

STATE OF NEW YORK
DIVISION OF TAX APPEALS

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

Petitioner, Bausch & Lomb, Inc., One Lincoln First Square, P.O. Box 54, Rochester, New York 14601, filed a petition 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).

A hearing was held before Jean Corigliano, Administrative Law Judge, at the offices of the Division of Tax Appeals, 259 Monroe Avenue, Rochester, New York, on December 15, 1988 at 1:15 P.M., with all briefs to be submitted by April 7, 1989. Petitioner appeared by Charles J. Cutaia, CPA. The Division of Taxation appeared by William F. Collins (Michael B. Infantino, Esq., of counsel).

ISSUE

Whether the Division of Taxation properly adjusted petitioner's Federal net operating loss deduction by computing that loss as if petitioner and its wholly-owned domestic international sales corporation had filed a consolidated Federal return.

FINDINGS OF FACT

1. 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.

2. Petitioner is the 100 percent shareholder of Bausch & Lomb International, Inc., a corporation which qualified for the benefits of and operated under the rules pertaining to a

domestic international sales corporation (DISC) under Federal law. International (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.

3. 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.

4. 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.

5. 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 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.

6. 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.

7. 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. 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.

8. 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."

CONCLUSIONS OF LAW

A. A DISC is a corporation which meets the requirements of section 992(a) of the Internal Revenue Code. A DISC, as such, is not subject to any tax imposed by chapter 1 of the Internal Revenue Code. To effect the tax benefit intended, the implementing statute permits the DISC to "accumulate" approximately one-half of its income without subjecting its shareholders to current Federal taxes. The remaining half is "deemed distributed" to the shareholders, even if, in fact, it is not paid out as a dividend (IRC § 991 et seq).

A corporation meeting the requirements of IRC § 992(a) 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 (see also, 20 NYCRR 3-9.3). Pursuant to Tax Law § 208.9(i)(B), a stockholder of a tax exempt DISC must adjust each item of its receipts, expenses, assets and liabilities by adding its attributable share of each DISC's receipts, expenses, assets and liabilities. Intercorporate transactions are eliminated, and the stockholder's entire net income is reduced by subtracting the amount of the deemed distribution of income, if any, from each such DISC already included in Federal taxable income. To effectuate the adjustments required by section 208.9(i)(B), 20 NYCRR 3-9.4(a) requires any corporation owning stock in a tax exempt DISC to file its own corporation franchise tax report and a consolidated report with the DISC. A taxpayer owning

stock in a tax exempt DISC is not required to make any adjustments based solely on the DISC ownership when calculating its New York net operating loss deduction. However, because the taxpayer and the DISC must file a consolidated report, the adjustments necessary to eliminate the operations of the DISC from the taxpayer's income will have the effect of reducing the taxpayer's New York net operating loss.

B. The DISC involved here was tax exempt, and petitioner properly calculated the DISC adjustments required by Tax Law § 208.9(i)(B). These adjustments effectively reduced petitioner's New York net operating loss from \$13,507,256.00 to \$11,399,649.00. The adjustments the Division of Taxation made to this calculation are not in dispute and did not significantly change the amount of the New York net operating loss claimed by petitioner. Petitioner does challenge the Division's recalculation of petitioner's Federal net operating loss. The Division recalculated petitioner's Federal net operating loss by computing it as if petitioner had filed a consolidated Federal return with its DISC. This had the effect of reducing petitioner's Federal net operating loss to \$9,092,730.00. Pursuant to Tax Law § 208.9(f), the net operating loss deduction allowed under article 9-A is presumed to be the same as that which is allowed for Federal income tax purposes subject to three limitations, none of which apply here. Accordingly, the Division limited petitioner's net operating loss carryback from 1982 to 1979 to the amount of the Federal loss as calculated by the Division. It is petitioner's position that the Division lacked statutory authority to recalculate the Federal loss as it did.

The Division of Taxation justifies its reduction of petitioner's Federal net operating loss on two grounds. First, The Division argues that 20 NYCRR 3-8.7, governing the calculation of net operating losses for corporations filing reports on a combined basis, required petitioner to calculate its Federal loss as if it had filed a consolidated Federal return with its DISC. Second, the Division argues that it had the discretionary authority under Tax Law § 211.5 to adjust the calculation of the net operating loss to more accurately reflect petitioner's income.

C. 20 NYCRR 3-8.7(a) provides :

"If a corporation files a combined report for purposes of article 9-A,

regardless of whether it filed a separate return or consolidated return for Federal income tax purposes, the net operating loss and any carry back or carry forward for purposes of article 9-A will be computed as if the corporation had filed a consolidated return for the same corporations for Federal income tax purposes." (Emphasis added.)

Thus, if petitioner filed on a combined basis with its DISC in the years involved, it was required to compute its net operating loss as if it had filed a consolidated Federal return with that DISC. However, it is clear that a consolidated corporation franchise tax report is not a combined report; therefore, there is no support for the Division's contention that 20 NYCRR 3-8.7(a) controls where, as here, a taxpayer has filed a consolidated rather than a combined report.

All of the statutory provisions relating to combined reports are set forth at Tax Law § 211.4. That statute does not require the filing of a combined report solely on the basis of DISC ownership, although it does permit a taxpayer corporation which owns or controls directly or indirectly substantially all of the stock of a DISC, not tax exempt under section 208.9(i)(1), to file a combined report with that DISC at its election.

Section 211.4 also provides the Division with authority to require combined reports under certain circumstances. It makes no reference to consolidated reports. It must be noted that the Division did not require petitioner to file reports on a combined basis with the DISC.

To effectuate the requirements of Tax Law § 208.9(i)(B), 20 NYCRR 3-9.4 requires a reporting corporation which owns stock in a tax exempt DISC to file a consolidated report with that DISC. 20 NYCRR 3-9.4(a) states: "Any taxpayer subject to tax under article 9-A which is a stockholder of a tax exempt DISC must file its own report and a consolidated report with the DISC." 20 NYCRR 3-9.6 provides that a taxpayer which directly or indirectly owns or controls substantially all of the capital stock of a DISC may elect, or be required by the Division, to file a combined report with its DISC. This regulation would be unnecessary if consolidated and combined reports were considered to be the same (see also, 20 NYCRR 6-3.1[b]).

Accordingly, the net operating loss rules governing taxpayers filing on a combined basis do not apply to a taxpayer, such as petitioner, filing on a consolidated basis with a DISC, and 20 NYCRR 3-8.7 did not authorize the Division to recalculate petitioner's Federal net operating

loss as if petitioner had filed a consolidated Federal return with its DISC.

D. The Division of Taxation also takes the position that Tax Law § 211.5 grants the Commissioner of Taxation the authority to require a taxpayer which has filed a consolidated corporate franchise tax report with a DISC to compute its Federal net operating loss as if it had filed a consolidated Federal return with that DISC. Tax Law § 211.5 provides:

"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."

The statute thus provides the Commissioner with the authority to make certain adjustments to a corporation's entire net income so as to equitably determine the tax due (see also, 20 NYCRR 3-1.4). However, the statute only authorizes the Commissioner to adjust items of income, deductions and capital and to eliminate assets in computing any allocation percentage. The statute contains no provision explicitly granting the Tax Commissioner the discretion to adjust a corporation's Federal net operating loss which is neither an item of income, a deduction nor capital and is not an asset used in computing any allocation percentage. Under the provisions of Tax Law § 208.9(i)(B), a stockholder of a tax exempt DISC must make certain specific adjustments to its receipts, expenses, assets and liabilities in its reporting of DISC income. These provisions are said to be "[s]upplemental to the provisions of" Tax Law § 211.5. Thus, any distortion of income resulting from DISC ownership is addressed by the adjustments required by section 208.9(i)(B). Petitioner made these required adjustments, and its New York entire net income was increased accordingly. The Division of Taxation has presented neither legal argument nor evidence to support its claim that to avoid a distortion of its New York income petitioner should be required to calculate its Federal net operating loss as if it had filed a consolidated Federal return with its DISC.

Based on the foregoing discussion, it is concluded that the Division of Taxation had

neither statutory nor regulatory authority to require petitioner to calculate its net operating loss as if it had filed a consolidated Federal return with its wholly-owned DISC. Accordingly, petitioner was entitled to a total credit or refund of corporation franchise tax for the year 1979 of \$389,949.00.

E. The petition of Bausch & Lomb, Inc. is granted, and the Division of Taxation is directed to modify the Statement of Tax Reduction or Overpayment issued on August 14, 1985 accordingly.

DATED: Troy, New York
June 22, 1989

/s/ Jean Corigliano
ADMINISTRATIVE LAW JUDGE