STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
THE RACAL CORPORATION AND DECCA ELECTRONICS, INC.	:	DECISION DTA No. 807361
	:	
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 March 31, 1985 through March 31, 1987.	:	
	:	

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on March 5, 1992 with respect to the petition of The Racal Corporation and Decca Electronics, Inc., P.O. Box 407044, Mail Stop C218, Ft. Lauderdale, Florida 33340-7044. Petitioners appeared by Henry B. Miller, Esq. The Division of Taxation appeared by William F. Collins, Esq. (James Della Porta, Esq., of counsel).

The Division of Taxation submitted a brief on June 2, 1992. Petitioners submitted a brief on July 6, 1992. The Division of Taxation submitted a reply brief on September 21, 1992. Oral argument was heard on October 8, 1992.

Ernst and Young (John G. Chaconas, Esq. and Kenneth T. Zemsky, Esq., of counsel) filed a motion for leave to file an amicus curiae brief on exception on October 6, 1992. On November 5, 1992, petitioners filed a document in opposition to the motion. The Division of Taxation submitted a letter stating that the Division did not object to the motion. On November 27, 1992, the Tax Appeals Tribunal received the reply to petitioners' objection filed by Ernst and Young. The six months for the Tribunal to issue its decision in the matter began to run on November 27, 1992.

The Tax Appeals Tribunal has previously determined that it will look to the rules of the Court of Appeals regarding amicus curiae relief in deciding such motions (Matter of Consolidated Edison Co. of New York, Tax Appeals Tribunal, May 28, 1992; Matter of Standard

Mfg. Co., Tax Appeals Tribunal, July 11, 1991). 22 NYCRR 500.11(e) of such rules provides that:

> "[m]otions for amicus curiae relief, when appropriately made on notice to all of the parties and sufficiently in advance of the argument of the appeal to allow adequate court review of the motion and the proposed brief . . ." (emphasis added).

We do not feel that two days was sufficient time for the Tribunal to adequately review either the motion or the brief. Accordingly, the motion of Ernst and Young for leave to file an amicus curiae brief is hereby denied.

The Tax Appeals Tribunal renders the following decision per curiam.

ISSUE

Whether petitioners are entitled to exclude from entire net income interest income received from second tier subsidiaries.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge. These facts are set forth below.

As part of the submission of this matter, the duly authorized representatives of the parties entered into a stipulation of facts. The stipulation is set forth hereinafter, with all references to exhibits omitted.

STIPULATED FACTS

The Racal Corporation ("TRC") (formerly Racal Holdings, Inc.) is a Delaware corporation formed in 1977 and was the principal holding company for the Racal Electronics, Inc., U.S. affiliated group of companies ("REI") during the audit years, fiscal years ended March 31, 1985 through March 31, 1987. REI has owned 100% of TRC's issued and outstanding capital stock from 1977 to the present. TRC maintained a New York City office and filed New York tax returns during the audit years.

Decca Electronics, Inc. ("DEI") is a New York corporation organized in 1946. TRC has owned 100% of DEI's issued and outstanding capital stock since 1982. DEI was an inactive corporate shell during the audit years. DEI's only business activities were the accrual on loans to its subsidiaries and expenses related to its sole employee who managed the holding company's books and records. DEI filed New York corporation franchise tax returns during the fiscal years 1985, 1986 and 1987.

Decca Navigator Systems, Inc. ("DNSI") is a Delaware corporation organized in 1946. DEI owned all of DNSI's issued and outstanding voting stock during the fiscal years 1985, 1986 and 1987. During these years, DNSI was an inactive shell company that conducted no business during the audit years. The only business activity of this "paper" entity was the accrual of interest on loans from DEI entered into many years earlier and payment of other minor expenses allocated to them. DNSI was not subject to New York taxes nor did it file New York tax returns during the years at issue.

Decca Survey Systems, Inc., subsequently Racal Decca Survey, Inc. ("RDSI"), is a Delaware corporation formed in 1965. DNSI owned all of RDSI's issued and outstanding voting stock during the fiscal years 1985, 1986 and 1987. RDSI supplied survey equipment and rendered services to oil companies in Louisiana and Texas. Its headquarters are in Houston, Texas. RDSI was not subject to New York taxes nor did it file New York tax returns during the audit years.

In April 1980, REI's U.K. parent, Racal Electronics, PLC ("Racal"), acquired Decca Ltd. ("Decca") and its U.S. subsidiaries including DEI, DNSI and RDSI. Decca was a publicly-held U.K. company in the recording and electronics businesses prior to its acquisition by Racal.

Prior to Racal's acquisition in 1980, DEI, then London Records, operated the Decca Group's U.S. record business and served as the holding company and finance company for Decca's U.S. Group. Immediately prior to Decca's acquisition, Decca sold the record business and changed the name of the company to Decca Electronics, Inc. After Racal acquired Decca, DEI made no further loans to DNSI, RDSI or any of its other subsidiaries.

DNSI paid DEI $3,759,450 in interest during fiscal year 1985, $3,817,088 in interest during fiscal year 1986, and $4,122,456 in interest during fiscal year 1987 on DNSI's outstanding loans with DEI.

RDSI paid DEI $1,405,974 in interest during fiscal year 1985, $1,456,882 in interest during fiscal year 1986, and $1,557,946 in interest during fiscal year 1987 on RDSI's outstanding loans with DEI.

TRC/DEI had absolute control over the election and removal of DNSI and RDSI officers and directors during the fiscal years 1985, 1986 and 1987.

TRC/DEI had absolute control over all DNSI and RDSI operational, tax and financial matters during fiscal years 1985, 1986 and 1987. DNSI and RDSI officers and directors did not have the power or authority to act independently of TRC/DEI during the audit years.

TRC/DEI had the absolute power to cause dividends to be declared and paid from DNSI and RDSI during the fiscal years 1985, 1986 and 1987.

TRC/DEI had the absolute power to dictate the management and policies of DNSI and RDSI during the fiscal years 1985, 1986 and 1987.

TRC/DEI had the absolute right to sell or pledge all of DNSI's and RDSI's stock during the audit years.

TRC/DEI had the absolute power to maintain a shareholder derivative action during the audit years.

TRC/DEI have treated DNSI and RDSI as subsidiaries for all purposes, including but not limited to, the calculation and reporting of Federal income and State franchise taxes.

RDSI held itself out as a TRC/DEI subsidiary.

TRC, DEI, DNSI, and RDSI had common officers and directors during the fiscal years 1985, 1986 and 1987.

During the fiscal years 1985, 1986 and 1987, TRC, DEI, DNSI, and RDSI filed consolidated Federal tax returns with the REI affiliated group. RDSI and DNSI income and expenses were consolidated into and included with REI's audited financial statements in accordance with generally accepted accounting treatment of subsidiaries.

The New York Department of Taxation and Finance ("New York") sent DEI and TRC proposed adjustments to their 1985, 1986 and 1987 New York corporation franchise tax liability on April 9, 1989 in the amount of $585,364 and $16,492, respectively.

New York sent DEI and TRC notices of deficiency under Article 9-A of the Tax Law asserting a total of $614,969 in tax deficiencies for the fiscal years 1985, 1986 and 1987.

New York auditors filed an audit report regarding the alleged 1985, 1986 and 1987 tax deficiencies by DEI and TRC in August 1989.

ADDITIONAL FINDING OF FACT

The Division of Taxation (hereinafter the "Division") adjusted the entire net income of petitioners by adding back to entire net income the interest payments received by DEI from RDSI, which had been deducted by DEI as interest income from subsidiary capital.

OPINION

The Administrative Law Judge concluded that under the Division's regulations at 20 NYCRR 3-6.2 the question of whether DNSI and RDSI were subsidiaries of petitioners depended on whether petitioners were the beneficial owners of the stock of these corporations. The Administrative Law Judge found that petitioners were the beneficial owners of the stock because the stipulated facts clearly established that petitioners had dominion and command and received the economic benefit of the stock of the corporations.

The Administrative Law Judge's decision that petitioners had dominion and command over the stock of DNSI and RDSI was based on the facts that: petitioners had absolute control over the election and removal of DNSI and RDSI officers and directors and of DNSI's and RDSI's operational, tax and financial matters; DNSI and RDSI officers and directors did not have the power or authority to act independently of petitioners; petitioners had the absolute power to cause dividends to be declared and paid from DNSI and RDSI; petitioners had the absolute right to sell or pledge all of DNSI's and RDSI's stock; and petitioners had the absolute power to maintain a shareholder derivative action.

The Administrative Law Judge noted that TSB-M-79(1)C, which was issued by the Division under Article 32 of the Tax Law, interpreted "beneficial ownership" to include ownership by a corporation of a second tier subsidiary.

On exception, the Division argues that second tier subsidiaries do not constitute subsidiaries for the purposes of section 208(3) of the Tax Law because this section requires that the taxpayer own 50% of the voting shares of the corporation in order for the corporation to be the taxpayer's subsidiary. The Division contends that this interpretation of the statute has compelling support in the language the Legislature chose not to use in section 208(3) of the Tax Law, i.e., the Legislature's failure to include "indirect ownership" in the definition of subsidiary capital. The Division also argues that the three State Tax Commission decisions upon which the Division relies are entitled to great weight because they are interpretations of the former Commission's own regulations. The Division also states that because "this long held publicly stated interpretation of the Tax Law has not been disturbed by the Legislature it merits great deference" (Division's brief on exception, p. 8). Next, the Division argues that the Administrative Law Judge misinterpreted the regulations at 20 NYCRR 3-6.2(b) and incorrectly relied on interpretations under the bank tax imposed by Article 32 to interpret the corporation franchise tax. The Division also argues that the result of petitioners' position would be that all corporations with an indirect interest in other corporations would be subject to the subsidiary capital tax (Division's brief on exception, p. 16). The Division also argues that the form over substance doctrine cannot apply here to disregard the separate corporate entity because the Legislature did not indicate that this should occur. In its reply brief, the Division states that the stipulation should be interpreted in a manner consistent with corporate law so that where the stipulation speaks of control, it should be interpreted to mean de facto control, not de jure control.

In response, petitioners argue that section 208(3) of the Tax Law defines a subsidiary as a corporation whose stock is "owned" by a taxpayer. Petitioners also argue that the regulation at 20 NYCRR 3-6.2(b):

> "provides the test for 'ownership' of a subsidiary under N.Y. Tax Law § 208(3) is not 'mere record title,' but 'actual beneficial ownership,' even if less than 50% of a corporation's stock is registered in the name of the taxpayer. If the taxpayer does not have record title to more than 50% of a subsidiary's stock, it has the right to 'submit proof that it is the actual beneficial owner of such stock'" (Petitioner's brief on exception, p. 5).

Petitioners contend that the facts stipulated to by the Division establish that petitioners controlled every incident of ownership over RDSI and DNSI except for holding record title and, thus, were the beneficial owners of the corporations. Next, petitioners note that the statute does not use the word "directly" in describing ownership and, therefore, that there is nothing in the statute to support the Division's narrow interpretation. Petitioners also argue that the State Tax Commission decisions do not hold that a second tier subsidiary can never, as a matter of law, be a subsidiary corporation, but, instead hold that this is a question of fact. In addition, petitioners assert that the interpretation stated by the Division in TSB-M-79(1)C is relevant here because that document interprets statutory and regulatory provisions of the banking tax that are essentially the same as those at issue here. Finally, petitioners argue that the Division's regulation, which has been in effect for almost 50 years, clearly supports their position that, in determining ownership of subsidiaries in New York, the substance of ownership controls over the form.

We affirm the determination of the Administrative Law Judge.

Section 208(3) of the Tax Law provides that:

> "[t]he term 'subsidiary' means a corporation of which over fifty percent of the number of shares of stock entitling the holders thereof to vote for the election of directors or trustees is owned by the taxpayer."

Through its regulation at 20 NYCRR 3-6.2, the Division has amplified this definition. At subdivision (a) this regulation provides that:

> "(a) The term subsidiary means a corporation which is controlled by the taxpayer, by reason of the taxpayer's ownership of

more than 50 percent of the total number of the shares of stock . . . ."

The regulation continues, elaborating on the meaning of ownership, by stating at subdivision (b) that:

> "(b) The test of ownership is actual beneficial ownership, rather than mere record title as shown by the stock books of the issuing corporation. A corporation will not be considered to be a subsidiary because more than 50 percent of the shares of its voting stock is registered in the taxpayer's name, unless the taxpayer is the actual beneficial owner of such stock. However, a corporation will not be considered a subsidiary if more than 50 percent of the shares of its voting stock is not registered in the taxpayer's name, unless the taxpayer submits proof that it is the actual beneficial owner of such stock."[1]

These subdivisions of the regulation introduce a concept not apparent on the face of the statute, i.e., that the taxpayer controls the corporation through the beneficial ownership of the stock.

Thus, the question we are presented with is not one of simply interpreting and applying the statutory definition of subsidiary, but instead, of applying the regulation promulgated by the Division that defines a subsidiary in terms of control and defines ownership in terms of beneficial ownership. Applying this regulation, we agree with the Administrative Law Judge that under the stipulated facts DNSI and RDSI are subsidiaries of petitioners.

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[1]The remainder of 20 NYCRR 3-6.2 provides as follows:

> "(c) A corporation is a subsidiary for purposes of article 9-A if the taxpayer is the actual beneficial owner of more than 50 percent of the shares of such corporation's voting stock, even though the taxpayer has conferred the right to vote such stock on others, by means of a proxy, voting trust agreement or otherwise.
>
> "(d) In any case where the record holder of shares of voting stock of a corporation is not the actual beneficial owner of the stock, or where the right to vote such stock is not possessed by the record holder or by the actual beneficial owner of the stock, a full and complete statement of all relevant facts must be submitted.
>
> "(e) A corporation will be treated as a subsidiary of a taxpayer only for that part of the taxable year during which the taxpayer is the owner of more than 50 percent of the shares of stock of such corporation which, during that period, entitle the holders to vote for the election of directors or trustees" (20 NYCRR 3-6.2[c]-[e]).

Pursuant to the stipulated facts, petitioners had absolute control over all aspects of the operations and stock of RDSI and DNSI. According to Yelencsics v. Commissioner (74 TC 1513), which is cited by both parties, the Administrative Law Judge and the former State Tax Commission (see, Matter of Sears Indus., State Tax Commn., July 26, 1985), "[b]eneficial ownership is marked by command over property or enjoyment of its economic benefits" (Yelencsics v. Commissioner, supra, at 1527). Because the stipulated facts indicate that petitioners had command over DNSI and RDSI and obtained the economic benefits of these corporations, we conclude that petitioners had the beneficial ownership of DNSI and RDSI and that these corporations were subsidiaries within the meaning of the regulation.

The Division does not dispute the conclusion that petitioners had dominion and command over DNSI and RDSI, but asserts that because this control came about as a result of the ownership of the intermediate corporations it cannot be beneficial ownership.[2] Thus, as we understand it, the essence of the Division's argument is that the extent of this control is not relevant to the question before us because the source of this control, ownership of the intermediate corporations, cannot as a matter of law result in a subsidiary. Initially, we note that the Division's assertion is inconsistent with its recent modified advisory opinions which concluded that:

> "where a taxpayer under Article 9-A of the Tax Law is the owner of more than 50 percent of the voting stock of a CFC [controlled foreign corporation], the taxpayer's pro-rata share of such CFC's Subpart F income is deemed to be a dividend from such CFC and is attributable to subsidiary capital. In addition, where such CFC is

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[2]We do not understand the distinction the Division seeks to make, i.e., that the stipulation should be read to deal with de facto control and not de jure control. The following definition both defines "de facto" and contrasts it with the term "de jure":

> "De facto. In fact, in deed, actually. This phrase is used to characterize an officer, a government, a past action, or a state of affairs which must be accepted for all practical purposes, but is illegal or illegitimate. Thus, an offfice, position or status existing under a claim or color of right such as a de facto corporation. In this sense it is the contrary of de jure, which means rightful, legitimate, just, or constitutional" (Black's Law Dictionary 375 [5th ed 1979]).

We see nothing in the record before us that indicates that petitioners' control over RDSI and DNSI was illegal. Instead, the practical control flowed legally from petitioners' ownership of the stock in the intermediate corporations.

> a shareholder of another CFC (second-tier CFC), the taxpayer's pro-rata share of the second-tier CFC's Subpart F income is deemed to be a dividend that has been paid to the first-tier CFC . . . [and] is attributable to the taxpayer's ownership in the first-tier CFC and is attributable to subsidiary capital" (TSB-A-87[23.1]C; TSB-A-88[7.1]C issued November 2, 1992).

Moreover, despite extensive deliberation, we cannot find anything in the regulation or in the arguments advanced by the Division that supports its position.

In support of its argument that beneficial ownership does not encompass the instant situation, the Division states:

> "the concept of beneficial ownership of stock does not apply to situations involving three or more tier corporate structures unless there has been some transfer of rights in the stock, for example, where there has been a transfer of stock without transfer of legal title or where the transferee of the stock is not yet the holder of record on the books of the corporation or where there has been a transfer to a trustee" (Division's brief on exception, p. 11).

The statement asserts that there must be a transfer of rights in the stock before there can be beneficial ownership. Apparently, the Division is arguing that beneficial ownership can only result where a transfer results in a bifurcation of the beneficial interest from the legal title. We find this statement unpersuasive for a variety of reasons.

First, the Division has offered no rationale for this rule and none is apparent to us.[3] The cases cited by the Division involve instances where the beneficial interest came into existence as a result of a transfer, but there is nothing in these cases which indicates that this is the only way a beneficial interest could arise.

[3] This same rule was stated, also without explanation, by the State Tax Commission in Matter of Sears Indus. (supra). The other two State Tax Commission decisions relied on by the Division, Matter of Armour & Co. (State Tax Commn., April 4, 1985) and Matter of Texas Instruments (State Tax Commn., June 27, 1980) are even more conclusory than Sears in reaching the result that a second tier subsidiary is not a subsidiary for purposes of section 208(3) of the Tax Law. As decisions of a body of coordinate jurisdiction, the State Tax Commission decisions are not binding precedent for us, but are entitled to respectful consideration (see, Matter of Cruikshank's Estate, 169 Misc 514, 8 NYS2d 279). We have given these decisions respectful consideration; however, their failure to state an explanation for their conclusion renders them unpersuasive. With respect to the Division's argument that these Commission decisions are entitled to deference because they were not disturbed by the Legislature, we note simply that the regulation has been undisturbed by the Legislature for a longer time (since 1944 according to the Division). Therefore, under the Division's argument, the regulation, which we conclude encompasses the instant facts, is a policy statement entitled to more deference than the Commission decisions.

Second, as noted by the Administrative Law Judge, the Division itself, in TSB-M-79(1)C, has defined beneficial ownership to mean: "[t]he stockholder has beneficial ownership when it owns indirectly and controls the voting stock of another corporation." Through examples in this memorandum, the Division made it absolutely clear that beneficial ownership can result through the ownership of an intermediate corporation. This memorandum is important because it establishes that a corporation can beneficially own a second tier subsidiary, even without the transfer the Division insists upon here. Similarly, the Division has interpreted "beneficial interest" for purposes of the gains tax imposed by Article 31-B of the Tax Law to include the interest that a shareholder of a corporation has in the assets of the corporation (see, Tax Law § 1443[5] and 20 NYCRR 590.50).

The Division argues that the use of the term "beneficial ownership" in TSB-M-79(1)C has no application to the question before us because the memorandum was issued under the bank tax. The Division explains that this definition was consistent with the legislative intent of the bank tax provisions and asserts that it is not consistent with the legislative intent of the franchise tax provisions. The difficulty with the Division's argument is that the Division has not convinced us that this meaning of beneficial ownership is inconsistent with the legislative intent underlying the franchise tax provisions. The Division's argument on this point is that if the Legislature had intended to include second tier subsidiaries as subsidiaries, the statute would have qualified the word "owned" with the word "indirectly." In our view, the Division's argument applies with equal force to those circumstances that the Division acknowledges are within the definition of beneficial ownership, e.g., where there has been a transfer of stock without legal title or a transfer to a trustee. Therefore, to accept the Division's argument would require us to find that the entire regulation establishing beneficial ownership as the test of ownership is invalid. As the Division has not advanced the argument for this broad purpose, we find the argument unpersuasive for the narrower purpose offered.

Another reason that we find the Division's argument unpersuasive is that the Division's position on this issue appears to have changed, without explanation, over time. The brief on exception begins by saying that:

> "[w]hether a second tier subsidiary constitutes a subsidiary for purposes of Tax Law section 208.3 is never a question of fact. It is a question of law. That is, a second tier subsidiary never qualifies as a subsidiary for purposes of Tax Law section 208.3" (Division's brief on exception, pp. 2-3.)

In contrast, it appears that in a declaratory judgment action, the Division argued that whether a second tier subsidiary was a subsidiary was a question of fact (see, Xerox Corp. v. Department of Taxation & Fin., Sup Ct, Monroe County, Jan. 12, 1987, Provenzano, J., published at TSB-H-87[25]C). In a note to its publication of the Supreme Court's order granting Xerox's motion for summary judgment, the Division explained that:

> "[i]t was the Department's contention that, absent proof, the actual beneficial ownership of Rank Xerox, Ltd. could not be clearly determined, and therefore a factual issue was presented for determination by the Commission. The proof required by Commission regulation s 3-6.2 (a copy of which is attached) was explained to the court (in an affidavit of Marilyn Kaltenborn) pointing out that beneficial ownership is indicated by the absolute right to sell or pledge the stock, receive dividends from the stock, vote and maintain a shareholder derivative action; and that Xerox did not present proof of such factors" (Xerox Corp. v. Department of Taxation & Fin., TSB-H-87[25]C).

The factual questions regarding the nature and extent of Xerox's ownership of the subsidiary corporation's stock was one of the reasons recited by the Appellate Division, Third Department, in holding that the Supreme Court had erred in granting Xerox summary judgment in the declaratory action (Xerox Corp. v. Department of Taxation & Fin., 140 AD2d 945, 529 NYS2d 623, lv denied 72 NY2d 809, 534 NYS2d 666). In the instant case, in response to the parties' stipulation establishing the extensive control of petitioners over RDSI and DNSI, including some of the specific factors noted in Xerox, the Division now contends that the extent of control is not determinative because a second tier subsidiary can never be a subsidiary. This inconsistency is troubling and it diminishes the weight of the Division's argument.

The last argument advanced by the Division is that the Administrative Law Judge's determination leads to the absurd result that, "all corporations with an indirect interest in other corporations would be subject to the subsidiary capital tax" (Division's brief on exception, p. 16). We disagree.

The Administrative Law Judge's determination and our affirmance only hold that where a corporation controls all aspects of a second tier subsidiary's operation and management that this is beneficial ownership within the meaning of the regulation. This certainly does not mean that all corporations with an indirect interest in other corporations would be subject to the tax on subsidiary capital.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is denied;
2. The determination of the Administrative Law Judge is affirmed;
3. The petition of The Racal Corporation and Decca Electronics, Inc. is granted; and
4. The notices of deficiency dated June 15, 1989 are cancelled.

DATED: Troy, New York
May 13, 1993

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

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

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