STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :

of :

CMRC, LTD. : DETERMINATION DTA NO. 820282

:

for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1999 through 2002. :

Petitioner, CMRC, Ltd., c/o D'Arcangelo & Co., LLP, 3000 Westchester Avenue, Purchase, New York 10577, 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 1999 through 2002.

On September 6, 2005, petitioner, appearing by D'Arcangelo & Co., LLP (Margaret Warner, CPA), and the Division of Taxation by Mark F. Volk, Esq. (Nicholas A. Behuniak, Esq., of counsel) consented to have the instant controversy determined on submission without hearing. Documentary evidence was submitted by the Division of Taxation on October 27, 2005. Petitioner, appearing by Hodgson Russ, LLP (Christopher L. Doyle and Mark S. Klein, Esqs., of counsel) submitted its brief on January 30, 2006. The Division of Taxation by Mark F. Volk, Esq. (Nicholas A. Behuniak, Esq., of counsel) submitted its brief on April 3, 2006 and petitioner filed its reply brief on May 3, 2006 which date commenced the six-month period for the issuance of this determination. After review of the entire record, Catherine M. Bennett, Administrative Law Judge, renders the following determination.

ISSUE

Whether trust distributions from a charitable remainder unitrust to petitioner, a Subchapter S corporation, should be apportioned to New York using petitioner's investment allocation percentage, or whether the trust's distributions to petitioner should be apportioned to New York using petitioner's business allocation percentage.

FINDINGS OF FACT

The parties have stipulated and agreed that, for purposes of this action, twenty-one statements shall be accepted as facts, as modified by amendment to stipulation of facts dated January 24, 2006 and January 25, 2006, and are incorporated in the Findings of Fact presented below. Additional Proposed Findings of Fact offered by petitioner are addressed below, and where accepted, are incorporated into the findings herein. Disposition of the remaining Proposed Findings of Fact is addressed at Finding of Fact 19. All references to exhibits have been deleted.

1. Petitioner, CMRC, Ltd., a company created under the laws of the State of New York and authorized to do business in the State since 1980, is designated as a Sub-Chapter S corporation for both New York State and Federal tax filing purposes. Petitioner's primary business was the rental of commercial real estate.

2. From 1980 through August 1998, petitioner was the sole owner of certain real property located within the State of New York ("the building"), and during that same time period, petitioner utilized the building as business capital in its regular and ongoing business operations.

3. In August 1998, petitioner transferred title of the building to a charitable remainder unitrust ("the trust"). The building was the only asset ever transferred to the trust.

4. Petitioner is the sole beneficiary of the trust. According to the terms of the trust, every year for 20 years, the trust is required to make annual distributions to the beneficiary (petitioner) of 11.6% of the fair market value of the assets of the trust. At the end of the 20-year term of the trust, the trust is to distribute its remaining assets to a qualified charity.

5. Petitioner, in consultation with its legal counsel, formed the trust to satisfy charitable and Federal tax objectives. As a result of the creation of the trust and subsequent transfer, petitioner received a charitable deduction of $1,470,225.02, for the present value of the remainder interest in the trust, which was passed through to petitioner's four shareholders. Pursuant to the terms of the trust, established under Internal Revenue Code § 664(d)(2),

petitioner had the right to receive 11.6% of the net fair market value of the assets of the trust valued annually.

6. Petitioner's basis in the building at the time of transfer was $275,317.00, which became the basis for the building in the trust. On December 4, 1998, the trust sold the building for a gain of approximately $13,219,818.00. The gain was recorded on the trust's records, however, because of the status of the trust, the gain was not taxable to the trust.

7. During the tax years 1998 through 2002, the tax years in issue, the trust invested various portions of the cash proceeds from the sale of the building in a portfolio of stocks and bonds. During the same period, the trust made annual distributions to petitioner as required by the terms of the trust agreement, all of which are reflected on the relevant K-1 forms. These distributions to petitioner were derived from the dividends and interest earned on the trust's investments throughout the year.

8. When determining the tax consequences of the trust's distributions, petitioner sought the professional judgement and advice of D'Arcangelo & Co., LLP. D'Arcangelo is a large accounting and financial firm that employs approximately 100 professionals throughout five New York State offices. The firm maintained a longstanding relationship with petitioner, during which time it provided tax advice.

9. As part of its preparations in connection with petitioner's 1999 New York Form CT-3S, D'Arcangelo investigated the appropriate New York State tax treatment of the trust's distributions. D'Arcangelo determined that the trust's post-1998 distributions to petitioner should be treated as investment income by petitioner because the trust's underlying assets were comprised almost exclusively of stocks and bonds. Due to the clear nature of the trust's assets, D'Arcangelo did not feel that its conclusion was risky or unsupported by the Tax Law. Furthermore, D'Arcangelo was unable to locate any precedent that was contrary to its position. D'Arcangelo did not present its position as something that could potentially lead to future tax liability.

10. For the years at issue, the trust's trustee provided all relevant information and documentation concerning the trust, its assets and distributions to D'Arcangelo.

11. With regard to the annual distributions made from the Trust to petitioner during the years in issue, petitioner applied investment allocation percentages of 2.7898% in 1999, 0.8670% in 2000, 0.83300% in 2001, and 0.08923% in 2002, respectively, to the annual distributions in determining its taxable income.

12. Petitioner's New York State business allocation percentage was 100% during the years in issue.

13. The Division of Taxation ("Division") conducted a field audit of petitioner's books and records for the years at issue. As a result of the audit, the Division adjusted petitioner's tax liability for the years at issue by applying petitioner's business allocation factor to the annual distributions received by petitioner from the trust.

14. The Division issued Notice of Deficiency L023271889, as result of the adjustment noted in Finding of Fact "13," and asserted additional tax due in the amount of $41,980.00 plus interest and penalty.

15. If trust distributions to petitioner should be apportioned to New York using petitioner's allocation percentages, this method will also take into account the issuer's allocation percentage of the securities held by the Trust.

16. If it is determined appropriate to apply petitioner's investment allocation percentage to the distributions received by petitioner from the Trust, the Division's assessment should be cancelled in its entirety. If it is determined appropriate to apply petitioner's business allocation percentage to the distributions received by petitioner from the Trust, the parties agree that the tax portion of the assessment ($41,980.00) plus interest thereon should be accepted and upheld in their entirety.

17. Petitioner worked cordially with the Division during the audit and provided the Division with all requested information.

18. The Division assessed penalties against petitioner pursuant to §§ 1085(b)(1), 1085(b)(2) and 1085(k) of the Tax Law. The Division of Tax Appeals shall determine whether penalties should be upheld in this matter.

19. The numbered proposed Findings of Fact offered by petitioner were handled in the following manner:

a. Accepted and incorporated above: Proposed Finding 22.

b. Proposed Finding 23 was rejected as an inaccurate or misleading statement. The taxation of trust income in New York is governed by Article 22 of the Tax Law, which does not characterize trust income as "investment capital." Concerning the use of the term "investment capital" in New York Tax Law, it is a term of art in the computation of Franchise Tax on Business Corporations pursuant to Article 9-A of the Tax Law.

c. Proposed Finding 24 is modified for accuracy. Referring to b. above, the term "investment capital" is inaccurate and misleading as used in relation to the trust's income. The distributions were made from the interest and dividends earned on the trust's stocks and bonds, or overall investments.

d. Proposed Finding 27 is modified to eliminate the word "competent," since the record only references the amount of time tax advice was rendered, and not whether it was competent.

e. Proposed Finding 28 is accepted, but it is noted that the acceptance of this fact is by inference, based upon Ms. Warner's position as trustee and her independent contractor status with D'Arcangelo & Co.

f. Proposed Finding 29 is modified to eliminate the portion not established by the record. There is no evidence that the creation of the Trust structure was not motivated by a desire to avoid New York State taxes.

g. Proposed Finding 33 is modified to reflect the statement actually provided by affidavit referring to petitioner's cooperation with the Division.

SUMMARY OF THE PARTIES' POSITIONS

20. Petitioner maintains that the trust distributions to petitioner should be apportioned to New York using petitioner's investment allocation percentage rather than petitioner's business allocation percentage. Petitioner contends that the Division is precluded from applying Internal Revenue Code § 664(b), which characterizes distributions from, among other types, a charitable remainder unitrust, in the hands of the beneficiary to whom the annuity is paid, when New York

Tax Law requires that the trust's distributions be treated as investment income to petitioner. Petitioner further argues that the Division's use of IRC § 664(b) represents an arbitrary and capricious action by the Division, and its application violates petitioner's rights under the State and Federal Constitutions. Lastly, petitioner asserts penalties against it should be cancelled since petitioner acted in good faith and maintained a reasonable interpretation of the Tax Law.

21. The Division maintains the distributions from the trust should be apportioned to New York using petitioner's business allocation percentage, since the transfer of the building to the trust and its subsequent sale did not alter the character of the distributions to petitioner from the proceeds of its business capital. The Division argues that the penalties imposed upon petitioner in this matter should be upheld since petitioner has not shown there was substantial authority for its position and other such mitigating factors.

CONCLUSIONS OF LAW

A. New York State imposes an annual tax on all corporations for the privilege of exercising a corporate franchise, doing business, employing capital, owning or leasing property or maintaining an office in the State (Tax Law § 209). The tax is usually based upon a taxpayer's "entire net income," which is generally the same as the taxpayer's Federal taxable income with certain modifications, less income from investments in subsidiary corporations (Tax Law §§ 208[9]; 209). Once entire net income is determined, it is separated into "investment income," which is income limited to income from investment capital, i.e., investments in stocks, bonds and other securities, and "business income." Business income is entire net income less investment income (Tax Law § 208[5], [6], [8]). Business capital, also defined by the Tax Law in residual terms, is "all assets, other than subsidiary capital, investment capital and stock issued by the taxpayer, less liabilities not deducted from subsidiary or investment capital except that cash on hand and on deposit shall be treated as investment capital or as business capital as the taxpayer may elect" (Tax Law § 208[7]). Business capital includes those items generally considered assets of a corporation, i.e., accounts receivable, inventories, and interests in property (real and personal) held by the corporation (Pub. 452, NYTAX § 26.44).

The portion of a taxpayer's business income allocable to New York State is determined by multiplying the taxpayer's total business income by its “business allocation percentage” (“BAP”) (Tax Law § 210.3[a]; Reg. § 3-2.1). The BAP represents the arithmetic average of the ratios of the taxpayer's receipts, payroll and property values within New York State to those of the corporate taxpayer as a whole. A corporate taxpayer's investment income, in contrast, is allocated to New York State by multiplying the taxpayer's total investment income by its “investment allocation percentage” (“IAP”) (Tax Law § 210.3[b]). Unlike the taxpayer's BAP, which reflects the taxpayer's own activities in the State, the taxpayer's IAP reflects the degree of New York State presence of the issuers of the securities in which the taxpayer has invested (i.e., the corporations which have generated the taxpayer's investment income). The results of the allocated income computations are then added together to produce New York’s share of entire net income (Tax Law § 210.3[c]).

B. Prior to the creation of the trust, petitioner in this case, a Subchapter S corporation operating as a real estate rental company of commercial property, owned a piece of commercial rental property. The parties do not dispute that the property was “business capital” as that term is defined by New York Tax Law § 208(7). The dispute arises after the transfer of the property to a charitable remainder unitrust and concerns whether distributions from the trust, which subsequently sold the property, generating income from stocks and bonds, should now be classified as investment capital and no longer business capital.

The first question to address is what effect the transfer of the property to the trust has on the characterization of the asset as to petitioner’s company. Very simply, what petitioner did was dispose of and transfer the property in exchange for the charitable deduction to which it was entitled and an annuity receivable for 20 years, i.e. the right to receive the annual payments pursuant to the trust agreement. On petitioner’s books, the annuity receivable was the asset remaining from such transfer. There is no conversion of business capital to investment capital by virtue of such transfer, but rather the conversion of business capital from the form of real estate to the annuity receivable. An annuity receivable, or similar future right to receive income, is not included in the definition of “investment capital” (Regs. Sec. 3-3.2[a][1]), and is therefore business capital. Accordingly, up to and including the point of transfer into the trust, the asset classification did not take on a different form.

C. The next question is what effect, if any, does the sale of the building by the trust have on the characterization of the proceeds from such sale, and the ensuing distributions. But for the fact that the building may have needed to be sold to produce sufficient funds to meet the trust distribution mandates, it is not relevant that the trust sold the building. Selling the business capital within the trust did not change the character of the distributions to petitioner. The Division correctly claims that the creation of the trust pursuant to IRC § 664(d)(2) requires us to refer to § 664(b) which governs the character of distributions from the trust. The tax character of the amounts received by petitioner is determined by their source (CCH-EXP, Tax Research Consultant, ESTGIFT: 45210, *Tax Character of Charitable Annuity Trust or Unitrust Amounts*), that source being the disposition by petitioner of the building by its transfer to the trust. But for the creation of the trust funded by petitioner's business capital, the distributions would not have existed. The distributions, recorded as annuity income, akin to installment income from the sale of an asset, act to reduce the receivable, a business asset. Since New York entire net income begins with Federal taxable income, we cannot ignore that Federal taxable income in this case contains items that have a character defined by Federal law. Petitioner is correct that IRC § 664(b) does not distinguish between business income, investment income and subsidiary income. Such is not necessary to resolve the issue. What is received at the corporate level are trust distributions resulting from the disposition of a business asset, not income from petitioner's investments. The annuity in this case, from which the trust distributions in question are made, is funded from the investment of the proceeds, and substantial gain, from the sale of the real estate transferred to the trust by petitioner. Petitioner argues that since the trust distributions are generated from investments, the distributions should be deemed investment capital to petitioner and allocated to New York on the basis of its investment allocation percentage, a much lower percentage than petitioner's business allocation percentage of 100%. The flaw in this reasoning is that the investments held by the trust after the sale of the building are not the investments of the corporate petitioner, and the character of the income from the trust investments does not become investment income to petitioner. The asset in the hands of petitioner is the annuity receivable, which character remains unchanged as business capital. Petitioner has not carried its burden of showing that there exists some vehicle to convert the business capital to investment capital under these circumstances (Tax Law § 1089[e]).

Accordingly, the Division properly adjusted petitioner's tax liability for the years in issue by applying petitioner's business allocation factor to the annual distributions received by petitioner from the trust.

D. Petitioner next makes reference to its due process rights under the State and Federal Constitutions being violated by the Division's application of IRC § 664(b). Petitioner by its own design created a trust with significant tax benefits in accordance with IRC § 664. Other provisions of IRC § 664 are referred to throughout the trust agreement. It is well settled that Federal law, rules and regulations determine the amount of entire net income for state tax purposes, except and to the extent that they have been changed by express provision of the state statutes. The Federal determination, unless and until shown to be erroneous, furnishes the base for the computation of the state tax under Article 9-A (***People ex rel. Conway v. Lynch***, 258 NY 245; ***Ebling Co. v. Graves***, 259 AD 427, ***aff'd*** 284 NY 689). Petitioner does not dispute that Federal taxable income is the starting point, and by its very nature that would include Federal laws, rules and regulations. To now argue that its due process rights have been violated because IRC § 664 is not expressly incorporated into the New York Tax Law is completely devoid of reason. Petitioner has not carried its burden of proof as to how the application of a Federal provision it used itself in the same transaction which is the basis for this dispute has deprived petitioner of its due process rights.

E. The Division imposes penalties against petitioner pursuant to §§ 1085(b)(1), 1085(b)(2) and 1085(k) of the Tax Law. The penalties pursuant to §§ 1085(b)(1) and 1085(b)(2) may be waived if it is determined that the deficiency was not due to negligence or intentional disregard of, in this case, the Article 9-A rules and regulations. The only affidavit provided in this case is that of a CPA who worked as an independent contractor with D'Arcangelo, the advising CPA firm, and trustee of the trust in issue. Her statements alone do not establish that the actions of petitioner herein were not due to negligence or intentional disregard of the Tax Law. Further, there is nothing additional in the record which establishes the absence of neglect or intentional disregard. In fact, if anything, it appears to be an aggressive scheme to avoid New York State taxes.

The Division also imposed penalties pursuant to Tax Law § 1085(k) for a substantial understatement of tax for the years in issue. Even if there is a substantial understatement of tax, former section 1085(k) provides that 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 Division "may waive all or any part of the addition to tax . . . on a showing by [petitioner] that there was reasonable cause for the understatement . . . and that the taxpayer acted in good faith" (Tax Law § 1085[k]).

There is no statement on the return or statement attached to the return that would represent the kind of disclosure contemplated by former section 1085(k) in order to reduce the penalty. Petitioner has also cited no case law, ruling, regulation or made reference to any other document that would represent substantial authority for the treatment it adopted on its return concerning the taxation of the trust distributions. In fact, petitioner attempts to turn its back on the Federal law that it used to create the trust which produced significant tax benefits as though the law did not exist.

Petitioner maintains that penalties should be waived based on a showing of "reasonable cause" and "good faith" by petitioner. Petitioner contends that its reporting of the trust distributions was a reasonable interpretation of an unsettled section of the Tax Law, and that petitioner relied in good faith upon the advice of a tax professional. I do not doubt that petitioner was provided some form of tax advice of expert tax professionals. The record does not establish from petitioner what this advice was, nor how petitioner utilized it. It was only referenced by the trustee of the trust. Furthermore, the record is devoid of any evidence of petitioner's "efforts to ascertain the proper tax liability," or "an honest misunderstanding of fact or law that is reasonable in light of the experience, knowledge and education of the taxpayer." The key elements of reasonable cause and good faith are not at all present in this case (***see***, 20 NYCRR 2392.1[g]). Although the independent CPA provided an affidavit concerning some of the aspects of the professional advice, no other evidence was presented by petitioner concerning the circumstances surrounding the preparation of the tax returns or other facts that might support a finding of reasonable cause and good faith. The affidavit alone was sorely lacking. Lastly, the submission of this matter without a hearing does not excuse petitioner from presenting such evidence, and without it the burden simply is not carried.

F. The petition of CMRC, Ltd. is denied, and Notice of Deficiency L023271889, dated December 1, 2003, plus penalties and interest, is sustained.

DATED: Troy, New York
November 2, 2006

/s/ Catherine M. Bennett
ADMINISTRATIVE LAW JUDGE