

NEW YORK CITY TAX APPEALS TRIBUNAL
ADMINISTRATIVE LAW JUDGE DIVISION

In the Matter of the Petition : DETERMINATION
: :
of : TAT(H) 10-35(BT) et al
: :
ASTORIA FINANCIAL CORPORATION :
& AFFILIATES :
: :
: :

Murphy, C.A.L.J.:

Astoria Financial Corporation together with ten subsidiary Affiliates (Petitioner), filed a Petition for Hearing with the New York City (City) Tax Appeals Tribunal (Tribunal) on December 6, 2010 to review the City Department of Finance's (Department or Respondent) September 10, 2010 Notice of Determination of City Banking Corporation Tax (Bank Tax) Due issued with respect to the tax year ending December 31, 2006 (First Notice). Petitioner also filed a Petition for Hearing with the New York City (City) Tax Appeals Tribunal on October 5, 2011, to review Respondent's August 26, 2011 Notice of Determination of Bank Tax Due issued with respect to the tax years ending December 31, 2007 and December 31, 2008. (Second Notice). The Petitions, which were consolidated under Tax Appeals number TAT(H) 10-35 (BT) et al, covered the tax years ended December 31, 2006 through December 31, 2008 (Tax Years).

A hearing was held in this matter on March 6, 7, 8 and 11, 2013 and April 10 and 11, 2013, pursuant to Section 1-12 of the Tribunal Rules of Practice and Procedures (Rules). The representatives for the parties entered into a Stipulation of Facts (Stipulation) on September 5, 2012, agreeing to certain facts and to the submission of certain documents. At Hearing additional documents were submitted and testimony was taken. Petitioner appeared by Irwin M. Slomka and Kara M. Kraman of Morrison & Foerster LLP, New York, NY. Respondent was represented by Martin Nussbaum, Assistant Corporation Counsel and Andrew Lipkin, Senior Counsel. Petitioner and Respondent filed briefs in this matter. The final sur-reply brief filed on January 27, 2014. On July 18, 2014 the undersigned informed the parties, pursuant to § 1-12 (e) (1) of the Rules, that the time to issued a determination was being extended and the determination would be issued on or before October 28, 2014.

ISSUE

Whether Petitioner may be required to file its City Bank Tax Returns for the Tax Years on a combined basis which includes the non-taxpayer subsidiary Fidata Service Corporation.¹

FINDINGS OF FACT

Background. Astoria Financial Corporation (Astoria Financial) is a Delaware corporation headquartered in Lake Success, New York, located in Nassau County. It is a publicly-

¹ Respondent also required Petitioner to include its subsidiary Astoria Mortgage Corporation in its combined returns for the Tax Years. Petitioner does not object to this subsidiary being included, but continues to assert that the required combination is not appropriate.

held holding corporation for Astoria Federal Savings & Loan Association (Astoria).

Astoria is a federal savings and loan association also headquartered in Lake Success, New York. Astoria conducts a banking business, through branches, automated teller machines (ATMs) and telephone and internet facilities. Astoria maintains City bank branches in Brooklyn and Queens, and operates in Nassau Suffolk and Westchester Counties as well. It is principally engaged in taking deposits and making mortgage loans. By the Tax Years, between seventy and eighty-one percent (70%-81%) of all the mortgages originated by the Astoria group of related corporations involved underlying properties located outside New York State. (Petitioner's exhibit C). Astoria is presently subject to the supervision of the federal Office of the Comptroller of the Currency (OCC) (formerly the United States Office of Thrift Supervision [OTS] which was the chartering agency) and by the Federal Deposit Insurance Corporation [FDIC] (the deposit insurer).

Astoria is the parent corporation of several subsidiaries which do business within and/or without the City, including Astoria Federal Mortgage Corporation (Astoria Mortgage), Suffco Savings Corporation (Suffco) and Fidata Service Corporation (Fidata).

Astoria Mortgage. Astoria Mortgage is a New York corporation engaged in purchasing and originating mortgage loans, formed by Astoria in 1997. Astoria's reputation has always depended upon its role as a community-centered bank. During the mid-1990s, Astoria decided to expand its lending activities beyond New York

State, through establishing subsidiaries and acquiring unrelated financial institutions. (Tr 58-9). Astoria Mortgage primarily originates mortgage loans for property located outside New York State, through independent mortgage brokers and third-party originators. The mortgages, purchased with funds from Astoria, are immediately sold upon origination. During the Tax Years, Astoria Mortgage sold the majority of its non-New York mortgages to Fidata, occasionally selling mortgages to Astoria. Astoria Mortgage employs a network of account executives who work with bankers and brokers throughout the United States. (Tr 62).

Suffco. Suffco is a New York corporation with offices in Farmingdale, New York. It serves as the document custodian for Astoria and Fidata mortgage loans. Suffco retains the mortgage records after the loans have been closed by Fidata.

Star Preferred Funding and Astoria Preferred Funding. Star Preferred Funding Corporation (Star) was a New Jersey investment corporation wholly-owned by Astoria. Astoria Preferred Funding Corporation (Preferred Funding) was a Delaware real estate investment trust (a REIT) owned by Star Funding. Star was subject to New Jersey corporate income tax. Neither Star nor Preferred Funding did business in the City during the Tax Years.

Prior to July 2005, Preferred Funding, which was a REIT, owned Astoria's non-New York mortgages. Substantially all of the REIT's income was distributed annually to its shareholder, Star, consistent with the Internal Revenue Code (IRC) requirements for REITs.² The distributions were deductible for Internal Revenue

² See, generally, Internal Revenue Code (IRC) § 857, Taxation of real estate investment trusts and their beneficiaries. 26 USCA § 857.

Code (IRC) purposes, and the REIT had no federal taxable net income. Before 2005, the New Jersey Administrative Code provided that dividends received by a New Jersey corporation from a REIT subsidiary were 100% deductible. Star was therefore subject to a minimal New Jersey corporate tax. NJ Administrative Code § 18:7-5.2 (a) (2) (i) [2004].

Fidata. Fidata is a New York corporation which was formed on November 24, 1982. Astoria acquired Fidata from an unrelated entity in 1995, and for approximately ten years Fidata was a dormant service corporation. Fidata does not do business in the City.

Believing that New Jersey was considering eliminating the dividends deduction³ for REITs which would have the effect of increasing the New Jersey corporate tax liability of Star Funding, Astoria established Fidata as a Connecticut passive investment company (PIC) to hold the non-New York mortgages.

As a PIC, Fidata was required to maintain an office in Connecticut and to employ at least five individuals full-time in that state. Since July 1, 2005, Fidata offices have been located in leased office space in Norwalk, Connecticut. The lease for the Connecticut premises was originally entered into by Astoria in April of 2005, and was assigned to Fidata in July 2005. During the Tax Years Fidata employed between five and seven

³ See NJ Administrative Code § 18:7-5.2 [a] [2] [i] [1]. Dividends from a REIT are not eligible for the dividends received deduction.

individuals at this location, included an operations manager, document clearing specialists and a post-closing manager.⁴

A Connecticut PIC is permitted by statute to engage only in limited activities with respect to specific "intangible investments," including the purchase and sale of such investments, and the collection and distribution of income attributable to those investments (including interest income and gains from their sale). Conn Gen Stat § 12-213 (a) (27) (C). The qualifying intangible investments are restricted to loans secured by real property and include mortgage loans and certain short-term cash equivalents. Conn Gen Stat § 12-213 (a) (27) (C). The PIC cannot originate mortgages and can only purchase them. *Special Notice SN 2000(14)*, Connecticut Department of Revenue Services, August 28, 2000. (*Special Notice SN 2000(14)*). Fidata held two categories of PIC qualified loans: (1) loans which represented the 2005 contribution to capital, and (2) loans which it purchased from Astoria Mortgage and Astoria. Unlike the REIT Preferred Funding, Connecticut PIC provisions do not require that substantially all of Fidata's profits be distributed as dividends to its shareholder Astoria Mortgage. During the Tax Years Fidata did distribute substantial dividends to the parent Astoria.

The PIC may not hold loans "solely for the purpose of sale" to unrelated parties. *Special Notice SN 2000(14)*. However, the *Special Notice* provides that any loan "sold to an unrelated party **after being held for 90 days or more** from the date of origination shall not be considered a loan held solely for the purpose of

⁴ Respondent in error summarily dismisses the qualifications of Fidata staff presumably to establish that the corporate structure should not be respected. The employees were qualified individuals who performed specific corporate and financial tasks, for which they were compensated appropriately. Petitioner's exhibit 25-B.

sale." *Special Notice SN 2000(14)*. [Emphasis supplied]. Fidata, as a PIC, was not permitted to originate mortgage loans, nor did it hold mortgage loans "solely for the purpose of sale."

A PIC, which is not a taxpayer under the Connecticut General Statutes, is not subject to the Connecticut corporation business tax and, dividends received from a PIC are not considered "gross income." *Special Notice SN 2000(14)*.

Astoria filed a Notice of Establishment of Operating Subsidiary for Fidata with the United States Office of Thrift Supervision (OTS) on March 8, 2005. (OTS Notice). The OTS Notice stated that Fidata would be engaged in the business of acquiring mortgage loans, and the business would be conducted from offices in Connecticut. It also recited the purposes for establishing Fidata: to (1) manage the subsidiary's "cash-flow and asset growth" separate from Astoria; (2) provide Astoria with the opportunity to establish operations in Connecticut; (3) provide "security for future investment assets" by separating operating and investment assets; (4) enhance income through tax benefits and (5) protect Astoria from multi-state taxation. [Stipulation exhibit L OTS Notice]. The OTS Notice informed the regulatory agency that the "increased activity of [Fidata] will create certain operating efficiencies and revenue enhancements ..." for Astoria. [Stipulation exhibit L OTS Notice]

The specific activities in which the subsidiary would engage included holding contributed mortgages and purchasing other mortgages from Astoria, Astoria Federal, and possibly third parties. [Stipulation exhibit L OTS Notice] The Notice stated that the mortgage purchases by the Fidata would be "on an arm's

length basis." [Stipulation exhibit L OTS Notice]. The Notice provided for a Board to be comprised of an outside director of Astoria, two senior Astoria officers and one other individual. The Fidata corporate management structure was intended to include a President, Chief Executive Officer, Secretary and Treasurer. The President and Chief Executive Officer positions were to be filled by the President and Chief Executive Officer of Preferred Funding. [Stipulation exhibit L OTS Notice]. During the Tax Years the Board included Frank E. Fusco, Chairman, Peter M. Finn, Vice Chairman and Mr. Nydegger. Mr. Nydegger was also President and Chief Executive Officer, Mr. Finn was Secretary and Treasurer, and Thomas E. Lavery was Assistant Secretary. Fidata's management structure was constituted in accordance with the OTS Notice. On May 11, 2005 OTS granted Astoria the authority to proceed.

Effective July 1, 2005, Astoria reorganized its subsidiary structure. Preferred Funding held \$5,663,184,753 in primarily non-New York real estate mortgage loans. Pursuant to the reorganization, all of the capital stock of Fidata was contributed to Star, which contributed substantially all of that corporation's capital stock to Preferred Funding. Substantially all of the assets of Preferred Funding were transferred to Fidata as a capital contribution. Astoria then liquidated and dissolved both Star and Preferred Funding, and Astoria became the direct parent of Fidata.

Fidata used the principal and interest income from the contributed loans to purchase mortgage loans from Astoria and Astoria Mortgage, and subsequently used principal payments and interest income from all loans which it held to acquire

additional mortgage loans.⁵ Neither Astoria nor any of its subsidiaries provided funding to Fidata after the initial capitalization.

Fidata acquired mortgage loans at face value (adjusted by any fees). Astoria funded the mortgages through Astoria Mortgage, the mortgages were closed and sold immediately to Fidata. Approximately \$1.2-\$1.5 billion in mortgages were purchased each year during the Tax Years. The mortgages purchased were residential loans, including Adjustable Rate Mortgages (ARMs) (with, for example, 5-7 year initial fixed terms). Fidata did not purchase second liens or home equity lines of credit, and did not engage in sub-prime lending during the Tax Years. Mr. Fusco testified that at some point during the time of the financial crisis management determined not to pursue expansion in Connecticut. (Tr 89).

Mr. Nydegger testified to the procedures for purchasing mortgage loans. Each month a cash projection is made to determine the amount of funds which would be available to Fidata. Newly originated mortgages are purchased from Astoria Mortgage on a daily basis up to the available monthly amount. The mortgages are purchased at face value, in cash transferred to Astoria. The funds to pay for the mortgages are from principal and interest payments received on mortgages in Fidata's existing portfolio. Astoria Mortgage delivered executed notes and assignments of mortgage to Fidata. (Tr 386-388).

⁵ See Petitioner's exhibit C. Of Fidata's mortgage holdings, New York loans comprised 14.68% in 2006, 12.78% in 2007 and 12.06% in 2008.

As noted *infra*, Fidata did not originate loans. Neither did Fidata select the specific loans which it purchased from Astoria Mortgage. Rather, the purchasing decision was based on the amount of funds available to Fidata for purchase, consideration of Astoria's 'menu' of products and whether there are non-New York mortgages available.

Once the mortgages were purchased, they were assigned to Fidata and Fidata becomes the owner of the loans. (Petitioner's exhibit H). Similarly, where the Federal National Mortgage Association (FNMA or 'Fannie Mae') purchased loans from Astoria, Fannie Mae became the owner. The mortgages were recorded in the name of the lender, Astoria Mortgage, which is the practice in the industry.

Fidata was not involved in the solicitation, investigation, negotiation and/or approval (four of five activities collectively referred to as SINAA⁶) of any of the mortgage loans it received from Astoria Funding as a capital contribution, or which it purchased from Astoria and Astoria Mortgage. Administration and servicing of the loans which were contributed to the capitalization of Fidata were performed pursuant to purchasing, servicing, custodial and expense-sharing agreements between Fidata and related subsidiary corporations. For mortgages acquired after the capitalization of Fidata, administrative functions were initially performed by Astoria and/or Astoria Mortgage. At the end of 2005, Astoria contracted for mortgage servicing with an unrelated corporation, Dovenmeuhle Mortgage Inc. (DMI). Fidata paid Astoria \$25-\$26 million per year for

⁶ The fifth "A" of SINAA is "administration." Respondent accepts that Fidata was involved to an extent in administrative functions. Respondent's Reply Brief p. 17.

mortgage servicing, a fee which was considered by Mr. Nydegger to be a "normal business rate." (Tr 455).

Fidata paid \$480 million in dividends to its shareholder, Astoria, during the Tax Years. See e.g., Pet. Ex. K, L. The dividends were paid quarterly from interest income and principal. The dividend payments represented a substantial percentage of Fidata's net book income: for 2006, 68.30%; for 2007, 95.98%, and for 2008, 73.06%. Pet. Ex. F. The dividends were reflected in Astoria's City Bank Tax returns as distributions.

In 2005 and for a period of time thereafter, Fidata employees performed quality control activities, including due diligence and compliance review. (See e.g., Petitioner's exhibit P). By 2006, however, an unrelated company, Magnet Portfolio Services, was engaged to perform these services.

Fidata employees continued to be responsible for all post-closing activities with respect to mortgage loans purchased. They assembled the loan files, which included, for example, collection of certain documents and review of title policies. The loan files were then sent to Suffco (the affiliated records custodian corporation) which kept completed mortgage loan files for Fidata and Astoria. Fidata employees also administered a program which the parent established, the E-Z Mod Program, which affected the loans held by the PIC. (Petitioner's exhibit Q.)

Agreements between Fidata and Astoria. (1) Master Loan Purchase and Servicing Agreement (Master Loan Agreement). Fidata acquired mortgage loans from Astoria and Astoria Mortgage pursuant to the July 1, 2005 Master Loan Agreement. Generally,

the Master Loan Agreement provided that Astoria and/or Astoria Mortgage would sell residential and commercial first mortgage loans and certain cooperative loans in bulk to Fidata. (Stipulation exhibit N]. While record title of these loans remained with Astoria, the parties agreed that Fidata would be the beneficial owner of the mortgages and related notes. (Stipulation exhibits O,N).

Astoria agreed to service and administer the mortgage loans purchased by Fidata under Section 11 of the Master Loan Agreement and with respect to the provisions of an Addendum to the Agreement. [Exhibit 9 to Stip Ex N]. Astoria was responsible for escrow processing, collection processing, and customer service calls. Funds collected and received by Astoria (as servicer) were to be held in custodial accounts for Fidata and transferred to Fidata.⁷

Fidata paid Astoria \$25 million annually to service loans it purchased from Astoria. The fee, computed according to industry standards, was 25 basis points for a fixed rate mortgage and three-eighths of one percent for an adjustable loan. (Tr 319). This rate was the same rate which Astoria charged Fannie Mae and third parties.

Initially Astoria serviced the entire loan portfolio of the Astoria group, including subsidiary loans, federal loans (Fannie Mae, Federal Home Loan Mortgage Corporation (FHLM) also known as

⁷ The funds were distributed on a Distribution Date, which is the fifth business day of the month following the month in which the Cutoff Date occurs, and the Cutoff Date is the first day of the month in which the Closing Date occurs.

Freddie Mac) and loans which Astoria serviced for third parties. In 2005 Astoria contracted with DMI,⁸ a "private label" mortgage servicer, to service the loans. (Tr 324). The fee paid to DMI, as the fee paid to Astoria, was twenty-five basis points for a fixed-rate mortgage and three-eighths of a percentage for adjustable loans. This fee was a generally accepted service fee in the mortgage servicing industry. (Tr 351). Astoria charged its subsidiaries for their proportionate share of the fee paid to DMI, and the subsidiaries (including Fidata) reimbursed Astoria for the servicing fee calculated generally on a per loan or per loan level basis at the noted rate. (Tr 354-5).

(2) Expense Sharing Agreement. Fidata and Astoria also entered into an Expense Sharing Agreement on July 1, 2005, which provided that each party would reimburse the other for certain administrative expenses. The contemplated expenses included Fidata's using Astoria's "facilities and equipment" and in certain situations, personnel. [Stipulation exhibit O]. Fidata paid Astoria \$480,000 annually to provide intercompany services (accounting, human resources, and legal).

(3) Custodial Agreement. Fidata, Astoria Funding, Astoria and Suffco entered into a "Custodial Agreement" also on July 1, 2005. The Custodial Agreement outlined the responsibilities of the parties for the delivery and retention of loan documents on or before the loans' Closing Dates to Suffco as records custodian.

⁸ Ira Yourman, Petitioner's Senior Vice President and Director of Loan Administration and Servicing, testified concerning DMI. (Tr 35 -355). DMI is an independent company which services loans for approximately 200 clients. Mr. Yourman testified that the fees paid for servicing, to Astoria and to DMI, were "generally accepted servicing fees." (Tr at 351).

(4) Fidata also agreed that Astoria could use its mortgage loans as collateral for borrowing from Federal Home Loan Banks (FHLB).

Tax Returns. Astoria filed Forms NYC 1A NYC Combined Tax Returns for Banking Corporations, for each of the Tax Years. Petitioner and its combined subsidiaries conducted savings and loan activities within and without the City. The returns reported the allocated combined income, taxable assets, and capital stock for Astoria and several related subsidiary corporations. Astoria reported combined allocation percentages between 18.20% and 18.71% for the Tax Years. Submitted with the filed combined returns were *pro forma* Forms NYC 1 for Astoria Federal and Suffco, subsidiaries included in the combined filing. Astoria did not include Fidata and Astoria Mortgage in the combined Bank Tax filings. Pro forma returns for those corporations were included with Astoria's Federal consolidated returns for the Tax Years.

In 1985 Fidata elected to continue to file New York State (State) Corporation Franchise Tax (CFT) Returns, pursuant to State Tax Law Section 1452 (d), as a "grandfathered" Article 9-A entity, rather than file or be included in State Bank Tax returns. (State Tax Law § 1452 (d)). Accordingly, Fidata filed State CFT Returns for the Tax Years and could not be included in any State combined Bank Tax return. State Tax Law § 1462.

Fidata did not do business in the City and was not required to file either City General Corporation Tax or City Bank Tax Returns. As a non-filer, Fidata was not eligible to elect to

file its City returns as General Corporation Tax returns rather than Bank Tax returns, as provided by Administrative Code § 11-640 (d).

During the Tax Years, Fidata filed Connecticut Information Returns for Passive Investment Companies (Forms CT-1120 PIC). These returns generally reported Fidata's expenses, gross receipts and dividends for each reporting year. In addition, the corporation's employees were identified and their salaries listed.

The CRA. The federal Community Reinvestment Act (CRA) was enacted to enable Federal supervisory agencies to "assess an institution's record of helping to meet the credit needs of the local communities in which the institution is chartered" 12 Code of Federal Regulations (CFR). § 563e.11. 12 United States Code (USC) § 2901 (a). The CRA was created to overcome banking practices known as "redlining," where an institution failed to make loans to residents in certain low- and moderate-income areas while at the same time taking their deposits. (Tr at 478).⁹ The statute states that "the convenience and needs of communities include the need for credit services as well as deposit services" (12 USC § 2901 (a).)

The CRA requires financial supervisory agencies to use their examination authority to encourage this lending behavior. 12 USCA § 2901 (b). The supervisory agency's assessment of a banking

⁹ Congressional findings with respect to Community Reinvestment, 12 USCA § 2901 (a), which states that "the convenience and needs of communities include the need for credit services as well as deposit services" It further provides "regulated financial institutions have a continuing and affirmative obligation to help meet the credit needs of the local communities in which they are chartered."

corporation will specifically be considered when the institution makes certain applications, including requests for new branches and deposit facilities, relocation of offices, mergers with institutions which require agency approval, and acquisitions. (12 USC § 2903(a)(2) ; 12 CFR 563e.11 (b) (2); CFR 563e.29 (a).)

The CRA requires savings banks to meet three weighted "tests": lending, service, and investment. The "lending" test examines the institution's record of meeting credit needs in its assessment area. Both origination and purchases of loans are considered. Lending performance is examined with respect to the number and amount of the loans, the geographic distribution of the loans, the characteristics of the borrowers, the institution's community development lending, and whether the savings association uses innovative or flexible practices. (12 CFR 563e.22(b)(1)-(5)). The results of this test are given a fifty percent (50%) weight. The "service" test evaluates the savings association's "record of helping to meet the credit needs of its assessment area(s)..." and looks to the institution's delivery of retail services in the area and its community development activities. (12 CFR 563e.24). This test is given a 25% weight. The "investment" test evaluates the savings association's record of meeting the "credit needs" of its assessment area. This test is also given a 25% weight.¹⁰

A Federal savings association defines its own assessment area, which must include the area where the savings association has its main offices and the "surrounded geographies" where it originates or purchases loans. (12 CFR 563e-41). It may choose to include or exclude affiliate loans, provided the loans chosen

¹⁰ See, APPENDIX A TO PART 563E-RATINGS 12 CFR § 563e, App. A, Eff. Nov. 3, 2010, for specific examples of each of the test areas.

include all affiliate loans in the specific lending category. (12 CFR 563e.22 (c)).

The applicable supervisory agency rates savings association according to four categories: outstanding, satisfactory, needs to improve, or substantial noncompliance. (12 CFR 563e.21 (c)). Both the activities of originating and of purchasing loans are included for purposes of the CRA. The higher the rating, the more likely the banking corporation is to receive approval from the supervisory body for expansion of its services and facilities.

Astoria's chosen assessment area is located entirely within New York State. Astoria elected not to include any subsidiaries for purposes of the CRA rating, and CRA review primarily involves consideration of its New York loan activity. During the Tax Years, Astoria was examined by OTS in 2007 and its CRA rating was "Outstanding."

City Department of Finance Audits. In 2008 Respondent began an audit of the books and records of Astoria and related combined subsidiaries for the 2004 through 2006 report periods. (The 2008 audit). At some point during the course of the 2008 audit, the 2006 Tax Year was removed from consideration. The remaining audit review of Petitioner's 2004 and 2005 books and records, including Combined Tax Returns for Banking Corporations (Forms 1A,) was completed, and the 2004 and 2005 Bank Tax Returns were accepted as filed.

The Audit Comments for the 2008 Audit note a detailed examination of the allocation of expenses to the "Delaware REIT"

(apparently the former subsidiary, Astoria Funding). With respect to the costs for mortgage loan servicing, the comments note that Astoria "allocated cost[s] close to what FNMA and Freddie Mac would reimburse banks for mortgages bought." (Petitioner's exhibit Q). Nathan Iyer, Respondent's auditor, testified that the scope of the 2008 Audit was limited to reviewing the factors which comprised the allocation percentage, stating at various times that the factor considered was either the payroll factor or the receipts factor. (Tr at 708, 722). He also testified that while a consideration of the REIT structure and the allocation of its 'servicing' expenses would be considered for purposes of an Internal Revenue Code §482-style¹¹ adjustment (Tr at 731). Respondent did not include REITs in combined filings. He agreed that the parent of the REIT, Star Preferred, could be included in a combined report. (Tr at 736). In Mr. Iyer's opinion, if a REIT is paying sufficient dividends to its parent, the returns would be accepted as filed. (Tr at 734). The 2006 Tax Year ultimately was not included in the 2008 Audit review, but review of that period was preserved for the subsequent audit period.

In September 2009, Respondent began an audit of Petitioner's books and records for the 2006 and 2007 report periods. (The 2009 Audit). After the 2009 Audit was initiated, Respondent included review of Petitioner's 2008 report period in the examination. Two audit case files were maintained, one concerning the 2006 tax

¹¹ These adjustments would be similar to adjustments provided under IRC § 482. The adjustments are often referred to in a 'shorthand' as "482 adjustments" although they are solely adjustments made by Respondent Department. . The Code provides for either item review (Administrative Code § 11-646 [g]) which would be similar to a "482-type' adjustment or in the alternative, combination. (Administrative Code § 11-64 6 [f] [1] [B]; [g].

year and one the 2007-2008 period.¹² Respondent concluded at the end of these reviews that Petitioner should be required to include Fidata and Astoria Mortgage in its combined Bank Tax filing. Petitioner does not oppose including Astoria Mortgage in its combined report, but does not necessarily agree with Respondent's Audit conclusions and characterizations concerning the combination. Adjustments proposed with respect to Astoria Mortgage are not considered in this determination.

A State audit for the 2006-2007 period resulted in "No Change." There were no Federal audits of Petitioner for the Tax Years.

A Notice of Proposed Tax Adjustment was issued, asserting City Bank Tax liability, interest and penalty of \$8,044,814.93, based upon an adjustment of the expenses allocated to Fidata. Petitioner disagreed with the proposal. The matter was further reviewed by Respondent's auditors and by Respondent's legal representatives, who decided that rather than allocation adjustments, the Department would require a combined filing which included Fidata. (Tr at 1126).

A Notice of Determination was issued to Petitioner on September 14, 2010, asserting Bank Tax due for the 2006 Tax Year, in the base tax amount of \$3,407,414, with interest computed to

¹² Respondent made several document requests (IDRs) during the audit, including after issuing the Notice of Determination for the 2006 tax year was. (Respondent's Exhibits 5, 25A and 25B). The August 4, 2010 request (IDR 8) requested a list of Petitioner's loans. Petitioner provided Fidata's loan "portfolio" (a list of all the loans) for 2006 and 2007, on August 30, 2010. The auditor testified that the response was incomplete as no actual loan files were submitted. (Tr at 1135-2237). On June 7, 2011 (after the Notice for the 2006 Tax Year was issued) Respondent again asked for a "complete list of loans in FIDATA's [SIC] loan portfolio." (Respondent's exhibit 5.) It was not until June 28, 2011 that Respondent requested specific loan files. (Respondent's exhibit 21).

the date of the Notice and penalties asserted for substantial underpayment (Administrative Code § 11-676.11) and late-filing (Administrative Code § 11-676.1). On August 26, 2011, Respondent issued Petitioner a Notice of Determination asserting Bank Tax due for the 2007 and 2008 Tax Years, in the base tax amount of \$5,970,540.69, with interest computed to date of the Notice and penalties asserted for underpayment (Administrative Code § 11-676.11). (The Notices). Respondent agreed to waive the late-filing penalty imposed for the 2006 Tax Year, in the amount of \$340,741.41.

The Notices reflect Respondent's determination to require Fidata be included in Astoria's Tax Years combined Bank Tax filing. Respondent included income attributed to Fidata to Astoria's combined entire net income for the Tax Years and eliminated dividend income paid to Astoria by Fidata, certain interest income and other income, and service fees paid by Fidata as intercorporate adjustments.

Mr. Paul Compere (the Department field auditor on the 2009 Audit), and Mr. Iyer (who was Mr. Compere's supervisor on the 2009 Audit) each testified with respect to the 2009 Audit. Their findings are the subject of these proceedings. Both individuals testified that the proposed inclusion of Fidata in Petitioner's City Bank Tax Combined report was computed at the request of, and in consultation with, members of Respondent's Office of Legal Affairs, primarily at the direction of Mr. Michael Newmark, Director of Legal Advocacy for Respondent. (Tr at 716 1126).

Respondent asserted on audit that for the Tax Years there is a "mismatch of income and expenses" between the subsidiary Fidata

and Petitioner, with the result that the group's income is not properly reflected and combination is required. This position, articulated in the Audit Comments and restated in testimony, focuses principally on transactions between Fidata, Astoria Mortgage and Petitioner. The Audit Comments for the 2006 period, and the 2007-2008 period, each note that there were intercorporate transactions between the two subsidiaries and the "operating bank" (here presumed to be Astoria). In the 2006 Audit Comments (Petitioner's exhibit S) the transactions were characterized as "many" and in the 2007-2008 Audit Comments as "substantial." (Respondent's exhibit 21).

The identified transactions include the capital contribution to Fidata (described as "mortgage loan portfolios" in Respondent's exhibit 21), Astoria's management of the non-City loan portfolios for Fidata, and Fidata's payment to Astoria and Astoria Mortgage of "small management and custodial fees" (Respondent's exhibit 21) for administrative services for Fidata. (Petitioner's exhibit S). A general allegation was made in the 2007-2008 Audit Comments that Petitioner "deducted the expenses" while Fidata (and Astoria Mortgage) "reported the incomes." [Sic]. (Respondent's exhibit 21). In the opinion of the auditors, these transactions cause Petitioner's income to be reflected "incorrectly."

Respondent concluded that although Fidata is not doing business in the City (and therefore is not a City taxpayer), the corporation should be included in Petitioner's combined City Bank Tax reports in order to properly reflect Petitioner's combined City Bank Tax entire net income.

Expert Witness Testimony. Three individuals were offered as expert witnesses: Barbara Kent, Richard Pomp, and Anthony Saunders.

Barbara Kent. Petitioner offered the testimony of Barbara Kent as an expert in the Community Reinvestment Act. Ms. Kent is presently the President of the Coalition for Debtor Education at Fordham University School of Law in New York City. She was a consultant with the City firm Promontory Financial Group, where she advised concerning mortgage settlement issues between servicers and federal agencies. She is a consultant for Morrison & Foerster, the firm representing Petitioner in this matter. From 1998 through 2006 Ms. Kent held several positions with the New York State Banking Department, including as Director of Consumer Affairs and Financial Products. Among her responsibilities was the drafting of amendments to the New York Community Reinvestment Act (NYCRA).¹³ Ms. Kent was accepted as an expert in banking regulation, and the Federal and State CRA (collectively CRA).

Ms. Kent testified with respect to the State and Federal CRAs, their requirements and their application. She stated that in the period 1995-1997 the CRAs changed the focus of their activities from examining banks' "process" of making mortgage loans, to their loan "performance" in lower and middle income areas. (Tr at 479). She testified concerning the general provisions of the CRA. She noted the three required CRA performance tests (lending, service and investment), and the four

¹³ State Community Reinvestment Act (State CRA), NY Banking Law sec 28-B is substantially similar to the Federal CRA, except in two instances: New York has a 'basis banking account' requirement, and, because of the cost of mortgages in New York, banks may receive CRA credit for making loans to individuals whose income is above the 'moderate' level. (Tr at 472).

CRA ratings (outstanding, satisfactory, needs to improve or substantial noncompliance), that a bank chooses its CRA assessment area (which is geographical) generally as the area where the main office is located, that the institution will decide which loans will be included for regulatory consideration (Tr at 525-6) and that banks elect whether or not to have affiliates included in the CRA review, with the caveat that all affiliates of a specific line of business must be included (Tr at 519). She stated that an outstanding CRA rating will enhance the possibility that future applications by the bank to expand its services, for example, will be treated favorably. (Tr at 492).

Ms. Kent testified that the CRA "is designed to increase lending services in investment to low- and moderate-income individuals and neighborhoods within the assessment area." (Tr at 505).

Anthony Saunders. Respondent offered the testimony of Anthony Saunders as an expert in eight areas of finance and economics: (1) banking and finance; (2) financial economics; (3) international banking; (4) general economics; (5) financial institution portfolio risk analysis; (6) the regulation of financial institutions; (7) financial institutions operations; (8) financial investment portfolio management. By his own admission, Mr. Saunders is not an expert in federal or state and local taxation. (Tr at 818). He did not prepare a report, but a copy of slides from a Power Point presentation prepared for this case was admitted into evidence. (Respondent's exhibit 14).

Mr. Saunders is a graduate of the London School of Economics and Political Science, where he earned his Bachelors, Masters and

PhD degrees. He is presently the John M. Schiff Professor of Finance at the New York University Stern School of Business. A former Chair of the Stern Department of Finance, he is a member of the Department's Management Committee. He has published and lectured extensively, and has held several visiting positions with, for example, the Comptroller of the Currency, the International Monetary Funds, the Federal Reserve Board of Governors, several Federal Reserve Banks, and various foreign academic institutions. Professor Saunders has testified in other proceedings as an expert witness. He was accepted as an expert witness in the same enumerated fields at the Formal Hearing before the New York State Tax Appeals Tribunal, Administrative Law Judge Division, in *Matter of Interaudi Bank F/K/A/ Bank Audi*, [NY St Div of Tax Appeals DTA No. 821659, January 28, 2010] (ALJ Determination). Professor Saunders was accepted as an expert in this proceeding in the eight enumerated areas.

In preparation for his testimony, Professor Saunders reviewed the auditors' reports, portions of Petitioner's annual reports (but not the footnotes to the financial reports), records of meetings and a Thrift Financial Report for 2006. (Tr at 842) He also reviewed the Connecticut statutory provisions which apply to PICs.

Professor Saunders identified the economic issue presented by this matter to be whether Fidata lacked "economic substance." In his opinion Fidata lacked economic substance and, further, there was no "economic substance" to holding the enumerated mortgage assets. He based this opinion on a series of identified facts and characterizations. For example, he considered: where income and expenses attributable to the "mortgage portfolio" were

carried; where loans were originated; where loans were serviced; the number, characterization, and salaries of Fidata's employees; the composition of Fidata's Board of Directors, and the activity accomplished at Board meetings; the various effects of Fidata's federal consolidation with Astoria; the size and composition of the parent and subsidiary mortgage portfolios; and the CRA.

Professor Saunders defined "distortion" as the condition where there is no match of interest expense with interest income. (Tr at 987). He generally opined that there was "distortion" in the relationship between Fidata and Astoria because of a "net interest margin" which was the result of Astoria's paying "all interest expense" and earning only part of its income as interest earned. (Tr at 870).

Professor Saunders specifically concluded that the creation of Fidata and its continued operations enhanced three risks for Astoria: (1) a liquidity risk (a reduction in a source of funds to meet withdrawals); (2) an interest risk (on the balance sheet there was a "duration gap" and on income statements there was a "repricing gap") and (3) a credit risk (a risk of default due to the relationship between long-term assets and short-term liabilities). (Tr at 1240-1242).

His testimony was based in part on a mistaken assumption that Astoria had received moneys through the Federal Troubled Asset Relief Program (TARP) established following the 2008 financial crisis.¹⁴ In his opinion all banks which applied for

¹⁴ The witness attributed this conclusion to a December 11, 2008 article in a business magazine which he read through an internet site. He did not print a copy of that article and did not specify exactly when he viewed it. (Tr at 1006).

the funds were de facto 'troubled.' Further testimony clarified that Astoria did not receive any TARP funds.¹⁵

In Professor Saunders' opinion, there was no evidence that the loans which Fidata purchased from Astoria were purchased at arm's length. He opined that they were bought at "face value" which was less than what they might be worth given that "interest rates can change over time." (Tr at 1269). He did state that at the time of origination of the loan, face value was in fact market value. (Tr at 1266). He believed that Fidata was structured to provide banking clerical services (Tr at 874) and that putting assets into Fidata could be analogized to putting moneys into a "sweep account." (Tr at 904). In Professor Saunders' opinion there would be benefits to Astoria to hold the Fidata mortgage loans on its own balance sheet as it would reduce the parent's credit and interest rate risks. (Tr at 1248).

Professor Saunders concluded that Fidata was created as "a passive investment company to exploit tax considerations to allow Astoria Financial Corporation to reduce its New York City tax." (Tr at 931). He admitted that he was not an expert in either federal or state and local taxation (Tr at 818). Accordingly, he was unable to identify specific tax advantages.

In general, while his testimony concerning the economics of corporate structures and finance was reasoned, by his own admission he is not an expert in taxation and his conclusions

¹⁵ Professor Saunders testimony in this regard was further undermined by his admission that he was not particularly familiar with either the process of applying for the program, or what specifically transpired with respect to Astoria. (Tr at 1198, 1201, 1210).

concerning the tax consequences of Petitioner and Fidata's relationship and filings were not supported.

Richard Pomp. Petitioner offered the testimony of Richard D. Pomp as an expert in state tax policy. Mr. Pomp is the Alva P. Loisel Professor of Law, University of Connecticut School of Law, and an Adjunct Professor at New York University School of Law. He has been a visiting professor at several national and international universities. He holds a J.D. from Harvard Law School and a B.A. from the University of Michigan. His professional activities include membership on several tax commissions and advisory boards, and as a consultant for several state and local legislatures and departments of revenue. He is a contributor to legal casebooks, the author of several books and monographs, and numerous articles. Professor Pomp was accepted as an expert witness in tax policy.

Professor Pomp was asked by Petitioner to consider the appropriateness of using a distortion analysis to require Fidata be included in Petitioner's City Bank Tax combined filing. In preparation for his testimony, Professor Pomp reviewed Petitioner's financial records and spoke with Petitioner's officials. Professor Pomp did not prepare a report for submission into the record, but did testify concerning a group of slides which he prepared and which were introduced to clarify his testimony. (Petitioner's exhibit 14).

Professor Pomp testified generally that a contribution to capital by a parent to a subsidiary is essentially a deferral of taxable income, as the parent will receive income generated by the subsidiary's use of the asset, or realize a gain when the

stock of the subsidiary will be sold. In either case, the income attributable to the parent is taxable. In his opinion the contribution of mortgages by the related corporation to Fidata does not constitute distortion. (Tr at 637.) Further, he testified that Respondent's position is inconsistent with tax policy expressed, for example, in statutory and regulatory treatment of dividends. (Tr at 638).

Professor Pomp also testified that in his opinion forming Fidata to hold non-New York mortgages is itself a substantial "business purpose" which had the effect of protecting the "integrity" of Astoria's CRA rating. He stated that the issue which should be considered is whether there are "real economic consequences" to the examined activities. (Tr at 653). He testified that he "reject[ed] business purpose as being relevant to choice of entity." (Tr at 691).

Proposed Findings of Fact. Respondent offered 166 Proposed Findings of Fact. The following are in substance accepted to the extent reflected in the Statement of Facts and supported by the Stipulation and submitted documents: 1, 2, 3 (insofar as it refers to SINA, and not the administration function), 4, 5 (only with respect to Astoria Mortgage), 12, 13 first sentence only), 24, 26, 28, 32, 34, 36, 38, 44 (only that the loans were acquired at face values, 46, 48 51, 64, 65, 67, 68, 69, 70, 85, (only with respect to the actual letter), 88 (only to the extent it reflects exhibits admitted), 90 (without footnote), 91, 92, 93, 95, 96, 97, 100, 110, 143, 144, 146, 149, 152 (only to the extent it reflects the exhibit), 154 (only to the extent it reflects the exhibit). The following are not found as they request findings on evidentiary facts (primarily testimony): 5 (concerning

testimony) , 7-11, 15, 17-19, 21, 27, 29, 30, 37, 39, 40-43, 47, 49, 50, 52-55, 58-63, 66, 71, 73, 74, 76-84, 86-88, 89 99, 101-109, 111-142, 145, 147, 148, 150-153, 156-166. The following are not found: 6, 14, 16, 20, 35, 47, 57, 61, 89. The following call for a conclusion of law: 31, 33, 42, 47, 54, 75, 76, 85 (to the extent of the characterization), 155. (See generally, 19 NYCRR 400.12 Department of State, Hearings, Rules and Procedures, Proposed Findings of Fact).

STATEMENT OF POSITIONS

Petitioner asserts that Fidata, its wholly-owned subsidiary which does not do business in New York, was formed for the valid business purpose of maintaining Astoria's "outstanding" CRA rating, by holding the group's non-New York mortgages and thereby allowing the rating to be based primarily on Petitioner's portfolio of New York mortgage loans. Petitioner asserts that the corporation Fidata has economic substance and that it was formed for a bona fide business purpose. Petitioner further asserts that its transactions with Fidata were at arm's length. Therefore, Petitioner argues, its income is not inaccurately or improperly reflected when it did not include Fidata in combined returns for the Tax Years. Finally, Petitioner challenges the constitutionality and the constitutional application of Administrative Code §11-640 [a] [9], the City Bank Tax "grandfather" provision.

Respondent asserts that Fidata lacks economic substance, was not formed for a valid business purpose, and was formed to avoid City Bank Tax. Respondent argues that the transactions between Petitioner and Fidata were not at arm's length, and there was a

"mismatch" of income and expense between the subsidiary and the parent. Respondent concludes that there is an inaccurate reflection of City Bank Tax liability when Petitioner reports on a combined basis which does not include Fidata, and as a consequence, Petitioner's City Bank Tax combined entire net income is inaccurately reported. Respondent argues that this distortion of entire net income can only be cured by requiring Petitioner to include Fidata in its combined Bank Tax return.

CONCLUSIONS OF LAW

The Administrative Code imposes a tax on banking corporations doing business in the City. (Administrative Code § 11-639 [a]). A "banking corporation" is defined by the Code to include corporations which are authorized to do or are doing a "banking business." (Administrative Code § 11-640 [a] [1] through [7]; [b]). For the Tax Years, the Bank Tax was imposed against the greater of a banking corporation's (1) allocated entire new income, (2) allocated taxable assets, (3) allocated alternative entire net income, or (4) a minimum tax of \$125. (Administrative Code § 11-643.5).

A banking corporation doing business in the City is required to file its Bank Tax return on a combined basis with any banking corporation or bank holding corporation eighty percent (80%) or more of the voting stock of which it owns, directly or indirectly. (Administrative Code § 11-646 [f] [2] [i] [b]). Respondent may also require a combined filing, where it is determined that a combined return is "necessary in order to properly reflect the tax liability ... because of intercompany transactions (Administrative Code § 11-646 [g]) or some

agreement, understanding, arrangement or transaction" between the banking corporations (Administrative Code § 11-646 [f] [2] [i] [B]) where the City "activity, business, income or assets of the taxpayer is ... improperly or inaccurately reflected." (Administrative Code § 11-646 [g]). Each corporation in a combined Bank Tax filing must be a banking corporation or a bank holding corporation. (Administrative Code §§ 11-640, 11-646 [f] [2]).

A banking corporation or bank holding corporation which is not a taxpayer is not subject to the Bank Tax, does not file a Bank Tax return, and generally will not be required to be included in a City combined Bank Tax return. (Administrative Code § 11-646 [f] [2] [i] [B])). A non-City banking corporation may only be included in a Bank Tax combined report, where it is (1) part of the "unitary business" of the combined group (19 RCNY 3-05 [b] [3] [ii] [A]) and (2) Respondent Commissioner of Finance concludes that the combination is necessary because of either intercorporate transactions (referencing 19 RCNY 3-05 [b] [3] [ii] [C]) or

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 City is improperly or inaccurately reflected. (Referencing 19 RCNY 3-05 [b] [3] [ii] [d]) (19 RCNY 3-05 [b] [6]).

The Bank Tax Rules (Rules) require that the identified intercorporate transactions be "substantial" (at least 50%) between and among corporations in the group. (19 RCNY 3-05 [b] [3] [ii] [C]). If there are defined substantial intercorporate

transactions among the corporations engaged in the unitary business, the Regulations create a presumption of distortion of tax liability when reporting on a separate basis. (19 RCNY 3-05 [b] [3] [ii] [B], [C] [a]).

Distortion of income may be corrected by adjusting specific items of income or deduction, assets and/or compensation. (19 RCNY 3-03 [a] [3] [i]). If the adjustments do not correct the distortion, Respondent may require a combined return or may look to Rules Section 3-05 to require specific adjustments. (19 RCNY 3-03 [a] [3] [i]). The Rules identify several factors to consider, including control between the corporations, whether the parties are dealing at "arm's length" in their agreements or arrangements, and whether the agreement "has a reasonable business purpose, or whether it appears to be arbitrary or to have been motivated principally by a tax avoidance purpose." 19 RCNY 3-03 [a] [3] [iii]. Finally, the Rules permit consideration and application of the "principles" contained the Federal income tax regulations §§ 1.482-1 and 1.482-2. (19 RCNY 3-03 [a] [3] (iv)).

Bank subsidiary corporations which were subject to tax under the City General Corporation Tax (Administrative Code Title 11, Chapter 6, Subchapter 2) (GCT) for the taxable period ending during 1984, may elect to remain subject to that provision and not subject to the City Bank Tax. (Administrative Code § 11-640 [d]). This provision, generally referred to as the "grandfather election," is substantially similar to New York Tax Law § 1452 [d] (State Grandfather Provision). A corporation which makes the election may not be included in a Bank Tax combined report. Administrative Code § 11-640 [d]. See *Premier National Bancorp*

(NY St Div of Tax Appeals, DTA No. 19746, August 2, 2007). (The Tribunal considered similar requirements pursuant to the State 'grandfather' provision). Fidata made the grandfather election for State purposes, and could not be included in Astoria's State combined return. As it was not doing business in the City during the Tax Years, and consequently did not file Bank Tax returns, the City election was not available.

Astoria filed combined Bank Tax returns for the Tax Years with ten (10) subsidiary corporations, reporting entire net income allocated to the City. During this same period, Fidata was not doing business in the City and therefore was not required to file a City Bank Tax or City GCT return, nor could the corporation be included in Astoria's combined return unless the specific statutory and regulatory criteria were met. (Administrative Code §§ 11-646 [f] [2] [1] [b]; 19 RCNY §§ 3-05 [a] [6] [i]).

Banking corporation entire net income (ENI) is presumably the same as Federal taxable income computed pursuant to the provisions of the Internal Revenue Code allocated to the City. (Administrative Code § 11-641 [a] [1]). The Code provides that entire net income does not include sixty per cent (60%) of dividend income from subsidiary capital. (Administrative Code § 11-641 [e] [11]).¹⁶

Astoria meets the ownership criteria as it owns 100% of Fidata's voting stock. While ownership is a threshold

¹⁶ Petitioner is correct that the dividend exclusion was legislatively authorized. See, chap 170/1994 §89, eff. June 9, 1994. See, also, generally for the legislative history of the State Banking Corporation Tax, State TSB-M-85(16) (C) Memorandum February 10, 1986.

requirement for combination, it is never the only basis for requiring or permitting a combined filing. Fidata is clearly part of the overall unitary banking business of Astoria.

Respondent argues that Fidata is a "sham" corporation and/or the transactions with that corporation should be disregarded.¹⁷ Therefore, the first analysis must be whether the transactions merit "tax respect" and as a corollary whether the subsidiary corporation is a sham. (*Matter of Kellwood Company*, [NY St Div of Tax Appeals, DTA No. 820915, September 22, 2011] citing to *Countryside Ltd. Partnership v Commissioner*, (TC Memo 2008-3)). A two-part analysis is applied: (1) an objective test to determine if the corporation or the transactions have "economic substance;" and (2) a subjective test to determine whether the transactions were entered into for a legitimate non-tax business purpose. *Matter of Sherwin-Williams* [NY St Div of Tax Appeals, DTA No. 816712, June 5, 2003], confirmed *Sherwin-Williams Co. v. Tax Appeals Trib.*, 12 AD3d 112 [3d Dept 2004], **lv denied** 4 NY3d 709 [2005]. As the Tribunal noted, the tax respect analysis is a "factual inquiry."

Fidata is not a sham corporation. The corporation and its transactions with its parent have economic substance. The standard for finding economic substance (the 'objective prong' of a sham transaction analysis) is that the transactions were "entered into for profit exclusive of tax benefits." (*Rice's Toyota World v Commissioner*, 752 F2d 89 [4th Cir. 1985]; *Gillman v Commissioner*, 933 F2d 143 [2d Cir. 1991]; *Fleet Funding, Inc. & Fleet Funding II, Inc. v Commissioner of Revenue*, No C271862-63,

¹⁷ In this regard, while Respondent appears to concede that Fidata is not a sham corporation, it continues to argue that the transactions do not deserve tax respect. Respondent's Sur-Reply Brief p 10-11.

2008 Mass Tax LEXIS 12 (February 21, 2008)). Fidata was established to hold and purchase non-New York mortgages from its parent Astoria. It held the contributed mortgages, previously held by the subsidiary Preferred Funding, and it purchased additional mortgages at face value on an almost daily basis from Astoria Mortgage and Astoria for the Tax Years. The purchases were made from principal and interest Fidata received from mortgagees, and Astoria did not provide financing. The mortgages were not held without closing, for example, nor were they purchased at a "discount" less than face value. Purchases of the mortgage were for profit without tax benefit.

Fidata was formed for several legitimate non-tax business purposes (the subjective "prong"): to purchase and hold non-New York mortgages; to enhance Astoria's CRA rating; to expand Astoria's business in other states. The facts also establish that Fidata was created for a tax benefit-related purpose, as a Connecticut PIC, to eliminate potential New Jersey tax liability of the Astoria affiliate which held non-New York mortgages.¹⁸ The State Tribunal noted in *Kellwood*:

A subjective business purpose ... need not be free of tax consideration [cite omitted] as taxpayers possess a legal right 'to decrease the amount of what would be his taxes , or altogether void them by means which the law permits' (*Gregory v Helvering*, 293 US 465, 469 [1935].) However, as stated by the Court of Appeals for the Federal Circuit:

There is a material difference between structuring a real transaction in a

¹⁸ It is noted that Fidata was not formed specifically to avoid City Bank Tax liability. It was not a New York corporation, and it never did business in the City. Astoria's reported City entire net income never included income earned by Fidata though it did include income received from Fidata.

particular way to provide a tax benefit (which is legitimate) , and creating a transaction without a business purpose (which is illegitimate). (Coltec Indus. Inc. v US 454 F3d 1340, 1357 [Fed Cir. 2006]).

Fidata, and the transactions between Fidata and its parent Astoria, and with related corporations, merit tax respect.

Even though the examined transactions merit tax respect, Respondent may still require a corporation to be included in a combined return if it can establish that there are substantial intercorporate transactions between the corporations or some arrangement or agreement which results in an inaccurate reflection of tax liability. (Administrative Code § 11-646 [F] [2] [b].)

There are substantial intercorporate transactions between Fidata, Astoria, Astoria Mortgage, and Suffco. In fact, there appear to be few transactions performed by or with Fidata which were not intercorporate among the related corporations which comprise the presently configured combinable group (which includes Astoria Mortgage). Respondent is entitled to the presumption of distortion on the facts presented. (19 RCNY 3-05 [b] [3] [ii] [C] [a]).

Respondent has referred to several transactions and arrangements which it argues (explicitly and by inference) establish that Astoria's tax liability is distorted when it files its combined return without including Fidata. The transactions which will be considered include: establishing Fidata as a Connecticut PIC; the initial capital contribution of mortgage loans previously held by Preferred Funding; Fidata's payment of

dividends to Astoria; Fidata's purchase of mortgage loans at face value; Fidata's payment to Astoria for mortgage servicing; and Fidata's payment to Astoria for other expenses.

Establishing Fidata as a PIC. Fidata was established as a Connecticut passive investment company for legitimate business purposes, including to take advantage of the Connecticut statute's favorable tax treatment of PIC income and to contribute to Astoria's strategy for maintaining its CRA by holding non-New York mortgages. It has active day-to-day operations. It complies with the Connecticut statutory requirements including holding the eligible investments. It is structured as articulated in the OTS application, and its transactions with Astoria are common to those of a wholly-owned subsidiary and parent. It does not engage in proscribed activities, including loan origination.

Capital Contribution. A contribution by a parent corporation to a subsidiary is not per se a distortive transaction. (*Matter of U.S. Trust Corporation* [NY State Div of Tax Appeals, DTA No. 810461 April 11, 2006]). The State Tribunal in *U. S. Trust*, affirming the Administrative Law Judge's Determination, noted that a capital contribution represents a type of deferred benefit to the parent "in the form of increased value of the subsidiaries and [which] will be realized on sale or liquidation of the subsidiaries." By funding Fidata, the income from the contributed mortgages (capital) permitted Fidata to conduct its business of purchasing loans which generated principal and interest income. The capital contribution represents Astoria's investment in its subsidiary and does not create a distortion.

Dividends. The distribution of dividends to Astoria is a return on the capital investment in the wholly-owned subsidiary. Payment of dividends is not a basis for requiring combination. The dividend deduction is a federal benefit in which the City acquiesces. (Administrative Code § 11-641 [e] [11] [ii]. *Premier National Bancorp*). The distribution of dividends from a subsidiary to a parent/shareholder is consistent with the parent-subsubsidiary structure: in return for the capitalization, the parent holds the stock of the subsidiary and realizes a return of its investment, either upon the sale of the stock or through periodic dividends from income earned by the subsidiary. The distribution of dividends is not distortive. Further, is it not distortive that 60% of the dividends received are deductible pursuant to federal law.

Purchasing Mortgage Loans. All mortgage loans were purchased by Fidata from Astoria or Astoria Mortgage at face value. Face value is the value of the mortgage loan originated by Astoria Mortgage with the unrelated mortgagee. The purchases were arm's length transactions.¹⁹

Mortgage Servicing. Astoria either serviced Fidata mortgages or contracted with an unrelated entity to perform service functions for all of its loans. Astoria's earlier charges to Fidata for mortgage servicing and Fidata's subsequent payment of its proportionate share of the fees paid to DMI (\$25 million per year) are based on the standard acceptable to corporations in the same industry. The transactions are priced according to an arm's length standard and do not create distortion.

¹⁹ Respondent generally argues that the face value of the mortgages is not the amount the mortgage is "worth," reciting a series of possible actions which might affect a price (timing, interest, etc.). Since these are hypothetical at best, the argument is not accepted.

Administrative Services. Fidata paid Astoria \$480,000 per year to perform other administrative services. This fee is an arm's length price, representing the same amount which an unrelated service provider would provide.

The presumption of distortion which flows from the facts of substantial intercorporate transactions between related corporations is rebutted where the transactions are conducted at arm's length. (*Matter of Silver King Broadcasting of N.J.* [NY State Div of Tax Appeals, DTA No.812589, May 9, 1996.] See also, *Matter of Kellwood Company* [NY Tax Div of Tax App DTA No 820915, September 22, 2011], citing to *Matter of Sherwin-Williams* [NY Tax Div of Tax Appeals, DTA No 816712, June 5, 2003], confirmed *Sherwin-Williams Co v Tax Appeals Tribunal*, 12 A.D.3d 112 [2004]. **lv denied** 4 NY3d 709 [2005]; *Matter of Knowledge Learning Corporation and Kindercare Learning Centers, In.*, [NY State Div of Tax Appeals, DTA Nos. 823962 and 823963, September 28, 2014]). The intercorporate transactions between Astoria and Fidata and Fidata and other Astoria subsidiaries were at arm's length and do not establish that Petitioner's income was distorted.

Finally, Respondent may also require a combined filing where it is established that there is an arrangement or agreement between related corporations which causes income to be inaccurately reported if they do not file on a combined basis. Administrative Code § 11-646 [f] [1]; [g]. Respondent asserts that Fidata should be included in Astoria's combined report in order to cure the distortion resulting from the arrangements between the corporations, which it alleges cause a "mismatch" of income and expenses. Respondent relies primarily on the State Tax Appeals Tribunal decision in *Matter of Interaudi Bank F/K/A Bank*

Audi (USA) [NY State Div of Tax Appeals, DTA No. 821659, Tribunal April 14, 2001].

The State Tax Tribunal in *Interaudi* considered issues of combination of banking corporations. The Tribunal held that it was appropriate to require *Interaudi*, a New York banking corporation, to include its Delaware investment holding subsidiary, BA (USA) Investment, Inc. (BA Investment) in its combined State Bank Tax returns. The Tribunal initially found that there were not substantial intercorporate transactions between the parent corporation and its subsidiary. The Tribunal concluded, however, that the corporations should be combined as a result of the arrangement where *Interaudi*'s deducted interest expense attributable to the non-combined subsidiary's income, creating a distortion of net income.

The principal argument offered by Respondent, that there was a "mismatch" of income and expenses which requires combination, is not supported by the facts. To the extent that the argument depends upon the finding in *Matter of Interaudi*, it is noted that the analysis and conclusions in that case were based upon a factual comparison of related income and expenses between the parent and the subsidiary. Respondent has not established a with any specificity a similarly direct relationship between *Fidata* and *Astoria*.

The Decision in *Interaudi* is not "on all fours" with the facts of this matter as Respondent argues. Nor has it created binding precedent. The City Charter provides that the City Tribunal

shall follow as precedent the prior precedential decisions of the [State Tribunal] ... insofar as those decisions

pertain to any **substantive legal issues** currently before the [City] tribunal. New York City Charter § 170.d

The decision in *Interaudi* did not articulate any new binding legal principle. The State Tribunal applied the State statutory and regulatory provisions to the facts presented in that matter. The substantive legal issue decided in *Interaudi* was, that under the facts unless Interaudi filed a combined return with its subsidiary BA Investment, its income would be inaccurately reflected (distorted). The Tribunal affirmed the Administrative Law Judge Determination that there was distortion where the subsidiary was not included in Interaudi's combined report.

The same legal principles with respect to combination of a subsidiary investment corporation articulated in *Interaudi* apply in this case. The State statutory and regulatory provisions for combined reporting (Tax Law § 1462 [f] [2] [I]; 1462 [g]; and 20 NYCRR 21-2) are substantially similar to the Administrative Code and City Bank Tax Rules. However, the cases must be distinguished on their respective non-analogous facts.

In *Interaudi* the parent invested \$100 million in the subsidiary BA Investments from funds borrowed from its depositors. Interaudi incurred a deductible interest expense which could be attributed to its investment in the subsidiary²⁰, while the income from the subsidiary investment (income earned by BA Investments) was allocated outside NY and not subject to tax. The ALJ found this to be a "mismatching of related income and

²⁰ In *Interaudi* the Tribunal also noted that Interaudi's 1997 financial statements reported total stockholder equity of only \$38.7 million, concluding that the balance of the \$100 million could be attributed to deposits and other borrowing. Further, it noted that for the subsequent periods Interaudi "never had an equity balance that equaled or exceeded the dollar amount of the ... investment... ."

expenses resulting in distortion:" the expense which was claimed as a New York deduction was attributable to the non-New York investment which did not generate taxable income. These arrangements created a "mismatch" of income and expenses sufficient to create a distortion requiring combination.

Astoria did not use funds from deposits (or from other cash sources) to capitalize Fidata. The contribution was of assets (mortgages) held for several years by the related New Jersey subsidiary corporation Preferred Funding. Any income from those mortgages was non-New York income not subject to the City Bank Tax. It is not possible to correlate Astoria's interest deduction to income earned by Fidata on the contributed mortgages. There is no factual support for Respondent's allegations concerning the use of Astoria deposit income to purchase mortgages which comprised the Fidata capital contribution. Without more, it is presumed that the interest expense which Astoria reported on its various returns relates to a number of other sources including interest paid on money received from depositors, investments in other assets, or its own non-subsiary mortgage portfolio.

Astoria earned income from Fidata in the form of the dividend payments which represent a quantifiable return on Astoria's investment, and are not distortive. This class of transactions does not create (or contribute to) any alleged "mismatch." Astoria, and Astoria Mortgage, also earned income from Fidata's post-capitalization purchase of mortgages at face value. This class of transactions is not distortive, and it does not create a "mismatch." In either instance, the income was reported by Astoria and subject to tax to the extent provided in the statute and regulations. Further, any administrative

expenses incurred which were attributable to Fidata were compensated by arm's length reimbursements to Astoria.

Fidata earned income during the Tax Years from principal and interest payments made by the mortgagees of the mortgages which it held which were purchased from Astoria and Astoria Mortgage. This was not income from Astoria, nor was it Astoria's income disguised to avoid tax. It was income Fidata earned in the course of its day-to-day operations.

There is no mismatch of income and expenses in this case, as there was on the facts in *Interaudi*.²¹ The income reported by Astoria is the income that corporation (or combined group of affiliated corporations) received from its activities. The income Fidata realized is income it received from its activities, primarily the purchase of mortgage loans from Astoria. Fidata appropriately dividended a significant amount to its only shareholder Astoria, which Astoria reported and treated as a distribution, as permitted by statute. Astoria was compensated by Fidata for mortgage servicing and administrative services performed by Astoria, by related corporations, or by unrelated third parties an arm's length price. It cannot be said on the facts presented that Astoria's deductions were overstated or that its income was understated. (*Interaudi*). There was no improper arrangement or inaccurate reflection of income. There was no distortion in the Tax Years transactions between Astoria, Fidata and other Astoria affiliates.

²¹ Respondent's argument that the principles expressed in *Interaudi* apply because the magnitude of Petitioner's income and expenses was greater than that of *Interaudi* is irrelevant. Apparently Astoria was larger, or perhaps more financially successful, than *Interaudi*, but that is not the standard for combination.

Petitioner argues that Respondent unconstitutionally refused to apply the provisions of Administrative Code § 11-640 [a] [9] and permit Fidata to elect to be taxed as a general business corporation. The laws of the City of New York are presumed constitutional at the administrative level. A taxpayer may challenge the constitutionality of the application of Administrative Code provisions. In this matter, however, there can be no application of Administrative Code § 11-640 [a] [9] as Fidata was not a New York taxpayer and was not subject to the Code provisions. Fidata could never qualify for the grandfather election.

ACCORDINGLY, IT IS CONCLUDED THAT Petitioner Astoria is not required to include the subsidiary Fidata in combined City Bank Tax Returns for the Tax Years. The subsidiary is not a sham corporation. It was formed for legitimate business purposes and its transactions have economic substance. The substantial transactions between Fidata and its parent Astoria, and between Fidata and related corporations, were made at arm's length. There is no agreement or arrangement between the subsidiary and the parent and related corporations which causes Astoria' City Bank tax to be improperly or inaccurately reflected. The Notice of Determination dated September 10, 2010, and the Notice of

Determination dated August 26, 2011, are cancelled. The Petition of Astoria Financial Corporation and Affiliates is granted.

DATED: October 29, 2014
New York, New York

Anne W. Murphy
Chief Administrative Law Judge