

STATE OF NEW YORK
TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
VOLT INFORMATION SCIENCES, INC.	:	DECISION
for Redetermination of a Deficiency or for	:	DTA No. 802809
Refund of Corporation Franchise Tax under	:	
Article 9-A of the Tax Law for the Fiscal Years	:	
Ended October 31, 1978 through October 31, 1981.	:	

Petitioner Volt Information Sciences, Inc., 101 Park Avenue, New York, New York 10178 filed an exception to the determination of the Administrative Law Judge issued on November 21, 1991 with respect to its petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the fiscal years ended October 31, 1978 through October 31, 1981.

Petitioner appeared by Ernst & Young (Kenneth T. Zemsky, C.P.A.). The Division of Taxation appeared by William F. Collins, Esq. (James Della Porta, Esq., of counsel).

Both parties filed briefs on exception. Oral argument, at petitioner's request, was heard on April 16, 1992.

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

ISSUES

I. Whether it was proper for the Division of Taxation to require petitioner to add back to its entire net income the income which it received from certain subsidiaries.

II. Whether the Division of Taxation properly calculated the interest expense indirectly attributable to petitioner's subsidiary capital.

III. Whether petitioner has established that the Division of Taxation improperly included indebtedness, on which interest expense was deducted by the subsidiary under either Articles 9-A, 32 or 33 of the Tax Law, in petitioner's subsidiary capital.

IV. Whether the interest expense arising from the issuance of certain convertible debentures should be excluded from the Division of Taxation's calculation of interest expense indirectly attributable to subsidiary capital.

V. Whether the audit workpapers and the Division of Taxation's testimony at the hearing demonstrate that the audit was unreliable.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for findings of fact "3," "5," and "6" which have been modified. The Administrative Law Judge's findings of fact and the modified findings of fact are set forth below.

During the period in issue, petitioner, Volt Information Sciences, Inc. ("Volt"), provided technical labor services, such as engineers, on a contract basis to various industries such as aerospace, aircraft and telecommunications. Volt also supplied temporary office labor to businesses. Another segment of Volt's business engaged in the manufacture of computerized photo typesetters. In addition, Volt produced technical publications.

Volt filed a State of New York Corporation Franchise Tax Report for each of the fiscal years in issue. To the extent relevant herein, these returns disclose the following:

(a) Volt's Corporation Franchise Tax Report for the fiscal year ended October 31, 1978 included a schedule C entitled "Subsidiary Capital and Allocation." The instructions on the report directed taxpayers to "[i]nclude all corporations, except a DISC, in which you own more than 50% of the voting stock." The following corporations, employer identification numbers and percentages of voting stock owned were reported:

<u>Corporation</u>	<u>Employer Ident. No.</u>	<u>Percentage of Voting Stock Owned</u>
Volt Tech. Corp.	95-2056687	100.0
Autologic Inc.	94-1595880	88.0
Comm Residential	52-0936321	100.0
Jefferson Adams	13-2719371	100.0
MKUK Games Corp.	13-2270143	100.0
Volt Tech. Corp.	75-1055081	100.0
Volt Temp. Serv.	13-2836154	100.0
Volt Tech. Serv.	13-2835773	100.0
Shaw & Shaw Inc.	94-2452403	100.0

Volt's New York franchise tax report included a copy of Volt's consolidated U.S. Corporation Income Tax Return for the fiscal year ended October 31, 1978. Volt's Federal return included the following schedule of consolidated subsidiaries:

<u>Name</u>	<u>Employer Identification No.</u>
Volt Technical Corp. (DEL)	75-1055081
Volt Technical Corp. (CAL)	95-2056687
Autologic, Inc.	94-1595880
Community Residential Centers, Inc.	52-0936321
Jefferson-Adams Corporation	13-2719371
Volt Technical Services, Inc. (N.Y.)	13-5649428
MKUK Games Corporation	13-2770143
Volt Technical Services Corporation	13-2835773
Volt Temporary Services, Inc.	13-2836154
Shaw & Shaw, Inc.	94-2452403

(b) Volt's State of New York Corporation Franchise Tax Report for the fiscal year ended October 31, 1979 calculated its tax as the sum of allocated net income plus allocated subsidiary capital. The report included a schedule C which listed the following corporations in which it owned more than 50% of the voting stock. The corporations, employer identification numbers and percentages of voting stock were reported as follows:

<u>Corporation</u>	<u>Employer Ident. No.</u>	<u>Percentage of Voting Stock Owned</u>
Volt Tech. Corp.	95-2056687	100.0
Autologic Inc.	94-1595880	88.0
Comm Residential	52-0936321	100.0
Jefferson Adams	13-2719371	100.0
MKUK Games Corp.	13-2270143	100.0
Volt Tech. Corp.	75-1055081	100.0
Volt Temp. Serv.	13-2836154	100.0
Volt Tech. Serv.	13-2835773	100.0
Shaw & Shaw Inc.	94-2452403	100.0

Volt's New York Corporation Franchise Tax Report included a copy of Volt's consolidated U.S. Corporation Income Tax Return for the fiscal year ended October 31, 1978.

Volt's Federal return included the following schedule of consolidated subsidiaries:

<u>Name</u>	<u>Employer Identification No.</u>
Volt Technical Corp. (DEL)	75-1055081
Volt Technical Corp. (CAL)	95-2056687
Autologic, Inc.	94-1595880
Community Residential Centers, Inc.	52-0936321
Jefferson-Adams Corporation	13-2719371
Volt Technical Services, Inc. (N.Y.)	13-5649428
MKUK Games Corporation	13-2770143
Volt Technical Services Corporation	13-2835773
Volt Temporary Services, Inc.	13-2836154
Shaw & Shaw, Inc.	94-2452403

(c) Volt filed a State of New York Corporation Franchise Tax Report for the fiscal year ended October 31, 1980 which calculated tax as the sum of allocated net income and allocated subsidiary capital. The report included a schedule C which listed the following corporations in which it owned more than 50% of the voting stock. The corporations, employer identification numbers and percentages of voting stock were reported as follows:

<u>Corporation</u>	<u>Employer Ident. No.</u>	<u>Percentage of Voting Stock Owned</u>
Volt Tech. Corp.	95-2056687	100.0
Autologic Inc.	94-1595880	88.0
Comm Residential	52-0936321	100.0
Jefferson Adams	13-2719371	100.0
MKUK Games Corp.	13-2270143	100.0
Volt Tech. Corp.	75-1055081	100.0
Volt Temp. Serv.	13-2836154	100.0
Volt Tech. Serv.	13-2835773	100.0
Shaw & Shaw Inc.	94-2452403	100.0
Volt Energy Sys.	94-2627469	100.0
Volt Med Serv.	95-3474390	100.0
DRI Comp. Leasing	13-3026137	100.0
VDR Inc.	13-3025941	100.0
Volt Delta Res.	13-3026138	100.0
Delta Resources	13-3031524	100.0
Volt Electronics	13-3051873	100.0

Volt's New York Corporation Franchise Tax Report included a copy of Volt's consolidated U.S. Corporation Income Tax Return for the fiscal year ended October 31, 1980.

Volt's Federal return included the following schedule of consolidated subsidiaries:

<u>Name</u>	<u>Employer Identification No.</u>
Volt Technical Corp. (DEL)	75-1055081
Volt Technical Corp. (CAL)	95-2056687
Autologic, Inc.	94-1595880
Community Residential Centers, Inc.	52-0936321
Jefferson-Adams Corporation	13-2719371
Volt Technical Services, Inc. (N.Y.)	13-5649428
MKUK Games Corporation	13-2770143
Volt Technical Services Corp.	13-2835773
Volt Temporary Services, Inc.	13-2836154
Shaw & Shaw, Inc.	94-2452403
Volt Energy Systems, Inc.	94-2627469
Volt Medical Services, Inc.	95-3474390
DRI Computer Leasing, Inc. Formerly VDI, Inc.	13-3026137
VDR, Inc.	13-3025941
Volt Delta Resources, Inc.	13-3026138
Delta Resources, Inc.	13-3031524
Volt Electronics Corporation	13-3051873

(d) Volt filed a State of New York Corporation Franchise Tax Report for the fiscal year ended October 31, 1981. The return calculated tax as the sum of allocated capital and allocated subsidiary capital. The report included a schedule C which listed the following

corporations in which it owned more than 50% of the voting stock. The corporations, employer identification numbers and percentages of voting stock were reported as follows:

<u>Corporation</u>	<u>Employer Ident. No.</u>	<u>Percentage of Voting Stock Owned</u>
Volt Tech. Corp.	95-2056687	100.0
Autologic Inc.	94-1595880	88.0
Comm Residential	52-0936321	100.0
Jefferson Adams	13-2719371	100.0
MKUK Games Corp.	13-2270143	100.0
Volt Tech. Corp.	75-1055081	100.0
Volt Temp. Serv.	13-2836154	100.0
Volt Tech. Serv.	13-2835773	100.0
Shaw & Shaw Inc.	94-2452403	100.0
Volt Energy Sys.	94-2627469	100.0
Volt Med Serv.	95-3474390	100.0
DRI Comp. Leasing	13-3026137	100.0
VDR Inc.	13-3025941	100.0
Volt Delta Res.	13-3026138	100.0
Delta Resources	13-3031524	100.0
Volt Electronics	13-3051873	100.0

Volt's Federal return included a balance sheet which contained an asset account entitled "Due from Related Companies." According to the balance sheet, the value of the account increased during the fiscal year from \$12,332,993.00 to \$32,880,238.00. The balance sheet also contained an asset account entitled "Investment in Subsidiaries" which increased from the beginning to the end of its fiscal year from \$782,295.00 to \$983,713.00.

Volt's New York franchise tax report included a copy of Volt's consolidated U.S. Corporation Income Tax Return for the fiscal year ended October 31, 1981. Volt's Federal return included the following schedule of consolidated subsidiaries:

<u>Name</u>	<u>Employer Identification No.</u>
Volt Technical Corp. (DEL)	75-1055081
Volt Technical Corp. (CAL)	95-2056687
Autologic, Inc.	94-1595880
Community Residential Centers, Inc.	52-0936321
Jefferson-Adams Corporation	13-2719371
Volt Technical Services, Inc. (N.Y.)	13-5649428
MKUK Games Corporation	13-2770143
Volt Technical Services Corporation	13-2835773
Volt Temporary Services, Inc.	13-2836154
Shaw & Shaw, Inc.	94-2452403
Volt Energy Systems, Inc.	94-2627469
Volt Medical Services, Inc.	95-3474390
DRI Computer Leasing, Inc. Formerly VDI, Inc.	13-3026137
VDR, Inc.	13-3025941
Volt Delta Resources, Inc.	13-3026138
Delta Resources, Inc.	13-3031524
Volt Electronics Corporation	13-3051873
Volt Energy Systems (Mass.) Inc.	Number Applied For

We modify finding of fact "3" of the Administrative Law Judge's determination to read as follows:

In reviewing these reports and the reports of Volt's subsidiaries, the Division of Taxation (hereinafter the "Division") ascertained that, for the fiscal year ended October 31, 1979, Volt excluded from its entire net income \$513,943.00 (see, Exhibit "I," 1979 Corporate Franchise Tax Report, line 24, "interest, dividends and capital gains from Subsidiary Capital [itemize on rider]"). The report did not have attached to it a "rider" explaining the source of the \$513,943.00. The audit workpapers state, under the heading "Explanation," that the amount excluded by the taxpayer "from ENI (entire net income) is neither interest nor dividend from 100% owned subsidiary -- amount added back to ENI" (see, Exhibit "M," Field Audit Report, Schedules "F" and "B"). For the fiscal years ending October 31, 1980 and October 31, 1981, Volt excluded from its entire net income \$2,091,022.00 and \$5,186,451.00, respectively (see, Exhibit "J," 1980 Corporate Franchise Tax Report, line 26, and Exhibit "K," 1981 Corporate Franchise Tax Report, line 26, both captioned "interest, dividends and capital gains from Subsidiary Capital [itemize on rider]"). The report did not have a "rider" attached to it. The audit workpapers indicate that of these amounts, \$42,577.00 (1980) and \$1,240,393.00 (1981) "is added back to ENI since these are New York subsidiaries and the said subsidiaries had taken the full amounts as a deduction on their NY CT-3's" (see, Exhibit "M," Field Audit Report, Schedules "F-1," "B," and "B-1").¹

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The first paragraph of the Administrative Law Judge's finding of fact "3" read as follows:

"In reviewing these reports and the reports of Volt's subsidiaries, the Division of

The following chart illustrates the adjustments as reflected in the workpapers:

	<u>October 31, 1979</u>	<u>Fiscal Year Ended October 31, 1980</u>	<u>October 31, 1981</u>
Unidentified source	\$513,943.00		
Delta Resources, Inc.		\$60,225.00	\$ 909,460.00
DRI Computer Leasing		1,521.00	422,692.00
Credit		<u>(19,169.00)</u>	<u>(91,757.00)</u>
	<u>\$513,943.00</u>	<u>\$42,577.00</u>	<u>\$1,240,393.00</u>

The Division also added back to Volt's entire net income the interest expense which was deemed to be indirectly attributable to subsidiary capital. This adjustment was based on the Division's use of a formula which was designed to determine the portion of Volt's interest expense which was indirectly attributable to subsidiary capital. The formula used by the Division may be stated as follows:

$$\frac{\text{Investment in subsidiaries}}{\text{Total assets}} \times \frac{\text{Gross Interest Expense}}{\text{Interest indirectly attributable to subsidiary capital}} = \text{Interest Expense}$$

We modify finding of fact "5" of the Administrative Law Judge's determination to read as follows:

When it performed its analysis, the Division subtracted the amounts directly attributable to subsidiary capital from the average total assets per Volt's balance sheet to calculate adjusted total assets (see, Exhibit "M," Field Audit Report, Schedule "F-2," lines 1, 2, and 4). The investment in subsidiary capital was determined by adding the cost of subsidiary capital from Volt's accountant's workpapers to the amount of advances (see, Exhibit "M," Field Audit Report, Schedule "F-2," lines 10 and 11). The Division determined that the amounts of the advances were \$5,620,325.00, \$3,888,077.00, \$9,081,425.00 and \$23,351,328.00 for the

Taxation ("Division") ascertained that, for the fiscal year ended October 31, 1979, Volt excluded from its entire net income \$513,943.00. The Division concluded that this amount was neither interest nor dividends from a wholly-owned subsidiary. Therefore, the Division found that this amount should be added back to entire net income. For the fiscal years ending October 31, 1980 and October 31, 1981, the Division added back to Volt's entire net income the interest income which it had received from two wholly-owned subsidiaries on the ground that the interest income was received from New York subsidiaries which had taken the corresponding interest expense as a deduction on their corporate franchise tax reports."

We modified this finding of fact to include the specific references to the audit report to show that the amounts which the Division required to be added back for each year were excluded by Volt from entire net income on the basis that such amounts were interest, dividends and capital gains from subsidiary capital. The chart illustrating the adjustments as reflected in the workpapers has not been modified.

fiscal years ended October 31, 1978, October 31, 1979, October 31, 1980 and October 31, 1981, respectively. The interest expense was obtained from Volt's corporate income tax returns. For the fiscal years ending in 1980 and 1981, the interest expense was reduced because a portion of the proceeds from the indebtedness was not available for general corporate purposes (see, Exhibit "M," Field Audit Report, Schedule "F-2," line 21).²

We modify finding of fact "6" of the Administrative Law Judge's determination to read as follows:

One portion of the audit concerned the tax on subsidiary capital. The Division found that Volt failed to include in its calculation of subsidiary capital the loans from Volt to its subsidiaries and, therefore, it recalculated the tax by adding such loans to the average fair market value of subsidiary capital. The worksheets calculating subsidiary capital use the term "average loans" and do not show any loans for the fiscal years ended October 31, 1978 and October 31, 1979. The Division determined that the average loans from Volt to its subsidiaries were \$280,154.00 for the fiscal year ended October 31, 1980 and \$5,543,937.00 for the fiscal year ended October 31, 1981 (see, Exhibit "M," Field Audit Report, Schedule "E," total of lines 30 and 42 for FYE 1980 and 1981). In calculating the tax on subsidiary capital, Volt Technical Corp. (CA) and MKUK Games Corp. were included for each of the years in issue (see, Exhibit "M," Field Audit Report, Schedule "E," lines 3 and 16). DRI Computer Leasing, Inc. and Volt Delta Resources, Inc. were included for the fiscal years ended October 31, 1980 and October 31, 1981 (see, Exhibit "M," Field Audit Report, Schedule "E," lines 23 and 25).³

The Division issued a series of four notices of deficiency, dated September 17, 1985, to Volt which asserted a deficiency of corporation franchise tax as follows:

<u>Period Ended</u>	<u>Tax</u>	<u>Interest</u>	<u>Total</u>
October 31, 1978	\$ 43,355.00	\$41,178.00	\$ 84,533.00
October 31, 1979	34,019.00	28,656.00	62,675.00
October 31, 1980	4,524.00	3,325.00	7,849.00
October 31, 1981	115,393.00	67,101.00	182,494.00

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We modified finding of fact "5" of the Administrative Law Judge's determination by adding references to Exhibit "M," Field Audit Report, where appropriate.

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We modified finding of fact "6" of the Administrative Law Judge's determination by adding references to Exhibit "M," the Field Audit Report, where appropriate.

The notices of deficiency were protested and after a conciliation conference the tax amounts were adjusted as follows:

<u>Fiscal Year Ended</u>	<u>Tax</u>
October 31, 1978	\$ 42,302.00
October 31, 1979	33,253.00
October 31, 1980	1,914.00
October 31, 1981	114,297.00

At the hearing, Volt's vice president and comptroller testified that, in 1981, Volt raised \$30,000,000.00 by the public issuance of 12-1/8% convertible debentures. Said debentures were convertible into the company's common stock. The purpose of the debt offer was to help Volt achieve its planned strategic growth pattern through acquisitions. Volt's comptroller explained that, immediately upon the closing of the public offering, the funds were invested in Treasury bills, government securities and a very small percentage in corporate debentures. None of the proceeds from the public offering was advanced to its subsidiaries during the fiscal years in issue. According to Volt's comptroller, the level of its advances to its subsidiaries was not affected by the incurrence of the public debt. In 1982 or 1983, a portion of these monies was placed into Volt's general working funds and, when necessary, lent to first-tier or second-tier subsidiaries.

At the hearing, Volt's comptroller also testified that three companies, which were included in the Division's calculation of interest expense indirectly attributable to subsidiary capital, were second-tier subsidiaries. These corporations were Delta Resources, Inc., DRI Computer Leasing, Inc. and Autologic, Inc.

At the time of the hearing, neither the individual who performed the audit nor his supervisor was available due to their retirement from the Department. However, the Division did produce an individual who attempted to explain the audit adjustments. The workpapers prepared by the original auditor are very detailed and contain sufficient narrative to explain the adjustments which are in issue.

OPINION

At the outset, we briefly describe the statutory provisions relevant to the issues at hand and the relevant arguments of the parties.

Tax Law § 209(1) imposes a corporate franchise tax on every corporation doing business in New York. It provides, in pertinent part, that the tax shall be upon the corporation's "entire net income." For New York purposes, entire net income is generally the same amount reported as Federal taxable income, modified by certain additions and/or subtractions prescribed by statute (Tax Law § 208[9]).

One of the modifications provides that entire net income for New York State purposes does not include "income, gains and losses from subsidiary capital" (Tax Law § 208[9][a][1]). Furthermore, the Commissioner of Taxation has the discretionary authority to require a taxpayer to determine entire net income by including therein interest "directly or indirectly attributable . . . as a carrying charge or otherwise to subsidiary capital or to income, gains or losses from subsidiary capital" (Tax Law § 208[9][b][6]).⁴ The purpose of denying this deduction of interest is to prevent a parent corporation from obtaining a double tax benefit by taking a deduction for interest payments on loans incurred for directly or indirectly financing investments in subsidiaries while at the same time the parent's income from such investments is tax free (Matter of F. W. Woolworth Co. v. State Tax Commn., 126 AD2d 876, 510 NYS2d 926, affd 71 NY2d 907, 528 NYS2d 537).

The Commissioner exercises the discretion to calculate interest indirectly attributable to subsidiary capital through the use of a formula which, in effect, attributes a proportional part of the parent's interest

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To compute Federal taxable income, a taxpayer is allowed a deduction for interest expense on indebtedness in each report (Internal Revenue Code § 163[a]).

expense to each subsidiary (Matter of Unimax Corp. v. Tax Appeals Tribunal, 79 NY2d 139, 581 NYS2d 135).

A separate component of the franchise tax is the tax (at the rate of nine-tenths of a mill) imposed on the value of a parent's investment in subsidiary capital allocated within the State (Tax Law § 210[1][b]).

The term "subsidiary capital," the key term in each of the above provisions, is defined, in relevant part, as "investments in the stock of subsidiaries and any indebtedness from subsidiaries . . . on which interest is not claimed and deducted by the subsidiary for purposes of taxation under article nine-a of this chapter . . ." (Tax Law § 208[4][a], emphasis added). For purposes of the tax on subsidiary capital prescribed in section 210(1)(b), the amount of subsidiary capital is determined by:

"taking the average fair market value of the gross assets included therein less, in the case of business capital, average liabilities deductible therefrom which are payable by their terms on demand or within one year from the date incurred, other than loans or advances outstanding for more than a year as of any date during the year covered by the report . . ." (Tax Law former § 210[2]; see also, 20 NYCRR 3-6.4).

The term "subsidiary" means a corporation of which over fifty per centum of the number of shares of stock entitling holders thereof to vote for the election of directors or trustees is owned by the taxpayer (Tax Law § 208[3]; 20 NYCRR 3-6.2[a]). The policy of the former State Tax Commission was that ownership of stock in a so-called "second-tier subsidiary" is not attributed to the parent corporation (Matter of Sears Indus., State Tax Commn., July 26, 1985), and that they are not subsidiaries for purposes of the tax on subsidiary capital (Matter of Texas Instruments, State Tax Commn., June 27, 1980).

Turning to the case at hand, the Administrative Law Judge, relying on the explicit language of Tax Law § 208(4), determined that for the fiscal years ending October 31, 1980 and October 31, 1981 the Division was correct in adding back to Volt's entire net income the interest income which Volt had received from two wholly owned subsidiaries (Delta Resources, Inc. and DRI Computer Leasing). The rationale for the Administrative Law Judge's conclusion was that the interest income was not from subsidiary capital since both subsidiaries had taken

the corresponding interest expense as a deduction on their New York corporate franchise tax returns (Determination, conclusion of law "C") and, thus, should not be included in petitioner's entire net income.

The Administrative Law Judge also rejected petitioner's assertion that the Division's indirect attribution of interest expense to subsidiary capital was erroneous because a portion of the interest expense is attributable to "second-tier" subsidiaries. The Administrative Law Judge determined that the alleged "second-tier" subsidiaries were shown as subsidiaries on Volt's State returns, i.e., Autologic for each of the years at issue; Delta Resources, Inc. and DRI Computer Leasing for the 1980 and 1981 years, and that these contemporaneous tax returns were more reliable than the testimony of petitioner's witness. Thus, the Administrative Law Judge determined that Volt failed to prove that any of the interest which the Division had determined was indirectly attributable to subsidiary capital was, in fact, attributable to "second-tier" subsidiaries (Determination, conclusion of law "E").

The Administrative Law Judge also rejected petitioner's assertion that the interest expense from the debentures should be excluded from the amount of interest which is indirectly attributable to subsidiary capital, finding that under Matter of F. W. Woolworth Co. v. State Tax Commn. (supra) the Division's action was "rational" and concluding that "Volt has not shown that the Division's disallowance of the interest expense indirectly attributable to subsidiary capital was in error" (Determination, conclusion of law "L").

The Administrative Law Judge rejected petitioner's assertions that the amount ascribed to "average loans" in the calculation of subsidiary capital for purposes of the tax on such capital should be the same as the amounts listed as "advances" in the Division's formula for the calculation of interest indirectly attributable to subsidiary capital. The Administrative Law Judge concluded that there is no necessary correlation between those amounts for loans on the subsidiary tax calculation and those amounts designed as advances on the calculation of interest expense indirectly attributable to subsidiary capital calculation since the nature of those liabilities are separate and distinct from each other (Determination, conclusion of law "H").

Next, the Administrative Law Judge rejected Volt's assertion that the Division improperly calculated Volt's subsidiary capital by including therein loans on which the subsidiaries had deducted interest in computing their own tax liability. The basis for the Administrative Law Judge's decision was the failure of petitioner to show that the interest deducted by the subsidiaries on their corporate franchise tax reports related to specific loans included in subsidiary capital (Determination, conclusion of law "J").

Finally, the Administrative Law Judge rejected Volt's assertions that the Division's audit schedules and workpapers were inconsistent and unreliable, that the Division's witness could not explain what had been done, and that this reflects on the quality and reliability of the audit. The Administrative Law Judge concluded that:

"[t]he audit report and workpapers herein show that a very extensive and thorough audit was conducted. Under these circumstances, it obviously would have been preferable for the individual who conducted the audit to have testified. However, the lack of this testimony does not affect the validity of the audit (see, Matter of Mira Oil Co. v. Chu, 114 AD2d 619, 494 NYS2d 458, lv denied 68 NY2d 602, 505 NYS2d 1026)" (Determination, conclusion of law "M").

The Division urges that the determination of the Administrative Law Judge is correct in all respects and asks that we affirm it.

We affirm the determination of the Administrative Law Judge in its entirety.

We deal first with petitioner's assertion that the Administrative Law Judge erred in including DRI and Delta in petitioner's subsidiary capital for purposes of calculating petitioner's entire net income with regard to the exclusion of income, gains and losses from subsidiary capital, and the add-back of interest directly or indirectly attributable to subsidiary capital. Specifically, petitioner asserts that:

"1. With respect to the ALJ's Findings of Facts 2, it is crucial to point out that the taxpayer admitted the CT-3 Schedule C entitled 'Subsidiary Capital' was erroneously completed. Taxpayer's testimony and stock records subsequently sent to the ALJ proved that certain entities listed as subsidiaries on Schedule C were in fact second-tier subsidiaries which should not have been included on Schedule C. Moreover, the ALJ makes much of the fact that the second-tier entities were included on the Federal return as affiliated corporations. He fails to note that an 'affiliate' for Federal purposes is not synonymous with 'subsidiary' for New York State purposes.

"2. As to Finding of Fact 3, we refer to the transcript (pg. 87, lines 8-13) which makes it clear that interest income received from Delta Resources Inc. ('DRI') and DRI Computer Leasing ('DRIC') was added back to Volt's entire net income because as second-tier subsidiaries, DRI and DRIC do not qualify for subsidiary capital treatment" (Petitioner's exception).

We cannot agree with petitioner's assertion.

First, petitioner here relied principally on the testimony of its witness that petitioner's New York franchise tax reports were erroneously prepared and wrongly indicated that DRI and Delta were subsidiaries. There is nothing in the record to indicate, contrary to petitioner's assertion in its exception, that any "stock records [were] subsequently sent to the ALJ [which] proved that certain entities listed as subsidiaries on Schedule C were, in fact, second-tier subsidiaries which should not have been included on Schedule C." Accordingly, we find no reason to overturn the Administrative Law Judge's conclusion that:

"there is an unexplained conflict between testimony about events which occurred years earlier and contemporaneously prepared documents. In the absence of any documents or other corroborating evidence to support the testimony [of petitioner's witness], it is concluded that the tax returns are more reliable than the testimony and that Volt has not sustained its burden of proof of establishing that any of the interest which was indirectly attributable to subsidiary capital arose from second-tier subsidiaries" (Determination, conclusion of law "E").

Second, for the fiscal years ending October 31, 1980 and October 31, 1981, DRI and Delta together deducted \$42,577.00 and \$1,240,393.00, respectively, on their New York reports in interest they paid to Volt. This fact provides sufficient and clear basis for the Division to require such interest to be included in Volt's entire net income (Tax Law § 208[4][a]).

We also agree with the Administrative Law Judge's rejection of Volt's assertion that the Division improperly calculated Volt's net income as subsidiary capital by including therein loans, the interest on which the subsidiaries deducted in computing their own franchise tax liability. The Administrative Law Judge reasoned that:

"Volt is correct in its assertion that subsidiary capital does not include an indebtedness on which interest is deducted by the subsidiary in computing New York State franchise tax imposed on subsidiaries under Articles 9-A, 32 or 33 of the Tax Law (20 NYCRR 3-6.3[d]). However, there is no evidence in the record that the loans which the Division included in Volt's subsidiary capital were the same indebtedness which

the subsidiaries claimed as interest expense. Therefore, Volt has failed to sustain its burden of proof of establishing that it is entitled to an adjustment on this basis" (Determination, conclusion of law "J," emphasis added).

We deal next with petitioner's assertion in its exception that the proceeds of the debenture were not directly or indirectly attributable to subsidiary capital "since it demonstrated that no advances from the debenture proceeds were made to the subsidiaries in the audit period. This was acknowledged by the ALJ in Finding of Fact 8" (Petitioner's exception, ¶ 10).

We sustain the determination of the Administrative Law Judge on this issue.

The fact that no advances from the debenture proceeds were made to the subsidiaries does not determine the issue. In order to defeat the disallowance of the interest deduction, petitioner must establish that the indebtedness was not directly or indirectly attributable to subsidiary capital (Tax Law § 208[9][b][6]; see, Matter of F. W. Woolworth Co. v. State Tax Commn., supra). Factors such as a change in the book value of a parent's investment in its subsidiaries or a change in the amount of advances to a subsidiary may support the conclusion that the borrowing in issue was an element in a parent's decision to increase its investment in its subsidiaries (Matter of F. W. Woolworth Co. v. State Tax Commn., supra).

Here, the balance sheet of Volt's U.S. Corporation Income Tax Return for the fiscal year ended October 31, 1981 reports an asset account entitled "Due from Related Companies" which increased during its fiscal year from \$12,332,993.00 to \$32,880,238.00. The balance sheet reports that another asset account entitled "Investment in Subsidiaries" increased in value from \$782,295.00 to \$983,713.00. In view of the substantial increase in each of these accounts, it was rational for the Division to conclude that there was an inextricable connection between petitioner's financing decisions and its investments (see, Matter of F. W. Woolworth Co. v. State Tax Commn., supra). Volt has not shown that the Division's disallowance of the interest expense indirectly attributable to subsidiary capital was in error.

We deal next with petitioner's assertion in its exception that the amounts ascribed to "average loans" in the Division's calculation of subsidiary capital should be the same as the

amounts listed as "advances" in the Division's calculation of interest indirectly attributable to subsidiary capital.

We sustain the determination of the Administrative Law Judge that there is no correlation between the amounts for loans in the calculation of the base for the tax on subsidiary capital and the amounts denominated as advances in the calculation of interest expense indirectly attributable to subsidiary capital.

More particularly, the attribution of interest directly or indirectly attributable to subsidiary capital is discretionary with the Commissioner. In determining if interest expense is directly attributable to subsidiary capital, the purpose for which the indebtedness is incurred or continued is the determining factor, i.e., each asset to which interest expense is directly attributed, the amount of interest, the nature, the date and the amount of liability incurred to acquire the asset are identified.

If it is not possible to isolate the assets to which interest expense is directly attributable, the Division determines if the interest is indirectly attributable pursuant to its long-standing policy that each asset held by a corporation shares a portion of the cost of its borrowings (Matter of Unimax Corp. v. Tax Appeals Tribunal, supra). Thus, a proportional part of a corporation's interest expense on borrowings is attributed to subsidiary capital and results in an adjustment to determine entire net income. The formula used by the Division to calculate interest expense of the parent which is indirectly attributable to subsidiary capital is stated as follows:

$$\frac{\text{Investment in subsidiaries}}{\text{Total Assets}} \times \frac{\text{Gross Interest Expense}}{\text{Interest Expense}} = \frac{\text{Interest indirectly attributable to subsidiary capital}}{\text{Interest Expense}}$$

The overall result of this formula is that a parent will have an investment in its subsidiaries first, to the extent of the investment in the stock of each subsidiary to the parent and paid-in capital, and, second, to the extent of the net of loans and advances from the parent to each of its subsidiaries.⁵ This discretionary formula is designed to do an imprecise task, i.e., it

⁵The Division's first rule in calculating this numerator is that the parent's investment in each subsidiary must be separately determined. The sum of those investments is then totalled and put in the numerator of the fraction.

calculates the interest expense indirectly attributable to subsidiary capital and, as the Court of Appeals pointed out in Unimax in sustaining the validity of the formula, "it reduces the investments in subsidiaries below that required by statute" (Matter of Unimax Corp. v. Tax Appeals Tribunal, supra, 581 NYS2d 135, 138). The record here indicates that the Division properly applied this formula to the facts at hand.

The discretionary authority of the Division to calculate interest indirectly attributable to subsidiary capital and the formula utilized by the Division, which nets loans from the parent to each subsidiary, are in contrast to (1) the specific language imposing the tax on subsidiary capital allocated within New York State (Tax Law § 210[1][b]) as a separate component of the franchise tax,⁶ and (2) the specific language defining the amount of subsidiary capital as the average fair market value of the gross assets (Tax Law § 210[2]). We find no evidence here that the Division did not apply this language to the facts at hand.

We deal next with petitioner's assertion in its exception to finding of fact "10" of the Administrative Law Judge's determination that the auditor's workpapers were adequate. Petitioner asserts:

"[t]he record indicates numerous instances where the taxpayer pointed out inconsistencies within the workpapers. Neither the papers

The Division's second rule is to calculate the investment in each subsidiary as the total of two distinct components; the investment in the stock of the subsidiary and loans and advances between the parent and the subsidiary. These components reflect the language of Tax Law § 208(4), defining subsidiary capital as the investment in the stock of the subsidiary and any indebtedness from the subsidiary.

Within this calculation, the Division allows loans and advances to the parent by one of its subsidiaries to be offset against loans and advances from the parent to such subsidiary. However, as a result of the first rule, calculating the numerator for each subsidiary separately, the Division does not permit loans and advances to the parent to be offset against loans and advances to any other subsidiary. As a result of the second rule, the Division does not permit loans and advances to the parent to be offset against the investment in the stock of a subsidiary (Matter of Unimax Corp., Tax Appeals Tribunal, November 22, 1989, affd 165 AD2d 476, 568 NYS2d 164, affd 79 NY2d 139, 581 NYS2d 135).

⁶The tax is imposed because when a parent corporation computes its franchise tax on the entire net income base, most items of the subsidiary's capital, income, gain and loss are not included in the base.

themselves nor the Division's representative were able to clarify the errors and sloppiness in the workpapers" (Petitioner's exception).

We sustain the Administrative Law Judge.

The audit report and workpapers herein show that a very extensive and thorough audit was conducted. In fact, over 350 hours were expended on the audit by the Division. We agree with the Administrative Law Judge that, under these circumstances, it obviously would have been preferable for the individual who conducted the audit to have testified. However, the lack of this testimony does not affect the validity of the audit (see, Matter of Mira Oil Co. v. Chu, supra).

Finally, petitioner asserts that it "had not conceded the point addressed in Conclusion of Law N." Other than to state that it has not conceded the point, petitioner offers nothing on this issue. We find no basis to alter the conclusion of the Administrative Law Judge on this issue.

In rendering this decision, we did not take into account the new evidence petitioner submitted on exception. As the Division correctly points out, we have a strict policy of barring the submission of evidence after the hearing is closed. This policy is based on a sound principle:

"[i]n order to maintain a fair and efficient hearing system, it is essential that the hearing process be both defined and final. If the parties are able to submit additional evidence after the record is closed, there is neither definition nor finality to the hearing" (Matter of Schoonover, Tax Appeals Tribunal, August 15, 1991).

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Volt Information Sciences, Inc. is denied;
2. The determination of the Administrative Law Judge is affirmed;
3. The petition of Volt Information Sciences, Inc. is denied; and

4. The notices of deficiency dated September 17, 1985, as adjusted at conference, are sustained.

DATED: Troy, New York
October 15, 1992

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

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

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