

**NEW YORK CITY TAX APPEALS TRIBUNAL  
ADMINISTRATIVE LAW JUDGE DIVISION**

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<b>In the Matter of the Petition</b>	:	
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<b>of</b>	:	<b>DETERMINATION</b>
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<b>BANKERS TRUST CORPORATION</b>	:	<b>TAT (H) 04-36 (BT)</b>
<b>(f/k/a BANKERS TRUST NEW YORK CORPORATION)</b>	:	
<b>AND ITS AFFILIATED ENTITIES</b>	:	
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Gombinski, C.A.L.J.:

Bankers Trust Corporation (formerly known as Bankers Trust New York Corporation) and several affiliated corporations filed a Petition for Hearing with the New York City ("City") Tax Appeals Tribunal seeking a redetermination of a Disallowance of Claims for Refund of City Banking Corporation Tax ("Bank Tax") under Title 11, Chapter 6 of the City Administrative Code ("Code") for the years 1986, 1987 and 1993 ("Tax Years"). A series of pre-hearing conferences and a hearing were held. Each party filed two briefs. Petitioners were represented by Stephen Solomon, Kenneth Moore and Roger Blane, Esqs., of Hutton & Solomon LLP. The City Commissioner of Finance ("Commissioner") was represented by Martin Nussbaum, Esq., Assistant Corporation Counsel. Frances Henn, Esq., Senior Counsel of the City Law Department, participated in the briefing.<sup>1</sup>

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<sup>1</sup> Robert J. Firestone, Esq., formerly Senior Counsel of the City Law Department, also represented the Commissioner of Finance prior to his appointment as a Tax Appeals Tribunal Commissioner.

## **HOLDING**

For an upper-tier corporation to be entitled to deduct 17% of the interest paid to it by a 100% indirectly owned lower-tier corporation under Code §11-641(e)(11)(i), Petitioners must prove that the upper-tier corporation is the "actual beneficial owner" (*i.e.*, the "tax beneficial owner") of more than 50% of that lower-tier corporation's voting stock using a "substance over form" analysis. Petitioners failed to prove that the upper-tier corporation, rather than the record title holders, was the actual beneficial owner of the stock of two 100% indirectly owned corporations where all corporate formalities were respected and no nominee or similar agreement or arrangement existed.

## **FINDINGS OF FACT**

Bankers Trust Corporation (formerly known as Bankers Trust New York Corporation) ("BTNY") is a bank holding company organized under Article 3A of the New York State ("State") Banking Law. During the Tax Years, BTNY was the owner of 100% of the stock of Bankers Trust Company ("BT"), a State chartered banking corporation.

### **Case History**

BTNY, BT and several affiliated corporations ("Petitioners") filed combined Bank Tax returns (Forms NYC 1A) for the Tax Years.

In the combined returns, Petitioners reported interest income that BT received from subsidiaries that were not included in those returns. Petitioners claimed in those returns that BT was entitled to deduct 17% of such interest under Code §11-641(e)(11)(i) ("17% Deduction"). On audit, the City Department of Finance ("Department") disallowed the 17% Deduction with respect to interest BT received from indirect (*i.e.*, non-first-tier) subsidiaries. The State Department of Taxation and Finance ("State Tax Department") made the identical disallowance on audit with respect to Petitioners' State Banking Corporation Tax Returns for 1986 and 1987. Petitioners paid both the City and State deficiencies and reserved the right to claim State refunds. The record does not reflect that Petitioners similarly reserved their right to claim City refunds. Petitioners thus were limited to claiming City refunds based on State changes resulting from their State refund requests.

### **Refund Requests**

Petitioners subsequently claimed State refunds asserting that BT was entitled to deduct 17% of the interest paid to it by its indirect subsidiaries under Tax Law §1450(e) (which is identical to the City 17% deduction and thus is also referred to as the "17% Deduction"). The State Tax Department audited Petitioners' refund claims for tax years 1986 and 1987, as well as their 1993 State

Banking Corporation Tax return. The State audit was settled and that settlement was reflected in a Closing Agreement dated August 21, 1997. Based on the State settlement, Petitioners filed Forms NYC 3360B (City Banking Corporation Tax Report of Change in Tax Base Made by Internal Revenue Service and/or State Tax Department) claiming City refunds for the Tax Years ("Refund Requests"). The Department issued City refunds for each of the Tax Years.

Although the Department initially paid refunds to Petitioners, on January 26, 1999, it issued a Notice of Disallowance of the Refund Requests. While the Department followed the State changes and allowed the 17% Deduction with respect to interest paid to BT by its non-taxpayer indirect subsidiaries, the Department asserted that BT failed to properly allocate certain of its administrative and home office expenses to those indirect subsidiaries. On that same date, the Department issued a Notice of Determination to Petitioners to recover the refunds advanced to them, plus interest thereon. With a letter dated April 23, 1999, Petitioners paid those amounts on account.

### **Declaratory Judgment Action**

Petitioners filed a Request for a Conciliation Conference with the Department's Conciliation Bureau challenging the Notices of Disallowance and Determination. While that proceeding was pending,

Petitioners commenced a declaratory judgment action before the State Supreme Court, New York County. The conciliation conference was adjourned pending final determination of the declaratory judgment action.

In the declaratory judgment action, Petitioners asserted that since the Refund Requests were made in a required report of State changes, the Commissioner was barred, under Code §11-678.3, from raising new assertions. The Commissioner responded that notwithstanding the Code's prohibition against asserting new bases for deficiency assertions where the statute of limitations is open only by reason of changes made by a State or Federal taxing authority, no refund can be paid where there has been no overpayment of tax. The Commissioner therefore argued that it always is permissible to defend against a refund claim on the basis that the tax was not overpaid, without limitation as to the issues that can be raised.

The State Supreme Court granted Petitioners' motion for summary judgment in a decision, dated April 5, 2001, that barred the Commissioner's new basis for denying the refund claims. The Appellate Division of the Supreme Court reversed that holding in a decision entered on November 19, 2002. The issue was appealed to the Court of Appeals which, in a decision dated November 25, 2003,

dismissed Petitioner's complaint for failure to exhaust administrative remedies. *Bankers Trust Corp. v. N.Y. Dept. of Fin.*, 1 NY3d 315, 321, 323 (2003).

As a result of the Court of Appeals decision, the conciliation proceeding was reinstated and a conciliation decision was issued on July 29, 2004, discontinuing that proceeding. Petitioners then filed the Petition, dated October 28, 2004, initiating this case.

### **Pre-hearing Conferences**

During the pre-hearing conference procedure, both the procedural issue that was before the courts and the underlying substantive assertion that gave rise to that issue were resolved. First, Petitioners abandoned their argument that the City could not raise a new issue to deny a refund claim based on a State change. Then, at my suggestion, the Commissioner audited chosen test periods with respect to the issue of whether BT had failed to properly allocate expenses to its non-taxpayer indirect subsidiaries. As a result of that audit, the Commissioner withdrew her assertion that BT's expenses had to be adjusted due to its management activities regarding its indirect subsidiaries.

The case was not resolved, however, because the Commissioner renewed her initial assertion that BT did not have "actual

beneficial ownership" over the indirect subsidiaries sufficient to make them its subsidiaries and entitle it to the 17% Deduction. Although BT had claimed deductions with respect to interest paid by twenty-one indirectly owned subsidiaries, most of that interest was paid to BT by only two indirectly owned subsidiaries, Bankers Trust Holding (U.K.) Limited (a U.K. corporation) ("BT UK") and Bankers Trust GmbH (a German corporation) ("BT GmbH") (collectively, "Indirect Subsidiaries"). I inquired whether this fact could serve as a basis for streamlining the hearing process. Petitioners ascertained that due to limitations attributable to the Refund Claims having been made in a report of State changes, the maximum potential refunds would be granted if just the two Indirect Subsidiaries were found to be BT's subsidiaries. Petitioners consequently abandoned their assertion that the other nineteen indirectly owned subsidiaries should be treated as BT's subsidiaries for purposes of the 17% Deduction.

The parties agree that if BT is entitled to the 17% Deduction with respect to interest received from the Indirect Subsidiaries during the Tax Years, the principal tax amounts of the refunds due Petitioners are \$1,272,475 for 1986; \$1,294,193 for 1987; and \$3,824,106 for 1993. The parties further agree that if Petitioners are not entitled to that deduction, the principal tax amounts of the refunds due Petitioners (which arise as a result of interest

paid to BT from first-tier subsidiaries) are \$2,507 for 1986; \$711 for 1987; and \$258 for 1993.

### **Corporate Structure and Operation**

The business of BT and all of its directly and indirectly owned subsidiaries was managed and controlled, and its policies and practices were established in the State by the Management and Network Committees, each of which were comprised of BT's senior officers. The Management Committee decided the policies and procedures for the global operation of BT and its numerous direct and indirect subsidiaries. The Network Committee (consisting of BT's senior staff in the legal, tax and business divisions) implemented the decisions made by the Management Committee. The Network Committee's Policies and Procedures, dated July 1, 1995, indicate that BT performed a thorough review of any new business proposal prior to entering into it and the first possibly relevant question required to be addressed was:

Why is it necessary to create a new company or subsidiary? What specific legal, regulatory, tax, or business reasons preclude the use of an existing BT legal entity to book the proposed transaction or otherwise conduct business?

Exhibit Book B, No.20 at p. 8.

BT concluded that to operate in foreign countries it had to conduct its foreign business under Federal Reserve Act §25 ("Edge Act") (Tr. p. 205). BT thus formed Bankers International Corporation ("BIC") as an Edge Act corporation. During the Tax Years: (1) BT was the record title holder of 100% of the stock of BIC; (2) BIC was the record title holder of 100% of the stock of (a) BT Holdings (Europe) Limited ("BTE") and (b) BT International (Delaware) Inc. ("BTI"); (3) BTE was the record title holder of 100% of the stock of BT UK; (4) BTI was the record title holder of 100% of the stock of BT Foreign Investment Corporation ("BTFIC"); and (5) BTFIC was the record title holder of 100% of the stock of BT GmbH. This international corporate structure had a business purpose as it was dictated by the complex laws and regulations of the various jurisdictions in which these corporations did business (as well as by the Edge Act) and it was created for the purpose of insulating and protecting BT's assets.

There were four corporations between BT and the Indirect Subsidiaries ("Intermediate Corporations"): BTE and BTFIC ("Immediate Parents"), as well as BIC and BTI. The Intermediate Corporations' activities and functions were generally those of holding companies and they engaged in hedging transactions. They had no direct employees and their business was conducted by the officers and directors of the Intermediate Corporations (virtually

all of whom were also officers and directors of BT). Sometimes work was also performed through service agreements with related corporations for which there were charge-backs shown as salary since the charge was an allocation of the salary of an employee of a related corporation. (Tr. at 120-122.) The parties stipulated that during the Tax Years, the Intermediate Corporations were "separate corporate entities that were respected and treated as separate corporate entities under Federal, New York State and New York City income tax laws. They observed all required corporate formalities and procedures." (Tribunal Ex. 1, ¶52.)

The Indirect Subsidiaries were foreign corporations that conducted active banking businesses, observed all required corporate formalities and procedures of the respective local laws in the U.K. and Germany and were respected and treated as separate corporate entities under the laws of those countries. They were not required to file Federal, State or City tax returns.

BTNY, BT, the Intermediate Corporations and the Indirect Subsidiaries (collectively, "Group") complied with the corporate formalities and procedures indicative of independent corporate governance. James T. Byrne, an attorney who was BT's former Senior Vice President, Assistant Secretary, member of its Board of Directors and head of its Compliance, Government Relations, Public

Affairs and Corporate Affairs Departments, testified that "corporate housekeeping" policies were adopted to "make sure . . . that the companies [owned directly and indirectly by BTNY] are duly constituted companies, that they have done everything that is appropriate in order to keep the separation of liability from getting up to the bank." (Tr. at 287 [brackets added].) As Mr. Bryne further testified, the corporate structure prevented holders of debt of one corporation from being able to "pierce the corporate veil" and attempt to collect the debt from a high-tier corporation, unless that corporation guaranteed that debt. (Tr. at 260.) Through the Management Committee, BT possessed and exercised effective control over the business operations of the Indirect Subsidiaries, including the movement of assets, even though there was no trust or contractual agreement relating to the control of those corporations.

All employees of the Group had to abide by the Rules of Business Conduct adopted by BT. Under those rules, a member of the Management Committee had to approve any company directorship and fiduciary appointment with respect to a member of the Group. BT provided insurance indemnification coverage for all officers and directors of BT and its subsidiaries.

## **POSITIONS OF PARTIES**

Petitioners assert that the Indirect Subsidiaries were BT's subsidiaries for purposes of the 17% Deduction as BT beneficially owned over 50% of their voting stock through a chain of wholly-owned and controlled corporations. Petitioners rely on BT's substantial indirect management control over the Indirect Subsidiaries to support their claim. The Commissioner responds that the existence of the Intermediate Corporations would have to be disregarded for tax purposes to treat the Indirect Subsidiaries as BT's subsidiaries. She asserts that the Intermediate Corporations cannot be disregarded for tax purposes, even though they were holding companies, since they were actively engaged in meaningful business activity and thus were not mere "shells" or "shams."

## **DISCUSSION AND ANALYSIS**

If the Indirect Subsidiaries were subsidiaries of BT, their debt to BT would be "subsidiary capital." Code §11-638(e) (which is identical to State Tax Law §1450(e)). BT would then be entitled to the 17% Deduction with respect to the interest that the Indirect Subsidiaries paid to it on such debt. Code §11-641(e)(11)(i) (which is identical to State Tax Law §1453(e)(11)(i)). For the Indirect Subsidiaries to be BT's subsidiaries, BT must have owned more than 50% of each of the Indirect Subsidiaries' voting stock during the

Tax Years. Code §11-638(d) (which is identical to State Tax Law §1450(d)) provides that:

The term 'subsidiary' means a corporation or association of which over fifty percent of the number of shares of stock entitling the holders thereof to vote for the election of directors or trustees is owned by the taxpayer.

### **Actual Beneficial Ownership**

Although the statute does not define "ownership," the regulation in effect during the Tax Years states that the "test of ownership is actual beneficial ownership, rather than mere record title as shown by the stock book of the issuing corporation." Former City rule 19 RCNY §3-01(b) (i) and (ii) ("Former Rule") (which is identical to former State regulation 20 NYCRR §16-2.22(a) and (b) ("Former Regulation")) provided:

(i) The term "subsidiary" means a corporation which is controlled by the taxpayer, by reason of the taxpayer's ownership of more than 50 percent of the voting stock of such corporation.

(ii) The test of ownership is actual beneficial ownership, rather than mere record title as shown by the stock books of the issuing corporation. A corporation will not be considered a subsidiary because more than 50 percent of the shares of its voting stock is registered in the taxpayer's name, unless the taxpayer is the actual beneficial owner of such stock. However, a corporation will not be considered a subsidiary if more than 50 percent of the shares of its voting stock is not

registered in the taxpayer's name, unless the taxpayer submits proof that it is the actual beneficial owner of such stock.<sup>2</sup>

The term "actual beneficial ownership" is an unusual phrase that the Former Rule used to define "ownership," but did not define. The term "beneficial ownership" is a far more common phrase, which can have different meanings depending upon the circumstances in which it is used. Even within the same statutory scheme, the term beneficial ownership has been "defined differently for different purposes." *Egghead.com Inc. v. Brookhaven Capital Mgmt. Co.*, 340 F.3d 79, 83 (2d Cir. 2003) (regarding the different definitions of beneficial ownership under the SEC rules).

Beneficial ownership generally means either constructive ownership as provided for by statute (such as ownership by attribution under IRC §318) or tax ownership determined under a

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<sup>2</sup> The Former Rule was revised by the City, and the Former Regulation was revised by the State, to add the following language: "Actual beneficial ownership of a stock does not mean indirect ownership or control of a corporation through a corporate structure consisting of several tiers and/or chains of corporations." As the revised City rule does not, by its terms, apply to the Tax Years, this determination applies the language of the Former Rule. The regulatory history indicates that this language was intended to "clarify" (rather than change) the result under the Former Rule; and, in fact, the same result is reached in this determination's application of the Former Rule. See the Department's Notice of Rulemaking, 1997 N.Y. City Tax LEXIS 33 (August 27, 1997) which states that its amendments to the Former Rule were made to "respond" to *Matter of Racal Corp. and Decca Elecs., Inc.*, 1993 N.Y. Tax LEXIS 208, DTA 807361 (State Tax Appeals Tribunal 1993) ("*Racal*") "to clarify" the Department's position. See also the State Regulatory Impact Statement which provides that the revised regulation "more clearly states the long-standing rule" in accordance with *Racal*, to "offer guidance." Since *Racal* held that the Former Regulation did not provide that indirect ownership alone constitutes actual beneficial ownership, the analysis is the same under the current rule and current regulation as it was under the Former Rule and Former Regulation.

common law "substance over form" analysis (e.g., where title to stock is held by a nominee). If "actual beneficial ownership" means ownership by attribution,<sup>3</sup> the Indirect Subsidiaries would be subsidiaries of BT and of all other corporations in the Group that indirectly owned over 50% of their voting stock. If "actual beneficial ownership" instead means tax ownership, a determination would have to be made, using a substance over form analysis, as to whether the Immediate Parents or BT was the tax owner of the Indirect Subsidiaries' voting stock since two taxpayers cannot be the tax owner of the same interest in property.<sup>4</sup>

Under the statute, regulation and case law, "actual beneficial ownership" does not mean beneficial ownership by attribution. As a statutory matter, ownership by attribution is generally provided for by statute. The statute at issue, Code §11-638(d), does not explicitly provide for beneficial ownership by attribution; nor does it implicitly require such treatment.<sup>5</sup> As a regulatory matter, the

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<sup>3</sup> For example, IRC §318 (a) (2) (c) uses constructive ownership to attribute stock owned by a corporation to its 50% or more shareholders.

<sup>4</sup> By necessity, the determination of who is the economic and thus tax owner of stock is determined using a substance over form analysis. See *Yelencsics v. Commissioner*, 74 T.C. 1513, 1527 (U.S. Tax Court 1980), which held that ". . . in ascertaining the beneficial owner of stock, the substance of a sale transaction, and not merely its form, will control." Even a case that separately analyzed the issues of tax beneficial ownership and substance over form concluded that both concepts use a "similar analysis." *Cepeda v. Commissioner*, 67 T.C.M. (CCH) 2181 (U.S. Tax Court 1994).

<sup>5</sup> Code §11-638(d) only references the term "owned" (rather than "directly or indirectly owned") in determining the stock ownership required for a corporation to be a subsidiary. This is in contrast to other Code sections in the Bank Tax that use the term "directly and indirectly" owned. Code §§11-605.4,

Former Rule (in which the term "actual beneficial ownership" appears) also indicates that "actual beneficial ownership" does not reference beneficial ownership by attribution, but instead references tax beneficial ownership.<sup>6</sup>

The case law also indicates that beneficial ownership by attribution does not in itself constitute "actual beneficial

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11-640(a)(9) and (g)(2), and 11-646(f). Where the legislature uses the term "directly or indirectly" owned in one portion of the statute but not another, the presumption is that the legislature knew how to use the term "indirectly" when it wanted to do so and that its omission was intentional. *Pajak v. Pajak*, 56 N.Y.2d 394, 397 (1982); *Matter of the Foreclosure of Tax Liens by Clinton County*, 299 A.D.2d 709 (3d Dept. 2002); McKinney's N.Y. Statutes §74.

Nevertheless, the phrase "direct or indirect" has been read into a statute where necessary to achieve the underlying statutory purpose. In *Lazard Freres*, TAT(E) 93-107(UB) (Tax Appeals Tribunal 1996), the Commissioners of this Tribunal held that despite the statute's silence, the term "partner" had to be read to include direct or indirect partners under the Unincorporated Business Tax to achieve the statutory purpose of avoiding double taxation. Petitioners have not offered any compelling reason why allowing the 17% Deduction with respect to interest payments from indirectly owned corporations is necessary to achieve the unstated statutory purpose of that deduction. To the contrary, adding the word "indirect" could result in double or even exponentially greater taxation under the Code, which would undermine the statutory intention. The General Corporation Tax (which has the identical definition of subsidiary as the State Corporate Franchise Tax that was at issue in *Racal*) provides a separate tax on subsidiary capital. Code §11-604.1.A.(b). If a corporation is deemed to be a subsidiary of each upper-tier corporation that has a greater than 50% indirect interest in its voting stock, its capital would be included in the subsidiary capital of each of those higher-tier entities. Under the General Corporation Tax, each higher-tier entity with an greater than 50% indirect interest in that lower-tier corporation's voting stock would have to take that lower-tier corporation's capital into account in computing the tax on subsidiary capital. See *Racal*, which addressed this concern of inappropriate multiple taxation.

<sup>6</sup> The Former Rule's use of the phrase "actual beneficial ownership" indicates that a corporation that does not have record title to stock must be deemed to be the "actual" or "tax owner" of such stock to be considered its "actual beneficial owner." This conclusion is further supported by the Former Rule's statement that "the test of ownership is actual beneficial ownership **rather than** mere record title" (emphasis added) since, under a beneficial ownership by attribution analysis, the record holder of stock is still its tax owner. Only under a tax beneficial ownership analysis would a taxpayer not the record title holder be substituted for the record title holder as the beneficial owner of stock. Another aspect of the Former Rule which corroborates this result is discussed in fn 9, *infra*.

ownership." Petitioner BTNY brought a case before the State Tax Appeals Tribunal that also concerned the applicability of the 17% Deduction with respect to interest paid (during the prior taxable year) by an indirectly owned subsidiary. *Matter of Bankers Trust N.Y. Corp.*, DTA 811316 (1996) ("*State Case*") (emphasis added).<sup>7</sup> The State Case held that beneficial ownership by attribution through a chain of wholly-owned corporations does not constitute actual beneficial ownership:

. . . neither Tax Law §1450 nor the regulation interpreting it provide that indirect ownership of 100% of the stock of a second tier subsidiary corporation conclusively demonstrates actual control of such corporation **or** actual beneficial ownership of its stock.<sup>8</sup>

*State Case*. See also *Racal*. The *State Case* and *Racal* are precedential as they applied a statute and former regulation identical to those at issue here. City Charter §170(d).

Since "actual beneficial ownership" does not mean beneficial ownership by attribution under the statute, Former Regulation or

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<sup>7</sup> Although the State Case also involved the tax years 1986 and 1987, which are at issue here, it only addressed the refund claim regarding the 17% Deduction with respect to the 1985 tax year, which is not at issue here. *State Case*, Findings of Fact 4 and 14.

<sup>8</sup> The State Tax Appeals Tribunal defined "ownership" as "actual beneficial ownership" in accordance with the Former Regulation. Yet the above quote suggests that there are two independent tests of ownership: "actual beneficial ownership" and "**actual control**." However, it is not at all clear that there is an independent "actual control" test, particularly since this case (as discussed *infra*) provides that "**indirect ownership and control**" is a test for determining "actual beneficial ownership."

case law, it must mean tax beneficial ownership. Determining tax beneficial ownership, however, generally requires a far more difficult factual analysis than determining who is the direct (or even indirect) record title holder. Moreover, the issue of tax beneficial ownership seldom arises as tax beneficial ownership is rarely separated from record title. The Former Rule addressed these concerns by providing that "a corporation will not be considered a subsidiary if more than 50 percent of the shares of its voting stock is not registered in the taxpayer's name, unless the taxpayer submits proof that it is the actual beneficial owner of such stock." The Former Rule thus preserved the administrative simplicity of the statute's bright line greater than 50% voting stock ownership test, by effectively: (1) presuming that ownership is determined by record title; and (2) allowing the taxpayer the opportunity to rebut that presumption by proving that it, rather than the record title holder, is the actual beneficial owner of the stock at issue; *i.e.*, its tax beneficial owner.<sup>9</sup>

### **State Standard**

The State Case provides guidance regarding what a non-record title holder of stock must demonstrate to rebut the presumption that the record title holder is the tax beneficial owner of stock.

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<sup>9</sup> Had the Former Rule adopted a beneficial ownership test through attribution (similar to IRC §318) there would have been no need for a rebuttable presumption, since indirect ownership would also have been determined by record title.

Citing to its earlier holding in *Racal*, the State Tax Appeals Tribunal held that for a taxpayer to prove that it is the "actual beneficial owner" (i.e., tax beneficial owner) of the stock of an indirectly owned corporation, it must demonstrate that it:

. . . had "command over property or enjoyment of its economic benefits", "owns indirectly and controls the voting stock of another corporation"; or had the "absolute right to sell or pledge the stock, receive dividends from the stock and vote and maintain a shareholder derivative action." ("State Standard.")<sup>10</sup>

*State Case*. The *State Case* held that BTNY failed to establish that BT was the actual beneficial owner of the claimed subsidiaries as it merely proved that BT had indirect ownership of the stock of the corporations at issue. That case therefore provides little guidance how the standard that it established should be applied.<sup>11</sup>

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<sup>10</sup> Based on the conclusion reached in *Racal*, the *State Case* held that a taxpayer does not have to control "all aspects of the operation and management of the indirect subsidiaries" to be its actual beneficial owner. This statement, however, does not provide significant guidance since a taxpayer can be the tax beneficial owner of stock held in trust or under a nominee agreement without controlling all aspects of the operation and management of that corporation.

<sup>11</sup> The Commissioner asserts that the State Standard should be ignored as *dicta*. As BTNY offered "little evidence concerning the operations and nature of its subsidiaries" (*State Case*), the Commissioner is correct that the State Tax Appeals Tribunal had no opportunity to apply the State Standard's criteria and, thus, "flesh out what those criteria mean." Respondent's Brief, p. 28. However, the failure of a party to present evidence that is sufficient to meet a standard set forth in a case, does not mean that such standard does not exist. It simply means that the party failed to meet its burden of proof with respect to that standard. The consequence of the lack of relevant evidence in the *State Case* is that which the Commissioner herself correctly concluded; that with respect to the criteria in the State Standard: "guidance as to their meaning must be sought elsewhere." *Id.*

The proper application of the State Standard is dictated as much by its purpose as by its somewhat ambiguous language and structure. Its purpose is to provide guidance as to what must be demonstrated to establish "actual beneficial ownership." As the statute, Former Regulation and case law indicate that actual beneficial ownership is tax beneficial ownership and there can be only one tax owner of stock, all of the criteria in the State Standard must be applied in a manner that identifies the same taxpayer. Thus, the application of the various criteria in the State Standard must merely be different ways of reaching the same conclusion as to who is the tax beneficial owner of stock.

The criteria "command over property or enjoyment of its economic benefits" are general conditions of ownership that have been used in the case law to determine who is the true economic or tax beneficial owner of stock under a substance over form analysis. See *Anderson*, 164 F.2d 870, 873 (7<sup>th</sup> Cir. 1947), cert. den., 334 U.S. 819 (1948) (" . . . tax consequences flow from the substance rather than the form of a transaction; . . . command over property or enjoyment of its economic benefits marks the real owner for federal income tax purposes). See also *Yelencsics*, *supra*.

The criteria the "absolute right to sell or pledge the stock, receive dividends from the stock and vote and maintain a shareholder

derivative action" are specific facts which also indicate who is the true economic or tax owner of stock. See *Xerox Corp. v. Dept. of Taxation & Finance*, 140 A.D.2d 945 (4<sup>th</sup> Dept. 1988), *rv'g*, TSB-M-87(25)C, 1987 N.Y. Tax LEXIS 546 (Jan. 30, 1987); *Miller v. U.S.*, 345 F. Supp.2d 1046, 1050 (N.D. Cal. 2004), *aff'd*, 209 Fed. Appx. 690 (9<sup>th</sup> Cir. 2006); *U.S. v. Tuff*, 359 F. Supp.2d 1129, 1133, fn 4 (W.D. Wash. 2004), *aff'd*, 465 F.3d 1249 (9<sup>th</sup> Cir. 2006).

As specific facts establish the general conditions of ownership, the above criteria are parts of the same analysis and are best read conjunctively to provide that: "To be considered the actual beneficial owner of stock, a taxpayer who is not the record title holder must prove that it has command over that stock and enjoyment of that stock's economic benefits by demonstrating that it possesses the following criteria indicative of economic ownership: the absolute right to sell or pledge the stock, the right to receive dividends from the stock and the right to vote and maintain a shareholder derivative action with respect to the stock."

The last criteria in the State Standard is "indirect ownership and control." "Indirect ownership" is a factual issue that would be satisfied by indirect ownership of a percentage of stock that meets the statutory threshold; which here is greater than 50% of a corporation's voting stock. Indirect ownership is a factor used for

determining beneficial ownership by attribution (see IRC §318), rather than tax beneficial ownership (*i.e.*, actual beneficial ownership). Thus, for the term "indirect ownership and control" to be a test of tax beneficial ownership, "control" (which is a general condition of ownership) must be interpreted in the same manner as "command over property." Such interpretation was used by the United State Tax Court in *Cepeda v. Commissioner, supra* (emphasis added) ("a similar analysis of **control** and **command over property** as that which determines economic benefit is present in a 'substance over form' determination"). Moreover, if "control" were not applied as a test of tax beneficial ownership, "indirect ownership and control" would merely be a test of beneficial ownership by attribution. In such instance, "control" would mean "indirect ownership," which would preclude the term "control" from having any independent meaning.<sup>12</sup>

Although "indirect ownership and control" must be a test of tax beneficial ownership, Petitioners rely on TSB-M-79-(1)C(Rev) (October 19, 1979) ("TSB-M"), a non-precedential policy statement issued by the State Tax Department, to assert that BT's indirect

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<sup>12</sup> The State Case may have adopted "control" as a test of actual beneficial ownership because the Former Regulation defined "subsidiary" as a corporation that is "controlled" by a taxpayer. However, as the Former Regulation defined "control" as ownership of greater than 50% of a corporation's voting stock (which is the statutory definition of "subsidiary"), it precluded "control" from having any independent meaning. The unnecessary "control" requirement was eliminated from the Former Regulation (and Former Rule) when they were amended as discussed in fn 2, *supra*.

ownership interests through a chain of corporations made it the beneficial owner of the stock of the Indirect Subsidiaries. Petitioners' Brief pp. 2, 27 and 30. While the TSB-M suggested that it was applying a tax beneficial ownership standard by asserting that "indirect ownership and control" creates an "agent, instrumentality or alter ego" arrangement, the reality was that it applied a beneficial ownership by attribution standard.<sup>13</sup> Also, the TSB-M was not cited in the *State Case* and it was cited in *Racal* only for the proposition that a transfer of stock is not a prerequisite of finding actual beneficial ownership.

Moreover, in *Racal*, the State Tax Appeals Tribunal confirmed that the indicia that were later adopted in the State Standard are interrelated and apply to determine tax beneficial ownership using a substance over form analysis.<sup>14</sup> In *Racal* the parties stipulated

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<sup>13</sup> The TSB-M indicated that it was adopting a tax beneficial owner standard by asserting that at an 80% level of indirect stock ownership (the statutory threshold amount), "the controlled corporation is the mere agent, instrumentality or alter ego of the other corporation." However, to establish an agency relationship under the six factors set forth in *National Carbide Corp. v. Comm'r*, 336 US 422 (1949), or the three factors set forth in *Comm'r v. Bollinger*, 485 US 340, 345 (1988), "the corporation must establish that it is an agent for its shareholder with respect to the transactions in question by evidence other than the control that shareholders automatically possess over their corporations." Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, Seventh Ed., Vol. 1. (Warren, Gorham & Lamont 2006), ¶2.10.

<sup>14</sup> The Commissioner asserts that *Racal* held that the "control" requirement can only be met if the Intermediate Corporations are disregarded for tax purposes as sham corporations. For an indirect owner of stock to be deemed to be its tax beneficial owner either: (1) the existence of the intermediate corporations must be disregarded for tax purposes; or (2) the immediate parent corporations' record title ownership of the stock must otherwise be disregarded for tax purposes. Since the 17% Deduction allowed in *Racal* involved interest payments from two corporations (one of whose existence would have had to be ignored for tax

that the taxpayers had absolute control over the election and removal of officers and directors (who did not have the power or authority to act independently) and absolute power to dictate management and policies of the indirect subsidiary, and that the indirect subsidiary held itself out and was treated as a subsidiary of that upper-tier corporation for all purposes, including tax reporting.

The State Tax Appeals Tribunal found, in *Racal*, that the stipulation that the taxpayers had the "absolute right to sell or pledge the stock, receive dividends from the stock and vote and maintain a shareholder derivative action" (which is one of the groups of indicia in the State Standard) was sufficient to find that the taxpayers had absolute control over "all aspects of the operations and stock of the lower-tier corporations." (The *State Case* later indicated that such a level of control would constitute

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purposes had its existence been disregarded as a sham), the State Tax Appeals Tribunal merely ignored that corporation's record stock ownership of its immediate subsidiary.

Moreover, establishing that a corporation is a sham is difficult as the threshold of business activity required to respect separate corporate existence is low. *Strong. v. Comm'r*, 66 T.C. 12, 26 (1976), aff'd without opinion, 77-1 U.S.T.C. ¶9240 (2d Cir. 1977). A corporation's status as a separate taxable entity cannot be disregarded if it engages in some industrial, commercial or other activity besides avoiding tax. See, *Moline Properties, Inc. v. Comm'r*, 319 US 436, 438-439 (1943); *National Investors Corp. v. Hoey*, 144 F.2d 466, 467-68 (2d Cir. 1944). No allegation has been made here, nor do the facts support a finding, that the separate corporate existence of the Intermediate Corporations could be ignored. While the facts in *Racal* may have been sufficient to disregard the corporate existence of a lower-tier corporation, that was not the basis of the State Tax Appeals Tribunal's finding.

"indirect ownership and control" which is another group of indicia in the State Standard). *Racal* then found that by having such absolute "control," the taxpayers had "command" over the lower-tier corporations and "enjoyment of their economic benefit" (the last group of criteria in the State Standard). It was on this last basis that *Racal* determined that the lower-tier corporations were the taxpayers' subsidiaries.

The State Tax Appeals Tribunal thus confirms in *Racal* and the *State Case*, that the level of "control" required under "indirect ownership and control" must be "control" that is sufficient to result in a non-title holder being deemed the tax beneficial owner of stock under a substance over form analysis.

### **Tax Ownership of the Indirect Subsidiaries**

As to whether BT or the Immediate Parents were the tax beneficial owners of the stock of the Indirect Subsidiaries, the Immediate Parents did not hold that stock on behalf of BT either as a nominee or trustee, whether by formal agreement or in practice. Nor has any assertion been made that the Immediate Parents did not have a 100% economic interest in the stock of the Indirect Subsidiaries. To the contrary, the record establishes that BT's 100% indirect interest in the stock of the Indirect Subsidiaries was

not materially different from the economic interest that any upper-tier entity would have by virtue of a 100% indirect stock ownership.

Unlike *Racal* (where the parties stipulated that the subsidiaries acted and were treated, for all purposes, as if they were direct subsidiaries of the taxpayers rather than of the record title holders), it was stipulated here that all corporate formalities were adhered to by the Group.<sup>15</sup> The record is clear that the Immediate Parents owned the stock of the Indirect Subsidiaries in form and that, in substance, they acted and benefitted in accordance with that form. As BT did not have the absolute right to sell or pledge the Indirect Subsidiaries' stock, receive dividends from such stock or vote and maintain a shareholder derivative action with respect to such stock, BT did not have the type of direct control, command or enjoyment of economic benefits over the Indirect Subsidiaries' stock that would be sufficient to treat BT (rather than the Immediate Parents) as the tax owners of such stock.<sup>16</sup>

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<sup>15</sup> As the facts here are materially different than those in *Racal*, Petitioners would not prevail under the Department's Statement of Audit Procedures PP-2008-17 (April 7, 2008) regarding the applicability of *Racal*.

<sup>16</sup> Petitioners assert that a different result is mandated here than in the State Case as "the legal and economic realities" of BT's "ownership and control of its lower tier subsidiaries through a chain of controlled holding companies is evident and was clearly established by the credible and uncontroverted testimony, supported by corroborative documents in the record." Petitioners Brief at 41-42. However, as Petitioners correctly argued in the State Case, there "is no greater degree of control than that exemplified by 100% stock ownership."

## **Indirect Management Control**

Petitioners nevertheless assert that BT's indirect management control exercised through a chain of corporations was sufficient to create "beneficial ownership" of the Indirect Subsidiaries; *i.e.*, to shift ownership of the Indirect Subsidiaries from the Immediate Parents to BT. There is no dispute that BT dictated the overall policy of the Group and managed (and may even have micro-managed) the Indirect Subsidiaries. However, management control exercised through a chain of wholly-owned but independent corporations whose identities are respected for tax purposes is insufficient to disregard that corporation's record title under the substance over form doctrine, no matter how encompassing that control may be. See, *National Carbide*, 336 U.S. at 431-432: "[U]nder our decisions, when a corporation carries on business activity the fact that the owner retains direction of its affairs down to the minutest detail, provides all of its assets and takes all of its profits can make no difference tax-wise."

Moreover, treating management control as the control required under the second test of the State Standard, no matter how great that level of control might be, would transform the statutory, bright line greater than 50% voting stock ownership test into a factual quagmire that would be subject to easy manipulation. Were

exercised management control alone sufficient to trigger actual beneficial ownership, determining which corporation is a subsidiary of which other corporation within a chain of wholly-owned entities would require an amorphous factual inquiry at the end of each taxable year as to which corporation in the group of related corporations exercised the most management control and set what policies during which portions of the taxable year for each of the lower-tier corporations in that group. Given the effective presumption in the Former Regulation that record title establishes ownership, a taxpayer could assert that it exercised a degree of management sufficient to create "actual beneficial ownership" with respect to a lower-tier entity only in those taxable years in which such assertion would create an overall tax benefit for the related group of corporations.<sup>17</sup>

Since the lower-tier corporations (the Indirect Subsidiaries) had a business purpose and all corporate formalities were adhered to, and no nominee or similar arrangement or agreement existed, no basis exists under the substance over form doctrine to shift

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<sup>17</sup> Under the General Corporation Tax, a higher-tier entity could assert that it exercised sufficient management control over an indirect subsidiary to have 'beneficial ownership' of that corporation's stock and thus exclude interest paid to it by that corporation under Code §11-601.8(iv)(a)(1). Then, in a subsequent year in which the title holder sells the stock of that lower-tier corporation for a gain, the upper-tier entity could simply not assert the applicability of the regulatory exemption. The title holder (which previously could not treat the corporation whose stock it held as a subsidiary since there can only be one beneficial owner of stock) could now treat that lower-tier corporation as its subsidiary and exclude from income all gain on the sale of its stock under Code §11-601.8(iv)(a)(1).

ownership away from the record title holders (the Immediate Parents) to an indirect stock owner (BT).<sup>18</sup>

**ACCORDINGLY, IT IS CONCLUDED THAT** since Petitioners did not prove that BT was the "tax beneficial owner" of the stock of the Indirect Subsidiaries under a "substance over form" analysis, BT did not have "actual beneficial ownership" of that stock. Therefore, the Indirect Subsidiaries were not BT's subsidiaries and BT is not entitled to exclude 17% of the interest paid to it from the Indirect Subsidiaries. Petitioners' refund requests are denied except to the extent agreed to by the Commissioner as reflected in the Findings of Fact.

IT IS SO ORDERED.

New York, New York  
Date: December 23, 2008

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STEVEN J. GOMBINSKI  
Chief Administrative Law Judge

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<sup>18</sup> I have considered all other issues raised by the parties and find them to be unpersuasive.