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Taxation of Gains and Losses on Sales of New York Subsidiary Stock

By Bruce Clements

When dealing with New York combined group returns, capital gains and losses from subsidiary sales have important tax implications. Recent changes in New York law have created new statutory, regulatory, and judicial considerations for parties involved in these sales.

Under Article 9-A of the Tax Law, New York imposes a franchise tax on corporations equal to the highest of four bases: allocated entire net income (ENI), allocated capital, allocated minimum taxable income, or a fixed-dollar minimum tax. Income and capital are segregated into business and investment income and capital. In addition to the highest tax among these four items, section 210.1 adds a separate tax on subsidiary capital at nine-tenths of a mill (\$.0009) for each dollar of subsidiary capital allocated to New York, based on the fair market value of real property and marketable securities and the book value of other personal property. Sections 208.3 and 208.4 provide that subsidiary capital includes the stock and indebtedness of corporations of which the parent corporation owns more than 50% of the voting stock.

For purposes of Article 9-A (section 208), capital assets are classified as subsidiary capital, which are "investments in the stock of subsidiaries and any indebtedness from subsidiaries," investment capital, which are "investments in stocks, bonds and other securities, corporate and governmental, not held for sale to customers in the regular course of business, exclusive of subsidiary capital and stock issued by the taxpayer," and business capital, which encompasses "all assets, other than subsidiary capital, investment capital and stock issued by the taxpayer, less liabilities not deducted from subsidiary or investment capital."



Defining Entire Net Income

Section 208.9 provides that "entire net income" is "total net income from all sources, which shall be presumably the same as the entire taxable income (but not alternative minimum taxable income), which the taxpayer is required to report to the United States Treasury Department." ENI is subject to several adjustments, including that in section 208.9(a)(1), which states, "Entire net income shall not include: (1) income, gains and losses from subsidiary capital." Section 208.9(a)(1) thus requires that capital gains realized on the sale of a subsidiary be subtracted in computing entire net income and capital losses added back to income. Section

208.9(b)(6) provides also that entire net income is determined without deduction for "interest directly or indirectly and any other amount directly or indirectly attributable as a carrying charge or otherwise to subsidiary capital or to income, gains or losses from subsidiary capital." Section 211.4(b)(2) complicates matters by providing that "in computing ... combined subsidiary capital intercorporate stockholdings shall be eliminated."

The wording of sections 208.9(a)(1) and 211.4(b)(2) can produce different statutory interpretations and substantially different results. A broad view of these sections suggests that section 211.4(b)(2) modifies the definition of subsidiary capital in section

208.9(a)(1), therefore eliminating the addition of losses and reduction of gains on subsidiary investments from the entire net income equation. Alternatively, as the New York State Department of Taxation and Finance (DTF) has unsuccessfully argued, section 211.4(b)(2) was not intended by the legislature as a modification provision and instead applies only to the calculation of subsidiary capital for that portion of the tax base.

The Bausch & Lomb Controversy

In 1996, Bausch & Lomb, Inc. (B&L), sold a subsidiary, Oral Care, at a substantial capital loss (approximately \$93 million), deducted the loss on its 1996 return, and carried it back to prior years, applying for a refund (*In the Matter of Petition of Bausch & Lomb, Inc.*, Tax Appeals Tribunal, DTA No. 819883, December 20, 2007). In challenging the statute, B&L argued that the rule of section 208.9 disallowing losses attributable to subsidiary capital did not apply. The DTF denied the

B&L capital loss deduction, holding that the loss was excluded from the calculation of entire net income by section 208.9(a)(1) because it constituted "income, gains and losses from subsidiary capital," which must be added back in the statutory equation when calculating ENI. The DTF auditor concluded that because the B&L ownership of stock in Oral Care was an investment in subsidiary capital for New York State purposes, the loss was not allowed as an offset to combined group income. The administrative law judge ruled in favor of the DTF, and B&L appealed to the New York Division of Tax Appeals, Tax Appeals Tribunal.

B&L claimed that the capital loss on the sale of Oral Care was allowable as a deduction against other combined group income under the authority of section 211.4(b)(2), which, in their view, modified the definition of ENI under section 208.9(a). According to B&L, the loss on the sale of the Oral Care subsidiary was a capital loss

realized by the combined group (as intercorporate stockholdings are eliminated by that provision) and was not attributable to subsidiary capital; thus, it should be allowed as a deduction in determining ENI under section 208.9(a)(1). The DTF disagreed with this interpretation on the basis that the words "In computing ... combined subsidiary capital intercorporate stockholdings shall be eliminated" are not determinative in establishing what is comprised by the words in section 208.9(a), "Entire net income shall not include ... income, gains and losses from subsidiary capital." Instead, the DTF claimed that section 211.4(b)(2), although *eliminating* intercorporate stockholdings from the computation of subsidiary capital, does not control what items are *included* in ENI.

Interpreting Section 211.4(b)(2)

The entire issue before the Tax Appeals Tribunal was the statutory meaning of the section 211.4(b)(2) provision, "in computing ... combined subsidiary capital

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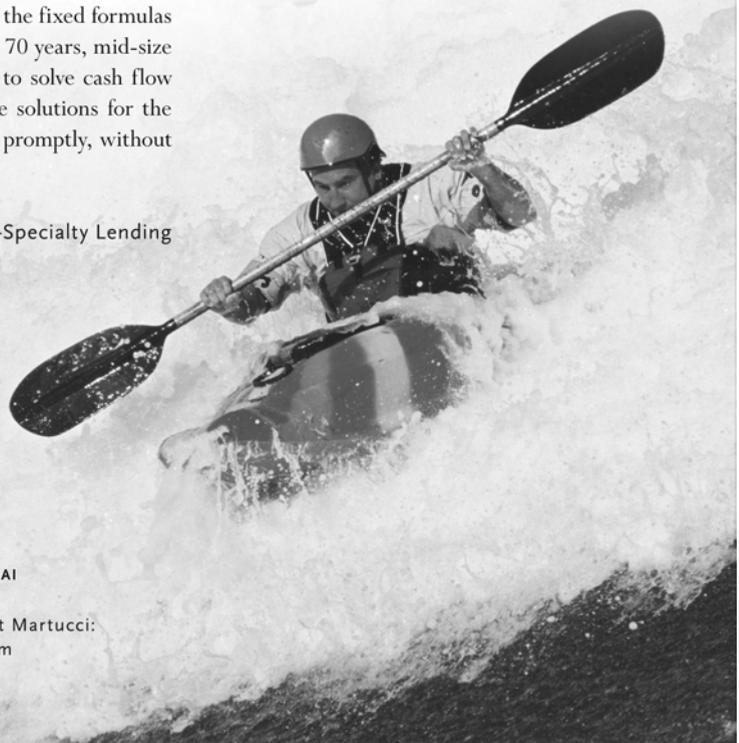


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intercorporate stockholdings shall be eliminated,” and whether this applies to the definition of “subsidiary capital” for purposes of the adjustment formula in section 208.9(a)(1). The DTF supported its interpretation of the statute by first arguing that the legislature did not intend for the elimination of intercorporate stockholdings in determining subsidiary capital provided in section 211.4(b)(2) to control the definition of subsidiary capital in section 208.9(a)(1). Otherwise, as the DTF argued, the drafters would have used specific language consistent between sections to clearly indicate the role of each.

For example, section 208.9(a)(1) includes the phrase “entire net income means.” Because similar words are not found in section 211.4(b)(2) defining subsidiary capital, the DTF claimed that a similar interpretation cannot be implied. As support, it offered commentary from a 1945 article explaining portions of the new law—“The New Problems of Consolidated Returns” by Ellis J. Staley, Jr., legal assistant to the commissioner of the New York State Department of Taxation and Finance. In the article, Staley stated:

Under new Article 9-A the first result has been eliminated by the provisions of the law which now exclude from entire net income for all taxpayers, whether or not reporting on a consolidated basis, all income, gains and losses from subsidiary capital which automatically eliminates any dividends received from a subsidiary. (Proceedings of the 1945 New York University Conference on the New York State Franchise Tax on Business Corporations)

Interpreting Staley’s statement, the DTF argued that drafters of the law intended for all losses to be eliminated (i.e., added back) in the entire net income calculation. The Tax Appeals Tribunal rejected this argument as an opinion and not an official part of the original bill’s legislative history.

In addition to the statutory interpretation, the DTF argued that allowing the Oral Care capital loss against the B&L combined group income would distort the economic income of the combined group, because the decline in the subsidiary’s value occurred over a period of years, beginning before the subsidiary became part of the combined group. Therefore, allowing a capital loss deduction from the

sale provides a “double counting” of the value decline, once in the calculation of the value of subsidiary capital and again in the reduced net income for the combined group. Finally, the DTF claimed that the losses realized on subsidiary value before the subsidiary entered the combined group should not be allowed. The Tax Appeals Tribunal found no basis in either of the distortion arguments because both rest on a presumption that losses realized over time or in different economic ownership structures, although economically valid, should not be allowed, and concluded that neither argument had legal support.

In addition, the Tax Appeals Tribunal noted that the DTF’s position in the B&L case was inconsistent with their own statutory interpretation in Advisory Opinion TSB-A-94(13)C (August 29, 1994). In this interpretation, the DTF held that a deduction for interest on debt incurred to acquire a combined subsidiary was not eliminated from the calculation of entire net income by section 208.9(b)(6), on the assumption that “This is proper because there is no subsidiary capital on the combined report to which to attribute the interest expense.” The DTF relied on 20 NYCRR 3-6.6, which applies section 211.4(b)(2) and provides the following: “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.” Although the paragraph of section 208.9 is different in this advisory opinion, the fundamental situation is analogous to the elimination of a realized loss in a combined group, supporting B&L’s position in determining the scope of subsidiary capital for defining entire net income in section 208.9.

The Tax Appeals Tribunal also refuted the DTF’s contention that its position was supported by an earlier holding in *Matter of H & S Holdings Limited* (Tax Appeals Tribunal, September 11, 1997). In that case, the tribunal interpreted the following language of section 210.12(a): “In the case of a combined report the term investment credit base shall mean the sum of the investment credit base of each corporation included on such report.” The tribunal concluded that this language requires that

each of the combined corporations must meet the conditions for the investment credit independently. As noted by the Tax Appeals Tribunal, the most this suggests is that the combined group is not treated as a single corporation in the face of a statutory provision that unambiguously provides otherwise, but does not determine the relationship between the two sections at issue in *Bausch & Lomb*, that is, sections 208.9(a)(1) and 211.4(b)(2).

After Bausch & Lomb: Retroactive Application

The Tax Appeals Tribunal’s decision in *Bausch & Lomb* specifically addressed loss deductions but raised a corresponding issue: If a corporation may deduct a loss on the sale of a stock of its subsidiary against combined group income, is a gain from the sale of its subsidiary taxable to the combined group? And, if so, how are gains to be classified in the New York statutory apportionment scheme?

On March 10, 2008, the DTF issued a revised policy, TSB-M-08(3)C. Under the TSB, the DTF plans to apply *Bausch & Lomb* to both gains and losses on the sale of subsidiary stock. As a result, upon a sale of subsidiary stock, gains will be taxable and losses will reduce income where both the parent and its subsidiary are included in a New York combined return. In addition, the DTF warned taxpayers that it would apply *Bausch & Lomb* retroactively to all open years. Therefore, taxpayers that excluded gains from ENI would be expected to file amended returns, paying any tax deficiency and seeking refunds where losses exist.

With the increased activity in business unit sales, vigilance is required in applying the New York capital gain and loss provisions. Sales of subsidiaries may generate substantial tax loss benefits, and businesses may have open years with carry-back losses to provide immediate tax refunds. □

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