

## NYC ALJ Permits Non-NYC Subsidiary to be Excluded from Combined Group

January 20, 2015

### Overview

An Administrative Law Judge (the “ALJ”) from the New York City Tax Appeals Tribunal recently ruled in favor of Astoria Financial Corporation (“Astoria Financial”), dismissing claims brought by the New York City Department of Finance (the “Department”) that Astoria Financial should have included a certain non-taxpayer subsidiary in its New York City combined Banking Corporation Tax (“Bank Tax”) returns for the years 2006-2008.<sup>1</sup> The Department is appealing this ALJ decision to the New York City Tax Appeals Tribunal. Accordingly, the decision is not yet final.<sup>2</sup>

In this Tax Alert we summarize this ALJ decision.

### Background

Astoria Financial is the holding company parent of Astoria Federal Saving & Loan Association (“Astoria”); both are headquartered in Nassau County, New York. Astoria and several subsidiaries, including Fidata Service Corporation (“Fidata”), a Connecticut-based passive investment company (“PIC”), engage in the banking business. As a bank operating in New York City, Astoria, together with ten of its subsidiaries, filed New York City combined Bank Tax returns during the audit period (tax years ending December 31, 2006 through December 31, 2008). Astoria did not include Fidata in these combined Bank Tax returns. The Department assessed tax against Astoria Financial of approximately \$9.4 million<sup>3</sup> for the audit years, asserting three separate theories under which Fidata should have been included in Astoria Financial’s New York City Bank Tax returns during the audit period.

### The ALJ’s Ruling

Having concluded without discussion that Fidata was part of Astoria’s unitary business, the ALJ first analyzed whether the transactions entered into by Fidata merited “tax respect” as legitimate business transactions, or whether Fidata was instead a sham corporation such that the transactions with Fidata or, Fidata itself, should be disregarded. The ALJ applied a two-part approach to address this analysis: (1) an objective test to determine if the corporation or the transactions had “economic substance;” and (2) a subjective test to determine whether the transactions were entered into for a legitimate non-tax business purpose. The ALJ enumerated several characteristics of Fidata’s operations that satisfied the objective test and concluded that Fidata was a legitimate entity organized for genuine business purposes. Additionally, the ALJ concluded that, on a subjective basis, Fidata had been formed for several legitimate non-tax business purposes, including to purchase and hold non-New York mortgages and to sustain Astoria’s “outstanding” rating under the federal Community Reinvestment Act.<sup>4</sup> The ALJ noted that although Fidata was also created for a tax-benefit-related purpose – to reduce overall tax liability by taking advantage of its Connecticut PIC status – this additional purpose does not render the entity a sham corporation because a subjective business purpose need not be free of tax considerations.

Next, the ALJ addressed whether the substantial intercorporate transactions between Astoria and Fidata created a presumption of distortion. The Department may require a corporation to be included in a New York City combined Bank Tax return if there are substantial intercorporate transactions or arrangements between the entities such that not including such transactions/entities in a combined tax return would result in an inaccurate reflection of tax liability.<sup>5</sup> However, notwithstanding the presence of substantial intercorporate transactions, the presumption of distortion may be rebutted if the transactions are conducted on arm’s-length terms. The ALJ concluded that the

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<sup>1</sup> New York City Div. of Tax Appeals, TAT(H) 10-35(BT) (Oct. 29, 2014), which may be accessed at the following link: <http://www.nyc.gov/html/tat/downloads/pdf/1035DET1014.pdf>.

<sup>2</sup> Note that ALJ determinations are not considered as precedent in the New York City Tax Appeals Tribunal or any New York State judicial proceeding. Charter of the City of New York, Ch. 7, Sec. 168.d. However, an ALJ’s reasoning and analysis may potentially suggest how that ALJ may address similar facts presented by another taxpayer.

<sup>3</sup> The amount appears to include the impact of Astoria Financial including its subsidiary (Astoria Mortgage Corporation) in its combined returns as well. Astoria Financial did not object to this subsidiary being included, but continued to assert that the required combination was not appropriate.

<sup>4</sup> 12 U.S.C. § 2901.

<sup>5</sup> New York City Admin. Code § 11-646(f)(2)(b).

intercorporate transactions between Astoria and Fidata and Fidata and other Astoria subsidiaries were effectuated on arms-length terms; thus the presumption of distortion was rebutted.

Finally, the ALJ addressed the Department's last argument, which was predicated on the statutory requirement for combined filing between related corporations where it is established that an arrangement or agreement between such corporations causes income to be inaccurately stated if not reported on a combined basis.<sup>6</sup> The Department relied on *Matter of Interaudi Bank F/K/A Bank Audi (USA)*,<sup>7</sup> in which the New York State Tribunal required Interaudi, a New York State banking corporation, to include its Delaware investment holding subsidiary in its combined New York State Bank Tax returns because there otherwise would have been a mismatching of related income and expenses. In general, the New York City Tax Appeals Tribunal is bound to follow the decisions reached by the New York State Tax Appeals Tribunal "insofar as those decisions pertain to any substantive legal issues currently before the [City] tribunal."<sup>8</sup> The ALJ ruled that it was not required to apply *Interaudi* in this case since Astoria's relationship with Fidata was not analogous to Interaudi's relationship to its investment subsidiary.

The ALJ noted that the Department had not established with any specificity a similarly direct relationship between Fidata and Astoria as was the case in *Interaudi*. In *Interaudi*, the parent invested in the subsidiary with funds borrowed from its depositors, while Astoria did not use funds from deposits (or from other cash sources) to capitalize Fidata. Rather, the contribution was made from mortgage assets held for several years by a related New Jersey subsidiary corporation, the income from which was non-New York income not subject to the Bank Tax. The ALJ found that there was no correlation between Astoria's interest deduction and the income earned by Fidata through the contributed mortgages. In the absence of contrary facts, the ALJ presumed that Astoria's reported interest expense related to a number of sources (other than its investment in Fidata), including interest paid on money received from depositors, investments in other assets, or its own non-subsidiary mortgage portfolio. Astoria earned income from Fidata in the form of the dividend payments that represent a return on investment and were not distortive. Moreover, all administrative expenses incurred by Astoria for Fidata were reimbursed on an arm's-length basis. Given these facts, the ALJ rejected the Department's argument that a combined filing was required in order to prevent a distortion of reflected taxable income, as was the case in *Interaudi*.

## Considerations

While this case is not precedential and is not yet final, it provides an example of the type of facts a taxpayer needs to establish in order to potentially defend a forced combination action by the Department. Also, this case demonstrates that it may be possible to defeat an *Interaudi* assertion by the Department if, as here, the facts of the matter are not "on all fours" (as the ALJ stated) with the facts in *Interaudi*.<sup>9</sup>

## Contacts

If you have questions regarding this New York City ALJ decision or other New York State or New York City tax matters, please contact any of the following Deloitte Tax LLP professionals.

Abe Teicher  
Partner  
Deloitte Tax LLP, New York  
[ateicher@deloitte.com](mailto:ateicher@deloitte.com)  
(212) 436-3370

Ken Jewell  
Director  
Deloitte Tax LLP, Parsippany  
[kjewell@deloitte.com](mailto:kjewell@deloitte.com)  
(973) 602-4309

Mary Jo Brady  
Senior Manager  
Deloitte Tax LLP, Jericho  
[mabradly@deloitte.com](mailto:mabradly@deloitte.com)  
(516) 918-7087

The authors of this alert would like to acknowledge the contributions of Jacob Schattner to the drafting process. Mr. Schattner is a Tax Consultant working as part of the New York Multistate Tax Practice of Deloitte Tax LLP.

<sup>6</sup> New York City Admin. Code §§ 11-646(f)(2)(b); (g).

<sup>7</sup> New York State Div. of Tax Appeals, Tax Appeals Tribunal, DTA No. 821659 (Apr. 14, 2001).

<sup>8</sup> New York City Charter § 170.d.

<sup>9</sup> The forced combination at issue in *Interaudi* would no longer arise in New York State, since as of January 1, 2015, New York State's Bank Tax under Article 32 is repealed. In addition, New York State has adopted mandatory water's edge unitary combined reporting for related corporations based on satisfaction of a more than 50 percent ownership or control standard and the existence of a unitary business among such related corporations (with an election, subject to certain requirements, which generally allows the inclusion of non-unitary members that meet the ownership requirement). Therefore, for tax years beginning on or after January 1, 2015, for New York State tax purposes, disputes about the composition of a combined group likely would be based on the unitary business principle instead of being based on distortion or substantial intercorporate transactions. New York City has not yet adopted the two New York State tax law changes at issue in this case (involving the Bank Tax and combined reporting methodology). However, on January 12, 2015, New York City Mayor Bill de Blasio proposed that New York City conform with New York State's corporate tax regime retroactive to January 1, 2015. If New York City conforms to the New York State tax changes noted above, this case may still potentially provide some insight for New York City combined Bank Tax reporting issues under audit for years prior to 2015.

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