STATE OF NEW YORK

DIVISION OF TAX APPEALS

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| In the Matter of the Petition | : | |
| of | : | |
| INTERNATIONAL NICKEL, INC. AND INCO ALLOYS INTERNATIONAL, INC. | : | DETERMINATION DTA NO. 810675 |
| for Redetermination of Deficiencies or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1984, 1985 and 1986. | : | |

Petitioners, International Nickel, Inc. and Inco Alloys International, Inc., c/o Inco United States, Inc., One New York Plaza, New York, New York 10004, filed a petition for redetermination of deficiencies or for refund of corporation franchise tax under Article 9-A of the Tax Law for the years 1984, 1985 and 1986.

A hearing was held before Jean Corigliano, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York on October 20, 1993 at 9:15 A.M. Both parties filed briefs. Petitioners filed a reply brief on March 21, 1994 which began the six-month statutory period for issuance of a determination. Petitioners appeared by John J. Fielding, C.P.A. The Division of Taxation appeared by William F. Collins, Esq. (John Michaelson, Esq., of counsel).

ISSUES

I. Whether petitioners properly classified income received from a pension reversion as investment income.

II. Whether, if the income received from the pension reversion is properly classified as business income, petitioners should be allowed toinclude that income in the receipts factor of their business allocation percentage.

III. Whether petitioners have established reasonable cause for abatement of penalties.

FINDINGS OF FACT

Petitioner International Nickel, Inc., a subsidiary of a Canadian corporation, is a Delaware corporation doing business in New York as a trader of non-ferrous metals. Petitioner Inco Alloys International, Inc. is a subsidiary of International Nickel, Inc. For tax years 1984 through 1986, petitioners filed New York corporation franchise tax reports on a combined basis. Petitioners will be referred to from here on as "INCO".

As the result of a field audit, the Division of Taxation ("Division") issued to International Nickel, Inc. four notices of deficiency, dated October 19, 1990, asserting tax deficiencies as follows:

| Period Ended | Corporation Franchise Tax | MTBTS* |
|---|---|---|
| December 31, 1984 | $ 17,960.00 | $1,183.00 |
| December 31, 1985 | 502,395.00 | |
| December 31, 1986 | 10,296.00 | |

* the Metropolitan Transportation Business Tax Surcharge

In addition to deficiencies in tax, the notices asserted interest and additional charges, or penalties.

The deficiencies asserted were adjusted on the faces of the notices of deficiency by crediting certain amounts paid (apparently, during or after the audit) to the total amounts of tax, penalty and interest asserted in the notices. Thus, the balances due are shown as $1,796.00 for the period ended December 31, 1984; $118.00 (MTBTS) for the same period; $134,398.00 for the period ended December 31, 1985; and $1,030.00 for the period ended December 31, 1986. INCO challenged all of the notices of deficiency in its petition; however, the only issued raised by INCO concerns its computation of 1985 income, specifically whether income from a pension reversion was properly treated by INCO as investment income. It is not known whether the amounts asserted for 1984 and 1986 have any relationship to this issue (although it appears that they do not). It is not known whether the entire amount of the 1985 deficiency relates to the pension reversion income.

Prior to 1985, INCO and several other related companies were participants in a defined benefit pension plan known as the INCO Retirement System (the "Pension Plan"). The Pension

Plan was funded entirely by employer contributions. The assets of the Pension Plan were held and managed by a trustee under a trust agreement with INCO's parent corporation; however, the parent corporation's board of directors maintained broad authority over the Pension Plan trust fund. The INCO Retirement System Rules and Regulations contain the following provisions evidencing that authority:

> "7.2 The Board of Directors shall appoint a Funding Committee which shall consist of such number of employees of the Companies as shall from time to time be determined by the Board of Directors. The members of the Funding Committee and their successors shall be appointed from time to time by the Board of Directors and shall have such tenure of office as the Board of Directors shall determine.
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> "7.3 With the advice of the actuary appointed pursuant to Section 7.8, the Funding Committee shall establish a funding policy and method consistent with the objectives of the System and requirements of the Act. The Funding Committee, either directly or through another committee designated under the System, shall cause such policy to be communicated to the person or persons responsible for determining policies in respect of investments of the Trust Fund and, under the funding method and policy then in effect, such Committee shall determine for authorization by the Board of Directors the amount of contributions to be made to the Trust Fund by the Companies to provide Pensions to Employees, Pensioners and their beneficiaries under the System.
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> "7.4 The Companies shall make such contributions to the Trust Fund as may be authorized by the Funding Committee and approved by the Board of Directors.
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> "7.5 All payments made pursuant to this Section 7 shall be paid to the Trustee under the Agreement of Trust and shall become a part of the Trust Fund. The Trust Fund shall be held and disbursed in accordance with the provisions of the System. No person shall have any interest in, or right to, any part of the Trust Fund, except as expressly provided in the System. The Trustee shall have exclusive authority and discretion to manage and control the assets of the System unless the authority to manage, acquire or dispose of such assets is delegated to one or more Investment Managers or Investment Committees pursuant to Section 7.7.
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> "7.6. The Board of Directors may remove the Trustee at any time upon notice as provided in the Trust Agreement, and, in such event or in the event any Trustee shall resign, the Board of Directors shall appoint a successor Trustee.
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> "7.7. The Board of Directors may appoint one or more Investment Managers or Investment Committees to manage, acquire or dispose of all or any portion of the assets of the System; provided that any Investment Manager so appointed shall qualify as such under the terms of the Act; and that the members of any Investment Committee shall be employees of the Companies. If an Investment Manager or Investment Committee shall have been appointed by the Board of Directors, the Trustees shall not invest or otherwise manage any assets of the System which are subject to the management of such Investment Manager or Investment Committee, unless otherwise directed by such Manager or Committee."

The Pension Plan was terminated as of 1985. At the time of termination, the plan was

overfunded, i.e., its assets exceeded its liabilities, and the excess amount reverted to the participating companies which had initially funded the plan. As a result, INCO received income, referred to as a pension reversion, in the amount of $98,855,000.00. It included this amount in its calculation of Federal taxable income and State entire net income for the 1985 tax year.

For purposes of computing and allocating its New York entire net income, INCO treated the pension reversion income as investment income. INCO attached a rider to its 1985 corporation franchise tax report which explains the nature of what it called "Pension Investment Income" as follows:

> "This income is characterized as non-business/non-apportionable income as it is composed of dividends, interest and gains/losses from a pension plan reversion."

INCO broke down total income from the pension reversion into the following categories and amounts: dividends in the amount of $25,138,000.00; U.S. Government interest in the amount of $11,352,000.00; other interest in the amount of $15,073,000.00; and capital gains in the amount of $47,292,000.00. INCO claimed a 50 percent deduction for dividend income pursuant to Tax Law § 208(9)(a)(2). Thus, its total investment income was reported as $86,286,000.00. Its total business income was reported as $7,341,378.00.

New York State allows every corporation to allocate its investment capital and income within and without New York so that corporations are subject to tax only on the portion of their activities attributable to New York. For corporate securities, the investment allocation percentage is calculated by determining the amount of capital employed in New York by the issuing corporations. All government obligations (Federal, State and local) are deemed to have a zero allocation percentage. The issuing corporation's allocation percentage is based on the issuer's allocation percentage, if any, indicated on the New York tax return filed by the issuing corporation. The Division publishes a listing of such percentages which can be obtained directly from the Division.

INCO calculated an investment allocation percentage for 1985 of 1.7966 percent. This was done in the following manner. INCO analyzed the Pension Plan's portfolio for 1983, 1984

and 1985 and, based on its own research, placed a market value on the corporate stock of each issuing corporation in the portfolio. INCO calculated a value for each of the three years in the analysis but used only the 1983 values to determine its 1985 investment allocation percentage. The market value of all corporate securities with a reported New York allocation percentage in 1983 was determined to be $76,442,612.00.[1] Each issuing corporation's allocation percentage was applied to the total value of that corporation's stock to determine the amount to be allocated to New York. This resulted in total market value allocated to New York of $6,010,931.00. Additional securities held by the pension fund were determined to have a market value of $258,134,496.00 and a zero allocation percentage. The allocation percentage was determined by dividing the New York amount ($6,010,931.00) by the total market value of all securities held by the pension fund in 1983 ($334,577,108.00). Thus, INCO treated the pension reversion income as though it was the owner of the underlying securities which produced that income and as if the dividends, interest and capital gains from those securities were received in 1985.

INCO's original contributions to the Pension Plan were treated as ordinary business expenses and deducted from business income. On its 1985 Federal tax return, INCO reported the income from the pension reversion as ordinary income. It reported no dividend income and no capital gain income.

On audit, the Division determined that the entire amount of the pension reversion is properly classified as business income. In addition, the Division disallowed the 50 percent deduction from dividend income claimed by INCO. The Division recalculated INCO's corporation franchise tax liability in accordance with these adjustments. The Division also asserted

additional charges for substantial understatement of the tax required to be reported.

INCO supplied the Division with all information requested on audit and cooperated fully

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[1]The total value of all corporate securities with a New York allocation was $76,442,612.00 in 1983, $79,093,885.00 in 1984 and $32,900,919.00 in 1985.

with the auditors. At the time of the audit, the Division had not promulgated regulations governing the proper treatment of pension reversions. The Division's policy of treating a pension reversion as business income was not disseminated to the public through regulation or any other official document.

CONCLUSIONS OF LAW

A. Under section 401(a)(2) of the Internal Revenue Code ("IRC"), a pension trust is not qualified unless, under the terms of the trust instrument, it is impossible for any part of the trust corpus or income to be diverted to purposes other than the exclusive benefit of the employees or their beneficiaries (see, Treas Reg § 1.401-2). The parties agree that the INCO Retirement System was a qualified pension trust under IRC § 401. Pursuant to IRC § 401(a)(2) an employer is permitted to recover, at the termination of the trust, "any balance remaining in the trust which is due to erroneous actuarial computations during the previous life of the trust" (Treas Reg § 1.401-2[b][1]). The parties agree that the INCO Pension Plan was terminated in 1985 and that INCO received a pension reversion representing the surplus remaining after the satisfaction of all liabilities to employees or their beneficiaries covered by the trust. The question to be resolved here is whether that pension reversion is properly reported as investment income or business income.

B. The New York corporation franchise tax is imposed on the highest of four alternative tax bases (Tax Law § 210[1]). Of the four alternative methods of determining the franchise tax, the method used most often, and the one used by INCO, is based on the corporation's entire net income. A corporation's entire net income is presumed to be the same as entire Federal taxable income, subject, however, to specific statutory additions, subtractions and modifications (Tax Law § 208[9]). To calculate the franchise tax, the corporation is required to divide entire net income into investment income and business income. As used in article 9-A, "'investment income' means income, including capital gains in excess of capital losses, from investment capital, to the extent included in computing entire net income" (Tax Law § 208[6]; emphasis added). "The term 'business income' means entire net income minus investment income" (Tax

Law § 208[8]). In general, investment capital means investments in stocks, bonds and other securities (Tax Law § 208[5]). The taxpayer corporation is allowed a deduction from entire net income of 50 percent of the dividends it receives from nonsubsidiary corporations (Tax Law § 208[9][a][2]).

INCO never directly owned the underlying stocks, bonds or other securities which generated the income which it received in the form of a pension reversion in 1985. INCO did not invest its capital in the stocks, bonds and other securities which generated the Pension Plan income. Since the pension reversion was not income from INCO's investments, it was not investment income to INCO (see, Custom Shop v. Tax Appeals Tribunal, 195 AD2d 702, 600 NYS2d 295). INCO's arguments for treating the pension reversion as investment income are not persuasive.

Because its contributions actually funded the Pension Plan and because its parent corporation controlled the trust which held the Pension Plan assets, INCO argues that it should be allowed to treat the pension reversion as its own investment income. It states:

> "Although the corporation may not have directly owned the investment assets, its parent controlled the investments and managed the fund on behalf of INCO's employees. Since Inco was entitled to the proceeds of the overfunding which was generated by investments in stocks, bonds and other securities, Inco reasonably looked through the asset to determine its character. An analogous situation would be the manner in which a corporate partner is required to look through to the underlying investments in a partnership to determine its investment capital even though the corporate partner and partnership are distinct entities" (Petitioner's brief, p. 7).

In support of this position, INCO cites to section 4-6.5 of the Commissioner's regulations which sets forth "[r]ules relating to allocation by a corporate partner of a partnership." That regulation provides, among other things, that:

> "a taxpayer which is a partner of a partnership must include its proportionate part of the . . . assets and liabilities of the partnership which are used in the computation of investment capital in computing its investment allocation percentage" (20 NYCRR 4-6.5[a][1]).

Petitioner claims that a pension trust, like a partnership, "also has look through attributes" and, therefore, that it was reasonable for INCO "to 'look through' to the investments of the trust in determining how the proceeds of the pension reversion was [sic] allocated" (Petitioner's brief,

pp. 7-8).

The regulation relied on by INCO has no applicability to a pension reversion. As a general matter, an entity classified as a partnership is not subject to the personal income tax under either New York or Federal law. Each partner, however, is taxed separately in his or her individual capacity as a partner carrying on a trade or business. Thus, section 3-13.2 of the Rules and Regulations of the Department of Taxation and Finance provides as follows:

> "**Source and character of partnership items.** Each partnership item of income, capital, gain, loss or deduction has the same source and character in the hands of a partner for article 9-A purposes as it has in its hands for Federal income tax purposes. Where an item is not characterized for Federal income tax purposes or is not required to be taken into account for Federal income tax purposes, the source and character of the item shall be determined as if such item were realized by the partner directly from the source from which realized by the partnership, or incurred by the partner in the same manner as incurred by the partnership" (emphasis added).

If a pension plan trust fund were taxed like a partnership, INCO would have been required to include its share of the assets and income of the pension trust in its calculation of investment capital and investment income during all of the years previous to the Pension Plan's termination. Moreover, INCO would have been liable for Federal and State tax on that income. It was not required to do so because a pension plan trust fund is not treated like a partnership under Article 9-A of the Tax Law. Simply put, there is no legal authority for the "look through" principle INCO employed to calculate its investment income.

C. Article 9-A of the Tax Law provides for the separate allocations of business income and business capital, investment income and investment capital and subsidiary capital, within and without New York State (20 NYCRR 4-1.1). The taxpayer's business allocation percentage generally is calculated on the basis of a three-factor formula, consisting of: (1) real and tangible personal property within and without New York; (2) business receipts within and without New York; and (3) payroll within and without New York (Tax Law § 210[3][a]). A taxpayer's receipts include those from the sale of tangible personal property where shipment is made to points in New York, the performance of services within New York (with certain qualifications), rentals from New York property, royalties from the use of patents and copyrights within New York and all other business receipts earned within New York (Tax Law § 210[3][a]).

INCO argues that if the pension reversion is business income, then it should be included in the business receipts factor of its business allocation percentage. The Division defines business receipts as the "gross income received in the regular course of the taxpayer's business, provided such receipts are includible in the computation of the taxpayer's entire net income for the taxable year" (20 NYCRR 4-4.1[a]). Under this definition, the pension reversion would not be includable in business receipts since it was not received in the ordinary course of business. INCO offers no challenge to this regulation; rather, it argues that the pension reversion should be included in the business receipts factor in order to avoid distortion of New York income (Tax Law § 210[8]). INCO offers no basis for its claim that failure to include the pension reversion in business receipts will distort the calculation of entire net income, but it seems to presume that a one-time receipt of income in such a large amount shows distortion. I cannot agree. The receipt of the pension reversion may have been anomalous, but this in itself does not establish distortion in the year in which it was received.

D. Finally, INCO contends that the penalties imposed for substantial understatement of tax due (Tax Law § 1085[k]) should be abated. Section 1085(k) provides, in pertinent part, as follows:

> "The amount of such understatement [subject to additional charges] 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."

INCO is unable to cite any legal authority to support its treatment of the pension reversion. The "look through" theory it employed has no basis in statute or regulation, and there is no conceivable principle in the corporation franchise tax law which would justify INCO's use of such a theory. INCO has pointed to none. Under these circumstances, its claim that it "had substantial authority for the position taken" (Petitioner's brief, p. 9) is meritless.

INCO also alleges that:

"[d]istortion would have arisen if the pension reversion was treated as business

> capital and income and allocated by the business allocation percentage [and, therefore,] that INCO's interpretation that the pension reversion was investment capital is not without merit" (Petitioner's brief, p. 9).

INCO has not established that treating the pension reversion as business income results in distortion of its New York income. INCO's real point seems to be that categorizing the pension reversion as business income results in a larger tax liability than results from treating it as investment income. This does not lend authority to INCO's position or establish that the position was taken in good faith.

Finally, petitioner's return did not adequately disclose the relevant facts affecting the treatment of the pension reversion. The return showed that the pension reversion was categorized as investment income and, on a rider to its corporation franchise tax report, INCO stated that the pension investment income it received "is characterized as non-business/non-apportionable income as it is composed of dividends, interest and gains/losses from a pension reversion plan." All of this is a conclusory statement of INCO's position. It does not reveal the relevant facts or legal authority supporting that position. In addition, petitioners have not shown that there was a reasonable basis for treating the pension reversion as investment income. Under these circumstances, a finding that there was adequate disclosure meriting cancellation of penalties would merely invite abuse (compare, IRC § 6662[d][2][B][ii]).

E. The petition of International Nickel, Inc. and Inco Alloys International, Inc. is denied and the notices of deficiency issued on October 19, 1990 are sustained.

DATED: Troy, New York
August 11, 1994

/s/ Jean Corigliano
ADMINISTRATIVE LAW JUDGE