STATE OF NEW YORK

DIVISION OF TAX APPEALS

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

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Petitioner, Interaudi Bank f/k/a/ Bank Audi (USA), filed a petition for redetermination of a deficiency or for refund of franchise tax on banking corporations under Article 32 of the Tax Law for the years 1997, 1998 and 1999.

A hearing was commenced before Frank W. Barrie, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on January 29, 2008 at 10:30 A.M., continued at the same location on January 30, 2008 at 9:15 A.M. and March 31, 2008 at 10:30 A.M., and continued to conclusion at the same location on April 22, 2008 at 9:15 A.M., with all briefs to be submitted by January 23, 2009, which date began the six-month period for the issuance of this determination. Upon the retirement of the administrative law judge from state service, this matter was reassigned to Andrew F. Marchese, Chief Administrative Law Judge, pursuant to the authority of section 3000.15(f) of the Rules of Practice and Procedure of the Tax Appeals Tribunal (20 NYCRR 3000.15[f]). The due date for the issuance of the determination was extended for an additional three month period pursuant to the authority of section 3000.15(e)(1) of the Rules of Practice and Procedure of the Tax Appeals Tribunal (20 NYCRR 3000.15[e][1]).

Petitioner appeared by Brian E. Gledhill, Esq. The Division of Taxation appeared by Daniel Smirlock, Esq. (Nicholas A. Behuniak, Esq., of counsel).

***ISSUES***

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

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

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

***FINDINGS OF FACT***

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

East. Petitioner also provides foreign exchange facilities and letter of credit services to its customers. Petitioner's clients are relatively limited in number but extremely diversified by location, mostly residing throughout North and South America, but also in Europe and the Middle East.

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

3. Prior to the creation of its investments subsidiary, petitioner's investment securities had been held in a custodial account that was maintained at Manufacturer's Hanover Trust Company and managed by Mr. J.B. Chandler, senior vice president and treasurer of petitioner, under the investment policies established by petitioner's investment committee and board of directors. As a result of a series of bank acquisitions and mergers, Chase Manhattan Bank became custodian of the account. By 1997, petitioner's senior management perceived that this series of bank mergers had resulted in a deterioration in the quality of the custodial services provided to petitioner. It was perceived that necessary account information was not being furnished in a timely manner and that there was no one contact at Chase to whom petitioner's management could consistently go for information and for resolution of problems.

Petitioner's management resolved to find a solution to its custody issues and, after investigating several alternatives, decided to form an investment holding subsidiary in the State of Delaware. In advising the New York State Banking Department of its decision, Mr. Louis R.

Cina, first senior vice president of petitioner, stated, “The purpose of this subsidiary is to segregate the investment portfolio (approximately $100MM) for control purposes and for tax planning.” Petitioner selected Delaware Trust Capital Management, Inc. (DTCM) as the custodian for its investment portfolio. DTCM was a subsidiary of Delaware Trust Company which was itself a subsidiary of CoreStates Bank. DTCM was also the parent of Griffin Corporate Services, Inc.

4. In addition to solving custody issues, petitioner’s management was exploring tax planning opportunities. In a nine-page letter to Mr. Cina dated October 9 1997, Michael H. Goldsmith of Arthur Andersen LLP, petitioner’s accountants, states:

> As discussed, we are writing to provide you with background on the formation and maintenance of a passive investment company in Delaware as a mechanism to reduce state and local taxes.
>
> * * *
>
> The primary advantage to be realized from a passive investment company is the freeing of income streams from onerous state and local tax burdens. Based on the Bank’s 1997 projected book income, we estimate that the potential annual state and local tax savings may be in excess of $750,000 (see attached calculations and assumptions).
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> * * *
>
> A DHC [Delaware Holding Company], while a useful mechanism to reduce the state tax burden of a corporation, can be subject to attack by state taxing authorities. Generally, state taxing authorities from states other than Delaware have utilized the following four lines of attack in an attempt to tax the income of a DHC:
>
> 1. Determine that the DHC has no substance in Delaware, so that it can be taxed in full in the state of commercial domicile of the parent.
>
> 2. Determine that the DHC is doing business in another state even though it may have substance in Delaware. In this case, the DHC should have the right to apportion its income.

> 3. Reallocate items of income and expenses between the DHC and its affiliates to reflect an arms-length arrangement, similar to the power of the Internal Revenue Service under IRC § 482.
>
> 4. Require a combined return in the case of states that allow or require combined or unitary reporting.
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> * * *
>
> In states that require or allow the filing of a combined or unitary return, it is probable that the fourth line of attack may be used to force combination of the DHC with the other entities. If so, the benefit of the DHC in those states will be lost, as the state will look to the combined income and apportionment of the group to determine the proper tax liability, and any benefit derived through intercorporate transactions will be eliminated.
>
> The New York Department of Finance has been extremely aggressive in its attempts to force the combination of operating and holding companies. To do so, the Department relies on ownership, unitary and distortion requirements to assert that a combined return is required to appropriately reflect New York income. However, based on our experience and New York case law, the State is willing to negotiate these cases at the audit and administrative levels. In such cases, we are often able to secure favorable settlements under which all tax benefits of a DHC are not lost.

5. BA (USA) Investment, Inc. (BA Investments) was incorporated by petitioner on December 16, 1997 under the laws of the State of Delaware as an investment holding company by the filing of a Certificate of Incorporation with the Delaware Secretary of State with the stated purpose of "management and maintenance of its intangible investments and the collection and distribution of the income from such investments or from tangible property physically located outside Delaware . . . ." BA Investments was formed by petitioner under the provisions of section 351 of the Internal Revenue Code. Petitioner contributed qualifying section 351 property to BA Investments in the form of approximately $98 million worth of investment securities plus a small amount of cash and received in return 100 percent of BA Investment's newly-issued common stock. During the entire audit period, BA Investments limited its activities to

management and maintenance of marketable, investment grade securities. At no time during the audit period did BA Investments invest in tangible property or in any form of intellectual property, including trade names, trademarks, copyrights or patents or engage in any licensing of such intellectual property.

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

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

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

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

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

8. BA Investments established a three-member investment committee pursuant to the provisions of its by-laws. The investment committee met monthly. During the audit period, Mr. Chandler and Ms. Dobrznski were members of the investment committee. The third member was Ronald Bradten, a DTCM professional economist who resigned after approximately one year. He was replaced by Dung Vukhac, also a professional economist and senior vice president with DTCM. The actions of the investment committee were reviewed at the quarterly meetings of the board of directors.

During the audit period, BA Investments limited its investments to marketable securities such as U.S. Treasury securities, including bills, notes and bonds; U.S. government agency obligations; mortgage backed securities such as GNMA's and FNMA's; corporate bonds rated investment grade or better; and tax exempt municipal bonds. In addition, BA Investments maintained an interest-bearing money market account through DTCM at CoreStates Bank and its successor, First Union Bank. The money market account was used as a sweep account for the income-producing securities. That is, all interest earned from the securities was deposited into the money market account. Similarly, when securities matured or were paid down prior to maturity, the proceeds were deposited into the money market account. Petitioner's witnesses testified that during the audit period, BA Investments engaged in few if any trades in its investment account. In fact, there is no evidence in the record of any such transactions.

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

10. In February of 2001, the Division of Taxation commenced an audit of petitioner, which, after a series of consents extending the period for assessment of franchise tax, ultimately resulted in the issuance of a Notice of Deficiency dated March 10, 2005 against petitioner. The Notice of Deficiency assessed tax in the amount of $1,070,389.00, interest in the amount of $530,888.77 and penalty in the amount of $101,714.00 for a total of $1,702,991.77. The assessment was based upon a finding that the transfer of the investment portfolio from petitioner to BA Investments was a distortive arrangement. The auditors determined that BA Investments' income in 1998 represented approximately 81% of the total income of petitioner's federal consolidated group. In 1999, BA Investments' income represented approximately 98% of the total income of the consolidated group. The auditors also determined that BA Investments' expenses were less than one percent of its income in both 1998 and 1999, while petitioner's expenses, as reported on its New York return, increased from 81.2% of its income in 1997 (pre-transfer) to 96.1% in 1999 (post-transfer). The auditors concluded that petitioner was managing

the portfolio, not BA Investments, that the portfolio was an integral part of petitioner's capital requirements and that petitioner was incurring the costs of the portfolio instead of BA Investments. The auditors concluded that inclusion of BA Investments in petitioner's combined report was necessary to cure the asserted distortion. In addition, an adjustment was made to petitioner's deposits factor related to interest income arising from International Banking Facility (IBF) lending to the New York branch. Penalty was imposed pursuant to the provisions of Tax Law § 1085(k) for substantial understatement of liability.

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

12. Next, a petition was filed with the Division of Tax Appeals on April 13, 2007 contesting the Notice of Deficiency as modified at BCMS. The petition alleged that the Notice of Deficiency was erroneous in that it was based upon a bank tax computation that combined the income and other tax attributes of a nontaxpayer (BA Investments) with the income and other tax attributes of petitioner in computing petitioner's New York State bank tax for the years 1997 through 1999. In addition, the petition alleges that the conciliation order errs in sustaining the penalty imposed on petitioner because the Division of Taxation has never articulated a rationale for the imposition of penalty and because there exists reasonable cause based upon the good-faith filing by petitioner of its bank tax returns consistent with the requirements of the Tax Law and consistent with the decision in the ***Matter of U.S. Trust Corporation*** (Tax Appeals Tribunal, April 11, 1996 ). Finally, the petition alleges that the conciliation order is unlawful under the nondiscrimination requirement of the Commerce Clause of the Federal Constitution in that it

treats BA Investments, a corporation that was formed under the laws of, and operating in, a foreign state, less favorably than an alien corporation operating within New York State that is conducting identical business activities, but which was formed under the laws of a foreign nation, and by virtue of that fact is neither combinable under 20 NYCRR 21-2.1(c) nor subject to bank tax under Tax Law § 1452(g).

13. At hearing, the Division of Taxation called as an expert witness Professor Anthony Saunders who is currently a Professor of Finance at the Stern School of Business of New York University. He earned his Bachelors, Masters and Ph.D. degrees from the London School of Economics. In addition, he is on the nomination committee for the Nobel Prize in Economics, on the investment advisory board of Zurich Financial Services and is a research advisor at the FDIC Center for Financial Research. Professor Saunders also holds visiting positions with the Comptroller of the Currency, the International Monetary Fund, the Federal Reserve Board of Governors and the Federal Reserve Banks of Philadelphia and New York. Professor Saunders was accepted by the Administrative Law Judge as an expert witness in the areas of banking and finance, financial economics, international banking, general economics, financial institution portfolio risk analysis, the regulation of financial institutions, financial institutions operation and management, and financial institution investment portfolio management.

Professor Saunders's testimony may be summarized as follows:

- The creation of BA Investments was not driven by business purposes, such as improved investment portfolio management at a lower cost to petitioner or a reduction in petitioner's regulatory capital costs.
- The creation and continuing arrangement with BA Investments increased petitioner's liquidity risk and interest rate risk exposures.

- The creation and arrangement with BA Investments increased petitioner's costs and caused petitioner's financial position to be inaccurately reported because of the mismatching of income and expenses on the passive investments.
- The only economic explanation for BA Investments' existence is state and local tax purposes.

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

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

15. As a New York commercial bank, petitioner is audited by the New York State Banking Department every other year. Under the alternate year program, the FDIC audits petitioner in the year that it is not audited by the Banking Department. At the conclusion of the audit, the Banking Department issues a Report of Examination of petitioner. The Report of Examination consists of three major sections, Conclusions and Recommendations, Assessment, and Supplemental Information. The Assessment section contains an analysis of capital, asset quality, management, earnings, liquidity, and sensitivity to market risk and a rating with respect to each component of the Assessment section. The ratings range from one, for the strongest institutions, to five, for the weakest institutions. Each rating is accompanied by a narrative which explains the basis for the rating assigned.

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

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

ASSETS

| | 1998 | 1999 |
|---|---|---|
| CURRENT ASSETS | | |
| Cash and cash equivalents | $ 17,844,768.55 | $ 36,846,295.00 |
| Accrued interest receivable | 768,692.45 | 760,301.00 |
| Prepaid rent | 5,000.00 | 4,500.00 |
| Total current assets | 18,618,451.00 | 37,611,096.00 |
| INVESTMENTS – AVAILABLE FOR SALE | | |
| U.S. Government securities | 28,049,269.90 | 22,910,276.00 |
| States and political subdivisions | 3,185,271.55 | 623,439.00 |
| Federal agencies | 6,556,270.22 | 3,790,793.00 |
| Eurobonds | 8,432,276.05 | 6,708,311.00 |

| | | |
|---|---|---|
| Foreign commercial paper | 2,200,202.86 | 2,200,184.00 |
| F.N.M.A. Floating rate | 19,056,985.09 | 19,733,487.00 |
| Unrealized gains (loss) securities – available for sale | 899,539.15 | (114,884.00) |
| Total investments – available for sale | 69,056985.09 | 55,851,606.00 |
| INVESTMENTS – HELD TO MATURITY | | |
| Municipals | 14,328,987.53 | 14,332,402.00 |
| Total investments | 83,385,972.62 | 70,184,008.00 |
| TOTAL ASSETS | $ 102,004,433.62 | $ 107,795,104.00 |

LIABILITIES AND STOCKHOLDER'S EQUITY

| | 1998 | 1999 |
|---|---|---|
| CURRENT LIABILITIES | | |
| Accounts payable | $ 10,364.00 | $ 5,154.00 |
| Federal income taxes payable | 341,824.82 | 37,913.00 |
| Total Liabilities | 352,188.82 | 43,067.00 |
| STOCKHOLDER'S EQUITY | | |
| Common Stock | 1,000.00 | 1,000.00 |
| Additional paid-in capital | 95,325,119.04 | 95,337,806.00 |
| Retained earnings | 5,768,411.43 | 11,566,028.00 |
| Add: Unrealized gains (losses)on Securities available for sale | 557,714.33 | 152,797.00 |
| Total Stockholder's equity | 101,652,244.80 | 107,752,037.00 |
| TOTAL LIABILITIES AND STOCKHOLDER'S EQUITY | $ 102,004,433.62 | $ 107,795,104.00 |

## STATEMENT OF INCOME AND RETAINED EARNINGS

| | | |
|---|---|---|
| Investment Income | | |
| U.S. Gov't securities | $ 1,946,372.26 | $ 1,675,818.00 |
| States and subdivisions | 245,510.96 | 152,776.00 |
| Federal agencies | 627,005.82 | 335,953.00 |
| Eurobonds | 530,947.65 | 452.642.00 |
| Foreign commercial paper | 120,875.02 | 118.654.00 |
| F.N.M.A. floating rate | 1,093,762.30 | 1,130,719.00 |
| Municipals | 646,797.39 | 663,399.00 |
| Dividends | 371,224.29 | 1,285,892.00 |
| Net gain on sale of Securities | 229,218.33 | 19,946.00 |
| Total Investment Income | 5,811,714.02 | 5,835,799.00 |
| Operating Expenses | | |
| Accounting fees | 6,000.00 | 6,000.00 |
| Bank charges | 16,531.48 | 18,164.00 |
| Franchise taxes | 50.00 | 50.00 |
| Furniture and fixtures | 1,550.00 | .00 |
| Miscellaneous | 4,594.64 | 4,715.00 |
| Office expenses | 357.05 | .00 |
| Payroll taxes | 199.00 | 393.00 |
| Premises | 6,000.00 | 6,000.00 |
| Salaries | 7,600.00 | 2,400.00 |
| Telephone | 420.42 | 460.00 |
| Total Operating Expenses | 43,302.59 | 38,182.00 |
| NET INCOME | 5,768,411.43 | 5,797,617.00 |
| Retained Earnings - beginning of year | .00 | 5,768,411.00 |
| Retained Earnings - end of year | $ 5,768,411.43 | $11,566,028.00 |

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

| ASSETS: | 1997 | 1998 | 1999 |
|---|---|---|---|
| Cash and Cash Equivalents | $ 250,345,558 | $ 300,017,849 | $ 375,022,334 |
| Investment Securities | 98,273,931 | 103,914,167 | 109,803,345 |
| Loans, net | 196,176,049 | 200,026,729 | 196,694,472 |
| Bank Premises and Equipment, net | 5,968,950 | 5,574,863 | 5,736,189 |
| Customer's Liability on Acceptances | 2,141,933 | 1,095,991 | 1,285,943 |
| Accrued Interest Receivable | 2,911,963 | 2,854,469 | 3,260,895 |
| Other Assets | 8,562,936 | 3,661,015 | 3,657,717 |
| TOTAL ASSETS | $ 564,381,320 | $ 617,145,083 | $ 695,460,895 |
| LIABILITIES AND STOCKHOLDER'S EQUITY | | | |
| LIABILITIES: | | | |
| Total Deposits | $ 500,980,375 | $ 551,957,154 | $ 626,012,038 |
| Other Short-Term Borrowing | 9,109,000 | 8,620,000 | 9,016,482 |
| Acceptances Outstanding | 2,141,933 | 1,095,991 | 1,285,943 |
| Other Liabilities | 5,999,787 | 4,495,108 | 5,070,196 |
| Subordinated debentures | 7,500,000 | 7,500,000 | 7,500,000 |
| TOTAL LIABILITIES | 525,731,095 | 574,118,253 | 648,884,659 |
| STOCKHOLDER'S EQUITY: | | | |
| Common Stock | 3,750,000 | 3,750,000 | 3,750,000 |
| Additional Paid-in Capital | 13,750,000 | 13,750,000 | 13,750,000 |
| Undivided Profits | 20,663.647 | 24,969,256 | 29,172,945 |
| Accumulated other | | | |

| | | | |
|---|---|---|---|
| Comprehensive Income (loss), net | 486,578 | 557,574 | (96,709) |
| TOTAL STOCKHOLDER'S EQUITY | 38,650,225 | 43,026,830 | 46,576,236 |
| TOTAL LIABILITIES AND STOCKHOLDER'S EQUITY | $ 564,381,320 | $ 617,145,083 | $ 695,460,895 |

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

| | 1997 | 1998 | 1999 |
|---|---|---|---|
| **Interest Income:** | | | |
| Loans | $ 18,257,523 | $ 19,545,060 | $ 18,847,477 |
| Interest-bearing deposits with banks | 8,332,151 | 8,687,651 | 10,521,183 |
| Investment securities | 6,077,143 | 4,177,104 | 5,994,332 |
| Federal funds sold | 2,938,523 | 6,006,361 | 5,079,465 |
| Total interest income | 35,605,340 | 38,416,176 | 40,442,457 |
| **Other Operating Income:** | | | |
| Commissions, fees and other income | 3,470,821 | 3,332,196 | 3,310,177 |
| Securities gains, net | 905 | 185,563 | 19,946 |
| Total other operating income | 3,471,726 | 3,517,759 | 3,330,123 |
| **Interest Expense:** | | | |
| Deposits | 16,800,044 | 19,266,177 | 26,281,712 |
| Subordinated debentures | 818,385 | 814,010 | 789,322 |
| Other short-term borrowing | 4,946,006 | 4,677,371 | 334,251 |
| Total interest expense | 22,564,435 | 24,757,558 | 27,405,285 |
| **Provision for Possible Loan Losses** | 250,000 | 100,000 | 100,000 |
| **Other Operating Expenses:** | | | |
| Salaries and employee benefits | 4,985,495 | 5,298,736 | 5,429,831 |
| Depreciation and amortization | 749,393 | 706,118 | 421,213 |
| Other real estate expenses | 218,586 | 430,157 | 219,078 |
| FDIC assessment | 46,800 | 23,040 | 26,400 |
| General and administrative | 3,649,266 | 4,165,717 | 3,902,084 |

| | | | |
|---|---|---|---|
| Total other operating expenses | 9,649,540 | 10,623,768 | 9,998,606 |
| **Income Tax Provision** | 2,571,000 | 2,147,000 | 2,065,000 |
| **NET INCOME** | $ 4,042,091 | $ 4,305,609 | $ 4,203,689 |

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

***SUMMARY OF THE PARTIES' POSITIONS***

19. It is petitioner's position that, in the absence of substantial intercorporate transactions between the combined group and BA Investments, the Division of Taxation (Division) bears the burden of proving the existence of distortion before it can require that BA Investments, a New York nontaxpayer, be included in the combined report. Petitioner asserts that the Division has failed to meet its burden of proof of distortion as that concept has been applied by the controlling precedents, ***Matter of Premier National Bancorp*** (Tax Appeals Tribunal, August 2, 2007) and ***Matter of U.S. Trust Corporation*** (Tax Appeals Tribunal, April 11, 1996).

Next, petitioner asserts that Tax Law § 1462(g) discriminates against interstate commerce in that New York extends to certain corporations engaged in the same investment activities, but doing so principally out of a New York management office, an exemption from both the bank tax and the corporation franchise tax, under Tax Law § 1452(g) and § 1462(f)(4)(ii) in the case of bank tax and Tax Law § 209(2-a) and § 211(4)(a)(5) in the case of corporation franchise tax.

Similarly, corporations "grandfathered" under the provisions of Tax Law § 1452(d) may eliminate or reduce their corporation franchise tax liability without the risk of combination.

Finally, petitioner asserts that the substantial understatement penalty must be cancelled because the return as filed caused no understatement. Since BA Investments is a nontaxpayer, petitioner was not able, in the first instance, to include BA Investments in its combined report. It was only the exercise of the Commissioner's discretion in the course of the audit that caused BA Investments to be included in the combined report. In any event, reasonable cause existed based upon existing precedents and the penalty should be waived.

20. It is the Division's position that BA Investments should be combined with petitioner and the other members of the combined group for purposes of filing New York State franchise tax because BA Investments lacked economic substance and because an agreement, understanding or arrangement existed whereby the activity, business, income or assets of petitioner within New York State were improperly and inaccurately reflected.

The Division maintains that tax minimization was the sole and entire motivating force behind the transfer of the investment portfolio to BA Investments and that it was a mere contrivance which lacked any underlying substance

21. The Division submitted 172 proposed findings of fact. These proposed findings of fact have been substantially incorporated into the above findings of fact except to the extent that they are not fully supported by the record in this matter or are not relevant to the outcome of this determination.

## *CONCLUSIONS OF LAW*

A. Section 1462(f)(2)(I) of the Tax Law provides as follows:

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

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

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

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

As relevant to the instant matter these provisions are more succinctly explained by regulation section 21-2.6(a) which provides as follows:

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

B. One might conclude from the wording of section 1462(g) of the Tax Law that the Division must show that it first attempted to correct any distortion by use of a discretionary adjustment before requiring a nontaxpayer to be included in a combined report. However, such is not the case. In ***Matter of U.S. Trust Corporation*** (Tax Appeals Tribunal, April 11, 1996), the Tribunal held that:

> The authority for the Division to require combination of a nontaxpayer banking corporation or bank holding company is Tax Law § 1462(f)(2)(I). The authority is conditioned only upon the Division finding that combination is necessary to "properly reflect . . . tax liability because of intercompany

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

C. It is not disputed that BA Investments is owned 100% by petitioner and that it is part of a unitary business conducted by petitioner. Regulation section 21-2.3(b)(3)(i) provides, in part that:

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

In the instant matter, any intercorporate transactions between the combined group and BA Investments are so insignificant that they clearly do not rise to the level of 50 percent. At most, Mr. Chandler and Mr. Cina were providing limited services to BA Investments for which BA

Investments neither compensated them nor reimbursed petitioner. Accordingly, no presumption is created that inclusion of BA Investments in the combined group is made necessary in order to properly reflect the tax liability of petitioner. Thus, to require that BA Investments be included in the combined group, the Division must demonstrate that there exists some agreement, understanding or arrangement between petitioner and BA Investments whereby the activity, business, income or assets of petitioner is improperly or inaccurately reflected. This concept of improperly or inaccurately reflected activity, business, income or assets is commonly referred to as distortion.

D. Petitioner relies upon ***Matter of Premier National Bancorp*** (Tax Appeals Tribunal, August 2, 2007) for the proposition that no distortion exists by virtue of a parent's capital contributions to its investment subsidiary. To the extent that we focus only on the transaction involving the capital contribution to the subsidiary (in the instant matter, securities and a small amount of cash) in return for the stock of the investment subsidiary upon its formation, petitioner is correct. The value of the stock taken back can be expected to equal the securities and cash contributed. However, it must also be recognized that ***Premier National Bancorp*** did not involve a New York nontaxpayer investment subsidiary as we have in the instant matter. Rather, it involved a passive investment company which had elected under section 1452(d) of the Tax Law to be "grandfathered" as an Article 9-A taxpayer under the Tax Law rather than become subject to the bank tax under Article 32 of the Tax Law. As a result of that election, the grand-fathered Article 9-A investment subsidiary received more advantageous tax treatment of its investment income. The Division attempted to counteract the effect of the election in the ***Premier National Bancorp*** case by requiring a discretionary adjustment under section 1462(g). However, this would have had the effect of cancelling out the Article 9-A election and rendering section 1452(d) a nullity. The Tribunal determined that the election was properly enacted by the Legislature without qualifications and that it was beyond the power of the Division to overrule the Legislature by placing qualifications on the election which have the effect of negating the election. Accordingly, ***Premier National Bancorp*** is not dispositive of the matter here at issue.

E. The Division justifies its use of combination in the instant matter by claiming that BA Investments is a mere shell – a sham concocted by petitioner's accountant solely for purposes of avoiding tax properly due to the State of New York. The Division argues in its brief that:

> BA [Investments] also lacks underlying "substance." From the very origins of the transaction the company's real substance has been contrived. The nine page AA [Arthur Anderson] letter specifically articulates the steps to be taken in order to form a Delaware investment company in order to "reduce state and local taxes." The AA Letter goes on to note that with regard to establishing substance in Delaware, "[b]y real substance, we mean an operating office with at least one full-time employee *clothed* with decision-making authority." (emphasis added). It was AA who brought Bank Audi (USA) to Griffin in order to set up the subsidiary. Bank Audi (USA) never even considered another custodian to solve its "problem." It is undisputable that Griffin is nothing more than a "commercial domicile provider," which, as Ms. Yori explained, is an entity which helps companies form subsidiaries in Delaware and "provide[s] the substance" for such entities, including "[t]he office space, officers, directors, employees, to suit their individual purposes." As is abundantly clear, this "substance" is nothing more than canned window dressing and a staged prop.

The Division has introduced the testimony of their expert, Professor Saunders, that BA Investments was not created for any business purpose such as improved portfolio management, that BA Investment's creation increased petitioner's costs as well as its liquidity risk and interest rate risk exposures and that BA Investment's creation caused petitioner's financial position to be inaccurately reported because of the mismatching of income and expenses. Professor Saunders concluded that the only economic explanation for BA Investment's existence is for purposes of avoidance of state and local taxes.

Professor Saunders is a noted economist whose opinions regarding the economic aspects of this matter are deserving of some deference. However, it was brought out on cross-examination that Professor Saunders has no expertise, or even detailed knowledge, of federal or state bank tax laws. Moreover, he formulated his conclusions mainly from his review of the audit case file. He did not consult with the Division's auditors prior to writing his report and never interviewed any officers or employees of petitioner. Thus, his conclusions regarding state and local tax avoidance motivations may be subject to challenge. While it may be true from a purely academic point of view that the formation of BA Investments had the potential for negative results as regards liquidity and interest rate risks, it must also be recognized that BA Investments was not a sham corporation in any conventional sense (***see Matter of U.S. Trust Corporation***). It was not an empty shell. It was exceedingly well capitalized. It was not formed to create fake losses so as to generate tax deductions for petitioner. It was intended to generate a profit from its very inception and did in fact generate such profit. It did not pretend to serve some function (e.g., trademark protection) which was actually being performed by its parent. However, BA Investments was intended to be a passive entity. It held investment securities that it owned and collected interest and the proceeds when securities matured or were paid down early. It did not actively buy or sell securities for its portfolio. The only activity petitioner can point out is the selection of a new money market fund for its sweep account. BA Investments did not buy or sell securities for petitioner's portfolio or for any customer's portfolio. It did not own patents, trademarks or real property.

While BA Investments may be short on actual corporate activity, that alone does not provide a basis for requiring combination. It is well settled that tax avoidance through appropriate tax planning is a legitimate business purpose. If that can be accomplished without the creation of distortion, then there is no reason to require combination.

F. In 1997, when petitioner invested approximately $100 million (in the form of securities and cash) in its new passive investment subsidiary, from where did petitioner obtain the funds to make this investment? If petitioner used funds which it had borrowed from its depositors, then it had, just as the Division claims, created an arrangement whereby the expense of obtaining such funds (the interest paid to depositors) was allocated to New York State while the income earned on such funds was allocated outside of New York State. This is the very definition of distortion. If, on the other hand, petitioner used funds for which petitioner incurred no expense (e.g,. paid-in capital or undistributed profits), then it is hard to see where there is any mismatching of income and expenses which would cause distortion.

The difficulty is, of course, that money is a fungible commodity and the funds that petitioner invested in its Delaware subsidiary do not have little tags stating their origin as either debt or equity. However, a review of petitioner's consolidated balance sheet reveals that in 1997, the year that BA Investments was created and funded, petitioner had only $38.7 million in total stockholder equity. The $100 million invested in BA Investments could not possibly be entirely attributed to stockholder equity. In fact, less than half could be so attributed. The rest, at least $61.3 million, must be attributed to deposits ($501 million in 1997) or other borrowing ($25 million) all of which caused petitioner to incur interest expenses. Petitioner reported interest expense of $22.6 million in 1997, with $24.8 million in interest expense in 1998 and $27.4 million in 1999. On the other hand, BA Investments reported investment income of $5.8million for 1998 and $5.8 million for 1999 while reporting no interest expense whatsoever for either 1998 or 1999.

It can only be concluded that petitioner created a distortion in its income by claiming an interest deduction in its combined report attributable to assets held by a subsidiary corporation which was not included in the combined report. As a result either its deductions were overstated or its income was understated. By including BA Investments' income in the combined report, this distortion is eliminated.

G. Petitioner argues that the Division's attempt to combine the income and tax attributes of BA Investments with those of petitioner under Tax Law § 1462(g) when that section is read in conjunction with sections 1452(d) and (g) and 1462(f)(4)(ii) and (iii) discriminates against interstate commerce in violation of both the Commerce Clause and the Equal Protection Clause of the U.S. Constitution. Petitioner argues that,"[t]he cited New York statutes, when considered together, on their face provide a significant, direct, local commercial advantage to corporations engaged solely in investment activities in New York when compared to BA [Investments], a corporation similarly situated and engaged solely in investment activities in Delaware." Moreover, petitioner alleges that, "[e]xamination of New York State's legislative purpose in enacting Tax Law § 1452(g) demonstrates that the State has engaged in prohibited protectionism, and for that reason the State's action is not entitled, upon examining its constitutionality, to any flexible judicial balancing of benefits and burdens that might be claimed by the State."

Petitioner's argument appears to confuse petitioner with BA Investments. BA Investments is not a New York taxpayer. The Division of Taxation is not suggesting that BA Investments is subject to tax in New York or that it should be subject to tax in New York. On the other hand, petitioner is a New York taxpayer. New York is entitled to demand that petitioner pay the correct amount of tax due as required by the statute. The statute authorizes the Division of Taxation to correct a distortion created by petitioner's own actions. The lynchpin of combination is not whether the subsidiary is a taxpayer but whether the activity, business, income or assets of the taxpayer are improperly or inaccurately reflected.

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

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

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

H. I am persuaded that the penalty imposed in the instant matter should not be cancelled. Tax Law §1085(k) provides:

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

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

Petitioner argues that the definition of "understatement" is imbued with the concept of volitional filing and that because petitioner could not file a combined return with BA Investments due to the prohibition found in Tax Law §1462(f)(2)(i)(B), no understatement could result from the failure to include BA Investments in the return which it filed. Thus, petitioner argues that because it was prohibited from including BA Investments in its combined report, a substantial understatement would be impossible. However, it seems clear that had petitioner asked the Tax Commissioner whether it was necessary to include BA Investments in its combined report in order to properly reflect its tax liability under Article 32, the Commissioner would have answered in the affirmative. Moreover, the statute includes a mechanism whereby petitioner could have disclosed the relevant information in its return or in a statement attached to its return and would have been thereby protected from imposition of the substantial understatement penalty. It is noted that at no time did petitioner seek the advice of the Division of Taxation regarding the necessity of including BA Investments in its combined return on either an informal basis or by requesting an advisory opinion (***see*** Tax Law § 171 [24]) which would have established the Division's position in a binding manner.

In light of the advice given to petitioner by its accountant as recounted in Finding of Fact 4, it is clear that petitioner was cognizant that its course of action was likely to be challenged by the Division of Taxation. Petitioner was also advised that Arthur Anderson was able to secure favorable settlements because of the state's willingness to negotiate these cases. Thus, it appears that petitioner's strategy was to ignore the Division's expected disagreement with petitioner's position in anticipation that the Division would nevertheless agree to an outcome favorable to petitioner at the audit or litigation stage. The fact that the Division of Taxation is now less willing to agree to settlements favorable to taxpayers does not establish that petitioner had reasonable cause.

I. The petition of Interaudi Bank f/k/a Bank Audi (USA) is denied and the Notice of Deficiency dated March 10, 2005, as modified by the BCMS Conciliation Order dated March 2, 2007, is sustained.

DATED: Troy, New York
January 28, 2010

/s/ Andrew F. Marchese
CHIEF ADMINISTRATIVE LAW JUDGE