition. "In the construction of a statute, meaning and effect should be given to all its language, if possible, and words are not to be rejected as superfluous when it is practicable to give each a distinct and separate meaning" (McKinney's Consolidted Laws of NY, Book 1, § 231). "Actual" as defined in Webster's Ninth New Collegiate Dictionary (p. 54) means "existing or occurring at the time: current". Its use here indicates that all artificial valuations of paid-in capital are dismissed for Tax Law § 186 purposes and that the fair market value of BUG stock received by shareholders of the merged companies is the correct measure of actual paid-in capital. The conclusion of the Administrative Law Judge that "actual paid-in capital" means "historical book value" ignores the presence and significance of the term "actual" as used in the statute and it requires a strained reading of the statute. Rather than valuing the new shareholders' equity investment in BUG, the Administrative Law Judge would require a valuation of the shareholders' equity investment in the discontinued corporations that had been merged into BUG. However, the statute refers simply to the paid-in capital of the corporation upon which the Tax Law § 186 franchise tax is imposed, not to that of other entities

involved in a corporate acquisition or reorganization. Further, the interpretation offered by the Division in its guidelines specifically looks to contributions by shareholders of the taxpayer corporation rather than contributions from shareholders to corporations which may have been acquired. The historical interpretation urged by the Division and adopted by the Administrative Law Judge is certainly not apparent on the face of the statute nor in the Division's guidelines.

We also conclude that the Administrative Law Judge and the Division were incorrect in their position that BUG's use of the pooling of interests method for its financial statements was fatal to its claim that paid-in capital for Tax Law § 186 purposes should be measured in a different manner. In particular, it was concluded that since BUG used the pooling of interests method to combine the companies, BUG and its shareholders were required to use that method for tax purposes and accept all of the tax consequences of that method. In addition, the Administrative Law Judge concluded that if petitioner increased its paid-in capital by the fair market value of the stock it received, then petitioner would be stepping up its paid-in capital in a manner which was inconsistent with (1) the pooling of interests method, (2) petitioner's own financial statements and (3) the principle that nonrecognition of gain goes hand in hand with no increase in basis.

We find this position to be not only impractical but also wholly inconsistent with the language of Tax Law § 186. First, in a practical manner, this position would work to bind the Division to the particular accounting method utilized by the taxpayer. Such a stance, taken to a logical extension, would allow for a taxpayer which utilizes an accounting method that artificially overstates the value of its paid-in capital to reap a benefit to which it is clearly not entitled. Surely a taxpayer's method of accounting is not binding on a taxing authority whether that method is beneficial or detrimental with respect to the tax at issue. It is a common practice for taxpayers to have variations in their financial and tax records (see, McDonald's Restaurants of Illinois v. Commr., 688 F2d 520, 82-2 USTC ¶ 9581 at 85,091, n. 6). The Administrative Law Judge's concern that BUG is unfairly attempting to step up its paid-in capital which would produce undeserved income tax advantages to the shareholders is unfounded and based upon a

consideration of other areas of the tax law not relevant herein. Our decision rests upon an interpretation of the corporate franchise tax law, independent of external considerations such as the personal income taxes of BUG's shareholders and the accounting requirements imposed upon BUG by the Department of Public Service. As a result, we reject the assertion by the Administrative Law Judge that nonrecognition of gain requires that there be no increase in basis as these considerations are independent and separate from the corporate franchise tax law such that one is not controlling upon the other (see, 500 Fifth Avenue v. State Tax Commn., 28 AD2d 1162, 284 NYS2d 350, 352).

Rather than providing an unwarranted benefit, the valuation of the new shareholders' equity investment in BUG at the time it occurred only causes an increase in the paid-in capital which accurately accounts for the consolidations which occurred. An increase limited to the historical cost would not represent the actual value of the capital contributed at the time of the consolidations and would be unfair to the new shareholders of BUG. As discussed above, an increase by the fair market value is further supported by the language of the statute itself and the interpretation of the statute by the Division in TSB-M-82(8)-C. As a result, we conclude that BUG was correct in valuing its paid-in capital in an amount equal to the fair market value of the stock contributed to BUG by the acquired companies.

The reliance by the Administrative Law Judge on Matter of Rochester Gas and Electric Corp. v. State Tax Commn. (28 AD2d 631, 280 NYS2d 217, affd 25 NY2d 857) is somewhat confusing and we address the case in order to clarify our differences. In Rochester the court held that for purposes of calculating the excess dividends tax a stock dividend would be considered a dividend under Tax Law § 186. Implicit in this decision was the rule that a corporation is not permitted to increase its paid-in capital by combining it with amounts from retained earnings in order to avoid paying tax on stock dividends. In the present case it is clear, and the Administrative Law Judge agreed, that the paid-in capital of BUG should be increased as a result of the consolidations. The remaining question is the amount of the increase. The significant difference between the present case and Rochester is that there was no event which would trigger

an increase in paid-in capital in Rochester, while in the instant matter it is clear that an increase in paid-in capital is required but that the extent of the increase is the issue at hand. On the basis of this fundamental distinction we find no correlation between the decision of the court in Rochester and the determination with which we are confronted.

Since we have concluded that BUG is entitled to the valuation of its paid-in capital on the basis of the previously discussed arguments we find it unnecessary to address the issue of whether the Division's tacit acceptance of BUG's returns for several years compelled the conclusion that BUG should receive the fair market value treatment which it desired.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of The Brooklyn Union Gas Company is granted;

2. The determination of the Administrative Law Judge is reversed;

3. The petition of The Brooklyn Union Gas Company is granted; and

4. The refund claim filed by Brooklyn Union Gas Company on or about July 2, 1985 is granted.

DATED: Troy, New York
May 10, 1990

/s/John P. Dugan
John P. Dugan
President

/s/Francis R. Koenig
Francis R. Koenig
Commissioner

/s/Maria T. Jones
Maria T. Jones
Commissioner