STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
INTERAUDI BANK F/K/A BANK AUDI (USA)	:	DECISION DTA NO. 821659
for Redetermination of a Deficiency or for Refund of Franchise Tax on Banking Corporations under Article 32 of the Tax Law for the Years 1997, 1998 and 1999.	:	

Petitioner, Interaudi Bank f/k/a/ Bank Audi (USA), filed an exception to the determination of the Administrative Law Judge issued on January 28, 2010. Petitioner appeared by Brian E. Gledhill, Esq. The Division of Taxation appeared by Daniel Smirlock, Esq. (Nicholas A. Behuniak, Esq., of counsel).

Petitioner filed a brief in support of its exception. The Division of Taxation filed a brief in opposition. Petitioner filed a reply brief. Oral argument, at petitioner's request, was heard on October 20, 2010 in Troy, New York.

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

ISSUES

I. Whether petitioner can be required to include its subsidiary, BA (USA) Investment, Inc., in the combined reports that it filed under Article 32 of the Tax Law for the tax years 1997 through 1999.

II. Whether the assessment at issue discriminates against interstate commerce.

III. Whether the substantial understatement penalty imposed by the assessment at issue should be cancelled.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for findings of fact "3" and "8," which have been modified. The Administrative Law Judge's findings of fact and the modified findings of fact are set forth below.

Petitioner is a commercial banking corporation organized and chartered under the New York State Banking Law on June 6, 1983. Petitioner conducted its banking business under the name Bank Audi (USA) until May 1, 2003, when it changed its name to Interaudi Bank. At all times since its organization, including the years at issue, petitioner has been a domestic commercial bank. Its principal corporate office is located at 19 East 54th Street, New York, New York, where it also operates a bank branch. As a commercial bank, petitioner is engaged in the business of providing full banking facilities to U.S. and foreign clients. Petitioner provides checking, savings, money market and time deposit accounts to its customers and, in turn, makes both commercial and personal loans to its customers. As a regular part of its business, petitioner issues commitments to extend credit, commercial letters of credit and standby letters of credit to commercial borrowers throughout North and South America, as well as in Europe and the Middle East. Petitioner also provides foreign exchange facilities and letter of credit services to its customers. Petitioner's clients are relatively limited in number but extremely diversified by location, mostly residing throughout North and South America, but also in Europe and the Middle East.

As a New York chartered corporation engaged in a commercial banking business in the United States, petitioner is subject to regulation at both the federal and state levels. Petitioner is a member bank of the Federal Deposit Insurance Corporation (FDIC). Petitioner is not a member bank of the Federal Reserve System, and for that reason is characterized as a nonmember, state-chartered bank. At the federal level, the FDIC is petitioner's primary regulator. Petitioner is regulated at the state level by the New York State Banking Department.

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

> Prior to the creation of its investments subsidiary, petitioner's investment securities had been held in a custodial account that was maintained at Manufacturer's Hanover Trust Company and managed by Mr. J.B. Chandler, senior vice president and treasurer of petitioner, under the investment policies established by petitioner's investment committee and board of directors. As a result of a series of bank acquisitions and mergers, Chase Manhattan Bank became custodian of the account. By 1997, petitioner's senior management perceived that this series of bank mergers had resulted in a deterioration in the quality of the custodial services provided to petitioner. It was perceived that necessary account information was not being furnished in a timely manner and that there was no one contact at Chase to whom petitioner's management could consistently go for information and for resolution of problems.
>
> On September 30, 1997, petitioner's management resolved to find a solution to its custody issues and, after investigating several alternatives, decided to form an investment holding subsidiary in the State of Delaware. In advising the New York State Banking Department of its decision, Mr. Louis R. Cina, first senior vice president of petitioner, stated, "The purpose of this subsidiary is to segregate the investment portfolio (approximately $100MM) for control purposes and for tax planning." By letter to Mr. Cina dated December 4, 1997, Manuel Kunsky, Deputy Superintendent of Banks, stated that the Banking Department had no objections to petitioner's formation of an investment subsidiary. Petitioner selected Delaware Trust Capital Management, Inc. (DTCM) as the custodian for its investment portfolio. DTCM was a subsidiary of Delaware Trust Company, which was itself a subsidiary of CoreStates Bank. DTCM was also the parent of Griffin Corporate Services, Inc.[1]

In addition to solving custody issues, petitioner's management was exploring tax planning opportunities. In a nine-page letter to Mr. Cina dated October 9, 1997, Michael H. Goldsmith of

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[1] We have modified finding of fact "3" to more accurately reflect the record.

Arthur Andersen LLP, petitioner's accountants, states:

> As discussed, we are writing to provide you with background on the formation and maintenance of a passive investment company in Delaware as a mechanism to reduce state and local taxes.
>
> * * *
>
> The primary advantage to be realized from a passive investment company is the freeing of income streams from onerous state and local tax burdens. Based on the Bank's 1997 projected book income, we estimate that the potential annual state and local tax savings may be in excess of $750,000 (see attached calculations and assumptions).
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> * * *
>
> A DHC [Delaware Holding Company], while a useful mechanism to reduce the state tax burden of a corporation, can be subject to attack by state taxing authorities. Generally, state taxing authorities from states other than Delaware have utilized the following four lines of attack in an attempt to tax the income of a DHC:
>
> 1. Determine that the DHC has no substance in Delaware, so that it can be taxed in full in the state of commercial domicile of the parent.
>
> 2. Determine that the DHC is doing business in another state even though it may have substance in Delaware. In this case, the DHC should have the right to apportion its income.
>
> 3. Reallocate items of income and expenses between the DHC and its affiliates to reflect an arms-length arrangement, similar to the power of the Internal Revenue Service under IRC § 482.
>
> 4. Require a combined return in the case of states that allow or require combined or unitary reporting.
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> * * *
>
> In states that require or allow the filing of a combined or unitary return, it is probable that the fourth line of attack may be used to force combination of the DHC with the other entities. If so, the benefit of the DHC in those states will be lost, as the state will look to the combined income and apportionment of the group to determine the proper tax liability, and any benefit derived through intercorporate transactions will be eliminated.
>
> The New York Department of Finance has been extremely aggressive in its

> attempts to force the combination of operating and holding companies. To do so, the Department relies on ownership, unitary and distortion requirements to assert that a combined return is required to appropriately reflect New York income. However, based on our experience and New York case law, the State is willing to negotiate these cases at the audit and administrative levels. In such cases, we are often able to secure favorable settlements under which all tax benefits of a DHC are not lost.

BA (USA) Investment, Inc. (BA Investments) was incorporated by petitioner on December 16, 1997 under the laws of the State of Delaware as an investment holding company, by the filing of a Certificate of Incorporation with the Delaware Secretary of State with the stated purpose of "management and maintenance of its intangible investments and the collection and distribution of the income from such investments or from tangible property physically located outside Delaware . . . ." BA Investments was formed by petitioner under the provisions of section 351 of the Internal Revenue Code. Petitioner contributed qualifying section 351 property to BA Investments in the form of approximately $98 million worth of investment securities plus a small amount of cash, and received in return 100 percent of BA Investment's newly-issued common stock. During the entire audit period, BA Investments limited its activities to management and maintenance of marketable, investment grade securities. At no time during the audit period did BA Investments invest in tangible property or in any form of intellectual property, including trade names, trademarks, copyrights or patents or engage in any licensing of such intellectual property.

James J. Tullis was the sole incorporator of BA Investments. Mr. Tullis is a marketing development representative for Griffin Corporate Services. On December 18, 1997, he adopted a resolution electing the initial directors of the corporation. They were Louis R. Cina, first senior vice president of petitioner; J.B. Chandler, senior vice president and treasurer of petitioner; Lazaro S. Suri, vice president and controller of petitioner; Joan L. Dobrzynski (a/k/a Joan Yori), an employee of Griffin and Barbara A. Steen, also an employee of Griffin. BA Investments held quarterly board of directors meetings in Delaware.

In addition to being one of BA Investments' directors, Joan Dobrzynski was BA Investments' president and office manager and a member of its investment committee. On December 18, 1997, BA Investments and Joan Dobrzynski entered into an employment agreement, which specified her duties as:

> Employee shall perform assigned functions related to the management of the company including, but not limited to, maintaining accounts and records, preparing and accepting correspondence and filing legal documents, ordering and maintaining stationery, manning the telephones, handling the mail, interfacing with the company's lawyers and accountants, paying of the Company's bills, scheduling corporate meetings, safekeeping corporate records, completing and filing the annual Delaware Franchise tax return, and other duties as reasonably assigned.

Her salary was set at $2,000.00 per year. While performing her duties as president of BA Investments, Ms. Dobrzynski concurrently held approximately 100 other officer positions and part-time jobs with other clients of Griffin. Her titles with the other companies included those of president, secretary, assistant treasurer, corporate secretary and assistant secretary.

During the audit period, BA Investments leased private office space from Griffin Corporate Services, Inc., in Wilmington, Delaware, where it maintained its business office. The office included desk space, filing cabinets, chairs and a telephone. All of BA Investments' corporate records were kept in the Wilmington office. BA Investments never owned or leased office space in New York.

We have modified finding of fact "8" of the Administrative Law Judge's determination to read as follows:

> BA Investments established a three-member investment committee pursuant to the provisions of its by-laws. The investment committee met monthly. During

> the audit period, Mr. Chandler and Ms. Dobrznski were members of the investment committee. The third member was Ronald Brasten, a DTCM professional economist who resigned his position at BA Investments after approximately one year. He was replaced by Dung Vukhac, also a professional economist and senior vice president with DTCM. The actions of the investment committee were reviewed at the quarterly meetings of the board of directors.
>
> During the audit period, BA Investments limited its investments to marketable securities such as U.S. Treasury securities, including bills, notes and bonds; U.S. government agency obligations; mortgage backed securities such as GNMA's and FNMA's; corporate bonds rated investment grade or better; and tax exempt municipal bonds. In addition, BA Investments maintained an interest-bearing money market account through DTCM at CoreStates Bank and its successor, First Union Bank. The money market account was used as a sweep account for the income-producing securities. That is, all interest earned from the securities was deposited into the money market account. Similarly, when securities matured or were paid down prior to maturity, the proceeds were deposited into the money market account. Petitioner's witnesses testified that during the audit period, BA Investments engaged in few if any trades in its investment account. In fact, there is no evidence in the record of any such transactions.[2]

For each of the years here at issue (tax years 1997 through 1999), petitioner and its subsidiaries including BA Investments, which together constituted an includible parent corporation and an affiliated group of corporations that satisfied the federal 80 percent stock ownership requirement, filed federal income tax returns on a consolidated basis under the provisions of IRC §1502. For each of the years here at issue, petitioner filed its New York bank tax returns on a combined basis with all of its subsidiaries except BA Investments. During the period at issue, BA Investments did not file tax returns in New York State under either the Article 32 bank tax or the Article 9-A corporation franchise tax.

In February of 2001, the Division of Taxation (Division) commenced an audit of petitioner, which, after a series of consents extending the period for assessment of franchise tax,

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[2] We have modified finding of fact "8" to more accurately reflect the record.

ultimately resulted in the issuance of a Notice of Deficiency dated March 10, 2005 against petitioner. The Notice of Deficiency assessed tax in the amount of $1,070,389.00, interest in the amount of $530,888.77 and penalty in the amount of $101,714.00 for a total of $1,702,991.77. The assessment was based upon a finding that the transfer of the investment portfolio from petitioner to BA Investments was a distortive arrangement. The auditors determined that BA Investments' income in 1998 represented approximately 81% of the total income of petitioner's federal consolidated group. In 1999, BA Investments' income represented approximately 98% of the total income of the consolidated group. The auditors also determined that BA Investments' expenses were less than one percent of its income in both 1998 and 1999, while petitioner's expenses, as reported on its New York return, increased from 81.2% of its income in 1997 (pre-transfer) to 96.1% in 1999 (post-transfer). The auditors concluded that petitioner was managing the portfolio, not BA Investments, that the portfolio was an integral part of petitioner's capital requirements and that petitioner was incurring the costs of the portfolio instead of BA Investments. The auditors concluded that inclusion of BA Investments in petitioner's combined report was necessary to cure the asserted distortion. In addition, an adjustment was made to petitioner's deposits factor related to interest income arising from International Banking Facility (IBF) lending to the New York branch. Penalty was imposed pursuant to the provisions of Tax Law § 1085(k) for substantial understatement of liability.

A conciliation conference was requested in the Bureau of Conciliation and Mediation Services (BCMS), and on March 2, 2007 a Conciliation Order was issued sustaining the Notice of Deficiency in the reduced amount of $1,029,115.00, plus penalty of $99,421.00 plus updated interest. The reduction was attributable to the resolution of the IBF issue at conciliation.

Next, a petition was filed with the Division of Tax Appeals on April 13, 2007, contesting the Notice of Deficiency as modified at BCMS. The petition alleged that the Notice of Deficiency was erroneous in that it was based upon a bank tax computation that combined the income and other tax attributes of a nontaxpayer (BA Investments) with the income and other tax attributes of petitioner in computing petitioner's New York State bank tax for the years 1997 through 1999. In addition, the petition alleged that the conciliation order erred in sustaining the penalty imposed on petitioner because the Division had never articulated a rationale for the imposition of penalty and because there exists reasonable cause based upon the good-faith filing by petitioner of its bank tax returns consistent with the requirements of the Tax Law and consistent with the decision in the ***Matter of U.S. Trust Corp.*** (Tax Appeals Tribunal, April 11, 1996). Finally, the petition alleged that the conciliation order is unlawful under the nondiscrimination requirement of the Commerce Clause of the Federal Constitution in that it treats BA Investments, a corporation that was formed under the laws of, and operating in, a foreign state, less favorably than an alien corporation operating within New York State that is conducting identical business activities, but which was formed under the laws of a foreign nation, and by virtue of that fact is neither combinable under 20 NYCRR 21-2.1(c) nor subject to bank tax under Tax Law § 1452(g).

At the hearing, the Division called as an expert witness Professor Anthony Saunders, who is currently a Professor of Finance at the Stern School of Business of New York University. He earned his Bachelors, Masters and Ph.D. degrees from the London School of Economics. In addition, he is on the nomination committee for the Nobel Prize in Economics, on the investment advisory board of Zurich Financial Services and is a research advisor at the FDIC Center for Financial Research. Professor Saunders also holds visiting positions with the Comptroller of the

Currency, the International Monetary Fund, the Federal Reserve Board of Governors and the Federal Reserve Banks of Philadelphia and New York. Professor Saunders was accepted by the Administrative Law Judge as an expert witness in the areas of banking and finance, financial economics, international banking, general economics, financial institution portfolio risk analysis, the regulation of financial institutions, financial institutions operation and management, and financial institution investment portfolio management.

Professor Saunders' testimony is summarized as follows:

- The creation of BA Investments was not driven by business purposes, such as improved investment portfolio management at a lower cost to petitioner or a reduction in petitioner's regulatory capital costs.
- The creation and continuing arrangement with BA Investments increased petitioner's liquidity risk and interest rate risk exposures.
- The creation and arrangement with BA Investments increased petitioner's costs and caused petitioner's financial position to be inaccurately reported because of the mismatching of income and expenses on the passive investments.
- The only economic explanation for BA Investments' existence is state and local tax purposes.

It is Professor Saunders' opinion that petitioner has been able to retain control over investment decisions regarding the assets transferred to BA Investments since three out of five directors of BA Investments were senior executives of petitioner and the remaining two were junior employees of DTCM. Petitioner's long-term buy and hold investment philosophy of limited trading of low risk conservative securities was thereby continued. Accordingly, there would be no advantage to be realized from an investment perspective by the transfer of the investment assets to BA Investments. On the other hand, Professor Saunders found that several negatives resulted from the creation of BA Investments. He found that increased potential demand for funds by depositors and reduced availability of liquid assets because of the transfer of investment assets to BA Investments resulted in increased liquidity risk for petitioner. Moreover, an unexpected increase in interest rates would increase the cost of funds without increasing the return on fixed rate assets and would cause the market value of longer term assets to fall more than the market value of shorter term deposit liabilities. Professor Saunders calls this a "maturity mismatch." Finally, Professor Saunders found that duplication of services (e.g., accounting services) could increase the cost of the investment function without realizing any gain in investment returns. From all this, Professor Saunders concluded that the true reason for the creation of BA Investments and the only economic explanation for its existence was to exploit tax considerations that allow petitioner to circumvent the Article 32 taxes.

Professor Saunders also observed that the creation of BA Investments and its arrangement with petitioner caused petitioner's financial position to be inaccurately reported because of the mismatching of income and expenses related to passive investments. He found that the expenses related to acquiring the funds used to acquire the investment assets (e.g., interest on deposits and purchased funds) and the salaries of the managers of the investment portfolio (e.g., J.B. Chandler) were all paid by petitioner, while income on the portfolio accrued to BA Investments in Delaware. Moreover, while portfolio income accrued to BA Investments, petitioner still used the portfolio assets to meet capital adequacy and other regulatory purposes.

As a New York commercial bank, petitioner is audited by the New York State Banking Department every other year. Under the alternate year program, the FDIC audits petitioner in the year that it is not audited by the Banking Department. At the conclusion of its audit, the Banking

Department issues a Report of Examination of petitioner. The Report of Examination consists of three major sections, Conclusions and Recommendations, Assessment, and Supplemental Information. The Assessment section contains an analysis of capital, asset quality, management, earnings, liquidity, and sensitivity to market risk and a rating with respect to each component of the Assessment section. The ratings range from one, for the strongest institutions, to five, for the weakest institutions. Each rating is accompanied by a narrative that explains the basis for the rating assigned.

Petitioner submitted into evidence the Banking Department's reports of examination of petitioner as of the close of business on March 31, 1998 and March 31, 2000 as a rebuttal to Professor Saunders' report. The first report includes the period during which BA Investments was created and activated. It is to be noted that these examinations are conducted on a consolidated basis that includes BA Investments. The 1998 report consists of 30 pages, 24 of which have been redacted in their entirety and 4 of which have been partially redacted. The 2000 report consists of 23 pages, 18 of which have been redacted in their entirety and 3 of which have been partially redacted. From the little information that was not redacted, it can be determined that the ratings assigned by the Banking Department for liquidity and sensitivity to market risk did not change from 1998 to 2000. Due to the extent of material redacted, it cannot be determined if the Banking Department considered whether the creation of BA Investments might have a negative impact on petitioner's liquidity and sensitivity to market risk as has been suggested in Professor Saunders's report. Moreover, it cannot be determined if the Banking Department concluded that the creation of BA Investments might have a negative impact on petitioner's liquidity and sensitivity to market risk albeit of such a magnitude that it did not warrant a change in the ratings.

Petitioner introduced into evidence the financial statements of BA Investments as compiled by BA Investments' accountants for calendar years 1998 and 1999. These statements reveal the following:

ASSETS

	1998	1999
CURRENT ASSETS		
Cash and cash equivalents	$ 17,844,768.55	$ 36,846,295.00
Accrued interest receivable	768,692.45	760,301.00
Prepaid rent	5,000.00	4,500.00
Total current assets	18,618,451.00	37,611,096.00
INVESTMENTS – AVAILABLE FOR SALE		
U.S. Government securities	28,049,269.90	22,910,276.00
States and political subdivisions	3,185,271.55	623,439.00
Federal agencies	6,556,270.22	3,790,793.00
Eurobonds	8,432,276.05	6,708,311.00
Foreign commercial paper	2,200,202.86	2,200,184.00
F.N.M.A. Floating rate	19,056,985.09	19,733,487.00
Unrealized gains (loss) securities – available for sale	899,539.15	(114,884.00)
Total investments – available for sale	69,056985.09	55,851,606.00
INVESTMENTS – HELD TO MATURITY		
Municipals	14,328,987.53	14,332,402.00
Total investments	83,385,972.62	70,184,008.00
TOTAL ASSETS	$ 102,004,433.62	$ 107,795,104.00

LIABILITIES AND STOCKHOLDER'S EQUITY

	1998	1999
CURRENT LIABILITIES		
Accounts payable	$ 10,364.00	$ 5,154.00

Federal income taxes payable	341,824.82	37,913.00
Total Liabilities	352,188.82	43,067.00
STOCKHOLDER'S EQUITY		
Common Stock	1,000.00	1,000.00
Additional paid-in capital	95,325,119.04	95,337,806.00
Retained earnings	5,768,411.43	11,566,028.00
Add: Unrealized gains (losses)on Securities available for sale	557,714.33	152,797.00
Total Stockholder's equity	101,652,244.80	107,752,037.00
TOTAL LIABILITIES AND STOCKHOLDER'S EQUITY	$ 102,004,433.62	$ 107,795,104.00

STATEMENT OF INCOME AND RETAINED EARNINGS

Investment Income		
U.S. Gov't securities	$ 1,946,372.26	$ 1,675,818.00
States and subdivisions	245,510.96	152,776.00
Federal agencies	627,005.82	335,953.00
Eurobonds	530,947.65	452.642.00
Foreign commercial paper	120,875.02	118.654.00
F.N.M.A. floating rate	1,093,762.30	1,130,719.00
Municipals	646,797.39	663,399.00
Dividends	371,224.29	1,285,892.00
Net gain on sale of Securities	229,218.33	19,946.00
Total Investment Income	5,811,714.02	5,835,799.00
Operating Expenses		
Accounting fees	6,000.00	6,000.00
Bank charges	16,531.48	18,164.00
Franchise taxes	50.00	50.00
Furniture and fixtures	1,550.00	.00
Miscellaneous	4,594.64	4,715.00
Office expenses	357.05	.00
Payroll taxes	199.00	393.00
Premises	6,000.00	6,000.00
Salaries	7,600.00	2,400.00
Telephone	420.42	460.00

Total Operating Expenses	43,302.59	38,182.00
NET INCOME	5,768,411.43	5,797,617.00
Retained Earnings - beginning of year	.00	5,768,411.00
Retained Earnings - end of year	$ 5,768,411.43	$11,566,028.00

Petitioner introduced into evidence its annual reports for the periods at issue. These reports are made on a consolidated basis and include the accounts of petitioner and its subsidiaries, which are wholly owned. The consolidated balance sheets reveal, in part, the following:

ASSETS:	1997	1998	1999
Cash and Cash Equivalents	$ 250,345,558	$ 300,017,849	$ 375,022,334
Investment Securities	98,273,931	103,914,167	109,803,345
Loans, net	196,176,049	200,026,729	196,694,472
Bank Premises and Equipment, net	5,968,950	5,574,863	5,736,189
Customer's Liability on Acceptances	2,141,933	1,095,991	1,285,943
Accrued Interest Receivable	2,911,963	2,854,469	3,260,895
Other Assets	8,562,936	3,661,015	3,657,717
TOTAL ASSETS	$ 564,381,320	$ 617,145,083	$ 695,460,895

LIABILITIES AND STOCKHOLDER'S EQUITY

LIABILITIES:			
Total Deposits	$ 500,980,375	$ 551,957,154	$ 626,012,038
Other Short-Term Borrowing	9,109,000	8,620,000	9,016,482
Acceptances Outstanding	2,141,933	1,095,991	1,285,943
Other Liabilities	5,999,787	4,495,108	5,070,196
Subordinated debentures	7,500,000	7,500,000	7,500,000

TOTAL LIABILITIES	525,731,095	574,118,253	648,884,659
STOCKHOLDER'S EQUITY:			
Common Stock	3,750,000	3,750,000	3,750,000
Additional Paid-in Capital	13,750,000	13,750,000	13,750,000
Undivided Profits	20,663.647	24,969,256	29,172,945
Accumulated other Comprehensive Income (loss), net	486,578	557,574	(96,709)
TOTAL STOCKHOLDER'S EQUITY	38,650,225	43,026,830	46,576,236
TOTAL LIABILITIES AND STOCKHOLDER'S EQUITY	$ 564,381,320	$ 617,145,083	$ 695,460,895

Petitioner's Consolidated Statements of Income reveal, in part, the following:

	1997	1998	1999
Interest Income:			
Loans	$ 18,257,523	$ 19,545,060	$ 18,847,477
Interest-bearing deposits with banks	8,332,151	8,687,651	10,521,183
Investment securities	6,077,143	4,177,104	5,994,332
Federal funds sold	2,938,523	6,006,361	5,079,465
Total interest income	35,605,340	38,416,176	40,442,457
Other Operating Income:			
Commissions, fees and other income	3,470,821	3,332,196	3,310,177
Securities gains, net	905	185,563	19,946
Total other operating income	3,471,726	3,517,759	3,330,123
Interest Expense:			
Deposits	16,800,044	19,266,177	26,281,712
Subordinated debentures	818,385	814,010	789,322
Other short-term borrowing	4,946,006	4,677,371	334,251
Total interest expense	22,564,435	24,757,558	27,405,285
Provision for Possible Loan Losses	250,000	100,000	100,000

Other Operating Expenses:			
Salaries and employee benefits	4,985,495	5,298,736	5,429,831
Depreciation and amortization	749,393	706,118	421,213
Other real estate expenses	218,586	430,157	219,078
FDIC assessment	46,800	23,040	26,400
General and administrative	3,649,266	4,165,717	3,902,084
Total other operating expenses	9,649,540	10,623,768	9,998,606
Income Tax Provision	2,571,000	2,147,000	2,065,000
NET INCOME	$ 4,042,091	$ 4,305,609	$ 4,203,689

In its annual reports for the period 1997-1999, petitioner and its subsidiaries reported total interest expense of $22,564,435.00 for 1997, $24,757,558.00 for 1998 and $27,405,285.00 for 1999. Of these amounts, nothing is attributed to BA Investments. Even though it reported no interest expense, BA Investments reported interest income over $5 million for each of 1998 and 1999.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The Administrative Law Judge found that although BA Investments is owned 100% by petitioner and that it is part of a unitary business conducted by petitioner, the intercorporate transactions did not rise to the level of creating a presumption that inclusion of BA Investments in the combined group is required. Thus, the Administrative Law Judge concluded that to require BA Investments be included in the combined group, the Division must demonstrate distortion. The Administrative Law Judge found that BA Investments was not a sham corporation or an empty shell, that it was intended to generate a profit from its very inception and did generate such profit. However, the Administrative Law Judge also found that the Division demonstrated an arrangement between petitioner and BA Investments whereby the activity, business, income or assets of petitioner is improperly or inaccurately reflected. The Administrative Law Judge determined that petitioner created distortion in its net income, by claiming significant interest deductions in its combined report while such expenses were attributable to assets held by a subsidiary corporation that was not included in the combined report. The Administrative Law Judge concluded that by including BA Investments in the combined report, this distortion was eliminated.

ARGUMENTS ON EXCEPTION

It is petitioner's position that Tax Law § 1462(g) and § 1462(f)(2)(i)(B), Bank Tax Regulation 20 NYCRR 21-2.6(a), and the Tribunal's decisions in ***Matter of Premier Natl. Bancorp*** (Tax Appeals Tribunal, August 2, 2007) and ***Matter of U.S. Trust Corp., supra*** prohibit the Division's exercise of administrative discretion to combine the income and activities of BA Investments with petitioner absent a finding of distortion in tax liability. Petitioner argues that distortion does not exist in a corporation's formation of a subsidiary by means of a contribution to capital under IRC § 351(a), which petitioner contends is the only arrangement specified by Audit as resulting in distortion.

It is also petitioner's position that, in the absence of intercorporate transactions between the combined group and BA Investments, the Division bears the burden of proving that distortion exists before it can require that BA Investments, a New York nontaxpayer, be included in the combined report. Petitioner asserts that the Division has failed to meet its burden of proof of distortion.

Petitioner also argues that the Division improperly raised additional allegations of distortion at the hearing below that were not specified during the audit and, as such, the allegations should not be considered.

Petitioner further argues that the Administrative Law Judge erred in admitting into evidence the testimony of the Division's expert, Professor Saunders, and his written report, over petitioner's objections. Petitioner contends that the Division did not lay an appropriate foundation for such expert testimony, that such testimony lacks reliability and credibility, and that such testimony should not be accorded any weight.

Petitioner asserts that the Division is applying Tax Law § 1462(f)(2)(i)(B) and § 1462(g) to petitioner and its out-of-state subsidiary in a discriminatory manner causing economic injury to petitioner, while affording favorable, discriminatory tax treatment to similarly situated proprietary investment companies conducting business from office locations in New York State, in violation of the Commerce Clause and Equal Protection Clause of the U.S. Constitution. Petitioner argues that the alleged discriminatory tax treatment was intentionally contemplated by New York State in the design and passage of the legislation involved and, as such, the legality of the assessment must be subjected to strict scrutiny.

Finally, petitioner asserts that the Division improperly imposed a substantial understatement penalty, arguing that since BA Investments is a nontaxpayer, petitioner was not able, in the first instance, to include BA Investments in its combined report. It was only the exercise of the Commissioner's discretion in the course of the audit that caused BA Investments to be included in the combined report. Petitioner also asserts that its filing was based on substantial authority and that reasonable cause exists for the abatement of penalties.

It is the Division's position that BA Investments should be combined with petitioner and the other members of the combined group for New York State tax filing purposes because the arrangement whereby BA Investments possesses and reaps income from investments that are financed by debt and expenses incurred by petitioner, distorts petitioner's tax reporting position.

OPINION

We affirm the determination of the Administrative Law Judge.

Section 1462(f)(2)(i) of the Tax Law provides as follows:

> Any banking corporation or bank holding company which is exercising its corporate franchise or doing business in this state in a corporate or organized capacity, and
>
> (A) which owns or controls, directly or indirectly, eighty percent or more of the voting stock of one or more banking corporations or bank holding companies, or
>
> (B) whose voting stock is eighty percent or more owned or controlled, directly or indirectly, by a banking corporation or a bank holding company,
>
> shall make a return on a combined basis under this article covering itself and such corporations described in clause (A) or (B) and shall set forth such information as the tax commission may require unless the taxpayer or the tax commission shows that the inclusion of such a corporation in the combined return fails to properly reflect the tax liability of such corporation under this article. Provided, however, that no banking corporation or bank holding company not a taxpayer shall be subject to the requirements of this subparagraph unless the tax commission deems that the application of such requirement is necessary in order to properly reflect the tax liability under this article, because of intercompany transactions or some agreement, understanding, arrangement or transaction of the type referred to in subsection (g) of this section.

Section 1462(g) of the Tax Law provides as follows:

> In case it shall appear to the tax commission that any agreement, understanding or arrangement exists between the taxpayer and any other corporation or any person or firm, whereby the activity, business, income or assets of the taxpayer within the state is improperly or inaccurately reflected, the tax commission is authorized and empowered, in its discretion and in such manner as it may determine, to adjust items of income or deductions in computing entire net income or alternative entire net income and to adjust assets, and to adjust wages, salaries and other personal service compensation, receipts or deposits in computing any allocation percentage, provided only that entire net income or alternative entire net income be adjusted accordingly and that any asset directly traceable to the elimination of any receipt be eliminated from assets so as to accurately determine the tax. If however, in the determination of the tax commission, such adjustments do not, or cannot effectively provide for the accurate determination of the tax, the commission shall be authorized to require the filing of a combined report by the taxpayer and any such other corporations. Where (1) any taxpayer conducts its

> activity or business under any agreement, arrangement or understanding in such manner as either directly or indirectly to benefit its members or stockholders, or any of them, or any person or persons directly or indirectly interested in such activity or business, by entering into any transaction at more or less than a fair price which, but for such agreement, arrangement or understanding, might have been paid or received therefor, or (2) any taxpayer enters into any transaction with another corporation on such terms as to create an improper loss or net income, the tax commission may include in the entire net income or alternative entire net income of the taxpayer the fair profits which, but for such agreement, arrangement or understanding, the taxpayer might have derived from such transaction.

More specifically, 20 NYCRR 21-2.6(a) provides as follows:

> A banking corporation or bank holding company which is not a taxpayer cannot be included in a combined return under section 21-2.2 of this Subpart unless it is part of a unitary business with the other corporations in the group (see section 21-2.3[b][1] of this Subpart) and the Tax Commission determines that the inclusion of such corporation is necessary in order to properly reflect the tax liability of one or more banking corporations or bank holding companies included in the group because of:
>
> (1) intercorporate transactions (see section 21-2.3[b][3] of this Subpart); or
>
> (2) some agreement, understanding, arrangement or transaction existing between the taxpayer and any other combinable corporation, whereby the activity, business, income or assets of the taxpayer within New York State is improperly or inaccurately reflected (see section 21-2.3[b][4] of this Subpart).

The Administrative Law Judge properly noted that the Division is not required to attempt to correct any distortion by use of a discretionary adjustment pursuant to Tax Law § 1462(g) before requiring a nontaxpayer to be included in a combined report. Rather, to require that BA Investments be included in the combined group, the Division must demonstrate that there exists some agreement, understanding or arrangement between petitioner and BA Investments whereby the activity, business, income or assets of petitioner are improperly or inaccurately reflected. As we held in ***Matter of U.S. Trust Corp., supra***:

> The authority for the Division to require combination of a nontaxpayer banking corporation or bank holding company is Tax Law § 1462(f)(2)(I)(sic). The authority is conditioned <u>only</u> upon the Division finding that combination is

> necessary to "properly reflect . . . tax liability because of intercompany transactions or some agreement, understanding, arrangement or transaction of the type referred to in subsection (g) of this section." In short, nothing in this section requires the Division to attempt remedial adjustments under section 1462(g) as a condition precedent to the requirement of combination by the Division. The reference to (g) is merely to describe the nature of the agreement, understanding or arrangement which forms the basis for the Division's determination to require combination, i.e., "[a]ny agreement, understanding or arrangement . . . between the taxpayer and any other corporation . . . whereby the activity, business, income or assets of the taxpayer within the state is improperly or inaccurately reflected" (Tax Law § 1462[g]).

This concept of improperly or inaccurately reflected activity, business, income or assets is commonly referred to as distortion.

There is no dispute that BA Investments is owned 100% by petitioner and that it is part of a unitary business conducted by petitioner. 20 NYCRR 21-2.3(b)(3)(i) provides, in part, that:

> If there are substantial intercorporate transactions among the banking corporations or bank holding companies engaged in a unitary business, it will be presumed that the tax liability of the taxpayer will be improperly reflected when the taxpayer reports on a separate basis. In determining whether there are substantial intercorporate transactions, the Tax Commission will consider transactions directly connected with the business conducted by such corporations, such as:
>
> (a) performing services for other corporations in the group;
>
> (b) providing funds to other corporations in the group; or
>
> (c) performing related customer services using common facilities and employees.
>
> Service functions will not be considered when they are incidental to the business of the corporation providing such services. Service functions include, but are not limited to, accounting, legal and personnel services. The substantial intercorporate transaction test may be met where as little as 50 percent of a corporation's receipts or expenses are from one or more qualified activities described in this paragraph . . . .

There is also no dispute that any intercorporate transactions between the combined group and BA Investments are so insignificant that they do not rise to the level of 50 percent, and accordingly, no presumption is created that inclusion of BA Investments in the combined group is made necessary in order to properly reflect the tax liability of petitioner. Thus, the Administrative Law Judge properly determined that to require that BA Investments be included in the combined group, the Division must demonstrate that there exists some agreement, understanding or arrangement between petitioner and BA Investments whereby the activity, business, income or assets of petitioner are improperly or inaccurately reflected.

Petitioner relies upon ***Matter of Premier Natl. Bancorp, supra*** for the proposition that no distortion exists by virtue of a parent's capital contributions to its investment subsidiary. As the Administrative Law Judge properly noted, to the extent that we focus only on the transaction involving the capital contribution to the subsidiary (in the instant matter, securities and a small amount of cash) in return for the stock of the investment subsidiary upon its formation, petitioner is correct. The value of the stock taken back can be expected to equal the securities and cash contributed. However, petitioner incorrectly asserts that this is the only arrangement specified by Audit as resulting in distortion. Contrary to petitioner's assertion, the Division has identified the particular arrangement that materially distorts petitioner's net income. Specifically, the Division has shown that the transfer of petitioner's investments to BA Investments is an arrangement whereby expenses incurred in order to fund the purchase of assets are left with petitioner, but the assets themselves (and associated income generated from such assets) are transferred to a different entity. The record reveals that in 1997, when petitioner invested approximately $100 million in BA Investments, petitioner used funds it had borrowed from its depositors, creating an arrangement whereby the expenses of obtaining such funds (the interest paid to depositors) was allocated to New York State, while the income earned on such funds was allocated outside of New York State. This arrangement created a mismatching of related income and expenses resulting in distortion. The Administrative Law Judge properly concluded that petitioner created a distortion in its net income by claiming significant interest deductions in its combined report, while such expenses were attributable to assets held by a subsidiary corporation that was not included in the combined report. As a result, either its deductions were overstated, or its income was understated. By including BA Investments' income in the combined report, this distortion was properly eliminated.

Petitioner objects to the testimony and written report of the Division's expert, Professor Saunders, which was admitted into evidence by the Administrative Law Judge. Petitioner contends that the Division did not lay an appropriate foundation for such expert testimony, that the testimony lacks reliability and credibility, and that as such, the testimony should not have been admitted into evidence or, if allowed, should not be accorded any weight.

A review of the Administrative Law Judge's determination shows that the Administrative Law Judge did not specifically rely on Professor Saunders' testimony or report in arriving at his conclusions. The Administrative Law Judge found that although Professor Saunders is a noted economist whose opinions regarding the economic aspects of this matter are deserving of some deference, it was brought out on cross-examination that Professor Saunders has no expertise, or even detailed knowledge, of federal or state bank tax laws. Moreover, as the Administrative Law Judge noted, Professor Saunders formulated his conclusions mainly from his review of the audit case file. He did not consult with the Division's auditors prior to writing his report and never interviewed any officers or employees of petitioner. Thus, the Administrative Law Judge properly found that Professor Saunders' conclusions regarding state and local tax avoidance motivations may be subject to challenge. Rather than relying on Professor Saunders' testimony and report, the Administrative Law Judge thoroughly reviewed the evidence in the record to arrive at his determination. Indeed, the financial statements of petitioner admitted into the record indicate that in 1997, the year that BA Investments was created and funded, petitioner had only $38.7 million in total stockholder equity. The $100 million invested in BA Investments could not be entirely attributed to stockholder equity. The rest, at least $61.3 million, must be attributed to deposits ($501 million in 1997) or other borrowing ($25 million), all of which caused petitioner to incur interest expenses. Petitioner reported interest expense of $22.6 million in 1997, with $24.8 million in interest expense in 1998 and $27.4 million in 1999. Conversely, BA Investments reported investment income of $5.8 million for 1998 and $5.8 million for 1999, while reporting no interest expense whatsoever for either 1998 or 1999. An analysis for the other years at issue (1998 and 1999) reveals that for each of those years, petitioner never had an equity balance that equaled or exceeded the dollar amount of the subject investment that had been transferred to BA Investments. Thus, the Administrative Law Judge properly concluded that petitioner created a distortion in its income by claiming an interest deduction in its combined report attributable to assets held by a subsidiary corporation that was not included in the combined report.

Contrary to petitioner's assertion that the Division improperly raised allegations of distortion at the hearing that were not specified during the audit, the record shows that in the course of the audit, the Division's auditor determined that the arrangement at issue created distortion to petitioner's net income because the expenses were on petitioner's books, while the assets and income were not. Petitioner's reliance on ***Matter of U.S. Trust Corp., supra*** in this regard is misplaced. In ***U.S. Trust***, the Tribunal quoted the underlying Administrative Law

Judge's determination, which observed that the intercorporate transactions "cavalierly referred to in the Division's brief" were not identified as grounds for combination on audit and that the Division's assertions were not substantiated at hearing. The Tribunal agreed with the Administrative Law Judge's finding that "there is insufficient evidence in the record to support a finding that U.S. Trust's tax liability was inaccurately reported because of unspecified services it performed in connection with the acquisition of subsidiaries by UST Delaware" (***Matter of U.S. Trust Corp.***, ***supra***). Unlike the circumstances in ***U.S. Trust***, here the Division has pointed out specifically both the subject arrangement and the distortion created by the arrangement, which is supported by the evidence in the record.

Petitioner next argues that the Division's attempt to combine the income and tax attributes of BA Investments with those of petitioner under Tax Law § 1462(g) when that section is read in conjunction with sections 1452(d) and (g) and 1462(f)(4)(ii) and (iii) discriminates against interstate commerce in violation of both the Commerce Clause and the Equal Protection Clause of the U.S. Constitution. Petitioner argues that Tax Law §§ 1452(d) and (g) were "intentionally and explicitly designed to favor, promote, and protect the New York State economy, and in particular, the financial services sector of the New York State economy, over the economies of sister states, and to create a constitutionally proscribed, direct, commercial advantage to local companies, by creating an illegal, 'inexorable hydraulic pressure' on corporations conducting business in interstate commerce to locate their proprietary investment operations in New York State . . ." (Exception, Attachment B, p. 63).

As can be readily seen from the above quotations, petitioner is not merely challenging the actions of the Division in the instant matter but argues that the statutes themselves are invalid. It is well settled that arguments that a statute is invalid on its face are not matters that fall within the purview of the Division of Tax Appeals. As we stated in ***Matter of Eisenstein*** (Tax Appeals Tribunal, March 27, 2003):

> The Division of Tax Appeals is a forum of limited jurisdiction and is not authorized to determine the facial constitutionality of statutes (***Matter of J.C. Penney Co.***, Tax Appeals Tribunal, April 27, 1989; ***Matter of Fourth Day Enters.***, Tax Appeals Tribunal, October 27, 1988).

Accordingly, all of the challenged statutes are presumed to be valid at this level of review.

Finally, petitioner challenges the substantial understatement penalty imposed by the assessment. Tax Law § 1085(k) provides:

> Substantial understatement of liability. – If there is a substantial understatement of tax for any taxable year, there shall be added to the tax an amount equal to ten percent of the amount of any underpayment attributable to such understatement. For purposes of this subsection, there is a substantial understatement of tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of ten percent of the tax required to be shown on the return for the taxable year or five thousand dollars. For purposes of the preceding sentence, the term "understatement" means the excess of the amount of the tax required to be shown on the return for the taxable year, over the amount of the tax imposed which is shown on the return reduced by any rebate (within the meaning of subsection (h) of section one thousand eighty-one). The amount of such understatement shall be reduced by that portion of the understatement which is attributable to the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return. The tax commission may waive all or any part of the addition to tax provided by this section on a showing by the taxpayer that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith.

As the Administrative Law Judge correctly noted, the Division does not have the burden of providing a rationale to prove that penalties should be imposed (***see Matter of Philip Morris***, Tax Appeals Tribunal, April 29, 1993). Rather than leaving it to the Commissioner's discretion, the law provides that penalties are to be imposed under specified circumstances and it shall be the burden of the taxpayer to demonstrate that reasonable cause exists for the waiver of penalties.

Petitioner argues that it could not file a combined return with BA Investments due to the prohibition found in Tax Law §1462(f)(2)(i)(B). Petitioner contends that because it was not permitted by the statute to include a nontaxpayer such as BA investments in its return, it may not be assessed a substantial understatement penalty for a failure to include a tax amount "required to be shown" in a return.

In determining whether reasonable cause and the absence of willful neglect exist, the most important factor to be considered is the extent of the taxpayer's efforts to ascertain the proper tax liability (***see LT & B Realty v. State Tax Commn.***, 141 AD2d 185 [1988]). As noted by the Administrative Law Judge, at no time did petitioner seek the advice of the Division regarding the necessity of including BA Investments in its combined return on either an informal basis or by requesting an advisory opinion (Tax Law § 171[24]), which would have established the Division's position in a binding manner. Moreover, in light of the advice given to petitioner by its accountant, as specified in the findings of fact, it is clear that petitioner was cognizant that its course of action was likely to be challenged by the Division. As such, we find that the substantial understatement penalty was properly imposed.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Interaudi Bank f/k/a Bank Audi (USA) is denied;
2. The determination of the Administrative Law Judge is affirmed;
3. The petition of Interaudi Bank f/k/a Bank Audi (USA) is denied; and

4. The Notice of Deficiency dated March 10, 2005, as modified, is sustained.

DATED:Troy, New York
April 14, 2011

/s/ James H. Tully, Jr.
James H. Tully, Jr.
President

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

/s/ Charles H. Nesbitt
Charles H. Nesbitt
Commissioner