

New York State Department of Taxation and Finance
Taxpayer Services Division
Technical Services Bureau

TSB-H-81(36)C
Corporation Tax
June 18, 1981

STATE OF NEW YORK
STATE TAX COMMISSION

ADVISORY OPINION

PETITION NO. C800924A

On September 24, 1980, a Petition for Advisory Opinion was received from Seatrain Shipbuilding Corporation, One Chase Manhattan Plaza, New York, New York 10005.

Petitioner is a corporation subject to the Franchise Tax on Business Corporation imposed under Article 9-A of the Tax Law. Petitioner raises three issues arising under Article 9-A, each of which will be addressed separately.

I May accounts receivable from Petitioner's parent (Seatrain Lines, Inc.) be offset by loans and advances from Petitioner's parent in computing business capital?

Petitioner, a wholly-owned subsidiary of Seatrain Lines, Inc., is engaged in the construction of crude oil carriers of the type commonly known as "supertankers". Contracts for these vessels call for a fixed price. Any cost overruns are recoverable by Petitioner from its parent.

Certain overrun losses resulted in the creation of accounts receivable representing funds due to Petitioner from its parent. Thus, in effect, the overruns created assets for Petitioner. Concurrently, other funds from the parent were being advanced as loans to Petitioner to cover various construction expenses and fixed asset expenditures for the vessels' construction. These loans were separate and in addition to the funds due for the cost overruns. Petitioner entered these payables to its parent on its books in order to record these advances. Due to the extensive time necessary to construct vessels of the tremendous size and complexity involved, and the unique nature of the business enterprise, the liabilities continued to exist on Petitioner's books for more than one year's duration.

Section 208.7 of the Tax Law defines the term "business capital" as all assets, other than subsidiary capital, investment capital and stock issued by the taxpayer, less liabilities not deducted from subsidiary capital or investment capital which are payable by their terms on demand or within one year from the date incurred, other than loans or advances outstanding for more than a year as of any date during the year covered by the report." (emphasis added). The Franchise Tax Regulations provide that such liabilities include "accounts payable, wages payable, accrued taxes, accrued expenses, accrued interest, notes and other written obligations if they are payable by their terms on demand or within one (1) year from the date incurred." 20 NYCRR 3-4.3(a).

Inasmuch as the liabilities in question were "outstanding for more than a year as of any date during the year covered by the report" and were not "payable by their terms on demand or within one year from the date incurred," they may not be subtracted from Petitioner's assets pursuant to section 208.7 of the Tax Law.

II Does Petitioner have a regular place of business outside New York State?

Petitioner's vessels are assembled by using a modular method of construction. Some of the modules were constructed by submanufacturers or independent contractors located outside New York State. Petitioner supplied raw materials either directly or through suppliers.

Material was shipped from the Brooklyn, New York shipyard to an independent manufacturer in Texas for processing into modules for hulls. A permanent employee of Petitioner was on site in Texas to oversee all processing work performed. After the modules were completed they were returned by barge to Brooklyn for assembly.

Section 210.3(a)(4) of the Tax Law provides that, for taxable years beginning before January 1, 1978, "If the taxpayer does not have a regular place of business outside the state other than a statutory office, the business allocation percentage shall be one hundred per cent "The term "regular place of business" is defined in the Franchise Tax Regulations as "any bona fide office (other than a statutory office), factory, warehouse or other space which is regularly used by the taxpayer in carrying on its business. If, for example, in the regular course of its business, a taxpayer: . . . delivers raw materials or partially finished goods to an independent contractor to be converted, processed, finished or improved and the converted, processed, finished or improved goods remain in the possession of the independent contractor until shipped to customers, the plant of such independent contractor is considered a regular place of business if the taxpayer retains title to the material or goods." 20 NYCRR 4-2.2(b).

The site in Texas is not a "regular place of business" of the Petitioner. The provision of the Regulations cited above requires shipment from the independent contractor's place of business to the taxpayer's customers. Additionally, Petitioner is not holding itself out to be doing business at the Texas location.

III Is Petitioner required to make an addition to federal taxable income, pursuant to Section 208.9(b)(5) of the Tax Law, in the amount of certain interest paid to its parent?

The nature of Petitioner's business, its general financial condition and its cost overruns created a need for outside borrowing from nonrelated lenders. Because of certain legal restraints placed upon the company, as well as certain business considerations, the outside financing was obtained by Seatrain Lines, Inc. from non-related commercial lending institutions. The parent corporation was able to negotiate terms preferable to those available to its subsidiaries. The money borrowed by the parent was re-lent to Petitioner.

Section 208.9(b)(5) of the Tax Law provides, in pertinent part, that in arriving at entire net income for franchise tax purposes an addition to federal taxable income must be made in the amount of certain interest paid on indebtedness directly or indirectly owed to any stockholder or shareholder owning more than five per cent of the taxpayer's issued capital stock, or to a subsidiary of such a stockholder or shareholder. (Such a stockholder or shareholder, or subsidiary thereof, shall hereinafter be referred to as "stockholder.")

Under certain conditions, where a "stockholder" of a corporation borrows money from an unrelated source, and then lends the borrowed funds to such corporation, some or all of the interest paid to such "stockholder" by such corporation is deemed to have actually been paid to the "stockholder" merely as a conduit, and the provisions of section 208.9(b)(5) are not applicable to such interest. These conditions are:

1. The deduction for interest expense must be for indebtedness owed by the corporation to a "stockholder".
2. The corporation must demonstrate that at the time the indebtedness was incurred the "stockholder's" financial standing allowed it to borrow funds at a lower rate of interest than that obtainable by the corporation.

- 3. The corporation must demonstrate that the funds loaned to it were borrowed by the "stockholder" from an entity unrelated to either the "stockholder" or the corporation, for the purpose of re-lending the funds to the corporation.
- 4. The corporation must demonstrate that, at about the time the loan was made, it was not under-capitalized and that the funds were needed to meet ordinary business expenses or working capital needs, and were not a substitute for an investment in the stock of the corporation.

If all four conditions are met, the "stockholder" is deemed to have acted as a mere conduit between the unrelated source of funds and the corporation. The corporation is allowed to deduct as interest expense an amount equivalent to the amount of interest paid by the "stockholder" to the unrelated source of funds.

In the present case Petitioner has failed to demonstrate capitalization sufficient to satisfy the fourth criterion listed above.

Financial statements submitted by Petitioner show capitalization as follows:

6% Non-cumulative preferred \$1,000 par value per share; authorized 500 shares, issued 250 shares	\$ 250,000
Common stock - no par; authorized 200 shares, issued 100 shares	<u>750,000</u>
	\$1,000,000

In the periods from fiscal year ended June 30, 1970 through fiscal year ended June 30, 1978 the capitalization has not changed. During the same period Petitioner's debt owed to its parent has exceeded \$30,000,000 and in fiscal year ended June 30, 1978 approached \$40,000,000.

Capitalization of \$1,000,000 to conduct a business of this magnitude is clearly not adequate. The ratio of Petitioner's debt, owed to its parent, to its equity, ranges from 30:1 to 39:1.

Inasmuch as Petitioner does not satisfy all four criteria listed above, it is required to make the addition to federal taxable income, in computing its entire net income, prescribed in section 208.9(b)(5) of the Tax Law.

DATED: June 17, 1981

s/LOUIS ETLINGER
Deputy Director
Technical Services Bureau