STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
BAUSCH & LOMB INCORPORATED	:	DECISION
for Redetermination of a Deficiency or for refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Year 1979.	:	

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on June 22, 1989 with respect to the petition of Bausch & Lomb, Inc., One Lincoln First Square, P.O. Box 54, Rochester, New York 14601 for redetermination of a deficiency or refund of corporation franchise tax under Article 9-A of the Tax Law for the year 1979 (File No. 805252). Petitioner appeared by Charles J. Cutaia, C.P.A.. The Division of Taxation appeared by William F. Collins, Esq. (James Della Porta, Esq., of counsel).

Both parties submitted briefs. Oral argument was held on January 30, 1990 at the request of the Division.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

ISSUE

Whether the Division of Taxation properly calculated petitioner's Federal net operating loss deduction by reducing that loss by the amount of the deferred income from its tax exempt wholly-owned domestic international sales corporation.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except that findings of fact "2" "5" and "7" have been modified as indicated below.

Petitioner, Bausch & Lomb, Inc., is a New York corporation headquartered in Rochester, New York. For all of the years involved here, petitioner timely filed New York corporation

franchise tax reports; where appropriate, these reports were filed on a combined basis with several of petitioner's subsidiaries.

We modify finding of fact "2" of the Administrative Law Judge's determination to read as follows:

> Petitioner is the 100 percent shareholder of Bausch & Lomb DISC Corporation, a corporation which qualified for the benefits of and operated under the rules pertaining to a domestic international sales corporation (DISC) under Federal law. Bausch & Lomb DISC Corporation (the "DISC") qualified as a tax exempt DISC under New York Tax Law. Petitioner filed a consolidated corporation franchise tax report with its DISC for all years at issue here. For the years at issue, petitioner and the DISC filed separate Federal income tax returns.[1]

For the tax year ended December 26, 1982, petitioner had a Federal net operating loss and a capital loss and filed for a Federal tax refund. The net capital loss presents no issue in this case.

On June 14, 1985, petitioner filed a claim for refund of corporation franchise tax for the year 1979 in the amount of $389,949.00, based on a carryback of the 1982 net operating loss and capital loss. Petitioner reported a Federal net operating loss available for carryback to 1979 of $11,200,338.00.

We modify finding of fact "5" to read as follows:

> The New York net operating loss computed by petitioner was $11,399,649.00. In computing the loss, petitioner started with the Federal net operating loss, adjusted for additions and substractions required by New York in arriving at entire net income, and also added the 1982 deferred DISC income of $2,107,608.00 that had not been taxed for Federal purposes but was required to be included in income for New York purposes.[2]

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[1]Finding of fact "2" has been modified to correct the name of petitioner's DISC corporation from "Bausch and Lomb International" as found by the Administrative Law Judge to "Bausch and Lomb DISC Corporation".

[2]Finding of fact "5" of the Administrative Law Judge's determination read as follows:

> "In calculating its New York net operating loss deduction, petitioner began with the amount it originally reported as its entire net income for 1979 and then made

On its claim for refund, petitioner claimed a net operating loss deduction of $11,200,338.00, the lesser of the reported Federal and State net operating losses.

We modify finding of fact "7" to read as follows:

> Upon receipt of petitioner's refund claim, the Division of Taxation recalculated both the Federal and State net operating losses reported by petitioner. In calculating the New York net operating loss, the Division began with the Federal net operating loss of $11,200,338.00, to which it made several adjustments. None of these adjustments are at issue here. The Division's calculations resulted in a New York net operating loss of $11,411,647.00, slightly more than that calculated by petitioner. The Division also recalculated petitioner's Federal net operating loss, and it is this recalculation which is in dispute. In essence, the Division computed petitioner's Federal net operating loss as if petitioner had filed a consolidated Federal return with its DISC and as if the deferred DISC income was taxable for Federal purposes. This resulted in the Division adding back to petitioner's 1982 Federal taxable income the federally deferred DISC income of $2,107,608.00. When calculated in this manner, petitioner's Federal net operating loss amounted to $9,092,730.00. [3]

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several adjustments to income as required by New York State. The only adjustments pertinent to this inquiry are those related to its DISC income. Petitioner's net deferred DISC income in 1979 was $2,107,608.00. Petitioner added this amount to its entire New York income after the required New York adjustments (a net loss of $13,507,257.00), to arrive at a New York net operating loss of $11,399,649.00.

We modified finding of fact "5" to indicate that the deferred DISC income of $2,107,608.00 was income in 1982, not 1979.

[3]Finding of fact "7" of the Administrative Law Judge's determination read as follows:

> "Upon receipt of petitioner's refund claim, the Division of Taxation recalculated both the Federal and State net operating losses reported by petitioner. In calculating the New York net operating loss, the Division began with the Federal net operating loss of $11,200,338.00, to which it made several adjustments. None of these adjustments are at issue here. The Division's calculations resulted in a New York net operating loss of $11,411,647.00, slightly more than that calculated by petitioner. The Division also recalculated petitioner's Federal net operating loss, and it is this recalculation which is in dispute. In essense, the Division computed petitioner's Federal net operating loss as if petitioner had filed a consolidated Federal return with its DISC. This resulted in the Division adding back to petitioner's 1979 Federal taxable income the federally deferred DISC income of $2,107,608.00. When calculated in this manner, petitioner's Federal net operating loss amounted to $9,092,730.00."

We modified this fact to indicate that the deferred DISC income of $2,107,608.00 was income in 1982 not 1979.

In accordance with the adjustments described, the Division of Taxation issued to petitioner, on August 14, 1985, a Statement of Tax Reduction or Overpayment, reducing petitioner's net refund to $316,295.00. The statement included the following explanation: "Pursuant to Subpart 3-7 and 3-8 of the Tax Regulations, allowed a capital loss carryback and a net operating loss carryback limited to the Federal net operating loss adjusted to reflect Deferred DISC income."

OPINION

Section 208.9(f) of the Tax Law provides for a net operating loss deduction as follows:

> "(f) A net operating loss deduction shall be allowed which shall be presumably the same as the net operating loss deduction allowed under section one hundred seventy-two of the internal revenue code of nineteen hundred fifty-four, or which would have been allowed if the taxpayer had not made an election under subchapter s of chapter one of the internal revenue code, except that (1) any net operating loss included in determining such deduction shall be adjusted to reflect the inclusions and exclusions from entire net income required by paragraphs (a), (b) and (g) hereof, (2) such deduction shall not include any net operating loss sustained during any taxable year beginning prior to January first, nineteen hundred sixty-one, or during any taxable year in which the taxpayer was not subject to the tax imposed by this article, and (3) such deduction shall not exceed the deduction for the taxable year allowable under section one hundred seventy-two of the internal revenue code of nineteen hundred fifty-four, or the deduction for the taxable year which would have been allowable if the taxpayer had not made an election under subchapter s of chapter one of the internal revenue code; and"

The scheme of the statute is clear: the calculation begins with the allowable Federal deduction, this amount is adjusted for New York purposes, but the adjusted amount is limited to the allowable Federal deduction (see, Matter of Royal Indemnity, Tax Appeals Tribunal, February 19, 1988, affd Matter of Royal Indemnity v. Tax Appeals Tribunal, 148 AD2d 845, 539 NYS2d 510, affd 75 NY2d 75, 550 NYS2d 610). The issue here is how petitioner, a 100% shareholder of a tax exempt DISC, should account for the amount of DISC income deferred from Federal tax when petitioner is calculating its State net operating loss deduction.

Under the Federal law, tax is deferred on up to 50% of a DISC's income in any year (Internal Revenue Code § 991 et seq). A corporation meeting the requirements of section 992(a)

of the Internal Revenue Code is not subject to tax under Article 9-A of the Tax Law if it meets the additional requirements set forth at section 208.9(i) of the Tax Law. However, a stockholder of such a tax exempt DISC must adjust each item of its receipts, expenses, assets and liabilities by adding its attributable share of the DISC's receipts, expenses, assets and liabilities (Tax Law § 208.9[i]). Thus, while the tax exempt DISC does not pay State tax there is no deferral of the State tax on the DISC income to the shareholder.

Petitioner accounted for the 1982 deferred DISC income of $2,107,608.00 by treating it as an adjustment required by section 208.9(i) to be made to calculate its State net operating loss deduction: petitioner reduced its Federal net operating loss deduction by $2,107,608.00. The Division does not dispute that petitioner made this adjustment and that it was required as an adjustment under section 208.9(i). Instead, the Division asserts that petitioner should further account for the deferred DISC income by reducing its Federal net operating loss deduction/limitation of section 208.9(f)(3) by this amount.

In the determination below, the Administrative Law Judge found that the Division lacked the statutory authority to require petitioner to reduce the deduction/limitation of section 208.9(f)(3). On exception, the Division argues that it has authority to reduce the limitation because it is requiring petitioner to calculate its Federal net operating loss deduction as if it had filed on a consolidated basis with its DISC for Federal purposes and that it has the authority under section 211.5 of the Tax Law to require such an "as if" calculation. The Division argues that the "as if" calculation is necessary here to fill a gap that would otherwise exist in the statutory scheme. Finally, the Division argues that to deny it the authority to require this "as if " calculation will call into question the validity of other instances where a similar calculation is required.

Petitioner responds that it has adequately accounted for the deferred DISC income by making the 208.9(i) adjustment to the Federal net operating loss deduction. Further, petitioner argues that its calculation is consistent with the scheme of 208.9(f), while the Division's, which would reduce the Federal limitation by a New York modification, is inconsistent with the statute.

We affirm the Administrative Law Judge.

The statute the Division relies on provides as follows:

> "5. In case it shall appear to the tax commission that any agreement, understanding or arrangement exists between the taxpayer and any other corporation or any person or firm, whereby the activity, business, income or capital of the taxpayer within the state is improperly or inaccurately reflected, the tax commission is authorized and empowered, in its discretion and in such manner as it may determine, to adjust items of income, deductions and capital, and to eliminate assets in computing any allocation percentage provided only that any income directly traceable thereto be also excluded from entire net income, so as equitably to determine the tax. Where (a) any taxpayer conducts its activity or business under any agreement, arrangement or understanding in such manner as either directly or indirectly to benefit its members or stockholders, or any of them, or any person or persons directly or indirectly interested in such activity or business, by entering into any transaction at more or less than a fair price which, but for such agreement, arrangement or understanding, might have been paid or received therefor, or (b) any taxpayer, a substantial portion of whose capital stock is owned either directly or indirectly by another corporation, enters into any transaction with such other corporation on such terms as to create an improper loss or net income, the tax commission may include in the entire net income of the taxpayer the fair profits which, but for such agreement, arrangement or understanding, the taxpayer might have derived from such transaction." (Tax Law § 211.5, emphasis added.)

The statute authorizes the Division to adjust deductions when the taxpayer's income has been improperly or inaccurately reflected (see, Matter of Servair, Inc. v. State Tax Commn., 132 AD2d 737, 517 NYS2d 98, at 99). The Division has never specifically described the inaccuracy it sought to correct here. Instead, the Division has simply urged that there must be an inaccuracy because petitioner and its DISC were required to file on a consolidated basis for State purposes while they filed separately for Federal purposes. We find the use of the section 211.5 power here inappropriate for the following reasons.

First, the problem the Division claims that it seeks to correct - the consolidated/separate filings - is not necessarily connected to the deferred DISC income. Merely consolidating petitioner's and the DISC's Federal returns would not cause the deferred DISC income to become taxable for Federal purposes. Thus, the Division would do more than merely calculate an "as if" consolidated Federal return. It would recharacterize the deferred DISC income and calculate the Federal net operating loss deduction/limitation as if the deferred DISC income were taxable under Federal law.

For the problem that does exist - that a portion of the DISC income was not taxed at the Federal level - petitioner has already made an adjustment, reducing the State net operating loss deduction by the amount of the deferred income. This adjustment required under section 208.9(i) of the Tax Law, with which the Division agrees, adequately accounts for the discrepancy between the State and Federal law so that we perceive no inaccuracy to be corrected, nor gap to be filled, by section 211.5.

Further, as petitioner points out, to reduce the Federal net operating loss deduction/limitation by the deferred DISC income, which is a purely New York modification, would be inconsistent with the scheme of section 208.9(f) of the Tax Law. As noted earlier, the statute requires the modification of the Federal deduction with New York changes and then limits the deduction to the lesser of the modified New York deduction or the Federal deduction. If the Federal deduction/limitation was adjusted by the New York modifications, its function as a limitation would end because the two numbers would always be the same.

Finally, we find the Division's reliance on the decision in Matter of Health-Chem v. State Tax Commn. (132 Misc 2d 941, 506 NYS2d 269) misplaced. In that decision the court noted that by regulation the Division of Taxation (20 NYCRR 3-8.1[a]) permitted a corporation which filed separately for State purposes but on a consolidated basis for Federal purposes to calculate a net operating loss deduction on its State return as if it filed on a separate basis for Federal purposes. The Division argues that the regulation is similar to the adjustment sought to be made here. We find the regulation discussed in Health-Chem as well as the regulation at 20 NYCRR 3-7, which treats companies that file on a combined basis for State purposes and separately for Federal purposes as if they had filed on a consolidated Federal basis, inapplicable to the situation before us. These regulations seek to adjust the Federal net operating loss deduction only for the difference in the composition of the filing group on the Federal and State returns. The regulations do not address the situation where an item of income is treated differently at the Federal and State levels and thus are not applicable here.

For all of the above reasons we conclude that the Division of Taxation incorrectly required petitioner to recalculate its Federal net operating loss deduction/limitation under section 208.9(f)(3) of the Tax Law.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is denied;

2. The determination of the Administrative Law Judge is affirmed;

3. The petition of Bausch and Lomb, Inc. is granted; and

4. The Division of Taxation is directed to modify the Statement of Tax Reduction or Overpayment dated August 14, 1985 accordingly.

DATED: Troy, New York
July 19, 1990

/s/John P. Dugan
John P. Dugan
President

/s/Francis R. Koenig
Francis R. Koenig
Commissioner

/s/Maria T. Jones
Maria T. Jones
Commissioner