STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :

of :

KNOTT HOTELS CORPORATION : DETERMINATION
DTA NO. 806535

for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1977 through 1980. : :

Petitioner, Knott Hotels Corporation, P.O. Box 1887, El Cajon, California 92022, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the years 1977 through 1980.

A hearing was held before Thomas C. Sacca, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on December 11, 1990 at 9:15 A.M. Petitioner filed its brief on November 15, 1991 and its reply brief on February 3, 1992. The Division of Taxation filed its brief on December 5, 1991. Petitioner appeared by Price Waterhouse (John J. Fielding, C.P.A.). The Division of Taxation appeared by William F. Collins, Esq. (Anne W. Murphy, Esq., of counsel).

ISSUES

I. Whether petitioner's payments, as guarantor under a lease agreement, of real estate taxes and rental payments on behalf of its subsidiary are properly classified as business expenses or amounts directly or indirectly attributable to petitioner's investment in its subsidiary.

II. Whether petitioner may be permitted to include its foreign subsidiary in its combined franchise tax return filed for the year 1976.

FINDINGS OF FACT

On March 27, 1986, the Division of Taxation issued to petitioner, Knott Hotels Corporation, four notices of deficiency. The notices pertained to the fiscal years ended

December 31, 1977, October 31, 1978, October 31, 1979 and October 31, 1980 and set forth tax deficiencies of $25,602.00, $23,012.00, $46,126.00 and $126,146.00, respectively. The notices were based upon an audit of petitioner in which certain business expenses classified by petitioner as "bad debts" were disallowed by the Division and reclassified as losses from subsidiary capital and added back to petitioner's entire net income.

The Bureau of Conciliation and Mediation Services' Conciliation Order, dated October 28, 1988, reduced petitioner's tax liability for the fiscal years ended October 31, 1979 and October 31, 1980 to $37,822.00 and $113,471.00, respectively. The reductions were based upon petitioner's subsequently filed amended Federal income tax return for the year 1977 showing a lesser Federal taxable income than that shown on the original 1977 return. The original return was used by the Division in computing the amount of tax due for that year.

Petitioner was incorporated in the State of Delaware in 1927. Its headquarters are located in El Cajon, California and, at all relevant times herein, it has been involved in the business of operating hotels throughout the United States, including New York State.

Through the period ended December 31, 1977, petitioner filed on a combined basis in New York State with its subsidiaries doing business in New York. During 1977, the subsidiaries were merged into Knott Hotels and petitioner subsequently filed on a separate, non-combined basis. Knott Hotels, in turn, is a subsidiary of Trusthouse Forte, Inc., and it files on a consolidated basis with that corporation for Federal purposes.

Prior to the merger of the affiliated corporations into Knott Hotels, petitioner owned a corporation entitled The Westbury Chicago, Inc. ("Westbury"). On October 21, 1971, Westbury, as lessee, entered into a Lease Agreement with Lake Shore National Bank, as lessor. On the same date, petitioner entered into a Guaranty Agreement with the lessor, whereby it guaranteed the performance of Westbury under the Lease Agreement, including the payments of real estate taxes and rental payments. During 1976, as a result of Westbury's failure to meet its obligation under the Lease Agreement, petitioner became responsible for $2,008,000.00 in real estate taxes and rental payments under the Guaranty Agreement. Petitioner classified these

payments as business expenses in computing its 1976 Federal taxable income and New York State entire net income. In 1976, petitioner had incurred net operating losses which were carried forward to the fiscal years in issue.

On audit, the Division reduced the net operating loss incurred in 1976 by disallowing the business expenses claimed for the payment of the real estate taxes and lease payments pursuant to the Guaranty Agreement. The Division classified the payments as losses from subsidiary capital and added the amount back to Federal taxable income in computing petitioner's entire net income for 1976.

At the commencement of the hearing held on December 11, 1990, petitioner requested for the first time that Westbury be permitted, for the year 1976, to file on a combined basis with Knott Hotels and the other subsidiaries that operated in New York State.

Following the taking of testimony and documentation during the hearing commenced on December 11, 1990, the record of this matter was left open to provide both parties with an opportunity to present additional documentation concerning the issues involved and to request that the hearing be reconvened to present additional testimony. The hearing was rescheduled for May 7, 1991, adjourned to allow the parties additional time to submit and review documentation relating to the combined reports issue and rescheduled again for September 23, 1991.

During a telephone conversation one week prior to the hearing date, the representatives for both parties advised the Administrative Law Judge that they did not wish to introduce any further evidence into the record of this matter. In a letter dated September 23, 1991, the Administrative Law Judge advised the representatives of both parties that the record of this matter was closed.

On February 3, 1992, petitioner submitted with its reply brief six exhibits relating to the issues at hand. As the record of this matter was closed on September 23, 1991, these six exhibits have not been admitted into evidence nor considered in making this determination.

CONCLUSIONS OF LAW

A. Tax Law § 208.9(a)(1) provides that a taxpayer's entire net income does not include income, gains or losses from subsidiary capital. However, the Division is permitted to adjust reported entire net income to include amounts "directly or indirectly attributable...to subsidiary capital, or to income, gains or losses from subsidiary capital" (Tax Law § 208.9[b][6]; 20 NYCRR 3-2.3[a][8]; see, Matter of Unimax Corporation v. Tax Appeals Tribunal, 165 AD2d 476, 568 NYS2d 164, affd 79 NY2d 139, 581 NYS2d 135).

B. Tax Law former § 208.4 defines "subsidiary capital" as follows:

> "investments in the stock of subsidiaries and any indebtedness from subsidiaries, exclusive of accounts receivable...provided, however, that, in the discretion of the tax commission, there shall be deducted from subsidiary capital any liabilities payable by their terms on demand or within one year from the date incurred, other than loans...outstanding for more than a year..., which are attributable to subsidiary capital."

The franchise tax regulations provide that, in computing entire net income, Federal taxable income is to be adjusted by the addition of amounts representing losses from subsidiary capital which were deducted in computing the Federal income base (see, 20 NYCRR 3-2.3[a][8]).

During the year 1976, petitioner's subsidiary, The Westbury Chicago, Inc., was responsible for rental payments and real estate taxes due under its Lease Agreement. On Westbury's failure to make such payments, petitioner became liable for such expenses pursuant to the Guaranty Agreement with Westbury's lessor. Petitioner then classified these payments as business expenses in its computation of its own Federal taxable income. In computing petitioner's entire net income, the Division adjusted the reported Federal loss by excluding these payments, which reduced petitioner's 1976 net operating loss deduction available for carryover to the years in issue for New York franchise tax purposes.

Petitioner is not entitled to include the payments made on behalf of Westbury in computing its 1976 entire net income (loss). The payments made by petitioner were on behalf of its subsidiary, and therefore represent losses attributable to subsidiary capital (Tax Law § 208.4), which are properly added back to petitioner's Federal taxable income (loss) in computing entire net income (loss) for the year 1976 (Tax Law § 208.9[a][1]; 20 NYCRR 3-2.3[a][8]).

C. Tax Law § 211.4 provides, in part, as follows:

> "In the discretion of the tax commission, any taxpayer, which owns or controls either directly or indirectly substantially all of the capital stock of one or more other corporations, or substantially all the capital stock of which is owned or controlled either directly or indirectly by one or more other corporations or by interests which own or control either directly or indirectly substantially all the capital stock of one or more other corporations, may be required or permitted to make a report on a combined basis covering any such other corporations and setting forth such information as the tax commission may require; ...provided, further, that no combined report covering any corporation not a taxpayer shall be required unless the tax commission deems such a report necessary, because of inter-company transactions or some agreement, understanding, arrangement or transaction referred to in subdivision five of this section, in order properly to reflect the tax liability under this article."

D. The regulations in effect during the years in issue, 1976 through 1980, were those promulgated by the former New York State Tax Commission on August 31, 1976 which apply to taxable years beginning on or after January 1, 1976.

The regulation at 20 NYCRR former 6-2.1(a) provided, in part, as follows:

> "The reporting requirements of article 9-A contemplate that each corporation is a separate taxable entity and shall file its own report. However, the Tax Commission, in its discretion, may require a group of corporations to file a combined report or may grant permission to a group of corporations to file a combined report where the requirements of stock ownership or control are met. In addition, in deciding whether it will require or permit combined reporting, the Tax Commission will consider whether the group of corporations is engaged in a unitary business and whether there are substantial intercorporate transactions among the corporations."

Hence, the regulation established the threshold requirements for permitting combined reporting pursuant to Tax Law § 211.4 as unity of ownership, engagement in a unitary business and substantial intercorporate transactions.

The regulation at 20 NYCRR former 6-2.2 expounded upon the initial requirement that there be unity of ownership, i.e., that the taxpayer own or control directly or indirectly substantially all the capital stock of the other corporations which are to be included in a combined report. "Substantially all" was defined in 20 NYCRR former 6-2.2(b) as 80 percent or more of the voting stock.

Once a determination of unity of ownership was made, the regulation at 20 NYCRR former 6-2.3(a) required an exercise of discretion by the Tax Commission with regard to the

permission or requirement for combined reporting based upon whether the corporations were in substance parts of a unitary business conducted by the entire group of corporations and whether there were substantial intercorporate transactions among the corporations. With regard to the requirement that the corporations be parts of a unitary business, the regulation states that the Tax Commission:

> "will consider whether the activities in which the corporation engages are related to the activities of the other corporations in the group, such as:
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> (1) manufacturing or acquiring goods or property for other corporations in the group; or
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> (2) selling goods acquired from other corporations in the group; or
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> (3) financing sales of other corporations of the group.
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> The Tax Commission will consider a corporation to be part of a unitary business if it is engaged in the same or related lines of business as the other corporations in the group, such as:
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> (4) manufacturing similar products; or
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> (5) performing similar services; or
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> (6) performing services for the same customers." (20 NYCRR former 6-2.3[b].)

The regulation also sets forth guidelines for determining substantial intercorporate transactions as follows:

> "In determining whether the substantial intercorporate transaction requirement is met, the Tax Commission will consider only transactions directly connected with the business conducted by the taxpayer, such as described in paragraph (1), (2) or (3) of subdivision (b) of this section. Service functions, such as accounting, legal, and personnel will not be considered. The substantial intercorporate transaction requirement may be met where as little as fifty percent (50%) of a corporation's receipts are from any qualified activities. It is not necessary that there be substantial intercorporate transactions between any one member with every other member of the group. It is, however, essential that there be substantial intercorporate transactions among all members of the combined group." (20 NYCRR former 6-2.3[c].)

Foreign corporations such as The Westbury Chicago, Inc. subsidiary involved in the instant action were addressed in the regulation at 20 NYCRR former 6-2.5, dealing with corporations not required or permitted to file a combined report, wherein it was stated that:

"[a] foreign corporation not subject to tax will not be required to be included in a

> combined report unless the requirement described in section 6-2.2 of this Subpart has been met and the Tax Commission determines that the inclusion is necessary to properly reflect the tax liability of one or more taxpayers included in the group because of:
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> (1) intercorporate transactions; or
>
> (2) some agreement, understanding, arrangement or transaction whereby the activity, business, income or capital of any taxpayer is improperly or inaccurately reflected."

E. Every domestic or foreign corporation annually pays a franchise tax upon the basis of its entire net income for the privilege of doing business in this State (Tax Law § 209[1]). Whether a taxpayer is permitted or required to file on a combined basis with other corporations is determined after considering whether, under all of the circumstances of the intercompany relationships, combined reporting fulfills the statutory purpose of avoiding distortion of, and more realistically portraying, true income (Matter of Coleco Indus., Inc. v. State Tax Commn., 92 AD2d 1008, 461 NYS2d 462, affd 59 NY2d 994, 466 NYS2d 682).

Petitioner has failed to offer any documentation or testimony which would establish that petitioner and Westbury meet the requirements of filing on a combined basis as outlined by the former regulations or that combined reporting fulfills the statutory purpose of avoiding distortion of, and more realistically portraying, true income. Petitioner has failed to establish that it owned "substantially all" of the capital stock of Westbury, that the corporations were engaged in a unitary business or that substantial intercorporate transactions existed between petitioner and Westbury. Absent documentary and testimonial evidence addressing the requirements of the regulations and relevant case law, it cannot be determined whether petitioner and Westbury should be permitted to file on a combined basis (see, Matter of Coleco Industries, Inc. v. State Tax Commn., supra; Matter of American International Group v. Tully, 89 AD2d 687, 453 NYS2d 797, affd 59 NY2d 832, 464 NYS2d 755; see also, 20 NYCRR former 6-2.2, 6-2.3, 6-2.5).

It is noted that franchise tax regulation 20 NYCRR former 6-2.4 lists the information that should be provided by a taxpayer when requesting to file on a combined basis. As previously discussed, none of such information was introduced into the record of this matter.

F. Petitioner's reliance upon the Tax Appeals Tribunal's decision in Matter of Autotote Limited (April 12, 1990) is misplaced. In Autotote, petitioner's requests to file on a combined basis came both during the audit and prior to the issuance of the notices of deficiency. As a result, the taxpayer in Autotote was "the subject of an audit by the Division in which its business activities were examined and its intercorporate dealings with its subsidiary scrutinized." The facts determined upon audit and stipulated to by the parties indicated that the taxpayer met the conditions of the Division's regulations on combined reporting, but filing on a combined basis was denied because petitioner's request was untimely pursuant to 20 NYCRR former 6-2.4(a). The Tribunal determined that because the facts established that the stock ownership test was met, that the taxpayer and its parent were part of a unitary business conducted by the two corporations and that there were substantial intercorporate transactions between the corporations, filing on a combined reporting basis was appropriate.

In the present matter, there was no in-depth analysis by the Division of the intercorporate relationship between petitioner and Westbury during the year 1976. There are no facts in the record which indicate or establish that the stock ownership test has been met, that petitioner and Westbury were engaged in a unitary business or that substantial intercorporate transactions existed between the corporations. Finally, there is no evidence that establishes that petitioner and Westbury should file a combined report to avoid distortion and more realistically portray true income. Therefore, petitioner is denied permission to include Westbury in its combined report for the year 1976.

G. Following the closing of the record in this matter, the filing by petitioner of its brief and the Division of Taxation's filing of its brief, petitioner included with its reply brief six exhibits relating to the issues involved in this matter.

In order to maintain a fair and efficient hearing system, it is essential that the hearing process be both defined and final. If the parties are able to submit additional evidence after the record is closed, there is neither definition nor finality to the hearing. Further, the submission of evidence after the closing of the record denies the adversary the right to question the evidence

on the record (see, Matter of Schoonover, Tax Appeals Tribunal, August 15, 1991). Therefore, the documentation submitted after the closing of the record has not been considered in making this determination.

H. The petition of Knott Hotels Corporation is denied and the notices of deficiency, dated March 27, 1986, are sustained.

DATED: Troy, New York
August 20, 1992

/s/ Thomas C. Sacca
ADMINISTRATIVE LAW JUDGE