April 2008

State Tax Return

Volume 15 Number 2

New York: The Other Shoe Drops in *Bausch & Lomb*

Carolyn Joy Lee
New York
(212) 326-3966

Dennis Rimkunas
New York
(212) 326-3412

New York's Corporate Franchise Tax (Article 9-A) provides generally that entire net income ("ENI") "shall not include: income, gains and losses from subsidiary capital . . ."[1] A subsidiary is any corporation of which over fifty percent of the number of voting shares is owned by the taxpayer corporation.[2] New York corporate taxpayers, and their advisors, have operated, for decades, under the assumption that gains from the sale of subsidiaries are not taxable and losses are not deductible. Turns out, this is not the law.

In December of 2007, the New York Tax Appeals Tribunal, in *Bausch & Lomb*,[3] allowed a parent corporation to deduct a loss on the sale of its subsidiary's stock, because the parent and the subsidiary filed on a combined basis. This decision not only overturned the long-standing position of the New York State Department of Taxation and Finance (the "Department"), it came as a major surprise to many.

The obvious and immediate question raised by the Tribunal's decision is, if a corporation is allowed to deduct a loss on the sale of a stock of its subsidiary, might the gain from the sale of its subsidiary be taxable? On March 10, 2008, the Department issued a Technical Service Bureau Memorandum ("TSB-M") stating exactly that.[4] The TSB-M contains the Department's new position with respect to the sale by a parent of its subsidiary's stock, when the parent and the subsidiary file on a combined basis.

The TSB-M provides as follows:

1. During the tax year when the parent corporation sells the combined subsidiary's stock, to determine the parent's ENI, federal taxable income will not be modified. In other words, the federal gain or federal loss from the sale of the subsidiary's stock will be reflected in the parent's ENI.

---

[1] N.Y. Tax Law § 208.9(a)(1).

[2] N.Y. Tax Law § 208.3.

[3] *In the Matter of Petition of Bausch & Lomb, Inc.*, Tax Appeals Tribunal, DTA No. 819883, December 20, 200

[4] TSB-M-08(3)C, March 10, 2008.

©Jones Day 2008

2. If loss on the sale of a combined subsidiary results in capital loss carryforward or carryback, the federal loss will be reflected in ENI in the later or earlier years, without regard to whether the subsidiary is combined with the parent in those other years.

3. After ENI is computed, the gain or loss on the sale of stock of the subsidiary is considered business income, not investment income.

4. In determining the group's business allocation percentage, the factors will include those of the subsidiary, for the period of its inclusion in the group.

5. The receipts from the sale of the subsidiary's stock will not be included in the receipts factor of the parent's business allocation percentage.[5]

6. Expenses that are attributable to the stock of a combined subsidiary will be allowed as deductions.[6] (This rule is also relevant in the context outside of *sales* of subsidiaries.)

7. The stock of the subsidiary is not included in combined business capital, combined investment capital or combined subsidiary capital for any period when the subsidiary is included in the combined report.

8. The Department's position as set forth in the TSB-M is retroactive to all open years.

It remains to be seen whether the Department's position articulated above is a correct interpretation of the law.[7] It will certainly be challenged in the near future, considering the potentially devastating impact it has on companies that sold their subsidiaries prior to *Bausch & Lomb*. Interestingly, the representatives from the New York City Department of Finance have stated that they have always maintained the position articulated in *Bausch & Lomb*.

In addition to the headline-grabbing news that New York will now tax gains on sales of combined subsidiaries,[8] the TSB-M raises some nuanced points. It is not clear at all, for example, that the sale of the stock results in business income, as the TSB-M posits, and not investment income.[9] That, in turn, raises questions whether the gain from the stock sale should properly be apportioned using the investment allocation

---

[5] This conclusion is premised on New York's general rule that the receipts factor does not include proceeds from the sale of a capital asset. N.Y.C.R.R. § 4-4.6(e).

[6] *See* TSB-A-94(13)C.

[7] "New York Tribunal Weighs In, Twice, on What Combined Reporting Means," Carolyn Joy Lee (*TaxAnalysts*, Jan. 29, 2008).

[8] In light of the recently revised combination rules and, now, this TSB-M, one must wonder whether New York's much-touted status as a headquarters capital is a thing of the past.

[9] N.Y. Tax Law §§ 208.5-208.6; N.Y.C.R.R. § 3-3.2.

©Jones Day 2008

percentage, and if so, whether the issuer's allocation percentage should be calculated based on the factors of the combined group or of the subsidiary alone.[10] On the good news front, the Department's allowance of a deduction for expenses attributable to the subsidiary's stock means that "push down debt" planning is no longer needed for the parent to deduct interest on loans from third parties the proceeds of which are contributed to a combined subsidiary.[11]

The TSB-M specifically states that it applies under Article 9-A. This means that banks taxable under Article 32 will continue to apply a completely different set of rules. In saying that no modification to federal income is made in computing ENI under Article 9-A, the Department apparently is importing into ENI the exact amount of gain calculated for federal purposes, which means using federal basis with all the adjustments consolidation can produce. That approach may, however, be at odds with the rule addressed in *Univisa*[12] – that members of a federal group begin the computation of ENI as if they were separate filers.

The TSB-M does not address the Department's position with respect to the treatment of transactions where the parties make an I.R.C. § 338(h)(10) election. The Department's prior advisements discussing I.R.C. § 338(h)(10) elections made clear that, in a combined reporting setting, the parent would not include the gain from the sale of the stock of the subsidiary on its returns because the gains from such sale were excluded from the parent's ENI under the subsidiary capital exclusion.[13] *Bausch & Lomb*, however, invalidated such analysis and now New York's treatment of sales where the parties make an I.R.C. § 338(h)(10) election is unclear. There is a regulation that provides that the Department will continue to respect the I.R.C. § 338(h)(10) election.[14] However, it is unclear whether the rationale behind the regulation survives, or instead has morphed into the concept that, because there is no federal gain on the stock sale, the amount imported into ENI is zero.

It must be remembered that all of the foregoing relates to sales of *combined* subsidiaries. As we have noted in past publications, the composition of a combined group in New York is not always clear. And because the State's statute now differs from the City's, a subsidiary might be combined under one regime, and not under the other.

One thing is clear: The Tribunal and the Department have found another way to keep tax lawyers and accountants busy for years to come. Bless them! ■

---

[10] N.Y. Tax Law § 210(3)(b); N.Y.C.R.R. § 4-7.2.

[11] N.Y. Tax Law § 208.9(b)(6).

[12] *In the Matter of the Petition of Univisa, Inc.*, Tax Appeals Tribunal, DTA No. 820289, September 20, 2007.

[13] TSB-M-91(4)C, April 17, 1991; TSB-A-99(22)C.

[14] N.Y.C.R.R. § 3-2.2(c).

©Jones Day 2008

This article is reprinted from the *State Tax Return,* a Jones Day monthly newsletter reporting on recent developments in state and local tax. Requests for a subscription to the *State Tax Return* or permission to reproduce this publication, in whole or in part, or comments and suggestions should be sent to Teresa M. Barrett-Tipton (214.969.5186) in Jones Day's Dallas Office, 2727 N. Harwood, Dallas, Texas 75201 or StateTaxReturn@jonesday.com.

©Jones Day 2008. All Rights Reserved. No portion of the article may be reproduced or used without express permission. Because of its generality, the information contained herein should not be construed as legal advice on any specific facts and circumstances. The contents are intended for general information purposes only.