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Tribunal Strikes Down Aggressive Positions By Taxpayer And Department

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State and local tax lawyers tend to spend most of their time tax planning for corporate clients. With certain notable exceptions, however, (primarily dealing with combined reporting issues) cases in the Division of Tax Appeals seldom involve corporate tax issues. It is noteworthy therefore that there have been two interesting New York tax cases involving New York's Franchise Tax regime; one a precedential State Tribunal decision, the other a non-precedential determination by a State Administrative Law Judge ("ALJ"). Both cases involve situations where a party wanted to achieve a result that was clearly impermissible under the Tax Law.

'AIL Systems Inc.'

In *AIL Systems, Inc.*,[1] the State Tribunal addressed the Franchise Tax consequences of a federal §338(h)(10) election. Under that federal provision, taxpayers can elect to characterize a sale of 80% or more of a corporation's stock as an asset sale. Although in form, the corporation remains in existence owning the same assets, for federal tax purposes the transaction is treated as if the assets were sold by the "old" target corporation to a "new" target corporation and the old corporation thereafter liquidated. The old target corporation pays federal income tax on gain from the asset sale, while the new target enjoys a stepped-up tax basis in the assets deemed sold to it.

The New York tax issue presented to the Tribunal was whether the sale of stock, together with a federal §338(h)(10) election, trigger recapture of state investment tax credits on qualifying property acquired by the corporation in prior years. Those credits were required to be recaptured on a "disposition" of the qualifying property prior to the end of its useful life.[2] The question presented to the Tribunal was whether the federal deemed asset sale was a "disposition" of the assets for purposes of New York's credit.

In a 1986 Technical Services Bureau Memorandum[3] (the "Memorandum"), the Division[4] had announced its conformity to the federal deemed sale analysis of section 338(h)(10) transactions, including for purposes of credit recapture. Analogies to the federal recapture rules further supported this position (since the federal investment tax credit included a recapture provision[5] that was triggered on a deemed sale of assets).[6]

The taxpayer argued that the issue was still unclear since the applicable Franchise Tax regulation[7] has not been amended to reflect the policy set out in the Memorandum. The Tribunal agreed with the taxpayer's characterization of these memoranda as "merely informational statements issued by the Division to disseminate current policies and guidelines and are advisory in nature, have no legal force or effect, are not binding and do not rise to the level of a promulgated rule or regulation." The Tribunal, however, noted that this particular Memorandum "states a straightforward interpretation of the governing statute." The Tribunal goes on to conclude that the Division need not promulgate a regulation "simply to acquiesce in the treatment prescribed by the Internal Revenue Code." Moreover, the Tribunal concluded that New York's general conformity to federal law supports the interpretation in the Memorandum even though the question at hand arose not under the definition of taxable income, but instead in the interpretation of New York's own tax credits.

Citing these authorities and analogies the Tribunal held that the taxpayer's §338(h)(10) election effected a "disposition" that required it to recapture New York investment tax credits claimed in prior years. The Tribunal further indicated that the new target had purchased that property, and could claim new credits if the property otherwise qualified in its hands -- an analysis presumably predicated on the facts obtaining at the time of the deemed sale.

Given the Department's prior guidance, this conclusion is not much of a surprise. It is noteworthy, however, that the Tribunal also upheld the penalty imposed on the taxpayer for failing to report the credit recapture. Under former Tax Law section 1085(k), a penalty for substantial understatement of tax shall

be reduced if there is "substantial authority" for the treatment as reported on the return or if the relevant facts are "adequately disclosed in the return or in a statement attached to the return". The penalty may also be waived on a showing that there was "reasonable cause" and that the taxpayer "acted in good faith."

The Tribunal noted that the taxpayer's Franchise Tax Return (Form CT-3) reported a loss on the deemed sale of the assets but did not make any disclosure either in the return or in a rider concerning the return's lack of federal conformity on the credit recapture. The Tribunal also noted that the taxpayer "has cited no authority of any kind in which deemed-sale treatment prescribed by section 338 was disregarded for any purpose in calculating" Federal, New York State or New York City corporate tax. The Tribunal dismissed in passing "pronouncements of tax collectors and courts of other states applying other laws and policies."

A Telling Analysis

The Tribunal's analysis of the taxpayer's position regarding the penalty may prove telling for others. "The fine hand of expert tax planners seems evident in the transaction. . . . It [therefore] beggars credulity to suggest that the failure to report recapture was simply the innocent oversight of an insouciant accountant. . . . It is hard to escape the suspicion that petitioner hoped that the matter would slip through the audit net unnoticed. This is behavior for which the predictable sting of the substantial understatement penalty is an appropriate deterrent."[8]

Another recent Franchise Tax case demonstrates how the Department can also advance extraordinarily strained interpretations of the law in an attempt to achieve a desired result. In *Premier National Bancorp, Inc.*[9], the State attempted to use its discretionary adjustment authority to insert the income of a grandfathered Article 9-A subsidiary into the Article 32 combined report of its banking corporation affiliates.

'Grandfathered 9-A' Firms

"Grandfathered 9-A" corporations are corporations that were subject to tax under Article 9-A before the 1985 revisions of Article 32, and elected to retain that general corporation status back in 1985, rather than being shifted into the Bank Tax regime of Article 32.[10] The Tax Law explicitly states that an Article 9-A corporation is never includible in an Article 32 return.[11] The 9-A corporation in this case (previously named Gare Ventures, Ltd.) was sold by Republic National Bank to FNBHV, a predecessor of Premier, in 1998. The ALJ noted that "At the time of the acquisition, Gare had no employees and virtually no assets. However, Gare had unique tax status, making the company an attractive investment."

Following the acquisition of Gare, the Bank contributed substantial funds to the subsidiary which proceeded to make investments which under Article 9-A enjoyed more favorable treatment than Article 32 would afford. The subsidiary paid a management fee to its parent which the ALJ specifically found to be reasonable. This is a fairly common structure that has been used by most if not all large financial institutions since 1985. The ALJ noted that in addition to the clear statutory provisions, the Division itself issued several Technical Services Bureau Advisory Opinions throughout the 1990's in which it acknowledged that Grandfathered 9-A corporations retained their status as such regardless of the lack of activity in the corporation or the sale or other transfer of its stock following the Grandfather Election.[12]

The ALJ noted that the Division began the audit of the petitioner in 2000 and at that time it changed its posture. The ALJ spent a great deal of time detailing the various ways the Division attempted to eliminate the use of Grandfathered 9-A corporations including attempts to obtain a legislative amendment. The ALJ noted "The legislation did not pass in 2003, and although the Division gave consideration to its resubmission in 2004, the Division did not believe it had the necessary support because it related to a financial modernization project and did not attempt a 2004 proposal."

In the absence of a legislative solution the Division sought to get around the clear statutory prohibition on combining Article 9-A and 32 corporations by using its discretionary adjustment authority, arguing that to properly reflect the income, etc. of the Bank group it was necessary to include the income, etc., of the 9-A corporation.[13] The ALJ noted that this case is the first attempt by the Division to impose its discretionary adjustment in this context. After a detailed analysis of the Division's discretionary authority, and of the confusing and varying ways in which the Division attempted to apply it in this case, the ALJ soundly rejected the State's position. The ALJ noted that where a rule could be set forth in a statute, the case law dictates that discretionary authority cannot be used as a substitute for amending that law or providing for a new rule. The ALJ noted that in 1985 the Legislature consciously decided to permit corporations to elect to retain Article 9-A status, fearing that corporations would otherwise relocate to Delaware or other states. The ALJ noted that the Legislature "could have easily considered then, or at some point in the last 20 years, the tangential issues that have arisen as a result of the grandfather provision, and modified the law as it stands…. Instead, the Division is attempting to utilize its discretionary authority to essentially supplant the two statutes which govern the case."

'Tax Shelter,' 'Tax Evasion'

Of even greater concern than the State's baseless attempt to apply discretionary adjustments is the State's attempts to categorize the "arrangement between petitioner and [the Article 9-A subsidiary as] an abusive tax shelter,"[14] or as "tax evasion." Reaching so aggressively to apply the labels of "tax shelter" and "tax evasion" to this planning is exactly the sort of bogeyman taxpayers have feared would come to pass if the State were given wide latitude to define tax shelters. Fortunately, this ALJ saw through the State's argument in this

case as “absurd.”[15] As the situation stands now, there is reason to question whether a broad grant of authority to the Division will be appropriately exercised.

Conclusion

The two cases discussed in this article are welcome in that they show that the State Division of Tax Appeals is capable of seeing through the confusion inherent in litigated cases to reach reasoned interpretations of the difficult statutory provisions incorporated into the Franchise Tax and the Bank Tax. However, in marked contrast to *AIL Systems*, the ALJ in *Premier National Bancorp, Inc*. has no authority to penalize the Department for taking a position in conflict with long-standing clear statutory authority. Thus, the taxpayer was forced to expend substantial legal fees (not that there is anything wrong with that), to defend a position that has been settled since 1985.

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[1] DTA #819303. (NYS TAT, May 4, 2006.)

[2] Tax Law section 210(12)(g)(1).

[3] TSB-M-86(3)C, April 3, 1986.

[4] For those 2 or 3 of our readers who are fascinated with bureaucratic terminology, the Department of Taxation and Finance (sometimes referred to as the “Department”), is broken down into various Divisions. The enforcement of state taxes is the responsibility of the Audit Division which is assisted by the Technical Services Division and the Office of Counsel. However, all of the tax enforcement elements of the Department are generally referred to as the “Division of Taxation” or simply the “Division” in opinions by ALJ’s and the Tax Appeals Tribunal.

[5] Prior IRC section 47. The credit recapture provisions are now in IRC section 50.

[6] Revenue Ruling 70-391, 1970-2C.B. 3 and Revenue Ruling 73-461, 1973-2 C.B. 10. These rulings were issued under former IRC section 334(b)(2), the predecessor to IRC section 338.

[7] 20 NYCRR section 5-2.8.

[8] *Id*.

[9] DTA No. 819746 (April 27, 2006).

[10] Tax Law section 1452(d).

[11] Tax Law section 1462(f)(4)(iii).

[12] *See, e.g.*, *Matter of Robert J. Buckley*, TSB-A-94(8)C, *Matter of Apple Bank for Savings*, TSB-A96(7)C. One of the Advisory Opinions cited by the ALJ was obtained by our firm, *Roberts and Holland LLP*, TSB-A-98(10)C.

[13] N.Y. Tax Law §1462(g).

[14] *Id*.

[15] *Id*., Conclusions of Law ¶F.

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