NEW YORK CITY TAX APPEALS TRIBUNAL

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| In the Matter of | : | DECISION |
| ASTORIA FINANCIAL CORPORATION & AFFILIATES | : | TAT (E) 10-35 (BT) et al. |
| Petitioner. | : | |

The Commissioner of Finance of the City of New York (Respondent) filed an exception to a Determination of the Chief Administrative Law Judge (CALJ) dated October 29, 2014 (CALJ Determination)[1] which cancelled Notices of Deficiency of New York City Banking Corporation Tax (BCT) issued by the New York City Department of Finance (Department) to Astoria Financial Corporation and Affiliates (collectively Petitioner) for the tax years ending December 31, 2006 through December 31, 2008 (Tax Years).

Respondent appeared by Martin Nussbaum, Esq., Assistant Corporation Counsel of the New York City Law Department. Petitioner appeared by Irwin M. Slomka, Esq., and Kara M. Kraman, Esq., of Morrison & Foerster LLP.

Astoria Financial Corporation (Astoria Holding) is a publicly-traded Delaware corporation that is a holding corporation for Astoria Federal Savings and Loan Association (Astoria Savings). Both Astoria Holding and Astoria Savings are headquartered in Lake Success, New York in Nassau County. Astoria Savings is a federally-chartered savings and loan association "principally engaged in taking deposits

[1] Except as otherwise noted, the CALJ's Findings of Fact, although paraphrased herein, generally are adopted for purposes of this Decision. Certain Findings of Fact not necessary to this Decision have not been restated and can be found in the CALJ Determination. Respondent submitted 166 proposed findings of fact to this Tribunal in support of its Exception. We will not address those proposed findings of fact individually by number. Those proposed findings of fact not consistent with the facts described in this Decision are rejected.

and making mortgage loans relating to New York properties."[2] Astoria Savings maintains bank branches in New York City (City) through which it conducts a banking business in the City. During the Tax Years, Astoria Savings was subject to the supervision of the United States Office of Thrift Supervision (OTS)[3] and by the Federal Deposit Insurance Corporation. According to Petitioner's Annual Reports for the Tax Years,[4] the percentage of Petitioner's mortgage loan portfolio represented by loans secured by property in New York was 39% in 2006, 35.6% in 2007 and 37% in 2008. The remainder of the mortgage loan portfolio was secured by property in other states. Astoria Savings' deposits came primarily from the areas around its offices in Queens, Brooklyn, Nassau, Suffolk and Westchester counties.[5] During the Tax Years, it ranked fourth in market share for deposits in the Long Island market.[6]

Astoria Federal Mortgage Corporation (Astoria Mortgage), a New York corporation, is a subsidiary of Astoria Savings and is engaged principally in purchasing and originating mortgage loans. It began operations in 1997.[7] Mr. Frank Fusco, an officer of Astoria Holding and Astoria Savings, testified that Astoria Mortgage was formed to allow the expansion of mortgage lending outside New York.[8] Astoria Mortgage's staff consists of account executives whose function is to work with third-party brokers and third-party loan originators.[9] Mr. Fusco testified that to originate mortgage loans, Astoria Mortgage obtains funds from Astoria Savings.[10] Astoria Mortgage does not hold the mortgage loans it acquires; it sells them immediately.[11]

Prior to 2005, Astoria Savings owned a New Jersey corporation, Star Preferred Funding Corporation (Star), which owned all of the interests in a real estate investment

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[2] Stipulation of Facts (Stipulation) ¶12.
[3] Now the Comptroller of the Currency.
[4] Respondent's Exhibit (Resp. Ex.) 1, Form 10-K, at 3; Resp. Ex. 2, Form 10-K, at 3; Resp. Ex. 3, Form 10-K, at 4.
[5] Resp. Ex. 1 at 17; Resp. Ex. 2 at 18; Resp. Ex. 3 at 20.
[6] *Id.*
[7] Tr 57.
[8] Tr 47.
[9] Tr 57, 63.
[10] Tr 61. Despite Mr. Fusco's testimony, the Parties stipulated that Astoria Savings "and/or Astoria Mortgage provided the initial loan funding . . . for all mortgage loans contributed to or acquired by Fidata." Stipulation ¶22.
[11] Tr 61, 64.

trust, Astoria Preferred Funding Corporation (Astoria REIT). Astoria REIT held non-New York mortgage loans.[12] As a real estate investment trust (REIT), Astoria REIT had to distribute a substantial portion of its income to its shareholder, Star, or be subject to adverse tax consequences. Mr. Fusco testified that under New Jersey law, Star received favorable New Jersey tax treatment on its dividends from Astoria REIT.[13] Mr. Fusco further testified that around late 2003 or 2004, the New Jersey legislature was considering changing its tax law to eliminate the favorable state tax treatment received by Astoria REIT and Star.[14] Mr. Fusco testified that, in response to that possibility, Petitioner decided to use an entity in Connecticut to carry on the activities conducted by Astoria REIT because Connecticut had favorable tax rules for "passive investment companies."[15] Connecticut also was close to the geographic area where Astoria Savings already operated.[16]

It was decided to use an inactive subsidiary[17] of Astoria Savings called Fidata Service Corp. (Fidata) because it was a "grandfathered 9A corporation"[18] for New York State tax purposes.[19] Fidata is a New York corporation that was acquired by Astoria Savings as part of another acquisition in 1995.[20] Fidata is a direct subsidiary of Astoria Savings. To operate Fidata in Connecticut, Astoria Savings had to apply to OTS for authorization to set up an "operating subsidiary" in Connecticut. In a letter to OTS dated March 8, 2005 (March 8 OTS Letter), Astoria Savings stated that it was setting up Fidata as an operating subsidiary in Connecticut to:

> "create certain operating efficiencies and revenue enhancements, as well as [to] provide an opportunity to expand Astoria [Savings] business operations in Connecticut.
> . . .

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[12] Tr 68.
[13] Tr 69-70, 75.
[14] Tr 71.
[15] Tr 73-74.78-79.
[16] Tr 79.
[17] Stipulation Ex. L; Tr 66.
[18] See discussion *infra* accompanying n 79.
[19] Tr 73.
[20] Tr 66; Stipulation ¶15.

"It is anticipated that the operation of [Fidata] will promote greater retained earnings for [Astoria Savings] and thereby will serve to further strengthen Astoria [Savings] for the following reasons:

"(1). . . [Fidata] will not be subject to [the REIT dividend distribution] requirements, which will . . . allow Astoria [Savings] to isolate and manage [Fidata's] cash-flow and asset growth from those of Astoria [Savings].

"(2) The formation of [Fidata] will provide an opportunity for Astoria [Savings] to expand its current Connecticut operations.

"(3) [Fidata] will provide security for future investment assets through the separation of operating and investment assets.

"(4) [Fidata] should help enhance Astoria [Savings'] income through the recognition of certain tax benefits.

"(5) [Fidata] would also help protect Astoria [Savings] from potential taxation by states other than New York."[21]

OTS approved the operation of Fidata in a letter dated May 11, 2005.[22] Effective July 1, 2005, Astoria REIT transferred substantially all of its assets, consisting of $5,663,184,753 in real estate mortgage loans, to Fidata as a capital contribution.[23] Although the mortgage loans were contributed to Fidata, Astoria Savings and Astoria REIT entered into a Loan Purchase and Servicing Agreement dated as of July 1, 2005 (Legacy Loan Purchase Agreement) under which Fidata agreed to acquire the loans from Astoria REIT and Astoria Savings agreed to continue to act as the servicer of those loans.[24] Thereafter, Astoria REIT and Star were dissolved.

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[21] Stipulation Ex. L.
[22] Stipulation Ex. M.
[23] Stipulation ¶18.
[24] The Legacy Loan Purchase Agreement provides that while Astoria REIT would transfer the loans to Fidata as a capital contribution, the transaction was structured as a sale to "conform to industry practice." Stipulation Ex. J at 1, 7th WHEREAS clause.

Fidata, Astoria Mortgage and Astoria Savings also entered into a Master Loan Purchase and Servicing Agreement dated as of July 1, 2005[25] (Future Loan Purchase Agreement) under which Fidata agreed to purchase loans from Astoria Savings and Astoria Mortgage from time to time. Under that agreement, Astoria Savings agreed to act as the servicer of the loans purchased. Both the Legacy Loan Purchase Agreement and the Future Loan Purchase Agreement contained representations and warranties as to the ownership and other terms of the loans to be purchased and provisions governing the consequences of a breach of any of those warranties. There is no evidence in the Record that any such breach was identified by Fidata. Mr. Fusco testified that no one at Fidata reviewed the credit risks of the loans acquired on July 1, 2005.[26]

Fidata, Astoria REIT, Astoria Savings and another subsidiary of Astoria Savings, Suffco Service Corp. (Suffco), entered into a Custodial Agreement dated as of July 1, 2005[27] under which Suffco agreed to take possession, and to act as custodian, of the loans acquired by Fidata from Astoria REIT under the Legacy Loan Purchase Agreement.

Fidata and Astoria Savings entered into an Expense Sharing Agreement also dated as of July 1, 2005[28] under which the parties agreed that Fidata could use Astoria Savings' facilities and personnel from time to time as necessary and Fidata would compensate Astoria Savings for the cost of such facilities and personnel.

To qualify as a passive investment company under Connecticut law, Fidata had to have offices in Connecticut and had to have at least five full-time employees. Fidata leased an office in Norwalk, Connecticut during the Tax Years. The President of Fidata was Frederick Nydegger, who testified that the office contained about 831 square feet.[29] Mr. Nydegger testified that he worked part time, on average two to three days per week but as often as five days.[30] Mr. Nydegger was paid $57,209 in 2006, $55,109 in 2007 and

[25] Stipulation Ex. N.
[26] Tr 198.
[27] Stipulation Ex. K.
[28] Stipulation Ex. O.
[29] Tr at 397.
[30] Tr at 438.

$65,776 in 2008.[31] Fidata also had five full-time employees in that office during the Tax Years.[32] The total payroll for Fidata was $237,239 in 2006, $259,409 in 2007 and $253,642 in 2008.[33]

George Ligouri, the Assistant Manager for final documents of Fidata, testified that he supervised the four other employees of Fidata at the Norwalk office.[34] He further testified that there was no manager of final documents at Fidata. Mr. Ligouri testified that he and his staff were responsible for reviewing the documentation for the loans bought by Fidata to ensure that the documents in the loan files were accurate and complete and that no pages or signatures were missing.[35] He testified that these were typical post-closing functions and that they did not duplicate functions performed by Astoria Savings as servicer of the loans.[36]

Ira Yourman, a Senior Vice President of Astoria Savings, testified that he was the director of loan administration and servicing.[37] He testified that the servicing fee charged by Astoria Savings to Fidata was the same rate it charged Fannie Mae[38] and that the rate was standard in the industry. Although Astoria Savings agreed to act as the servicer of the loans acquired by Fidata under both the Legacy Loan Purchase Agreement and the Future Loan Purchase Agreement, in a letter dated July 1, 2005, Fidata agreed to let Astoria Savings outsource the loan servicing to an unrelated third party, Dovenmuehle Mortgage Inc. (DMI).[39] Mr. Yourman testified that Astoria Savings profited from that arrangement.[40] He further testified that all payments on the loans serviced by DMI were made in the name of Astoria Savings as the servicer and, in the event of a default under a

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[31] Stipulation Ex. V.
[32] Stipulation ¶30.
[33] Stipulation Ex. V.
[34] Mr. Ligouri testified that he joined Fidata in 2008 but that he understood that the procedures and activities at Fidata during the Tax Years were the same as during his employment. Tr 359-60. There was no objection to his testimony.
[35] Tr 360-364.
[36] Tr 362, 364.
[37] Tr 310.
[38] Fannie Mae is the Federal National Mortgage Association.
[39] Pet. Ex. I.
[40] Tr 319.

loan held by Fidata, while Fidata would be notified, Astoria Savings as the servicer, not Fidata, would be the party to any legal proceedings.[41] Finally, he testified that this arrangement was standard in the industry.[42]

The Parties stipulated that "Fidata was not involved in the solicitation, investigation, negotiation, or approval . . . of any of the mortgage loans it received from" Astoria REIT or of any of the mortgage loans it subsequently acquired from Astoria Savings or Astoria Mortgage.[43]

Mr. Nydegger testified that as president of Fidata, his primary responsibility was to maximize the return on the funds of Fidata through the purchase of mortgages.[44] His job was to determine how much money was available at the end of the month to purchase mortgages after paying any dividends to Astoria Savings and any taxes.[45] His authority to write checks on Fidata's money market account, which was the primary account used to purchase mortgage loans and where principal and interest payments on the loan portfolio were deposited, was limited to $25,000.[46] Two other accounts were funded from the money market account and were used for payroll and operating expenses of the office.[47] Mr. Nydegger testified that he had unlimited check-writing authority over the operating account. The Record is silent as to whether his check-writing authority over the payroll account was limited. Mr. Nydegger testified that his background was as a certified public accountant and that he had no mortgage investing experience or expertise.[48] He further testified that when Fidata purchased loans from Astoria Mortgage, no one at Fidata performed any due diligence on the loans.[49]

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[41] Tr 323-325.
[42] Tr 324.
[43] Stipulation ¶25.
[44] Tr 401.
[45] Tr 402-403.
[46] Tr 398-399.
[47] Tr 400-401.
[48] Tr 401.
[49] Tr 464.

Mr. Fusco was chairman of the board of directors of Fidata. He testified that Astoria Mortgage sells mortgage loans to either Astoria Savings or to Fidata.[50] Fidata purchases additional loans under the Future Loan Purchase Agreement from both Astoria Savings and Astoria Mortgage using the interest and principal it receives on the loans it holds.[51] None of the funds Fidata used to purchase additional loans came from Astoria Savings.[52]

Nancy Tomich, a Senior Vice President of Astoria Savings, testified that during the Tax Years, Fidata purchased loans on property located outside New York.[53] Ms. Tomich testified that Fidata purchased those loans immediately after the loans were closed.[54] She testified that mortgage loans were sold to Fidata by allocating them on the books of Petitioner[55] and that Fidata became the owner of the loans at that time notwithstanding that the paperwork to effect the transfer might take anywhere from four days to a month to complete.[56] She further testified that although mortgages are sold by Astoria Mortgage to Fidata, the mortgages remain recorded in the name of Astoria Mortgage as the lender, which was standard industry practice.[57]

Several witnesses testified that Fidata purchased loans from Astoria Mortgage on a daily basis.[58] However, Mr. Nydegger testified that Fidata paid for the loans purchased on a monthly basis.[59] The March 8, 2005 OTS Letter stated that the Connecticut entity would purchase loans "on an arms-length basis." The Future Loan Purchase Agreement provided that Fidata would purchase loans at their principal amount with adjustments for brokers' premiums, fees, interest and escrows.[60] Mr. Fusco testified that the purchase price, as defined in the Future Loan Purchase Agreement, was an arms-length price on

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[50] Tr 62.
[51] Stipulation ¶22; Tr 388.
[52] Tr 388.
[53] Tr 284.
[54] Tr 286.
[55] Tr 298.
[56] Tr 302.
[57] Tr 292.
[58] Tr 198, 287
[59] Tr 402-403. *See also* testimony of Ms. Tomich Tr 286.
[60] Stipulation Ex. N at 8, "Purchase Price" defined.

the date the loan was closed, which also was the date on which Fidata purchased it.[61] Professor Anthony Saunders of the Stern School of Business at New York University, an expert witness for Respondent, conceded that at the time a loan is originated, the face value of a loan is its fair market value but stated that value can change in as little as a day if interest rates move.[62]

Petitioner offered the testimony of Barbara Kent as an expert on federal and state banking regulation including the federal Community Reinvestment Act (CRA) and the New York equivalent.[63] She testified that the CRA was enacted in response to banks engaging in "redlining" a practice of taking deposits in poor and minority areas but not making loans or providing other banking services in those areas.[64] The CRA calls for banks to be rated on three measures: lending, investing and servicing. The lending component makes up half of the rating. The lending component is based on the lending activity of the bank in its "assessment area" particularly whether loans are made in low and moderate income parts of the assessment area. A bank sets its own assessment area, which is usually where its main offices are located. The ratings are "outstanding", "satisfactory" and "needs improvement". Mr. Fusco testified that Astoria Savings had received ratings of "outstanding" beginning in 1994 or 1995.[65]

Ms. Kent testified that for purposes of the lending component of its rating under the CRA, a bank can decide whether to include loans originated or acquired by its affiliates, but if it includes one affiliate it must include all affiliates.[66] She further testified that if a bank made a loan within its assessment area, there is no difference for purposes of the CRA whether the bank holds that loan or sells it.[67]

Monte Redman, the current CEO and president of Astoria Holding and Astoria Savings, testified that Petitioner's assessment area for purposes of the CRA was around

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[61] Tr 106.
[62] Tr 849, 1266, 1268.
[63] Tr 473-474.
[64] Tr 478.
[65] Tr 104.
[66] Tr 486.
[67] Tr 497.

its headquarters and branches.[68] He testified generally about the importance to Astoria Holding and Astoria Savings of maintaining an outstanding CRA rating.[69] He also testified that after Astoria Savings went public in 1993, it wanted to, and did, make significant acquisitions to grow its business and that having an outstanding CRA rating helped Astoria Savings avoid the problems other banks with lower ratings had experienced making acquisitions.[70]

Petitioner filed consolidated federal income tax returns for the Tax Years including Astoria Mortgage and Fidata. Fidata paid dividends to Astoria Savings of $145,000,000 in Tax Year 2006, $210,000,000 in Tax Year 2007 and $143,000,000 in Tax Year 2008.[71]

Petitioner filed combined BCT returns for the Tax Years but did not include Astoria Mortgage or Fidata in those returns. Petitioner reported combined allocated entire net losses of approximately ($6.2 million) for 2006, ($12 million) for 2007 and ($6.7 million) for 2008.[72] After auditing the BCT returns of Petitioner for the Tax Years, the Department concluded that both Astoria Mortgage and Fidata should be included in the BCT returns for the Tax Years. The Department issued a notice of determination dated September 14, 2010 asserting a BCT deficiency of $3,407,414.13 plus interest and late filing and substantial underpayment penalties for the 2006 Tax Year (2006 Notice).[73] The Department also issued a notice of determination dated August 26, 2011 asserting a BCT deficiency of $5,970,540.69 plus interest and a substantial understatement penalty for the 2007 and 2008 Tax Years (2007-2008 Notice). Petitioner conceded the inclusion of Astoria Mortgage in the combined BCT returns for the Tax Years so the hearing before the CALJ addressed solely the inclusion of Fidata in Petitioner's combined BCT returns for the Tax Years.

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[68] Tr 578, 583.
[69] Tr 579-581.
[70] Tr 580.
[71] Resp. Ex. 27.
[72] Stipulation Ex. W, X & Y. Petitioner paid BCT on its combined allocated alternative entire net income in each of the Tax Years.
[73] The Department later waived the late filing penalty in Stipulation ¶5.

Respondent asserts that Fidata should be included in the combined BCT returns filed by Petitioner for the Tax Years because the transactions among Fidata, Astoria Savings and Astoria Mortgage lacked economic substance and business purpose and, even if they are considered to have economic substance, those transactions resulted in a distortion of the income of Astoria Savings as reflected in the combined BCT returns for the Tax Years. Respondent asserts that Astoria Savings' deposits were the source of funds used to generate the loans originally held by Astoria REIT and the loans later acquired by Fidata. Respondent argues that Astoria Savings continued to take deductions for interest paid on those deposits while none of the interest income on the loans transferred to Fidata in 2005 and on loans subsequently purchased by Fidata was included in the combined BCT returns. Respondent notes that Fidata used a portion of its interest income to pay dividends to Astoria Savings, which were 60% exempt from BCT. Respondent asserts that, as a result, there was a mismatch of income and expense on those returns for the Tax Years causing Petitioner's BCT liability to be improperly reflected.

Petitioner responds that Fidata had economic substance and was formed for non-tax business purposes. Petitioner further asserts that the transactions among Fidata, Astoria Mortgage and Astoria Savings were not distortive because the acquisition of mortgage loans from Astoria REIT is not an intercorporate transaction considered for purposes of the requirements for combination under *Matter of U.S. Trust Corporation*, 1996 WL 189212 (NY St Div of Tax Appeals DTA No. 810461, April 11, 1996) (*U.S. Trust*). In addition, Petitioner responds, the loans purchased from Astoria Mortgage and Astoria Savings under the Future Loan Purchase Agreement were purchased at arm's length prices and loan servicing fees paid by Fidata to Astoria Savings were consistent with industry standards.

For the reasons discussed below, we find that Petitioner is not required to include Fidata in Petitioner's combined BCT returns for the Tax Years.

Under §11-639(a) of the Administrative Code of the City of New York (Administrative Code), the BCT applies to every banking corporation doing business in the City. For this purpose, a banking corporation includes any corporation organized under the laws of New York or any other state that is doing a banking business.[74] A banking business includes any activity that a corporation may conduct under certain sections of the New York Banking Law or that is "substantially similar" to any such activity.[75]

Certain corporations originally subject to the City General Corporation Tax (GCT) for tax years ending in 1984 that were "doing a banking business" were eligible to make a one-time election to continue to be taxed under the GCT and not the BCT.[76] A similar provision existed under the New York State Franchise Tax on Banking Corporations (State Bank Tax) equivalent to the BCT allowing corporations subject to the New York State Franchise Tax under Tax Law Article 9-A to elect to continue to be subject to that tax.[77] Fidata was eligible to, and did, make such an election for State Bank Tax purposes[78] but was not subject to the GCT in 1984 and, therefore, was not eligible to make the equivalent election for BCT purposes. As a result, Fidata was not permitted to be included in a combined State Bank Tax return for the Tax Years but was eligible to be included in Petitioner's combined BCT returns for the Tax Years.

As in effect during the Tax Years, Administrative Code §11-646(f)(2)(i) requires banking corporations and bank holding companies doing business in the City to file combined BCT returns with any 80% or more owned banking corporations, except for any such corporation for which the taxpayer or Respondent shows that including that corporation in the combined return "fails to properly reflect the tax liability of" that corporation. Administrative Code §11-646(f)(2)(i) further provides that a corporation that is not otherwise subject to the BCT because it is not doing business in the City

[74] Administrative Code §11-640(a).
[75] Administrative Code §11-640(b).
[76] Administrative Code §11-640(d).
[77] Former Tax Law §1452(d).
[78] Corporations making such an election are referred to as "grandfathered Article 9-A" corporations.

cannot be required to be included in a combined BCT return of another banking corporation or bank holding company unless Respondent concludes that including such a corporation in the combined return is necessary "to properly reflect the [BCT] liability . . . because of intercompany transactions or some agreement, understanding, arrangement or transaction of the type referred to in [Administrative Code §11-646(g)]."

Petitioner does not dispute that Fidata meets the stock ownership requirements of Administrative Code §11-646(f)(2)(i) or that Fidata is "doing a banking business" within the meaning of Administrative Code §11-640(a). Respondent does not assert that Fidata was doing business in the City during the Tax Years.[79]

Administrative Code §11-646(g) provides that if "it shall appear . . . that any agreement, understanding or arrangement exists between the taxpayer and any other corporation or any person or firm, whereby the activity, business, income or assets of the taxpayer within the city is improperly or inaccurately reflected" Respondent has the authority to adjust the taxpayer's income, deduction or assets or to include any such other corporation in a combined BCT return with the taxpayer. Respondent is not obligated to attempt to make adjustments to the taxpayer's income, deductions or assets before asserting that a combined return is required. (*U.S. Trust,* 1996 WL 189212 [NY St Div of Tax Appeals DTA No. 810461, April 11, 1996].)

The Banking Corporation Tax Rules of the City of New York (BCT Rules) under Administrative Code §11-646(f) (19 RCNY 3-05[b][3][ii][C][a]), provide that where there are "substantial" intercorporate transactions among banking corporations or bank holding companies engaged in a unitary business, it is presumed that the tax liability of a banking corporation subject to the BCT is improperly reflected if the taxpayer files a separate BCT return. Petitioner does not dispute that Fidata is engaged in a unitary business with Petitioner.

[79] Stipulation ¶16.

In determining whether substantial intercorporate transactions exist giving rise to the presumption of improper reflection of income, the BCT Rules provide that the transactions to be considered are those "directly connected with the business conducted by such corporations, such as: (1) performing services for other corporations in the group; (2) providing funds to other corporations in the group; or (3) performing related customer services using common facilities and employees. . . . The substantial intercorporate transaction test may be met where as little as 50 percent of a corporation's receipts or expenses are from one or more qualified activities. . . ." (19 RCNY 3-05[b][3][ii][C][a].)

The New York State Tax Appeals Tribunal (State Tribunal) concluded in *U.S. Trust* that, under the State regulation equivalent to 19 RCNY 3-05(b)(3)(ii)(C)(a), capital contributions are not intercorporate transactions that give rise to the presumption because they are not "directly connected with the business" of the group. Therefore, the contribution to the capital of Fidata of the mortgage loans previously owned by Astoria REIT is not an intercorporate transaction taken into consideration in determining whether there were substantial intercorporate transactions between Fidata and Petitioner giving rise to a presumption of distortion.

Nevertheless, during the Tax Years, all of Fidata's ongoing loan purchases under the Future Loan Purchase Agreement were with Astoria Mortgage and Astoria Savings. In addition, Suffco provided custodial services to Fidata. Finally, Fidata paid Astoria Savings to service the loans held by Fidata. Therefore, we find that there were substantial intercorporate transactions between Fidata and Astoria Savings, Astoria Mortgage and Suffco creating a presumption that the combined BCT liability of Petitioner for the Tax Years, as reported without the inclusion of Fidata, was improperly reflected.

In *Matter of The Talbots, Inc.*, 2008 WL 4294963 (NY St Div of Tax Appeals DTA No. 820168, September 8, 2008), the State Tribunal concluded that before examining whether the presumption of distortion has been rebutted by a taxpayer, it is necessary to determine whether the intercorporate transactions in question have economic

substance or business purpose apart from the tax benefits. Quoting its earlier decision in *The Matter of The Sherwin-Williams Co.*, 2003 WL 21368741 (NY St Div of Tax Appeals DTA No. 816712, June 5, 2003) *affd* 12 AD3d 112 (3d Dept 2004) (*Sherwin-Williams*), the State Tribunal stated that a determination of whether a business purpose exists requires an inquiry into the taxpayer's motives for the transactions, while the economic substance question requires a determination as to whether there was a "reasonable possibility of profit" from the transaction apart from tax benefits.[80] The State Tribunal has held that a transaction must meet both parts of this test to be given effect for tax purposes. (*Matter of Kellwood Co.*, 2011 WL 4537050 [NY St Div of Tax Appeals DTA No. 820915, September 22, 2011] [*Kellwood*].) The State Tribunal in *Kellwood* further described the economic substance test as not only including an inquiry as to any profit motive but also as to whether the transaction "objectively affected [the taxpayer's] net economic position," citing *ACM Partnership v Commr. of Internal Revenue,* 157 F3d 231 (3d Cir, 1998) (*ACM Partnership).*

The CALJ concluded that Fidata was formed for "several legitimate non-tax business purposes."[81] In the March 8 OTS Letter, it was explained that Fidata was to be operated in Connecticut to:

> "promote greater retained earnings for [Astoria Savings] and thereby will serve to further strengthen Astoria [Savings] for the following reasons:
>
> "(1). . . [Fidata] will not be subject to [the REIT dividend distribution] requirements, which will . . . allow Astoria [Savings] to isolate and manage [Fidata's] cash-flow and asset growth from those of Astoria [Savings].
>
> "(2) The formation of [Fidata] will provide an opportunity for Astoria [Savings] to expand its current Connecticut operations.
>
> "(3) [Fidata] will provide security for future investment assets through the separation of operating and investment assets.

[80] The State Tribunal in *Sherwin-Williams* cited *Rice's Toyota World v Commr*, 752 F2d 89 (4th Cir 1985).
[81] CALJ Determination 35.

> "(4) [Fidata] should help enhance Astoria [Saving's] income through the recognition of certain tax benefits.
>
> "(5) [Fidata] would also help protect Astoria [Savings] from potential taxation by states other than New York."[82]

The fourth and fifth purposes are expressly tax related. With regard to the second purpose, nothing in the Record suggests that any steps were taken to expand Petitioner's operations in Connecticut and Mr. Fusco confirmed that.[83] In any event, as a passive investment company, Fidata would not have been able to directly engage in lending in Connecticut so we give no weight to that ostensible business purpose.

Mr. Fusco described the first purpose as maintaining the separation of the cash flow from non-New York mortgages from that from New York mortgages.[84] Mr. Fusco described the third purpose as providing "security for its investment assets. . . . because [Fidata] is so restrictive on the types of assets it could own, you really can't take much credit risk. You've got mortgages and you've got cash, . . . and that's managed by . . . a separate company, it's managed by another individual. . . ."[85] Mr. Fusco did not elaborate or explain what he meant by this. The non-tax business purposes for the organization of Fidata described in items one and three of the March 8 OTS Letter are vague and were not made appreciably clearer by Mr. Fusco's testimony. However, Respondent did not cross examine Mr. Fusco in regard to that testimony.

Respondent relies on the testimony of Professor Saunders in arguing that those ostensible business purposes have no validity. Professor Saunders described the first purpose as tax-related in that a REIT has to pay out a large portion of its income in dividends so not being subject to that requirement gave Fidata flexibility in terms of the timing of dividends, which he described as "a very important thing in corporate finance, . . . to time dividends to minimize taxes, I guess."[86] Given that Professor Saunders is not a tax expert, his testimony describing the first purpose as tax-related deserves little weight.

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[82] Stipulation Ex. L.
[83] Tr 88-89.
[84] Tr 88.
[85] Tr 89.
[86] Tr 864-865.

Mr. Fusco's testimony was not related to the timing of dividends but to the separation of the cash flow and asset growth of Fidata from that of Petitioner.

Professor Saunders described the third purpose, providing security for future investment through the separation of operating and investment assets as "questionable"[87] because Fidata was wholly-owned by Petitioner. He further stated that he found no evidence that the existence of "Fidata allowed [Petitioner] to isolate and manage [Fidata's] cash flow and asset growth separately from that of [Petitioner] since the board [of Fidata] was controlled by [Petitioner]."[88] His testimony is somewhat inconsistent with his later testimony to the effect that the ownership of mortgage loan assets in Fidata hurt the liquidity of Petitioner because Fidata lacked the flexibility to convert the loans into cash by packaging them into mortgage-backed securities.[89] It is not clear how isolation of assets in Fidata could hurt Petitioner's liquidity yet not allow for a separation of cash flow and assets because of common control. Thus we disregard Professor Saunders' testimony on these points.

Petitioner further argued, and the CALJ found,[90] that one of the business purposes behind the organization of Fidata to hold non-New York mortgages was to enhance Astoria Savings' CRA rating. Based on the evidence in the Record regarding the CRA, it is evident that keeping non-New York mortgages out of Astoria Savings was a legitimate business purpose. Given that Astoria Savings opted to exclude all of its affiliates for purposes of the CRA rating, that purpose was accomplished by having the non-New York loans originated in Astoria Mortgage. While the Record makes it clear that loans originated by Astoria Mortgage were not included for purposes of Astoria Savings' CRA rating regardless of whether they were immediately sold by Astoria Mortgage or held by it, Mr. Fusco testified that Astoria Mortgage was not structured to hold the loans[91] and his testimony was not questioned or controverted by any evidence offered by Respondent. In

[87] Tr 866.
[88] Tr 892.
[89] Tr 894-95.
[90] CALJ Determination 35.
[91] Tr 61.

its Brief in Support of Exception, Respondent argues that prior to the establishment of Fidata in Connecticut, Fidata also was not capitalized sufficiently to hold the loans and that, as both Astoria Mortgage and Fidata were controlled by Petitioner, either could have been capitalized to hold the mortgages.[92] However this argument is unsupported by anything in the Record and cannot substitute for Respondent's failure to offer any evidence to contradict Mr. Fusco's testimony.

Respondent asserts that the CRA-related business purpose is not explicitly articulated in any document contemporary with the establishment of Fidata in Connecticut and asserts that it was conceived after the fact in connection with this litigation by Petitioner or Petitioner's counsel.[93] Whether the CRA was a non-tax purpose identified at the time Fidata was organized in Connecticut, it nevertheless was a business purpose for keeping non-New York loans out of Astoria Savings. Mr. Fusco testified that keeping the non-New York mortgages out of Astoria Savings' CRA rating calculation was a consideration in the formation of Astoria REIT and Star.[94]

Respondent points out that according to two documents of which the CALJ took judicial notice, federal regulators look at the assets and activities of subsidiaries to see if lending activities are allocated differently solely to enhance a CRA rating. Based on those documents, Respondent suggests that keeping non-New York loans in Fidata would not enhance Astoria Savings' CRA rating.[95] However, Respondent offered no evidence that regulators examined the activities of Fidata vis à vis the lending activity of Petitioner, or that, if such an examination occurred, it resulted in a lower CRA rating for Astoria Savings.

Respondent argues that Petitioner offered no evidence that "moving existing or newly-originated mortgage loans among and between the bank and its subsidiaries enhanced the bank's investment, lending, or service to low and moderate income

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[92] Respondent's Brief in Support of Exception (Resp. Brief in Support) 89.
[93] *Id* at 92.
[94] Tr 67-68.
[95] Resp. Brief in Support at 90.

neighborhoods in its CRA assessment area."[96] Based on this assertion, Respondent argues that maintaining Petitioner's high CRA rating was not a business purpose served by Fidata. Respondent points to the fact that the percentage of total New York mortgage loans held by the combined group during the Tax Years did not increase and actually decreased from 39% to 37% as evidence that the existence of Fidata did nothing to facilitate mortgage lending in New York. We disagree with Respondent's argument. Petitioner did not allege that Fidata served to enhance Astoria Savings lending to low and moderate income neighborhoods in its CRA assessment area so as to enhance its CRA rating. Petitioner's witnesses testified that keeping non-New York mortgage loans out of Astoria Savings was necessary to maintain its CRA rating. Nothing in the Record contradicts that testimony or suggests that the CRA rating of Petitioner declined during the Tax Years.

Respondent's assertion that non-New York loans could have been retained by Astoria Mortgage is not sufficient in the face of the uncontroverted testimony of Mr. Fusco that Astoria Mortgage was not structured to hold those loans. The fact that a business purpose could have been accomplished in a way other than that chosen by the taxpayer does not negate the validity of that business purpose.

Until 2005, Astoria REIT served a dual purpose of purchasing and holding non-New York loans generated by Astoria Mortgage separate from Astoria Savings while achieving favorable tax treatment for the income from those loans. It is clear that the organization of Fidata as a Connecticut passive investment company was initiated solely to preserve the favorable tax treatment of the non-New York mortgage loans held by Astoria REIT on July 1, 2005 and future non-New York mortgage loans purchased from Astoria Mortgage. However, it also continued to serve the ongoing non-tax business purpose of keeping those loans out of Astoria Savings.

The United States Supreme Court has held in *Gregory v Helvering,* 293 US 465, 469 (1935):

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[96] *Id* at 91.

> "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."

The State Tribunal also has held that "[a] subjective business purpose for engaging in a transaction need not be free of tax considerations." (*Kellwood,* 2011 WL 4537050 [NY St Div of Tax Appeals DTA No. 820915, September 22, 2011].) As stated by the Court of Appeals for the Federal Circuit in *Coltec Indus. Inc. v U.S.*, 454 F3d 1340, 1357 (Fed Cir 2006):

> "[T]here is a material difference between structuring a real transaction in a particular way to provide a tax benefit (which is legitimate), and creating a transaction, without a business purpose, in order to create a tax benefit (which is illegitimate)."

Based on the Record, we cannot say that the transfer of the assets of Astoria REIT to Fidata or Fidata's subsequent operations served no business purpose. Although it is clear that the tax purposes were substantial, separating the non-New York loans from Astoria Savings was a sufficient non-tax business purpose to support the transactions. The movement of the assets of Astoria REIT to Fidata was not an artificial transaction created to generate a tax benefit. It was a bona fide transaction undertaken to avoid the adverse tax consequences of leaving the assets in the New Jersey REIT while retaining the structure that enabled Astoria Savings to maintain its favorable CRA rating, which, as Mr. Redman testified, was important to the business of Astoria Savings. Thus we find that the organization of Fidata as a Connecticut passive investment company to acquire the assets of Astoria REIT and to continue its operations had sufficient business purpose apart from the tax benefits.

The next inquiry is whether the transactions among Fidata, Astoria Savings and Astoria Mortgage had economic substance. The Third Circuit Court of Appeals stated that, "where a transaction objectively affects the taxpayer's net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations." (*ACM Partnership,* 157 F3d 231, 248, n 31 [3d Cir, 1998] [*ACM Partnership*].) The State Tribunal in *Kellwood* cited *ACM Partnership* in

concluding that the economic substance test not only included an inquiry as to any profit motive but also as to whether the transaction "objectively affected [the taxpayer's] net economic position." As we already have concluded, the transfer of the mortgage loan portfolio of Astoria REIT to Fidata and the continuation of the activity of Astoria REIT by Fidata facilitated the outstanding CRA rating of Astoria Savings enhancing its business in multiple ways according to the testimony of Mr. Redman. Thus we find that the arrangement had economic substance apart from any tax benefits because it enhanced the "non-tax business interests" of Astoria Savings.

The Record indicates that significant components of the transactions among Fidata, Astoria Savings and Astoria Mortgage were accomplished through bookkeeping entries. Ms. Tomich testified that the loans to be purchased by Fidata were allocated to it but that the mortgages were recorded in the name of the lender, Astoria Mortgage. While Fidata was notified in the event of a default, Astoria Savings as the named servicer, not Fidata, would have been the named party in any legal proceedings. The uncontroverted testimony establishes that all of these practices were standard in the industry.

The Record makes it clear that Fidata was a separate operating entity from Astoria Savings and Astoria Mortgage. It had five full-time employees in Connecticut and a bona fide office and bank accounts in its name. Mr. Nydegger, the president of Fidata, testified that it was his decision as to how much money it had available to purchase loans from Astoria Mortgage. Respondent introduced no evidence to contradict Mr. Nydegger's testimony.

Respondent asserts that Fidata lacked economic substance based on the fact that Mr. Nydegger was a part-time employee and that all of the employees lacked the education and skills to evaluate the credit risks of the loans Fidata purchased, performed no due diligence and did not reject any loans. Nevertheless, Fidata had bank accounts over which the president had at least dual, and to some degree sole, signatory power. It also had an office and employees who were not employees of Petitioner or any other company. Although the post-closing functions performed by Fidata were primarily

clerical, they were necessary functions that did not duplicate functions performed by Astoria Savings with respect to the loans purchased by Fidata. Fidata contracted with affiliated entities to perform much of the work of servicing the loans in its portfolio, but it paid substantial fees for that work.

Having concluded that the establishment of Fidata had economic substance and served some business purpose apart from the tax benefit, we next examine whether the presumption of distortion has been rebutted by Petitioner. That presumption can be rebutted by a showing that the intercorporate transactions creating the presumption were conducted at arm's length. (*Sherwin-Williams; Matter of Silver King Broadcasting of N.J. Inc.*, 1996 WL 272379 [NY St Div of Tax Appeals DTA No. 812589, May 9, 1996].)

The March 8 OTS Letter contains a statement that mortgage loans would be purchased by Fidata at an arm's length price. OTS' approval of the operation of Fidata was made in reliance on the representations made in the March 8 OTS Letter. The Record shows that the purchase price for each of the loans Fidata purchased from Astoria Mortgage and Astoria Savings during the Tax Years was equal to the face amount of the loan with certain adjustments. More than one witness testified that the purchases were made daily immediately after the loans were funded. However, Mr. Nydegger testified that payment for the loans was made on a monthly basis. Mr. Fusco testified that the face amount of a loan is its fair market value on the date it is funded. Professor Saunders also testified that the fair market value of a loan was equal to its face value on the date the loan was made but that value could change in as little as a day if interest rates changed. Any such fluctuations in value after the purchase of the loans would have had no effect on the purchase price. In any event, there is no evidence in the Record of any fluctuations in value with regard to the loans purchased by Fidata during the Tax Years that might have caused the purchase price not to be an arm's length price for such loans.

Respondent argues that the fact that the employees of Fidata lacked the qualifications to evaluate the credit risks of the loans purchased, did no due diligence and

never rejected a loan is evidence that the sales were not at arm's length.[97] Respondent asserts that "there is no evidence that the face value of a package of loans acquired by Fidata is equal to the fair market value a non-related party would [pay] in an arm's length transaction."[98] Respondent points out that Mr. Nydegger testified that he did not know if any of the mortgage loans purchased by Fidata were second mortgage loans or home equity loans.[99] While Fidata's staff performed no due diligence on the loans purchased and did not reject any loans, Mr. Fusco testified that none of the loans were high risk loans, second mortgage loans or home equity loans and that Petitioner was not engaged in subprime lending.[100] None of the evidence offered by Respondent negates the uncontroverted testimony of Petitioner's witnesses and Professor Saunders that on the date of origination, the face amount of a mortgage loan is its fair market value. Given the testimony that the loans were purchased immediately upon origination, we conclude that the purchases were at arm's length prices.

The loan servicing fees paid by Fidata to Astoria Savings during the Tax Years were paid at a rate consistent with industry standards and at a rate charged by Astoria Savings to Fannie Mae. While the Record indicates that Astoria Savings profited from its outsourcing of the loan servicing to DMI, that alone does not establish that the loan servicing fees paid by Fidata were not consistent with an arm's length price.

Fidata and Astoria Savings entered into the Expense Sharing Agreement under which Fidata agreed to compensate Astoria Savings for the cost of Fidata's use of Astoria Savings' facilities or personnel. The Record does not indicate whether that arrangement represented an arm's length pricing arrangement. However, the BCT Rules at 19 RCNY 3-05(b)(3)(ii)(C)(a) provide that incidental services, including accounting, legal and personnel services are not considered for purposes of the substantial intercorporate

[97] Resp. Brief in Support 39-41.
[98] *Id* at 26.
[99] Tr 463-464.
[100] Tr 201, 203-205.

transaction requirement. Moreover, Respondent does not assert that the Expense Sharing Agreement resulted in a distortive arrangement.

Under *U.S. Trust,* the capital contribution of the mortgage loans held by Astoria REIT to Fidata is not an intercorporate transaction taken into account in determining whether such transactions result in a presumption that the BCT liability of Petitioner is not properly reflected, i.e., is distorted. We note, however, that this does not mean that a capital contribution cannot give rise to a finding of distortion and, therefore, a finding that combination is appropriate. *See Matter of Interaudi Bank,* 2011 WL 1537402 (NY St Div of Tax Appeals DTA No. 821659, April 14, 2011) *(Interaudi Bank)* discussed below at 25-26.

No other transactions between Fidata and Astoria Savings or any other affiliates of Astoria Holding were identified by Respondent.[101] Because Petitioner has established that the transactions between Fidata and Astoria Savings and Astoria Mortgage relevant to the presumption were conducted at arm's length, we find that Petitioner has successfully rebutted the presumption of distortion. As a result, Fidata is not required to be included in Petitioner's combined BCT returns for the Tax Years on the basis of substantial intercorporate transactions.

However, that does not end the inquiry. Administrative Code §11-646(f)(2)(i) provides that a non-taxpayer banking corporation can be required to be included in a combined BCT return of another banking corporation or bank holding company if including that corporation in the combined return is necessary "to properly reflect the

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[101] There is no evidence in the Record as to whether the fees, if any, paid to Suffco for its custodial services were arm's length, however, Respondent does not assert that any such fees were not arm's length.

While the CALJ found that Fidata agreed to let Astoria Savings "use its mortgage loans as collateral for borrowing from" the Federal Home Loan Bank (FHLB) (CALJ Determination at 14), we reject that finding of fact as not supported by evidence in the Record. There is testimony in the Record that Fidata had to authorize Astoria Savings to use its loan portfolio to facilitate Astoria Savings' liquidity. (Tr 231.) In an effort to rebut testimony of Professor Saunders, Petitioner's counsel attempted to introduce into evidence a document that he described as indicating that Fidata did, in fact, pledge its loan portfolio as collateral for FHLB borrowing. (Tr 1301.) However, Respondent's counsel objected to the introduction of that document and, although it was marked for identification, it was never introduced into evidence. (Tr 1302-5.) Consequently, we cannot consider any aspect of the possible pledging of its assets by Fidata for the benefit of Astoria Savings in examining the intercorporate transactions between Fidata and Astoria Savings.

[BCT] liability . . . because of intercompany transactions *or* some agreement, understanding, arrangement or transaction. . . ." (Emphasis added.) Thus there are two separate and independent grounds for requiring a non-taxpayer banking corporation to be included in a combined return. Although we have concluded that Petitioner has rebutted the presumption of distortion that would require Fidata to be included in Petitioner's combined BCT returns, we still must consider whether there is an "agreement, understanding or arrangement" between Fidata and Petitioner "whereby the activity, business, income or assets of" Petitioner in the City "is improperly or inaccurately reflected." (Administrative Code §11-646[g].)

Respondent asserts that the facts of the case before us are indistinguishable from those in *Interaudi Bank,* 2011 WL 1537402 (NY St Div of Tax Appeals DTA No. 821659, April 14, 2011), in which a New York chartered bank subject to the State Bank Tax transferred approximately $100 million of its investment assets to a subsidiary that qualified as a passive investment company under Delaware law. That subsidiary had one part-time employee who was paid $2,000 annually. While she was the president of the subsidiary, she also was an employee of a company that was an affiliate of the entity hired to be the custodian of the assets of the subsidiary and she held approximately 100 positions as an officer with other clients of that same company. Nevertheless, the administrative law judge found that the passive investment company,

> "was not an empty shell. It was exceedingly well capitalized. It was not formed to create fake losses so as to generate tax deductions. . . . It was intended to generate a profit from its very inception and did in fact generate such profit. It did not pretend to serve some function . . . which was actually being performed by its parent."[102]

In *Interaudi Bank* there were no intercorporate transactions other than the initial capital contribution of the investment assets so no presumption of distortion was created. However, the State Tribunal affirmed the administrative law judge's determination that the transfer of the investment assets to the subsidiary was an "arrangement, agreement or

[102] *Interaudi Bank,* 2010 WL 422473 (NY St Div of Tax Appeals DTA 821659, January 28, 2010) at 25.

understanding" that resulted in a mismatch of income and related expense causing the State Bank Tax liability of the bank to be distorted. The administrative law judge stated:

> "If petitioner used funds which it had borrowed from its depositors, then it had . . . created an arrangement whereby the expense of obtaining such funds (the interest paid to depositors) was allocated to New York State while the income earned on such funds was allocated outside of New York State. This is the very definition of distortion. If, on the other hand, petitioner used funds for which petitioner incurred no expense (e.g,. paid-in capital or undistributed profits), then it is hard to see where there is any mismatching of income and expenses which would cause distortion."[103]

The administrative law judge found that, at the time the investment assets were transferred to the subsidiary, the source of those assets was deposits held by the bank or other borrowings all of which resulted in interest expense incurred by the bank while the subsidiary earned over $5 million in investment income but incurred no interest expense. This finding was based on the administrative law judge's finding that the stockholders' equity in the bank was only about $38.7 million at the time almost $100 million in assets were transferred to the subsidiary. The administrative law judge held:

> "It can only be concluded that petitioner created a distortion in its income by claiming an interest deduction in its combined report attributable to assets held by a subsidiary corporation which was not included in the combined report. As a result either its deductions were overstated or its income was understated. By including BA Investments' income in the combined report, this distortion is eliminated."[104]

Respondent argues that the relationship between Fidata and Petitioner is comparable to that between the bank and the Delaware investment subsidiary in *Interaudi Bank* because Petitioner claims a deduction on its combined BCT returns for interest expense on deposits while interest income on mortgage loans held by Fidata is not included in Petitioner's income reported on those returns resulting in a similar distortive mismatch of income and expense.

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[103] *Id* at 26.
[104] *Id* at 27.

Respondent argues that this Tribunal is required to follow the result in *Interaudi Bank* as binding precedent. We disagree. The City Charter provides that the Tribunal "shall follow as precedent the prior precedential decisions of the . . . New York State Tax Appeals Tribunal . . . insofar as those decisions pertain to any substantive legal issues currently before the tribunal." (City Charter §170.d.) City Charter §170.d does not require this Tribunal to reach the same result in a case before it as was reached in a State Tribunal decision if the facts are not substantially similar in all material respects. (*Matter of U.S. Trust Corp. and Subsidiaries*, 1997 WL 754084 [NYC Tax Appeals Trib. TAT (E) 93-204 (BT) et al, November 25, 1997].)

In effect, City Charter §170.d applies the doctrine of stare decisis to decisions of the State Tribunal with respect to this Tribunal. "The doctrine of stare decisis provides that once a court has decided a legal issue, subsequent appeals presenting similar facts should be decided in conformity with the earlier decision."[105] *Interaudi Bank* represents binding precedent for this Tribunal only if it is sufficiently factually similar to the case before us.

*Interaudi Bank* is factually distinguishable from the case before us in at least one significant and material respect. The assets held by the investment subsidiary in *Interaudi Bank* were acquired by the parent bank and transferred to that subsidiary directly by the parent bank shortly before the tax years in question. As a result, there was a clear shift in the income generated by those assets from the parent bank to the subsidiary. The record in that case included a balance sheet for the parent bank for the year of the transfer and other detailed information regarding that transfer. The administrative law judge was able to examine the financial situation of the parent bank at the time of that transfer in concluding that the assets were purchased with the proceeds of deposits on which the parent bank paid interest.

[105] *People v Bing*, 76 NY2d 331, 337-338 (1990).

By contrast, Astoria Savings did not transfer assets to Fidata. Rather, in 2005, Astoria REIT, which began holding non-New York mortgage loans in 1996 or 1997,[106] transferred its portfolio of primarily non-New York mortgage loans to Fidata.[107] Unlike the record in *Interaudi Bank*, the Record before us contains no specific evidence, either documentary or testimonial, of the circumstances under which Astoria REIT acquired its initial portfolio of mortgage loans in 1996 or 1997 or what the stockholder equity of Astoria Savings was at that time. The Record before us includes specific information about only the 2005 transfer of assets from Astoria REIT to Fidata.

In support of its argument that, as in *Interaudi Bank*, the mortgage loans held by Fidata have been separated from the funding source for those assets, which Respondent argues are the deposits held by Astoria Savings, Respondent notes that in 2005, the stockholders' equity in Petitioner was less than the amount of the mortgage loan portfolio transferred to Fidata by Astoria REIT.[108] But in the absence of information in the Record regarding the formation of Astoria REIT in 1996 or 1997 or the circumstances under which it acquired its initial portfolio of mortgage loans at that time, we lack sufficient evidence to reach the same conclusion as was reached in *Interaudi Bank* that the mortgage loans transferred to Fidata in 2005 were funded by deposits or other liabilities on which Astoria Savings incurred interest expense during the Tax Years.

Respondent relies heavily on the testimony of Professor Saunders to support its argument that the establishment of Fidata in Connecticut to hold non-New York mortgages represented an "agreement, understanding, arrangement or transaction" resulting in the improper reflection of Petitioner's income or activity in the City.

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[106] Tr 69.

[107] Astoria REIT was not subject to the BCT and could not be included in a combined BCT return. (Administrative Code §11-603.7.) As in effect during the Tax Years, Administrative Code §11-603.7 provided that "a real estate investment trust . . . shall not be subject to any tax under subchapter three of this chapter [6]." Subchapter three of chapter 6 of the Administrative Code is the subchapter under which the BCT is imposed. In 2009, Administrative Code §11-646(f)(2) was amended so that effective for taxable years beginning on or after January 1, 2009, captive REITs, as defined, were required to be included in a combined BCT return. (Ch. 201, §14 of the Laws of New York of 2009.) Under the amended statute, Astoria REIT would have been required to be included in a combined BCT return with Petitioner beginning in 2009.

[108] Respondent's Brief in Support of Exception 6.

Professor Saunders concluded that by holding long term mortgage loans in Fidata, the liquidity and credit risks of Astoria Savings were increased because as a Connecticut passive investment company Fidata could not securitize its mortgage portfolio, could not sell mortgage loans or otherwise easily and quickly convert its assets to cash if needed by Astoria Savings.[109] For that reason primarily, Professor Saunders concluded that the holding of mortgage loans in Fidata not only lacked business purpose but had a negative effect on the financial situation of Petitioner.[110] As evidence of the liquidity problems of Petitioner, he noted that Astoria Savings had received TARP[111] funds under the federal bailout of troubled banks in 2008, although he could not specifically point to Fidata as a cause of any such problems.[112] Professor Saunders stated that he had not seen the CAMELS report on Petitioner, which, he testified, was a federal report examining the capital, asset quality, management competence, earnings, liquidity and sensitivity market risk of banks.[113] As was later pointed out by Petitioner's counsel on cross examination, Professor Saunders was mistaken as to two facts that figured prominently in his conclusions; first, Astoria Savings did not receive TARP funds and was not identified as a troubled bank, and second, under the rules applicable to Connecticut passive investment companies, Fidata was permitted to sell mortgage loans held by it after a certain period.[114] Thus essential facts underlying Professor Saunders' testimony were incorrect.

As was previously noted, in some respects Professor Saunders testimony appears inconsistent. He testified that by placing mortgage loans in Fidata, the liquidity risk of Petitioner was increased. At the same time, he testified that because Fidata's board of directors was controlled by Astoria Savings and it was 100% owned by Astoria Savings, assets held by Fidata were not more secure than if they had been held by Astoria Savings.[115]

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[109] *See e.g.* Tr 894-895, 904, 907.
[110] Tr 894.
[111] TARP stands for Troubled Asset Relief Program.
[112] Tr 904, 929.
[113] Tr 878-880.
[114] Tr 1210, 1260-1262.
[115] Tr 866, 893.

Based on all of the foregoing, we find Professor Saunders' testimony unpersuasive on the issue of distortion.

Respondent points to the relative size of the items of income and expense reported by Fidata and Astoria Savings during the Tax Years as evidence that the organization of Fidata to hold non-New York mortgage loans resulted in a distortive separation of the interest income from those mortgage loans from the expenses incurred by Astoria Savings in producing those assets, which Respondent contends, were funded by deposits held by Astoria Savings. While certain income and expense factors of Fidata appear disproportionate when compared with those of Astoria Savings, that disproportion alone does not represent proof that the interest income earned by Fidata was derived from assets funded by deposit liabilities of Astoria Savings. There is no evidence in the Record as to how Astoria REIT acquired its original mortgage loan portfolio, and, as we have previously concluded, the mortgage loans subsequently acquired by Fidata were purchased at arm's length prices.

It is true that during the Tax Years, Fidata purchased loans from Astoria Mortgage and that Fidata paid dividends to Astoria Savings. However, the amount paid by Fidata for loans, over $1 billion in each Tax Year, significantly exceeded the amount paid as dividends, which was only $200 million or less in each of the Tax Years. The Record does not indicate how the amount of loans purchased by Fidata from Astoria Mortgage compared to the total volume of loans originated by Astoria Mortgage in each Tax Year. Nor is there any evidence in the Record as to what Astoria Mortgage did with the funds paid by Fidata for the loans it purchased from Astoria Mortgage. While Astoria Savings and/or Astoria Mortgage funded the principal amounts of the loans purchased by Fidata during the Tax Years,[116] Fidata paid the face value of those loans with funds derived from the interest and principal earned on its portfolio, not from deposits held by, or contributions from, Astoria Savings. Thus there is no clear circular flow of funds among the three entities during the Tax Years.

[116] Stipulation ¶22.

There is no question that had the interest income reported by Fidata in each of the Tax Years been reported on Petitioner's combined BCT return, Petitioner would have had a greater BCT liability. However, that is not enough to conclude that Fidata must be included in a combined BCT return with Petitioner to properly reflect the business, activity, assets or income of Petitioner in the City.

Under the BCT Rules, income from a loan is allocated to the City if the loan is located in the City, which is determined based on where the greater portion of income-producing activity occurred. (19 RCNY 3-04[f][2][i].) The activities to be considered for this purpose are "solicitation," "investigation," "negotiation," "final approval" and "administration." (19 RCNY 3-04[f][2][iii].) The Parties have stipulated that Fidata did not perform any portion of the first four of those activities with respect to the mortgage loans it held or acquired.[117] To the extent those activities with respect to mortgage loans purchased by Fidata were conducted by Astoria Mortgage, which was not located in the City, or by Astoria Savings from offices outside the City, income from those loans was not allocable to the City in any event. We note that the allocation percentage determined by the auditor for each of the Tax Years was slightly lower than that originally reported by Petitioner.[118]

Based on the foregoing, we conclude that Petitioner has rebutted the presumption of distortion by establishing that prices paid by Fidata in the intercorporate transactions between Fidata and Petitioner were arm's length prices. We further conclude that the Record does not support a finding that there was "any agreement, understanding or arrangement" between Fidata and Petitioner that resulted in the improper reflection of the "activity, business, income or assets of" Petitioner requiring the inclusion of Fidata in Petitioner's combined BCT returns for the Tax Years under Administrative Code §11-646(g). Therefore, the CALJ Determination is affirmed and the 2006 Notice and the

[117] Stipulation ¶25.
[118] Resp. Ex. 18, Sch. J; Resp. Ex. 22 at W6-W7.

2007-2008 Notice are cancelled.[119] Commissioner Frances J. Henn did not participate in this Decision.

Dated: May 19, 2016
New York, NY

Ellen E. Hoffman
President and Commissioner

Robert J. Firestone
Commissioner

[119] We have considered all of the other arguments of the Parties and find them unpersuasive. Respondent has argued that the CALJ should not have admitted the testimony of Richard Pomp as an expert witness to testify as to New York tax policy. As we have previously stated, this Tribunal is an administrative body and that the rules of evidence are very loosely applied. This Tribunal is an adjudicative body of special expertise in the area of taxation. While expert testimony outside of the field of taxation, even testimony as to the state of the law in a particular area, can be useful in a given case, we are of the opinion that presentation of relevant law is solely the responsibility and purview of the Parties' representatives and the administrative law judge. Where, as here, expert testimony is offered in the area of tax law, especially New York tax law, we see no justification for its admission. Nevertheless, there is no indication that the CALJ relied on Mr. Pomp's testimony in her determination. Therefore, we need not rule on Respondent's argument.