STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
BRITISH LAND (MARYLAND), INC.	:	DETERMINATION DTA NO. 806894
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Fiscal Years Ending March 31, 1983 through March 31, 1985.	:	

Petitioner, British Land (Maryland), Inc., 90 Broad Street, 12th Floor, New York, New York 10004, 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 fiscal years ending March 31, 1983 through March 31, 1985.

A hearing was held before Robert F. Mulligan, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on June 20, 1990 at 1:15 P.M., with all briefs to be filed by December 21, 1990. Petitioner appeared by Schulte Roth & Zabel (Roger B. Mead, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (James Della Porta, Esq., of counsel).

ISSUE

Whether a gain resulting from the sale of an office building located in Baltimore, Maryland, may properly be included in petitioner's entire net income for purposes of calculating New York State corporation franchise tax.

FINDINGS OF FACT

The parties have stipulated that the transcript of petitioner's City of New York Department of Finance hearing involving the same issue with respect to New York City General Corporation Tax and the exhibits submitted at such hearing are to be incorporated into the record in this case. References to said transcript and exhibits will be indicated by the notations "NYC Tr. __" and "NYC Ex. __". References to the transcripts of and exhibits received at the

Division of Tax Appeals hearing held on June 20, 1990 will be indicated by the notations "Transcript __" and "Exhibit __".

Petitioner, British Land (Maryland), Inc., was incorporated in Delaware on May 3, 1973.[1] It is an indirect subsidiary of The British Land Company Plc ("British Land"),[2] an international real estate investment firm based in London, England. At the time of its organization, petitioner was a direct subsidiary of British Land (Maryland) N.V., which itself was a fifth-tier subsidiary of British Land (Transcript 37; Exhibit "J"). British Land (Maryland) N.V. was based in Curacao, Netherlands Antilles (NYC Ex. "3", p. 41). Petitioner subsequently became a

subsidiary of Union Property Holdings (Investments) Ltd. (NYC Ex. "12"), a second-tier subsidiary of British Land.

The Baltimore Property

By an Agreement of Sale and Purchase, dated as of May 4, 1973 (NYC Ex. "3"), petitioner agreed to purchase all of the capital stock of The First Charles Street Corporation ("First Charles"), a Maryland corporation which owned a 27-story office building known as the

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[1]On the New York State Corporation Franchise Tax Report for the fiscal year ending March 31, 1984 (Exhibit "G[1]") the space for state or country of incorporation was left blank. The application for extension of time for filing the report indicates petitioner to be a Maryland corporation. The New York City General Corporation Tax Return for the fiscal year ending March 31, 1983 (NYC Ex. "C[2]") indicates it to be a Maryland corporation. The New York City return for the fiscal year ending March 31, 1984 (NYC Ex. "C[3]") shows no state of incorporation. The New York City return for the fiscal year ending March 31, 1985 (NYC Ex. "C[4]") shows it to be a Delaware corporation. Virtually all of the other significant documents in evidence describe petitioner as a Delaware corporation (e.g., NYC Exs. "3", "4", "5", "6", "9", "10", "11", "12" and "15"). One document, the Management and Exclusive Agency Agreement for petitioner's New York City building (NYC Ex. "17"), refers to petitioner as "a New York general partnership".

[2]Prior to November 3, 1981, British Land was known as The British Land Company, Ltd. On that date, it re-registered as a public limited company and became known as The British Land Company Plc (Exhibit "I[11]", p. 9).

Arlington Federal Building at 201 North Charles Street, Baltimore, Maryland, together with the two ground leases for the land on which the building was situated. The consideration was stipulated to be $4,815,000.00. The agreement stated that the building was encumbered by a consolidated deed of trust securing an obligation of $6,646,974.77 (as of April 30, 1973).

The chronology of the closing and the financing arrangements is not entirely clear. All elements of the transaction, however, appear to have been completed between May 2, 1973 and September 1, 1973:

(a) The Agreement of Sale and Purchase (supra) specified the closing date as May 2, 1973, which is two days before the date of the said agreement and the day before petitioner's date of incorporation.

(b) By a promissory note dated September 1, 1973 (NYC Ex. "4"), petitioner borrowed $4,700,000.00 from National Westminster Bank Limited ("NWB"). The note stated that it was guaranteed by "The British Land Company, Limited" pursuant to a guaranty agreement dated May 22, 1973 and was secured by a pledge agreement with petitioner and British Land (Maryland) N.V., as pledgors, dated as of August 1, 1973. The note also stated that it was secured by a deed of trust, similarly dated as of August 1, 1973, between petitioner and First Charles, jointly, and James P. Garland and David E. Belcher, Trustees.

(c) Under the terms of the pledge agreement of August 1, 1973 (NYC Ex. "27"), petitioner acknowledged being indebted to NWB for $4,700,000.00.[3] The agreement recited that the loan had been made to petitioner "to provide funds for the purchase by [petitioner] of all the issued and outstanding capital stock of First Charles". By the terms of the pledge agreement, petitioner and its then-parent corporation pledged and assigned to NWB all of First Charles' capital stock (which was owned by petitioner) and all of petitioner's capital stock (which was owned by its parent).

(d) The balance of the purchase price, i.e., $115,000.00, was obtained through an

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[3]The pledge agreement refers to the note as being of "even date", i.e. August 1, 1973; however, as stated in Finding of Fact "4(b)", the date of the note is September 1, 1973. Part of the pledge agreement (at least the signature page) seems to be missing from NYC Ex. "27".

unsecured loan from Schroder Bank (NYC Tr. 40). The loan was secured in 1975 by a third lien on the premises (NYC Tr. 47).

Due to foreign exchange currency controls in the United Kingdom, it was necessary that British Land borrow 100% of any investment made outside the United Kingdom. It was for this reason that the Baltimore property was acquired by petitioner on a fully financed basis.

First Charles was merged into petitioner as of April 30, 1975 (NYC Ex. "5", note 1; also, NYC Ex. "C-1", Deed of Assignment, p. 2).

Schroder Bank, which had found the Arlington Federal Building as an investment for petitioner and had coordinated the purchase, retained the Baltimore real property management firm of W. C. Pinkard & Co., Inc. ("Pinkard") to assist in management of the building. After one or two years, petitioner decided to deal directly with Pinkard.

Pinkard became involved in the management of the building in the mid-1970's or shortly thereafter. The earliest building management agreement in the record reveals that Pinkard was petitioner's manager effective January 1, 1977 (NYC Ex. "13", p. 7).

Petitioner entered into management agreements with Pinkard dated March 10, 1977, covering the period January 1, 1977 through December 31, 1979 (NYC Ex. "13"), and January 4, 1980, covering the period January 1, 1980 through December 31, 1982 (NYC Ex. "14"). Under the agreements, Pinkard had broad powers to act for petitioner, which was virtually an absentee landlord. Pinkard was to advertise the space for rental and find tenants, maintain the building and see to repairs, hire employees, collect rents, make mortgage payments and do virtually everything necessary to operate the building. Under the agreement, petitioner's approval was necessary for certain acts, such as instituting lawsuits and for establishing leasing terms.

All income from the building was to be deposited by Pinkard in a trustee or agency account. Pinkard was to disburse funds for expenses and also for the fees to be paid to itself as managing agent under the contract. If there was a deficit in the account, petitioner was to pay Pinkard the amount of the deficit. The March 10, 1977 agreement provided that surplus funds

were to be remitted to petitioner within five days after petitioner's written request (NYC Ex. "13", p. 4). The January 4, 1980 agreement provided that the balance remaining at the end of each month was to be remitted to petitioner "for its general funds", or at anytime upon five days' notice (NYC Ex. "14", p. 4). All payments, notices, etc. were to be sent to petitioner at the following addresses:

Contract Period	Address
1/1/77 - 12/31/79	c/o Schroder Real Estate One State Street New York, New York 10004
1/1/80 - 12/31/81	10 Cornwall Terrace Regent's Park London, England NWI 4QP

Pinkard's management of the building generally followed the terms of the management contracts. Pinkard submitted an annual budget which, when approved by petitioner, constituted authorization for many expenditures. Pinkard would consult with petitioner with respect to major renovations or capital improvements, or with respect to negotiations of larger leases. Pinkard was free to handle emergency repairs and negotiate smaller leases. All leases, however, were sent to London for execution by petitioner.

Accounting for the Baltimore building was handled by the Baltimore office of Arthur Andersen & Co. Petitioner's financial statements (at least for the fiscal years ending March 31, 1976, 1981 and 1982) were certified by Arthur Anderson & Co.'s London office (NYC Exs. "5" and "6"). Pinkard suggested that petitioner retain another accountant to certify escalation expenses for the Baltimore property, as it would not be cost effective for a large accounting firm to handle such a task. Petitioner approved and a local accountant was retained for that purpose.

Monthly financial statements were sent to Mr. Colin Stubbs, Chief Accounting Officer of British Land, at its London offices.

Pinkard developed a successful strategy for acquiring the fee interest in the land under the Arlington Federal Building. In addition to the fact that the building would be more valuable if the fee interest were acquired, refinancing the building without the fee interest would have

been extremely difficult. Arlington Federal Savings and Loan, which controlled the fee, had merged with Central Savings Bank and the new entity, under the name Central Savings Bank, needed additional office space in the building. Pinkard recommended that petitioner not permit the bank to expand into additional space and also not permit the change of the name of the building from the Arlington Federal Building to the Central Savings Bank Building unless the owner sold the fee interest. This strategy was successful.

The fee interest was acquired by another indirect subsidiary of British Land, British Land (B of C), Inc. ("B of C"). The precise date or cost of the acquisition is not specified in the record, however, petitioner's vice-president, John H. Weston Smith, testified that the transaction took place in approximately 1980 and the cost was "approximately 1.5 to 1.9 million dollars" (NYC Tr. 48). Pinkard's president, Walter D. Pinkard, Jr., recalled that the price was "about 2 million dollars" (NYC Tr. 218).

The value of the Baltimore property increased between 1973 and 1984 for a number of reasons, including:

(a) an improved economic climate in downtown Baltimore, due to the Inner Harbor redevelopment project;

(b) sound management by Pinkard, which resulted in improved occupancy rates;

(c) renovations to the building; and

(d) acquisition of the fee interest by an affiliate.

Sometime after the fee had been acquired by B of C and the building, renamed the Central Savings Bank Building, had been fully rented, petitioner (or British Land) determined that there was a weakening in the Baltimore office rental market and that the property should be sold.

Accordingly, by a contract of sale made as of March 30, 1984 (NYC Ex. "7"), petitioner and B of C agreed to sell their respective interests in the building and the land on which it was located to Lawrence Ruben Company ("Ruben"). Under the terms of the contract, petitioner agreed to transfer its interest to a newly-formed subsidiary, Lexchar, Inc., and B of C agreed to

transfer its interest to a newly-formed subsidiary, Char Holding, Inc. The stock of the new subsidiaries was then to be purchased by Ruben. The purchase price of petitioner's assets was to be $22,000,000.00.[4] The purchase price of B of C's assets was to be $2,200,000.00.

Under the agreement, Lexchar, Inc. and Char Holding, Inc. were to be incorporated under Maryland law not earlier than two days prior to settlement, to engage in no business activity prior to the transfer, and to have no assets or liabilities except as provided for in the contract (NYC Ex. "7", p. 2).

Lexchar, Inc. was incorporated on March 29, 1984 and petitioner's interest in the Central Savings Bank building was transferred to it by a Deed of Assignment dated March 30, 1984, in exchange for the issuance of the stock of said subsidiary. The transfer was subject to total secured indebtedness (principal and interest on the consolidated deed of trust) of $4,264,879.00 (NYC Ex. "C-1", attachment "Deed of Assignment").

On March 30, 1984 Ruben assigned its rights under the contract of sale for the purchase of Lexchar, Inc. stock to Chipaole, Inc., a Maryland corporation (NYC Ex. "C-1", attachment "Assignment and Assumption"). Lexchar, Inc. was to be merged into Chipaole, Inc., whereupon Chipaole, Inc. was to be dissolved and liquidated, and its assets were to be distributed to Lexington Charles Limited Partnership ("Lexington"), a Maryland limited partnership. It appears that Ruben also assigned its rights under the contract to the purchase of Char Holding, Inc. stock to Esile, Inc., a Maryland corporation, and that a similar process was to take place, with Char Holding, Inc. to be merged into Esile, Inc., whereupon Esile, Inc. was to be dissolved and liquidated, and its assets were to be distributed to Baysic Land Limited Partnership ("Baysic").

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[4]The $22,000,000.00 apparently included the sum of $4,242,215.00 then remaining due on the consolidated deed of trust. The contract of sale provides that the purchase price of petitioner's assets was $22,000,000.00 "of which the debt secured by the [deed of trust] shall be a part. The balance of the purchase price shall be paid in federal funds immediately available in New York City" (NYC Ex. "7", p. 4). The deed of trust (referred to as the "mortgage note") appears to have been assumed by the buyer (NYC Ex. "26", note 5 to financial statement). The difference of $22,664.00 between the balance due, as stated in the contract of sale, and the total secured indebtedness, as stated in the deed of assignment (Finding of Fact "19"), is unexplained.

The transaction was structured as a sale of stock in order to minimize real property transfer taxes. Under a cross-indemnification agreement dated March 30, 1984 (NYC Ex. "C-1", attachment "Cross- Indemnification Agreement"), Baysic and Lexington, as buyers, and petitioner and B of C, as sellers, agreed to pay and indemnify each other for closing taxes as follows:

(a) sellers were to pay all conveyancing taxes and buyers were to pay all documentary stamp taxes;

(b) the conveyancing and stamp taxes were agreed to be .025 times the remaining principal balance on the existing mortgage;

(c) buyers agreed to indemnify sellers for 40% of conveyancing taxes on the series of transactions in excess of $85,300.00 and stamp taxes in excess of $21,325.00; and

(d) sellers agreed to indemnify buyers for 60% of conveyancing taxes found to be due on the series of transactions in excess of $85,300.00.

Petitioner made an inducement payment to B of C of $1,250,000.00 "for it to enter into the sale agreement" of March 30, 1984 (NYC Ex. "26", p. 6).

The NWB note (Finding of Fact "4[c]") was paid off from the proceeds of the sale of the Baltimore property (NYC Tr. 96).

The Baltimore property operated at a substantial net loss until at least 1982. The financial statements in the record (NYC Exs. "5" and "6") show the following:

	1975	1976	1981	1982
Rental Income	$1,906,701	$2,009,556	$1,969,460	$2,542,325
Interest, Exchange & Other Income	-	-	222,576	37,711
Cost and Expenses (Including Interest & Depreciation)	2,731,337	2,695,215	3,527,717	4,250,422
Net Loss	(824,636)	(685,659)	(1,335,681)	(1,670,386)
Accumulated Deficit (at End of Year)	(1,370,997)	(2,056,656)	(7,567,895)	(9,238,281)

The financial statements also indicate payments on the "mortgage note" (apparently referring to the debt secured by the consolidated deed of trust) and additional investment in the building,

as well as substantial amounts due to or from petitioner's parent or fellow subsidiaries, and long-term bank loans. No attempt will be made to tabulate said items herein, as the statements of changes in financial position included in the financial statements appear to make inconsistent use of parentheses to signal decreases and/or increases and, consequently, any portrayal of said amounts would be nothing but guesswork.

The deficits incurred for each year necessitated substantial borrowing by petitioner. Petitioner borrowed $590,000.00 from Schroder Bank and also received loans from its own affiliates (NYC Tr. 108). Petitioner's vice-president, John H. Weston Smith, testified that funds to cover the shortfalls would have come from a Bermuda subsidiary of British Land which would have obtained the funds from Australia (NYC Tr. 141). The interest on the intercompany loans was accumulated, rather than paid on a current basis (NYC Tr. 147).

The New York Property

By an agreement made as of February 5, 1982 (NYC Ex. "8"), Carton Realty, Inc. ("Carton"), a New York corporation, as purchaser, contracted to purchase all of the issued and outstanding capital stock of Ninety Broad Street Building Corporation ("Broad Street"), a Delaware corporation, from Stone & Webster, Incorporated ("Stone & Webster"), also a Delaware corporation.

Broad Street was the fee owner of the land and building known as 90 Broad Street, New York, New York, and the adjacent parking lot known by the address 8-12 Stone Street and 27-29 Bridge Street, New York City. The purchase price was $27,600,000.00.

By an assignment dated as of October 1, 1982 (NYC Ex. "9"), Carton, as assignor, assigned to petitioner, as assignee, its rights under the agreement of February 5, 1982. The assignment stated that Carton was "acting in all respects and at all times as the nominee of [petitioner] and its affiliate, The British Land Company Plc."

Under a Loan Agreement dated October 29, 1982 (NYC Ex. "10"), British Land, as borrower, and petitioner, as guarantor, and Standard Chartered Merchant Bank Limited, on behalf of itself and as agent for three other banks, British Land obtained a loan facility of up to

$40,000,000.00. The loan facility was to be used solely to finance petitioner's acquisition of the freehold of the premises at 90 Broad Street and the adjacent 8-12 Stone Street and 27-29 Bridge Street in New York City. The agreement stated that petitioner was to purchase the capital stock of Broad Street which was to be dissolved and the property distributed to petitioner.

Drawings under the agreement were not to exceed $30,000,000.00 with respect to the acquisition. The remaining $10,000,000.00 was to be available for any income deficit and for costs of enhancing the value of the property.

Petitioner made a mortgage dated as of November 5, 1982 (NYC Ex. "11") to Standard Chartered Merchant Bank Limited, acting on behalf of itself and as agent for the other banks, covering the real property at 90 Broad Street, 8-12 Stone Street and 27-29 Bridge Street in New York City. The mortgage secured the $30,000,000.00 loan for the acquisition of the property.

By a guarantee, the date of which is illegible on the copy thereof in the record (NYC Ex. "12") but which appears to be contemporaneous with the loan agreement, petitioner guaranteed the obligations of British Land under said agreement. The guarantee, however, was to be enforced only against the property securing the mortgage and certain rents, issues and profits thereof, as well as certain security deposits and insurance proceeds. It was agreed that no deficiency judgement would be sought or enforced against petitioner "except in respect to funds representing surplus funds relating to the Premises" (NYC Ex. "12", p. 4).

Petitioner's vice-president, John H. Weston Smith, testified that British Land had considered forming a separate corporation to acquire the New York property, but decided against it, as petitioner was considering the sale of the Baltimore property. Mr. Weston Smith stated that this was consistent with British Land's practice in other cases and that, in fact, B of C had owned and sold a California building before acquiring the land on which the Baltimore building was situated.

By an instrument dated as of November 5, 1982 (NYC Ex. "16"), petitioner appointed the real estate management firm of Jones Lang Wootton ("JLW") to act as its special agent for the purpose of executing all leases and other documents related to the leasing of the building

known as 90 Broad Street.

By an agreement made as of February 1, 1985 (NYC Ex. "17"), petitioner appointed JLW as exclusive managing agent and leasing agent for the building. Under the terms of the agreement, JLW was to act for petitioner in almost every respect with regard to the operation of the building, including leasing, maintenance, cleaning, repairs, supervision of tenants and obtaining insurance. Many of JLW's actions on petitioner's behalf, such as entering into maintenance contracts or hiring advertising agencies, required petitioner's prior approval, but some, such as emergency repairs, did not.

JLW was to prepare annual budgets and to establish and maintain books of account and other records. It was to deliver to petitioner a monthly report setting forth detailed statements of collections, disbursements, etc. JLW also was to deliver to petitioner a quarterly list of recommended adjustments to the approved budget, and submit an annual report.

JLW was to maintain "operating accounts" at a New York bank and deposit into said accounts all funds collected by JLW, except for JLW's compensation and also except for security deposits, which were to be held in a separate account.

Within 20 days after the end of each month, JLW was to remit to petitioner all unexpended funds in the operating accounts to the extent that the balance in said accounts exceeded the amount reasonably estimated by JLW as necessary to provide working capital. The funds were to be sent to a bank account designated by petitioner (NYC Tr. 158, 163). For the fiscal year ending March 31, 1984, there was a surplus cash flow (before debt service) of $506,020.00. (NYC Tr. 177; NYC Ex. "19").

While there was no written management contract in effect prior to February 1, 1985, JLW performed essentially the same functions as those set forth in the agreement between November 5, 1982 and the execution of the agreement on February 1, 1985 (NYC Tr. 151). Moreover, the special agency (Finding of Fact "35") was in effect during said period.

JLW implemented and carried out a capital improvement program for the building, including renovation of the windows and modification of the lobby, and also coordinated tenant

construction. JLW would obtain estimates for the work and would then seek approval from petitioner.

Starting in or about 1984, petitioner maintained office space at 90 Broad Street. It was used by petitioner's vice-president, John H. Weston Smith, with respect to management of petitioner's affairs and also to the management of properties of petitioner's affiliates in the United States (NYC Tr. 182). While Mr. Weston Smith frequently travelled to the United Kingdom and throughout the United States, he was available for the majority of the time at 90 Broad Street.

Accounting for the building was handled by the New York office of Arthur Andersen & Co.

Home Office Income and Expenses

Certain "Home Office" or "London" income and expenses were not segregated on the records kept for each of the two buildings by the Baltimore and New York offices of Arthur Andersen & Co. Exhibit "1" and NYC Exs. "29" and "31" each include an analysis which attempts to allocate such items retroactively (NYC Tr. 262).

The Federal Income Tax Returns

On its Federal income tax returns for the fiscal years ending March 31, 1983 and March 31, 1984, petitioner combined its income and deductions for the Baltimore and New York properties. On the fiscal 1983 return, depreciation for the two buildings was shown separately on Section C of Form 4562, as follows:

Building Baltimore		$445,362.00
Building New York (5 months)	259,525.00	
	$704,887.00	

The Federal return for fiscal 1984 shows depreciation on "Buildings" of $1,091,353.00. This figure is broken down on Statement 7 attached to the return, as follows:

90 Broad St.	$ 618,090.00
90 Broad St. - 1982 Add.	4,767.00
90 Broad St. - 1983 Add.	23,134.00
Baltimore Bldg.	445,362.00
	$1,091,353.00

The fiscal 1984 return reported a long term capital gain of $13,023,844.00 on 100 shares of Lexchar, Inc. stock.

The Maryland Corporation Income Tax Returns

Petitioner filed a Maryland corporation income tax return for the fiscal year ending March 31, 1983 (NYC Ex. "D") on which no tax was shown to be due because of negative Federal income. The Maryland apportionment factor, however, was shown as .3559 based on a three-factor formula showing the following:

	Within and Without Maryland	Maryland	Decimal Factor
Total Receipts	4,853,865	2,887,040	.5948
Value of Property	22,963,288	10,856,965	.4728
Wages, Salaries	110,798	-	-0-
Total of Factors		1.0676	
Average of Factors	$\frac{1.0676}{3} = .3559$		

Petitioner's Maryland corporation income tax return for the fiscal year ending March 31, 1984 (NYC Ex. "E") shows petitioner's Federal taxable income of $4,341,444.00 (which includes the gain on the sale of the Lexchar, Inc. stock) and Maryland taxable income of $4,499,105.00. After a deduction of $1,442,750.00 for net rental and other income from real estate or tangible personal property, adjusted business income was $3,056,355.00. This income was apportioned by a Maryland apportionment factor of .540511 computed on the Maryland three factor formula as follows:

	Within and Without Maryland	Maryland	Decimal Factor
Total Receipts	21,007,693	16,313,479	.7765479
Value of Property	42,362,931	12,898,430	.3044744
Wages, Salaries	-	-0-	
Total of Factors		1.081022	
Average of Factors		$\frac{1.081022}{2} = .540511$	

Adjusted business income apportioned to Maryland was $1,651,993.00. Rental and other income from real estate or tangible personal property located in Maryland totalling $556,563.00 was added back, resulting in adjusted income allocated to Maryland of $2,208,556.00. Maryland tax was $154,599.00.

The New York Audit

Petitioner filed a New York State Corporation Franchise Tax Report for the fiscal year ending March 31, 1984[5] on which it reported Federal taxable income (before net operating loss and special deductions) of $12,951,592.00, an addition of $21,076.00 for New York State franchise tax deducted on the Federal return and $2,241.00 for ACRS deductions, resulting in a total of $12,974,909.00. It then subtracted the gain of $13,023,844.00 on the sale of subsidiary capital (the Lexchar, Inc. stock), as well as $112,282.00 for a New York net operating loss and $1,121.00 for allowable New York depreciation, resulting in entire net income of ($162,338.00).

The business allocation percentage reported was 39.95903%, resulting in allocated taxable net income of ($64,869.00). Tax of $6,665.00 was calculated based on allocated capital. A Metropolitan Transportation Business Tax Surcharge Report was also filed for the same year showing a surcharge of $1,133.00.

The New York District Office performed a limited scope audit of petitioner for the fiscal years ending March 31, 1983 through March 31, 1985. The scope was limited to subsidiary capital, business allocation, entire net income and computation of capital. The only audit adjustments at issue herein concern the fiscal year ending March 31, 1984, i.e., the auditor's disallowance of the subtraction of the $13,023,844.00 gain on the sale of petitioner's subsidiary, Lexchar, Inc., which had been subtracted as

a gain on the sale of subsidiary capital. It appeared to the auditor that the subsidiary had been formed for the purpose of circumventing New York State tax liability on the sale of the Baltimore property. The field audit report states:

> "Properly, the basis for transfer of the building from the taxpayer to subsidiary should have been fair market value instead of net book value."

Petitioner's tax for the fiscal year ending March 31, 1984 was recomputed as follows:

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[5]The New York report for fiscal 1983 is not in the record.

"Entire Net Income as Reported Per CT-3	(162338)
Add: Interest to Stockholders*	182587
Add: Profit on Sale of Building Erroneously Deducted from ENI	13023844
Adjusted Entire Net Income	13044093
Adjusted Business Allocation Percentage	64.1395%
Allocated Business Income	8366416
Tax Rate	10%
Audited Tax Due	836642
MTA Tax Surcharge	
Audited Tax Due	836642
MCTD Alloc %	100%
Allocated Tax	836642
Tax Rate	17%
Surcharge Due Per Audit	142229
* Interest paid to stockholders	202874
Less: 10% exclusion	20287
Amount to be added back	182587"

The auditor also noted that, on its report, petitioner had reduced total capital by the $22,000,000.00 selling price of Lexchar, Inc. for the fiscal year ending March 31, 1984, but that no adjustment was being made prorating subsidiary capital to reflect only two days of existence in said year, since petitioner was being placed on the entire net income method.

Petitioner executed two consents extending the period of limitation of the assessment of tax for the fiscal years ending March 31, 1983 and March 31, 1984 to May 31, 1988.

On January 19, 1988, notices of deficiency and statements of audit changes were issued to petitioner as follows:

Period Ended	Tax	Interest	Additional Charge	Total
3/31/84	$829,977.00	$356,652.68	$82,997.70	$1,269,627.38
3/31/84 (Surcharge)	141,096.00	60,630.91	14,109.60	215,836.51

Petitioner has conceded that if the tax is to be calculated on allocated capital, the correct tax (including surcharge) is $73,765.00 (Transcript 18; Exhibit "1").

CONCLUSIONS OF LAW

A. Tax Law § 208.9(a)(1) provides (with certain exceptions not relevant here) that the "entire net income" of a taxpayer shall not include income, gains and losses from subsidiary capital. The Division of Taxation, in disallowing the subtraction of $13,023,844.00 as a gain on

the sale of subsidiary capital, attributed the gain to petitioner, finding that fair market value should have been used for the transfer, not book value. This increased petitioner's entire net income for the fiscal year ending March 31, 1984 by said amount, resulting in recomputation of petitioner's tax on the allocated entire net income method (Tax Law § 210.1[a]) for said year, rather than allocated capital (Tax Law § 210.1[b]), the method which had been used by petitioner.

B. While the disallowance of the deduction was technically correct, courts have required that an otherwise valid assessment must result in a tax which is fair and equitable. In cancelling a deficiency based on the gain on the sale of a Boston office building realized by a taxpayer which also owned a hotel in Buffalo, New York, the Third Department held:

> "While the method of assessment adopted by the Commission[6] may technically come within the framework of the statute and the regulations, it reaches such an unfair and inequitable result on the facts in this particular case that the procedure cannot be justified.
>
> * * *
>
> A franchise tax should bear a reasonable relationship to the privilege granted, and if the assessment is all out of proportion to the amount of business done within this State it is arbitrary and unreasonable. The capital gain on the sale of the Boston office building should not have been included as income. (Hans Rees' Sons v. State of North Carolina, 283 U.S. 123)." (Sheraton Buildings, Inc. v. Tax Commission, 15 AD2d 142, 144, affd 13 NY2d 802.)

C. The relief granted in Sheraton, which is essentially the same relief requested by petitioner, is equitable in nature. In fact, the Sheraton court cancelled the assessment at issue therein based on the "unfair and inequitable result" arrived at by application of the statute and regulations.

It is a well established and ancient maxim that "he who comes into equity must come with clean hands" (30 CJS, Equity, § 93). This principle expresses the fundamental concept underlying equity jurisprudence and means:

> "that equity refuses to lend its aid in any manner to one seeking its

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[6] Effective September 1, 1987, the term "State Tax Commission", as used in this context, was to be deemed to refer to the Division of Taxation or the Commissioner of Taxation and Finance (Tax Law § 2026).

> active interposition who has been guilty of unlawful or inequitable conduct in the matter with relation to which he seeks relief" (id.).

Petitioner has not entered into these proceedings with clean hands. Petitioner substantially reduced its Maryland tax on the gain in issue by including its New York assets and revenues in its Maryland allocation formula (Finding of Fact "47"), while allocating no portion of the gain to New York for the same period. By adopting these inconsistent positions, petitioner has been guilty of, if not unlawful, at least inequitable conduct, and thus is not entitled to the equitable relief sought.

Adding to the complexity of this case, is the fact that there appears to have been some confusion with respect to the taxation of the gain by Maryland. Although both parties claimed that gain was not taxed by Maryland,[7] and in some instances seemed to be speaking in the context of Maryland corporation income tax (Testimony of John H. Weston Smith [Transcript 59], Petitioner's Post-Hearing Memorandum p. 11, Division of Taxation's Brief p. 5, petitioner's Reply Memorandum of Law p. 3 et seq.), it appears that they may have been speaking only with respect to the Maryland transfer taxes. It is noted that the parties did not address the fact that Maryland corporation income tax returns were filed by petitioner. The Maryland return filed by petitioner for its fiscal year ending March 31, 1984, clearly shows that the gain in question (as reduced by the allocation formula) was subjected to Maryland corporation income tax.

D. While the Division of Taxation did not raise the issue in its answer, at the hearing, or in its brief, the clean hands maxim need not be pleaded as a defense. A court may raise the issue sua sponte (55 NY Jur. 2d, Equity § 123). In fact, an appellate court may raise it for the first time on appeal (Muscarella v. Muscarella, 93 AD2d 993).

E. No determination is made herein as to whether the doctrine of equitable estoppel would apply against petitioner. Although the clean hands

doctrine and the doctrine of equitable estoppel (or estoppel in pais) are often used

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[7]It appears that the City of New York Department of Finance also took this position at the hearing involving the New York City General Corporation Tax (NYC Tr. 266).

interchangeably and have been said to be somewhat related and interdependent, the two doctrines represent distinct concepts (see, 30 CJS, Equity, § 94, footnote 95). It is noted that the elements to be proven in equitable estoppel are more complex than the standard of unlawful or inequitable conduct to be applied in determining whether a party has "clean hands". (See also, Quasi-Estoppel or Duty of Consistency, Mertens Law of Fed Income Tax § 60.05. It is also noted, however, that the Federal cases in this area are somewhat distinguishable from the instant case, since in the Federal cases the inconsistent positions were taken with respect to one taxing authority [the Internal Revenue Service] rather than two [Maryland and New York], which was the case here.)

F. Since the determination herein is based on the failure of petitioner to qualify for equitable relief on a threshold basis, no determination is made as to whether the tax imposed would otherwise be invalid under Sheraton, or under United States Supreme Court cases such as Hans Rees' Sons, which is cited therein (Conclusion of Law "B").[8] However, in view of the extensive record in this case, and in recognition of the fact that further proceedings may be had herein, it may be helpful to set forth some of the more pertinent facts which could be relevant under Sheraton, as well as such facts which could distinguish this case from Sheraton.

There clearly are significant facts which would seem to sustain petitioner's argument. From the time of petitioner's acquisition of the Baltimore property in 1973, until November 1982, when it acquired the New York property, petitioner did not conduct business in New York. After petitioner purchased the New York building, each of the two properties was operated independently of the other, with different real estate management firms managing each building and with separate books being kept for each building by different offices of Arthur Andersen & Co. Moreover, the guaranty made by petitioner with respect to the mortgage loan for the New York property was to be enforced only against said property (Finding of Fact "33").

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[8]For the same reason, no determination is made herein with respect to whether this was an appropriate case for a discretionary adjustment under Tax Law § 210.8.

The most significant distinction between this case and Sheraton, is that this case involves substantial intercorporate transfers and other intercorporate transactions between and among British Land affiliates with respect to the two properties, a factor that does not appear to have been present in Sheraton. It was, for example, petitioner's ultimate parent, British Land, which was the borrower under the loan facility used for the acquisition of the New York building. Also, while separate accounts were maintained for each building, the monthly surplus of each was swept from the trustee or operating accounts of the respective buildings and remitted to petitioner in London. What happened to the funds at that point is not clear. It does appear, however, the petitioner's parent organization freely transferred funds and structured transactions between and among the subsidiaries as suited its needs. One example of this is the $1,250,000.00 "inducement payment" made by petitioner to British Land (B of C), Inc. (Finding of Fact "23"). Another is the international transfer of funds to cover deficits incurred by the Baltimore property (Finding of Fact "26").

A second distinction between the instant case and Sheraton, is that the taxpayer in Sheraton paid an excise tax (similar to New York's franchise tax) to Massachusetts on the full amount of the gain, without apportionment. Here, petitioner paid tax to Maryland based on an apportionment formula which reduced the Maryland tax by use of the New York property and revenues.

G. The petition of British Land (Maryland), Inc. is denied and the notices of deficiency dated January 19, 1988 are sustained.

DATED: Troy, New York
10/3/91

ADMINISTRATIVE LAW JUDGE