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Consolidated Returns Generate Complications

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The Internal Revenue Code ("IRC") and the New York State Tax Law ("Tax Law") have separate regimes for determining the portion of income of affiliated corporations subject to income tax and franchise tax.

Under the IRC, an affiliated group of corporations may elect to file a consolidated return in lieu of separate returns.[1] For this purpose, an affiliated group consists of, generally, one or more chains of qualifying corporations connected with a common parent corporation. Corporations must be commonly owned to the extent of 80 percent of the vote and value of the stock of each corporation.[2] In order to file on a consolidated basis, all of the "includible corporations"[3] that are members of the affiliated group must consent to the consolidated return.

New York, in contrast, has a separate regime under which certain corporations will be eligible to be permitted or required to be included in a combined reporting group under Article 9-A.[4] Like consolidation, combined reporting requires common ownership. However, it does not require a common parent corporation. Combined reporting further parts company with federal consolidation in requiring the existence of certain business relationships which unite the members and are reflected in the combined report.[5]

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As a result, corporations that file a federal consolidated return may file separate New York returns or a New York combined report that includes some, but not all, of the members of the federal consolidated group. Such situations commonly apply in cases where only some of the members of the federal group would be taxable in New York on a separate return basis and there is no basis (such as intercompany transactions) that would cause the taxpayer or the Tax Division to include one or more of the non-New York members.

Complications

The existence of two separate but overlapping tax reporting regimes can create complications in a variety of situations. In a recent decision,[6] the New York State Tax Appeals Tribunal ruled that a corporation's election to reattribute net operating losses ("NOLs") from a subsidiary to a parent corporation, which election was effective under the IRC and the consolidated return regulations thereunder, would not be given effect for purposes of the Tax Law.

The case involved Univisa, Inc. ("Univisa") a media company, and its wholly-owned subsidiary, Univisa Sports Holding Inc. ("USHI"). USHI's only business activity was a 50 percent ownership interest in a partnership engaged in business in New York (the partnership published The National Sports Daily). Over the three year period 1989-1991, USHI reported losses aggregating over $68 million which were included as part of the federal consolidated return and in its New York separate company return.[7]

Pursuant to Treasury Regulation section 1.1502-20(g)(1), Univisa filed an election with its 1991 federal tax return to "reattribute" all of the losses sustained by USHI to itself. After 1991 USHI did not conduct any business. USHI filed New York State Forms CT-245 for 1992 and 1993 disclaiming tax liability and paying only a maintenance fee. From 1994 through 1997 USHI was listed as inactive on the Schedule 851 of the Univisa federal consolidated return.

After a federal audit, Univisa was permitted to utilize the USHI losses it reattributed to itself to years when USHI was no longer a part of the consolidated group. Univisa also sought, in its separate New York tax return, the deductions in respect of USHI's NOLs. These losses were sustained during years when Univisa and USHI were subject to tax under Article 9-A.[8] Nevertheless, the Tax Division challenged the use of the NOLs for purposes of the Tax Law on the ground that the losses were not those of Univisa.

Administrative Law Judge

The Administrative Law Judge ("ALJ") held in favor of Univisa[9] and the Tax Division took an exception to the Tax Appeals Tribunal. The parties

generally agreed that the issue in the case was whether the reattributed loss is a loss of Univisa or USHI within the meaning of New York State Regulations section 3-8.1(a) which provides, in relevant part,

> A taxpayer is allowed a deduction similar to that allowed under section 172 of the Internal Revenue Code, . . . in computing entire net income for purposes of Article 9-A. *A corporation which reports as part of a consolidated group for Federal income tax purposes but on a separate basis for purposes of article 9-Acomputes its net operating loss and its net operating loss deduction as if it were filing on a separate basis for Federal income tax purposes.* (Emphasis added by ALJ).

The ALJ upheld the reattribution of the subsidiary's NOLs to its parent following the Treasury consolidated return regulation that considers the parent to succeed to the reattributed losses as if the losses were succeeded to in a corporate acquisition of assets within the scope of IRC §381(a)(such as a liquidation under IRC §332 or certain reorganization transactions).[10] Under this analysis, the reattributed losses are considered to become losses of the parent corporation as a separate entity. In that event, the parent would be entitled to claim such losses as its own during the subsequent years to which the losses are carried -- "as if it were filing on a separate basis."

The ALJ noted that the instructions for Form CT-3 provide that filers must complete a "pro forma" Form 1120 reporting the federal taxable income that would have been required on a separate federal tax return and that Univisa had complied with this requirement. The ALJ also noted, following the Treasury Regulation, that the USHI losses would be treated as belonging to Univisa even if Univisa ceased to file as a part of the federal consolidated group after the year in which the losses were reattributed. The ALJ also relied on the fact that, if the loss carryovers remained with USHI for New York tax purposes, the losses would never be available to USHI since a corporation may deduct losses under Article 9-A only to the extent allowed for federal tax purposes. Since the losses would be considered Univisa's losses on the federal level, there would be no corresponding federal losses incurred by USHI.

Tribunal Holding

The Tribunal reversed the ALJ and held that the reattributed losses could not be used by Univisa.[11] The Tribunal concluded that the reattribution of the loss depends entirely on the parent and subsidiary filing a consolidated federal income tax return for the year in which the loss arose or was reattributed (here, 1991). The Decision stated in this regard:

> If pro forma separate-company Federal returns were prepared for petitioner and USHI for 1991, it appears that no such transfer of the net operating loss would occur since the Federal consolidated return regulations would not apply. On those returns USHI would instead continue to have its Federal net operating loss carry-over and petitioner would not.

The Tribunal noted that the petitioner acknowledged "that if Univisa had always filed on a separate company basis, it would not have been permitted to make a reattribution election" but argued "that since the Federal net operating loss deductions do not depend on the filing of a consolidated return for the years to which the losses are carried, the losses are properly treated as separate-company items. . . ." The Tribunal concluded that "a more natural reading of . . . section 3-8.1(a) would apply the 'as if separate' principle to both the origin and destination years."

Univisa also argued, relying on language in the federal consolidated regulations, that the reattribution should be treated as occurring under IRC section 381(a) and should thus be viewed as a "deemed merger" of USHI into Univisa. If there had been a merger of the two corporations, it appears likely that the NOL would have carried over for New York purposes as well.[12] The Tribunal rejected the deemed merger analogy, noting that "there is no reason to think that under the Federal regulations the subsidiary corporation is deemed to disappear or to transfer to the parent corporation any tax attributes other than the portion of its net operating losses . . . ."[13] The Tribunal concluded that the reference to IRC section 381(a) is intended only to incorporate various ordering rules and limitations that apply in merger or similar transactions.

The Tribunal relied on a prior Appellate Division decision in *W.H. Morton v. State Tax Commission*.[14] That case involved a corporate subsidiary that filed as part of a federal consolidated group but a separate New York tax return. The subsidiary paid compensation to its officers and was reimbursed for such payments by affiliated corporations. For federal purposes, the payments and the reimbursements offset each other. The State Tax Commission held and the Appellate Division confirmed that the reimbursements constituted income to the subsidiary and the deductions were added back as officers' salaries under the prior alternative tax.

Finally, the Tribunal responded to the position advanced by Univisa and adopted by the ALJ that "a purpose of section 3-8.1 of the regulations is to provide parity of treatment between taxpayers that file separate New York franchise tax reports regardless of whether they join in filing Federal consolidated returns." Since the Tax Division's approach would permanently eliminate the use of the NOLs generated by USHI, parity would not be achieved. The Tribunal's response is that the loss would, for purposes of the pro forma return, be restored to USHI. The Tribunal went on to say that, even if the losses were rendered unusable by USHI, "that consequence should not weigh heavily in deciding the issue."

Practitioners

For practitioners, the last statement is the most significant. As the Tribunal noted, the Appellate Division and the Court of Appeals have decided many cases in which NOLs were rendered useless. The most famous of these cases

are *Sheils v. State Tax Commission*[15] and *Gurney v. Tully*.[16] Both of those cases involve situations in which adjustments to federal income had the effect of eliminating a New York NOL without any tax benefit.

This mismatching between NOLs for federal and New York purposes is one of the most common problems faced by corporations filing consolidated returns. As previously stated, the New York NOL rules generally limit the availability of a New York loss to the amount of the loss allowed as a deduction for federal purposes,[17] and the State courts have interposed on top of this rule a rule that the federal and State NOLs must be attributable to the same years.[18] These computations are particularly complicated in situations where affiliated corporations file separate New York returns or file on a combined basis where the New York combined group differs from the federal consolidated group.

Furthermore, the differences between the New York State and the federal definitions of taxable income, as well as New York's alternative taxes, when coupled with the rules limiting the New York NOL deduction to the amount of the federal, can give rise to instances in which the net operating losses are being utilized at the federal level, but are not fully utilized for New York purposes. For example, if New York income is less than federal (for example, due to deductions for income from subsidiaries), the available New York NOLs may decrease as losses are claimed federally, even though not all these losses have been claimed as deductions in calculating New York income.

Since the analysis of New York net operating losses is derivative of the federal, subject to additional limitations, the results are often harsh. It is therefore crucial for practitioners and their clients to consider both the federal and State regimes, as well as (where applicable) the New York City General Corporation Tax regime, which may introduce even further variations and limitations on a taxpayer's ability to deduct losses.

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[1] IRC §1501 et seq.

[2] IRC §1504(a).

[3] Section 1504(b) provides that corporations (including certain insurance companies, S corporations and foreign corporations) are not "includible corporations" for this purpose. Once the election to file a consolidated return is made, each member of the affiliated group that is not excluded under section 1504(b) must be included in the consolidated return. Treas. Reg. §1.1502-75.

[4] N.Y. Tax Law §211(4). Articles 32 and 33 of the Tax Law, which apply respectively to banks and insurance companies, also have provisions for combined returns. See N.Y. Tax Law §§1462(f) & 1515(f)(1).

[5] The current version of Tax Law § 211(4) requires corporate affiliates to file on a combined basis if there are substantial intercorporate transactions among the related corporations. Previously, a taxpayer or the Division had to demonstrate distortion to be eligible to file a report on a combined basis. (Note: New York City has not conformed to the new State rules; thus, the existence of distortion remains as a general prerequisite for combination.)

[6] *Univisa, Inc.*, DTA No. 820289, N.Y. S. Tax Appeals Tribunal (Sept. 20, 2007).

[7] Neither the Tribunal Decision nor the ALJ Determination in *Univisa* addressed the question of why Univisa and USHI filed on a separate company basis for Article 9-A purposes, rather than on a combined basis. Media companies frequently file (or are required to file) combined reports due to the synergies provided by the various related businesses. *See*, *e.g*., *Penthouse International, Ltd*., DTA No. 806745, N.Y.S. Tax Appeals Tribunal (Jan. 20, 1994). It is possible that since USHI only had a 50 percent interest in the entity that published The National Sports Daily, the normal synergies were inapplicable.

[8] To the extent the corporation generating the NOLs is not subject to New York tax when the losses were incurred, the losses will not be allowed as a deduction under Article 9-A. N.Y. Tax Law § 208(9)(f)(2).

[9] *Univisa, Inc*., DTA No. 820289, N.Y.S. Div. of Tax Appeals, Administrative Law Judge Unit (Aug. 3, 2006).

[10] Treas. Reg. section 1.1502-20(g).

[11] Presumably as a result of Univisa's victory at the ALJ level, the Tax Division agreed before the Tribunal that penalties would not be imposed.

[12] In some states net operating losses are specific to the corporation that incurred them, and do not survive its merger into a new entity. New York takes a more liberal approach. Subject to certain limitations, losses of a predecessor corporation that are allowable for federal purposes to its successor will be allowed for New York purposes as well. See *American Can Co. v. State Tax Comm'n*, 37 A.D.2d 649 (3d Dept. 1971); *Charrette Corp.,* N.Y. Dept. Tax'n & Fin., TSB-A-85(20)C (Oct. 10, 1985).

[13] The Tribunal noted earlier in its Decision that there was some confusion as to the application of the reattribution election in this case since, ordinarily, the election is made in connection with the disposition of the stock of the subsidiary. The Tribunal noted that "we must assume that some event constituting a disposition of the USHI stock occurred in [1991] although the USHI stock continued to be held by petitioner until 1997."

[14] 91 A.D.2d 1080 (N.Y. App. Div., 1st Dept., 1983), *aff'd,* 59 N.Y.2d 690 (N.Y. 1983).

[15] 72 A.D.2d 896 (N.Y. App. Div., 3rd Dept., 1979), *rev'd*, 52 N.Y.2d 954 (N.Y. 1981).

[16] 67 A.D.2d 303 (N.Y. App. Div. 3rd Dept., 1979), *aff'd*, 51 N.Y. 2d 818 (N.Y. 1980). The issue also arises under New York's personal income tax provisions. In this case, the court determined that "the amount of a net operating loss deduction which may be claimed by a New York state resident on his personal income tax return may not exceed the amount which the individual claimed on his federal income tax return for that year." Id.

[17] N.Y. Tax Law §208(9)(f)(3).

[18] See *Eveready v. State Tax Comm'n*, 129 A.D.2d 958 (N.Y. App. Div., 3rd Dept. 1986); *Lehigh Valley Industries, Inc.*, DTA No. 801617, N.Y.S. Tax Appeals Tribunal (May 5, 1988); see also 19 N.Y.C.R.R. §3-8.5.

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