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Allow Loss on Sale of Subsidiary Included in Combined Report

Stock of Combined Subsidiary Is Not "Subsidiary Capital"

Recently, the State Tax Appeals Tribunal considered whether a $93 million loss Bausch & Lomb incurred on the sale of its stock in a subsidiary that was included in the parent's combined group for certain years should be disallowed for Corporation Franchise Tax purposes on the basis that the parent's ownership of the stock was an investment in "subsidiary capital." (*Bausch & Lomb, Inc., and Affiliates*, DTA No. 819883, December 20, 2007)

Bausch & Lomb and many of its subsidiaries filed as a combined group for many years during which time the composition of the group varied. The group reported capital gains and losses on a consolidated basis, *i.e.*, capital gains for one member of the combined group were netted against losses incurred by other members of the combined group. Bausch & Lomb sold all of its stock in one subsidiary that had been included in the combined report for a substantial loss which it carried back to a previous year, resulting in a refund claim for that year. The Division of Taxation denied the claim.

The issue in this matter focuses on Tax Law Sec. 211.4(b)(2), which specifies that "in computing combined subsidiary capital intercorporate stockholdings shall be eliminated." The question is whether this statutory language applies in determining what constitutes "[i]ncome, gains and losses from subsidiary capital" within the meaning of Tax Law Sec. 208.9(a)(1), which excludes these items from entire net income, *i.e.*, whether stock in the combined subsidiary should be regarded as "subsidiary capital" in determining whether loss on the sale of that stock is disallowed as being attributable to subsidiary capital.

The Division of Taxation asserted that the elimination of intercorporate stockholdings from the computation of subsidiary capital does not affect what items are included in entire net income, a view the State Administrative Law Judge had adopted. Bausch & Lomb countered that the language quoted above from Tax Law Sec. 211.4(b)(2) essentially modifies the exclusion of income, gains and losses from subsidiary capital under Tax Law Sec. 208.9(a).

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The Division supported its position by noting the ''distortions'' that would result from accepting Bausch & Lomb's argument. First, the Division pointed out that the decline in the subsidiary's value occurred over a period of years that began when the subsidiary was not included in the combined group — and therefore, that value was subject to the tax on subsidiary capital — resulted in ''double accounting'' for the reduced value of the subsidiary, *i.e.*, both a reduced tax on subsidiary capital and reduced entire net income after the sale of the subsidiary. The Tribunal found no merit to this theory of distortion, reasoning that this result was simply a consequence of the legislature's decision to apply the Corporation Franchise Tax on more than one base.

Equally unconvincing to the Tribunal was the Division's second theory of distortion — that built-in losses which economically accrued before a subsidiary joined in a combined report or when members of the combined group were different should not be allowed. The Division could cite no basis in the Tax Law or regulations for imposing such a limitation on the use of losses.

Ultimately, the Tribunal concluded that Tax Law Sec. 211.4(b)(2) means that intercorporate stockholdings are *not* ''subsidiary capital'' when a subsidiary is included in a combined report. Accordingly, Bausch & Lomb's loss was allowed.

Observations: While Bausch & Lomb may be pleased with the outcome of this Tribunal decision, many corporate taxpayers will not be. That's because the converse of allowing a loss on the sale of stock in a combined subsidiary to be taken in computing entire net income is that gain on the sale of stock in a combined subsidiary is taxable. Both taxpayers and their advisors will need to review transactions involving the sale of combined subsidiaries for all open tax years.

Partnership Interest Valued at Market Value for City Capital Tax

Entity Approach vs. Aggregate Approach

The New York City Tax Appeals Tribunal recently considered an issue of importance to corporations owning interests in partnerships that own real property: whether in computing the tax on capital under the City's General Corporation Tax, the asset included in capital is the corporation's intangible partnership interest — value at book value — or its share of the partnership's real property — valued at fair market value. (*National Bulk Carriers, Inc. and Affiliates*, TAT (E) 04-33 (GC), November 30, 2007)

National Bulk Carriers, a New Jersey corporation, owns various subsidiaries that in turn own interests in partnerships that own real estate, including office buildings in New York City. National Bulk computed its GCT liability based on the capital method, *i.e.*, the amount of its business and investment capital allocated to the City, since that alternative base produced the greatest liability. In determining the value of assets under the capital method, National Bulk included the value of its interests in the partnerships as shown on its books in accordance with GAAP.

The Department of Finance disagreed with the position taken by the corporation on its return, asserting that National Bulk should not be treated as owning interests in the partnerships — the ''entity approach'' — but instead should be treated as owning a ratable share of the partnerships' assets — the ''aggregate or conduit approach.'' The difference in the character of the property to be valued

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between the entity approach and the aggregate approach resulted in a substantial assessment for the tax years at issue. (Valuing the real estate of the partnerships at fair market value resulted in a greater tax liability than valuing the corporation's interests in the partnerships based on GAAP.)

The Tribunal concluded that the aggregate or conduit approach should be used, *i.e.*, National Bulk should be treated as owning a ratable share of the partnerships' property and those assets should be included in business capital at their fair market value. According to the Tribunal, since the aggregate approach is required for purposes of computing a corporate partner's business allocation percentage (*see* 20 NYCRR § 4-6.5(a)(1)), logic dictates that the same approach be used in determining the assets to be included in business capital. (''It would be inconsistent to use the aggregate method in determining the income subject to GCT and the BAP but use the entity approach to determine the business capital allocated by that same BAP.'') The Tribunal also pointed out that use of the entity approach advocated by National Bulk ''would permit taxpayers to manipulate the value of their capital under the Capital Method simply by moving assets into and out of entities that can be treated as partnerships or corporations merely by 'checking a box'.''

Observations: National Bulk had insisted that its position was supported by an undisturbed State Administrative Law Judge determination. In *Arcade Broadway Rentals, Inc. et al.*, December 31, 1998, a State ALJ concluded that for purposes of computing Corporation Franchise Tax liability under the capital base, a corporation's interest in a partnership that owned real property was properly valued at the amount reflected on the corporation's books in accordance with GAAP. (The State and City tax provisions in question are essentially identical.)

In reaching this conclusion, the State ALJ reasoned that, as a general rule, partnership interests are treated as personal property, and that in most areas of the law, New York respects the separate identity of partnerships. The ALJ explained that applying the aggregate or conduit approach to compute certain items related to the entire net income base and to the business allocation percentage are limited exceptions to the general partnership rule, based on specific statutory and regulatory language. Because there are no such provisions governing the determination of the capital base, the ALJ found that the general rule that a partnership interest is personal property separate and apart from the underlying assets — the entity approach — controlled the treatment of a partnership interest in the hands of the corporate partner.

National Bulk indicated that in the years following *Arcade Broadway*, the City Department of Finance never announced that it disagreed with the result of that case. The corporation argued that in the absence of a pronouncement by the City Tax Commissioner disagreeing with the result reached in *Arcade Broadway*, ''it was entitled to rely on the determination as guidance and to follow it in computing its GCT liability for the Tax Years because to do otherwise 'would not have been prudent.' '' The Tribunal rejected this reasoning:

> There is no requirement that [the Commissioner] issue a pronouncement when there is a disagreement with a determination of a State Tribunal administrative law judge involving a provision comparable to one contained in the [City Administrative] Code. Such a determination cannot become precedential merely because [the Commissioner] did not publicly disagree with the result in the matter.

In fact, noted the Tribunal, National Bulk actually relied on *Arcade Broadway* when it filed amended City GCT returns after becoming aware that the Department of Finance disagreed with that State determination.

The State Department of Taxation has made changes to Corporation Franchise Tax regulations to adopt the aggregate approach to the taxation of corporate partners for tax years beginning on or after January 1, 2007. Essentially, the regulations require a corporate partner to use the aggregate method with respect to its interest in a partnership if it has access to the information necessary to compute its tax — including the tax on capital — using that method. (In rare instances, the regulations permit corporate partners to use the entity method.) Accordingly, for State capital tax purposes, a corporate partner must value partnership assets and liabilities at fair market value — effectively overturning the State ALJ's non-binding determination in *Arcade Broadway*.

No Tax on Deemed Sale by Nonresident Shareholder of S Corp

Section 338 Does Not Apply to Sale of S Corporation

A recent State Administrative Law Judge determination concluded that a nonresident's New York source income did not include gain on a ''deemed sale'' of a New York S corporation's assets pursuant to an Internal Revenue Code section 338(h)(10) election made by the S corporation's shareholders and the acquiring corporation. (*Gabriel S. and Frances B. Baum; Christian M. Boegner and Joanna Townshend*, DTA Nos. 820837 and 820838, December 20, 2007)

Under Tax Law Sec. 208(9), an S corporation must compute its entire net income as if it had not made an S election, *i.e.*, as if it were a C corporation. Since the S corporation was not a member of a selling consolidated or affiliated group of corporations as required for federal purposes, a 338(h)(10) election was not available to the S corporation at the State level. Accordingly, the federal fiction of a ''deemed asset sale'' and a ''deemed distribution in complete liquidation'' provided for under section 338(h)(10) did not apply to the sale of the S corporation for State purposes.

Because section 338(h)(10) did not apply, gain from the deemed asset sale did not pass through to the nonresident shareholder as New York source income. Therefore, for personal income tax purposes, the shareholder's gain from the sale of the S corporation was considered to have resulted from the sale of stock. As a nonresident, the shareholder was not required to include gain from the sale of an intangible asset — stock — in New York source income.

Observations: An earlier State ALJ determination also centered on the interplay between the way New York S corporations are treated for Corporation Franchise Tax purposes and a 338(h)(10) transaction. The issue was whether a New York S corporation must include gain from a 338(h)(10) deemed asset sale in its entire net income. (*Zweig Total Return Advisors, Inc.*, December 16, 2004)

The deemed asset sale by Zweig, a federal and State S corporation, resulted in a substantial federal taxable gain to the shareholders. The Division of Taxation assessed Corporation Franchise Tax against Zweig Advisors, arguing that Zweig Advisors should be treated as having sold all of its assets on the acquisition date at fair market value. According to the Division, the difference between that fair market value and the adjusted basis of the corporation's assets constituted gain to Zweig Advisors. The Division pointed to Internal Revenue Code section 338(a), the initial election that must be made by the purchaser in order for a 338(h)(10) election to be made by the seller and purchaser.

The Division also focused on Tax Law Sec. 208(9)(i), which provides that entire net income is presumably the same as the entire net income the taxpayer must report for federal purposes. Since Zweig Advisors had been required to report the gain on the deemed asset sale for federal purposes, the Division maintained that it must do the same for Corporation Franchise Tax purposes.

The ALJ accepted Zweig Advisors's contention that gain on the deemed asset sale was not taxable based on Tax Law Sec. 208(9)(ii), which specifies that a New

York S corporation's entire net income is determined as if the corporation were a C corporation for federal purposes. As the ALJ in the recent determination observed, shareholders of a C corporation cannot make a 338(h)(10) election unless the corporation is a member of a consolidated or affiliated group. (Zweig Advisors fit neither category; it had been eligible for the 338(h)(10) election based on its status as an S corporation.) Since the 338(h)(10) election was invalid for State purposes, no part of Internal Revenue Code section 338 applied, *i.e.*, the transaction was treated as a sale of stock by the shareholders.

Doctor Who Owned Testing Lab Liable for Withholding Taxes

Reversal of ALJ Determination

While it may not be unusual for busy professionals to become involved in a sideline business, some might want to hesitate the next time an ''opportunity'' comes along. Just ask Dr. Robert Goodman, a doctor engaged full-time in a private medical practice who was found to be a ''responsible person'' with respect to the unpaid withholding taxes of a corporation involved in medical testing. (*Robert Goodman*, DTA No. 820171, November 15, 2007)

Dr. Goodman owned and operated a medical practice in Brooklyn, where he was present five days a week. Two acquaintances who ran a medical testing service approached him with a business proposition: assume ownership from another doctor who was giving them trouble. The business needed a physician authorized to practice medicine in New York in order to bill health insurers for patient charges. By contract, another entity with which his acquaintances were associated had general responsibility for managing the non-medical aspects of the business. Dr. Goodman would not have to put any money down and they would supply the $40,000 needed to purchase the business from the other doctor. Dr. Goodman would merely supervise some of the medical aspects of the business. In return for performing these supervisory services, Dr. Goodman would be paid $25,000 a year. To further entice Dr. Goodman, he was told that the business would be combined with similar operations, which eventually would make him a lot more money.

Dr. Goodman liked the idea and became the testing service company's president and sole shareholder. He became a signatory on the company's bank accounts and had authority to sign checks on behalf of the business. Dr. Goodman had authority to hire, supervise, evaluate and terminate all physicians employed by the testing service. As planned, his acquaintances handled the business's day-to-day operations and signed company checks. Dr. Goodman visited the offices of the company only two times a year during the period at issue.

Dr. Goodman was unaware that the company had failed to remit withholding taxes, although he was not prevented from examining the business's books and records maintained by the management company. He simply ''assumed the business was run properly.'' He never inquired as to the status of the business. (His testimony: ''*I don't know about the business aspects. I didn't care. I thought it was being taken care of.*'') Indeed, the testing service company continued to pay expenses — other than withholding taxes — after Dr. Goodman discovered that the company had failed to remit withholding taxes.

Favorable ALJ Determination

Dr. Goodman received a sympathetic ruling from a State Administrative Law Judge, who reasoned that even if the doctor was a ''responsible person'' by virtue of his position as president, sole shareholder and a signatory on the business's bank account, he was *not* liable for the unpaid withholding taxes since his failure to remit the taxes was not ''willful.'' (When withholding taxes are involved, the Division of Taxation must show that the individual's failure to collect and remit the taxes was ''willful'' in order to establish the individual's liability as a responsible

person.) The ALJ characterized Dr. Goodman as having been ''somewhat negligent in failing to ensure that the [business's] tax liabilities were properly met.'' The ALJ also gave weight to the fact that Dr. Goodman invested no money in the business and was never paid the $25,000-a-year salary he was promised.

''Reckless Disregard'' Equates to ''Willful''

The Tax Appeals Tribunal disagrees with the ALJ's conclusions, finding that Dr. Goodman was a ''responsible person'' and that his failure to ensure that withholding taxes were remitted was ''willful.'' With regard to the ''responsible person'' issue, it was clear to the Tribunal that Dr. Goodman was not a passive investor or lacked authority to act on behalf of the corporation, but simply decided not to do so. Further, the Tribunal found that Dr. Goodman had a financial interest in the corporation by virtue of his right to annual payments and because his medical license — a valuable asset — had been used by the testing service company to bill insurance companies. With regard to the ''willful'' issue, the Tribunal stressed that ''[a] responsible officer's failure can be willful, notwithstanding his lack of actual acknowledge, where it is determined the officer recklessly disregarded his corporate responsibilities including the responsibility to see that taxes were paid.'' In finding that Dr. Goodman recklessly disregarded his corporate responsibilities, the Tribunal emphasized his failure to visit the company more than twice a year; his failure to examine the books and records of the company; and his failure to ensure that taxes were being paid to the State.

Observations: In virtually any case when an individual is both an officer and substantial shareholder, he or she will be deemed to be a responsible person. That finding ends the inquiry if sales and use tax liability is in question. If unremitted withholding taxes are involved, the Division of Taxation will have to show that the individual's failure to collect and remit withholding taxes was willful. In most cases, an officer who is a substantial shareholder will have the authority to direct which corporate obligations get paid and which get set aside. If not, he or she usually will be in a position to ensure that withholding taxes are remitted or, at a minimum, be able to check the corporation's books and records to establish whether taxes are being remitted. When these factors are present, the failure to comply with the Tax Law will inevitably be considered ''willful.''

Lack of Adequate Records Did Not Preclude Resale Exemption

Beverage Vendor Met Burden of Proving Audit Result Erroneous

When a vendor's sales records are either nonexistent, not produced or inadequate for the purpose of conducting a detailed sales tax audit, the Division of Taxation may resort to the use of an estimated or indirect audit method, so long as that method is reasonably calculated to reflect sales taxes due. Once the Division resorts to an estimated audit method, the burden of proof falls on the vendor to show by ''clear and convincing evidence'' that the audit method was ''unreasonable'' or that the results were ''unreasonably accurate.'' Few vendors who face this burden succeed, since the Division of Tax Appeals routinely finds the audit method reasonable and concludes that any inaccuracy in the audit results are caused by the vendor's failure to maintain adequate records. However, as a recent State Administrative Law Judge determination illustrates, the Division of Taxation is not free to ignore its own regulations or turn a blind eye to the facts and circumstances of the vendor's business. (*Valley Stream Beverages, Inc.*, DTA No. 821117, November 8, 2007)

Valley Stream Beverage sells beverages — mostly beer and soda — at both retail and wholesale. In response to the Division of Taxation's request for books and records — including exemption certificates — for purposes of a sales tax audit, Valley produced monthly summary worksheets which contained entries for beer, soda and ice sales, bottle deposits, bottle returns, checks, charges and cash. It

did not produce cash register tapes to verify the amounts listed on the monthly worksheets. Based on the lack of detailed records, the Division decided to estimate Valley's sales tax liability using a test-period methodology focusing on Valley's bank deposits and cash payroll.

During the audit, Valley provided the Division with two resale certificates listing it as the seller and another beverage company, Turnpike Beverage, as the purchaser. These certificates were incomplete since neither was dated or indicated whether the certificate was a single-use or blanket certificate, as required on the form. Further, neither certificate described the business of the purchaser, as required on the form. Later during the audit, Valley provided completed blanket resale certificates for Turnpike Beverage.

Eventually the Division assessed a hefty sales tax deficiency, a significant part of which was attributable to the auditor's disallowance of sales made to Turnpike Beverage as exempt sales for resale. However, for the last nine months of the three-year audit period, the Division allowed an exemption for sales made to Turnpike Beverage. Valley challenged the assessment, arguing that the audit result was ''erroneous'' because the Division had improperly disallowed exempt sales to Turnpike Beverage.

The ALJ ruled in Valley's favor, pointing to regulations (Reg. Sec.532.(4)(b)(6)) which make it clear that when a vendor fails to obtain a timely or completed resale certificate, that failure does not change the tax status of related transactions, *i.e.*, the vendor still has the right to prove that the transactions were exempt.

Considering all of the evidence, the ALJ concluded that Valley had met its burden of proving that the sales to Turnpike Beverage were wholesale sales. The ALJ noted that the volume of beverages sold to Turnpike Beverage created a ''reasonable inference that Turnpike Beverage was not the end user... of such goods, but that Turnpike in fact resold such beverages to consumers.'' That inference alone might not be enough to meet the burden of proof, the ALJ explained, but it was sufficient when coupled with the credible testimony of Valley's owner which established that Valley regularly sold products to Turnpike Beverage in order to save costs (Valley's owner also owned Turnpike during a portion of the audit period). Moreover, the ALJ said by allowing an exemption for sales to Turnpike that occurred at the end of the audit period, ''the Division itself has conceded that [Valley] regularly made wholesale sales to Turnpike Beverage.'' Finally, the ALJ gave some weight to the untimely and flawed resale certificates.

Division Not Estopped from Taxing Service Company Purchases

Tax Department Advice Addresses Different Situation

The Tax Appeals Tribunal has ruled that a food service company providing management services to facilitate tax-exempt clients' food operations performed by the clients' employees was not exempt from sales and use tax on its purchases of nonfood items. The company's contention that it made these purchases as an ''agent'' of its tax-exempt clients was rejected. Affirming the State Administrative Law Judge on this issue, the Tribunal explained that the food service company's control over the details of the food operations supported a finding that it was not merely an agent of its clients. Agency provisions in the contracts between the company and its clients were deemed to be less significant than the conduct of the parties in carrying out the contracts.

The food service company's alternative assertion that purchases of the nonfood items in question were excluded from tax as ''purchases for resale'' had no merit. According to the Tribunal — again affirming the ALJ — these items were purchased by the company to provide a service — the management of food operations — and not for resale.

The company's third contention — that the Division of Taxation was estopped from assessing tax or denying a refund in connection with its purchase of nonfood items — was the charm before the ALJ. Unfortunately, the Tribunal was not equally convinced. The company's predecessor had written a letter asking the Tax Department's Technical Services Bureau for advice about the correct treatment of its nonfood items purchased ''for resale'' under a contract to provide meals and cafeteria services for a tax-exempt hospital. The response was that those purchases were ''for resale'' and, therefore, exempt from sales tax. The Tribunal found that the material facts underlying the letter and the present matter differed because the food company was not reselling the nonfood items, *i.e.*, the response merely confirmed that if the food company was making purchases for resale, those purchases would not be taxable. (*Sodexho USA, Inc. et al.*, DTA Nos. 820020–820024, November 21, 2007)

New York City Creates Office of Administrative Tax Appeals

Tax Commission and Tax Appeals Tribunal Combined

Mayor Michael Bloomberg has signed into law a City Council measure that combines the City Tax Commission and the City Tax Appeals Tribunal. (*Int. No. 597-A*, approved December 5, 2007, and effective January 20, 2008, or as soon as practicable thereafter.)

The Tax Commission is the City's forum for independent administrative review of real property tax assessments set by the Department of Finance. In addition to considering whether property is correctly assessed, the Tax Commission also reviews exemption claims that are denied. Glenn Newman is the current President of the Commission.

The City Tax Appeals Tribunal is an independent agency created under the City Charter to resolve disputes between taxpayers and the Department of Finance involving taxes administered by the City (other than City real property taxes). Glenn Newman is one of the three Commissioners serving on the Tribunal and is also President of the Tribunal.

The new Office of Administrative Tax Appeals (the OATA) will consist of the Tax Commission and the Tax Appeals Tribunal. The OATA will provide staff and administrative assistance to the Tax Commission and the Tribunal.

Observations: The intent behind combining the Tax Commission and the Tribunal is to allow the sharing of resources and a more efficient use of staff. Moreover, placing the Tribunal within the Office of Administrative Tax Appeals distances the Tribunal from the Department of Finance.

No Benefit to Officers from Cancellation of Corporate Penalty

Corporation Had Qualified for Amnesty

In *William P. Mackiewicz, Jr.* (June 7, 2007), the State Tax Appeals Tribunal ruled that when a conciliation conferee relieved a corporation from fraud penalties, cancellation of fraud penalties assessed against the corporation's sole shareholder and officer was required. According to the Tribunal, since the amount of the ''tax determination'' asserted against the corporation was reduced by eliminating the fraud penalties, the statutory framework — under which fraud penalties are simply a function of the amount of tax involved — mandated a corresponding reduction in the assessment against the officer/shareholder. In the Tribunal's words, ''the liability of a person under a duty to act for a corporation may not exceed the liability of the corporate entity from which such personal liability is derived.''

Despite the broad language of the *Mackiewicz, Jr.* decision, three officers involved in a recent Tribunal decision were unable to escape liability for a sales tax fraud penalty even though the corporation's fraud penalty had been eliminated — in this case, through tax amnesty. (*Dong Ming Li et al.*, DTA Nos. 820331 and 820333, December 20, 2007)

The Tribunal emphasized that in *Mackiewicz, Jr.* the Bureau of Conciliation and Mediation Services made a ''redetermination'' reducing penalties asserted against the corporation. In the present matter, the reduction of fraud penalties against the corporation was not a ''redetermination'' based on a finding that the penalties were erroneous or excessive. The Tribunal clarified its position on the derivative liability of officers: ''While a responsible officer's liability may derive from his actions on behalf of the corporation..., the general rule remains that the liability of a responsible officer is separate and independent from that of the corporation....''

Observations: The corporation — the operator of a Chinese restaurant — had been investigated by the Division of Taxation's Revenue Crimes Bureau for failing to remit sales tax that had been collected from patrons. Ultimately, the officers entered guilty pleas to misdemeanors; the corporation itself was neither convicted of a crime relating to sales tax nor was it under investigation for commission of a crime. Accordingly, the corporation had qualified for a tax amnesty program that was in effect for the period November 18, 2002, through January 31, 2003. Because they had been convicted a crime relating to the sales tax they had collected as responsible persons, the officers were *not* eligible for amnesty. The Tribunal refused to allow the officers to indirectly obtain the benefit of the corporation's amnesty.

Governor Nominates Budget Official to Tax Commissioner Post

Senate Confirmation Required

Governor Eliot Spitzer has nominated Robert Megna to the post of Commissioner of the State Department of Taxation and Finance. Megna has served as the Director of Revenue and Economics Unit at the State Division of the Budget since 1998. Mr. Megna's experience includes service as the Assistant Commissioner of the Office of Tax Policy in the Virginia Department of Taxation, employment in several roles for the State Department of Taxation and Finance, and work for the Assembly Ways and Means Committee. He received a M.Sc. from the London School of Economics and Political Science, and a B.A. and M.P.A. from Fordham University. Senate confirmation of his nomination is required.

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