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# Tribunal Case on Subsidiary to Have Great Impact

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Despite a tremendous reluctance to devote two straight articles to issues affecting corporate tax combined returns, the recent decision of the New York State Tax Appeals Tribunal (the "Tribunal") in *Bausch & Lomb, Inc., and Affiliates*[1] will have a significant impact on corporate groups operating in New York State.[2]

The Tribunal reversed a determination of the Administrative Law Judge[3] and ruled that a loss recognized on the sale of the stock of a subsidiary (where the corporation and the subsidiary were members of the same combined group) will not be disallowed as a loss attributable to subsidiary capital. Since the Division of Taxation (the "Division") cannot appeal from an adverse Tribunal decision, the holding in *Bausch & Lomb* is binding subject to future legislative (or possibly regulatory) actions. Corporations considering sales of subsidiary stock should understand the impact of this decision.

### Facts of "Bausch & Lomb Inc."

The factual background of the case is relatively straightforward.[4] Bausch & Lomb, Inc. ("B&L") is a New York corporation headquartered in Rochester. B&L files a federal consolidated return with numerous subsidiaries. Some of the subsidiaries are included with B&L in a New York combined return and others file separate New York returns. The composition of the B&L combined group varied over the years. In 1988 B&L acquired the stock of Dental Research Corporation, maker of the Interplak battery powered toothbrushes and renamed it Bausch & Lomb Oral Care Division, Inc. ("Oral Care"). B&L paid $133,000,000 in cash and notes for the stock, which exceeded the fair market value of the tangible and intangible assets by $119,000,000 which amount was treated for financial reporting purposes, but not for tax purposes, as goodwill amortizable over 40 years.

B&L maintained Oral Care as a wholly owned subsidiary. For the years prior to 1995, Oral Care was not included in the B&L combined group but filed a separate New York Franchise Tax Return. In those years, B&L included the value of the Oral Care stock in the computation of subsidiary capital in its combined return. In 1995, many of Oral Care's functions were relocated from Oral Care's location in Georgia to the B&L facilities in Rochester. As a result of the restructuring, in January 1996 B&L requested permission to include Oral Care in the 1995 B&L combined group. The Division gave tentative permission in March and, consequently, Oral Care was included in the B&L combined return for 1995 when it was filed in September 1996.

From 1992 through 1995, the Oral Care business suffered from competition, market value decline and operating losses. B&L meanwhile decided to focus on its core healthcare and optics businesses. As a result, in 1996, B&L sold the stock of Oral Care. At that time, the cost basis of the stock was approximately $110,000,000,[5] the selling price was approximately $17,000,000 and the resulting tax loss as reflected on the Federal Form 1120 was over $93,000,000. The B&L combined group claimed the loss on its 1996 returns, elected to carry it back to 1995 and filed a refund claim which became the basis of the case.

The Division, in connection with the audit of the refund claim, first questioned whether Oral Care should have been included in the B&L combined group but eventually confirmed the inclusion. The Division, nevertheless, denied the refund claim stating in a letter "that [t]he refund was due to the loss on the sale of a subsidiary, which per Regulation Section 3-7.2 does not qualify for a capital loss carryback."[6] After a Conciliation Conference proved unsuccessful, B&L commenced a refund suit.

### Issue

The legal issue can be summarized succinctly. Two provisions of the Tax Law potentially apply to the sale of Oral Care stock. The first provision is Tax Law section 208.9(a) which provides, in relevant part "Entire net income shall not include: (1)income, gains and losses

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from subsidiary capital. . . .” The second provision is Tax Law section 211.4 which provides for the filing of combined returns. Section 211.4(b)(2) provides

> (2) Tax bases. In computing combined entire net income, . . . intercorporate dividends shall be eliminated, in computing combined business and investment capital intercorporate stockholdings and intercorporate bills, notes and accounts receivable and payable and other intercorporate indebtedness shall be eliminated and in computing combined subsidiary capital intercorporate stockholdings shall be eliminated . . . .

B&L's refund claim was based on the reading of these two provisions that once Oral Care became included in the B&L combined group, it ceased to be subsidiary capital for purposes of Tax Law section 208.9(a). The sale of the stock of Oral Care should then be treated as the sale of a “division” of B&L and its loss included in entire net income.[7]

The Division's argument, which was adopted by the Administrative Law Judge, was that Tax Law section 211.4(b)(2) does not change the character of the loss as derived from subsidiary capital. As noted in the Tribunal Decision, the Administrative Law Judge wrote, in his determination,

> The wording of Tax Law section 211(4) does not provide the interpretation that B&L seeks. The only instructions provided by the Legislature . . . regarding the computation of combined entire net income is that “intercorporate dividends shall be eliminated.” Thus, . . . the Legislature did not explicitly state that Tax Law section 208(9)(a)(1) was superseded by Tax Law section 211(4) . . . even when the subsidiary is part of the combined group. [8]

The Administrative Law Judge also relied on the Tribunal decision in *Matter of H&S Holdings Ltd.*.[9] and further argued that the result sought by B&L would result in distortion[10] because the decline in the value of the Oral Care stock appeared to have occurred when Oral Care was not part of the B&L combined group and that the losses would be carried forward to years following the sale of Oral Care when again, it would not be part of the combined group.

**Tribunal's Opinion**

The Tribunal's opinion notes that under Article 9-A corporations are required to calculate tax under various bases including the tax on entire net income and the tax on subsidiary capital. It notes that entire net income is computed by excluding “income, gains and losses from subsidiary capital” under section 208.9(a)(1) and, similarly, entire net income is determined, in the discretion of the Division, without deduction for “interest directly or indirectly and any other amount directly or indirectly attributable . . . to subsidiary capital or to income, gains or losses from subsidiary capital”.[11] Subsidiary capital is instead subject to a separate tax of 0.9 mill per dollar of subsidiary capital allocated to New York.[12] Subsidiary capital includes stock of and indebtedness from subsidiaries,[13] corporations of which the parent corporation owns over 50 percent of the voting stock.[14]

After quoting Tax Law section 211.4(b)(2), the Tribunal noted that the Division's argument is “that section 211.4(b)(2), although eliminating intercorporate stockholdings from the computation of subsidiary capital, does not affect what items are included in entire net income.”[15] The Tribunal viewed the Division's argument as semantic, focusing on the introductory language of section 208.9 (“The term ‘entire net income’ means . . .,”) as support for the position that it can be altered only by provisions that are themselves definitions. This argument was unpersuasive to the Tribunal.

The Tribunal was also influenced by the inconsistency between the Division's position in the case and its Advisory Opinion, TSB-A-94(13)C.[16] In that Advisory Opinion, the Division addressed the issue of how to compute the disallowance of interest attributable to subsidiary capital in the context of a parent that borrowed funds to purchase the stock of a subsidiary that filed a combined return with the parent corporation. As noted by the Tribunal, the Division relied on Regulation section 3-6.6 that interprets section 211.4(b)(2)[17] and provides:

> In computing combined subsidiary capital, all investments in the stock of subsidiaries included in the combined report and any indebtedness from subsidiaries included in the combined report must be eliminated.

As a result, the Division held that the parent corporation's deduction for interest to acquire the combined subsidiary was not eliminated by section 208.9(b)(6) quoting the Advisory Opinion's conclusion “This is proper because there is no subsidiary capital on the combined report to which to attribute the interest expense.” The Division's brief observed that advisory opinions are not binding and tried to distinguish it on the grounds that it was interpreting section 208.9(b)(6) not section 208.9(a)(1). The Tribunal noted that the Division has not recanted its position in the Advisory Opinion and that the interpretation of section 211.4(b)(2) and regulation section 3-6.6 as determining the scope of “subsidiary capital” was exactly B&L's position. The Tribunal concluded that the Division's positions could not be reconciled.

The Tribunal then proceeded to dismantle the Division's distortion argument noting that the fact that the decline in value of Oral Care reduced B&L's subsidiary capital during the years it was not a member of the combined group was not surprising, but a logical consequence of the different nature of the two taxes on entire net income and on subsidiary capital because the Legislature decided to apply the corporation franchise tax on more than one base. Had Oral Care prospered during those years, its profits would have been included on its separate franchise tax return and would have increased the B&L subsidiary capital.

The Tribunal concluded there was no legal basis for limiting the use of losses accrued before Oral Care became a member of the combined group and noted there was no shift in ownership and therefore no "trafficking" in the losses.

Finally, the Tribunal found that *H&S Holdings*,[18] cited by the Division, did not support its position. In that case the Tribunal relied on the specific language of Tax Law section 210.12(a) which provided that the investment credit base "shall mean the sum of the investment credit base of each corporation included on such report." The Tribunal concluded that the language required that each of the combined corporations must independently meet the conditions for claiming the credit.

Since as noted above, the Division cannot appeal this decision, it will be curious to see if the Division seeks to change the result in this case either legislatively or through administrative action. It is possible the Division will conclude it is happy with the Tribunal's Decision since gains from sales of combined subsidiaries will also be included in entire net income.[19] If the aggregate gains for all taxpayers from sales of combined subsidiaries exceeds their aggregate losses the State would have a net increase of taxable income for all taxpayers subject to the business corporation tax.

**Conclusion**

The decision will also make it important for corporations and their tax advisors to examine carefully whether subsidiaries should or should not be included in a combined return. In light of the 2007 amendments to Tax Law section 211.4(a) which greatly expands the situations where corporations will be combined, the effect of this case will grow over time.

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1 DTA No. 819883, N.Y.S. Tax Appeals Tribunal (Dec. 20, 2007). One of the authors and other attorneys at Roberts & Holland LLP assisted (the technical term is kibbitzed) Arthur Gelber and Patricia Brumbaugh, the representatives of the Petitioners. In addition, Prof. Richard D. Pomp and Robert D. Plattner, Esq. submitted a brief amicus curiae in support of the Petitioners. Mr. Plattner is now Deputy Commissioner in charge of the Office of Tax Policy Analysis, New York State Department of Taxation and Finance.

2 While the Tribunal Decision involves the New York State corporate tax (Article 9-A), the decision may impact taxpayer's with similar fact patterns under the New York City general corporation tax inasmuch as the relevant legal provisions are similar.

3 *In the Matter of Bausch & Lomb, Inc., and Affiliates*, DTA No. 819883, N.Y.S. Div. of Tax Appeals, Administrative Law Judge Unit (May 18, 2006).

4 The facts are as stated in the Tribunal decision. *In the Matter of Bausch & Lomb, Inc., and Affiliates*, DTA No. 819883, N.Y.S. Tax Appeals Tribunal (Dec. 20, 2007).

5 Under the federal consolidated return regulations, losses of a subsidiary which are included in the federal consolidated return require a downward adjustment to the basis of the stock of the subsidiary. Treas. Reg. §1.1502-32(b)(2).

6 *In the Matter of Bausch & Lomb, Inc., and Affiliates*, *supra* note 4.

7 Shortly before the sale of Oral Care, B&L sold its Sports Optics Division, an operational unit of B&L. *Id.* This loss was included in the computation of the B&L combined groups entire net income. *Id.*

8 Quotation edited for length.

9 DTA No. 813573, N.Y.S. Tax Appeals Tribunal (Sept. 11, 1997).

10 The premise of a combined report, is to avoid the distortion of income among related corporations.

11 Tax Law Section 208.9(b)(6).

12 Tax Law Section 210.1(e).

13 Tax Law Section 208.4.

14 Tax Law Sections 208.3 and 208.4.

15 *In the Matter of Bausch & Lomb, Inc., and Affiliates*, *supra* note 4.

16 *In re Richard W. Genetelli*, N.Y.S. Dep't of Taxation and Finance, TSB-A-94(13)C (Aug. 29, 1994).

17 20 NYCRR § 3-6.6.

18 DTA No. 813573, N.Y.S. Tax Appeals Tribunal (Sept. 11, 1997).

19 Although not clear, it has generally been understood that taxpayers and their advisors have previously excluded such gains from combined entire net income and that the Division has not challenged such exclusions on audit.