

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

TSB-A-86 (21) C
Corporation Tax
October 22, 1986

STATE OF NEW YORK
STATE TAX COMMISSION

ADVISORY OPINION

PETITION NO. C850211A

On February 11, 1985, a Petition for Advisory Opinion was received from Landauer Associates, Inc., 335 Madison Avenue, New York, New York 10017.

The issue presented is whether a portion of a management fee paid by a subsidiary to its parent corporation for services rendered by the parent corporation should be included by the subsidiary as compensation paid to every stockholder owning in excess of five percent of its issued capital stock when computing the franchise tax measured by entire net income plus compensation pursuant to section 210.1(a)(3) of the Tax Law, to the extent of salaries paid to officers and employees of the parent corporation, including any profit sharing and employee benefits.

Petitioner is a taxpayer under Article 9-A of the Tax Law and was incorporated in Delaware on September 24, 1978. Petitioner's operations consist primarily of consultation on real estate transactions in New York, Georgia and Illinois. Petitioner is a subsidiary of Landauer International Inc. (referred to herein as "LII") a holding and management company incorporated in Delaware on April 3, 1979. The officers of LII are viewed as experts in the real estate field. LII performs managerial services for its subsidiaries for which it receives a fee. The management fee Petitioner pays to LII includes reimbursement for expenses incurred by LII on behalf of Petitioner and payment for various administrative functions such as accounting and bookkeeping services that LII provides.

Petitioner contends that the compensation, profit sharing and employee benefits paid to the officers and employees of LII included in the management fee, should not be included in the computation of Petitioner's tax measured by entire net income plus compensation because a "management fee" is not a payment of salaries and other compensation to elected or appointed officers or to a stockholder owning in excess of five percent of its issued capital stock. It contends that compensation for individual services and management fees are two entirely different and unique items.

Petitioner also contends that Petitioner and LII are both paying the proper amounts of New York State franchise tax and that there is no attempt to avoid tax. It contends that if the management fee Petitioner paid to LII is included in Petitioner's computation of the tax measured by entire net income plus compensation, the fee will be taxed twice by New York State because LII includes the management fee in its New York State taxable income and pays tax on it at the statutory rate.

Article 9-A of the Tax Law imposes a franchise tax on general business corporations rather than a tax on income. The tax is imposed for the privilege of doing business, employing capital, owning or leasing property, or maintaining an office in New York State in a corporate capacity. The tax is computed on the value of that privilege, which is measured by income (or some alternate basis) and is not considered to be imposed directly on income.

Accordingly, compensation paid to a stockholder owning in excess of five percent of its issued capital stock may be included in the tax base of both a subsidiary and its parent.

Section 210.1(a)(3) of the Tax Law states, in part:

"(a) a tax. . . (3) computed . . . on thirty per centum of the taxpayer's entire net income plus salaries and other compensation paid to the taxpayer's elected or appointed officers and to every stockholder owning in excess of five per centum of its issued capital stock minus thirty thousand dollars... ."

Section 3-3.1(b) of the Business Corporation Franchise Tax Regulations states that:

"The tax measured by entire net income plus compensation is to prevent tax avoidance by distributing profits in the form of excessive salaries. However, this measure of the tax does not prevent the Tax Commission from disallowing deductions claimed for unreasonable salaries in computing entire net income."

Section 3-3.2(f) of the Business Corporation Franchise Tax Regulations provides that "a stockholder owning in excess of five percent of its issued capital stock" means a person or corporation who is the beneficial owner of more than five percent of the total number of shares of the issued and outstanding capital stock of the taxpayer.

In 1961, Edward Best, Tax Department Counsel, addressed in a memorandum the treatment of service charges as compensation to stockholders. The facts are as follows - A subsidiary corporation is the distributor of its own product and the parent corporation manufactures, stores, sells and ships the subsidiary's product. The sales price of the product to the subsidiary consists only of materials, direct labor cost and factory overhead. The subsidiary corporation pays "service charges" to its parent corporation for the reimbursement of shipping expenses, selling expenses, administrative expenses (general office expenses) and corporate expenses (parent's officers' salaries) incurred by the parent corporation on behalf of the subsidiary.

Counsel determined that the shipping and selling expenses were valid expenses reimbursable to the parent corporation, citing Funkhouser Industries, Inc., 16 TCM 890, Dec. 22,624(M), TC Memo. 1957-197, in which the Court held that amounts charged by the parent company on account of freight charges, warehouse storage of books, records and merchandise and some liquidation

expenses defrayed and furnished by the parent company for the taxpayer's benefit were deductible. However, Counsel determined that the administrative expenses were not connected with the storage, sale or shipment of the subsidiary's product. Therefore, administrative expenses were deemed to be compensation. The corporate expenses were also considered to be compensation. Thus, the portion of "service charges" which was applicable to administrative expenses and corporate expenses was deemed to be compensation paid to a stockholder owning in excess of five percent of its issued capital stock.

As shown, the statute has been interpreted to mean that items in the nature of service charges or management fees paid by a subsidiary to its parent are included as "salaries and other compensation paid to a stockholder" to the extent that such fee or charge exceeds the reimbursement of expenses paid by the parent on behalf of the subsidiary.

Accordingly, when computing the tax measured by entire net income plus compensation pursuant to section 210.1(a)(3) of the Tax Law, Petitioner must include as "salaries and other compensation" the portion of the management fee paid to its parent that is in excess of the reimbursement of expenses paid by the parent on behalf of Petitioner. This amount includes salaries and the related expenses of the parent's employees and officers as well as any profit factor included in the management fee.

DATED: October 22, 1986

s/FRANK J. PUCCIA
Director
Technical Services Bureau

NOTE: The opinions expressed in Advisory Opinions
are limited to the facts set forth therein.