STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
PREMIER NATIONAL BANCORP, INC.	:	
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.	:	DECISION DTA NO. 819746

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on April 27, 2006 with respect to the petition of Premier National Bancorp, Inc., c/o M & T Bank, One M & T Plaza, Buffalo, New York 14203. Petitioner appeared by Hodgson Russ LLP (Christopher L. Doyle, Esq., of counsel). The Division of Taxation appeared by Daniel Smirlock, Esq. (Nicholas A. Behuniak, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception. Petitioner filed a brief in opposition. The Division of Taxation filed a brief in reply. By order dated January 4, 2007, the Tax Appeals Tribunal granted the motion brought by Roberts & Holland LLP (Carolyn Joy Lee, Esq., of counsel) to file an *amicus curiae* brief in this matter. Oral argument, at the Division of Taxation's request, was heard on January 22, 2007 in New York, New York.

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

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

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

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.

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.

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.

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).

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.

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").

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

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

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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.

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.

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.

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.

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.

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.

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.

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.

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 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.

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.

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.

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.

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 is not available to taxpayers under Article 9-A.

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.

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.

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.

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.

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.

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.

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 (***see***, Hearing Tr., 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.

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.

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.

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."

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.

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 above), 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

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.

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.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

In her determination, the Administrative Law Judge held that the Division abused its discretionary authority by attempting to, in effect, nullify the election by Investment Company to file its tax returns as an Article 9-A corporation. The Administrative Law Judge determined that the Division was basically attempting to force combination between Holding and Investment Company which is expressly prohibited by statute. Lastly, the Administrative Law Judge concluded that Tax Law § 1462(g) was not applicable in this case since the Division did not demonstrate any improper reflection of tax liability on behalf of Investment.

ARGUMENTS ON EXCEPTION

The Division argues that it properly used its discretionary authority to take the investments located in Investment Company and transfer them and place them with Holding because the Division states that the assets are more properly reflected with Holding. The Division claims that it was authorized to do this because the assets that are held by Investment Company were transferred to that subsidiary for the sole purpose of tax avoidance. In order to establish that Investment Company had no business purpose, the Division argues that Holding maintained

absolute control over the assets and utilized the assets the same both before and after the transfer to the subsidiary. The Division also alleges that Investment Company does not have employees of its own and it is Holding that runs and operates Investment Company.

In opposition, petitioner states its agreement with the reasoning employed by the Administrative Law Judge in her determination. Investment Company herein sought and received an election to be treated as an Article 9-A corporation for tax purposes. Petitioner argues that the Division has the authority to review whether the election was properly made or whether it had been terminated. Petitioner claims that once the proper election was made, the Division cannot use its discretionary authority to force combination of the Article 9-A subsidiary with the Article 32 Holding corporation. Petitioner states that this is expressly prohibited by statute as correctly determined by the Administrative Law Judge. Petitioner asserts that the Legislature provided the opportunity for taxpayers to seek this election and Investment Company took advantage of this election and it cannot now be disturbed by the Division.

OPINION

As set forth by the Administrative Law Judge in her determination, in 1985, the New York State Legislature enacted sweeping changes to the franchise tax applicable to banking corporations (L 1985, ch 298). The changes sought to address the fact that the banks were now "competing directly or indirectly, with, among others, investment bankers, stock brokers and finance companies; all of which are taxable as general business corporations" (Memo in support, 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").

This extension of Article 32 to these bank subsidiaries had the potential to change significantly and adversely the tax treatment of then-existing New York corporations. For example, a filing under Article 32 would impact such subsidiaries' allocation of their investment income since an Article 32 corporation allocates its investment income to New York based upon its presence within the state as opposed to an Article 9-A corporation which allocates its investment income based on the relative presence in the state of the issuers of the securities in the Article 9-A corporation's portfolio.

Thus, in an effort to enact a change in the taxation of banking subsidiaries that would not unfairly impact existing taxpayers, the Legislature enacted Tax Law § 1452(d) to permit affected subsidiaries to elect to continue to file under Article 9-A as follows:

> [A] corporation described in paragraph three of this subsection which was subject to the tax imposed by article nine-A of this chapter for its taxable year ending during nineteen hundred eighty-four may, on or before the due date for filing its return (determined with regard to extensions) for its taxable year ending during nineteen hundred eighty-five, make a one time election to continue to be taxable under such article nine-A. Such election shall continue to be in effect until revoked by the taxpayer. In no event shall such election or revocation be for a part of a taxable year.

The 1985 legislation also included a corresponding provision which stated:

> 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 (Tax Law § 1462[f][4][iii]).

Therefore, it is clear that the Legislature provided for a corporation which elected to be treated under Article 9-A by filing its 1985 tax return under Article 9-A to retain this status, i.e., a grandfathered Article 9-A corporation, until it revokes this election by opting to file under Article 32. Moreover, the Legislature explicitly prohibited the filing of combined returns for the Article 32 parent with the Article 9-A subsidiaries.

It is undisputed that Investment Company made a valid election as an Article 9-A corporation pursuant to statute. Moreover, Investment Company never revoked its election by filing as an Article 32 corporation. Thus, as a grandfathered Article 9-A corporation, the Division was unable to force it to file on a combined return with Holding. Therefore, the Division invoked Tax Law § 1462(g) by claiming its authority to make a discretionary adjustment to correct what it believed was an improper reflection of tax liability. The Administrative Law Judge exhaustively addressed the application of Tax Law § 1462(g) and the regulations to the facts of this case. We need not reiterate her thorough analysis within the body of this decision.

We do agree with the result reached by the Administrative Law Judge herein that the Division did abuse its discretion in applying Tax Law § 1462(g). The Division states that petitioner's transactions with Investment Company lack a business purpose or lack economic substance arguing that the subsidiary was set up solely for tax avoidance. It is with this premise we disagree.

In ***Rice's Toyota World v. Commissioner***, the court set forth a two-prong test to determine whether a transaction is, for tax purposes, a sham. The court held: "To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists" (***Rice's Toyota World v. Commissioner***, 752 F2d 89, 85-1 USTC ¶ 9123, 87,092, 87,093).

The Administrative Law Judge noted that the investment objectives and parameters of Investment Company differed from that of petitioner. The Administrative Law Judge stated that Investment Company did not have to concern itself with pledging community support or

monitoring interest rate risks and it could invest in securities other than the securities that Holding was obliged to hold.

With respect to the second prong of the test, the Administrative Law Judge emphasized that Holding invested in Investment Company for the purpose of making a profit. The profit would necessarily be greater because Investment Company was afforded Article 9-A tax treatment, but the goal of the transaction was to make money. At no point did petitioner create fictitious losses or deductions to minimize its gains. As the facts demonstrate, Investment Company made approximately $1.8 million in 1998 and over $11 million in 1999 without any consideration of the tax benefits.

As aptly summarized by the *amicus curiae* in its brief:

> Investment Company paid less tax, and thus its after-tax profit was higher, because it could properly claim the benefit of the Article 9-A tax regime. But without question, based on the facts set forth by the ALJ: (i) Investment Company was acquired by Holding in a bona fide third-party transaction; (ii) Investment Company was in fact capitalized with significant assets, which became its capital, not its parent's; (iii) Investment Company set about a plan of investment designed to make money; and (iv) Investment Company, in its own right, made real profits (*Amicus curiae* brief, p. 14).

Therefore, we do not find that application of Tax Law § 1462(g) is appropriate in the circumstances presented in this case. Thus, we agree with the Administrative Law Judge that the Division abused its discretion in making an adjustment that was in direct contravention of Tax Law § 1462(f)(4)(iii).

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 sustained;

3. The petition of Premier National Bancorp., Inc. is granted; and

4. The Notice of Deficiency dated May 6, 2002, and thereafter adjusted, is cancelled.

DATED: Troy, New York
August 2, 2007

/s/ Charles H. Nesbitt
Charles H. Nesbitt
President

/s/ Carroll R. Jenkins
Carroll R. Jenkins
Commissioner

/s/ Robert J. McDermott
Robert J. McDermott
Commissioner